

THE NATIONAL UNDERWRITER COMPANY

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

**Robert Bloink, Esq., LL.M.,
William H. Byrnes, Esq., LL.M, CWM®**

The book you hold in your hands is the user friendly, authoritative resource that covers—and clarifies—the vital tax issues facing small businesses and individuals. It is the essential tax reference for financial advisors & planners, insurance professionals, CPAs, attorneys, and other practitioners advising small businesses and individuals.

For those advising small business, *2015 Tax Facts on Individuals & Small Business* covers many vital topics, including:

- Healthcare
- Home Office
- Contractor vs. Employee
- Business Deductions and Losses
- Business Life Insurance
- Small Business Valuation
- Small Business Entity Choices
- Accounting

For the advisor assisting individuals, you receive clear, concise, and highly practical guidance on:

- Income
- Deductions
- Exemptions
- Tax Credits
- Capital Gains

Highlights of the 2015 Edition

- Additional federal income taxation coverage and questions
- Additional non-taxable exchanges coverage and questions
- Greatly expanded discussion of the net investment income and medicare tax

- Expansion of healthcare coverage to include the individual mandate under the Affordable Care Act (ACA)
- Greatly expanded coverage of and additional questions on business succession planning
- More than 20 new Planning Points, written by practitioners for practitioners

This newest addition to the ***Tax Facts*** collection delivers expert insights and practice-tested guidance you won't find anywhere else. It will enable you to maximize the tax advantages for a broad array of your clientele, helping you to serve more clients more effectively—and grow your business in the process.

Related Titles Also Available

- Tax Facts on Insurance & Employee Benefits
- Tax Facts on Investments
- Field Guide to Estate Planning, Business Planning & Employee Benefits
- Social Security & Medicare Facts
- Healthcare Reform Facts
- Health Savings Accounts Facts
- Retirement Plans Facts

For customer service questions or to place additional orders, please call 1-800-543-0874.

Keep Up with Critical Tax Changes

Critical legislative changes that affect the subject matter in these books will be posted at **www.TaxFactsUpdates.com**. Bookmark the site so that you can easily access new critical information that affects your clients and your business.

2015 TAX FACTS

ON INDIVIDUALS & SMALL BUSINESS

Accounting • Business Deductions • Business Life Insurance
Capital Gains and Losses • Casualty and Theft Losses
Charitable Giving • Choice of Entity • Employer Sponsored Health
Plans • Fringe Benefits • Independent Contractors and Employees
Individual Income Taxation • Net Investment Income and Medicare Tax
Nontaxable Exchanges • Small Business Succession Planning
Small Business Valuation • Tax Shelters

Robert Bloink, Esq., LL.M.
William H. Byrnes, Esq., LL.M., CWM®

2015 Edition

Tax Facts on Individuals & Small Business is published annually by the Professional Publishing Division of The National Underwriter Company. This edition reflects selected pertinent legislation, regulations, rulings and court decisions as of August 1, 2014. For the latest developments throughout the year, check out www.TaxFactsUpdates.com.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. —From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.

Circular 230 Notice —The content in this publication is not intended or written to be used, and it cannot be used, for the purposes of avoiding U.S. tax penalties.

ISBN 978-1-941627-18-1

Copyright© 2015

THE NATIONAL UNDERWRITER COMPANY

4157 Olympic Blvd., Suite 225
Erlanger, KY 41018

All rights reserved.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without prior written permission of the publisher.

Printed in U.S.A.

TABLE OF CONTENTS

TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS – VOLUME 1

List of Questions	Page xxxi
Part I: Life Insurance	Q 1 – Q 223
Part II: Group Term Life Insurance	Q 224 – Q 243
Part III: Business Life Insurance	Q 244 – Q 312
Part IV: Health Insurance	Q 313 – Q 423
Part V: Long-Term Care Insurance	Q 424 – Q 436
Part VI: Annuities	Q 437 – Q 565
Part VII: Federal Income Taxation	Q 566 – Q 674
Part VIII: Federal Estate Tax, Gift Tax, Generation-Skipping Transfer Tax, and Valuation	Q 675 – Q 786
Part IX: International Tax	Q 787 – Q 823

APPENDICES AND TABLES

Annuity Tables	Appendix A
Income Tax Tables	Appendix B
Valuation Tables	Appendix C
Transfer Tax Tables	Appendix D

TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS – VOLUME 2

List of Questions	Page xxxi
Part I: Cafeteria Plans	Q 3501 – Q 3514
Part II: Compensation	Q 3515 – Q 3522
Part III: Deferred Compensation	Q 3523 – Q 3596
Part IV: Dependent Care Assistance Programs	Q 3597
Part V: Educational Benefit Trusts	Q 3598
Part VI: Employee Death Benefits	Q 3599 – Q 3601
Part VII: Individual Retirement Plans	Q 3602 – Q 3664
Part VIII: Pension and Profit Sharing	Q 3665 – Q 3879
Part IX: Rollover	Q 3880 – Q 3897
Part X: Split Dollar Plan	Q 3898 – Q 3906
Part XI: Tax Sheltered Annuities for Employees of Section 501(c)(3) Organizations and Public Schools	Q 3907 – Q 3962
Part XII: Welfare Benefit Funds	Q 3963 – Q 3989
Part XIII: Disclosure Requirements	Q 3990 – Q 4023

APPENDICES AND TABLES

Indexed Employee Limits	Appendix E
RMD Tables	Appendix F

One Year Term Rates	Appendix G
Annuity Tables V and VI	Appendix H
Table I (Group Term Life Insurance Cost)	Q 229
Table of Cases	Page ???
Table of IRC Sections Cited	Page ???
Index	Page ???

TAX FACTS ON INVESTMENTS

List of Questions	Page xxix
Part I: Stocks	Q 7501 – Q 7549
Part II: Options	Q 7550 – Q 7579
Part III: Futures	Q 7580 – Q 7586
Part IV: Straddles and Other Transactions	Q 7587 – Q 7610
Part V: Bonds	Q 7611 – Q 7684
Part VI: Precious Metals and Collectibles	Q 7685 – Q 7698
Part VII: Limited Partnerships	Q 7699 – Q 7735
Part VIII: S Corporations	Q 7736 – Q 7740
Part IX: Real Estate	Q 7741 – Q 7789
Part X: Oil and Gas	Q 7790 – Q 7819
Part XI: Equipment Leasing	Q 7820 – Q 7834
Part XII: Cattle	Q 7835 – Q 7842
Part XIII: Financial Institutions	Q 7843 – Q 7849
Part XIV: Mutual Funds, Unit Trusts, REITs	Q 7850 – Q 7910
Part XV: Limitation on Loss Deductions	Q 7911 – Q 7931
Part XVI: Deduction of Interest and Expenses	Q 7932 – Q 7953
Part XVII: Charitable Gifts	Q 7954 – Q 8002
Part XVIII: Intellectual Property	Q 8003 – Q 8009
Part XIX: Captive Insurance	Q 8010 – Q 8020
Part XX: Reverse Mortgages	Q 8021 – Q 8038

APPENDICES AND TABLES

Valuation Tables	Appendix A
Table of Cases	Page 573
Table of IRC Sections Cited	Page 577
Index	Page 590

TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

List of Questions	Page xxi
Part I: Federal Income Tax for Individuals and Small Businesses	Q 8501 – Q 8559
Part II: Capital Gains and Losses	Q 8560 – Q 8576
Part III: Investment Income Tax and Additional Medicare Tax	Q 8577 – Q 8604
Part IV: Nontaxable Exchanges	Q 8605 – Q 8626
Part V: Investor Losses	Q 8627 – Q 8648

Part VI: Casualty and Theft Losses	Q 8649 – Q 8660
Part VII: Employees vs. Independent Contractors	Q 8661 – Q 8675
Part VIII: Business Expense Deductions	Q 8676 – Q 8693
Part IX: Bad Debt and Worthless Securities.....	Q 8694 – Q 8701
Part X: Business Life Insurance	Q 8702 – Q 8724
Part XI: Employer-Sponsored Accident & Health Insurance Benefits.....	Q 8725 – Q 8777
Part XII: Employee Fringe Benefits.....	Q 8778 – Q 8804
Part XIII: Choice of Entity and the Small Business.....	Q 8805 – Q 8851
Part XIV: Business Succession Planning.....	Q 8852 – Q 8883
Part XV: Small Business Valuation	Q 8884 – Q 8895
Part XVI: Accounting	Q 8896 – Q 8915
Part XVII: Charitable Giving	Q 8916 – Q 8930

APPENDICES AND TABLES

Income Tax Tables.....	Appendix A
Transfer Tax Tables.....	Appendix B
Table of Cases	Page 423
Table of IRC Sections Cited.....	Page 428
Index.....	Page 439

The following Appendices and Tables are available for free download at:
www.TaxFactsUpdates.com.

- Property That Can Be Given Under Uniform Gifts to Minors Act (by state)
- Donee's Age When Custodianship Established under UGMA or UTMA Ends
- States Authorizing Durable Power of Attorney; Ages of Majority in the Various States
- Tax Exempt Equivalents
- Numerical Finding List

Keep Up with Critical Tax Changes

Critical legislative changes that affect the subject matter in these books will be posted at **www.TaxFactsUpdates.com**. Bookmark the site so that you can easily access new critical information that affects your clients and your business.

Additional information and features are available in the online service, *Tax Facts Online*, the premier actionable and affordable reference on the taxation of insurance, employee benefits, and investments. *Tax Facts Online* is the only source that is reviewed daily and updated regularly by our expert editors. Go to **www.taxfactsonline.com** to sign up for a free trial.

ABOUT SUMMIT PROFESSIONAL NETWORKS

Summit Professional Networks supports the growth and vitality of the insurance, financial services and legal communities by providing professionals with the knowledge and education they need to succeed at every stage of their careers. We provide face-to-face and digital events, websites, mobile sites and apps, online information services, and magazines giving professionals multi-platform access to our critical resources, including Professional Development; Education & Certification; Prospecting & Data Tools; Industry News & Analysis; Reference Tools and Services; and Community Networking Opportunities.

Using all of our resources across each community we serve, we deliver measurable ROI for our sponsors through a range of turnkey services, including Research, Content Development, Integrated Media, Creative & Design, and Lead Generation.

For more information, go to <http://www.SummitProfessionalNetworks.com>.

About The National Underwriter Company

The National Underwriter Company is a Summit Professional Network.

For over 110 years, The National Underwriter Company has been the first in line with the targeted tax, insurance, and financial planning information you need to make critical business decisions. Boasting nearly a century of expert experience, our reputable Editors are dedicated to putting accurate and relevant information right at your fingertips. With *Tax Facts*, *Tools & Techniques*, *National Underwriter Advanced Markets*, *Field Guide*, *FC&S®*, *FC&S Legal* and other resources available in print, eBook, CD, and online, you can be assured that as the industry evolves National Underwriter will be at the forefront with the thorough and easy-to-use resources you rely on for success.

The National Underwriter Company Update Service Notification

This National Underwriter Company publication is regularly updated to include coverage of developments and changes that affect the content. If you did not purchase this publication directly from The National Underwriter Company and you want to receive these important updates sent on a 30-day review basis and billed separately, please contact us at (800) 543-0874. Or you can mail your request with your name, company, address, and the title of the book to:

The National Underwriter Company
4157 Olympic Boulevard
Suite 225
Erlanger, KY 41018

If you purchased this publication from The National Underwriter Company directly, you have already been registered for the update service.

National Underwriter Company Contact Information

To order any National Underwriter Company title, please

- call 1-800-543-0874, 8-6 ET Monday –Thursday and 8 to 5 ET Friday
- online bookstore at www.nationalunderwriter.com, or
- mail to The National Underwriter Company, Orders Department, 4157 Olympic Blvd., Ste. 225, Erlanger, KY 41018

INTRODUCTION TO 2015 TAX FACTS ON SMALL BUSINESS & INDIVIDUAL INCOME TAXATION

Welcome to the 2015 edition of *Tax Facts on Small Business & Individual Income Taxation*! This year's edition of our newest addition to the *Tax Facts* series continues to offer a comprehensive guide to advising small business and individual clients. This publication enters its second year with greatly expanded coverage in a number of key areas as part of our continued commitment to the product and to addressing the most critical issues faced by individual and small business clients today.

Tax Facts on Small Business & Individual Income Taxation is presented in the same easy-to-use question and answer format that has made our earlier volumes (*Tax Facts on Insurance, Employment Benefits and Investments*) the research tools that financial professionals reach for first. We created this volume in 2013 in response to subscriber feedback indicating a need for a concise research tool to guide small business owner clients throughout the entirety of their small business endeavors—from choosing the appropriate business entity to succession planning and valuation guidelines.

This year, we have expanded our coverage in several key areas. We added a number of new questions on the net investment income and Medicare taxes. In particular, we added numerous examples to illustrate how the complex net investment income tax works. Similarly, we expanded other parts of the book dealing with taxation issues. The sections on federal income taxation, capital gains tax and nontaxable exchanges have all been expanded significantly with numerous additional questions, examples and practical advice added to each of these sections.

In addition, we greatly expanded our business succession planning section with new questions in order to provide detailed analysis of the various strategies that may be employed by small business owners looking toward retirement—including the potential pitfalls and tax traps that should be avoided in order to ensure successful transitioning. The 2015 edition also features coverage on the basics of the Affordable Care Act with emphasis on the individual mandate in order to answer your client's questions on health care reform.

As always, readers can rely on our industry experts, who have added “planning points” throughout the text that allow you to build on the expertise of these practitioners and the real life client scenarios they have encountered through years of practical experience.

Each year, we strive to make your research more efficient than ever, providing plain English examples that will allow you to grasp complicated concepts quickly and easily. Our 2015 editions feature an expanded version of our recently developed indexing tool that will guide your research based on the Internal Revenue Code sections that apply to your specific client question. In the same vein, we have strategically organized our questions into discrete subparts that make it simple and easy to navigate through complicated client questions—when combined with our new Code-based index, we believe you will find this streamlines your research process and saves you time and effort.

Please keep in mind that updated information on critical tax law changes will be available as they occur for all subscribers at www.TaxFactsUpdates.com. This includes any tax code changes that may emerge from the negotiations over the various expired tax code provisions that continue to progress through Congress as we go to press with this edition.

Explanations of additional changes throughout the year—including revenue rulings, case law decisions, and legislative and regulatory activity—are available through subscription to our online tax service, *Tax Facts Online*. *Tax Facts Intelligence*, a monthly newsletter that provides the most current analysis of recent IRS rulings and industry developments, rounds out the suite of *Tax Facts* publications.

This edition of *Tax Facts* was developed with the assistance of authors Professor William H. Byrnes and Professor Robert Bloink. Prof. Byrnes founded the online Graduate Program of International Tax and Financial Services of Thomas Jefferson Law School and has been the author of numerous books, treatises and scholarly articles. Prof. Bloink is an insurance industry expert whose practice incorporates sophisticated wealth transfer techniques, as well as counseling institutions in the context of their insurance portfolios. He is also a professor of tax for the Graduate Program of International Tax and Financial Services, Thomas Jefferson School of Law.

ABOUT THE EDITORS

ABOUT THE AUTHORS

Robert Bloink, Esq., LL.M.



Robert Bloink worked with insurance industry producers to help put in force in excess of \$2B of life and annuity policies in the past ten years. His insurance practice incorporates sophisticated wealth transfer techniques, as well as counseling institutions in the context of their insurance portfolios and other mortality based exposures. He is a professor of tax for the Graduate Program of International Tax and Financial Services, Thomas Jefferson School of Law. Mr. Bloink has previously taught as an adjunct or visiting professor at USD and St. Thomas law schools.

Previously, Mr. Bloink served as Senior Attorney in the IRS Office of Chief Counsel, Large and Mid-Sized Business Division, where he litigated many cases in the U.S. Tax Court, served as Liaison Counsel for the Offshore Compliance Technical Assistance Program, coordinated examination programs audit teams on the development of issues for large corporate taxpayers, and taught continuing education seminars to Senior Revenue Agents involved in Large Case Exams. In his governmental capacity, Mr. Bloink became recognized as an expert in the taxation of financial structured products and was responsible for the IRS' first FSA addressing variable forward contracts. Mr. Bloink's core competencies led to his involvement in prosecuting some of the biggest corporate tax shelters in the history of our country.

William H. Byrnes, Esq., LL.M.

William Byrnes is the leader of Summit Professional Network's National Underwriter Financial Advisory Publications for the Reference Division, "one of the leading authors and best-selling authors in the professional markets" with 30 books and 23 book chapters that have sold in excess of 100,000 copies in print and online, with over one thousand online annual database subscribers. William Byrnes has been featured in major media (e.g. Wall Street Journal, USA Today).



William Byrnes' weekly articles are published in National Underwriter Advanced Markets, Tax Facts Online, ThinkAdvisor and LifeHealthPro. "The authors' knowledge and experience in tax law and practice provides the expert guidance for National Underwriter to once again deliver a valuable resource for the financial advising community," (Reuters, January 21, 2014). "In the field of international tax, Prof. William Byrnes is among LexisNexis's best-selling authors ..." Ray Camiscioli, Esq., LexisNexis, Inc.

William Byrnes served in senior positions of Coopers and Lybrand where he consulted for multinationals and high net wealth business owners. He has been commissioned and consulted by a number of governments on their tax, fiscal, and education policy. He was a tenured law faculty member in Miami, Florida, and in the early nineties pioneered online tax and financial services

education. He is now Associate Dean of Thomas Jefferson School of Law's International Tax & Financial Services web-conference programs in San Diego (see www.profwilliambyrnes.com).

LEAD CONTRIBUTING EDITOR

Alexis Long, J.D.



Alexis Long formerly practiced corporate law as an associate with the business transactions group at Schulte Roth & Zabel in New York City. She was a corporate, securities and finance editor for the Practical Law Company before moving to Thomas Jefferson School of Law as publications director. She holds a J.D. from the University of Michigan Law school.

THE TAX FACTS EDITORIAL ADVISORY BOARD

Jonathan H. Ellis, J.D., LL.M. (Taxation)

Mr. Ellis is currently a Shareholder in the law firm of Plotnick & Ellis, P.C., where his practice focuses primarily on estate planning, estate administration, elder law, and the representation of closely held businesses.

He has a B.S. in Accounting from Pennsylvania State University, J.D. from Widener University, and LL.M. (Taxation) from Temple University. In addition, Mr. Ellis is Executive Editor and Co-author, and along with Stephen Leimberg, et.al., of *Tools and Techniques of Estate Planning*, 16th Edition, The National Underwriter Company, as well as a Co-Author of the 15th Edition. Also, Mr. Ellis is the author of the book "Drafting Wills and Trusts in Pennsylvania", 2010 Edition for PBI Press. Mr. Ellis is also a member of the Editorial Advisory Board for Tax Facts 2012 through 2015, The National Underwriter Company. In addition, he is the author of 30 articles for Pennsylvania Tax Service Insights (LexisNexis Matthew Bender). Finally, he is a former member of the Adjunct Faculty at Villanova Law School where he taught Family Wealth Planning.



Mr. Ellis frequently speaks to a variety of groups, including attorneys, accountants and financial planners throughout Pennsylvania, New Jersey, Delaware and Maryland. Mr. Ellis is also the Course Planner for the PBI Courses "Drafting Wills and Trusts in Pennsylvania", "Wills v. Trusts: A Primer on the Right Tool for Your Clients", "Use of Trusts", and "Post-Mortem Estate Planning", and a participant in a variety of additional courses for PBI. He is also an annual participant in the Villanova University's annual tax conference, cosponsored with the Internal Revenue Service.

He is a member of the Pennsylvania, New Jersey and Florida Bars; the Montgomery County Bar Association; and the Philadelphia Estate Planning Council. Mr. Ellis is also a Fellow of the American College of Trust and Estate Counsel.

Karl Frank, CFP®, MSF, MBA, MA



Karl Frank is the President of A&I Financial Services LLC, a Colorado company that helps a small number of successful businesses and families grow and protect their investments and choose how they want to be taxed. Karl and his team provide an array of small business advisory services in the Denver area.

Karl is a leader and a giver in the Denver community. He launched Denver Financial Planning Day in 2009, bringing together the best CFPs in Colorado and providing advice to everyone, whether they are homeless or have millions in their checking accounts. He is the 2014 President of the Financial

Planning Association (FPA) of Colorado and has held numerous Director level roles for this, and other, nonprofit organizations. Karl was nominated by his peers as a “Leader in the Profession” and is profiled in the June 2012 edition of the *Journal of Financial Planning* for “Going the Extra Mile.”

He is a Top of the Table member of the Million Dollar Roundtable (MDRT). MDRT membership is recognized internationally as the standard of excellence in the life insurance and financial services business. He was one of less than ten advisors in Colorado to achieve Top of the Table status every year since 2008. Additionally, he is among the top representatives at his broker dealer, Geneos, and a four-time winner of broker dealer of the year.

Karl is also the author of *Go Tax Free* and has written numerous articles that appear in publications such as the *Denver Business Journal* and *Denver Post*. His exit planning work for business owners was featured in *Financial Advisor Magazine* and *Investment Advisor Magazine*.

An accomplished public speaker, Karl spoke at the MDRT annual convention in 2013 about tax planning and retirement strategies to a group of more than 1,000 financial professionals. He frequently appears on local television stations and is also actively involved with the Metro Denver Chamber of Commerce as a member of the CEO Exchange.

Karl’s education includes a Certified Financial Planner® designation and three Masters Degrees. He earned a Master of Business Administration and Masters of Science in Finance from the University of Denver, Daniels College and Reimann School of Finance. He also has a Master of Arts in English from the University of Colorado at Boulder. He holds FINRA securities licenses 7, 24, 52, 63, and 65, as well as a life insurance license.

Johni Hays, J.D.

Johni Hays is Vice-President at Thompson and Associates. With almost 20 years’ experience as a practicing attorney in charitable and estate planning, Johni Hays is a recognized expert on the subject of charitable gift planning. Johni is the author of the book, *Essentials of Annuities* and co-author of the book, *The Tools and Techniques of Charitable Planning*. Johni serves on the Editorial Advisory Board for the books *Tax Facts on Investments* and *Tax Facts on Insurance and Employee Benefits*. She serves as a charitable planning author of Steve Leimberg’s electronic newsletter service, LISI, found at



www.leimbergservices.com. Johni has been quoted in the Wall Street Journal and has published charitable planning articles in Estate Planning Magazine, Planned Giving Today, Fundraising Success, Life Insurance Selling and the National Underwriter magazines.

Johni is in demand as a national lecturer on estate and charitable planning, probate, living wills, annuities, life insurance, retirement planning and IRAs, as well as income, estate and gift taxation. Johni has been engaged in the practice of law with an emphasis in charitable and estate planning since 1993.

Prior to joining Thompson & Associates, Johni served as the Senior Gift Planning Consultant for The Stelter Company. Prior to that as the Executive Director of the Greater Des Moines Community Foundation Planned Giving Institute. In addition, Johni practiced estate planning with Myers Krause and Stevens, Chartered law firm in Naples Florida, where she specialized in estate planning.

Johni graduated cum laude with a Juris Doctor degree from Drake University in Des Moines, Iowa, in 1993. She also holds a Bachelor of Science degree in Business Administration from Drake University and graduated magna cum laude in 1988.

Johni is the president of the Charitable Estate Planning Institute and she also serves on the national board of the Partnership for Philanthropic Planning (PPP) formerly the National Committee on Planned Giving. Johni serves on the Technical Advisory Board for the Stelter Company and is a charter member of PPP's Leadership Institute. She is also a member of the Mid-Iowa Planned Giving Council and the Mid-Iowa Estate and Financial Planners Council (president 2007-2008). Johni has been a member of both the Iowa Bar and the Florida Bar since 1993. She resides in Johnston, Iowa, with her husband, Dave Schlindwein.

Jay Katz, J.D., LL.M.



Jay Katz is a tax attorney in Delaware with more than a decade of experience in private practice litigating tax cases and handling audits, collection matters, and offers in compromise for corporate and individual clients. He has earned LL.M.s in taxation from both the NYU and University of Florida graduate tax programs. During twelve years as a professor at Widener University Law School and Beasley School of Law at Temple University, Jay has taught virtually every tax and estate planning course on the curriculum and was the director of the Widener tax clinic.

In addition to being a coauthor of the 4th Edition of *The Tools & Techniques of Income Tax Planning*, Jay has penned seven published tax articles, including "An Offer in Compromise You Can't Confuse: It is not the Opening Bid of a Delinquent Taxpayer to Play Let's Make a Tax Deal with the Internal Revenue Service," 81 *Miss. L.J.* 1673 (2012) (lead article); "The William O. Douglas Tax Factor: Where Did the Spin Stop and Who Was He Looking Out For?" 3 *Charlotte Law Review* 133 (2012) (lead article); and "The Untold Story of Crane v. Commissioner Reveals an Inconvenient Tax Truth: Useless Depreciation Deductions Cause Global Basis Erosion to Bait A Hazardous Tax Trap For Unwitting Taxpayers," 30 *Va. Tax Rev.* 559 (2011).

Caroline B. McKay, J.D.



Caroline B. McKay is an Associate Counsel of the Advanced Markets department for John Hancock Insurance (USA). In her current position, Caroline provides estate and business planning support to home office employees, field personnel, and producers. Caroline is also a recurring host on John Hancock's weekly JHAM Radio program and a regular speaker at industry meetings around the country.

Caroline is a contributing author of the 16th edition of *The Tools & Techniques of Estate Planning* by Stephan Leimberg and previously has been published on [Wealth Management.com](http://WealthManagement.com).

Prior to joining John Hancock, Caroline was in private practice in the Boston area where she concentrated her practice on estate planning, probate, business succession planning, and charitable planning for moderate and high net worth individuals and companies.

Caroline received her Bachelor of Arts degree, *magna cum laude*, in History from Colby College in Waterville, Maine, and her Juris Doctor degree *cum laude* from Suffolk University Law School, Boston, Massachusetts. While at Suffolk Law, she was a member of the Law Review and was published in the Suffolk University Law Review. Upon receiving her J.D., Caroline spent one year clerking for the Honorable Chief Justice Paul Suttell of the Rhode Island Supreme Court.

Jayne Elizabeth Zanglein

Jayne Elizabeth Zanglein is a prolific writer on employee benefits. She contributes regularly to journals such as the *ABA Supreme Court Preview*, the *Journal of Taxation of Employee Benefits*, and the *NYU Review of Employee Benefits and Executive Compensation*. Her treatise, *ERISA Litigation*, was published in 2003 and is now in its fourth edition. She serves as an employee benefits expert and neutral in class action cases.



She is the cochair of the Fiduciary Duties Committee of the ABA Section on Labor and Employment Law's subcommittee on Employee Benefits. She has served on various task forces including Governor Cuomo's Task Force on Pension Fund Investments. She has worked on pension fund reform in Ontario and South Africa. She currently teaches law and dispute resolution at Western Carolina University.

OTHER CONTRIBUTORS

Publisher

Kelly B. Maheu, J.D., is Managing Director of the Professional Publishing Division of The National Underwriter Company, a Division of Summit Professional Networks. Kelly has been with The National Underwriter Company since 2006, serving in editorial, content acquisition, and product development roles prior to being named Managing Director.

Prior to joining The National Underwriter Company, Kelly worked in the legal and insurance fields for LexisNexis®, Progressive Insurance, and a Cincinnati insurance defense litigation firm.

Kelly has edited and contributed to numerous books and publications including the *Personal Auto Insurance Policy Coverage Guide*, *Cyberliability and Insurance*, *The National Underwriter Sales Essentials Series*, and *The Tools and Techniques of Risk Management for Financial Planners*.

Kelly earned her law degree from The University of Cincinnati College of Law and holds a BA from Miami University, Ohio, with a double major in English/Journalism and Psychology.

Senior Tax Editor

Richard H. Cline, J.D., is the Senior Tax Editor for the Professional Publishing Division at the National Underwriter Company. He is responsible for both the print and online versions of Tax Facts as well as developing new tax products for our customers.

Richard joined the company in 2013 but has over twenty-five years of tax editing and publishing experience. Prior to joining our team, Richard worked for Lexis-Nexis, CCH, Inc., and PricewaterhouseCoopers.

He has a B.S. degree from Franklin and Marshall College in Lancaster, Pennsylvania, and earned his law degree from Tulane University in New Orleans, Louisiana.

Managing Editor

Christine G. Barlow, CPCU, is Managing Editor of the Professional Publishing Division, a division of Summit Professional Networks. Christine has fifteen years' experience in the insurance industry, beginning as a claims adjuster then working as an underwriter and underwriting supervisor handling personal lines. Before joining FC&S, Christine worked as an Underwriting Supervisor for Maryland Auto Insurance Fund, and as Senior Underwriter/Underwriter for companies Montgomery Mutual, Old American, Charter Group, and Nationwide.

Editorial Services

Connie L. Jump, Supervisor, Electronic Publication Production

Patti O'Leary, Editorial Assistant

ABBREVIATIONS

AAA	Accumulated Adjustments Account
ACA	Affordable Care Act
ACE	Adjusted Current Earnings
Acq. (Nonacq.)	Commissioner's acquiescence (nonacquiescence) in decision
AFR	Applicable Federal Rate
AFTR	American Federal Tax Reports (Research Institute of America, early decisions)
AFTR2d	American Federal Tax Reports (Research Institute of America, second series)
AGI	Adjusted Gross Income
AJCA 2004	American Jobs Creation Act of 2004
AMT	Alternative Minimum Tax
AMTI	Alternative Minimum Taxable Income
ARRA 2009	American Recovery and Reinvestment Act of 2009
ATRA 2012	American Taxpayer Relief Act of 2012
BTA	Board of Tax Appeals decisions (now Tax Court)
BTA Memo	Board of Tax Appeals memorandum decisions
CA or -- Cir.	United States Court of Appeals
CB	Cumulative Bulletin of Internal Revenue Service
CCA	Chief Counsel Advice
Cl. Ct.	U.S. Claims Court (designated U.S. Court of Federal Claims in 1992)
CLASS Act	Community Living Assistance Services and Support Act
COBRA	Consolidated Omnibus Budget Reconciliation Act of 1985
CRTRA 2000	Community Renewal Tax Relief Act of 2000
Ct. Cl.	Court of Claims (designated U.S. Claims Court in 1982)
DOL Adv. Op.	Department of Labor Advisory Opinion
EAP	Employee Assistance Program
EGTRRA 2001	Economic Growth and Tax Relief Reconciliation Act of 2001
EIEA 2008	Energy Improvement and Extension Act of 2008
EOLI	Employer-Owned Life Insurance
ERISA	Employee Retirement Income Security Act of 1974
ERTA	Economic Recovery Tax Act of 1981
ESBT	Electing Small Business Trust
F.2d	Federal Reporter, second series (later decisions of U.S. Court of Appeals to Mid-1993)
F.3rd	Federal Reporter, third series (decisions of U.S. Court of Appeals since Mid-1993)
F.Supp.	Federal Supplement (decisions of U.S. District Courts)
Fed.	Federal Reporter (early decisions)
Fed. Cl.	U.S. Court of Federal Claims
Fed. Reg.	Federal Register
FICA	Federal Insurance Contributions Act
FIFO	First-in first-out
FSA	Field Service Advice
FSA	Flexible spending account
FTE	Full-time equivalent employee
GCM	General Counsel Memorandum (IRS)
GRAT	Grantor Retained Annuity Trust
HCE	Highly compensated employee
HDMP	High deductible medical plan
HIPAA '96	Health Insurance Portability and Accountability Act

HHS	The Department of Health and Human Services
HRA	Health Reimbursement Account
HSA	Health Savings Account
HIREA (2010)	Hiring Incentives to Restore Employment Act
IDGT	Intentionally Defective Grantor Trust
IFRS	International Financial Reporting Standards Accounting Board
IR	Internal Revenue News Release
IRB	Internal Revenue Bulletin of Internal Revenue Service
IRC	Internal Revenue Code
IRS	Internal Revenue Service
IRSRA '98	IRS Restructuring and Reform Act of 1998
IT	Income Tax Ruling Series (IRS)
ITCA	Installment Tax Correction Act of 2000
JCWAA	Job Creation and Worker Assistance Act of 2002
JGTRRA 2003	Jobs and Growth Tax Relief Reconciliation Act of 2003
KETRA 2005	Katrina Emergency Tax Relief Act of 2005
Let. Rul.	Letter Ruling (issued by IRS)
LIFO	Last-in first-out
LLC	Limited liability company
LLP	Limited liability limited partnership
LLP	Limited liability partnership
MAGI	Modified Adjusted Gross Income
MERP	Medical Expense Reimbursement Plan
MFDRA 2007	Mortgage Forgiveness Debt Relief Act of 2007
MHPAEA	Mental Health Parity and Addiction Equity Act
MSA	Archer medical savings account
NHCE	Non highly compensated employee
NMHPA	Newborns' and Mothers' Health Protection Act
OASDI	Old age survivor and disability insurance
OBRA	Omnibus Budget Reconciliation Act of (year of enactment)
P.L.	Public Law
PLR	Private Letter Ruling
P&PS Rept.	Pension and Profit Sharing Report (Prentice-Hall)
PBGC	Pension Benefit Guaranty Corporation
PFEA 2004	Pension Funding Equity Act of 2004
PHC	Personal holding company
PHSA	Public Health Service Act
PPA 2006	Pension Protection Act of 2006
PPACA	Patient Protection and Affordable Care Act
Prop. Reg.	Proposed Regulation
PSC	Professional service corporation
PTE	Prohibited Transaction Exemption
QSSS	Qualified Subchapter S Subsidiary
QSST	Qualified Subchapter S Trust
REA '84	Retirement Equity Act of 1984
REIT	Real Estate Investment Trust
Rev. Proc.	Revenue Procedure (issued by IRS)
Rev. Rul.	Revenue Ruling (issued by IRS)
SBJPA '96	Small Business Job Protection Act of 1996
SBWOTA 2007	Small Business and Work Opportunity Tax Act of 2007

SCA	IRS Service Center Advice
SCIN	Self-cancelling installment note
SSBIC	Specialized small business investment company
TAM	Technical Advice Memorandum (IRS)
TAMRA '88	Technical and Miscellaneous Revenue Act of 1988
TC	Tax Court (official reports)
TC Memo	Tax Court memorandum decisions (official reports)
TC Summary Opinion	Tax Court Summary Opinion
TD	Treasury Decision
TEAMTRA 2008	Tax Extenders and Alternative Minimum Tax Relief Act of 2008
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
Temp. Reg.	Temporary Regulation
TIPA 2007	Tax Increase Prevention Act of 2007
TIPRA 2005	Tax Increase Prevention and Reconciliation Act of 2005
TIR	Technical Information Release (from the IRS)
TRA	Tax Reform Act of (year of enactment)
TRA '97	Taxpayer Relief Act of 1997
TRA 2010	Tax Relief Act of 2010
TRHCA 2006	Tax Relief and Health Care Act of 2006
TTCA 2007	Tax Technical Corrections Act of 2007
URAA '94	Uruguay Round Agreements Act of 1994
US	United States Supreme Court decisions
USERRA '94	Uniformed Services Employment and Reemployment Rights Act of 1994
USTC	United States Tax Cases (Commerce Clearing House)
VTTRA 2001	Victims of Terrorism Tax Relief Act of 2001
WFTRA 2004	Working Families Tax Relief Act of 2004
WHBAA 2009	Worker, Homeownership, and Business Assistance Act of 2009
WHCRA	Women's Health and Cancer Rights Act
WRERA 2008	Worker, Retiree, and Employer Recovery Act of 2008

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS COMPLETE LIST OF QUESTIONS

PART I: FEDERAL INCOME TAX FOR INDIVIDUALS AND SMALL BUSINESS

8501. Who must file a federal income tax return?
8502. Who is allowed to file a joint federal income tax return? Who is eligible to file as a qualifying widow(er) with a dependent child?
8503. Who is eligible to file a federal income tax return as head of household?
8504. Who is a “qualifying person?”
8505. What does it mean to be considered unmarried?
8506. What are the tax advantages of filing as head of household?
8507. What is a taxable year for individual income tax purposes?
8508. How does a taxpayer compute yearly tax liability?
8509. What are the current income tax rates for individuals?
8510. Why are many tax provisions indexed for inflation each year?
8511. What indexing factor does the IRS use to make the adjustments for inflation?

What Is Income?

8512. What is gross income?
8513. What is adjusted gross income?
8514. Is a taxpayer’s discharge of indebtedness taxable?

Exemptions

8515. What is the personal exemption?
8516. Are personal and dependency exemptions for high-income taxpayers subject to being phased out?
8517. When can a taxpayer claim a dependency exemption for a qualifying child and a qualifying relative?
8518. Who is entitled to the dependency exemption for qualifying children when the parents are divorced or have never been married?

Deductions

8519. What is the standard deduction?
8520. What taxpayers are ineligible to use the standard deduction?
8521. What is the standard deduction for a taxpayer who may be claimed as a dependent by another taxpayer?
8522. What are itemized deductions and how are they deducted?

8523. Are state and local sales taxes deductible?
8524. What are miscellaneous itemized deductions? To what extent are they deductible?
8525. Are the itemized deductions of high-income taxpayers subject to phase-out?
8526. What types of interest are deductible?
8527. What are the rules for the deductibility of investment interest by an individual taxpayer?
8528. What is deductible trade or business interest?
8529. What is deductible qualified residence interest?
8530. To what extent is the deductibility of interest limited by the application of the passive activity loss rules?
8531. Is the interest on extended payments of estate tax deductible?
8532. Is the interest on education loans deductible?
8533. Is personal interest deductible?
8534. How much of a charitable contribution is deductible?
8535. What are the income percentage ceilings that limit the income tax deduction for charitable contributions?
8536. What are the rules to determine the income percentage ceilings for monetary charitable contributions to public charities and private foundations in the same tax year?
8537. How does the character of property donated to charity (long-term capital gain property, tangible personal property, S corporation stock, partial interests in property) impact the income tax deduction allowed to the taxpayer?
8538. What income tax deduction may a taxpayer take for making a charitable donation to an organization classified as a private foundation?
8539. What substantiation requirements must a taxpayer satisfy in order to claim an income tax deduction for a charitable donation?
8540. When is an individual taxpayer entitled to a deduction for medical expenses?

Credits

8541. What is a refundable tax credit and what are some examples?
8542. How does a nonrefundable tax credit work and what are some examples?
8543. Who qualifies for the tax credit for the elderly and the permanently and totally disabled and how is the credit computed?
8544. Who qualifies for the child tax credit?

Social Security

8545. Are social security and railroad retirement benefits taxable?
8546. What other issues relate to the taxation of social security and railroad retirement benefits?
8547. What are the social security tax and Medicare rates for self-employed taxpayers?
8548. What are the social security and Medicare tax rates for traditional employees and employers?

COMPLETE LIST OF QUESTIONS

Estimated Tax and Self-Employment Tax

8549. Who must pay the estimated tax and are penalties imposed for underpayment of the tax?

8550. Who must pay the self-employment tax?

Alternative Minimum Tax

8551. What is the alternative minimum tax and how is it calculated?

8552. Are personal tax credits allowed as an offset against AMT liability?

8553. How is alternative minimum taxable income (AMTI) computed?

8554. Is there an AMT credit for an AMT liability in a prior tax year?

8555. Is there a phase out of the alternative minimum tax exemption?

8556. Are there special AMT exemption rules that apply to a child subject to the kiddie tax?

Minors

8557. What is the “kiddie tax”?

8558. Can parents include the amount of their child’s unearned income subject to kiddie tax on their own income tax return?

8559. Who is taxed on the income from property that is transferred to a minor under a uniform “Gifts to Minors” act?

PART II: CAPITAL GAINS AND LOSSES

8560. What is a “capital asset”?

8561. What are the current long-term capital gains tax rates?

8562. How is net capital gain taxed?

8563. What rates apply to capital gains property classified as Section 1250 property, Section 1202 stock or collectibles?

8564. What new rules have been developed in the past years to change long-term capital gain rates?

8565. What is “tax basis” and how is it used in determining the amount of a taxpayer’s capital gain or loss?

8566. How is tax basis adjusted and what affect does it have in the computation of capital gain or loss?

8567. What is the “holding period” for long-term and short-term capital gain; and how is the holding period calculated?

8568. Are there any special rules applicable in determining whether a gain or loss is long-term or short-term when a short sale is involved?

8569. How is a loss realized on a sale between related persons treated for tax purposes?

8570. Can the redemption of a debt obligation result in capital gains treatment?

8571. When is the gain or loss from sale or exchange of an option to purchase property treated as a capital gain or capital loss?

8572. Are there any special rules that apply in determining whether the sale of a patent gives rise to capital gains treatment?

8573. What is the netting process used to determine whether the taxpayer has a capital gain or loss?

8574. What is the tax significance of short-term capital gain?

8575. Is there a limitation to the amount of capital losses a taxpayer may deduct in a tax year? How are disallowed capital losses treated?

8576. What are the reporting requirements for capital gains and losses?

PART III: INVESTMENT INCOME TAX AND ADDITIONAL MEDICARE TAX

8577. What is the net investment income tax?

8578. What is modified adjusted gross income for purposes of the investment income tax?

8579. What is net investment income?

8580. Who is liable for paying the investment tax?

8581. Are distributions from retirement accounts and qualified plans included in net investment income?

8582. If a taxpayer converts a traditional IRA to a Roth IRA, does a taxable distribution take place that would subject the converted funds to the investment income tax?

8583. How do the net investment income rules apply to amounts received under an annuity contract?

8584. What is “net gain” with respect to the disposition of property and net investment income?

8585. How are gains from the disposition of property netted against losses in determining “net gain” included in net investment income?

8586. Can excess net investment income losses be used to reduce other net investment income?

8587. How does gain on the sale of a taxpayer’s principal residence impact the determination of whether the taxpayer is subject to the investment income tax? Also, is any or all of the gain subject to net investment income tax?

8588. How does a taxpayer determine whether income is derived from the taxpayer’s trade or business and, if so, excluded from net investment income?

8589. What is the importance of whether trade or business activities are considered “passive” with respect to the taxpayer?

8590. Can a taxpayer “group” multiple activities in order to meet the material participation test for purposes of the net income investment exclusion?

8591. Can a taxpayer regroup activities after an initial grouping has already taken place?

8592. How does the investment income tax effectively increase the tax rate for capital gains and dividends?

8593. Can federal income tax credits be used to offset net investment income tax liability?

8594. What form is used to report net investment income tax?

COMPLETE LIST OF QUESTIONS

8595. When is an estate or trust subject to the investment tax?
8596. Which trusts are not subject to the net investment income tax?
8597. What considerations are relevant in determining if a trade or business is non-passive with respect to a trust for purposes of treating the income derived therefrom as excluded from net investment income?
8598. What is the additional Medicare tax? Who is liable for paying the additional Medicare tax?
8599. If one spouse's wages exceeds \$200,000, triggering mandatory withholding by the employer of the additional Medicare tax, but when combined with the second spouse's wages, the couple's wages are less than the \$250,000 threshold for married taxpayers filing jointly (meaning there is no additional Medicare tax owing), can the first spouse request his or her employer not to withhold the additional Medicare tax?
8600. What are the consequences of an employer's failure to withhold the additional Medicare tax that an employee is liable to pay?
8601. Can a taxpayer request additional withholding specifically earmarked to pay anticipated additional Medicare tax?
8602. Can a taxpayer make estimated tax payments to cover the additional Medicare tax liability?
8603. How does a taxpayer calculate additional Medicare tax liability if the taxpayer receives both wage income and self-employment income in the same tax year?
8604. Are noncash fringe benefits received by an employee subject to the additional Medicare tax?

PART IV: NONTAXABLE EXCHANGES

8605. What is a nontaxable exchange? What is the difference between a nontaxable exchange and a tax-free transaction?
8606. What exchanges of property qualify as like-kind exchanges and nonrecognition treatment?
8607. What is a taxpayer's basis in property received in a like-kind exchange?
8608. What are the tax consequences if a taxpayer receives consideration other than like-kind property in the exchange?
8609. Can a taxpayer defer recognition of gain under the like-kind exchange rules if the exchange is made between related parties?
8610. When might a taxpayer want to avoid like-kind exchange treatment?
8611. What are the tax consequences of an involuntary conversion?
8612. How does the type of property into which the lost or destroyed property is converted into impact whether the taxpayer can claim nonrecognition treatment as the result of an involuntary conversion?
8613. Is a taxpayer who has an involuntary conversion into money required to replace the lost or destroyed property within a certain amount of time to qualify for nonrecognition treatment?
8614. Must a taxpayer's property be completely destroyed to qualify for nonrecognition treatment under the rules for involuntary conversions?

8615. Under what circumstances does all or part of the gain from the sale of a personal residence qualify for nonrecognition treatment?

8616. Are there circumstances in which a taxpayer can exclude the gain on the sale of a personal residence even though the taxpayer fails to meet the requirements otherwise required for exclusion treatment?

8617. How much gain is a taxpayer permitted to exclude from income on the sale of a personal residence? How is the exclusion calculated?

8618. If a taxpayer has multiple residences, which residence qualifies as the principal residence in determining whether exclusion of gain upon sale is permissible?

8619. Is a taxpayer permitted to exclude gain on the sale of a principal residence used partially for business purposes?

8620. Can a taxpayer exclude gain on the sale of vacant land under the same principles that apply to excluding gain on the sale of a principal residence?

8621. In the case of an involuntary conversion of a primary residence, how does the nonrecognition treatment under IRC Section 1033 and the exclusion of gain under IRC Section 121 interact?

8622. Does an exchange of corporate stock for corporate stock qualify for nonrecognition treatment?

8623. What are the requirements to exclude 50 percent of the gain on the sale of qualified small business stock?

8624. How does an offsetting short position impact a taxpayer's eligibility to exclude 50 percent of the gain on the sale of qualified small business stock?

8625. Under what circumstances may a noncorporate taxpayer roll over gain from the sale or exchange of qualified small business stock that is held for six months or more?

8626. Under what circumstances can a taxpayer roll over the gain from a sale of stock in a specialized small business investment company?

PART V: INVESTOR LOSSES

8627. What is a tax shelter?

8628. What is an abusive tax shelter?

8629. What are the "at risk" rules with respect to investor losses?

8630. What types of investment activities apply to the "at risk" rules?

8631. Who is subject to the at risk rules? Do the at risk rules apply to partnerships and S corporations?

8632. How does a taxpayer subject to the at risk rules determine how much is "at risk" in an investment?

8633. What rules apply in determining a taxpayer's amount "at risk" when the taxpayer has borrowed the funds contributing to the activity?

8634. What rules apply for determining whether a taxpayer has amounts "at risk" when the taxpayer has received qualified nonrecourse financing with respect to the purchase of real property?

COMPLETE LIST OF QUESTIONS

8635. What are the passive loss rules?
8636. To which taxpayers do the passive rules apply?
8637. What is a passive activity for purposes of the passive loss rules?
8638. How is it determined whether a taxpayer materially participates in activity for purposes of determining whether an activity is active or passive?
8639. What happens if a taxpayer's passive losses for a tax year are disallowed?
8640. What special passive activity rules apply to taxpayers who invest in rental real estate?
8641. How are the passive activities of publicly-traded partnerships treated under the passive loss rules?
8642. Do the passive loss rules apply to casualty losses?
8643. How do the passive loss rules interact with the at-risk rules?
8644. What are the tax results when a taxpayer disposes of interests in a passive activity?
8645. Can a taxpayer deduct interest expenses incurred in relation to property the taxpayer holds for investment?
8646. What is the result if a taxpayer has interest expenses that exceed net investment income for the tax year?
8647. What are the tax consequences when a taxpayer elects to treat all or a portion of capital gain or qualified dividend income as investment income when calculating the allowable investment interest deduction?
8648. Is the determination of a taxpayer's allowable investment interest deduction coordinated with the passive loss rules?

PART VI: CASUALTY AND THEFT LOSS

8649. What is a casualty loss?
8650. What is a theft loss?
8651. How do the rules governing theft and casualty losses interact with the rules governing involuntary conversions of property?
8652. When is a taxpayer entitled to take a deduction for a theft loss?
8653. How is the amount of a taxpayer's allowable casualty or theft loss deduction determined?
8654. What limitations apply to the amount a taxpayer is able to claim as a casualty or theft loss deduction?
8655. When will a taxpayer's otherwise allowable casualty loss deduction be disallowed? How does a taxpayer's eligibility to file an insurance claim with respect to the loss impact the availability of the deduction?
8656. Can a casualty loss be spread over more than one tax year? What is the reasonable prospect of recovery doctrine?
8657. Is a business-related casualty loss treated differently than a personal casualty loss?
8658. What are the tax consequences to a taxpayer who has both personal (nonbusiness) casualty (or theft) gains and losses for the same tax year?

8659. What special rules apply to taxpayers who suffer casualty losses within a federally-declared disaster area?

8660. What is a qualified insolvent financial institution loss? Can a taxpayer treat such a loss as a casualty loss?

PART VII: EMPLOYEES VS. INDEPENDENT CONTRACTORS

8661. Who is an “employee” for employment tax purposes?

8662. How is it determined whether a taxpayer is an independent contractor or a common law employee?

8663. What is the self-employment tax? Who is liable for paying it?

8664. How are employment expenses treated differently based on whether a taxpayer is an employee or an independent contractor?

8665. Can a self-employed individual participate in a retirement savings plan?

8666. If a self-employed owner-employee establishes a qualified retirement plan, is that plan entitled to ERISA protections that are normally granted to employees who participate in similar plans?

8667. Is a taxpayer classified as an independent contractor, and thus self-employed, entitled to deduct the cost of health insurance coverage?

8668. What are the consequences if an employer wrongly characterizes an employee as an independent contractor?

8669. Are there any safe harbor provisions that an employer can use in order to ensure that its independent contractors are properly classified so that they will not retroactively be deemed employees?

8670. How can an employer show that it had a reasonable basis for classifying its workers as independent contractors, rather than employees, in order to qualify for the Section 530 safe harbor?

8671. Is a life insurance agent typically an employee or an independent contractor? How does this classification impact the agent’s ability to deduct business expenses?

8672. How are renewal commissions received by a life insurance agent taxed?

8673. How is the sale of a life insurance agent’s renewal commissions taxed?

8674. Are there any circumstances where an insurance agent’s commissions may be taxable to a company rather than to the agent?

8675. Are partners and members of LLCs considered independent contractors or employees?

PART VIII: BUSINESS EXPENSE DEDUCTIONS

8676. What is a business expense deduction?

8677. Is a taxpayer entitled to deduct business travel expenses?

COMPLETE LIST OF QUESTIONS

8678. When is a taxpayer considered to be “away from home” for purposes of deducting business travel expenses? What if the taxpayer is away from the taxpayer’s residence for an extended period of time for business reasons?

8679. Can a taxpayer deduct business travel expenses if the taxpayer travels so frequently that it is found that the taxpayer has no “tax home” for determining whether the “away from home” requirement of Section 162 is met?

8680. Are business-related travel expenses deductible if a taxpayer resides in a location that is far from the taxpayer’s principal place of business?

8681. Is a taxpayer entitled to a deduction for travel expenses when the taxpayer has multiple places of business?

8682. Can a taxpayer deduct travel expenses for a trip that has both business and personal elements?

8683. Do any special rules apply for a taxpayer who wishes to deduct business-related travel expenses for travel that takes place outside the United States?

8684. Can a taxpayer deduct business-related transportation expenses incurred when the taxpayer is not travelling away from home on business?

8685. When is a taxpayer entitled to deduct moving expenses?

8686. Can an employer deduct moving expenses for which it reimburses its employees? Are reimbursed moving expenses included in the taxpayer-employee’s gross income?

8687. Is a taxpayer entitled to claim a deduction for business-related education expenses?

8688. What special rules apply when a taxpayer deducts business-related entertainment expenses and meals?

8689. When is a business-related entertainment or meal expense “ordinary and necessary” so that it may be deducted?

8690. What limitations apply to prevent a taxpayer from deducting lavish or extravagant business-related entertainment expenses?

8691. What substantiation requirements apply when a taxpayer deducts business-related entertainment and meal expenses?

8692. When is a taxpayer entitled to deduct expenses incurred in maintaining a home office?

8693. How does an employer’s reimbursement or failure to reimburse an employee’s expenses impact a taxpayer’s business expense deductions?

PART IX: BAD DEBT AND WORTHLESS SECURITIES

8694. When can a taxpayer deduct losses sustained as a result of a bad debt? What is the difference between a business bad debt and a nonbusiness bad debt?

8695. When is a taxpayer entitled to claim a bad debt deduction?

8696. What accounting methods are available for a taxpayer to use in accounting for bad debts?

8697. Is a bad debt deduction permitted when a debt is only partially worthless?

8698. Is a bad debt deduction permitted when a loan made between related parties becomes worthless?

8699. When is a deduction permitted if a taxpayer owns securities that become worthless?

8700. Is a loss sustained as a result of worthless securities treated as an ordinary loss or a capital loss?

8701. What special rules apply to the deductibility of losses incurred on small business stock?

PART X: BUSINESS LIFE INSURANCE

8702. What is business life insurance?

8703. What is the income tax treatment to the insured of the premiums paid on business life insurance?

8704. What rules govern the deductibility of payment of the premiums on business life insurance?

8705. Can a corporation deduct the premiums it pays on a life insurance policy insuring the life of an employee or stockholder?

8706. When a corporation owns a life insurance policy insuring the life of a key employee, are the premiums paid by the corporation taxable to the key employee?

8707. Are premiums paid by a corporation on life insurance to fund a stock redemption agreement taxable to an insured stockholder?

8708. Are life insurance premiums paid by an employer taxable income to an insured employee if the proceeds are payable to the employee's estate or personal beneficiary and the policy is owned by the employee?

8709. Are life insurance premiums paid by an employer taxable income to an insured employee if the proceeds are payable to the employee's estate or personal beneficiary and the corporation owns the policy?

8710. How are life insurance policy premiums paid by an S corporation to insure a shareholder or employee taxed?

8711. Are life insurance policy premiums deductible if paid by a partnership or an individual partner on the life of a copartner?

8712. Are life insurance premiums paid by a partner for insurance on the partner's own life deductible by the partner if the proceeds are payable to a partnership or to a copartner?

8713. Can a sole proprietor deduct life insurance premiums paid for insurance on the sole proprietor's own life?

8714. Can an employee of a sole proprietor deduct life insurance premiums the sole proprietor pays to insure the life of the sole proprietor?

8715. Are death proceeds of business life insurance exempt from income tax? Could receipt of tax-exempt income from insurance proceeds reduce an otherwise tax-deductible capital loss?

8716. For employer-owned life insurance contracts issued after August 17, 2006, are there any special requirements that must be met in order for the proceeds to be exempt from income tax?

COMPLETE LIST OF QUESTIONS

8717. When will the sale of a life insurance policy cause the loss of the income tax exemption for death proceeds? What is the transfer for value rule?

8718. When is a life insurance policy transferred for value?

8719. What are the exceptions to the transfer for value rule that will permit a policy to be sold or otherwise transferred for value without the loss of the income tax exemption for death proceeds?

8720. If an employer (or the employer's qualified plan) sells or distributes a policy that insures an employee's life to the insured's spouse or other family member, will the transfer cause the loss of the income tax exemption for death proceeds?

8721. What is a Section 79 plan?

8722. How is it determined whether the cost of group-term life insurance provided under a Section 79 plan exceeds the \$50,000 excludable limit?

8723. Are there any exceptions to the general rule that an employee may only exclude the first \$50,000 of group-term life insurance provided under a Section 79 plan?

8724. Do any nondiscrimination requirements apply to Section 79 plans?

PART XI: EMPLOYER-SPONSORED ACCIDENT & HEALTH INSURANCE BENEFITS

8725. May an employer deduct as a business expense the cost of premiums paid for accident and health insurance for employees?

8726. What credit is available for small employers for employee health insurance expenses?

8727. Is the value of employer-provided coverage under accident or health insurance taxable income to an employee?

8728. Is the value of employer-provided coverage under accident or health insurance taxable income to an employee if the employee has a choice as to whether to receive coverage or a higher salary?

8729. Is the value of employer-provided coverage under accident or health insurance taxable income to an employee when the coverage is provided for the employee's spouse, children or dependents?

8730. When will amounts received by an employee under employer-provided accident and health insurance be taxable income to the employee?

8731. Are benefits paid under an employer-sponsored plan by reason of the employee's death received tax-free?

8732. Are benefits provided under an employer's noninsured accident and health plan excludable from an employee's income?

8733. What nondiscrimination requirements apply to employer-provided health insurance plans?

8734. What is a self-insured health plan?

8735. Are reimbursements attributable to employee contributions to a self-insured health plan taxable to the employee?

8736. What nondiscrimination requirements apply to self-insured health plans?
8737. What are the tax consequences for amounts paid by an employer to highly compensated employees under a discriminatory self-insured medical expense reimbursement plan?
8738. Are premiums paid by a taxpayer for personal health insurance deductible?
8739. Are benefits received under a personal health insurance policy taxable income?
8740. How are accident or health benefits taxed for stockholder employees of a closely-held C corporation?
8741. How is health insurance coverage for partners and sole proprietors taxed?
8742. How is health insurance coverage taxed for S corporation shareholders?
8743. What is a health reimbursement arrangement (HRA) and how is it taxed?
8744. What is a health savings account (HSA) and how is it taxed?
8745. Who is an eligible individual for purposes of maintaining an HSA?
8746. Can an individual participate in both an HSA and a health FSA?
8747. What is a high deductible health plan for purposes of an HSA?
8748. What are the contribution limits to an HSA?
8749. What rules govern employer contributions to employee HSAs? Must an employer who offers HSAs to its employees contribute the same amount for each employee?
8750. What are the contribution rules for employers who establish HSAs for employees when an employee has not established an HSA at the time the employer makes contributions or is not eligible to participate for the entire year?
8751. Are there any exceptions to the comparability rules that govern employer contributions to employee HSAs?
8752. Is there a penalty if an employer fails to meet the HSA comparability requirements with respect to contributions to employee HSAs?
8753. Can employers allow employees to roll funds into their HSAs from HRAs or FSAs? What is a qualified HSA distribution?
8754. What is the penalty for making excess contributions to an HSA? How does an excess contribution impact the taxation of distributions from the HSA?
8755. How are funds accumulated in an HSA taxed prior to distribution?
8756. How are amounts distributed from HSAs taxed?
8757. What is the Affordable Care Act? When do its provisions become effective?
8758. What kinds of health plans are governed by the Affordable Care Act?
8759. What tax credit is available for employers who purchase health insurance? When does the credit become available?
8760. What employers are eligible for the new tax credit for health insurance under the Affordable Care Act?
8761. How does the Affordable Care Act impact the use of health savings accounts (HSAs)?
8762. What penalties are imposed by the Affordable Care Act for employers who violate the health insurance nondiscrimination rules?

COMPLETE LIST OF QUESTIONS

8763. What is the penalty if an employer fails to provide the required health insurance under the Affordable Care Act?
8764. What is the penalty if an individual fails to obtain the required health insurance under the Affordable Care Act?
8765. When may a taxpayer be exempt from the rule that every taxpayer must obtain a certain level of health coverage or pay a penalty?
8766. How does a taxpayer who may be exempt from the Affordable Care Act requirements obtain the exemption?
8767. What are the requirements to claim the premium assistance tax credit under the Affordable Care Act?
8768. What is “household income” and how does it determine whether an individual is eligible for a premium assistance tax credit?
8769. If a taxpayer is eligible for the premium assistance tax credit, what happens if the household income level or family size changes during the tax year?
8770. Can a taxpayer still qualify for a premium assistance tax credit if exempt from the shared responsibility penalty under the Affordable Care Act?
8771. Is a taxpayer eligible for a premium assistance tax credit if enrolled in an insurance plan offered through an employer?
8772. How does an eligible taxpayer obtain the premium assistance tax credit?
8773. If taxpayer changes health coverage during a year and has a gap in coverage will the taxpayer be subject to the shared responsibility penalty?
8774. Are U.S. citizens who are not U.S. residents subject to the shared responsibility penalty?
8775. What determines whether health coverage offered by an employer is “affordable” under the Affordable Care Act?
8776. When does employer-sponsored health coverage provide “minimum value” for purposes of the Patient Protection and Affordable Care Act?
8777. Is there any transition relief for individuals with respect to the shared responsibility penalty provisions effective in 2014?

PART XII: EMPLOYEE FRINGE BENEFITS

8778. How are funds provided to employees through an educational assistance program taxed?
8779. What requirements must an education assistance program (EAP) meet in order to receive tax-preferred treatment?
8780. What types of “educational assistance” may be provided on a tax-preferred basis through an employer-provided educational assistance program?
8781. What reporting requirements apply to employers who provide assistance to employees through an educational assistance program?

8782. What is a dependent care assistance program?
8783. Is dependent care assistance provided by an employer as a fringe benefit taxable income to the employee? Do any nondiscrimination requirements apply in order for these benefits to be received tax-free?
8784. Is the employer entitled to a deduction for amounts paid to employees under a dependent care assistance program?
8785. Is there a limit to the amount that an employee may exclude for payments paid by an employer under a dependent care assistance program?
8786. What reporting requirements apply in connection with amounts paid by an employer under a dependent care assistance program?
8787. What is a cafeteria plan? What information must an employer provide in order to establish a cafeteria plan for its employees?
8788. How can a cafeteria plan be used by employers to offer employee benefits?
8789. What nondiscrimination requirements apply to cafeteria plans that provide benefits to highly compensated or key employees?
8790. What is a simple cafeteria plan for small businesses?
8791. What are the tax benefits that can be realized by providing employee benefits through a cafeteria plan?
8792. What is a health flexible spending arrangement (FSA)?
8793. What is a dependent care flexible spending arrangement (FSA)?
8794. Is a surviving spouse of an employee taxed on the value of death benefits paid under a plan of the employer?
8795. What types of benefits can an employer provide in the form of services that do not require an employee to include the value of the benefit in income?
8796. What types of tax-preferred transportation-related fringe benefits can an employer provide to its employees?
8797. Can an employee exclude from income the value of employee discounts offered by the employer?
8798. What is a “working condition” fringe benefit?
8799. What is a “de minimis” fringe benefit?
8800. How is the value of a fringe benefit that is not excludable under IRC Section 132 determined for purposes of determining the amount that must be included in the employee’s income?
8801. Can an employer provide employee fringe benefits through a stock bonus plan?
8802. What special requirements apply to a stock bonus plan offered by an employer?
8803. What rules govern distributions from an employer-sponsored stock bonus plan?
8804. Does participation in an employer’s stock bonus plan entitle the employee-participant to voting privileges?

PART XIII: CHOICE OF ENTITY AND THE SMALL BUSINESS

8805. What is a sole proprietorship and how is it formed?
8806. How is a sole proprietorship taxed?
8807. What is a partnership and how is it formed?
8808. How does a partner acquire interests in a partnership? Is the allocation of income amongst partners impacted if a partner acquires a partnership interest by gift?
8809. Is a partnership entitled to deduct its organizational expenses?
8810. How is a partnership taxed?
8811. How is partnership income and loss allocated among partners? What is the “substantial economic effect test”?
8812. How are partnership losses and deductions attributable to nonrecourse obligations allocated among partners?
8813. How is the tax treatment of a partner’s distributive share determined? When does a partner report income and loss?
8814. How is a partner’s basis in the partnership calculated?
8815. What liabilities are included in determining a partner’s adjusted basis in a partnership interest?
8816. How is a sale of partnership interests taxed?
8817. What is a family partnership? What special considerations apply in the context of a family partnership?
8818. What is a publicly traded partnership?
8819. What special rules apply in the tax treatment of a publicly traded partnership?
8820. Are there any safe harbor provisions that allow a partnership to avoid taxation as a publicly traded partnership based on a finding that its shares are traded on a secondary market (or the equivalent thereof)?
8821. What is an LLP? How is an LLP taxed?
8822. What is a C corporation?
8823. How is a C corporation formed?
8824. Is a corporation entitled to a deduction for the expenses it incurs in organizing as a corporation?
8825. How is a C corporation taxed?
8826. What is the corporate dividend exclusion?
8827. How is a C corporation shareholder taxed upon the sale of the shareholder’s stock in the corporation?
8828. What special considerations apply in determining a stockholder’s basis in securities, such as corporate stock?

8829. What is the accumulated earnings tax that a C corporation may be subject to? When does the tax apply?

8830. What is the personal holding company tax that a C corporation may be subject to? When does the tax apply?

8831. Are C corporations subject to the alternative minimum tax? How is the corporate alternative minimum tax calculated?

8832. Are there any exceptions to the rule that corporations may be subject to the alternative minimum tax? Can small corporations be exempt from AMT requirements?

8833. What is a controlled group of corporations?

8834. How is the treatment of transactions between corporations impacted by membership in a controlled group? How are corporate members of a controlled group taxed?

8835. What is an S corporation and how is it formed?

8836. How is an S corporation taxed? When may S corporation income be taxed at the corporate level?

8837. How is the shareholder of an S corporation taxed?

8838. What special considerations apply in determining a shareholder's basis in S corporation stock?

8839. How are S corporation distributions taxed?

8840. Who can be a shareholder in an S corporation? What restrictions apply to 2 percent shareholders in an S corporation?

8841. What restrictions apply to an S corporation's ability to issue stock?

8842. What is a qualified subchapter S subsidiary (QSSS)?

8843. What is an LLC and how is an LLC formed?

8844. How is an LLC taxed? How is it determined whether an LLC is taxed as a partnership or corporation?

8845. What is a professional service corporation (PSC)? Is there any difference between the tax treatment of C corporations and PSCs?

8846. What is a B corporation?

8847. How is a B corporation taxed?

8848. How might the losses that may be incurred during operation of a business impact choice of entity decisions?

8849. What considerations regarding transferability of interests in an entity should be taken into account when choosing the business entity form?

8850. Can the treatment of employment benefits in an entity structure impact choice of entity?

8851. When can estate planning considerations impact a choice of entity decision?

PART XIV: BUSINESS SUCCESSION PLANNING

8852. What is a buy-sell agreement?
8853. Why are buy-sell agreements often used in business succession planning?
8854. How is a buy-sell agreement funded?
8855. What types of insurance can be used to fund a buy-sell agreement?
8856. Can the use of life insurance to fund a cross-purchase buy-sell agreement cause the premiums to be treated as constructive dividends to shareholders in a closely-held C corporation? How can this result be avoided?
8857. What potential tax consequences arise if the corporation owns the life insurance policy on a majority shareholder's life that is used to fund a buy-sell agreement, but the named beneficiary is a party other than the corporation?
8858. When is a buy-sell agreement triggered? What are the differences between mandatory and optional buyout triggers?
8859. What is the "redemption" type buy-sell agreement? How is this different from a cross-purchase buy-sell agreement?
8860. What is an IRC Section 302 stock redemption?
8861. What is an IRC Section 303 stock redemption? How is a Section 303 redemption useful in the context of a closely-held corporation?
8862. How are interests subject to a buy-sell agreement valued?
8863. What is a "showdown clause" in the context of a buy-sell agreement? When should one be used?
8864. How can the fact that a business owner holds a minority or majority interest in an entity impact the use of a buy-sell agreement?
8865. What is a right of first refusal? What is the difference between a right of first refusal and a buy-sell agreement?
8866. What special considerations apply when an S corporation uses a buy-sell agreement?
8867. How can an installment sale be used to "fund" a buy-sell agreement?
8868. What are the tax consequences of using an asset sale to liquidate a C corporation, rather than transitioning the business through some other form of succession planning?
8869. What tax considerations make the liquidation of an S corporation different than the liquidation of a C corporation?
8870. What gift tax concerns apply in the family business context when planning for business succession?
8871. How can a grantor retained annuity trust be used in family business succession planning?
8872. How can an intentionally defective grantor trust be used in family business succession planning?
8873. What are self-cancelling installment notes (SCINs)? How can SCINs be used in family business succession planning?

8874. Are there any special provisions available to allow the estate of a small business owner to defer payment of estate taxes?

8875. What issues arise when a family partnership is considering its small business succession strategy?

8876. How can a buy-sell agreement be useful in transitioning a family partnership?

8877. What special considerations arise when developing a business succession plan for a family partnership that is formed between a parent and adult children?

8878. How can the existence of preferred stock complicate business succession planning in the context of a family-owned business?

8879. How can the existence of voting stock create adverse estate tax consequences in the context of a transfer of stock in a controlled corporation?

8880. Can a qualified terminable interest property (QTIP) trust be useful in reducing the estate tax burden in a family business' succession plan?

8881. Can a qualified terminable interest property (QTIP) trust be used in a family business succession plan if the business interests at issue are subject to a buy-sell agreement?

8882. Should the transfer of stock to a successor generation pursuant to a family business succession plan be structured as gifts or compensation?

8883. How can a three-year grantor retained income trust (GRIT) be used in family business succession planning?

PART XV: SMALL BUSINESS VALUATION

8884. How is the value of a small business determined? Why is valuing a small business different from valuation in other business contexts?

8885. What general principles govern small business valuation for estate and gift tax purposes?

8886. How does the existence of a buy-sell agreement impact small business valuation?

8887. How are shares of stock valued in a closely-held corporation?

8888. What is the market valuation approach used in valuing closely-held business interests?

8889. What is the income valuation approach that is used in valuing closely-held business interests?

8890. How is "goodwill," important in valuing small business interests?

8891. What factors are used in determining the intangible value of a small business?

8892. What types of external risks are important in determining the value of a small business?

8893. How does the current management structure of a small business impact valuation?

8894. How can a majority or minority interest impact the value of a small business interest?

8895. What special estate tax valuation issues must be considered in the small business context?

PART XVI: ACCOUNTING

8896. What is an accounting period?

8897. How is a partnership's accounting period determined?

COMPLETE LIST OF QUESTIONS

8898. How is an S corporation's accounting period determined?
8899. When can a partnership or S corporation elect an otherwise impermissible accounting period?
8900. How does a partnership or S corporation establish that it has a valid business purpose for adopting an accounting period that deviates from its required accounting period?
8901. When is it permissible for a taxpayer to adopt an accounting period that is less than 12 months?
8902. Can an accounting period be changed once chosen?
8903. What is the cash basis method of accounting?
8904. What is the accrual method of accounting?
8905. Are there taxpayers required to use the accrual method of accounting, rather than the cash basis method?
8906. Can a taxpayer choose to use both the cash basis and accrual methods of accounting?
8907. Can a taxpayer change an accounting method once it has been chosen?
8908. What is the installment method of accounting and when is it used?
8909. What interest requirements apply when a taxpayer uses the installment method of accounting?
8910. What special accounting rules apply in the installment context of related party sales?
8911. Is a taxpayer required to use the installment method to account for an installment sale?
8912. What types of contracts are considered "long-term contracts" for purposes of determining the proper method of accounting?
8913. How does a taxpayer account for revenue and costs under a long-term contract?
8914. Are there any exceptions to the rule that a taxpayer must use the percentage of completion method in accounting for long-term contracts?
8915. What is inventory accounting? What methods are generally used by taxpayers to account for inventory?

PART XVII: CHARITABLE GIVING

8916. What deduction is an individual allowed to take with respect to gifts made to charitable organizations?
8917. How is the value of property donated to charity determined?
8918. What verification is required to substantiate a deduction for a charitable donation?
8919. What appraisal requirements may be required in connection with substantiating a charitable deduction for donated property that exceeds certain valuation thresholds?
8920. Are the substantiation requirements impacted if the charity disposes of the donated property after the taxpayer has already claimed a charitable deduction?
8921. What are the penalties if a taxpayer overvalues property donated to charity?
8922. What are the income percentage limits for deductions of a charitable contribution?
8923. When is the deduction for charitable donations taken?

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

8924. Can an individual deduct the fair market value of appreciated real estate or intangible personal property such as stocks or bonds given to a charity?

8925. Is a charitable deduction available for the donation of appreciated tangible personal property, such as art, stamps, coins and gems?

8926. How is the charitable contribution deduction computed when property is sold to a charity at a reduced price (in a “bargain sale”)?

8927. How is the amount of a charitable contribution determined when a taxpayer donates property subject to a mortgage or other debt?

8928. Can a deduction be taken for a charitable contribution of less than the donor’s entire interest in property?

8929. What deduction is available when a taxpayer only grants the charity the right to use property, rather than donating an ownership interest in the property?

8930. What are the tax consequences of a charitable contribution of a partnership interests?

PART I: FEDERAL INCOME TAX FOR INDIVIDUALS AND SMALL BUSINESS

8501. Who must file a federal income tax return?

Taxpayers with annual income that equals or exceeds certain threshold amounts are required to file a federal income tax return for the year. The threshold amounts are indexed annually for inflation. In 2014, based on filing status, every taxpayer whose gross income equals or exceeds the following amounts must file a tax return:¹

- (1) Married persons filing jointly—\$20,300 (if one spouse is blind or 65 or older—\$21,500; if both spouses are blind or 65 or older—\$22,700; if both spouses are blind and 65 or older—\$25,100).
- (2) Surviving spouse—\$16,350 (if 65 or older or blind—\$17,550; if 65 or older and blind—\$18,750).
- (3) Head-of-household—\$13,050 (if blind or 65 or older—\$14,600; if 65 or older and blind—\$16,150).
- (4) Single persons—\$10,150 (if blind or 65 or older—\$11,700; if blind and 65 or older—\$13,250).
- (5) Married filing separately—if neither spouse itemizes, a return must be filed if gross income equals or exceeds \$10,150 in 2014 (if blind or 65 or older—\$11,350; if blind and 65 or older—\$12,550).
- (6) Dependents—every individual who may be claimed as a dependent of another must file a return for 2014 if he has either (x) unearned income in excess of \$1,000 (plus any additional standard deduction if the individual is blind or 65 or older) or (y) total gross income that exceeds the sum of any additional standard deduction if the individual is blind or 65 or older plus the greater of (a) \$1,000 or (b) the lesser of (i) \$350 plus earned income, or (ii) \$6,200.

Taxpayers claiming the additional deduction for blindness may need to attach additional documents to a tax return to verify entitlement to the additional standard deduction.

Certain parents whose children are required to file a return may be permitted to include the child's income over \$2,000 on their own return, thus avoiding the necessity of the child filing a return (see Q 8557).

A taxpayer with self-employment income must file a return if *net* self-employment income is \$400 or more.

An individual who was subject to wage withholding but did not have gross income in excess of the threshold amounts described above may desire to file a return in order to receive a refund

1. IRC Secs. 6012(a), 63(c), 151; Rev. Proc. 2013-35, 2013-47 IRB 537.

of the withheld taxes. Similarly, an individual not required to file a return may desire to file a return in order to receive a refund resulting from a refundable credit (a tax credit or refund payable to the taxpayer even if she or she had paid no tax), such as the earned income credit.

8502. Who is allowed to file a joint federal income tax return? Who is eligible to file as a qualifying widow(er) with a dependent child?

Only legally married spouses may file joint returns. As a result of the Supreme Court's decision in the *Windsor* case, the federal government is compelled to recognize same-sex marriages that were legally executed in any U.S. state. As a result, the IRS must apply the tax laws to same-sex spouses in the same way as it is applied to all spouses.

Although the income and deductions of both spouses are reported, a joint return may be filed even if only one spouse has income. If one spouse dies during the tax year, the spouses are considered married for the entire year; and, thus, may file a joint return.

Qualifying Widow(er)

For 2 years following the death of a spouse, the surviving spouse may file as a "qualifying widow(er)" with a dependent (using the joint filer tax brackets), if he or she meets the following:

- Was entitled to file a joint return with the deceased spouse in the year of death, even if a joint return was not filed
- Has a child or stepchild (excludes a foster child) for whom an exemption can be claimed
- Child lived with the surviving spouse all year
- Paid more than half of the cost of keeping up the home¹

Finally, if the surviving spouse remarries, he or she can no longer file as a qualifying widow(er); and, instead must file married filing separately or married filing jointly.

8503. Who is eligible to file a federal income tax return as head of household?

An individual who meets the following requirements may file as head of household:

- Not married or considered married (excluding a qualifying widow(er) with dependent child² see Q 8504)
- Paid more than half the cost of maintaining a home for the tax year
- A "qualifying person" lived with the individual more than half the year (except for temporary absences)
- Is not a nonresident alien³

1. IRC Sec. 2.

2. IRC Sec. 2(b)(1).

3. IRC Secs. 2(b), 2(d).

8504. Who is a “qualifying person?”

As stated above, in order to claim head of household filing status, an individual must maintain a home for a “qualifying person.” A “qualifying person” is a:

1. A “qualifying child” (i.e., son, daughter, or grandchild) who is:
 - (a) Single (even if an exemption cannot be claimed for the person)
 - (b) Married and can be claimed as an exemption
2. A “qualifying relative” who is the individual father or mother and can be claimed as an exemption
3. A “qualifying relative” other than a parent, i.e., grandparent, brother, or sister and can be claimed as an exemption.¹

8505. What does it mean to be considered unmarried?

An individual legally married may nonetheless be considered unmarried if the individual meets all of the following requirements:

- Filed a separate return
- Paid more than half the cost of maintaining the home for the tax year
- The other spouse did not live in the home during the last 6 months of the tax year
- The home was the main abode of the individual’s child, stepchild, or foster child for more than half the year (except for temporary absences)
- Must be able to claim the child as an exemption or cannot claim the exemption because the exemption was transferred to the non-custodian spouse²

8506. What are the tax advantages of filing as head of household?

Filing as head of household is much more tax advantageous than filing separately. The main advantages are a higher standard deduction (\$9,100 for 2014) and lower tax rates.³

8507. What is a taxable year for individual income tax purposes?

The basic period for computing income tax liability is one year, known as the *taxable year*. The taxable year may be either (a) the calendar year or (b) a fiscal year. A “calendar year” is a period of 12 months ending on December 31. A “fiscal year” is a period of 12 months ending on the last day of a month other than December.⁴

1. IRS Publication 17.

2. IRS Publication 17.

3. Rev. Proc. 2013-35, 2013-47 IRB 537.

4. IRC Secs. 441(a), 441(b), 441(d), 441(e).

Although most individuals report tax liability on a calendar year, it is possible to use a fiscal year. In any event, the year used for reporting tax liability must generally correspond to the taxpayer's accounting period.¹ Thus, if the taxpayer keeps books on a fiscal year basis the taxpayer cannot determine tax liability on a calendar year basis. If the taxpayer keeps no books, however, reporting on a calendar year basis is required.² Once the taxpayer has chosen a tax year, it cannot be changed without the permission of the Internal Revenue Service.³ A principal partner cannot change to a taxable year other than that of the partnership unless the principal partner establishes, to the satisfaction of the IRS, a business purpose for doing so.⁴

A personal service corporation is required to use the calendar year for computing tax liability unless it can establish a valid business purpose for using a different period. The code specifically provides that deferral of income to shareholders does not constitute a valid business purpose.⁵

Under certain circumstances, partnerships and S corporations are required to use the calendar year for computing income tax liability.⁶

A short period (one that is less than 12 months) return is required where (1) the taxpayer changes the taxpayer's annual accounting period, and (2) a taxpayer has been in existence for only part of a taxable year.⁷ A short period is treated in the law as a "taxable year."⁸

Example: On June 1, 2014, ASK, Inc., a C corporation reporting its tax liability based on a calendar year began doing business. Since ASK was not operating for the entire calendar year, a short period return (June 1 through December 31) is required.

If the short period return is made because of a change in accounting period, the income during the short period must be annualized, and deductions and exemptions prorated.⁹ But income for the short period is not required to be annualized if the taxpayer is not in existence for the entire taxable year.¹⁰ For a discussion of the considerations applicable in determining a taxpayer's accounting period, see Q 8896 to Q 8902.

For the final regulations affecting taxpayers who want to adopt an annual accounting period (under IRC Section 441), or who must receive approval to adopt, change, or retain their annual accounting periods (under IRC Section 442), see Treasury Regulation Sections 1.441-0 to 1.441-4.

1. IRC Sec. 441(f)(1).

2. IRC Sec. 441(g).

3. IRC Sec. 442.

4. IRC Sec. 706(b)(2).

5. IRC Sec. 441(i).

6. See IRC Secs. 706(b), 1378.

7. IRC Sec. 443(a).

8. IRC Sec. 441(b)(3).

9. IRC Secs. 443(b), 443(c).

10. Treas. Reg. §1.443-1(a)(2).

For the general procedures for establishing a business purpose and obtaining approval to adopt, change, or retain an annual accounting period, see Revenue Procedure 2002-39.¹

In Revenue Procedure 2003-62, the IRS has set forth the procedure under which IRC Section 442 allows individuals (e.g., sole proprietors) filing tax returns on a fiscal year basis to obtain automatic approval to change their annual accounting period to a calendar year.²

The exclusive procedures for (1) certain partnerships, (2) S corporations, (3) electing S corporations, (4) personal service corporations, and (5) trusts to obtain automatic approval to adopt, change, or retain their annual accounting period are set forth in Revenue Procedure 2006-46.³

8508. How does a taxpayer compute yearly tax liability?

A taxpayer computes the amount of tax owed using the following basic steps:

1. Gross income for the taxable year is determined (see Q 8512);
2. Certain deductions are subtracted from gross income (above the line deductions) to arrive at adjusted gross income (see Q 8519 to Q 8521);
3. The deduction for personal and dependency exemptions is determined (see Q 8515 to Q 8518);
4. Itemized deductions are totaled (see Q 8522), compared to the standard deduction and the additional standard deduction, if applicable (see Q 8519), and (generally) the greater amount, along with the deduction for exemptions, is deducted from adjusted gross income to arrive at taxable income;
5. The proper tax rate is applied to taxable income to determine the tax (see Q 8509);
6. The following amounts are subtracted from the tax to determine the net tax payable or overpayment refundable: (1) credits (see Q 8541 and Q 8542), and (2) prepayments toward the tax (e.g., overpayments or credits from a prior tax year carried over, tax withheld by an employer or estimated tax payments).

In some cases, there may be an alternative minimum tax liability. The steps in calculating the alternative minimum tax are explained in Q 8551.

1. 2002-1 CB 1046, *as modified by*, Notice 2002-72, 2002-2 CB 843, *and further modified by*, Rev. Proc. 2003-79, 2003-2 CB 1036.

2. 2003-2 CB 299, *modifying, amplifying, and superseding*, Rev. Proc. 66-50, 1966-2 CB 1260, *and modifying and superseding*, Rev. Proc. 81-40, 1981-2 CB 604. See also Ann. 2003-49, 2003-2 CB 339.

3. 2006-45 IRB 859.

8509. What are the current income tax rates for individuals?

Based on a taxpayer's filing status, the following individual income tax rates are applicable in 2014:¹

Taxable Income				
Tax Rate	Single	Married Filing Jointly Including Qualifying widow(er) with dependent child	Married Filing Separately	Head of Household
10%	\$0-\$9,075	\$0-\$18,150	\$0-\$9,075	\$0-\$12,950
15%	\$9,075-\$36,900	\$18,150-\$73,800	\$9,075-\$36,900	\$12,950-\$49,400
25%	\$36,900-\$89,350	\$73,800-\$148,850	\$36,900-\$74,425	\$49,400-\$127,550
28%	\$89,350-\$186,350	\$148,850-\$226,850	\$74,425-\$113,425	\$127,550-\$206,600
33%	\$186,350-\$405,100	\$226,850-\$405,100	\$113,425-\$202,550	\$206,600-\$405,100
35%	\$405,100-\$406,750	\$405,100-\$457,600	\$202,550-\$228,800	\$405,100-\$432,200
39.6%	Over \$406,750	Over \$457,600	Over \$228,800	Over \$432,200

8510. Why are many tax provisions indexed for inflation each year?

Many tax provisions are indexed annually for inflation so that increases in a taxpayer's income that result solely from inflation does not push them in a higher tax bracket or over thresholds that would reduce or eliminate certain tax benefits.

For example, Asher a single taxpayer earns \$89,350 as the manager of a computer superstore. Assume at that income level, Asher is at the very end of the 25 percent tax bracket. At the end of the year, he receives a cost of living adjustment (another term for an adjustment for inflation) that increases his salary to \$92,000. If tax brackets were not indexed for inflation, Asher's cost of living raise of \$2,650 (\$92,000 minus \$89,350) would be taxed at 28 percent. Yet, based on inflation, \$92,000 of today's dollars is the equivalent of \$89,350 of yesterday's dollars. Thus, without indexing, Asher would experience a tax hike. However, by adjusting the tax brackets by inflation, i.e., increasing the 25 percent bracket to \$92,000, Asher's tax liability essentially remains unchanged.

The following are examples of tax sensitive items indexed for inflation:

- Individual income tax brackets
- Basic standard deduction
- Additional standard deduction (taxpayers 65 or older)
- Exemptions
- Alternative minimum tax exemption amount

1. Rev. Proc. 2013-35, 2013-47 IRB 537.

- Maximum earned income credit
- Overall limitation on itemized deductions
- Education credits (Hope Scholarship, American Opportunity and Lifetime Learning Credits)
- Adoption credit
- Child tax credit
- Low income housing credit
- Phase out of exemptions
- Deductibility of interest on education loans¹

8511. What indexing factor does the IRS use to make the adjustments for inflation?

The indexing factor (referred to in the IRC as the cost-of-living adjustment) is the percentage by which the Consumer Price Index (CPI) for the prior calendar year exceeds the CPI for a year designated as a reference point in each respective IRC Section. In all cases, the CPI is the average Consumer Price Index as of the close of the 12-month period ending on August 31 of the calendar year.² Thus, for example, in calculating the new tax rate schedules, the minimum and maximum dollar amounts for each rate bracket (except as described below) are increased by the applicable cost-of-living adjustment. The rates (percentages) themselves are not adjusted automatically for inflation. This method of increase explained above, however, does not apply to the phase out of the marriage penalty in the 15 percent bracket.³

The Secretary of the Treasury has until December 15 of each calendar year to publish new tax rate schedules (for joint returns, separate returns, single returns, head of household returns and for returns by estates and trusts) that will be effective for taxable years beginning in the subsequent calendar year.⁴ As a practical matter the new numbers for the following tax year are often available as early as October of the preceding year. For a schedule of current tax rates, see Q 8509.

What Is Income?

8512. What is gross income?

Gross income is the starting point in the computation of taxable income upon which individuals are subject to income tax. Gross income is a broad concept that includes all income (whether derived from labor or capital) *excluding* those items that are specifically excluded;

1. Rev. Proc. 2013-35, 2013-47 IRB 537.

2. IRC Secs. 1(f)(3), 1(f)(4).

3. IRC Sec. 1(f)(2).

4. IRC Sec. 1(f)(1).

and, thus, not taxable. For example, gross income includes salary, fees, commissions, business profits, interest and dividends, rents, alimony received, and gains from the sale of property—but not the mere return of capital expended by the taxpayer to purchase or improve the property.¹

The following is a non-exhaustive list of items that are *excluded* from gross income and received tax-free by an individual taxpayer:

1. gifts and inheritances;²
2. gain (within limits) from the sale of a personal residence (see Q 8587);
3. 50 percent of gain (within limits) from the sale of certain qualified small business stock held for more than five years (see Q 8563);
4. interest on many bonds of a state, city or other political subdivision;
5. Social Security and railroad retirement benefits (within limits—see Q 8545 to Q 8548); veterans' benefits (but retirement pay is taxable);³
6. Workers' Compensation Act payments (within limits);⁴
7. death proceeds of life insurance and, as to death proceeds of insurance on the life of an insured who died before October 23, 1986, up to \$1,000 annually of interest received under a life income or installment option by a surviving spouse;⁵
8. amounts paid or expenses incurred by an employer for qualified adoption expenses in connection with the adoption of a child by an employee if the amounts are furnished pursuant to an adoption assistance program;⁶
9. contributions to a "Medicare Advantage MSA" by the Department of Health and Human Services;⁷
10. exempt-interest dividends from mutual funds;
11. interest on certain U.S. savings bonds purchased after 1989 and used to pay higher education expenses (within limits);⁸
12. contributions paid by an employer to Health Savings Accounts;⁹

1. IRC Sec. 61(a).

2. IRC Sec. 102.

3. IRC Sec. 104(a)(4).

4. IRC Sec. 104(a)(1).

5. IRC Secs. 101(a), 101(d).

6. IRC Sec. 137.

7. IRC Sec. 138.

8. See IRC Sec. 135.

9. IRC Sec. 106(d).

13. distributions from Health Savings Accounts (HSAs) used to pay qualified medical expenses;¹ and
14. federal subsidies for prescription drug plans.²

8513. What is adjusted gross income?

Adjusted gross income is broadly defined as gross income minus certain specifically deductible items allowed by the Code. Deductions from gross income also referred to as above the line deductions are the most tax beneficial type of deductions because they tend to be dollar per dollar with fewer limitations than what are known as below-the-line or itemized deductions. Additionally, as a measuring rod adjusted gross income is important because many thresholds upon which tax benefits phase out or taxes phase in are directly tied to adjusted gross income (for example, subject to the taxpayer being able to itemize, medical expenses are deductible only to the extent that they exceed 10 percent of adjusted gross income for the tax year).

The Code specifically designates which deductions are subtracted from adjusted gross income as above the line deductions. Following is a list of deductions permitted by the Code:

1. expenses directly incurred in carrying on a trade, business or profession (not as an employee – see Q 8522);
2. the deduction allowed for contributions made by a self-employed individual to a qualified pension, annuity, or profit sharing plan, or a simplified employee pension or SIMPLE IRA plan;
3. certain reimbursed expenses of an employee in connection with employment, provided the reimbursement is included in gross income (if the employee accounts to his employer and reimbursement does not exceed expenses, reporting is not required);
4. deductions related to property held for the production of rents and royalties (within limits);
5. deductions for depreciation and depletion by a life tenant, an income beneficiary of property held in trust, or an heir, legatee or devisee of an estate;
6. deductions for losses from the sale or exchange of property;
7. the deduction allowed for amounts paid in cash by an eligible individual to a traditional individual retirement account (IRA), or individual retirement annuity;
8. the deduction allowed for amounts forfeited as penalties because of premature withdrawal of funds from time savings accounts;

1. IRC Sec. 223(f)(1).

2. IRC Sec. 139A.

9. alimony payments made to the taxpayer's spouse;
10. certain reforestation expenses;
11. certain jury duty pay remitted to the taxpayer's employer;
12. moving expenses permitted by IRC Sec. 217;
13. the deduction for Archer Medical Savings Accounts under IRC Section 220(i);
14. the deduction for interest on education loans;
15. the deduction for qualified tuition and related expenses;
16. the deduction for contributions (within limits) to Health Savings Accounts;
17. the deduction for attorneys' fees involving discrimination suits; and
18. the deduction for certain expenses of elementary and secondary school teachers up to \$250 (made retroactively effective for 2012 and 2013 by the American Taxpayer Relief Act of 2012, this provision has yet to be extended for 2014 and beyond).

8514. Is a taxpayer's discharge of indebtedness taxable?

If a creditor of a taxpayer discharges all or part of a debt for no consideration, the amount of debt discharged is potentially taxable to the taxpayer.¹ However, such debt discharge is excluded from gross income; and, thus not taxable, if the discharge: (1) occurs in a bankruptcy; (2) occurs when the taxpayer is insolvent and the discharge does not render the taxpayer solvent; (3) the indebtedness discharged is "qualified farm indebtedness;"² (4) in the case of a taxpayer other than a C corporation, the indebtedness discharged is "qualified real property business indebtedness;" or (5) the indebtedness discharged is "qualified principal residence indebtedness" (see "Mortgage Forgiveness Debt Relief Act of 2007," below) that is discharged before January 1, 2014.³ So unless Congress reinstates the exclusion for the discharge of "qualified principal residence indebtedness," it would not apply.

Importantly, as stated above, "discharge of debt income" is triggered when a debt is forgiven for no consideration. So, if any consideration is involved, it would not be considered discharge of indebtedness income. Significantly, under those circumstances, the so-called discharge is completely taxable as none of the above exclusions would apply.

Example: Asher borrows \$10,000 from his employer. Instead of repaying the loan, his employer forgives the debt after Asher works 200 hours of overtime. In other words, it is as if the employer paid Asher \$10,000 for his services; which, Asher, in turn used to repay the loan. Thus, the discharge of the loan is essentially compensation for services, or taxable wage income (not discharge of debt income).

1. IRC Sec. 61(a)(12).

2. See IRC Section 108(g)(2), as amended by ATRA.

3. IRC Sections 108(c)(3), 108(a)(1)(A), 108(a)(1)(B), 108(a)(1)(C), 108(a)(1)(D); IRC Sec. 108(a)(1)(E).

In some cases, even though consideration is involved, the discharge of debt may not necessarily be taxable. For example, suppose a shareholder of a corporation loans \$10,000 to the corporation. Subsequently, the shareholder forgives the loan for no consideration. Because the loan comes from someone with shareholder status, the proceeds of the forgiven loan that remain in the corporation are essentially a capital contribution to the corporation. It is as if the corporation repaid the loan to the shareholder, who, in turn, made a capital contribution to the corporation. Contributions to a corporation are not taxable to the corporation. So in this case, discharge of debt that is the equivalent of a capital contribution does not trigger taxable income.¹

Exemptions

8515. What is the personal exemption?

A personal exemption is essentially a fixed tax deduction adjusted for inflation each year. For tax year 2014, the exemption amount is \$3,950.² With an exception discussed below, regardless of filing status, each individual taxpayer who files a return is entitled to claim a personal exemption.

Married couples filing joint returns are entitled to claim two personal exemptions (one for each spouse). In addition to a personal exemption, an additional exemption in the same amount (sometimes referred to as a “dependency exemption”) is available for each individual a taxpayer may claim as a dependent.

There are several special rules that apply to claiming exemptions. A married spouse filing a separate return may claim an exemption for the spouse provided the other spouse has no gross income and is not claimed as a dependent by another taxpayer.³ A child or other dependent (such as a parent) who files his or her own return may not claim a personal exemption.⁴ Generally, the exemption will not be allowed unless the Social Security number of the individual for whom the personal or dependency exemption is being claimed is provided.⁵

8516. Are personal and dependency exemptions for high-income taxpayers subject to being phased out?

Yes. Beginning in 2013, the personal and dependency exemptions of taxpayers with income over certain defined threshold levels are subject to being reduced and potentially phased out completely. The dollar amount of personal and dependency exemptions of taxpayers with adjusted gross income above the threshold levels (adjusted annually for inflation⁶) is reduced by 2 percent for every \$2,500 (or fraction thereof; \$1,250 in the case of a married individual filing separately). Depending upon filing status, at certain adjusted gross income levels, the exemptions are phased out to zero.

1. Treas. Reg. §1.61-12(a).

2. IRC Sec. 151. Rev. Proc. 2013-35, 2013-47 IRB 537.

3. IRC Sec. 151.

4. IRC Sec. 151(d)(2).

5. IRC Sec. 151(e).

6. IRC Secs. 151(d)(3), 151(d)(4); Rev. Proc. 2013-35, 2013-47 IRB 537.

For 2014, the following chart illustrates the range of adjusted gross income in which the exemptions are gradually reduced until they are totally phased out:

Filing Status	AGI Threshold At Which Phase Out Begins	AGI Amount At Which Exemptions are Completely Phased Out
Married Joint and Surviving Spouse	\$305,050	\$427,550
Head of Household	\$279,650	\$402,150
Unmarried Individuals	\$254,200	\$376,700
Married Separate	\$152,525	\$213,775 ¹

8517. When can a taxpayer claim a dependency exemption for a qualifying child and a qualifying relative?

In addition to the personal exemption, a taxpayer is entitled to an additional exemption (referred to as a dependency exemption) for each individual a taxpayer may claim as a dependent.² Under certain circumstances, the taxpayer may claim the exemption even though the dependent files a return. The taxpayer must include the Social Security number of any dependent claimed on the tax return.³

There are two categories of dependents 1) a “qualifying child” and 2) a “qualifying relative.”⁴

Qualifying child. The term “qualifying child” means an individual who:

- (1) is the taxpayer’s “child” (see below) or a descendant of such a child, or the taxpayer’s brother, sister, stepbrother, stepsister or a descendant of any such relative;
- (2) has the same principal place of abode as the taxpayer for more than one-half of the taxable year;
- (3) is younger than the taxpayer claiming the exemption and (i) has not turned age 19 as of the close of the calendar year in which the taxable year of the taxpayer begins, or (ii) is a student who has not turned age 24 as of the close of such calendar year;
- (4) has not provided over one-half of his or her own support for the calendar year in which the claiming taxpayer’s taxable year begins; and
- (5) who has not filed a joint tax return (other than to claim a refund) for the taxable year.⁵

1. Rev. Proc. 2013-35, 2013-47 IRB 537.

2. IRC Sec. 151, 152.

3. IRC Sec. 151(e).

4. IRC Sec. 152(a).

5. IRC Sec. 152(c).

A “child” (including an adopted child) is an individual who is: (1) a son, daughter, stepson, or stepdaughter of the taxpayer; or (2) an “eligible foster child” of the taxpayer.¹ An “eligible foster child” means 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.²

Qualifying relative. The term “qualifying relative” means an individual:

- (1) who is the taxpayer’s:
 - (i) child (who is not otherwise a “qualifying child”) or a descendant of a child;
 - (ii) brother, sister, stepbrother, or stepsister;
 - (iii) father or mother or an ancestor of either, or stepfather or stepmother;
 - (iv) son or daughter of a brother or sister of the taxpayer;
 - (v) brother or sister of the father or mother of the taxpayer;
 - (vi) son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or
 - (vii) an individual (other than a spouse) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer’s household.
- (2) whose gross income for the calendar year in which the taxable year begins is less than the exemption amount;
- (3) for whom the taxpayer provides over one-half of the individual’s support for the calendar year in which the taxable year begins; *and*
- (4) who is not a qualifying child of the taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which the taxable year begins.³

8518. Who is entitled to the dependency exemption for qualifying children when the parents are divorced or have never been married?

For purposes of determining if a parent is entitled to the dependency exemption for qualifying children, it makes no difference whether the parents were divorced or had never been married.⁴ As a general rule, the custodial parent is entitled to claim the dependency exemption. According to the Code, the parent having custody for the greater portion of the year is considered to be the “custodial parent.”⁵ However, if both parents have custody for equal amounts of

1. IRC Sec. 152(f).

2. IRC Sec. 152(f)(3).

3. IRC Sec. 152(d).

4. *King v. Comm.*, 121 TC 245 (2003). See also Preamble, REG-149856-03, 72 Fed. Reg. 24192, 24194 (5-2-2007).

5. IRC Sec. 152(e)(1)(B).

time during the taxable year, the parent with the highest adjusted gross income is entitled to claim the exemption.¹

One the other hand the custodial parent may release the claim for exemption to allow the noncustodial parent to claim the exemption. In order to claim the exemption, the custodial spouse executes a Form 8332 that the noncustodial parent must attach to the tax return. As explained below, it is also possible for the custodial spouse to revoke the release of the exemption in order to claim it for himself or herself.

Post 2008 Rules for Release and Revocation of Release of Claim to Exemption

For tax years beginning after July 2, 2008, there are prescribed ways to release the claim to the exemption to the noncustodial parent as well as to revoke the release of the claim to the exemption from the noncustodial parent (effectively returning to the custodial parent).

- ***Releasing the Exemption to Noncustodial Spouse***

As mentioned above, the custodial spouse may release the claim to the exemption by executing a Form 8332 (Release/Revocation of Claim to Exemption for Child by Custodial Parent). Form 8332 provides the custodial parent with the option of releasing the right to claim the exemption for a single tax year or for multiple tax years. In the alternative, the custodial spouse may execute a conforming written document that includes the same information as it appears on a Form 8332. However, such written declaration must have been executed for the *sole purpose* of releasing the exemption to the noncustodial spouse for one or more tax years. Importantly, this means that attaching a court document such as a decree or a divorce or separation agreement would not be an acceptable written instrument even if it contains all of the required information.² Also, in order to claim the exemption, the noncustodial parent must attach the Form 8332 or written declaration to the tax return.

- ***Revoking the Release of the Exemption to Noncustodial Spouse***

According to the regulations, the custodial parent has the unilateral right to revoke the release of the exemption from the noncustodial spouse in order to claim it for himself or herself. To do so, the custodial parent is required to provide a noncustodial written notice of the intent to revoke and make reasonable efforts to deliver such notice to the noncustodial parent. The revocation is effective no earlier than the tax year *following* the calendar year in which the custodial parent delivered or made reasonable efforts to deliver the notice to the noncustodial spouse.³

Example: Ashley and Asher are divorced parents with one child. Prior to tax year 2014, Ashley had executed a Form 8332 releasing the claim to the dependency exemption to Asher through tax year 2016. In February 2015, Ashley provides Asher written notice of her intent to revoke the release. Even though Asher received written notice of Ashley's intent to revoke the release, it would not be effective earlier than tax year 2015. Thus, for tax year 2014, Asher remains entitled to claim the dependency exemption.

1. IRC Sec. 152(c)(4)(B).

2. Treas. Reg. §1.152-4(e).

3. Treas. Reg. §1.152-4(e)(3).

Similar to the release, the revocation is made on Form 8332 or a separate conforming written document containing the same information contained on Form 8332. If a separate written document is used it must be executed for the sole purpose of revoking the release. Similar to the release, the revocation must specify the year or years in which it is to be in effect. To re-claim the exemption, the custodial spouse must attach the Form 8832 or conforming document to the return.¹

Deductions

8519. What is the standard deduction?

The standard deduction is one of two “below-the-line” deduction options available to taxpayers. In other words, once a taxpayer determines adjusted gross income (gross income minus above the line deductions), the taxpayer may also deduct the sum of their exemptions and the greater of 1) the standard deduction; or 2) the sum of their itemized deductions (see Q 8522).²

The standard deduction for the 2014 tax year is \$12,400 for married taxpayers filing jointly and surviving spouses, \$9,100 for heads of households, and \$6,200 for single taxpayers and married taxpayers filing separately.³ The standard deduction is adjusted annually for inflation.⁴

Taxpayers who do not itemize and who are age 65 or older or blind are entitled to increase their standard deduction. In 2014, taxpayers who are married or are surviving spouses are each entitled to an additional deduction of \$1,200, if age 65 or older as well as an additional \$1,200 deduction if blind. The additional standard deduction is \$1,550 for unmarried taxpayers age 65 or older as well as \$1,550 for unmarried blind taxpayers.⁵ The additional amounts for elderly and blind taxpayers are indexed for inflation.⁶

8520. What taxpayers are ineligible to use the standard deduction?

The following taxpayers are ineligible for the standard deduction and unless they have itemized deductions, there are no “below-the-line” deductions:

- (1) married taxpayers filing separately, if either spouse itemizes,⁷
- (2) non-resident aliens,
- (3) taxpayers filing a short year (less than 12 months) return because of a change in their annual accounting period, and
- (4) estates or trusts, common trust funds, or partnerships.⁸

If a taxpayer dies within the tax year, his or her standard deduction is unaffected.

1. Treas. Reg. §1.152-4(c)(3).

2. IRC Sec. 63.

3. IRC Sec. 63(c); Rev. Proc. 2013-35, 2013-47 IRB 537.

4. IRC Sec. 63(c)(4).

5. IRC Sec. 63(f); Rev. Proc. 2013-35, 2013-47 IRB 537.

6. IRC Sec. 63(c)(4).

7. See, e.g., Legal Memorandum 200030023.

8. IRC Sec. 63(c)(6).

Example: Ashley an unmarried individual dies on February 1, 2014. As a result, her final tax year is only 32 days. However, even though Ashley died early in the tax year, in filing Ashley final Form 1040, the executor or administrator of Ashley's estate would deduct the entire standard deduction for a single filer.

8521. What is the standard deduction for a taxpayer who may be claimed as a dependent by another taxpayer?

For taxable years beginning in 2014, the standard deduction for an individual who may be claimed as a dependent by another taxpayer is the greater of \$1,000 or the sum of \$350 and the dependent's earned income.¹ These dollar amounts are adjusted for inflation.²

Planning Point: Self-employed and small business owners may be able to shift income taxable at their higher tax brackets to their lower tax bracket children by employing them in the business. This way the children's wage income would be taxed at their lower rates. The work must be legitimate and the pay must be reasonable, although it can be at the higher end of the reasonable scale.

8522. What are itemized deductions and how are they deducted?

As discussed in Q 8519, taxpayers are entitled to a "below-the-line" deduction, i.e., a deduction from adjusted gross income in arriving at taxable income, of the greater of 1) the applicable standard deduction (including the additional standard deduction for taxpayers who are blind and/or age 65 or older based on filing status); or, 2) the sum of their itemized deductions. So, in order to make a determination as to which amount to deduct, the taxpayer must total all deductible items that qualify as itemized deductions. If the total amount of itemized deductions exceeds the standard deduction, the taxpayer deducts that larger sum.

The following is a non-exhaustive list of the itemized deductions:

- ...Interest (including mortgage interest on a principal residence), within limits (see Q 8526);

- ...Personal expenses for the production or collection of taxable income, within limits, or in conjunction with the determination, collection or refund of any tax (but some of these expenses may be considered "miscellaneous itemized deductions" (see Q 8525)). However, certain business expenses and expenses for the production of rents and royalties are above the line deductions rather than itemized deductions;

- ...Personal taxes of the following types: state, local and foreign real property taxes; state and local personal property taxes; state, local and foreign income, war profits and excess profits taxes, and the generation-skipping tax imposed on income distributions. If taxes other than these are incurred in connection with the acquisition or disposition of property, they must be treated as part of the cost of such property (included in basis) or as a reduction in the amount realized on the disposition;³

1. IRC Sec. 63(c)(5); Rev. Proc. 2013-35, 2013-47 IRB 537.

2. IRC Sec. 63(c)(4).

3. IRC Sec. 164(a).

...Uncompensated personal casualty and theft losses. These are deductible only to the extent that the aggregate amount of uncompensated losses in excess of \$100 (for each casualty or theft) exceeds 10 percent of adjusted gross income. The taxpayer must file a timely insurance claim for damage to property that is not business or investment property or else the deduction is disallowed to the extent that insurance would have provided compensation.¹ Uncompensated casualty and theft losses in connection with a taxpayer's business or in connection with the production of income are deductible in full. For more on casualty losses, see Q 8621 to Q 8641;

...Contributions to charitable organizations, within certain limitations (see Q 8534 to Q 8539);

...Unreimbursed medical and dental expenses, and expenses for the purchase of prescribed drugs or insulin incurred by the taxpayer for himself and his spouse and dependents, to the extent that such expenses exceed 10 percent of adjusted gross income (7.5 percent of adjusted gross income for taxpayers 65 or older) (see Q 8540);

...Unreimbursed expenses of an employee connected with his employment. Generally, such expenses are "miscellaneous itemized deductions" (see Q 8525);

...Federal estate taxes and generation-skipping transfer taxes paid on "income in respect of a decedent."

8523. Are state and local sales taxes deductible?

Under AJCA 2004, taxpayers could elect to deduct state and local general sales taxes instead of state and local income taxes when they itemized deductions.² This option was available for tax years 2004 through 2011.³ ATRA extended this option through 2013, with retroactive application to the 2012 tax year. As of the date of this publication, Congress has not acted to extend this deduction for 2014 and beyond.

8524. What are miscellaneous itemized deductions? To what extent are they deductible?

"Miscellaneous itemized deductions" are a subset of itemized deductions *other than* the regular itemized deductions for (1) interest, (2) taxes, (3) non-business casualty losses and gambling losses, (4) charitable contributions, (5) medical and dental expenses, (6) impairment-related work expenses for handicapped employees, (7) estate taxes on income in respect of a decedent, (8) certain short sale expenses, (9) certain adjustments under the IRC claim of right provisions, (10) unrecovered investment in an annuity contract, (11) amortizable bond premium, and (12) certain expenses of cooperative housing corporations.⁴

1. IRC Sec. 165(h)(5)(E).

2. IRC Sec. 164(b)(5)(A).

3. IRC Sec. 164(b)(5)(I), as amended by TEAMTRA 2008.

4. IRC Sec. 67(b).

Examples of miscellaneous itemized deductions include unreimbursed employee business expenses, such as professional society dues or job hunting expenses, and expenses for the production of income, such as investment advisory fees or the cost for storage of taxable securities in a safe deposit box.¹

“Miscellaneous itemized deductions” are included in the itemized deduction pool only to the extent that the aggregate of all miscellaneous itemized deductions for the tax year exceeds 2 percent of adjusted gross income.² Expenses that relate to both a trade or business activity (an above-the-line deduction) and a production of income or tax preparation activity must be allocated between the activities on a reasonable basis.³

Example: In 2014, Asher a single taxpayer has adjusted gross income of \$100,000. His deductible mortgage interest and property taxes (regular itemized deductions) total \$4,000. In addition, Asher has unreimbursed employee business expenses of \$2,500. Because unreimbursed employee business expenses are miscellaneous itemized deductions, they are deductible and added to the total of Asher’s other regular itemized deductions only to extent they exceed 2 percent of his adjusted gross income. In this case, Asher’s miscellaneous itemized deductions of \$2,500 exceed \$2,000 (2 percent of adjusted gross income) by \$500. As a result, Asher’s total itemized deductions would be \$4,500 (\$4,000 plus \$500). However, because the standard deduction for a single filer is \$6,200, Asher would deduct the higher standard deduction amount.

A taxpayer may not avoid the treatment of an item that would be a miscellaneous itemized deduction by virtue of it passing through to him or her through an entity such as a partnership or S corporation.⁴

Example: Ashley is a 50 percent partner in a partnership engaging in an activity for the production of income. In 2014, Ashley’s allocable share of section 212 production of income deductible expenses is \$200. Even though Ashley did not directly incur that expense, she must treat the \$200 deductible items as a miscellaneous itemized deduction. Thus, she must add the \$200 to all her other miscellaneous deductions to determine whether the aggregate amount of those items exceed 2 percent of her adjusted gross income.⁵

8525. Are the itemized deductions of high-income taxpayers subject to phase-out?

Yes. The aggregate of most itemized deductions is reduced dollar-for-dollar by the lesser of (1) 3 percent of the individual’s adjusted gross income that exceeds \$254,200 for a single filer (\$305,050 in the case of a married taxpayer filing jointly, \$279,650 for heads of household, and \$152,525 for married taxpayers filing separately) or (2) 80 percent of the amount of such itemized deductions otherwise allowable for the taxable year.⁶ The threshold income levels for determining the phaseout are adjusted annually for inflation.⁷

1. Temp. Treas. Reg. §1.67-1T(a)(1).

2. IRC Sec. 67(a).

3. Temp. Treas. Reg. §1.67-1T(c).

4. IRC Sec. 67(c)(1); Temp. Treas. Reg. §1.67-2T.

5. Temp. Treas. Reg. §1.67-2T(b)(2) Example.

6. IRC Sec. 68(a).

7. IRC Sec. 68(b); as amended by ATRA, Sec. 101(2)(b); Rev. Proc. 2008-66, 2008-45 IRB 1107; Rev. Proc. 2013-35, 2013-47 IRB 537.

The phase-out of the value of itemized deductions is not applicable to medical expenses deductible under IRC Section 213, investment interest deductible under IRC Section 163(d), or certain casualty loss deductions.¹ The limitation also is not applicable to estates and trusts.² For purposes of certain other calculations, such as the limits on deduction of charitable contributions or the 2 percent floor on miscellaneous itemized deductions, the limitations on each separate category of deductions are applied *before* the overall ceiling on itemized deductions is applied.³ The deduction limitation is not taken into account in the calculation of the alternative minimum tax.⁴

8526. What types of interest are deductible?

Whether or not interest is deductible depends on its classification as one of the following types of interest: (1) investment interest, (2) trade or business interest, (3) qualified residence interest, (4) interest relating to passive activities, (5) interest incurred on extended payment of estate tax, (6) interest on education loans or (7) personal interest. The deductibility of these seven types of interest is discussed in detail in Q 8527 to Q 8533.

The proper allocation of interest generally depends on the use to which the loan proceeds are put, except in the case of certain qualified residence interest. Detailed rules for classifying interest by tracing the use of loan proceeds are contained in temporary regulations.⁵

In some cases, the Code may specifically disallow the deductibility of interest. For example, no deduction is allowed for interest paid on a loan used to buy or carry tax-exempt securities.⁶ The rationale for the disallowance is to prevent the taxpayer from receiving an unwarranted double tax benefit. (first, the exclusion of the interest from gross income; and, second, a deduction for the interest on a loan used to purchase the underlying tax-exempt security).

Interest expense that is deductible under the rules outlined in Q 8527 to Q 8533 may also be subject to the additional limitations on itemized deductions (unless it is investment interest, which is not subject to that provision). See Q 8524 for a discussion of the limits on itemized deductions.

8527. What are the rules for the deductibility of investment interest by an individual taxpayer?

Any interest expense on indebtedness properly allocable to property held for investment is classified as investment interest.⁷ However, there is a limitation as investment is deductible to the extent of net investment income. Any excess is carried forward to subsequent tax years subject to the same terms and conditions. Net investment income is investment income less

1. IRC Sec. 68(c).

2. IRC Sec. 68(e).

3. IRC Sec. 68(d).

4. IRC Sec. 56(b)(1)(F).

5. See Temp. Treas. Reg. §1.163-8T.

6. IRC Sec. 265.

7. IRC Sec. 163(d)(3).

investment expenses (other than interest). Investment income is income from property held for investment such as interest, dividends, annuity income and royalties.¹

Example: In 2014, Asher has net investment income of \$7,500 and investment interest of \$10,000. Because the deductibility of investment interest is limited to net investment income, only \$7,500 of the \$10,000 of investment interest is deductible. The excess disallowed investment interest of \$2,500 is carried forward to subsequent years.²

Excluded from the definition of investment income is net long-term capital gain and “qualified dividends.” These types of income are taxed at a maximum rate of 15 percent or 20 percent depending on the taxpayer’s overall income (i.e., the 20 percent rate applies to high income taxpayers). On the other hand, other types of investment income such as non-qualified dividends, interest income, etc. are taxed at ordinary income rates (up to 39.6 percent). However, if a taxpayer elects to treat long-term capital gains or qualified dividends as ordinary income (waives the application of the 15 percent and 20 percent maximum rates), that income does count as investment income.

Example: Same as the above example, except that Asher has a combined \$2,500 of qualified dividends and net long-term capital gain. If Asher makes an election waiving the 15 percent and 20 percent maximum rates with respect to that income (meaning it could be taxed to up to 39.6 percent), he may include it as investment income. If he does, Asher can deduct the full \$10,000 of investment interest because adding the \$2,500 of qualified dividends and net long-term capital gain to the \$7,500 of other net investment income, there would be a total offset.³

8528. What is deductible trade or business interest?

Trade or business interest, as the name suggests, includes any interest incurred in the conduct of a trade or business. So for example, if a taxpayer borrows funds for working capital in a trade or business, the interest payments would be deductible.

8529. What is deductible qualified residence interest?

Qualified residence interest is interest paid or accrued during the taxable year on debt that is secured by the taxpayer’s qualified residence and that is either (a) “acquisition indebtedness” (that is, debt incurred to acquire, construct or substantially improve the qualified residence, or any refinancing of such debt), or (b) “home equity indebtedness” (any other indebtedness secured by the qualified residence).

A “qualified residence” is the taxpayer’s principal residence and one other residence that is essentially a second home.⁴ A taxpayer may only treat an aggregate of \$1,000,000 as acquisition indebtedness (spread over the two residences), *but* the amount of refinanced debt that may be treated as acquisition indebtedness is limited to the amount of debt being refinanced. The aggregate amount that may be treated as “home equity indebtedness” (that is, borrowing against the

1. IRS Publication 530 (2013).

2. IRC Sec. 163(d).

3. IRC Sec. 1(h)(11)(D)(i).

4. IRC Sec. 164(h)(4)(A).

fair market value of the home, less the acquisition indebtedness to borrow against the “equity” in the home) is \$100,000,¹ or a combined maximum of \$1,100,000 of indebtedness.

Example: In 2012, Ashley and Asher, a married couple, purchase a principal residence for \$400,000 financed in part by a \$300,000 home acquisition loan. In 2014, pursuant to a refinancing they borrow \$350,000 to pay off the initial \$300,000 loan and the other \$50,000 to purchase two cars. Of the amount borrowed, only \$300,000 (the amount necessary to pay off the initial acquisition loan) is treated as acquisition debt. The other \$50,000 does not qualify as acquisition indebtedness. However, assuming the residence is worth \$400,000 (meaning there is \$100,000 of equity), the \$50,000 additional indebtedness would qualify as home equity indebtedness. As a result, the interest on the total indebtedness would be deductible as qualified residence interest.

8530. To what extent is the deductibility of interest limited by the application of the passive activity loss rules?

A passive activity is generally an activity that involves the conduct of a trade or business in which the taxpayer does not materially participate, or any rental activity.² Generally, the deductibility of passive expenses is limited to the amount of passive income. The excess, passive loss, is not deductible. Instead, it is carried over to subsequent tax years for potential deductibility against passive income generated in those years. The same rules apply to the deductibility of interest related to a passive activity. So the extent that otherwise deductible interest is related to a passive activity, some or all of the interest deduction Interest deductions that are allocated to passive activities may be similarly disallowed.³ See Q 8635 to Q 8644 for a detailed discussion of the passive loss rules.

8531. Is the interest on extended payments of estate tax deductible?

If an extension to pay Federal estate tax over a period of time is in effect, the interest portion of the payment is deductible.⁴

8532. Is the interest on education loans deductible?

An above-the-line deduction is available to certain taxpayers for interest paid on a “qualified education loan.”⁵ In 2014, the deduction is limited to \$2,500 of such interest. However, the deduction is phased out for taxpayers with modified AGI between \$65,000 and \$80,000 (\$130,000 and \$160,000 for joint returns). Certain other requirements must be met for the deduction to be available.⁶

8533. Is personal interest deductible?

Pursuant to IRC section 163(h)(1), all personal interest is deductible. However, in defining personal interest, all of the types of interest described Q 8527 through Q 8532 are not considered personal interest, and, thus, are deductible subject to the limitations discussed therein.

1. IRC Sec. 164(h)(3).

2. IRC Sec. 469.

3. IRC Sec. 469, Treas. Reg. §1.163-8T.

4. IRC Sec. 163(h)(2).

5. IRC Secs. 163(h)(2)(F), 221.

6. See IRC Sec. 221; Treas. Reg. §1.221-1.

Generally, non-deductible personal interest includes but is not limited to consumer credit card interest, car loans and interest on tax deficiencies.

8534. How much of a charitable contribution is deductible?

An individual who itemizes may take a deduction for certain contributions “to” or “for the use of” charitable organizations. A gift is made “to” a charitable organization if it is a direct gift of property to the charitable organization. An indirect contribution of an interest in property to a charity that does not result in a complete gift of the property itself is considered to be a contribution “for the use of” the charity. For example, a gift of an income interest in property, but not the underlying property itself, to charity is considered to be a gift “for the use of” the charity.¹ The term “for the use of” does not refer to a gift of the right to use property such as office space. Such a gift would generally be a nondeductible gift.

The amount that may be deducted by the taxpayer in any tax year is subject to the income percentage ceilings explained below. The amount of the contribution depends on whether it is a gift of money or property; and, if the latter, the type of property. Also, for any charitable gift, the type of charity is also relevant. These rules are explained in Q 8537 and Q 8538.

Charitable giving is discussed in detail in Q 8916 to Q 8930.

8535. What are the income percentage ceilings that limit the income tax deduction for charitable contributions?

50 percent ceiling. For a charitable contribution of money, an individual is allowed a charitable deduction of up to 50 percent of his or her adjusted gross income if made to the following types of organizations: churches, schools, hospitals or medical research organizations, organizations that normally receive a substantial part of their support from federal, state, or local governments or from the general public and that aid any of the above organizations, and federal, state, and local governments. Also included in this list is a limited category of private foundations (private operating foundations and conduit foundations²) that generally direct their support to public charities.³ The above organizations are often referred to as “public charities” or “50-percent-type charitable organizations.”

Thus, a monetary contribution to a public charity is limited to 50 percent of adjusted gross income. The excess amount is carried over for a period of 5 years subject to the same limitations. Any amount of a charitable contribution not deducted within that time period is lost.⁴

Example: In 2014, Asher made a monetary charitable contribution of \$30,000 to a public charity. Asher’s adjusted gross income is \$50,000. Due to the 50 percent ceiling, Asher’s contribution is limited to \$25,000 (50 percent of \$50,000). The remaining \$5,000 is carried over to the next year subject to the same limitations for up to 5 years.

1. See Treas. Reg. §1.170A-8(a)(2).

2. See IRC Sec. 170(b)(1)(E).

3. IRC Sec. 170(b)(1)(A).

4. IRC Sec. 170(d).

30 percent ceiling. For a charitable contribution of money to a private foundation, the amount of the contribution is limited to 30 percent of the taxpayer's adjusted gross income. See Q 8538 for the definition of a private foundation.

8536. What are the rules to determine the income percentage ceilings for monetary charitable contributions to public charities and private foundations in the same tax year?

The combined monetary contributions to public charities and private foundations can never be more than 50 percent of adjusted gross income. Within the 50 percent ceiling the deductible charitable contribution to a private foundation cannot be more than 30 percent. The application of this rule by the following example:

Example: In 2014, Asher contributes \$70,000 to a public charity and \$50,000 to a private foundation. His adjusted gross income is \$180,000.

Step 1 – Compute the limitation the charitable deduction to the public charity.

If the charitable contribution to the public charity was equal or greater than 50 percent of adjusted gross income, this would be the end of the computation as the amount of the charitable contribution to the public charity in excess of 50 percent of adjusted gross income plus the full amount of the charitable contribution to the private foundation would not be deductible. Instead, those amounts would be carried forward into subsequent tax years.

In this case, Asher's \$70,000 charitable contribution to the public charity is less than \$90,000, or 50 percent of his \$180,000 of adjusted gross income. Thus, the entire \$70,000 charitable contribution is deductible.

Step 2 – Compute the charitable contribution deduction to the private foundation.

Since the maximum amount deductible is 50 percent of adjusted gross income, after the Step 1 public charity deduction of \$70,000 there remains only \$20,000 of potentially deductible charitable contributions to the private foundation. So in computing how much of Asher's \$50,000 contribution to a private foundation is deductible, it can be no greater than the lesser of \$20,000 or 30 percent of his adjusted gross income of \$54,000. Since \$20,000 is the lesser amount, \$20,000 of Asher's \$50,000 private foundation charitable contribution is deductible. The remaining \$30,000 is not currently deductible and must be carried over into the next tax year subject to the same rules for up to 5 subsequent tax years.¹

8537. How does the character of property donated to charity (long-term capital gain property, tangible personal property, S corporation stock, partial interests in property) impact the income tax deduction allowed to the taxpayer?

If an individual makes a charitable contribution to a public charity (see Q 8534) of property that, if sold, would have resulted in long-term capital gain (other than certain tangible personal property, see below), the taxpayer is generally entitled to deduct the full fair market value of the property, but the deduction will be limited to 30 percent of adjusted gross income.²

1. IRC Sec. 170(b)(1)(B)(i).

2. IRC Sec. 170(b)(1)(C).

Long-term capital gain property. “Long-term capital gain” means “gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.”¹

Example: Asher owns raw land he purchased 5 years ago for \$100,000. The fair market value of the land is \$500,000. If Asher were to sell the land, he would recognize \$400,000 long-term capital gain. Because the land is long-term capital gain property, if Asher contributes the land to a public charity, he would be entitled to a \$500,000 charitable deduction. However, the amount deductible would be limited to 30 percent of his adjusted gross income.

If any portion of a gift of long-term capital gain property to a public charity is disallowed as a result of the adjusted gross income ceiling, the taxpayer may carry the deduction over for five years subject to the same 30 percent ceiling.²

In lieu of a full fair market value contribution of property subject to the 30 percent ceiling, a taxpayer may elect to take a lesser contribution of the property’s basis subject to the 50 percent ceiling. Once made, such an election applies to all contributions of capital gain property during the taxable year (except unrelated use gifts of appreciated tangible personal property, as explained below). The election is generally irrevocable for the year in which it is made.³

Example: Asher owns raw land he purchased 5 years ago for \$100,000. The fair market value of the land is \$500,000. If Asher were to sell the land, he would recognize \$400,000 long-term capital gain. Because the land is long-term capital gain property, if Asher contributes the land to a public charity, he would be entitled to a \$500,000 charitable deduction. However, if Asher elects to limit his charitable deduction to \$100,000 (the land’s basis), the amount deductible would be 50 percent of his adjusted gross income.

See Q 8538 for the rules regarding contribution of property to private foundations.

Tangible Personal Property. The treatment of a contribution of appreciated tangible personal property (i.e., property which, if sold, would generate long-term capital gain) depends on whether the use of the property is related or unrelated to the purpose or function of the (public or governmental) organization. If the property is related use property (e.g., a contribution of a painting to a museum), generally the full fair market value is deductible, subject to the 30 percent ceiling. However, if the property is unrelated to the purpose or function of the charity, the deduction is generally limited to the donor’s adjusted basis.⁴

Other Gifts of Property. The deduction for any charitable contribution of property is reduced by the amount of gain that would *not* be long-term capital gain if the property were sold at its fair market value at the time of the contribution.⁵ In other words, the amount of such gifts are limited to the basis in the property.

In the case of a gift of S corporation stock, special rules (similar to those relating to the treatment of unrealized receivables and inventory items under IRC Section 751) apply in

1. IRC Sec. 1222(3).

2. IRC Sec. 170(b)(1)(C)(ii).

3. IRC Sec. 170(b)(1)(C)(iii); *Woodbury v. Comm.*, TC Memo 1988-272, *aff’d*, 90-1 USTC ¶150,199 (10th Cir. 1990).

4. IRC Secs. 170(e)(1)(B), 170(b)(1)(C); Treas. Reg. §1.170A-4(b).

5. IRC Sec. 170(e)(1)(A).

determining whether gain on such stock is long-term capital gain for purposes of determining the amount of a charitable contribution.¹

8538. What income tax deduction may a taxpayer take for making a charitable donation to an organization classified as a private foundation?

Most private foundations are family foundations subject to restricted contribution limits. Certain other private foundations (i.e., conduit foundations and private *operating* foundations), which operate much like public charities, are treated as public charities (see Q 8534).² A private foundation is a charitable organization other than an organization described in IRC Sections 509(a)(1) through 509(a)(4). More specifically, a private foundation is usually a charitable organization that is 1) funded from a limited group such as an individual, family or company; 2) its expenses tend to be paid from investment earnings rather than regular charitable contributions; and 3) under certain circumstances it makes contributions to other charitable organizations. The term “private foundations” as used under this heading refers to standard private (e.g., family) foundations.

The amount of the deduction for a contribution of appreciated property (tangible or intangible) contributed *to or for the use of* private foundations generally is limited to the donor’s adjusted basis. However, certain gifts of qualified appreciated stock made to a private foundation are deductible at their full fair market value.³

Qualified appreciated stock is generally publicly traded stock which, if sold on the date of contribution at its fair market value, would result in a long-term capital gain.⁴ Such a contribution will not constitute qualified appreciated stock to the extent that it exceeds 10 percent of the value of all outstanding stock of the corporation. Family attribution rules apply in reaching the 10 percent level.⁵ The IRS has determined that shares in a mutual fund can constitute qualified appreciated stock.⁶

Planning Point: Donor Advised Funds are an increasingly popular way for a donor to obtain more choice and control over how and when taxation occurs. A donor can wait to make a charitable contribution until the end of the calendar year, after the donor knows how much the donor wants (and is able) to deduct, make a gift to a public charity, and then decide the recipients of the donation at a future date.

Planning Point: From a tax perspective, it is not advisable to donate an investment with a taxable loss. This is because the transfer of loss property to a charity does not allow for the taxpayer to claim the loss. In this situation, the taxpayer should consider selling the investment in order to claim a taxable loss; and, then make a deductible charitable contribution of the proceeds from the sale.

1. IRC Sec. 170(e)(1).

2. See IRC Secs. 170(b)(1)(E), 170(b)(1)(A)(vii).

3. IRC Sec. 170(e)(5).

4. IRC Sec. 170(e)(5).

5. IRC Sec. 170(e)(5)(C).

6. Let. Rul. 199925029. See also Let. Rul. 200322005 (ADRs are qualified appreciated stock). Instruction for Form 8283 (Rev. December 2013).

8539. What substantiation requirements must a taxpayer satisfy in order to claim an income tax deduction for a charitable donation?

A taxpayer-donor is not entitled to a charitable deduction for a contribution of cash, check, or other monetary gift unless the donor maintains either a bank record or a written communication from the donee showing the name of the organization and the date and the amount of the contribution.¹

A taxpayer must substantiate a charitable contribution of \$250 or more (whether in cash or property) by a contemporaneous written acknowledgment of the contribution supplied by the charitable organization. The taxpayer is not required to provide substantiation if certain information is reported on a return filed by the charitable organization.² (An organization can provide the acknowledgement electronically, such as in an e-mail addressed to the donor).³ Special rules apply to the substantiation and disclosure of quid pro quo contributions and contributions made by payroll deduction.⁴ A taxpayer must generally obtain a qualified appraisal for contributions of property that is difficult to value if the taxpayer claims a deduction of more than \$5,000 for the donation.⁵

A taxpayer is not entitled to a deduction for a contribution of clothing or household items unless the property is in new or good used condition. A deduction for a contribution of clothing or household items may be denied if the property has minimal monetary value. These rules do not apply to a contribution of a single item if the taxpayer claims a deduction of more than \$500 and includes a qualified appraisal with the return. Household items include furniture, furnishings, electronics, linens, appliances, and similar items; but not food, art, jewelry, and collections.⁶

Special rules apply to certain types of gifts, including charitable donations of patents and intellectual property, and for donations of used motor vehicles, boats, and airplanes.⁷

8540. When is an individual taxpayer entitled to a deduction for medical expenses?

A taxpayer who itemizes deductions can deduct unreimbursed expenses for “medical care” (the term “medical care” includes dental care) and expenses for *prescribed* drugs or insulin for himself, spouse and dependents. The deduction is only allowed to the extent that such expenses exceed 10 percent of adjusted gross income for the tax year. (On a joint return, the 10 percent floor amount is based on the combined adjusted gross income of husband and wife).

To determine whether the taxpayer is entitled to a deduction, the taxpayer first determines net unreimbursed expenses by subtracting all reimbursements received during the year from

1. IRC Sec. 170(f)(17).

2. IRC Sec. 170(f)(8).

3. IRS Pub. 1771 (March 2008), p. 6.

4. Treas. Regs. §§1.170A-13(f), 1.6115-1.

5. IRC Sec. 170(f)(11).

6. IRC Sec. 170(f)(16).

7. See IRC Secs. 170(e)(1)(B), 170(f)(11), 170(f)(12), 170(m); Notice 2005-44, 2005-25 IRB 1287.

total expenses for medical care paid during the year. The taxpayer must then subtract 10 percent of the taxpayer's adjusted gross income from net unreimbursed medical expenses. Only the balance, if any, is deductible.¹ The deduction for medical expenses is not subject to the phase-out in itemized deductions for certain upper income taxpayers. (See Q 8524).

Though the 7.5 percent threshold increased to 10 percent in 2013, taxpayers can continue to use the 7.5 percent threshold through 2016 if the taxpayer or the taxpayer's spouse has attained age 65 before the end of the taxable year.

"Medical care" is defined as amounts paid: (a) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (b) for transportation primarily for and essential to such medical care; (c) for qualified long-term services; or (d) for insurance covering such care or for any qualified long-term care insurance contract.²

The IRS has ruled that amounts paid for diagnostic and certain similar procedures and devices are deductible medical care expenses, provided that they are not compensated by insurance or otherwise, even though the individuals had no symptoms of illness prior to incurring the expense. According to the IRS, this includes an annual physical examination, a full-body electronic scan and a pregnancy test.³

The term "medical care" does not include cosmetic surgery or other similar procedures unless necessary to correct a deformity resulting from a congenital abnormality, a personal injury resulting from accident or trauma, or a disfiguring disease.⁴ Despite this general rule, in *Al-Murshidi v. Comm.*,⁵ the surgical removal of excess skin from a formerly obese individual was not found to be "cosmetic surgery" for purposes of IRC Section 213(d)(9)(A) because the procedures meaningfully promoted the proper function of the individual's body and treated her disease. Therefore, the costs of the surgical procedures were deductible despite the "cosmetic surgery" classification given to the procedures by the surgeon.

A taxpayer can deduct the medical expenses paid for a dependent (within the specified limits) even though the taxpayer is not entitled to a dependency exemption. The fact that the dependent's income for the year exceeds \$3,950 is immaterial so long as the taxpayer has furnished over one-half of his support during that tax year. A child of parents who are divorced (or in some situations, separated) and who between them provide more than one-half of the child's support for the calendar year and have custody of the child for more than one-half of the calendar year will be treated as a dependent of both parents for purposes of this deduction.⁶ In the case of a multiple support agreement, however, only the person designated to take the dependency exemption may deduct the dependent's medical expenses, and then only to the extent that he

1. IRC Sec. 213.

2. IRC Sec. 213(d)(1).

3. Rev. Rul. 2007-72, 2007-50 IRB 1154.

4. IRC Sec. 213(d)(9); see, e.g., Let. Rul. 200344010.

5. TC Summary Opinion 2001-185.

6. IRC Sec. 213(d)(5).

actually paid the expenses.¹ See Q 8518 for a discussion of which parent is entitled to take the dependency exemption.

Deductible medical expenses include amounts paid for lodging, up to \$50 per individual per night, when being away from home is *primarily for and essential to* medical care if such care is provided by a physician in a licensed hospital (or similar medical care facility) and there is no element of personal pleasure, recreation or vacation in the travel away from home. No deduction is allowed if the lodgings are “lavish or extravagant.”² A mother was permitted to deduct lodging expenses incurred when her child was receiving medical care away from home and her presence was essential to such care.³ A parent’s costs of attending a medical conference (i.e., registration fee, transportation costs) to obtain information about a chronic disease affecting the parent’s child were deductible so long as the costs were primarily for and essential to the medical care of the dependent. However, the costs of meals and lodging incurred by the parent while attending the conference were not deductible.⁴ The IRS has privately ruled that taxpayers could deduct special education tuition for their children as a medical care expense where the children attended a school primarily to receive medical care in the form of special education and each child had been diagnosed as having a medical condition that handicapped the child’s ability to learn in the years in which tuition was paid.⁵

Generally, medical expenses are deductible only in the year they are paid, regardless of when the expenses are incurred. Despite this, in *Zipkin v. U.S.*, expenses incurred by a taxpayer to build a home to meet his wife’s special health needs were properly deducted in the year the home became habitable, even though the costs had been paid in earlier years.⁶ Costs paid by parents to modify a van used to transport their handicapped child were deductible in the year those costs were paid; however, the court held that depreciation was not a deductible medical expense.⁷

Medical expenses of a decedent paid out of the estate within one year from date of death are considered paid by the decedent at the time the expenses were incurred.⁸ A decedent’s medical expenses cannot be taken as an income tax deduction unless a statement is filed waiving the right to deduct them for estate tax purposes. Amounts that are not deductible under IRC Section 213 may not be treated as deductible medical expenses for estate tax purposes. Thus, expenses that do not exceed the 10 percent floor are not deductible.⁹

The Social Security hospital tax that an individual pays as an employee or self-employed person cannot be deducted as a medical expense.¹⁰ Conversely, a 65-year-old who has signed up for the supplementary medical plan under Medicare can treat his monthly premiums as amounts

1. Treas. Reg. §1.213-1(a)(3)(i).

2. IRC Sec. 213(d)(2).

3. Let. Rul. 8516025.

4. Rev. Rul. 2000-24, 2000-19 IRB 963.

5. See Let. Rul. 200521003. See also Let. Rul. 200729019.

6. 2000-2 USTC ¶50,863 (D. Minn. 2000).

7. *Henderson v. Comm.*, TC Memo 2000-321.

8. IRC Sec. 213(c).

9. Rev. Rul. 77-357, 1977-2 CB 328.

10. See IRC Sec. 213(d).

paid for insurance covering medical care.¹ Premiums paid for Medicare Part D, the voluntary prescription drug insurance program that went into effect on January 1, 2006, are included in the definition of medical expenses.²

The unreimbursed portion of an entrance fee for life care in a residential retirement facility that is allocable to future medical care is also deductible as a medical expense in the year paid (but, if the resident leaves the facility and receives a refund, the refund is includable in gross income to the extent it is attributable to the deduction previously allowed).³ Either the percentage method or the actuarial method may be used to calculate the portions of monthly service fees (paid for lifetime residence in a continuing care retirement community) allocable to medical care.⁴ Despite this, a federal district court held that none of the entrance fee paid by married taxpayers to an assisted living facility was properly deductible as a medical expense because: (1) no portion of the entrance fee was attributable to the couple's medical care; and (2) the entrance fee was structured as a loan, which cannot serve as the basis for a deduction (the court cited *Comm. v. Tufts* in reaching this conclusion⁵).⁶

Amounts paid by an individual for medicines and drugs that can be purchased over-the-counter (without a doctor's prescription) are not deductible.⁷ However, amounts paid by an individual for equipment (e.g., crutches), supplies (e.g., bandages), or diagnostic devices (e.g., blood sugar test kits) may qualify as amounts paid for medical care and may be deductible under IRC Section 213. The IRS has ruled privately that crutches used to mitigate the effect of the taxpayer's injured leg and blood sugar test kits used to monitor and assist in treating the taxpayer's diabetes were amounts paid for medical care and deductible.⁸

The costs of nutritional supplements, vitamins, herbal supplements, and "natural medicines" cannot be included in medical expenses unless they are recommended by a doctor as treatment for a specific medical condition diagnosed by a doctor.⁹ Certain expenses for smoking cessation programs and products are deductible as a medical expense.¹⁰

Amounts paid by individuals for breast reconstruction surgery following a mastectomy for cancer and for vision correction surgery are medical care expenses and are deductible. Amounts paid by individuals to whiten teeth discolored as a result of age are not medical care expenses and are not deductible.¹¹

Costs paid by individuals for participation in a weight-loss program as treatment for a specific disease or diseases (e.g., obesity, hypertension, or heart disease) diagnosed by a physician

1. Rev. Rul. 66-216, 1966-2 CB 100.

2. See IRS Pub. 502, Medical and Dental Expenses.

3. Rev. Rul. 76-481, 1976-2 CB 82, as clarified by Rev. Rul. 93-72, 1993-2 CB 77; Let. Rul. 8641037.

4. *Baker v. Comm.*, 122 TC 143 (2004).

5. 461 U.S. 300, 307 (1983).

6. *Finzer v. United States*, 496 F. Supp. 2d 954 (N.D. Ill. 2007).

7. Rev. Rul. 2003-58, 2003-22 IRB 959.

8. Rev. Rul. 2003-58, above; see also IRS Information Letter INFO-2003-169 (6-13-2003).

9. IRS Pub. 502, Medical and Dental Expenses.

10. See Rev. Rul. 99-28, 1999-25 IRB 6.

11. Rev. Rul. 2003-57, 2003-22 IRB 959.

are deductible as medical expenses. Conversely, the costs of diet food are not deductible.¹ According to IRS Publication 502, this includes fees paid by a taxpayer for membership in a weight reduction group and attendance at periodic meetings. Membership dues for a gym, health club, or spa cannot be included in medical expenses, but separate fees charged for weight loss activities can be included as medical expenses. In informational guidance, the IRS has also stated that taxpayers may deduct exercise expenses, including the cost of equipment to use in the home, if required to treat an illness (including obesity) diagnosed by a physician. For an exercise expense to be deductible, the taxpayer must establish the purpose of the expense is to treat a disease rather than to promote general health, and that the taxpayer would not have paid the expense but for this purpose.²

Expenses for childbirth classes were deductible as a medical expense to the extent that the class prepared the taxpayer for an active role in the process of childbirth.³ Egg donor fees and expenses incurred in the process of obtaining a willing egg donor count as medical care expenses that are deductible.⁴

Finally, the cost of prescribed drugs brought in or shipped from another country is deductible only if imported legally. Additionally, the cost of prescribed drugs purchased and consumed in another country are also deductible provided the drug is legal in both the other country and the United States.⁵

Credits

8541. What is a refundable tax credit and what are some examples?

On Form 1040, after the amount of tax owed is computed, the taxpayer is entitled to subtract certain payments and credits from the tax to arrive at the amount of tax that is actually payable.

Refundable credit is a tax credit that can result in a refund or credit even if the taxpayer owes no tax or it exceeds the amount of tax owing. The refundable credits include:

- ... Taxes withheld from salaries and wages.⁶
- ... Overpayments of tax.⁷
- ... The excess of Social Security withheld (two or more employers).⁸
- ... The earned income credit.⁹

1. Rev. Rul. 2002-19, 2002-16 IRB 778.

2. Information Letter INFO 2003-0202.

3. Let. Rul. 8919009.

4. Let. Rul. 200318017; see also Information Letter INFO 2005-0102 (3-29-2005).

5. IRS Publication. 502.

6. IRC Sec. 31(a).

7. IRC Sec. 35.

8. Treas. Reg. §1.31-2.

9. IRC Sec. 32.

...The 72.5 percent health care tax credit for uninsured workers displaced by trade competition.¹

...The unused long-term minimum tax credit.

Example: In 2014, Ashley, a single mother is entitled to an earned income tax credit of \$3,500. Her income tax liability before the application of the credit is \$1,000. Other than the earned income tax credit, Ashley has no other credits. Because the earned income credit is a refundable credit, Ashley is entitled to a refund of \$2,500 (\$3,500 credit minus \$1,000 tax liability).

8542. How does a nonrefundable tax credit work and what are some examples?

A nonrefundable credit is a credit that is limited by the amount of the taxpayer's tax liability for the year. A taxpayer is only entitled to claim nonrefundable tax credits to the extent that the combined amount of the credits does not exceed total income tax liability for the tax year. So unlike refundable credits (Q 8541), a nonrefundable credit can never result in a refund or credit.

However, because certain nonrefundable credits in excess of a taxpayer's tax liability for a tax year may be carried forward into future tax years (and others cannot be carried over), it is important to consider the order in which a taxpayer claims the nonrefundable credits.² The American Taxpayer Relief Act of 2012 (ATRA) extended many expiring credits for 2012 and 2013 (as indicated below). As of the date of this publication, however, Congress has yet to act in order to extend most of these credits for 2014 and beyond.

The following tax credits are classified as *nonrefundable credits*:

...Personal credits which consist of the child and dependent care credit;³ the credit for the elderly and the permanently and totally disabled,⁴ the qualified adoption credit,⁵ the nonrefundable portion of the child tax credit,⁶ the American Opportunity (extended under ATRA through 2017), Hope Scholarship, and Lifetime Learning credits,⁷ the credit for elective deferrals and IRA contributions (the "saver's credit," which became permanent under PPA 2006);⁸

...The nonbusiness energy property credit (retroactively extended under ATRA for 2012 and 2013)⁹; and the residential energy efficient property credit;¹⁰

...Other nonbusiness credits;¹¹

1. IRC Sec. 35.

2. See, for example, IRC Secs. 23 (adoption expense credit), 25 (mortgage interest credit) and 25D (residential energy efficient property credit) for examples of nonrefundable credits that may be carried over to succeeding tax years.

3. IRC Sec. 21.

4. IRC Sec. 22.

5. IRC Sec. 23.

6. See IRC Sec. 24.

7. IRC Sec. 25A, as amended by ATRA, Sec. 103.

8. IRC Sec. 25B.

9. IRC Sec. 25C, as amended by ATRA, Sec. 401.

10. IRC Sec. 25D.

11. See e.g., IRC Secs. 53, 901.

... The general business credit is the sum of the following credits determined for the taxable year: (1) the investment credit determined under IRC Section 46 (including the rehabilitation credit); (2) the work opportunity credit determined under IRC Section 51(a) (retroactively extended under ATRA for 2012 and 2013); (3) the alcohol fuels credit determined under IRC Section 40(a); (4) the research credit (retroactively extended under ATRA for 2012 and 2013) determined under IRC Section 41(a); (5) the low-income housing credit determined under IRC Section 42(a); (6) the enhanced oil recovery credit under IRC Section 43(a); (7) in the case of an eligible small business, the disabled access credit determined under IRC Section 44(a); (8) the renewable electricity production credit under IRC Section 45(a) (extended only through 2009 under EIEA 2008); (9) the empowerment zone employment credit determined under IRC Section 1396(a) (retroactively extended under ATRA for 2012 and 2013); (10) the Indian employment credit as determined under IRC Section 45A(a) (retroactively extended under ATRA for 2012 and 2013); (11) the employer Social Security credit determined under IRC Section 45B(a); (12) the orphan drug credit determined under IRC Section 45C(a); (13) the new markets tax credit determined under IRC Section 45D(a) (retroactively extended under ATRA for 2012 and 2013); (14) in the case of an eligible employer (as defined in IRC Section 45E(c)); the small employer pension plan startup cost credit determined under IRC Section 45E(a); (15) the employer-provided child care credit determined under IRC Section 45F(a); (16) the railroad track maintenance credit determined under IRC Section 45G(a) (retroactively extended under ATRA for 2012 and 2013); (17) the biodiesel fuels credit determined under IRC Section 40A(a) (retroactively extended under ATRA for 2012 and 2013); (18) the low sulfur diesel fuel production credit determined under IRC Section 45H(a); (19) the marginal oil and gas well production credit determined under IRC Section 45I(a); (20) for tax years beginning after September 20, 2005, the distilled spirits credit determined under IRC Section 5011(a); (21) for tax year beginning after August 8, 2005, the advanced nuclear power facility production credit determined under IRC Section 45J(a); (22) for property placed in service after December 31, 2005, the nonconventional source production credit determined under IRC Section 45K(a); (23) the energy efficient home credit determined under IRC Section 45L(a) (extended through 2013); (24) the energy efficient appliance credit determined under IRC Section 45M(a) (extended through 2013); (25) the portion of the alternative motor vehicle credit to which IRC Section 30B(g)(1) applies; and (26) the portion of the alternative fuel vehicle refueling property credit to which IRC Section 30C(d)(1) applies (extended through 2013).¹

A credit was also available for new qualified plug-in electric drive motor vehicles acquired and placed in service after 2009. The amount of the credit can vary from \$2,500 to \$7,500 depending on battery capacity (and subject to phase-out based on number of vehicles sold by the manufacturer). The portion of the credit attributable to property of a character subject to

1. IRC Sec. 38(b).

an allowance for depreciation is treated as part of the general business credit. The balance of the credit is generally treated as a nonrefundable personal credit.¹ An alternative credit is available for certain plug-in electric cars placed in service after February 17, 2009 and before 2014 (retroactively extended under ATRA for 2012 and 2013). This credit is equal to 10 percent of cost, up to \$2,500.²

8543. Who qualifies for the tax credit for the elderly and the permanently and totally disabled and how is the credit computed?

The tax credit for the elderly and the permanently and totally disabled is a nonrefundable credit, meaning that it is available only to the extent that it does not exceed the taxpayer's tax liability (see Q 8542). The credit is available to taxpayers age 65 or older, or those who are under age 65, retired on disability, and were considered permanently and totally disabled when they retired.³

"An individual is permanently and totally disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months. An individual shall not be considered to be permanently and totally disabled unless he furnishes proof of the existence thereof in such form and manner, and at such times, as the Secretary may require."⁴

The credit equals 15 percent of an individual's IRC Section 22 amount for the taxable year, but may not exceed the amount of tax. This IRC Section 22 base amount is \$5,000 for a single taxpayer or married taxpayers filing jointly if only one spouse qualifies for the credit; \$7,500 for married taxpayers filing jointly if both qualify; and \$3,750 for a married taxpayer filing separately.⁵ Married taxpayers must file a joint return to claim the credit, unless they lived apart for the entire taxable year.⁶

For individuals under age 65, this base figure is limited to the amount of the disability income (taxable amount an individual receives under an employer plan as wages or payments in lieu of wages for the period the individual is absent from work on account of permanent and total disability) received during the taxable year.⁷ (The taxpayer may be required to provide proof of continuing permanent and total disability.)⁸ For married taxpayers who are both qualified and who file jointly, the base figure cannot exceed the total of both spouses' disability income if both are under age 65. If only one spouse is under age 65, the base figure cannot exceed the sum of \$5,000 plus the disability income of the spouse who is under 65.⁹

1. IRC Sec. 30D, as amended by ARRA 2009.

2. IRC Sec. 30, as amended by ARRA 2009 and ATRA.

3. IRC Sec. 22(b).

4. IRC Sec. 22(c)(3).

5. IRC Sec. 22(c).

6. IRC Sec. 22(e)(1).

7. IRC Sec. 22(c)(2)(B)(i).

8. GCM 39269 (8-2-84).

9. IRC Sec. 22(c)(2)(B)(ii).

The base figure (or the amount of disability income in the case of individuals under age 65, if lower) is reduced dollar-for-dollar by one-half of adjusted gross income in excess of \$7,500 (single taxpayers), \$10,000 (joint return), or \$5,000 (married filing separately).¹ A reduction is also made for Social Security and railroad retirement benefits that are excluded from gross income, and certain other tax-exempt income.²

8544. Who qualifies for the child tax credit?

The child tax credit is generally a nonrefundable tax credit that is available for each “qualifying child” (defined below) of eligible taxpayers who meet certain income requirements. The child tax credit may be refundable to the extent that the taxpayer has three or more qualifying children or for a certain portion of the taxpayer’s earned income (see below). The child tax credit is \$1,000 per child.³

The term *qualifying child* means a “qualifying child” of the taxpayer (as defined under IRC Section 152(c) – see below) who has not attained the age of 17;⁴ and

- (1) who is the taxpayer’s “child” (see below) or a descendant of such a child, or the taxpayer’s brother, sister, stepbrother, or stepsister or a descendant of any such relative;
- (2) who has the same principal place of abode as the taxpayer for more than one-half of the taxable year; *and*
- (3) who has not provided over one-half of his or her own support for the calendar year in which the taxpayer’s taxable year begins.⁵

Additionally, a qualifying child must be either a citizen or a resident of the United States.⁶

The term “child” means an individual who is: (1) a son, daughter, stepson, or stepdaughter of the taxpayer; or (2) an “eligible foster child” of the taxpayer.⁷ An “eligible foster child” means 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.⁸ Any adopted children of the taxpayer are treated the same as natural born children.⁹

The amount of the credit is reduced for taxpayers whose modified adjusted gross income (MAGI) exceeds certain levels. A taxpayer’s MAGI is adjusted gross income without regard to the exclusions for income derived from certain foreign sources or sources within United States possessions. The credit amount is reduced by \$50 for every \$1,000 or fraction

1. IRC Sec. 22(d).

2. IRC Sec. 22(c)(3).

3. IRC Sec. 24(a).

4. IRC Sec. 24(c)(1).

5. IRC Sec. 152(c).

6. IRC Sec. 24(c)(2).

7. IRC Sec. 152(f)(1).

8. IRC Sec. 152(f)(1)(C).

9. IRC Sec. 152(f)(1)(B).

thereof, by which the taxpayer's MAGI exceeds the following threshold amounts: \$110,000 for married taxpayers filing jointly, \$75,000 for unmarried individuals, and \$55,000 for married taxpayers filing separately.¹

The child tax credit is also refundable. If the child tax credit exceeds the taxpayer's tax liability, a taxpayer with one or two children can receive a refund of the lesser of the unused amount of the credit or 15 percent of earned income in excess of \$3,000.² For families with three or more qualifying children, the amount of the refundable credit is the greater of 15 percent of earned income over \$3,000 or the sum of social security and Medicare taxes paid minus the earned income credit.

The nonrefundable child tax credit can be claimed against the individual's regular income tax *and* alternative minimum tax (see Q 8551 and Q 8553). The tax credit cannot exceed the excess of (i) the sum of the taxpayer's regular tax plus the alternative minimum tax over (ii) the sum of the taxpayer's nonrefundable personal credits (other than the child tax credit, adoption credit, and saver's credit) and the foreign tax credit for the taxable year.³ Finally, the refundable child tax credit is not required to be reduced by the amount of the taxpayer's alternative minimum tax.⁴

Some additional restrictions applying to the child tax credit include: (1) an individual's tax return must identify the name and taxpayer identification number (Social Security number) of the child for whom the credit is claimed; and (2) the credit may be claimed only for a full taxable year, unless the taxable year is cut short by the death of the taxpayer.⁵

For purposes of applying a uniform method of determining when a child attains a specific age, the IRS has ruled that a child attains a given age on the anniversary of the date that the child was born (e.g., a child born on January 1, 1987, attains the age of 17 on January 1, 2004).⁶

Social Security

8545. Are social security and railroad retirement benefits taxable?

A taxpayer must include a portion of benefits in gross income if the taxpayer's modified adjusted gross income (in most cases the taxpayer's adjusted gross income) plus one-half of the Social Security benefits (including tier I railroad retirement benefits) received during the taxable year exceeds certain base amounts. The amounts that are required to be included in gross income are taxed as ordinary income. The more income the taxpayer has in addition to Social Security benefits, the greater the amount of those benefits are taxable. However, the amount of benefits taxable can never exceed 85 percent of the total benefits.

To calculate the extent to which social security benefits are taxable, add one half of Social Security benefits received during the tax year to all other income including wages, interest

1. IRC Sec. 24(b)(2).

2. IRC Sec. 24(d).

3. IRC Sec. 24(b)(3).

4. IRC Sec. 24(d)(1).

5. IRC Secs. 24(e), 24(f).

6. Rev. Rul. 2003-72, 2003-2 CB 346.

(including tax exempt interest), dividends, taxable pension distributions, etc. (modified adjusted gross income).¹ Next, compare that amount with the base amount which are the following:

- \$25,000 for single, head of household or qualifying widow
- \$25,000 for married filing separately and living apart from other spouse for the entire tax year
- \$32,000 for married filing jointly
- \$0 for married filing separately and living with his or her spouse any time during the tax year²

If the modified adjusted gross income plus one half of Social Security benefits is equal or less than the base amount, no portion of the Social Security benefits are taxable.

On the other hand, if the sum of modified adjusted gross income plus one half of Social Security benefits exceeds the base amount, then a portion of those benefits are potentially taxable. The computation, however, involves the “adjusted base amount” which is the following:

- \$34,000 for all filers with the exception of joint filers and a married taxpayer filing separately and living with his or her spouse any time during the tax year.
- \$44,000 for joint filers.
- \$0 for married taxpayer filing separately and living with his or her spouse any time during the taxable year.³

If the sum of modified adjusted gross income plus one half of Social Security benefits is *greater than* the base amount but *less than* the adjusted base amount, the amount included in gross income is the lesser of 1) one-half of the Social Security benefits received during the tax year; or 2) one-half of the excess of the sum of modified adjusted gross income plus one half of Social Security benefits exceeds the base amount (referred to as the “Section 86(a)(1) Amount”).⁴

Example: Married couple files a joint return. During the taxable year, they received \$12,000 in Social Security benefits and have a modified adjusted gross income of \$35,000. Their modified adjusted gross income plus one-half of their Social Security benefits [$\$35,000 + (\frac{1}{2} \text{ of } \$12,000) = \$41,000$] is greater than the *base amount* of \$32,000 but less than the *adjusted base amount* of \$44,000.

So in computing the taxable amount of Social Security benefits, consider the following: The taxpayers’ Social Security benefits are \$12,000 and the excess between modified adjusted gross income plus one-half of their Social Security benefits over the base amount is

1. IRC Sec. 86(b)(2).

2. IRC Sec. 86(c)(1).

3. IRC Sec. 86(c)(2).

4. IRC Sec. 86(a)(1).

\$9,000 (\$41,000 minus \$32,000). However, referring back to the formula, the amount includible is one-half of the lesser amount. Therefore, the amount of Social Security benefits included in gross income is \$4,500 (one half of \$9,000) because it is less than one 6,000 (one-half of the \$12,000 total Social Security benefits).

If the sum of modified adjusted gross income plus one half of Social Security benefits is *greater than* the adjusted base amount, the amount included in gross income is the lesser of the sum of 1) 85 percent of the amount of modified adjusted gross income over the adjusted base amount plus the lesser of (a) the Section 86(a)(1) Amount or b) one half of the difference between the adjusted base amount and the base amount) or 2) 85 percent of the Social Security benefits received during the tax year.

Example: During the taxable year, a single individual had a modified adjusted gross income of \$33,000 and received \$8,000 in Social Security benefits. His modified adjusted gross income plus one-half of his Social Security benefits [$\$33,000 + (\frac{1}{2} \text{ of } \$8,000) = \$37,000$] is greater than the applicable *adjusted base amount* of \$34,000.

So tracking the formula above: The lesser of

1) 85 percent of the amount of modified adjusted gross income over the adjusted base amount \$3,000 (\$37,000 modified adjusted gross income minus \$34,000 the adjusted base amount), or **\$2,550** plus the lesser of a) the Section 86(a)(1) Amount \$6,500 (which is one half of \$13,000, i.e., the excess of \$37,000 modified adjusted gross income over the base amount \$24,000) or b) **\$4,500** (which is one half of \$9,000, the difference between \$34,000 adjusted base amount and \$25,000 base amount; or

2) 85 percent of total Social Security benefits of \$8,000, or **\$6,800**.

So consolidating the above formula, 85 percent of \$3,000, or \$2,550 plus \$4,500 equals \$6,550 which is less than 85 percent of \$8,000, or \$6,800. So, the amount included in gross income is \$6,500.

8546. What other issues relate to the taxation of social security and railroad retirement benefits?

Railroad retirement benefits (other than Tier I benefits) are taxed like benefits received under a qualified pension or profit sharing plan. For this purpose, the Tier II portion of the taxes imposed on employees and employee representatives is treated as an employee contribution, while the Tier II portion of the taxes imposed on employers is treated as an employer contribution.¹

As mentioned above, the base amount and adjusted base amount of a married taxpayer filing separately who lives with his or her spouse anytime during the tax year is zero. This means it is much more likely that 85 percent of his or her Social Security benefits will be taxable even if the other income is on the low end. So the issue of whether separated taxpayers are living apart is significant.

To this point, the Tax Court held that the term “live apart” means living in separate residences for purposes of IRC Section 86(c)(1)(C)(ii). Thus, where the taxpayer lived in the same residence as his spouse for at least 30 days during the tax year in question (even though maintaining

1. See IRC Sec. 72(r)(1).

separate bedrooms), the Tax Court ruled that he did not “live apart” from his spouse at all times during the year; therefore, the taxpayer’s base amount was zero.¹

A taxpayer may elect to treat a lump sum payment of benefits as received in the year in which the benefits are attributable.²

Any workers’ compensation pay that reduced the amount of Social Security received and any amounts withheld to pay Medicare insurance premiums are included in the figure for Social Security benefits.³

Another issue that has arisen is whether Social Security disability payments should be lumped in with regular Social Security benefits. In *Green v. Comm.*,⁴ the taxpayer argued that his Social Security disability benefits were excludable from gross income⁵ because they had been paid in lieu of workers’ compensation. The Tax Court determined, however, that Title II of the Social Security Act is *not* comparable to workers’ compensation, which provides benefits based on a taxpayer’s employment. Instead, the Act allows for disability payments to individuals regardless of employment. Consequently, the taxpayer’s Social Security disability benefits were includable in gross income.

In a case of first impression, the Tax Court held that a taxpayer’s Social Security disability insurance benefits (payable as a result of the taxpayer’s disability due to lung cancer that resulted from exposure to Agent Orange during his Vietnam combat service) were includable in gross income under IRC Section 86 and were not excludable under IRC Section 104(a)(4). The court reasoned that Social Security disability insurance benefits do not take into consideration the nature or cause of the individual’s disability. Furthermore, the Social Security Act does not consider whether the disability arose from service in the Armed Forces or was attributable to combat-related injuries. Eligibility for purposes of Social Security disability benefits is determined on the basis of the individual’s prior work record, not on the cause of disability. Moreover, the amount of Social Security disability payments is computed under a formula that does not consider the nature or extent of the injury. Consequently, because the taxpayer’s Social Security disability insurance benefits were not paid for personal injury or sickness in military service within the meaning of IRC Section 104(a)(4), the benefits were not eligible for exclusion under IRC Section 104(a)(4).⁶

8547. What are the social security tax and Medicare rates for self-employed taxpayers?

Similar to the FICA tax imposed on wage income, the social security and Medicare taxes are imposed on self-employment income pursuant to the Self-Employment Contributions Act of 1954 (collectively the two taxes are more formally referred to as the “SECA tax”).⁷

1. *McAdams v. Comm.*, 118 TC 373 (2002).

2. IRC Sec. 86(e).

3. Rev. Rul. 84-173, 1984-2 CB 16.

4. TC Memo 2006-39.

5. Under IRC Section 104(a)(1).

6. *Reimels v. Comm.*, 123 TC 245 (2004), aff’d, 436 F.3d 344 (2d Cir. 2006); *Haar v. Comm.*, 78 TC 864, 866 (1982), aff’d, 709 F.2d 1206 (8th Cir. 1983), followed.

7. SECA is codified as Chapter 2 of the Internal Revenue Code.

Unlike a wage earner whose liability is limited to $\frac{1}{2}$ of the FICA tax, a self-employed individual is obligated to pay the entire amount of the 15.3 percent SECA tax, or 12.4 percent social security tax and 2.9 percent Medicare tax. Similar to FICA, the social security tax cap for self-employment income is the same dollar amount as the social security wage cap. Indexed for inflation, for 2014, the social security cap for self-employment income is \$117,000.¹

On the other hand, there is no cap on the amount of self-employment income subject to the Medicare tax. Moreover, effective for tax years beginning after December 31, 2012, subject to filing status thresholds, there is an Additional Medicare Surtax of 0.9 percent added to the 2.9 percent Medicare tax rate.

8548. What are the social security and Medicare tax rates for traditional employees and employers?

The social security tax and Medicare tax rates are the same on the wage income of a wage earner and as they are on the self-employment income of a self-employed individual. However, the operative statute for the imposition of payroll taxes on wage earners is the Federal Insurance Contributions Act (the “FICA tax”).² Unlike the self-employed, the liability for FICA tax imposed on the wages of a wage earner is split equally between the employee and the employer. In other words, the employee and the employer are each responsible for 6.2 percent of the 12.4 percent of social security tax and for 1.45 percent of the 2.9 percent of Medicare tax.³

Although the social security tax rate is much higher than the Medicare tax rate, it is capped at a certain amount of wages as adjusted annually for inflation. So, wages in excess of the cap amount are no longer subject to social security tax. For 2014, the social security tax caps at wages of \$117,000.⁴ Thus, the maximum amount of social security tax liability for the employee and employer shares would be \$14,508 ($12.4\% \times \$117,000$), or \$7,254 each.

On the other hand, there is no cap on the Medicare tax. This means the combined employer/employee 2.9 percent tax rate will be imposed on all wages without limit. So, for 2014, although the imposition of social security tax ceases on wages in excess of \$117,000, the imposition of Medicare tax continues to be imposed on all excess wages. Moreover, effective for tax years beginning after December 31, 2012, subject to filing status thresholds, there is an Additional Medicare Surtax of 0.9 percent added to the 1.45 percent rate on the employee portion of the Medicare tax.

Estimated Tax and Self-Employment Tax

8549. Who must pay the estimated tax and are penalties imposed for underpayment of the tax?

Subject to the potential imposition of penalties, any taxpayer who expects to owe tax of \$1,000 or more is required to make estimated tax payments.⁵ In other words, a taxpayer should

1. IRS Publication 517 (2013).

2. Codified as Chapter 21 of the Internal Revenue Code, IRC Secs. 3101-3128.

3. IRC Secs. 3101(a), 3111(a), 3101(b) and 3111(b).

4. Press Release, Social Security Administration (October 13, 2013).

5. <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Estimated-Taxes>.

project the current year's taxable income, tax and credits based on expected income, deductions, etc. Based on "a pay as you go" method, estimated tax payments are payable periodically throughout the year. For this purpose, tax liability includes regular income tax, alternative minimum tax as well as self-employment tax (Social Security and Medicare tax).¹

For self-employed taxpayers, the requirement to make estimated payments is more problematic than for employees. Unlike employees, no part of a self-employed individual's compensation is withheld by the payor and paid over to the IRS for taxes. Moreover, in addition to regular income tax, these taxpayers are required to pay the full 15.3 percent of the Social Security and Medicare tax. For this reason, a self-employed with even a modest amount of income who may owe little or no income tax, may, nonetheless have a significant Social Security and Medicare tax liability.

However, even employed individuals who are subject to withholding should consider making estimated payments under the following circumstances:

- The amount being withheld by the employer is insufficient.
- The taxpayer has a significant amount of other income such as dividends, interest, alimony, rent, etc. that is not subject to withholding.

On the other hand, an individual need not make estimated payments if all three of the following conditions are met:

- The individual had no tax liability for the prior tax year.
- The individual was a U.S. citizen for the entire tax year.
- The prior tax year was a 12 month period.²

Although estimated payments can be made at any time during the tax year, there is a "required annual payment" that is payable in "required installments" with specific due dates. For that purpose, the tax year is divided into four unequal quarters with the following due dates:

First Quarter January through March	April 15 th
Second Quarter April through June	June 15 th
Third Quarter June through August	September 15 th
Fourth Quarter September through December	January 15 th of following tax year ³

The "required annual payment" is a) 90 percent of the taxpayer's expected tax liability for the tax year or b) 100 percent of the tax owing for the prior tax year (assuming the prior

1. IRC Sec. 6654(a).

2. <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Estimated-Taxes>.

3. IRC Sec. 6654(c).

tax year spanned 12 months).¹ However, if the taxpayer's adjusted gross income exceeded \$150,000 (\$75,000 for filing married filing separately), the percentage in b), above is 110 percent.²

If the taxpayer fails to make timely estimated installment payments, the taxpayer is subject to penalties. Although the taxpayer can compute the penalty on Form 2210, the IRS will compute the penalty if the taxpayer does not complete the form.

8550. Who must pay the self-employment tax?

An individual who has annual net earnings from self-employment of \$400 or more is subject to self-employment tax.³ Generally, the income of sole proprietors, single member LLCs treated as a disregarded entity and general partners are considered to be self-employed. Self-employment tax is reported on Schedule SE attached to Form 1040. However, a self-employed taxpayer is entitled to an above-the-line deduction equal to one-half of the self-employment tax paid.⁴

In essence, self-employment tax is the combination of Social Security tax and Medicare tax. The Social Security tax is 12.4 percent and the Medicare tax is 2.9 percent.⁵ For 2014, the cap on Social Security taxes on up to \$117,000 of self-employment income. If the taxpayer has wages and self-employment income, the amount of self-employment income subject to the Social Security tax part is the difference between the cap amount and the amount of the taxpayer's wages.

Example: In 2014, Asher has wages of \$90,000. In addition, Asher has self-employment income of \$30,000. Since the Social Security wage base is \$117,000, only \$27,000 of Asher's \$30,000 of self-employment (\$117,000 minus \$90,000).

On the other hand, with regard to Medicare tax, there is no cap on self-employment income. Also, for self-employment over certain threshold amounts, there is an Additional Medicare Surtax of 0.9 percent added to the 2.9 percent Medicare rate, or a total of 3.8 percent. The threshold amounts are self-employment income in excess of \$250,000 for joint filers, \$125,000 for married filing separately and \$200,000 for all other filing status.⁶

Alternative Minimum Tax

8551. What is the alternative minimum tax and how is it calculated?

In addition to regular income tax, the *alternative minimum tax* (AMT) is an additional tax that certain taxpayers must pay. In theory, the purpose of AMT is prevent high income taxpayers from taking advantage of tax benefits (such as exclusions, deductions and credits) to substantially reduce or even eliminate their tax liability. However, in reality, due to complex rules, many relatively low income taxpayers are often subject to AMT.

1. IRC Sec. 6654(d)(1)(A).

2. IRC Sec. 6654(d)(1)(C).

3. IRC Sec. 6017.

4. IRC Sec. 164(f).

5. IRC Sec. 1401.

6. IRC Sec. 1401(b)(2).

The AMT is calculated as follows:

- (1) compute alternative minimum taxable income (AMTI, see Q 8553);
- (2) subtract the exemption amount from AMTI; and
- (3) multiply the remaining AMTI (step (2), above), by the applicable AMT rate.

For purposes of sheltering lower income taxpayers from being subject to AMT, the Code allows exemption amounts. Only AMTI in excess of the exemption amount is subject to AMT. The 2014 exemption amounts are as follows:¹

Filing Status	AMT Exemption
Married filing jointly or qualifying widow(er)	\$82,100
Single or Head of Household	\$52,800
Married filing separately	\$41,050

There are two AMT rates. For 2014, those rates are as follows:

AMT Rates	26%	28%
Married filing separately	Up to \$91,250	Over \$91,250
All other filing status	Up to \$182,500	Over \$182,500

For purposes of computing AMT, the taxpayer is allowed to take the foreign tax credit.² After computing AMT, it is compared with the taxpayer's regular income tax. If the regular tax is lower than AMT, the difference is AMT owing in addition to the tax. Stated differently, the taxpayer must pay the higher of AMT or the regular tax.³

Example: For 2014, Asher's regular income tax liability is \$75,000 but his AMT tax liability is \$92,000, or \$17,000 more than his regular income tax liability. Asher's liability is \$92,000 (\$75,000 regular income tax and \$17,000 AMT).

8552. Are personal tax credits allowed as an offset against AMT liability?

Several refundable tax credits such as the earned income credit and the refundable portion of the child tax credit are allowed as an offset against AMT liability. Other personal nonrefundable credits also allowed as an offset include:

- Adoption tax credit
- Child and dependent care credit
- Nonrefundable portion of the child tax credit
- Certain learning credits

1. IRC Sec. 55(d)(1), Rev. Proc. 2013-35, IRB 2013-47 537.

2. IRC Sec. 55(b)(1)(A).

3. IRC Sec. 55(a).

- Tax credit for IRAs and retirement plans
- Energy saving credits¹

8553. How is alternative minimum taxable income (AMTI) computed?

Alternative minimum taxable income (AMTI) is taxable income, with adjustments made in the way certain items are treated for AMT purposes and increased by tax preference items.²

Except as otherwise provided below and in Q 8554 and Q 8555, the provisions that apply in determining the regular taxable income of a taxpayer also generally apply in determining the AMTI of the taxpayer.³ In addition, references to a non-corporate taxpayer's adjusted gross income (AGI) or modified AGI in determining the amount of items of income, exclusion, or deduction must be treated as references to the taxpayer's AGI or modified AGI as determined for regular tax purposes.⁴

The following chart is a non-exclusive comparison of the different treatment of certain items in the computation of regular income tax as compared to the computation of AMT:⁵

Item	Regular Income Tax Computation	AMT Computation
Standard deduction (taxpayer does not itemize)	Allowed	Not allowed
Phase out of itemized deductions	Phased out if AGI exceeds applicable thresholds	No phase out
Medical Expenses	Allowed as itemized deductions to the extent they exceed 10% of AGI	Same.
Taxes	State income taxes, property taxes, etc. allowed as itemized deduction	Not allowed
Home Mortgage Interest	Allowed	Allows only acquisition indebtedness including loan to improve principal residence or second home. Interest attributed to refinanced amounts in excess of original loan not allowed.
State Tax Refund	Included in gross income if previously deducted as itemized deduction	Since state taxes are not allowed as a deduction, refunds are not included in income. Amount of regular income entered as a negative amount.

1. IRC Sec. 26(a)(2).

2. IRC Sec. 55(b)(2).

3. Treas. Reg. §1.55-1(a).

4. Treas. Reg. §1.55-1(b).

5. IRC Secs. 56, 58.

Item	Regular Income Tax Computation	AMT Computation
Interest expense related to tax-exempt interest income	Not allowed	Allowed if interest expense is related to tax-exempt private activity bonds
Miscellaneous itemized deductions	Allowed to the extent they exceed 2% of AGI assuming the taxpayer itemizes	Not allowed
Qualified stock options	Exercise of a qualified stock option not taxable	Difference between amount paid to acquire the stock and the FMV of the stock is included as AMTI income
Tax-exempt income	Not included in gross income	Included in AMTI income

8554. Is there an AMT credit for an AMT liability in a prior tax year?

There are two factors that contribute to the imposition of AMT. There are “exclusion items” and “deferral items.” An example of an exclusion item are miscellaneous itemized deductions or state or local taxes that are deductible for regular income tax purposes but never for AMT purposes. For this reason, there is never a credit for an exclusion item.

Conversely, for AMT purposes, a deferral item is simply a matter of a timing difference. For example, certain property depreciated using the accelerated depreciation method must be depreciated under the straight line method for AMT purposes. Thus, for regular income tax purposes, in the early years of property depreciated under the accelerated method will be higher than under the straight line method. For that reason, it will cause AMTI to be higher than regular taxable income. However, in the later years of property depreciated under the accelerated method, the amount of depreciation will be lower than amount of straight line depreciation.

Therefore, in the absence of an AMT credit for a deferral item, the taxpayer would be whipsawed with double negative tax consequences with respect to one item.

Example: In 2014, Asher is subject to AMT. Although for regular income tax purposes, based on the accelerated depreciation method, Asher is entitled to a \$2,500 depreciation deduction, for AMT purposes the straight line depreciation deduction is \$1,750. As a result, Asher’s depreciation deduction is the lesser \$1,750.

In 2015, Asher is not subject to AMT. However, based on the accelerated depreciation method, his regular income tax depreciation deduction is \$1,500 (it would have been \$1,750 if depreciated under the straight line method).

So, in the AMT year, Asher was not allowed to take the higher accelerated depreciation deduction. Then, in the non-AMT year, Asher was compelled to take the lower accelerated depreciation deduction.

Fortunately, there is an AMT credit to allow an adjustment in the non-AMT year. Using Form 8801, the AMT from the prior year is recalculated based on what it would have been but for the

deferral item.¹ So in the above example, Asher's AMT would be refigured using the accelerated depreciation deduction. The difference between the actual AMT tax and the recomputed AMT tax is the AMT credit. Although the AMT credit is nonrefundable, it is cumulative so it can be carried forward to subsequent tax years until it is fully used.²

8555. Is there a phase out of the alternative minimum tax exemption?

The purpose of the AMT exemption is to prevent its imposition on lower income taxpayers. The exemption amounts are: \$52,800 for single and head of household filers, \$82,100 for joint filers and \$41,050 for married separately filers.

However, the AMT exemption does phase out when AMTI reaches certain threshold levels.³ The phase out is a reduction of the exemption by 25 percent of each dollar over the applicable threshold. The following chart sets forth the applicable 2014 AMTI thresholds as well as the total phase out amount.

Filing Status	AMTI Exemption Phase Out Threshold Amount	AMTI Total Phase Out Amount
Married filing jointly or qualifying widow(er)	\$156,500	\$484,900
Single or Head of Household	\$117,300	\$328,500
Married filing separately	\$78,250	\$242,450

Example: In 2014, Asher and Ashley, a married couple have AMTI of \$200,000. Their AMT exemption without considering the phase out is \$82,100. However, the couple's AMTI is \$200,000 and the AMTI exemption phase out threshold amount is \$156,500. As a result, their AMT exceeds the threshold amount by \$43,500. Applying the phase out, the couple's 2014 exemption amount is reduced from \$82,100 to \$71,225 (a reduction of \$10,875, or 25 percent * \$43,500).

8556. Are there special AMT exemption rules that apply to a child subject to the kiddie tax?

If a child is subject to the kiddie tax, it is possible that he or she may be subject to AMT. Under special rules, the AMT exemption of a child subject to the kiddie tax is the lesser of the AMT exemption for a single taxpayer (\$52,800) or the total of the child's earned income plus \$7,250.⁴

Minors

8557. What is the "kiddie tax"?

This so-called "kiddie tax" prevents parents from shifting unearned income taxed at their higher rates to their children to be taxed at lower rates. So to prevent this type of income

1. IRC Sec. 53(d).

2. IRC Sec. 53(b).

3. IRC Sec. 55(d)(3).

4. IRC Sec. 59(j); Rev. Proc. 2013-35, 2013-47 IRB 537.

shifting, the kiddie tax subjects a child's unearned income in excess of \$2,000 to being taxed at the parents' highest marginal tax rate.

For the kiddie tax to apply, at least one parent must be alive at the close of the taxable year. The parent whose taxable income is taken into account is (a) in the case of parents who are not married, the custodial parent of the child (determined by using the support test for the dependency exemption) and (b) in the case of married individuals filing separately, the individual with the greater taxable income.¹ If the custodial parent files a joint return with a spouse who is not a parent of the child, the total joint income is applicable in determining the child's rate.

If there is an adjustment to the parent's tax, the child's resulting liability must also be recomputed. In the event of an underpayment, interest, but not penalties, will be assessed against the child.²

The kiddie tax applies only to "net unearned income." "Net unearned income" is defined as adjusted gross income that is not attributable to earned income, and that exceeds (1) the \$1,000 standard deduction for a dependent child in 2014, *plus* (2) the greater of \$1,000 or (if the child itemizes) the amount of allowable itemized deductions that are directly connected with the production of his unearned income.³ The source of the assets that produce unearned income need not be the child's parents.⁴

"Earned income" means all compensation for personal services actually rendered.⁵ A child is therefore taxed at his own rate on reasonable compensation for services that he or she performs.

Regulations specify that "unearned income" includes any Social Security or pension payments received by the child, income resulting from a gift under the Uniform Gifts to Minors Act, and interest on both earned and unearned income.⁶

As to which children are subject to the kiddie tax, it applies to:

- (1) a child under age 18; *or*
- (2) a child age 18 whose earned income does not exceed one-half of his or her support;
or
- (3) a child age 19 to 23 who is a fulltime student with earned income that does not exceed one-half of his or her support.⁷

Whether a child is under the threshold ages listed above is determined at the end of the tax year. "Child," for purposes of the kiddie tax, includes children who are adopted, related by

1. Temp. Treas. Reg. §1.1(i)-1T, A-11, A-12.

2. Temp. Treas. Reg. §1.1(i)-1T, A-17, A-19.

3. IRC Sec. 1(g)(4); Rev. Proc. 2013-35, 2013-47 IRB 537.

4. Temp. Treas. Reg. §1.1(i)-1T, A-8.

5. IRC Secs. 911(d)(2), 1(g)(4)(A)(i).

6. Temp. Treas. Reg. §1.1(i)-1T, A-8, A-9, A-15.

7. IRC Sec. 1(g)(2).

half-blood, or from a prior marriage of either spouse.¹ The kiddie tax applies without regard to whether the child is considered a dependent for tax purposes.

Example: In 2014, Pete is 16 with both parents alive. During 2014, Pete has \$1,400 of interest income from a bank savings account and \$1,700 he earned from a paper route. Some of the interest income is attributable to Pete's paper route earnings that were deposited in the account. The balance of the interest was generated from cash gifts Pete received from his parents and grandparents. Pete has no itemized deductions and can be claimed as a dependent on his parent's return.

Therefore, for the taxable year 2014, Pete's standard deduction is \$2,050, the amount of Pete's earned income, \$1,700 from the paper route, plus \$350. Of this standard deduction amount, \$1,000 is allocated against unearned income, and \$1,050 is allocated against earned income.

Although some of Pete's \$1,400 of interest income is attributable to some of his paper route income deposited into his bank account, it is all treated as unearned income. Of that amount, \$1,000 is taxed at Pete's own tax rate (10%). The remaining taxable unearned income of \$400 will be taxed at his parents' highest marginal tax rate.

8558. Can parents include the amount of their child's unearned income subject to kiddie tax on their own income tax return?

Under certain circumstances, parents may elect to include their child's unearned income subject to the kiddie tax on their own income tax return, thus avoiding the necessity of the child filing a return. The election is available to parents whose child has gross income of more than \$1,000 and less than \$10,000 (in 2014), all of which is from interest and dividends.² However, by doing so, the parents would increase their adjusted gross income and be subject to potential phase outs or other tax benefits that decrease as a result of certain threshold amounts of adjusted gross income.

The election is unavailable if there has been backup withholding under the child's Social Security number or if estimated tax payments have been made in the name and Social Security number of the child.

8559. Who is taxed on the income from property that is transferred to a minor under a uniform "Gifts to Minors" act?

As a general rule, the income is taxable to the minor. However, as discussed in Q 8557, unearned income of children (even potentially up to age 23), may be subject to the kiddie tax.

To the extent that income from the transferred property is used for the minor's support, it may be taxed to the person who is legally obligated to support the minor.³ State laws differ as to a parent's obligation to support. The income will be taxable to the parent only to the extent that it is actually used to discharge or satisfy the parent's obligation under state law.⁴

1. Temp. Treas. Reg. §1.1(i)-1T, A-13, A-14.

2. IRC Sec. 1(g)(7); Rev. Proc. 2008-66, 2008-45 IRB 107.

3. Rev. Rul. 56-484, 1956-2 CB 23; Rev. Rul. 59-357, 1959-2 CB 212.

4. IRC Sec. 677(b).

PART II: CAPITAL GAINS AND LOSSES

8560. What is a “capital asset”?

Generally, any property held as an investment is a capital asset, except that rental real estate is typically not a capital asset because it is treated as a trade or business asset.¹

The Code defines a “capital asset” by what it is not. So for purposes of determining whether a certain type of property is a capital asset, it cannot be any of the following types of property:

- (1) property (including inventory and stock in trade) held primarily for sale to customers;
- (2) real or depreciable property used in the taxpayer’s trade or business;
- (3) copyrights and literary, musical, or artistic compositions (or similar properties) created by the taxpayer, or merely owned by him, if the taxpayer’s basis in the property is determined (other than by reason of IRC Section 1022, which governs the basis determination of inherited property) by reference to the creator’s tax basis;
- (4) letters, memoranda, and similar properties produced by or for the taxpayer, or owned by him if the taxpayer’s basis is determined by reference to the tax basis of the producer or recipient;
- (5) accounts or notes receivable acquired in the taxpayer’s trade or business for services rendered or sales of property described in (1), above;
- (6) certain publications of the United States government;
- (7) any commodities derivative financial instrument held by a commodities derivatives dealer;
- (8) any hedging instrument clearly identified as such by the required time; or
- (9) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of the taxpayer’s trade or business.²

8561. What are the current long-term capital gains tax rates?

In 2014, for long-term capital gain, adjusted net capital gain (see Q 8562) is generally subject to the following tax rates:

- (1) 0 percent for taxpayers in the 10 and 15 percent tax brackets;
- (2) 15 percent for taxpayers in the 25 percent, 28 percent, 33 percent and 35 percent tax brackets; and
- (3) 20 percent for taxpayers in the 39.6 percent tax bracket.

1. See IRS Pub. 544.

2. IRC Sec. 1221; Treas. Reg. §1.1221-1.

However, detailed rules as to the exact calculation of the capital gains tax result in some exceptions. See Q 8562 (determining amount of capital gain), Q 8563 (Section 1250, Section 1202 and collectibles property) and Q 8567 (holding period requirement for determining whether gain is subject to long-term or short-term rates).¹

See Q 8573 for an outline of the netting process used in determining capital gains and losses when multiple asset classes are involved.

Beginning in 2013, taxpayers with adjusted gross income in excess of certain thresholds may be subject to the 3.8 percent net investment income tax pursuant to Code Section 1411 (see Q 8579 to Q 8588). This 3.8 percent is a surtax added to the taxpayer's otherwise applicable tax rate.

8562. How is net capital gain taxed?

"*Net capital gain* is the excess of net long-term capital gain for the taxable year over net short-term capital loss for such year.² However, net capital gain for any taxable year is reduced (but not below zero) by any amount the taxpayer takes into account under the investment income exception to the investment interest deduction.³

If a taxpayer has net capital gain for any tax year, the IRC provides that the tax will not exceed the *sum* of the following six items:

- (A) the tax computed at regular rates (without regard to the rules for capital gain) on the *greater* of (i) taxable income reduced by the net capital gain, or (ii) the *lesser* of (I) the amount of taxable income taxed at a rate below 25 percent, *or* (II) taxable income reduced by the adjusted net capital gain;
- (B) 0 percent of the taxpayer's adjusted net capital gain (or, if less, taxable income) that does not exceed the *excess* (if any) of (i) the amount of taxable income that would (without regard to this paragraph) be taxed at a rate below 25 percent *over* (ii) the taxable income reduced by the adjusted net capital gain;
- (C) 15 percent of the lesser of (i) so much of the taxpayer's adjusted net capital gain (or, if less, taxable income) as *exceeds* the amount on which a tax is determined under (B), above, or (ii) the *excess* of (I) the amount of taxable income which would be taxed at below 39.6 percent *over* (II) the sum of the amounts on which a tax is determined under (A) and (B), above;
- (D) 20 percent of the taxpayer's adjusted net capital gain (or, if less, taxable income) in *excess* of the sum of the amounts on which tax is determined under (B) and (C), above;
- (E) 25 percent of the *excess* (if any) of (i) the unrecaptured IRC Section 1250 gain (or, if less, the net capital gain (determined without regard to qualified dividend income)),

1. IRC Sec. 1(h), as amended by ATRA.

2. IRC Sec. 1222(11).

3. IRC Secs. 163(d)(4)(B)(iii), 1(h)(2).

over (ii) the *excess* (if any) of (I) the sum of the amount on which tax is determined under (A) above, *plus* the net capital gain, over (II) taxable income (See Q 8563 for a discussion of unrecaptured IRC Section 1250 gain); and

- (F) 28 percent of the amount of taxable income in *excess* of the sum of the amounts on which tax is determined under (A) through (D) above. See Q 8563 for a discussion of 28 percent gain.

For most long-term capital gains, this complicated formula generally results in a maximum capital gains rate on adjusted net capital gain for 2014 equal to: (i) 20 percent for individuals taxed at the 39.6 percent income tax rate, (ii) 15 percent for individuals taxed at the 25, 28, 33 or 35 percent income tax rates, and (iii) 0 percent for individuals taxed at the 15 percent or 10 percent income tax rates.

8563. What rates apply to capital gains property classified as Section 1250 property, Section 1202 stock or collectibles?

Gain attributable to the sale or exchange of collectibles, IRC Section 1202 gain (i.e., qualified small business stock), and unrecaptured IRC Section 1250 gain are subject to different tax rates. Gain on the sale or exchange of collectibles and IRC Section 1202 property is taxed at 28 percent, and unrecaptured gain on IRC Section 1250 property is taxed at 25 percent.¹

“Collectibles gain” is taxable gain on the sale or exchange of a collectible that is a capital asset held for more than one year² Examples of collectibles include artwork, gems and coins.³

“Section 1202 gain” is the gain on the sale or exchange of section 1202 stock. Pursuant to IRC Section 1202, an individual may exclude 50 percent of the taxable gain on the sale or exchange of “qualified small business stock” that is held for more than 5 years.

“Unrecaptured Section 1250 gain” is the portion of the gain on the sale or exchange of real property attributable to depreciation. Nonresidential real property (such as commercial buildings) and residential rental property (such as apartment buildings) are section 1250 property and are depreciated under the straight line method (i.e., the same amount of depreciation is taken every tax year).⁴ Each year’s depreciation reduces the basis of the real property by a like amount.⁵ So when such real property is sold, the gain attributable to the basis reduction is considered unrecaptured Section 1250 gain.

Example: Asher owns a commercial building with an original basis in the building of \$500,000. After several years, when the basis of the building had been reduced to \$350,000, Asher sells the building for \$500,000. Even though the building did not appreciate, Asher has a gain of \$150,000 (\$500,000 minus \$350,000), all of which is attributable to the depreciation reduction of basis. Such gain is considered to be unrecaptured Section 1250 gain.

1. IRC Sec. 1(h).

2. IRC Sec. 1(h)(5).

3. See IRC Sec. 408(m)(2).

4. IRC Sec. 168(b)(3)(A) and (B).

5. IRC Sec. 1016(a)(2).

8564. What new rules have been developed in the past years to change long-term capital gain rates?

Congress has taken steps in recent years to reduce the rates applicable to long-term capital gains. As such, long-term capital gains recognized on or after May 6, 2003 are subject to lower tax rates today than has historically been the case. For taxpayers in the 25, 28, 33 and 35 percent tax brackets with respect to ordinary income, the rate on long-term capital gains was reduced from 20 percent to 15 percent in 2003 through 2012. For taxpayers in the 10 and 15 percent brackets, the rate on long-term capital gains was reduced from 10 percent to 5 percent in 2003 through 2007, and then down to 0 percent in 2008 through 2012. As discussed below, these lower capital gain rates have been made permanent for tax years beginning after 2012.¹

The American Taxpayer Relief Act of 2012 (“ATRA”) extended the 0 percent and 15 percent capital gain rates for most taxpayers and increased the rates for taxpayers in the highest income tax bracket.

ATRA permanently increased the rate on long-term capital gains to 20 percent for taxpayers with taxable income exceeding an annual applicable threshold amount (for 2014, the threshold amount is \$406,750 for single taxpayers, \$457,600 for married taxpayers filing jointly, \$432,200 for heads of households and \$228,800 for married taxpayers filing separately and for 2013, the threshold amount was \$400,000 for single taxpayers, \$450,000 for married taxpayers filing jointly, \$425,000 for heads of households, and \$225,000 for married taxpayers filing separately). The applicable threshold amounts are adjusted annually for inflation.²

For taxpayers in the 10 or 15 percent income tax brackets, the rate on long-term capital gains is now permanently set at 0 percent. Taxpayers in the 25, 28, 33 and 35 percent tax brackets will continue to be taxed at 15 percent on long-term capital gains.³

In addition, beginning January 1, 2013, a new investment income tax of 3.8 percent applies to certain investment-type income (including income received from capital gains). The investment income tax applies for taxpayers whose annual adjusted gross income exceeds the investment income threshold amount (\$250,000 for married taxpayers filing jointly, \$125,000 for married taxpayers filing separately and \$200,000 for all other taxpayers).⁴ See Q 8579 to Q 8588 for a detailed discussion of the investment income tax.

The rates applicable for collectibles gain, IRC Section 1202 gain (i.e., qualified small business stock), and unrecaptured IRC Section 1250 gain have remained unchanged. See Q 8563.⁵

Repeal of qualified 5-year gain. For tax years beginning after December 31, 2000, if certain requirements were met, the maximum rates on “qualified 5-year gain” could be reduced to 8 percent and 18 percent (in place of 10 percent and 20 percent respectively). Furthermore,

1. IRC Sec. 1(h)(1), as amended by ATRA; TIPRA 2005 Sec. 102, amending JGTRRA 2003 Sec. 303.

2. IRC Secs. 1(i), 1(h), as amended by ATRA, Secs. 101(b)(3)(C) and 102(b); Rev. Proc. 2013-35, 2013-47 IRB 537.

3. IRC Sec. 1(h), as amended by ATRA, Sec. 102.

4. IRC Sec. 1411.

5. IRC Sec. 1(h).

a noncorporate taxpayer in the 25 percent bracket (or higher) who held a capital asset on January 1, 2001 could elect to treat the asset as if it had been sold and repurchased for its fair market value on January 1, 2001 (or on January 2, 2001 in the case of publicly traded stock). If a noncorporate taxpayer made this election, the holding period for the elected assets began after December 31, 2000, thereby making the asset eligible for the 18 percent rate if it was later sold after having been held by the taxpayer for more than five years from the date of the deemed sale and deemed reacquisition.¹ Under JGTRRA 2003, the 5-year holding period requirement, and the 18 percent and 8 percent tax rates for qualified 5-year gain, were repealed. Though this repeal was scheduled to sunset along with the reduced rates on long-term capital gains, it was made permanent under ATRA.

8565. What is “tax basis” and how is it used in determining the amount of a taxpayer’s capital gain or loss?

“Tax basis” is a taxpayer’s after tax investment in property. In other words, when a taxpayer acquires property for money, it is presumed to be his or her after tax investment in such property.² So when property is sold or exchanged, for purposes of computing gain, the difference between the amount received less the taxpayer’s basis in the property is the taxable gain.³ Similarly, for purposes of computing a loss (meaning the taxpayer received less than its original cost), the difference between the taxpayer’s basis in the property and the amount received is the taxable loss.⁴

Example: In 2012, Asher purchased Apple stock for \$1,000. In 2014, Asher sold the stock for \$1,500. Asher’s taxable gain is \$500, or the difference the amount received and his basis in the stock (\$1,500 minus \$1,000). Obviously, there would be no tax on the \$1,000 received because it would simply be the recovery of Asher’s initial after tax investment in the property, i.e., his basis.

In the alternative, if Asher sold the Apple stock for \$500, his taxable loss would be \$500, or the difference between his basis in the stock (what he paid for it) and what he received in the sale (\$1,000 minus \$500). In this case, Asher has a loss because the amount he received is less than what he originally paid.

If the taxpayer acquires property other than by purchase, basis is determined pursuant to different rules. For example, if the taxpayer acquires property from a decedent by inheritance or bequest, the basis in the property is its date of death fair market value.⁵

With respect to the gift of property, the general rule is the donee taxpayer takes the donor’s basis in the property.⁶

Example: Asher gifts Apple stock he purchased for \$1,000 to his friend Ashley. At the time of the gift, the stock had a fair market value of \$1,500. Ashley’s basis in the stock is \$1,000, the same as Asher’s. So if she sold the stock for \$1500, she would have a \$500 gain.

1. IRC Secs. 1(h)(2), 1(h)(9), prior to amendment by JGTRRA 2003; JCWAA 2002 Sec. 414(a) and CRTRA 2000 Sec. 314(c), amending TRA '97 Sec. 311(c).

2. IRC Sec. 1012.

3. IRC Sec. 1001(a).

4. IRC Sec. 1001(a).

5. IRC Sec. 1014.

6. IRC Sec. 1015(a).

On the other hand, there is an exception to the rule that the donee taxpayer takes the donor's basis in the property. This occurs when at the time of the gift, the donor's basis is greater than the fair market value of the gifted property. In that case, the donee taxpayer's basis is the fair market value of the property.¹

Example: Asher gifts Apple stock he purchased for \$1,000 to his friend Ashley. At the time of the gift, the stock had a fair market value of \$500. Because Asher's basis of \$1,000 is greater than its \$500 fair market value, Ashley's basis in the stock is \$500. So if she sold the stock for \$500, she would have no gain or loss. The reason for this rule to prevent one taxpayer to shift a taxable loss to the other taxpayer. If Ashley had taken Asher's \$1,000 basis, she would have reported a \$500 loss rather than Asher.

8566. How is tax basis adjusted and what affect does it have in the computation of capital gain or loss?

As discussed in Q 8565, gain or loss is measured by determining whether the amount received in exchange for property was more or less than the taxpayer's "basis." If the amount received is more than basis, there is a taxable gain. Conversely, if basis is greater than the amount received there is a taxable loss. However, during the taxpayer's ownership of property, certain adjustments to the original tax basis are required. Thus, tax basis as adjusted is referred to as "adjusted basis."

In the course of a taxpayer's ownership of property, basis can be increased or it can be decreased.

Capital Improvement

Example: Asher purchases a 10 story office building for \$500,000. Subsequently, Asher decides to add an 11th story to the building at a cost of \$100,000. As a capital improvement, Asher's original \$500,000 basis is adjusted upward to \$600,000² and becomes the adjusted basis in the building.

Depreciation

Broadly described, depreciation is a means of deducting the cost of an asset over its useful life. For example, the cost of a commercial building (excluding the land which is non-depreciable) is depreciated over 39 years.³ Based on a tax fiction, at the end of the 39 year depreciation period, the building will be completely "used up" and worth nothing. So every year, the basis of the building is adjusted downward by the amount of that year's depreciation deduction.⁴

Example: Asher purchases a 10 story office building for \$390,000.⁵ Because the building is depreciable over 39 years, each year Asher claims a \$10,000 depreciation deduction. So after 9 years, Asher's original basis is adjusted downward to \$300,000 (\$390,000 minus \$90,000). So, if at time Asher were to sell the building for \$400,000, he would have a taxable gain of \$100,000 (\$400,000 minus \$300,000).

1. IRC Sec. 1015(a).

2. IRC Sec. 1016(a)(1).

3. IRC Sec. 168(c).

4. IRC Sec. 1016(a)(2).

5. For purposes of this example, the amount of the purchase price attributable to the land is ignored.

8567. What is the “holding period” for long-term and short-term capital gain; and how is the holding period calculated?

Whether a capital gain or loss is long-term or short-term is determined by how long the taxpayer owned the property in question. Generally, a capital gain or loss is long-term if the property giving rise to the gain or loss was owned *for more than one year* and short-term if the property was owned *for one year or less*.¹

To determine how long a taxpayer has owned property (i.e., the “holding period”), the taxpayer must begin counting on the day *after* the property is acquired. For these purposes, the same date in each successive month is considered to be the first day of a new month. The date on which the property is disposed of is included (i.e., counted) in the holding period.²

If property is acquired on the last day of the month, the holding period begins on the first day of the following month. Therefore, if it is sold prior to the first day of the 13th month following the acquisition, the gain or loss will be short-term.³ According to IRS Publication 544 (published in November 1982), if property is acquired *near* the end of the month and the holding period begins on a date that does not occur in every month (e.g., the 29th, 30th, or 31st), the last day of each month that lacks that date is considered to begin a new month (however, later editions of Pub. 544 have omitted this statement).

Example 1: Mrs. Murphy bought a capital asset on January 1, 2014. She would begin counting on January 2, 2014. The 2nd day of each successive month would begin a new month. If Mrs. Murphy sold the asset on January 1, 2015, her holding period would not be more than one year. To have a long-term capital gain or loss she would have to sell the asset on or after January 2, 2015.

Example 2: Mrs. Tate bought a capital asset on January 30, 2014. She would begin counting on January 31, 2014. Since February does not have 31 days, Mrs. Tate will start a new month on February 28. In months that have only 30 days, the 30th will begin a new month.

In some cases, such as when property is received as a gift or in a like-kind exchange, the IRC allows for the “tacking” of a holding period meaning that the holding period of a previous owner of the property carries over to the new owner or the holding period of an asset exchanged for another carries over to the exchanged property.⁴

Example: Abe buys 500 shares of XYZ Corp. stock for \$7,500, on December 4, 2013. On September 20, 2014, Abe transfers the stock to his daughter, Diana, as a gift. On December 20, 2014, Diana sells the stock for \$9,000. Even though Diana actually owned the stock for more than a year, by application of the “tacking” rule, the holding period begins on December 4, 2013, the date the stock was purchased by Abe. Additionally, Diana assumes Abe’s \$7,500 basis in the stock. So upon the sale, Diana has a \$1,500 long-term capital gain (\$9,000 minus \$7,500).

1. IRC Sec. 1222.

2. Rev. Rul. 70-598, 1970-2 CB 168.

3. Rev. Rul. 66-7, 1966-1 CB 188.

4. IRC Sec. 1223.

8568. Are there any special rules applicable in determining whether a gain or loss is long-term or short-term when a short sale is involved?

Whether capital gain or loss on a short sale is long-term or short-term will ordinarily be determined by the seller's holding period in the stock used to close the sale.¹ For most purposes, the capital gain or loss is long-term if the holding period is more than one year. If the holding period is one year or less, the gain is short-term. (See Q 8567 for a detailed discussion of the holding period requirement.)

In a "short sale," a seller agrees to sell stock to another at a fixed price on a future date. If the future date is more than a year from the date the taxpayer acquired the stock, he or she would be able to convert short-term capital gain (taxed at ordinary tax rates, i.e., up to 39.6 percent) as compared to long-term capital gain rates (i.e., 15 percent or 20 percent). IRC Sections 1233 and 1259 are designed to prevent such abuse.

Example: On March 1, 2013, Asher acquires stock for \$200. On September 1, the fair market value of the stock is \$300. To lock in the appreciation, Asher enters a short sale to close on April 1, 2014. Without IRC Sections 1233 and 1259, Asher would effectively convert a short-term holding period into a long-term holding period; and, thus, recognize long-term capital gain.

To prevent individuals from using short sales to convert short-term gains to long-term gains or long-term losses to short-term losses, and to prevent the creation of artificial losses, the IRC and regulations provide special rules as follows:

- (1) If on the date the short sale is closed (see below), any "substantially identical property" has been held by the seller for a period of one year or less, any *gain* realized on property used to close the sale will, to the extent of the quantity of such substantially identical property, be *short-term* capital gain.² This is true even though the stock actually used to close the short sale has been held by the seller for more than one year. This rule does not apply to *losses* realized on the property used to close the sale;
- (2) If *any* substantially identical property is acquired by the seller after the short sale and on or before the date the sale is closed, any *gain* realized on property used to close the sale will, to the extent of the quantity of such substantially identical property, be *short-term* capital gain.³ This is true regardless of how long the substantially identical property has been held, how long the stock used to close the short sale has been held, and how much time has elapsed between the short sale and the date the sale is closed. This rule does not apply to *losses* realized on the property used to close the sale;
- (3) The holding period of any substantially identical property held one year or less, or acquired after the short sale and on or before the date the short sale is closed will, to the extent of the quantity of stock sold short, be deemed to have begun on

1. Treas. Reg. §1.1233-1(a)(3). See *Bingham*, 27 BTA 186 (1932), *acq.* 1933-1 CB 2.

2. IRC Sec. 1233(b)(1); Treas. Reg. §1.1233-1(c).

3. IRC Sec. 1233(b)(1); Treas. Reg. §1.1233-1(c).

the date the sale is closed or the date such property is sold or otherwise disposed of, whichever is earlier. If the quantity of such substantially identical property held for one year or less or so acquired exceeds the quantity of stock sold short, the “renewed” holding period will normally be applied to individual units of such property in the order in which they were acquired (beginning with earliest acquisition), but only to so much of the property as does not exceed the quantity sold short. Any excess retains its original holding period.¹ But where the short sale is entered into as part of an *arbitrage operation* in stocks or securities, this order of application is altered so that the “renewed” holding period will be applied first to substantially identical property acquired for arbitrage operations and held at the close of business on the day of the short sale and then in the order of acquisition as described in the previous sentence. The holding period of substantially identical property *not* acquired for arbitrage operations will be affected only to the extent that the quantity sold short exceeds the amount of substantially identical property acquired for arbitrage operations;²

- (4) If on the date of a short sale *any* substantially identical property has been held by the seller for more than one year, any *loss* realized on property used to close the sale will, to the extent of the quantity of such substantially identical property, be *long-term* capital loss.³ This is true even though the stock actually used to close the short sale has been held by the seller for a year or less. This rule does not apply to *gains* realized on the property used to close the sale.

8569. How is a loss realized on a sale between related persons treated for tax purposes?

If an individual sells property at a loss to a related person (as defined below), that loss is disallowed and may *not* be used to offset capital gains for income tax purposes.⁴ It makes no difference that the sale was a bona fide, arm’s-length transaction.⁵ Neither does it matter that the sale was made indirectly through an unrelated middleman.⁶ The loss on the sale of stock will be disallowed even though the sale and purchase are made separately on a stock exchange and the stock certificates received are not the certificates sold.⁷ However, these rules will not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.⁸

A loss realized on the exchange of properties between related persons will also be disallowed under these rules.⁹

1. IRC Sec. 1233(b)(2); Treas. Reg. §1.1233-1(c)(2).

2. IRC Sec. 1233(f); Treas. Reg. §1.1233-1(f).

3. IRC Sec. 1233(d); Treas. Reg. §1.1233-1(c)(4).

4. IRC Sec. 267(a); Treas. Reg. §1.267(a)-1 and Rev. Rul. 2008-5, 2008-3 IRB 271.

5. Treas. Reg. §1.267(a)-1(c).

6. See *Hassen v. Comm.*, 599 F.2d 305 (9th Cir. 1979).

7. *McWilliams v. Comm.*, 331 U.S. 694 (1947).

8. IRC Sec. 267(a)(1).

9. IRC Sec. 267(a)(1).

“Related persons” for this purpose includes the following:

- (1) members of the same family (i.e., brothers, sisters, spouses, ancestors, and lineal descendants (but not if they are in-laws));¹
- (2) an individual and a corporation of which the individual actually or constructively owns more than 50 percent of the stock;

Example: Amy owns a parcel of land with a fair market value of \$50,000. Amy’s basis in the land is \$100,000. Amy sells the land to a corporation wholly owned by his brother. Although Asher owns no stock of the corporation, through the attribution rules, a taxpayer is deemed to constructively own all the stock owned by his brother.² For that reason, the \$50,000 loss would be disallowed.

- (3) a grantor and a fiduciary of a trust;

The relationship between a grantor and fiduciary did not prevent recognition of loss on a sale of stock between them where the fiduciary purchased the stock in his individual capacity and where the sale was unrelated to the grantor-fiduciary relationship.³

- (4) fiduciaries of two trusts if the same person is the grantor of both;
- (5) a fiduciary and a beneficiary of the same trust;
- (6) a fiduciary of a trust and a beneficiary of another trust set up by the same grantor;
- (7) a fiduciary of a trust and a corporation of which the trust or the grantor of the trust actually or constructively owns more than 50 percent of the stock;
- (8) a person and an IRC Section 501 tax-exempt organization controlled by the person or members of his family (as described in (1) above);
- (9) a corporation and a partnership if the same person actually or constructively owns more than 50 percent of the stock of the corporation, and has more than a 50 percent interest in the partnership;
- (10) two S corporations if the same persons actually or constructively own more than 50 percent of the stock of each;
- (11) an S corporation and a C corporation, if the same persons actually or constructively own more than 50 percent of the stock of each;
- (12) generally, an executor and a beneficiary of an estate; or
- (13) possibly an individual and an individual retirement account (IRA).⁴

Special rules apply for purposes of determining constructive ownership of stock.⁵

1. See Let. Rul. 9017008.

2. IRC Sec. 267(c)(4).

3. Let. Rul. 9017008.

4. IRC Sec. 267(b).

5. See IRC Sec. 267(c).

Generally, loss will be disallowed on a sale between a partnership and a partner who owns more than a 50 percent interest, or between two partnerships if the same persons own more than a 50 percent interest in each.¹ Furthermore, with respect to transactions between two partnerships having one or more common partners or in which one or more of the partners in each partnership are related, a portion of the loss will be disallowed according to the relative interests of the partners.² If the transaction is between a partnership and an individual who is related to one of the partners, any deductions for losses will be denied with respect to the related partner's distributive share, but not with respect to the relative shares of each unrelated partner.³ Loss on a sale or exchange (other than of inventory) between two corporations that are members of the same controlled group (using a 50 percent test instead of 80 percent) is generally not denied but is deferred until the property is transferred outside the controlled group.⁴

If the related person to whom property was originally sold (or exchanged), sells or exchanges the same property (or property whose tax basis is determined by reference to such property) at a gain, the gain will be recognized only to the extent it exceeds the loss originally denied by reason of the related parties rules.⁵

Planning Point: If one family member is considering selling a closely held business to another at a loss, there are probably better ways to achieve tax savings than for the seller to give up a tax loss. A related party buyer might pay a little more for a business than a non-related party. The goodwill may be justifiably higher because of the relationship, the customer base or the reputation, among other reasons. The seller can realize tax savings through the deal structure; the buyer can realize savings by depreciation and amortization.

8570. Can the redemption of a debt obligation result in capital gains treatment?

Redemption of a debt obligation can result in recognition of gain or loss in situations where the obligation was acquired at a premium or discount. The relevant issue for determining whether the retirement or satisfaction of the debt can result in a capital gain or loss is whether a sale or exchange has taken place. Historically, cases dealing with the subject found that no sale or exchange takes place when the maker of a debt satisfies the obligations under the debt instrument.⁶ IRC Section 1271 was enacted to change this result in many situations involving the redemption of debt obligations.

Under Section 1271, amounts received by the holder when the debt instrument is redeemed are treated as having been received in an exchange.⁷ Because of this, gain or loss realized upon redemption can qualify for capital gains treatment.

1. IRC Sec. 707(b).

2. Temp. Treas. Reg. §1.267(a)-2T(c), A-2.

3. Treas. Reg. §1.267(b)-1(b).

4. IRC Sec. 267(f).

5. IRC Sec. 267(d); Treas. Reg. §1.267(d)-1.

6. See, for example, *Wood v. Commissioner*, 25 TC 468 (1955).

7. IRC Sec. 1271(a)(1).

However, some debt instruments contain “original issue discount” which is a type of interest. This would be a debt instrument in which the maturity price exceeds the purchase price. The difference is the interest component.

Example: Asher purchases an original issue discount debt for \$1,000 that matures two years later for \$1,250. The difference between the maturity amount and the purchase amount, \$250, is essentially interest.

Original issue discount interest is reportable as ordinary income. Such ordinary income may be realized, however, in some transactions where there was an intention to call the obligation before maturity at the time the obligation was originally issued.¹ If this is the case, any gain realized in the transaction must be treated as ordinary income to the extent that the amount of gain does not exceed the sum of (a) the original issue discount, reduced by (b) the portion of original issue discount previously included in the gross income of any holder of the obligation.²

The requirement that ordinary income be recognized does not apply to certain tax-exempt obligations and to holders who purchased the debt instrument at a premium.³

8571. When is the gain or loss from sale or exchange of an option to purchase property treated as a capital gain or capital loss?

The sale or exchange of an option to purchase property may result in capital gain if the underlying property subject to the option is a capital asset. Similarly, losses arising from the taxpayer’s failure to exercise the option may be treated as capital losses if the underlying property is a capital asset.⁴

Example: Brenda is considering an investment in real property, but, because the purchase price is high, she purchases an option to buy the property for \$5,000 within the next two years. The option is a capital asset because if Brenda had purchased the property outright it would have been a capital asset. Eleven months later, Brenda sells the option for \$6,000. The \$1,000 gain (\$6,000 selling price minus \$5,000 basis) is a short-term capital gain because Brenda held the option for less than one year.

Similarly, if the taxpayer fails to exercise the option, the option is treated as though it was sold or exchanged on the day the option expired for no consideration. Based on the taxpayer’s holding period, the loss will be either long-term or short-term capital loss.⁵

In a recent Tax Court decision, the Tax Court held that a taxpayer was entitled to an ordinary loss deduction, rather than recognition of a capital loss, when the taxpayer abandoned an option to purchase certain real property. Because the taxpayer was in the business of purchasing and developing real property, the underlying real property was not a “capital asset.” For that reason, the loss realized by the taxpayer when he abandoned his option was as an ordinary loss rather than a capital loss.⁶

1. IRC Sec. 1271(a)(2)(A).

2. IRC Sec. 1271(a)(2).

3. IRC Sec. 1271(a)(2)(B).

4. IRC Sec. 1234(a)(1).

5. IRC Sec. 1234(a)(2).

6. *Sutton v. Commissioner*, TC Summ. Op. 2013-6, IRC Sec. 1221(a).

IRC Section 1234 provides special rules with regard to options to buy or sell stock, securities or commodities. Specifically, IRC Section 1234(b) provides short-term capital gain or loss treatment for the grantor of an option as follows:

- The option lapses or is terminated in a closing transaction.
- The underlying property is stock, securities, commodities or commodities futures.
- The option is not issued in the ordinary course of the grantors trade or business

A “closing transaction” is defined as any transaction that terminates the taxpayer’s obligations under the option other than an exercise or lapse of the option.¹

See Q 8560 for a discussion of what constitutes a capital asset for purposes of capital gains treatment.

8572. Are there any special rules that apply in determining whether the sale of a patent gives rise to capital gains treatment?

Unlike typical asset sales, if the sale or exchange of a patent meets certain requirements, the sale will automatically qualify for long-term capital gains treatment regardless of the transferor’s holding period and whether or not the patent would have been classified as a capital asset in the hands of the holder who transfers the patent.²

Sale of a patent will qualify for long-term capital gains treatment if the holder of the patent transfers either “all substantial rights” in the patent or an undivided interest in the patent.

The phrase “all substantial rights” is defined in the regulations to mean all rights in the patent that have value at the time the rights to the patent are transferred, whether or not the holder of the patent is the owner of those rights.³ The holder does *not* transfer all substantial rights in the patent if the rights to the patent are:

- (1) limited geographically within the country;
- (2) confined to a period of time that is less than the entire remaining life of the patent;
- (3) limited to a grant of rights, in fields of use within trades or industries, which are less than all the rights covered by the patent that exist and have value at the time of the transfer; or
- (4) limited to a grant of rights that does not give the transferee rights to all the claims and inventions covered by the patent that exist and have value at the time of sale.⁴

Conversely, the holder does not lose long-term capital gain treatment by retaining rights that are not considered substantial. The regulations provide that, depending upon all of the facts

1. IRC Sec. 1234(b)(2).

2. IRC Sec. 1235(a).

3. Treas. Reg. §1.1235-2(b)(1).

4. Treas. Reg. §1.1235-2(b)(2).

and circumstances of the transaction as a whole, the holder may retain the right to prohibit sub-licensing or sub-assignment by the transferee and may also fail to convey the right to use or sell the property that is the *subject* of the patent.¹

The holder transfers an “undivided interest” in a patent when the holder transfers the same fractional share of every substantial right in the patent. A sale of the right to income from a patent, for example, does not constitute the sale of an undivided interest in the patent.²

This treatment is not available to all patent holders, however. The term “holder” is defined in IRC Section 1235 to include only (1) the original inventor of the property subject to the patent and (2) an individual who obtained his rights in the patent in exchange for money or other property *before* the property subject to the patent was actually put to use *if* that individual is neither (i) the inventor’s employer or (ii) related to the inventor.³

Planning Point: Due to the limited definition of “holder” under the patent laws, if an employer maintains the rights to patents on property invented by its employees, the employer will not be eligible for this special capital gains treatment upon sale of the patent.

8573. What is the netting process used to determine whether the taxpayer has a capital gain or loss?

The complex rules applicable to capital gains taxation essentially establish four different types of capital assets. These groups of capital assets are:

- (1) short-term capital assets, with no special tax rate;
- (2) 28 percent capital assets, generally consisting of collectibles gain or loss, and IRC Section 1202 gain;
- (3) 25 percent capital assets, consisting of assets that generate unrecaptured IRC Section 1250 gain; and
- (4) all other long-term capital assets, which are taxed according to the taxpayer’s income tax bracket: 20 percent (39.6 percent income tax bracket), 15 percent (25, 28, 33, or 35 percent income tax brackets), and 0 percent capital assets for taxpayers in the 15 and 10 percent tax brackets.

Within each group, gains and losses must be netted. Generally, if, as a result of this process, there is a net loss from asset-group “(1),” it is applied to reduce any net gain from groups “(2),” “(3),” or “(4),” in that order. If there is a net loss from group “(2),” it is applied to reduce any net gain from groups “(3)” or “(4),” in that order. If there is a net loss from group “(4),” it is applied to reduce any net gain from groups “(2)” or “(3),” in that order.⁴

If net capital losses result from the netting process described above, up to \$3,000 (\$1,500 in the case of married individuals filing separately) of losses can be deducted against ordinary

1. Treas. Reg. §1.1235-2(b)(3).

2. Treas. Reg. §1.1235-2(c).

3. IRC Sec. 1235(b).

4. IRC Sec. 1(h)(1), as amended by ATRA; Notice 97-59, 1997-2 CB 309.

income.¹ Any losses that are deducted would be treated as reducing net loss from groups “(1),” “(2),” or “(4),” in that order.

If there are net gains, such gains would generally be taxed as described above and discussed in Q 8561 and Q 8562.

If the taxpayer has capital gains and capital losses from investment property as well as gains and losses from section 1231 business property (depreciable property used in a trade or business and held for more than one year), the latter gains and losses netted against each other. If the netting results in a net gain, the gain is treated as if it were a long-term capital gain and included in the netting process for capital gains in group (4). On the other hand, if the netting results in a net loss from Section 1231 assets, this net loss is fully deductible as an ordinary loss and not subject to capital gain and loss netting.

Example: Claire, an attorney, sold 500 shares of stock gain recognizing a \$1,500 long-term capital gain and 200 shares of stock recognizing a \$300 short-term capital gain. In the same year she sold an oriental rug used in her home for the past 5 years at a loss of \$700 and a rental property, owned for 9 months, for a short-term capital loss of \$5,000. From her office she sold a computer system (a section 1231 asset) at a loss of \$1,200 and a set of law books (a section 1231 asset) at a gain of \$200. Both of these had been used in her practice for more than one year.

Claire’s various gains and losses (“G/L”) must first be grouped according to the following column headings and a net total computed for each group:

	Long-Term Capital G/L	Short-Term Capital G/L	IRC 1231 Business Assets
500 shares of stock	1,500		
200 shares of stock		300	
oriental rug*	---	---	---
rental property		(5,000)	
computer			(1,200)
law books			200
Net totals	1,500	(4,700)	(1,000)
* No loss deduction is allowed for the oriental rug since it was held for personal use. ¹			

Because the netting of the section 1231 assets resulted in a net \$1,000, it is treated as a fully deductible ordinary loss and not subject to further netting. Netting short-term capital gain against short-term capital loss results in a net short-term capital loss of \$4,700. That amount is netted against Claire’s net long-term gain of \$1,500 resulting in a net short-term loss of \$3,200. Capital losses in excess of capital gains are deductible only to the extent of \$3,000. The remaining \$200 capital loss is carried forward to subsequent tax years subject to the same rules.

1. IRC Sec. 1211(b).

2. IRC Sec. 165.1.

8574. What is the tax significance of short-term capital gain?

Although as discussed in Q 8573 above, like long-term capital gain, short-term capital gain is netted against capital losses, net short-term capital gain is *not* subject to the preferential capital gains rates. Instead, such gain is taxed as ordinary income (up to 39.6 percent).

8575. Is there a limitation to the amount of capital losses a taxpayer may deduct in a tax year? How are disallowed capital losses treated?

Unlike ordinary losses that are deductible against any type of income (ordinary or capital), capital losses are deductible against capital gains (long and short-term). However, a noncorporate taxpayer who has capital losses in excess of capital gains is entitled to deduct from ordinary income the lesser of (a) \$3,000 (\$1,500 for married taxpayers filing separately) or (b) the excess of the taxpayer's net capital losses over gains.¹ Any nondeductible losses may be carried forward indefinitely to subsequent tax years. Losses that are carried forward retain their character as either short-term or long-term in future years.

Conversely, corporations are only permitted to recognize capital losses to the extent of capital gains with no exception.² However, unlike noncorporate taxpayers who must carry forward nondeductible losses to subsequent tax years, corporations may carry disallowed capital losses *back* for three tax years (beginning with the earliest of the three) with any remaining nondeductible capital losses to be carried forward for five successive tax years (beginning with the earliest of the five).³

8576. What are the reporting requirements for capital gains and losses?

New boxes have been added to Form 1099-DIV to allow for the reporting of qualified dividends (Box 1b) and post-May 5, 2003 capital gain distributions (Box 2b). Likewise, new boxes have also been added to Form 1099-B for reporting post-May 5, 2003 profits or losses from regulated futures or currency contracts.⁴ Payments made in lieu of dividends ("substitute payments") are *not* eligible for the lower rates applicable to qualified dividends.

1. IRC Sec. 1211(b).

2. IRC Sec. 1211(a).

3. IRC Sec. 1212(a).

4. See Announcement 2003-55, 2003-38 IRB 597.

PART III: INVESTMENT INCOME TAX AND ADDITIONAL MEDICARE TAX

8577. What is the net investment income tax?

The investment income tax is surtax of 3.8 percent in addition to the regular income tax that certain high income taxpayers would otherwise owe on such income. The tax is imposed on the *lesser* of the following amounts:

- (1) Net investment income (see Q 8579 for an explanation of what amounts are included in net investment income); or
- (2) The excess (if any) of (i) the taxpayer's modified adjusted gross income (MAGI) (as explained in Q 8578, below, for most taxpayers MAGI is actually AGI) for the year over (ii) the applicable threshold amount.¹

The applicable threshold amount for single taxpayers is \$200,000. For married taxpayers filing a joint return, the applicable threshold amount is \$250,000 (see Q 8580 for a detailed discussion of who is liable for the investment income tax).

Example: In 2014, Erica and Mickey a married couple filing jointly have an AGI of \$400,000 including net investment income of \$125,000. The applicable threshold amount for a married couple filing jointly is \$250,000.

Applying the formula, the 3.8 percent net investment tax is imposed on the lesser of:

1. Net investment income of \$125,000; or
2. The excess of (i) AGI of \$400,000 over (ii) the applicable threshold amount of \$250,000, or \$150,000.

Because the lesser of the two amounts is the \$125,000 of net investment income, the 3.8 percent net investment income tax is imposed on the entire amount of net investment income.

Example: Assume in 2015, Erica and Mickey have AGI of \$300,000 including net investment income of \$125,000 (the same amount as it 2014).

Applying the formula, the 3.8 percent net investment tax is imposed on the lesser of:

1. Net investment income of \$125,000; or
2. The excess of (i) AGI of \$300,000 over (ii) the applicable threshold amount of \$250,000, or \$50,000.

In this case, the lesser of the two amounts is the excess of AGI over the applicable threshold amount. Thus, in spite of having net investment income of \$125,000, only \$50,000 is subject to the 3.8 percent net investment income tax.

Finally, certain trusts and estates are also subject to the net investment income tax (see Q 8595).

1. IRC Sec. 1411(a)(1).

8578. What is modified adjusted gross income for purposes of the investment income tax?

For most taxpayers, MAGI is the same as their AGI. This is because the only adjustments made to AGI in arriving at MAGI relate to foreign earned income. Specifically, in arriving at MAGI, AGI is increased by the excess of (1) any amounts excluded under IRC 911(a)(1) (foreign earned income) over (2) the amount of deductions and exclusions disallowed under IRC 911(d)(6) (which disallows certain deductions and exclusions that would otherwise be properly allocable to an amount excluded from gross income because it is foreign earned income).¹ Thus, absent any foreign earned income, AGI and MAGI are the same amount.

8579. What is net investment income?

Net investment income is the tax base for the 3.8 percent net investment income tax (See Q 8577 for a discussion of the computation of the tax). In general, net investment income potentially includes any income other than “earned” income that is subject to social security tax and Medicare tax. Basically, there are 3 categories of net investment income. Pursuant to IRC Section 1411(c)(1), subject to exceptions discussed in Q 8588, the 3 categories of investment income are:

- (a) income commonly considered to be traditional investment type income i.e., interest, dividends, annuities, rents and royalties;
- (b) gross income derived from a trade or business; and
- (c) net gain attributable to the disposition of property.²

8580. Who is liable for paying the investment tax?

Any taxpayer who has net investment income and modified adjusted gross income (MAGI) in excess of the applicable threshold amount is subject to the 3.8 percent net investment income tax. The applicable thresholds are MAGI in excess of \$200,000 for single taxpayers, \$125,000 for married taxpayers filing separately and \$250,000 for married couples filing jointly. Unlike many other income threshold amounts, these thresholds are not indexed annually for inflation.³

In addition to individuals, the net investment income tax applies to certain trusts and estates (see Q 8595).⁴ Nonresident aliens are not subject to the tax.⁵

8581. Are distributions from retirement accounts and qualified plans included in net investment income?

No. Although distributions from qualified plans often include earnings generated by traditional investment income, i.e., dividends and interests, distributions from qualified retirement

1. IRC Sec. 1411(d).

2. IRC Sec. 1411(c)(1)(A).

3. See Preamble to notice of proposed rulemaking, REG-130507-11, 77 Fed. Reg. 72611, 72615.

4. IRC Sec. 1411(a).

5. IRC Sec. 1411(e).

plans are not included in net investment income and thus are not subject to the net investment income tax.¹ This includes distributions from qualified plans pursuant to:

- (1) IRC Section 401(a) (qualified pension, stock bonus or profit-sharing plans);
- (2) IRC Section 403(a) (qualified annuity plans);
- (3) IRC Section 403(b) (tax-sheltered annuities);
- (4) IRC Section 408 (individual retirement accounts);
- (5) IRC Section 408A (Roth IRAs); and
- (6) IRC Section 457(b) (deferred compensation plans of state and local governments or tax-exempt organizations).

Deemed distributions under IRC Section 72(p) (loans from a qualified employer plan) are also excluded under this rule.² Additionally, amounts distributed from a qualified plan to purchase life insurance by the plan participant are not included in net investment income.³

8582. If a taxpayer converts a traditional IRA to a Roth IRA, does a taxable distribution take place that would subject the converted funds to the investment income tax?

In addition to actual retirement plan distributions (See Q 8581) that are excluded from net investment income, the final regulations also make it clear that deemed distributions from retirement plans are also excluded. For example, a rollover of funds from a traditional IRA into a Roth IRA never actually received by the taxpayer is nonetheless treated as a distribution for income tax purposes. Similar to actual retirement distributions, the IRA/Roth conversion deemed distribution is excluded from net investment income; and, thus, is not subject to the net investment income tax.⁴

8583. How do the net investment income rules apply to amounts received under an annuity contract?

Income from annuities included in gross income pursuant to IRC Sections 72(a) and 72(b) are also included in net investment income pursuant to IRC Section 1411(c)(1)(A)(i). For regular income tax purposes, a portion of an annuity payment is allocated to the taxpayer's investment in the annuity. That amount is excluded from gross income,⁵ and, thus, not treated as net investment income. The difference between the total payment and the excluded amount is included in gross income,⁶ as well as net investment income.⁷

1. IRC Sec. 1411(c)(5), Treas. Reg. §1.1411-8(a).

2. Treas. Reg. §1.1411-8(b)(2).

3. Treas. Reg. §1.1411-8(b)(3).

4. Treas. Reg. §1.1411-8(b)(2).

5. IRC Section 72(b).

6. IRC Section 72(a).

7. Treas. Reg. §1.1411-4(a)(1)(i). See also Preamble to Proposed Regulations, 77 Fed. Reg. 72618; Preamble to Final Regulations, 78 Fed. Reg. 72394.

Example: In 2014, Amy Annuitant received \$12,000 in annuity payments of which \$7,000 was allocated to her investment in the annuity. As a result, pursuant to IRC Section 72(b), Amy would exclude \$7,000 of the payments from gross income and net investment income. The difference between the total annuity payment of \$12,000 and her \$7,000 basis, or \$5,000 would be included in gross income and in net investment income, subject to the net investment income tax.

If the taxpayer *sells* the annuity contract for a gain, the entire gain would be treated as net investment income either under IRC Section 1411(c)(1)(A)(i) (as annuity income) or 1411(c)(1)(A)(iii) (net gain attributable to the sale of property). For example, if the sales price of the annuity does not exceed the annuity surrender value, the gain recognized (difference between the sales price and the taxpayer's investment or basis in the annuity) is treated as annuity income. If the sales price exceeds the annuity surrender value, the portion of the gain attributable to the difference between the surrender value and the taxpayer's investment or basis in the annuity is also treated as annuity income. However, the gain attributable to the difference between the sales price and the surrender value of the annuity would be treated as net gain attributable to the sale of the annuity.¹

8584. What is “net gain” with respect to the disposition of property and net investment income?

Pursuant to IRC Section 1411(c)(1)(A)(iii), “net gain” attributable to the disposition of property is included in net investment income. Significantly, the term “net gain” means dispositions of property that trigger gain and are netted against “losses” generated in those same types of dispositions. Similar to regular income taxation, only taxable gains and non-deductible losses are considered. Thus, because the gain must be “recognized” for income tax purposes, dispositions of property that are income tax-free are also net investment income tax-free. Examples of such tax-free gains include but are not limited to like-kind exchanges under IRC 1031 (See Q 8605 to Q 8626) and involuntary conversions (See Q 8605 to Q 8614).²

Although the term “net gain” means that the gains and losses described above have been netted, as discussed in Q 8589, gain attributable to the disposition of property held by a trade or business in which the taxpayer materially participates, i.e., non-passive (other than a trade or business trading in financial instruments and commodities) is excluded from net investment income. In other words,

- Net gain recognized from the disposition of property held in a trade or business in which the taxpayer materially participates – not included in net investment income
- Net gain recognized from the disposition of property held in a trade or business in which the taxpayer does not materially participate – included in net investment income.

1. IRC Section 1411(c)(1)(A)(iii).

2. Treas. Regs. §§1.1411-4(a)(1)(iii), 1.1411(d) (see examples).

- Net gain recognized from the disposition of investment property (no trade or business involved) – always included in net investment income.
- Net gain recognized from the disposition of any property held by business of trading financial instruments or commodities (regardless of the taxpayer's participation in the business) – always included in net investment income.

See Q 8585 for a discussion of how net investment income gains are netted against net investment income losses.

8585. How are gains from the disposition of property netted against losses in determining “net gain” included in net investment income?

As discussed in Q 8584, above, for purposes of IRC Section 1411(c)(1)(A)(iii) “net gain” means that gains are netted against “losses.” For example, a disposition of property held by a trade or business in which the taxpayer does not materially participate (passive) that results in a recognized gain would be offset by a similar disposition of property that results in an allowed deductible loss. Examples of losses include those allowed under IRC Section 165, i.e., casualty losses (see Q 8649), theft losses (see Q 8652), and losses realized as a result of worthless securities (see Q 8699) involving property held by a trade or business in which the taxpayer does not materially participate.

Additionally, the same rules for the deductibility of regular income tax losses also apply to the netting of net investment income losses against gains. So, similar to regular income tax, net investment income ordinary losses are netted against net investment income capital gain and net investment ordinary gain.

Also, the final regulations provide for the offset of capital losses and capital gains in arriving at “net gain” included in net investment income in the same way as they offset each other for regular income tax purposes. For regular income tax purposes, capital losses are deductible to the extent of capital gains plus \$3,000 of any excess being deductible against other income. The unused excess loss is carried over to subsequent tax years subject to being netted against capital gains generated in such years.¹ Similarly, for net investment income purposes, a taxpayer may use the same netting rules to reduce “net gain” to zero, with \$3,000 of any excess reducing other investment income. Any unused excess capital loss is carried over to subsequent years to be netted against capital gain in the same manner.²

Planning Point: Significantly, in the aggregate net investment income losses are only deductible to the extent of net investment income gains meaning that net gain cannot be reduced below zero.³ In other words, there can never be a “net loss.” However, as discussed in Q 8586, the final regulations do allow excess investment income losses to be used to reduce other net investment income.⁴

1. IRC Sec. 1211(b).

2. Treas. Reg. §1.1411-4(d)(2).

3. Treas. Reg. §1.1411-4(d)(2).

4. Treas. Reg. §1.1411-4(f)(1).

8586. Can excess net investment income losses be used to reduce other net investment income?

Yes. As discussed in Q 8586, the offsetting of net investment income losses against net investment income gains can never result in a “net loss.” However, pursuant to the final regulations, excess losses may be used to reduce other net investment income provided those losses were deducted in the computation of regular income tax. In other words, the loss must be deductible for regular income tax purposes for it to be deductible in this context.¹

Example: Iris, a single taxpayer has \$125,000 of interest and dividends, \$60,000 of ordinary losses from a trade or business in which Iris does not materially participate and long-term capital gain from the sale of undeveloped land. For purposes of IRC Section 1411(c)(1)(A)(iii), the net long-term capital gain is net investment income gain because the property was held for investment and there is no trade or business involved. The \$60,000 ordinary losses are net investment income losses because the underlying property was held by a trade or business in which Iris did not materially participate. As a result of netting the \$60,000 of ordinary losses against the \$50,000 of long-term capital gain, there is an excess loss of \$10,000. Assuming the excess loss is deducted for regular income tax purposes, the final regulations allow that amount to be deducted against the Iris’ other net investment income, i.e., \$125,000 of interest and dividend net investment income (includible under IRC Section 1411(c)(1)(A)(i)).²

So in the end, the entire amount of \$60,000 of net investment income loss was fully deductible against some type of net investment income. First, \$50,000 of the loss offset \$50,000 of long-term capital gain. Second, the excess loss, \$10,000 was deductible against the \$125,000 of interest and dividends, resulting in \$115,000 of net investment income.

8587. How does gain on the sale of a taxpayer’s principal residence impact the determination of whether the taxpayer is subject to the investment income tax? Also, is any or all of the gain subject to net investment income tax?

The sale of a taxpayer’s principal residence is potentially includible in net investment income as net gain from the sale of property.³ However, for income tax purposes, a single taxpayer excludes the first \$250,000 of capital gain realized from the sale of a principal residence from gross income (\$500,000 for a married couple filing jointly).⁴ Since only amounts included in gross income for regular income tax purposes are included in net investment income, the same amount of gain excluded from gross income is similarly excluded from net investment income.⁵ Consequently, the portion of the gain from the sale of a principal residence that is included in gross income is also included in net investment income.⁶

Example: In 2000, Dave and Janice purchased a principal residence for \$100,000. In 2014, they sell their residence for \$700,000 realizing a total gain of \$600,000. Pursuant to IRC Section 121, \$500,000 of

1. Treas. Reg. §1.1411-4(f)(1).

2. Treas. Reg. §1.1411-4(h).

3. IRC Sec. 1411(c)(1)(A)(iii). It is treated as investment income because it is not property held in a trade or business in which the taxpayer materially participates.

4. IRC Sec. 121(a).

5. Treas. Reg. §1.1411-1(d)(4)(i).

6. IRC Section 1411(c)(1)(A)(iii).

the gain is excluded from gross income and from net investment income. However, \$100,000 of the gain (the amount exceeding the \$500,000 exclusion) is includible in gross income and in net investment income. In addition, Dave and Janice have dividend and interest income of \$200,000. Their AGI is \$425,000.

Applying the formula (see Q 8577), the 3.8 percent net investment tax is imposed on the lesser of:

1. Net investment income of \$200,000 (interest and dividends) plus \$100,000 (taxable gain on sale of principal residence), a total of \$300,000; or
2. The excess of (i) AGI of \$425,000 over (ii) the applicable threshold amount of \$250,000 (married couple filing jointly), or \$175,000.

As illustrated in this example, the taxpayers' net investment income includes the interest and dividend income of \$200,000 plus only \$100,000 of the \$600,000 gain from the sale of their principal residence. The excluded gain of \$500,000 pursuant to IRC Section 121 does not factor into the computation. In other words, the amount of gain included in gross income is also the amount of gain treated as net investment income. Thus, because the excess of AGI over the applicable threshold amount (\$175,000) is less than the taxpayers' net investment income (\$300,000), the 3.8 percent tax is imposed on the lesser amount.

8588. How does a taxpayer determine whether income is derived from the taxpayer's trade or business and, if so, excluded from net investment income?

The test for determining whether interest, dividends, annuities, royalties and rents otherwise included as net investment income pursuant to IRC Section 1411(c)(1)(A)(i) are excluded from net investment income is different from the test to determine whether net investment income otherwise included pursuant to IRC Sections 1411(c)(1)(A)(ii) and (iii) are similarly excluded.

As to IRC Section 1411(c)(1)(A)(i) net investment income, i.e., the traditional types of investment income, the exclusion applies if such income is derived in the "ordinary course" of a trade or business within the meaning of Treasury Regulation Section 1.469-2T(c)(3)(ii). This means the income is the type the trade or business is designed to generate. The following are examples of such income:

1. Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
2. Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
3. Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

4. Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business;
5. Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property.¹

The common denominator in these examples is the nexus between the trade or business and the income generated. For example, interest income on loans is the type of income a bank is designed to generate. Conversely, interest or dividend income derived from invested working capital for future use in the taxpayer's trade or business is not that type of income; and, thus is treated as net investment income.² Moreover, under no circumstances is any income derived from trading in financial instruments or commodities ever be excluded from net investment income.³

As to income derived in a trade or business that is not treated as net investment income pursuant to IRC Sections 1411(c)(1)(A)(ii) and (iii), there is a much looser test for the application of the exclusion. That test is the same for both sections. As discussed in Q 8579, IRC Section 1411(c)(1)(A)(ii) deals with the regular gross income of a trade or business. Conversely, IRC Section 1411(c)(1)(A)(iii) deals with net gain attributable to the sale or exchange of property.

Unlike the IRC Section 1411(c)(1)(A)(i) exclusion, there is no requirement that the income must be of the type that the trade or business is designed to generate. Instead, to qualify for the exception, the income must be derived from a trade or business in which the taxpayer materially participates (non-passive) and under no circumstances is the income derived from trading in financial instruments or commodities.⁴ Stated differently, pursuant to IRC Section 1411(c)(1)(A)(ii), net investment income includes all income derived from a trade or business that is passive with respect to the taxpayer. However, if the trade or business is non-passive with respect to the taxpayer, the income is excluded from net investment income. For a discussion regarding determining whether an activity is passive or non-passive, see Q 8589.

As mentioned above, the same test is used to determine whether net gain attributable to disposition of property (sale or exchange) otherwise included in net investment income pursuant to IRC Section 1411(c)(1)(A)(iii) is excluded from net investment income. In applying this test, the net gain is excluded only if the disposed of property is held in a trade or business which is non-passive with respect to the taxpayer and is not derived from a business trading in financial instruments or commodities. Thus, the net gain from the disposition of property held by a trade or business that is passive with respect to the taxpayer would be included in net investment income.

1. Treas. Regs. §1.469-2T(c)(3)(ii); 1.1411-6.

2. IRC Section 1411(c)(3).

3. IRC Sec. 1411(c)(2).

4. IRC Sec. 1411(c)(2).

Net Investment Income Exclusion for Income Derived in the Taxpayer's Trade or Business

	Included as Net Investment Income	Excluded from Net Investment Income
IRC Section 1411(c)(1)(A)(i) Interest, Dividends, Annuities, Rents and Royalties	Traditional Investment Income	The type of income the business was designed to generate, i.e., interest income earned by a bank.
IRC Section 1411(c)(1)(A)(ii) Gross Income from a Trade or Business	Income derived from a trade or business that is passive with respect to the taxpayer or derived from a business trading in financial instruments or commodities. Also includes income from an activity that does not arise to the level of a trade or business.	Income derived from a trade or business that is non-passive with respect to the taxpayer other than income derived from a business trading in financial instruments or commodities.
IRC Section 1411(c)(1)(A)(iii) Net Gain from the Disposition of Property Held in a Trade or Business	The underlying trade or business is passive with respect to the taxpayer or is a business trading in financial instruments or commodities.	The underlying trade or business is non-passive with respect to the taxpayer and is not a business trading in financial instruments or commodities.

8589. What is the importance of whether trade or business activities are considered “passive” with respect to the taxpayer?

Prior to the enactment of the net investment income tax, the relevance of “passive” activities was to limit deductible passive expenses to passive income.¹ Now, as a result of the net investment income tax, the characterization of an activity as passive has new significance. As discussed in Q 8588, gross income derived from a trade or business and/or net gain attributable to the sale or exchange of property that is passive with respect to the taxpayer is included in net investment income subject to the 3.8 percent net investment income tax. To qualify for the exclusion, the taxpayer must “materially participate” in the business activity so as to make it a non-passive activity.

Section 1411 and the regulations reference the definition of passive activity set forth in IRC Section 469, indicating that the rules for determining whether an activity is active or passive apply in the context of determining whether the income is included in investment income.² Whether an activity is passive or non-passive depends on the level of the taxpayer's participation

1. IRC Sec. 469.

2. IRC Sec. 1411(c), Treas Reg. §1.1411-5(b).

in the activity. A passive activity is any trade or business activity in which the taxpayer does not “materially participate.”¹ Generally, a taxpayer is considered to *materially participate* in an activity if he is involved in the operations of the activity on a regular, continuous, and substantial basis. Many of the factors considered by the IRS involve the number of hours that the taxpayer devotes to the activity annually. The IRS may also compare the number of hours that a taxpayer devotes to the activity to the hours spent by others engaged in the same business. A traditional facts and circumstances test is typically applied in making a final determination. See Q 8638 for a discussion of the material participation requirement in the context of the passive activity rules.

So, if a taxpayer materially participates in a trade or business, it is considered non-passive; and, thus, the income described above would qualify for the exclusion. As an important caveat, even if the taxpayer participates in a trade or business, if the income from such business is considered to be self-employment income, it can never be considered net investment income. Instead, such income is subject to Medicare tax and potentially the Additional Medicare tax.²

For a detailed discussion of the passive activity rules in general, see Q 8635 to Q 8644.

8590. Can a taxpayer “group” multiple activities in order to meet the material participation test for purposes of the net income investment exclusion?

Another way to meet the material participation test is to “group” several activities into a single activity to meet the material participation test. Under Treasury Regulation Section 1.469-4,³ one or more trade or business activities may be “grouped” and treated as one economic unit for purposes of determining whether the taxpayer materially participated. By doing so, the taxpayer’s participation for all the activities would be aggregated as if it was one activity. Whether or not the IRS will recognize grouped activities as a single economic unit is based on facts and circumstances. The following five factors are relevant in determining whether such activities qualify to be treated as a single economic unit:⁴

- (1) similarities and differences in types of trades or businesses,
- (2) the extent of common control,
- (3) the extent of common ownership,
- (4) geographical location, and
- (5) interdependencies between or among the activities.

Once a taxpayer has grouped activities, the taxpayer is generally not permitted to regroup those activities in later tax years.⁵ See Q 8591 for the limited exception to this rule.

1. IRC Sec. 469(c).

2. IRC Section 1411(c)(6).

3. Treas. Reg. §1.469-4.

4. Treas. Regs. §§1.469-4(c)(1), 1.469-4(c)(2).

5. Treas. Reg. §1.469-4(e)(1).

8591. Can a taxpayer regroup activities after an initial grouping has already taken place?

Obviously, the grouping rules were the outgrowth of the passive activity income and loss rules that far predate the enactment of the net investment income tax. For the reason, allowing the taxpayer to regroup certain activities in view of net investment income tax considerations could potentially save a significant amount of tax.

The final regulations provide a small window allowing such a regrouping. In order to regroup,

- (1) the regrouping must occur only in the first taxable year beginning after December 31, 2012; and
- (2) the regrouping taxpayer must be subject to net investment income during that year.

In other words, regrouping is allowed only in the one single tax year referenced above, and, only if a taxpayer is subject to net investment income in that same year. Consequently, any taxpayer who is not subject to net investment income in that taxable year, but may be subject to it in a subsequent year, is not entitled to a “fresh start” regrouping.¹

Planning Point: In drafting the final regulations, the IRS refused to allow pass through entities such as S corporations and partnerships to regroup. In declining to do so, the final regulations noted that taxpayers not subject to the net investment income tax for the taxable year beginning after December 31, 2012, would get the benefit of regrouping indirectly (i.e., by virtue of the pass through of income from those entities), that they would not be entitled to receive directly.²

For additional discussion of the passive activity rules in general, see Q 8635 to Q 8644.

8592. How does the investment income tax effectively increase the tax rate for capital gains and dividends?

The 3.8 percent net investment income tax is a surtax, which means it is imposed independently on net investment income that is also subject to any other applicable income tax rate. To this point, the capital gains and dividend tax rate for taxpayers in the 39.6 percent tax bracket is 20 percent. However, if the taxpayer is also subject to the net investment income tax, there is an additional 3.8 percent tax imposed on those same capital gains and dividends. Thus, adding the two tax rates together, the overall effective tax rate for capital gain and dividends for those taxpayers is 23.8 percent (20% plus 3.8%).

For taxpayers who are not in the 39.6 percent tax bracket, the capital gains and dividend tax rate is only 15 percent. However, it is possible that such taxpayers with modified adjusted gross income that exceeds the threshold levels for the net investment income tax (see Q 8580) may also be subject to the net investment income tax. Adding the 15 percent regular income tax

1. Preamble to Final Regulations, 78 Fed. Reg. 72396.

2. Preamble to Final Regulations, 78 Fed. Reg. 72396.

capital gain and dividend rate to the 3.8 percent net investment income tax rate, the effective rate of such taxpayers would be 18.8 percent (15% plus 3.8%).

8593. Can federal income tax credits be used to offset net investment income tax liability?

Although Federal income tax credits set forth in Subtitle A of the IRC can offset any tax liability, the final regulations state that income tax credits are allowed only against regular income tax (Chapter 1 of Subtitle A) and may not reduce net investment income tax.¹ Examples of this type of tax credit include the foreign income tax credit and the general business tax credit.²

The denial of tax credits as an offset of the net investment income tax is reflected by the sequence of reporting tax and tax credits on Form 1040. To this point, regular income tax is reported on line 46 of Form 1040. All tax credits reducing that regular income tax are taken on the following lines 47 – 53. Beginning on line 56, the “other taxes” including the net investment income tax (reported on line 60) are reported. So logistically, all tax credits that reduce regular income tax are taken *before* the entry for the net investment income tax. Moreover, none of those credits are refundable credits (meaning the credits can only reduce the regular tax to zero and not generate a refundable overpayment). Thus, they are of no consequence with regard to the net investment income tax reported on line 60.

8594. What form is used to report net investment income tax?

As mentioned above, net investment income tax is reported on line 60 of Form 1040. On Form 8960 (attached to Form 1040), the taxpayer computes the tax. In addition to reporting all the taxpayer’s net investment income, amounts reported on Form 8814 (Parents’ Election to Report Child’s Interest and Dividends) are also included.

Planning Point: Similar to regular income tax or self-employment tax, individuals who expect to be liable for the net investment income tax may either make estimated tax payments or request their employer to withhold additional amounts to avoid being subject to penalties for underpayment of taxes.³

8595. When is an estate or trust subject to the investment tax?

Certain trusts and estates are also subject to the 3.8 percent net investment income tax. Basically, the tax is imposed on any net investment income that remains in the estate or the trust and, thus, is not distributed to beneficiaries, otherwise referred to as “undistributed net investment income.” Unlike individual taxpayers, the threshold amount is the amount at which the highest regular income tax bracket begins. Additionally, unlike the applicable threshold amount for individuals, the applicable threshold is adjusted for inflation.⁴ For example, in 2014, the amount at which the highest income tax bracket begins is adjusted gross income in excess of \$12,150. Since this amount is relatively low, many estates and trusts are likely to be subject to the tax.

1. Treas. Reg. §1.1411-1(c).

2. See IRC Secs. 27, 901, 38.

3. IRS Q&A on the Net Investment Income Tax, available at: <http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs> (last accessed April 25, 2014).

4. IRC Sec. 1411(a)(2)(B)(ii).

The following examples are used to demonstrate the computation of the net investment income tax for a trust.

Example: In 2014, the Dinosaur trust has AGI of \$16,000 and undistributed net investment income of \$6,000.

The net investment income tax is imposed on trusts and estates on the lesser of:

- 1) Undistributed Net Investment Income, \$6,000; or
- 2) The excess of (i) AGI of \$16,000, over (ii) \$12,500, the amount at which the highest regular tax bracket begins, or \$3,850.

Even though there is \$6,000 of undistributed net investment income, because the lesser of the two amounts is \$3,850, only that amount is subject to the 3.8 percent net investment income tax.

Example: In 2015, the Dinosaur trust has AGI of \$20,000 and undistributed net investment income of \$6,000.

The net investment income tax is imposed on trusts and estates on the lesser of:

- 1) Undistributed Net Investment Income, \$6,000; or
- 2) The excess of (i) AGI of \$20,000, over (ii) \$12,500, the amount at which the highest regular tax bracket begins, or \$7,850.

Because the lesser of the two amounts is the undistributed net investment income of \$6,000, the entire amount of undistributed net investment income is subject to the 3.8 percent net investment income tax.

8596. Which trusts are not subject to the net investment income tax?

Trusts not subject to the net investment income tax include charitable trusts exempt from tax under IRC Section 501¹ or IRC Section 664² (charitable remainder trusts) and trusts that are not classified as “trusts” for federal income tax purposes.³ Moreover, if all of the remaining interests in a trust are designated for certain qualified purposes, the trust is not subject to the net investment income tax. These qualified purposes described in IRC Section 170(c)(2)(B) include religious, charitable, scientific, literary or educational purposes.⁴

Finally, grantor trusts such as revocable trusts are not subject to the net investment income tax. This is because the income of a grantor trust is taxed directly to the grantor. As a result, any net investment income generated by the trust is included in the grantor’s net investment income – potentially subject to the 3.8 percent tax.⁵

1. Treas. Reg. §1.1411-3(b)(1)(ii).

2. Treas. Reg. §1.1411-3(b)(1)(iii).

3. Treas. Reg. §1.1411-3(b)(1)(iv).

4. Treas. Reg. §1.1411-3(b)(1), IRC Sec. 170(c)(2)(B).

5. Treas. Reg. §1.1411-3(b)(1)(v).

8597. What considerations are relevant in determining if a trade or business is non-passive with respect to a trust for purposes of treating the income derived therefrom as excluded from net investment income?

As discussed in Q 8589, whether a trade or business activity from which the taxpayer derives income from is passive depends on the taxpayer's level of participation in the activity in question. In the case of a trust that owns interests in a pass-through entity, such as an S corporation or partnership, it is the trustee's participation in the business activities that is relevant in determining whether the investment is active or passive with respect to the trust.

In a 2013 technical advice memorandum, the IRS expressed a restrictive view of what participation in a business activity by a trustee is attributable to the trust. In that memorandum, the IRS declared that a trustee's participation in a business in which the trust owned interests was *not* material even though the trustee was also the president of the company through which the business activity was conducted.¹ The IRS reached this conclusion based on its view that the trustee's participation in the company as an *employee* was separate from his role as trustee; and, thus, it was not attributable to the trust. Further, although the IRS did count the trustee's time spent serving as *trustee* in dealing with the company's business, it determined that the trustee's activities were nonetheless not "regular, continuous and substantial" within the meaning of IRC Section 469 (governing passive activities generally).²

Although the technical advice memorandum did not address the issue of whether the trust income was net investment income, it reflects the IRS view that the participation of a trustee as an employee or officer of an entity is not attributed to his or her role as the trustee. Based on such a restrictive view of the role of the trustee, it may be virtually impossible for any trust to materially participate in a business activity.

However, in a recent decision, the Tax Court rejected the IRS' restrictive position.³ In that case, a trust owned rental real estate properties and engaged in other real estate activities. Three of the five trustees worked full-time in the trust's wholly owned rental real estate LLC. The issue was whether the personal services of the trustees as employees of the LLC would be attributable to the trust.

Pursuant to IRC Section 469(c)(2), all rental activities are passive. In order to rebut that characterization, IRC Section 469(c)(7)(B) requires the taxpayer to meet the following two tests: (1) more than one-half of the personal services performed in the trades or businesses by the taxpayer during the taxable year is performed in real property trades or businesses in which the taxpayer materially participates; and, (2) the taxpayer performs more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates.

Consistent with the technical advice memorandum, the IRS argued that the personal services performed by the trustees as employees of the LLC were not attributable to the trust.

1. TAM 201317010.

2. IRC Sec. 469(h)(1).

3. *Frank Aragona Trust et. al. v. Comm.*, 142 T.C. No. 9 (March 27, 2014).

The Tax Court, however, rejected the IRS' view as being too narrow and held that the participation of the trustees as employees were attributable to the trust. So, because the activities of those trustees/employees met the two IRC Section 469(b)(7)(B) tests, the trust was deemed to have materially participated in the rental real estate activities, and, for that reason, they were non-passive activities.

Planning Point: Although the Tax Court case also did not involve net investment income, based on the holding, the non-passive rental income would have most likely been excluded from net investment income. Additionally, the Tax Court case is significant because it was a regular opinion reviewed by the entire Tax Court bench rather than a Tax Court Memorandum decision that carries less authoritative weight. In any event, IRS has not yet indicated whether it will follow the decision or continue to apply the restrictive view of the technical advice memorandum. Because a low applicable threshold subjects many trusts to the net investment income tax (see Q 8595), trustees should pay attention to how the IRS will deal with this issue as it relates to treating rental real estate activities of a trust as passive or non-passive.

8598. What is the additional Medicare tax? Who is liable for paying the additional Medicare tax?

The additional Medicare tax is a tax of 0.9 percent that is tacked on to the “regular” Medicare tax on all wages and self-employment income (collectively referred to as “earned income”) that exceed applicable thresholds amounts. Thus, on earned income in excess of the applicable threshold amount, the total Medicare tax rate is 3.8 percent (the 2.9 percent regular Medicare tax rate plus the 0.9 percent additional Medicare tax rate).

In spite of its name, the tax revenue generated by the Additional Medicare tax is not specifically earmarked for the Medicare fund. Similar to the regular Medicare tax, the additional Medicare tax is imposed only on individual taxpayers (see Q 8599 for a discussion of an employer's obligation to withhold the additional Medicare tax). Thus, entities such as C corporations, trusts and estates are not subject to the tax.¹

The applicable thresholds for the additional Medicare tax (not adjusted for inflation) are the sum of the taxpayers earned income (wages and/or self-employment income) in excess of the following amounts:

- (1) \$250,000 for married taxpayers filing jointly;
- (2) \$125,000 for married taxpayers filing separate returns; and
- (3) \$200,000 for single taxpayers and heads of households.²

Planning Point: The tax base of the additional Medicare tax and the net investment income are mutually exclusive. To this point, the additional Medicare surtax is imposed on earned income whereas the net investment income tax is imposed on investment income. This means that a taxpayer cannot be subject to both additional taxes on the same income.³ If income could be included in both tax bases, it will be included in the Medicare tax base.

1. IRC Sec. 3101(b)(2).

2. IRC Sec. 3101(b)(2).

3. IRS FAQ, Questions and Answers for the Additional Medicare Tax, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax> (last accessed April 23, 2014).

8599. If one spouse's wages exceeds \$200,000, triggering mandatory withholding by the employer of the additional Medicare tax, but when combined with the second spouse's wages, the couple's wages are less than the \$250,000 threshold for married taxpayers filing jointly (meaning there is no additional Medicare tax owing), can the first spouse request his or her employer not to withhold the additional Medicare tax?

No. Pursuant to IRC Section 3102(a), once an employee's wages exceed \$200,000 (the mandatory wage withholding amount), the employer must withhold 0.9 percent of the excess amount even if the employee does not actually owe any additional Medicare tax. So for wages in excess of \$200,000, the employer must withhold the additional Medicare tax even if those wages combined with his or her spouse's wages do *not* exceed the applicable threshold for a married couple filing jointly (\$250,000).¹ To the extent the amount withheld exceeds the employee's liability, the employee's remedy is to apply it as a payment against other tax he or she may owe or receive a refund for the excessive withholding.

8600. What are the consequences of an employer's failure to withhold the additional Medicare tax that an employee is liable to pay?

There are several possible ways that an employer might fail to withhold the additional Medicare tax an employee is liable to pay. For example, it might occur if both spouses individually earn wages under the mandatory \$200,000 withholding amount. So, if one spouse has wages of \$100,000 and the other spouse has wages of \$199,000, neither spouse's wages are subject to mandatory withholding. Yet, because the couple's combined wages of \$299,000 exceed the \$250,000 applicable threshold by \$49,000, they must pay the additional Medicare tax on that amount. Thus, on Form 8959, the couple would compute the additional Medicare tax of 0.9 percent on \$49,000 — reporting it on line 60 of Form 1040.²

On the other hand, an employer obligated to withhold the additional Medicare tax on wages in excess of \$200,000 may simply fail to do so. Under those circumstances, the employer remains obligated to pay the tax to the IRS unless and until the employer can prove that it was paid by the employee. However, even if the employee ultimately pays the tax, it does not relieve the employer of its liability for any interest or penalties assessed as a result of its failure to withhold the additional Medicare tax.³

8601. Can a taxpayer request additional withholding specifically earmarked to pay anticipated additional Medicare tax?

No, a taxpayer cannot make such a request. However, the taxpayer may modify Form W-4 to request his or her employer to withhold additional income tax. Even though the additional

1. IRS FAQ, Questions and Answers for the Additional Medicare Tax, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax> (last accessed April 14, 2014); Treas. Reg. §31.3102-4(a).

2. Treas. Reg. §31.3102-4(b), Example J.

3. Treas. Reg. §31.3102-4(c).

amount withheld is technically regular income tax (not additional Medicare tax), it is nonetheless credited as a payment to be applied to all Form 1040 tax liability owing including the additional Medicare tax.¹

8602. Can a taxpayer make estimated tax payments to cover the additional Medicare tax liability?

Although the additional Medicare tax is a separate tax, the IRS considers it to be part of the taxpayer's overall tax liability. So, if the taxpayer's withholdings are not sufficient to cover the entire tax liability, there may be a penalty imposed on the failure to make an estimated tax payment. For that reason, it may behoove a taxpayer who does not increase the amount withheld by the employer to make estimated payments to cover any shortfall.²

8603. How does a taxpayer calculate additional Medicare tax liability if the taxpayer receives both wage income and self-employment income in the same tax year?

The taxpayer's combined wages and/or self-employment income is subject to the additional Medicare tax. This means the tax is imposed on the excess of the taxpayer's entire amount of earned income over the applicable threshold. The following fact pattern demonstrates the three-step procedure for calculating the tax owed:

Example: Sam is a single taxpayer with \$130,000 in wages and \$145,000 in self-employment income, or total earned income of \$275,000. The applicable threshold for a single taxpayer is \$200,000.

Step 1 - Calculate additional Medicare tax on wages in excess of the applicable threshold;

As mentioned above, the applicable threshold for a single taxpayer is \$200,000. However, since Sam's wages of \$130,000 do not exceed the applicable threshold, there is no additional Medicare tax on his wages.

Step 2 - Reduce the applicable threshold by the total amount of wages, but not below zero;

In this case, the applicable threshold of \$200,000 minus Sam's \$130,000 of wages equals a reduced threshold of \$70,000.

Step 3 - Calculate the additional Medicare tax on any self-employment income received in excess of the reduced threshold.

In Step 1, \$130,000 of the applicable threshold is absorbed by Sam's wages. Then, in Step 2, the applicable threshold minus Sam's wages is reduced to \$70,000. Finally, in Step 3, Sam's self-employment income of \$145,000 exceeds the reduced threshold of \$70,000 by \$75,000, the amount of Sam's self-employment income subject to the additional Medicare tax. The actual tax is \$675 ($0.9\% \times \$75,000$).

1. See IRS Q&A on the Additional Medicare Tax, available at: <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax> (last accessed April 25, 2014).

2. See IRS Q&A on the Additional Medicare Tax, available at: <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax> (last accessed April 25, 2014).

8604. Are noncash fringe benefits received by an employee subject to the additional Medicare tax?

Yes. The value of any taxable noncash employee fringe benefits is added to his or her cash wages to determine whether the taxpayer's overall wage income exceeds the applicable threshold (see Q 8598). If so, the excess amount will be subject to the additional Medicare tax.¹ Moreover, similar to the payment of only cash wages, if the combined amount of cash wages and taxable noncash fringe benefits exceeds the mandatory wage withholding amount of \$200,000 (see Q 8599), the employer must withhold the additional Medicare tax on the excess amount of combined wage income.²

See Q 8778 to Q 8804 for a discussion of the tax treatment of various noncash fringe benefits.

1. IRS FAQ, *Questions and Answers for the Additional Medicare Tax*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax> (last accessed April 23, 2014).

2. IRS FAQ, *Questions and Answers for the Additional Medicare Tax*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Questions-and-Answers-for-the-Additional-Medicare-Tax> (last accessed April 23, 2014).

PART IV: NONTAXABLE EXCHANGES

8605. What is a nontaxable exchange? What is the difference between a nontaxable exchange and a tax-free transaction?

In certain circumstances, the IRC permits a taxpayer to obtain new property in order to replace previously held property without recognizing gain on the exchange. This nonrecognition treatment reflects Congress' acknowledgment that, while the taxpayer acquires a new asset in exchange for an existing asset, in substance the taxpayer has not changed economic position.

In a nontaxable exchange, although gain or loss on the disposition of property is not recognized at the time of the exchange, the nonrecognition treatment is only temporary. Thus, when the taxpayer eventually sells the replacement property the taxpayer will then be required to recognize gain or loss.

A direct exchange is not always necessary in order for a transaction to qualify as a nontaxable exchange. For example, in an involuntary conversion, a taxpayer obtains an asset to replace property that was lost. See Q 8611 to Q 8614 for a discussion of the rules applicable in the context of an involuntary conversion.

On the other hand, in a tax-free transaction, the gain or loss is never recognized. For example, within certain limits the gain on the sale of a taxpayer's primary residence is excluded from gross income; and, thus never taxed.¹

8606. What exchanges of property qualify as like-kind exchanges and nonrecognition treatment?

IRC Section 1031(a) provides that no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a "like-kind" to be held for productive use in trade or business or for investment.² IRC Section 1031 does not provide a permanent exclusion of gain or loss because the taxpayer's basis in property exchanged transfers to the exchanged property to become the basis of that property.³ So if the taxpayer subsequently sells the property, the deferred gain or loss would be recognized.

The phrase "like-kind" refers to the nature or character of the property and not to its grade or quality.⁴ So, whether real property is improved or unimproved is not relevant because virtually all types of real property are deemed to be of the same nature or character. Perhaps for this reason, the Section 1031 nonrecognition provision is frequently used in connection with exchanges of real property. Interestingly, the regulations equate a leasehold interest with at least 30 years to run as being equivalent to an ownership interest in real property.⁵

1. IRC Sec. 121.

2. IRC Sec. 1031(a)(1).

3. IRC 1031(d).

4. Treas. Reg. §1.1031(a)-1(b).

5. Treas. Reg. §1.1031(a)-1(c); *VIP Industries Inc. v. Commissioner*, TC Memo 2013-157.

Only certain types of property are eligible for nonrecognition treatment under the rules applicable to like-kind exchanges. Exchanges of stock in trade (or other property held primarily for sale) and stocks, bonds, notes, and other securities or evidences of indebtedness or interest are specifically excluded under Section 1031, even though they might otherwise qualify as business or investment property.¹ Additionally, IRC Section 1031(h) specifically excludes exchanges in which at least one of the properties is real property located outside the United States. Similarly, an exchange involving a partnership interest in a real estate partnership is specifically excluded from like-kind exchange treatment.²

Though the like-kind exchange rules are well-settled in the area of real property, application of the “like-kind” standard is not so clear with respect to exchanges of personal property. In Revenue Ruling 82-166, the IRS ruled that an exchange of gold bullion (held for investment purposes) for silver bullion (which would also be held for investment purposes) did not qualify as a like-kind exchange, based on the finding that silver and gold are intrinsically different metals and are used in different ways; silver is essentially an industrial commodity while gold is primarily utilized as an investment in itself. Therefore, the IRS reasoned that an investment in one of the metals is fundamentally different from an investment in the other metal.³ Conversely, the IRS has found that trades of major league player contracts, as well as the exchange of gold bullion for Canadian Maple Leaf gold coins, qualified for like-kind treatment.⁴

8607. What is a taxpayer’s basis in property received in a like-kind exchange?

In a transaction qualifying for nonrecognition treatment, the property received takes a carryover or transferred basis from the property given up. In this manner, the unrecognized gain or loss on the property disposed of is deferred by becoming the basis of the acquired property to be recognized later when the acquired property is disposed of in a taxable transaction.⁵

8608. What are the tax consequences if a taxpayer receives consideration other than like-kind property in the exchange?

If a transaction otherwise qualifying for nonrecognition treatment under IRC Section 1031 involves the receipt of money or non-like-kind property (“boot”) in addition to the like-kind property received in the exchange, any realized gain on the exchange must be recognized to the extent of the value of the boot received, and the carryover or transferred basis must be adjusted.

Example: Joanne who owns a small business has three delivery vans. In 2014, Joanne transfers one of the delivery vans, which had an adjusted basis of \$2,500 and a fair market value of \$2,800, to Calin, in exchange for a truck with a fair market value of \$2,200, and \$600 in cash.

Joanne’s realized gain is \$300 (\$2,200 truck and \$600 cash received, or \$2,800 minus \$2,500 basis). Because the cash is boot, Joanne must recognize gain to the extent of the boot. Joanne’s overall gain is \$300 and the boot is \$600. As a result, Joanne must recognize the entire \$300 gain.

1. IRC Sec. 1031(a)(2).

2. IRC Sec. 1031(a)(2)(D).

3. Rev. Rul. 82-166, 1982-2 CB 190.

4. Rev. Rul. 67-380, 1967-2 CB 291; Rev. Rul. 71-137, 1971-1 CB 104; Rev. Rul. 82-96, 1982-1 CB 113.

5. IRC Sec. 1031(d).

As to Joanne's carryover basis, it is increased by the amount of any gain recognized and decreased by the amount of any money received.¹ So in this case, Joanne's basis of \$2,500 is increased to \$2,800 as a result of the \$300 gain. Then that \$2,800 basis is decreased by the amount of money received, \$600, to \$2,200. As a result, Joanne's basis in the truck she received in the exchange is \$2,200. So if Joanne were to sell the truck for \$2,200 (its fair market value), she would have no gain or loss.²

Similarly, if the person who receives the like-kind property assumes a liability that secures the property, the transferor is treated as having received money to the extent of the assumed liability. If the property received in the exchange is also secured by a liability, then the boot deemed received is only the excess, if any, of the liability transferred with the exchange property over the liability assumed on the property received.³

Example: Al owns a warehouse with a basis of \$160,000, a value of \$200,000, and subject to a mortgage of \$150,000. He transfers the warehouse to Asher in exchange for an office building with a value of \$175,000, which is subject to a \$125,000 mortgage.

From a strictly economic perspective, Al's amount realized is the fair market value of the office building, \$175,000, plus a net assumption by Asher of \$25,000 of liability (Al's property is subject to \$150,000 mortgage and Asher's property is subject to a \$125,000 mortgage). Thus, Al's realized gain is \$40,000 (\$200,000 minus \$160,000 basis).

Although the transaction is a like-kind exchange, Al must recognize the realized gain to the extent of the boot received. In this case, as a result of the transfer of mortgages, Al is deemed to have received \$25,000 of money (\$150,000 minus \$125,000).

So of the \$40,000 realized gain, Al must recognize \$25,000. The balance of the gain, \$15,000 is not recognized.

Al's carryover basis is adjusted as follows: The \$160,000 basis is increased to \$185,000 by the \$25,000 of recognized gain. It is then decreased by \$25,000, the amount of money Al is deemed to receive. As a result, Al's basis in the office building is \$160,000.

Therefore, if Al were to sell the office building for \$175,000 (its fair market value), he would recognize \$15,000 of gain. So to recap, Al realized \$40,000 of gain with respect to the exchange. Of that amount, \$25,000 was immediately recognized and \$15,000 was deferred.

Realized Gain Computation:

Nonrecognized Portion of Gain

Amount Realized	\$200,000
Basis	\$160,000
Total Gain Realized	\$40,000
Recognized Gain (Mortgage Boot)	\$25,000
Deferred Gain	\$15,000

1. IRC Sec. 1031(d).

2. Treas. Reg. §1.1031(d)-1(b).

3. Treas. Reg. §1.1031(b)-1(c).

Recognized Portion Of Gain (Boot)

Mortgage Given Up	\$150,000
Mortgage Taken On	(\$125,000)
Boot	\$25,000

Basis of Building Received

Carryover Basis From Property Given Up	\$160,000
Plus: Gain Recognized	\$25,000
Less: Cash Boot Deemed Received	(\$25,000)
Basis of Building Received	\$160,000

8609. Can a taxpayer defer recognition of gain under the like-kind exchange rules if the exchange is made between related parties?

If like-kind property is exchanged between persons who are “related” to each other (as defined in IRC Sections 267(b) or 707(b)(1)), the nonrecognition treatment provided under Section 1031 will not apply if either party disposes of the property received within two years after the exchange.¹

If such a disposition is made by either party, then both parties must recognize the gain on the exchange in the year of the subsequent disposition.² IRC Section 1031(f) (2) contains certain specific exceptions to this rule and a general exception for transactions that the IRS concludes did not have tax avoidance as one of the principal purposes.

As a result, nonrecognition treatment will be permitted if the property was disposed of within two years of the exchange as a result of:

- (1) the death of the taxpayer or the related person; or
- (2) an involuntary conversion (see Q 8611) if the exchange occurred before the threat of the conversion arose.³

IRC Sec. 1031(f)(4) provides that if an exchange is part of a transaction (or series of transactions) structured to avoid the related party rules of Section 1031, the section will not apply at all (except for subsection (f)(4)) and any gain will be recognized in the year of the original sale.

8610. When might a taxpayer want to avoid like-kind exchange treatment?

Like-kind exchange treatment is not elective. Despite this, there are situations where a taxpayer may wish to avoid nonrecognition treatment. If this is the case, in order to avoid application of the like-kind exchange rules, the taxpayer should seek to structure the transaction so that one or more of the requirements under IRC Section 1031 are not met.

1. IRC Sec. 1031(f).

2. IRC Sec. 1031(f)(1).

3. IRC Sec. 1031(f)(2).

There are many reasons why a taxpayer may wish to recognize gain in the current year rather than deferring it until some point in the future. For example, a taxpayer may wish to recognize gain in order to obtain a higher basis in the property for depreciation purposes.

Example: Asher owns a warehouse with a fair market value of \$200,000 and a basis of \$40,000. In a like-kind exchange of the warehouse for an office building of equal value will result in Asher having a carryover basis of \$40,000 in the office building. However, if the exchange did not qualify as a like-kind exchange, Asher would recognize a gain of \$160,000 (\$200,000 minus \$40,000). However, due to the recognition of gain, Asher's basis in the office building would be \$200,000. Thus, with a higher basis, Asher would be entitled to greater depreciation deductions.

Additionally, if the taxpayer has a substantial amount of capital loss, a recognized gain would be offset by such loss (see Q 8575) or if taxpayer's current income tax rate is expected to rise in the future. See Q 8561 for a discussion of the current capital gains rates and their interaction with a taxpayer's income tax rates.

Planning Point: For taxpayers who anticipate that their capital gains rate will increase (perhaps from the current low of 0 percent (in 2008-2014 for taxpayers in the 10 or 15 percent ordinary income tax brackets) to as much as 23.8 percent when the investment income tax (see Q 8580 and Q 8597) is applied), deferring capital gains in a nontaxable exchange could actually cause their tax liability to increase. In 2013 and beyond, the long-term capital gains tax rate is 20 percent for high income taxpayers (but remains at 0 percent for taxpayers in the 10 and 15 percent tax brackets).

8611. What are the tax consequences of an involuntary conversion?

IRC Section 1033 applies to cases where property is compulsorily or involuntarily converted. This provision recognizes that a taxpayer who has suffered an involuntary conversion has experienced an economic hardship and may not have the ability to pay taxes on any gain resulting from the conversion. This is because any proceeds in excess of the taxpayer's basis in the converted property would generate taxable gain. Thus, IRC Section 1033 postpones recognition of the gain to the extent the proceeds obtained in the conversion, whether through insurance or otherwise, is reinvested in replacement property (see Q 8612).¹

An "involuntary conversion" may be the result of the destruction of property (whether in whole or in part, see Q 8614 for a discussion of partial conversions), the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation.

On the other hand, the taxpayer is required to recognize any gain that exceeds the amounts reinvested in replacement property following the involuntary conversion.²

Example: Patrick received \$500,000 in insurance proceeds when his warehouse with an adjusted basis of \$100,000 was destroyed in a hurricane. If Patrick decided to retire and keep the insurance proceeds, he would have a gain of \$400,000 (it is as if he sold the warehouse to the insurance company for \$500,000). However, in evaluating his financial situation, Patrick decides to downsize his business and purchase a new warehouse for \$350,000. Because Patrick reinvested \$150,000 less than he actually received, he must recognize \$150,000 of the \$400,000 gain.

1. IRC Sec. 1033(a).

2. IRC Sec. 1033(a)(2).

Planning Point: All the details of an involuntary conversion of property at a gain (including information about the replacement of the converted property, a decision not to replace it, or the expiration of the period for replacement) must be reported in the return for the year or years in which any of the gain is realized.¹

Section 1033 applies only with respect to gains. If a taxpayer experiences a loss as a result of an involuntary conversion, Section 1033 is inapplicable and the loss is recognized or not recognized in accordance with the general rules applicable to loss recognition. See, for example, Q 8649 to Q 8660, which explain the rules applicable when a taxpayer has experienced a casualty loss.

8612. How does the type of property into which the lost or destroyed property is converted into impact whether the taxpayer can claim non-recognition treatment as the result of an involuntary conversion?

Conversion into Similar Property

Whether or not the taxpayer is required to recognize gain resulting from an involuntary conversion of property depends upon the type of property into which the lost or destroyed property is converted.² If, as explained below, the replacement property is similar or related in service or use with the lost or destroyed property, no gain is recognized (losses are always recognized). For nonrecognition treatment to apply, no election is required.

The determination of whether property is similar for purposes of IRC Section 1033 is not the same for determining whether property is “like-kind” property for purposes of IRC Section 1031. The taxpayer’s use of the replacement property must be similar to the use of the converted property.³ For example, if a taxpayer’s principal residence is replaced by rental property, it would not be considered a similar use.

In the business context, the following factors are relevant in determining whether the taxpayer has replaced converted property with similar property:

- (1) Whether the properties provide a similar service to the taxpayer;
- (2) The nature of the business risks connected with the properties; and
- (3) The demands of the properties upon the taxpayer, including management, required services or relations to tenants.⁴

Conversion into Money or Dissimilar Property

The result is different when the original property is converted into money or dissimilar property. In such cases the proceeds arising from the disposition of the converted property must (within the time limits specified, see Q 8613) be reinvested in similar property (as described above)

1. Treas. Reg. §1.1033(a)-2(c)(2).

2. IRC Sec. 1033(a).

3. Rev. Rul. 70-466, 1970-2 CB 165.

4. Rev. Rul. 64-237, 1964-2 CB 319.

in order to avoid recognition of any gain realized.¹ If the taxpayer reinvests the entire proceeds into replacement property, no gain will be recognized. However, if the taxpayer only invests part of the proceeds, the taxpayer can elect to recognize the gain only to the extent that the cost of the replacement property exceeds the reinvested proceeds. Obviously, if the taxpayer fails to make the election the entire gain would be recognized.²

Example: In 2014, a warehouse Asher used in his trade or business was totally destroyed by fire. At the time of the destruction of the warehouse, the warehouse had an adjusted basis of \$100,000. The insurance company promptly paid Asher \$500,000 for the loss. As a result, Asher realizes a gain of \$400,000. Later that year, Asher purchases a new warehouse for \$350,000. Thus, the insurance proceeds exceeded the cost of the replacement property by \$150,000 (\$500,000 minus \$350,000). If Asher fails to make an election pursuant to IRC Section 1033(a)(2), the entire realized gain, \$400,000, would be included in his gross income. On the other hand, if Asher makes the election, only \$150,000 (the amount of the proceeds he did not reinvest) of the \$400,000 gain would be included in gross income.

8613. Is a taxpayer who has an involuntary conversion into money required to replace the lost or destroyed property within a certain amount of time to qualify for nonrecognition treatment?

In order to qualify for nonrecognition treatment under IRC Section 1033, the taxpayer must replace the property that has been involuntarily converted within a two-year period. The time period begins to run upon the date of the disposition of the converted property or, if the conversion results from condemnation of the property, the date when the condemnation became imminent.³

If a taxpayer's principal residence is destroyed as a result of an involuntary conversion that takes place in a federally-declared disaster area, the time period for purchasing replacement property is extended to four years.⁴

8614. Must a taxpayer's property be completely destroyed to qualify for nonrecognition treatment under the rules for involuntary conversions?

The involuntary conversion of a taxpayer's property does not need to occur as a result of one sudden event (e.g., a natural disaster) in order for the taxpayer to qualify for nonrecognition treatment under IRC Section 1033.⁵ For example, the IRS ruled that the progressive pollution of a taxpayer's water supply with salt water constituted an involuntary conversion for purposes of IRC Section 1033.⁶ Similarly, the IRS has ruled that chemical contamination of property, which did not destroy the property per se, but made it unsafe for its intended use, qualified as a Section 1033 "destruction."⁷

1. IRC Sec. 1033(a)(2)(A).

2. Treas. Reg. §1.1033(a)-2(c)(1).

3. IRC Sec. 1033(a)(2)(B).

4. IRC Sec. 1033(h).

5. Rev. Rul. 59-102, 1959-1 CB 200.

6. Rev. Rul. 66-334, 1966-2 CB 302.

7. Rev. Rul. 89-2, 1989-1 CB 259.

Despite this, if the taxpayer disposes of partially destroyed property that could have been repaired, nonrecognition treatment under IRC Section 1033 could be denied. This is because the decision not to repair is “voluntary” as compared to an “involuntary conversion.” For example, the Tax Court denied nonrecognition treatment when the taxpayer sold a ship damaged in a collision and invested both the sale proceeds and insurance proceeds in another vessel. Because the taxpayer could have used the insurance proceeds to repair the ship, but instead *chose* to purchase a second ship, the conversion was not involuntary. Although the court recognized that it may have been a sound business decision to replace rather than repair, having the choice negated the possibility that the conversion was involuntary. The taxpayer was, therefore, required to recognize all the gain realized in the transaction.¹

Conversely, the IRS has ruled privately that when the cost of repairs exceeded the value of the property prior to its destruction, there was no practical alternative other than selling the property and purchasing replacement property. Under these circumstances, the taxpayer was entitled to nonrecognition treatment under IRC Section 1033 although, theoretically, the property *could* have been repaired.²

Based on these rulings, a taxpayer whose property is partially destroyed will generally qualify for nonrecognition treatment under IRC Section 1033 if the economics of selling the property outweigh the cost of repairing it.

8615. Under what circumstances does all or part of the gain from the sale of a personal residence qualify for nonrecognition treatment?

As a general rule, taxpayers may exclude up to \$250,000 (\$500,000 for married taxpayers filing jointly) of gain on the sale of a principal residence.³ In order to qualify for this exclusion, the taxpayer must have owned and used the residence as the taxpayer’s principal residence for two of the preceding five years.⁴

Planning Point: Note that the Internal Revenue Code does not contain a definition of the term “principal residence.” IRS guidance advises that, whether or not property is used by the taxpayer as his principal residence depends on all the facts and circumstances in each case, including the good faith of the taxpayer. Determinative factors include the taxpayer’s place of employment, place of abode of family members, and the address listed on taxpayer’s tax returns.⁵

The use does not need to be continuous in order to satisfy this requirement, and short absences are disregarded for purposes of making the calculation. Thus, for example, a taxpayer who owns his principal residence for two years and takes a two-month vacation each summer will qualify for the Section 121 exclusion despite the fact that he was not physically present in his principal residence for a full 24 months.⁶

1. *Willis v. Commissioner*, 41 TC 468 (1964).

2. Let. Rul. 8928011.

3. IRC Sec. 121(b).

4. IRC Sec. 121(a).

5. Treas. Reg. §1.121-1(b)(2); IRS Chief Counsel Memo No. 200947036 (11-20-2009).

6. See IRS Pub. 523.

The taxpayer may only take advantage of this exclusion once within each two-year period.¹

Example: Shannon and Mike sell their home in January 2013, excluding \$50,000 of gain under IRC Section 121. In the same month, they purchase a new primary residence. Less than two years later, in August 2014, they sell that primary residence. Any gain on the 2014 sale cannot be excluded because they have already excluded gain from the sale of one principal residence under IRC Section 121 within a two-year period. The fact that their 2013 exclusion was only \$50,000 of a possible \$500,000 total exclusion is irrelevant.

However, in some cases, taxpayers may qualify for a reduced exclusion (i.e., a proportionate amount of the potential exclusion) if they sell multiple principal residences during a two-year period because of (a) a change in place of employment; (b) health problems or (c) certain unforeseen circumstances (see Q 8616 for a discussion of these exceptions).²

8616. Are there circumstances in which a taxpayer can exclude the gain on the sale of a personal residence even though the taxpayer fails to meet the requirements otherwise required for exclusion treatment?

If a taxpayer fails to meet the ownership and use requirements, or sells multiple primary residences within the two-year period, a portion of the exclusion (as discussed below) may still be available if the primary residence is sold for reasons that were *primarily* caused by a change in the taxpayer's place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.³ In determining a taxpayer's primary reason for selling a primary residence, the following factors are considered:

- (1) Whether the sale and the circumstances giving rise to the sale are proximate in time;
- (2) Material changes in the suitability of the property as the taxpayer's primary residence;
- (3) Impairments to the taxpayer's financial ability to maintain the property;
- (4) Whether the taxpayer has used the property as his residence during the period of ownership;
- (5) Whether or not the circumstances giving rise to the sale are reasonably foreseeable at the time when the taxpayer began using the property as his or her primary residence;
- (6) Whether or not the circumstances giving rise to the sale occur during the period of the taxpayer's ownership and use of the property as his or her principal residence.⁴

For taxpayers claiming a Section 121 exclusion based on a change in place of employment, a safe harbor applies if the change in employment occurs during the period of the taxpayer's ownership and use of the property as a principal residence and the taxpayer's new place of employment is at least 50 miles from the residence that was sold.⁵

1. IRC Sec. 121(b)(3).

2. See IRS Pub. 523, above.

3. IRC Sec. 121(c)(2).

4. Treas. Reg. §1.121-3(b).

5. Treas. Reg. §1.121-3(c)(2).

Similarly, for taxpayers claiming the exclusion based on health reasons, a safe harbor exists for taxpayers whose physician has recommended a change in residence for health reasons.¹

The exception for a sale based on “unforeseen circumstances” may be met based on any of the following specific events:

- (1) An involuntary conversion of the residence;
- (2) Natural or man-made disasters, or acts of war or terrorism, resulting in a casualty to the residence;
- (3) The death of the taxpayer;
- (4) Loss of employment resulting in eligibility for unemployment compensation;
- (5) Change in employment that results in the taxpayer’s inability to pay housing costs and reasonable basic living expenses for the taxpayer’s household;
- (6) Divorce or legal separation; or
- (7) Multiple births resulting from the same pregnancy.²

The taxpayer does *not* qualify for the exclusion based on unforeseen circumstances if the unforeseen circumstance is an *improvement* in the taxpayer’s financial condition.³

Example: In April 2013 George buys a house that he uses as his principal residence. He sells it in October 2014 because the house has greatly appreciated in value and mortgage rates have substantially decreased, making a bigger house affordable. The specific event safe harbors described above do not apply. Under the facts and circumstances, the primary reasons for the sale of the house--the changes in George’s house value and in the mortgage rates--are an improvement in his financial circumstances. However, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under IRC section 121(c)(2).⁴

For purposes of determining the reduced exclusion, the maximum amount of gain that would have been excluded but for the premature sale of the primary residence is multiplied by a fraction. The numerator of the fraction equals the shorter of (1) the aggregate periods during the five-year period ending on the date of the sale or exchange that the property has been owned or used by the taxpayer as a principal residence, or (2) the period after the date of the most recent prior sale or exchange by the taxpayer to which the two-year limitation applied and the date of the sale or exchange. The denominator equals two years.⁵

Example: On July 2, 2010, Ashley, a single taxpayer, purchased her first primary residence for \$150,000. More than two years later, on August 15, 2012, Ashley sold the home for \$200,000. Because she met all the requirements of IRC Section 121, Ashley excluded the entire amount of her gain. On September 15, 2012,

1. Treas. Reg. §1.121-3(d)(2).

2. Treas. Reg. §1.121-3(e)(2).

3. Treas. Reg. §1.121-3(e)(1).

4. Treas. Reg. §1.121-3(e)(4), Example 8.

5. IRC Sec. 121(c)(1).

Ashley purchased a new primary residence for \$250,000. Nine months later, on June 15, 2013, Ashley sold the new primary residence for \$275,000 because she lost her job and had to take a new job in a different state.

Although the sale of the new primary residence does not qualify for the full exclusion because Ashley used and owned the home for only nine months, the unforeseen circumstance of losing her job that necessitated her relocation qualify her for the exclusion. Applying the partial exclusion formula, her \$250,000 maximum exclusion (single taxpayer) is multiplied by 9/24, or \$93,750. This is because, per the formula, the numerator is the lesser of the time between the date of the sale of the previous home (August 15 or ten months to the June 15 sale date) or the time she used and owned the latter residence as her primary residence and the date of the sale (September 15 or nine months until the June 15 sale date). For that reason, Ashley may exclude the entire amount of her gain (\$25,000) because it was less than the reduced exclusion amount (\$93,750).

If the taxpayer is mentally or physically incapable of caring for himself, and the taxpayer owned and used the property as a principal residence for an aggregate of one year during the five-year period ending on the date of the sale or exchange, an exception to the use requirement applies. Such a taxpayer will be *treated as using* the property during any time within the five-year period that the taxpayer *owns* the property and resides in a facility (including a nursing home) licensed by the state or a political subdivision to care for such an individual.¹

8617. How much gain is a taxpayer permitted to exclude from income on the sale of a personal residence? How is the exclusion calculated?

Generally, an individual who sells a principal residence may elect to exclude up to \$250,000 of gain from gross income.² However, married couples filing jointly may exclude up to \$500,000 if they meet the following requirements:

- (1) they must file a joint return for the taxable year of the sale or exchange;
- (2) *either* spouse must meet the ownership requirements outlined in Q 8615;
- (3) *both* spouses must meet the use requirements outlined in Q 8615; and
- (4) *neither* spouse is ineligible to use the exclusion because he had used the exclusion in the two-year period ending on the date of the sale or exchange.³

8618. If a taxpayer has multiple residences, which residence qualifies as the principal residence in determining whether exclusion of gain upon sale is permissible?

Under IRC Section 121, an individual may elect to exclude up to \$250,000 (\$500,000 for married couples) on the sale of a principal residence (see Q 8615 and Q 8617). This exclusion is only available with respect to the taxpayer's principal residence. If a taxpayer has multiple residences, the taxpayer may still only exclude gain from the sale of the residence that is considered to be the principal residence.

1. IRC Sec. 121(d)(7).

2. IRC Sec. 121(b).

3. IRC Sec. 121(b).

Whether or not a residence is considered the taxpayer's principal residence for purposes of the Section 121 exclusion requires a traditional facts and circumstances analysis.¹ Assuming that the taxpayer alternates between two or more residences, the residence the taxpayer resides at for the majority of the time generally will be considered the principal residence. Additionally, other factors considered in making the determination, including the following nonexhaustive list:

- (1) the taxpayer's place of employment;
- (2) the principal place of residence of the taxpayer's family members;
- (3) the address listed by the taxpayer on his or her driver's license, tax returns, car registration and voter registration card;
- (4) the taxpayer's mailing address for bills and correspondence;
- (5) the location of the taxpayer's bank; and
- (6) the location of religious organizations and recreational clubs with which the taxpayer is affiliated.²

In a case involving two different residences in different states, the Tax Court held that the taxpayer's principal residence was the one in which the taxpayer spent a substantial amount of time, i.e., threw family parties and celebrated holidays, even though the second residence address appeared on the taxpayer's tax returns over the years. In addition, the Tax Court rejected the IRS' contention that the second residence in the other state was the taxpayer's principal residence because the taxpayer (1) owned a business in that state and (2) held a liquor license that required state residency.³

With respect to multiple residences, it is possible that over a five year period, a taxpayer may not spend the majority of days in any one residence for the two required years. Thus, he or she would not be able to take advantage of the exclusion due to the failure to meet the two-year use requirement (see Q 8615).

Example: In the past five years, Jim and Nancy alternated between homes in Michigan, Florida and New York. During that five-year period, they spent more time in the Florida residence than in any other home. *However*, within that period, there was only one year in which they spent the majority of days in Florida. Therefore, even though their primary residence is in Florida, they will be unable to exclude gain on its sale under Section 121 because they will be unable to satisfy the two-year use requirement.⁴

Although not expressly addressed in the regulations, if the taxpayers were able to satisfy the two-year use requirement for more than one residence during the relevant five year period, they should be able to exclude gain from the sale of *either* residence.

1. Treas. Reg. §1.121-1(b)(1).

2. Treas. Reg. §1.121-1(b)(2).

3. *Wickersham v. Commissioner*, TC Memo 2011-178.

4. See *Guinan v. U.S.*, 2003-1 USTC 50,475 (2003).

Example: During the previous five year period, Jim and Nancy spend the majority of their days in Florida during years one and two. In years three and five, they spend the majority of their days in Michigan. If they choose to sell the Florida or Michigan residence, they will have satisfied the two-year use requirement for both residences and, assuming the other requirements are met, they should be able to exclude the gain on the sale of *either* residence as their principal residence.

8619. Is a taxpayer permitted to exclude gain on the sale of a principal residence used partially for business purposes?

Business Portion of Property Separate from Taxpayer's Dwelling Unit

If a portion of a piece of property is used as the taxpayer's principal residence and another portion of that same property is used for business purposes, the taxpayer is required to allocate any gain on the sale of the property between the residential and business portions *if* the portion used for business is separate from the taxpayer's "dwelling unit."

"Dwelling unit," for this purpose, is defined in IRC Section 280A (a house, apartment, condominium, mobile home, boat or similar property) except appurtenant structures (such as a detached garage, barn or stable located on the same land) are excluded for purposes of Section 121.¹ Only the gain from the portion of the property that is used as the taxpayer's primary residence (dwelling unit) may be excluded under Section 121.²

Example: Joe operates a dock installation business on a small lake. Rather than renting a separate office space, Joe uses a barn located 100 feet from his home (the "dwelling unit") to store and repair any broken portions of the docks, as well as for general office space. During the past ten years, the barn has been his place of business and the home has been his primary residence. In year 11, Joe sells the entire property for \$360,000. Because the barn he used for his business is separate from his dwelling unit, he must allocate the basis of the property between the barn and the home.³

One way to allocate basis is based on physical size. To this point, when Joe acquired the property, the purchase price and basis for the entire property was \$300,000. Physically, the home occupies 2/3rds of the property and the barn occupies 1/3rd of the property. Thus, based on size, the basis of home should be \$200,000 and the basis of the barn should be \$100,000. However, as a result of depreciation deductions Joe claimed on the barn, the basis had been decreased to \$45,000.

As to the sale of the property in year 11, Joe's overall economic gain is \$60,000 (\$360,000 selling price less \$300,000 original purchase price). Based on the same allocation method described above, the gain should be allocated \$40,000 to the home and \$20,000 to the barn. As to the gain allocated to the home, since Joe meets the requirements of IRS Section 121, the entire amount of that gain is excluded from gross income.

On the other hand, \$20,000 of the gain is attributable to the barn. None of the gain attributable to the barn is excludible pursuant to IRC Section 121. Thus, it is as if Joe sold the barn for \$120,000 (allocating 2/3rds of the \$360,000 sales price to the barn). In other words, Joe's gain would be computed in the same way as if he had simply sold the barn. Thus, because his basis in the barn is \$45,000, Joe's taxable gain would be computed as follows:

1. Treas. Reg. §1.121-1(e)(1), IRC Sec. 280A(f)(1)(A).

2. Treas. Reg. §1.121-1(e)(1).

3. Treas. Reg. §1.121-1(e)(3).

Amount Realized	\$120,000
Original Basis	\$100,000
Capital Gain	\$20,000 (amount of gain attributable to the appreciation of the barn from \$100,000 to \$120,000)
Adjusted Basis	\$45,000 (\$100,000 minus \$55,000 depreciation deductions)
Unrecap Sec 1250 gain	\$55,000 (\$100,000 original basis minus adjusted basis).

Business Portion of Property Not Separate from Taxpayer's Dwelling Unit

Allocation is only required if the property used for business purposes is separate from the taxpayer's principal residence. However, if a taxpayer uses a *non-separate* portion of the residence for business and claims a depreciation deduction as a result of such use, the taxpayer may be required to recognize unrecaptured gain under IRC Section 1250.¹

Example: Kacey is a lawyer and has used three rooms in her residence as her law office between 2008 and 2014. Over this period, she claimed depreciation deductions totaling \$10,000. In 2014, she sells the house for a \$30,000 gain. She has no other capital gains or losses for the year. She must recognize \$10,000 of the gain (an amount equal to her depreciation deductions) but may exclude the remaining \$20,000 because she is not required to allocate gain between residential and business use property under Treasury Regulation Section 1.121-1(e)(1). If Kacey had not been entitled to claim depreciation deductions with respect to the business use of the house, the entire \$30,000 of gain would be excluded from gross income.²

8620. Can a taxpayer exclude gain on the sale of vacant land under the same principles that apply to excluding gain on the sale of a principal residence?

A taxpayer may be able to exclude gain on a sale of vacant land made within two years of the sale of a residence if certain requirements are met. A sale of vacant land can piggy back onto the sale of a taxpayer's principal residence provided (a) the vacant land is adjacent to a dwelling unit used by the taxpayer as the taxpayer's principal residence; (b) the taxpayer owned and used the vacant land as part of the taxpayer's principal residence; (c) the taxpayer sells the dwelling unit in a sale that meets the requirements of IRC Section 121 within two years before or two years after the date of the sale of the vacant land; and (d) the requirements of IRC Section 121 must have been otherwise met with respect to the land.³

For purposes of excluding the gain on the sale of the vacant land, the sale of the land and the dwelling is treated as a single sale. Therefore, the taxpayer's \$250,000 (\$500,000 for married couples) exclusion applies to the combined sale. If the sales take place in different tax years, gain on the sale of the dwelling unit is taken into account and excluded first. If after that, there is any of exclusion amount remaining it will be applied to the sale of the vacant land.⁴

1. Treas. Reg. §1.121-1(e)(1).

2. Treas. Reg. §1.121-1(e)(4), Ex.6.

3. Treas. Reg. §1.121-1(b)(3)(i).

4. Treas. Reg. §1.121-1(b)(3)(ii)(A).

Example: In 2013, Asher, a single taxpayer who owns a primary residence with adjacent land sells the primary residence for \$400,000 with respect to which there is a \$100,000 gain. Assuming Asher meets all the requirements of IRC Section 121, the entire \$100,000 gain is excluded from gross income. Because a single taxpayer can exclude up to \$250,000 of gain, there is \$150,000 of remaining available exclusion. In 2014, Asher sells the adjacent land for \$300,000 and realizes a \$200,000 gain. Again, assuming the requirements of IRC Section 121 are met, Asher can exclude \$150,000 of the \$200,000 gain. This is because the sale of the home and the vacant land are treated as a single transaction. Since the total gain was \$300,000 (\$100,000 on the home and \$200,000 on the vacant land), the \$100,000 gain on the sale of the home is excluded, \$150,000 of the gain on the land is excluded and \$50,000 of the gain in excess of \$250,000 is included in gross income.

If the taxpayer sells the dwelling unit in a tax year that begins *after* the tax year in which the vacant land is sold, and *after* the due date for the tax return for that earlier year, the taxpayer must include in gross income any gain on the sale of the vacant land in the year it is sold. Then upon the later sale of the dwelling unit, the taxpayer is permitted to claim the appropriate IRC Section 121 exclusion with respect to the vacant land by filing an amended return.¹

8621. In the case of an involuntary conversion of a primary residence, how does the nonrecognition treatment under IRC Section 1033 and the exclusion of gain under IRC Section 121 interact?

If a taxpayer's principal residence is destroyed and the proceeds from insurance are used to purchase a replacement residence, IRC Section 1033 and IRC Section 121 interact as follows:

1. For purposes of determining potential gain for purposes of IRC Section 1033, the amount realized is the fair market value of the relinquished property;
2. Next, the amount of gain that would have been excluded pursuant to IRC Section 121 is subtracted from that amount; and
3. Gain would be recognized to the extent that amount computed pursuant to 2), above exceeded the cost of a replacement home.²

Example: In 2014, Asher, a single taxpayer has a primary residence with a fair market value of \$600,000 and a basis of \$250,000. In a storm, Asher's home is totally destroyed. Asher uses \$300,000 of the \$600,000 insurance proceeds to purchase a new primary residence. Asher's regular realized gain would be \$350,000 (\$600,000 minus \$250,000). Of that gain, since Asher is a single taxpayer, he may exclude \$250,000.

Step 1 and Step 2. \$600,000 insurance proceeds minus the \$250,000 gain Asher can exclude pursuant to IRC Section 121 equals \$350,000.

Step 3. Asher used \$300,000 of the insurance proceeds to purchase a replacement home. However, since \$350,000 (Step 1 and Step 2 amount) exceeds that amount by \$50,000, the latter amount is included in gross income.³

1. Treas. Reg. §1.121-1(b)(3)(ii)(C).

2. IRC Sec. 121(d)(5)(B).

3. Rev. Proc. 2005-14, 2005-7 IRB 492.

Asher's basis should be computed as follows:

1. Original basis in home - \$250,000
2. Gain recognized - \$50,000
3. Gain Excluded - \$250,000
4. New Basis - \$550,000 (1 plus 2 plus 3).

Thus, Asher's new home has a fair market value of \$300,000 and a basis of \$550,000. The difference between the fair market value of the home and the basis reflects the \$250,000 of excluded IRC Section 121 gain. In essence, with this higher basis, Asher's exclusion is preserved. So, if Asher sells the home for up to \$550,000, there would be no realized gain.

8622. Does an exchange of corporate stock for corporate stock qualify for nonrecognition treatment?

Pursuant to IRC Section 1036, common stock in a corporation exchanged for common stock in the same corporation is tax-free. The nonrecognition rules of IRC Section 1036 apply to exchanges of common stock in the same corporation, even though the stocks are of a different class and have different voting, preemptive, or dividend rights.¹ Nonrecognition also applies to an exchange of preferred stock for preferred stock in the same corporation. However, gain or loss may be recognized if cash or other property is also received. This treatment applies both to exchanges between an individual shareholder and the corporation and to exchanges between two shareholders. Such an exchange is treated in substantially the same manner as a "like-kind" exchange (see Q 8606 to Q 8610).

Finally, the exchange of stock in different corporations and exchanges of common stock for preferred stock do *not* qualify for nonrecognition treatment even if the shares of stock are similar in all other aspects.²

8623. What are the requirements to exclude 50 percent of the gain on the sale of qualified small business stock?

If certain requirements are met, a noncorporate taxpayer (including certain partnerships and S corporations) may exclude from gross income 50 percent of any gain from the sale or exchange of qualified small business stock held for more than five years.³ With certain exceptions, a qualifying small business is:

- A C Corporation (excludes an S Corporation)
- Any trade or business other than one involving the performance of legal, health, engineering, architecture, account, actuarial services, etc. or any other trade or business in which the principal asset is the skill or reputation of its employees

At least 80 percent of its assets by value must be used in the active conduct of a qualified trade or business.

1. Rev. Rul. 72-199, 1972-1 CB 228, Treas. Reg. §1.1036-1.

2. IRC Secs. 1036, 1031(a), Treas. Reg. §1.1036-1.

3. IRC Sec. 1202, as amended by ARRA 2009. See also IRC Sec. 1(h)(7).

The aggregate amount of eligible gain from the disposition of qualified small business stock issued by one corporation that may be taken into account in a tax year may not exceed the greater of the following amounts:

- (a) \$10,000,000 (\$5,000,000 in the case of married taxpayers filing separately) reduced by the aggregate amount of such gain taken into account in prior years; *or*
- (b) 10 times the aggregate bases of qualified stock of the issuer disposed of during the tax year.

For purposes of the limitation in (b), the adjusted basis of any qualified stock will not include any additions to basis occurring after the stock was issued.¹

Gain realized by a partner, shareholder, or other participant that is attributable to a disposition of qualified small business stock held by a pass-through entity (i.e., a partnership, S corporation, regulated investment company, or common trust fund) is eligible for the exclusion if the entity held the stock for more than five years, and if the taxpayer held an interest in the pass-through entity at the time of acquisition and at all times since the acquisition of the stock.²

Significantly, a taxpayer is not entitled to the section 1202 50 percent exclusion as well as the reduced capital gains rates (15 percent and 20 percent). Instead, the tax rate is subject to a maximum rate of 28 percent. Coupled with the 50 percent exclusion, the actual maximum effective rate on the gain is 14 percent.

Any gain excluded under IRC Section 1202 by a married couple filing jointly must be allocated equally between the spouses for purposes of claiming the exclusion in subsequent tax years.³

Special rules apply to IRC Section 1202 stock for alternative minimum tax purposes (see Q 8551 to Q 8555 for a discussion of the AMT). An amount equal to 7 percent of the amount excluded from gross income for the taxable year under IRC Section 1202 will be treated as a preference item.⁴

8624. How does an offsetting short position impact a taxpayer's eligibility to exclude 50 percent of the gain on the sale of qualified small business stock?

Under IRC Section 1202, if a taxpayer has an *offsetting short position* with respect to any qualified small business stock, the otherwise applicable 50 percent exclusion (see Q 8623) is unavailable unless:

- (a) the stock was held for more than five years as of the date of entering into the short position; *and*

1. IRC Sec. 1202(b).

2. IRC Sec. 1202(g).

3. IRC Sec. 1202(b)(3)(B).

4. IRC Sec. 57(a)(7).

- (b) the taxpayer elects to recognize gain as if the stock were sold at its fair market value on the first day the offsetting position was held.¹

A taxpayer has an “offsetting short position” with respect to any qualified small business stock if the taxpayer (or a related party) has (a) made a short sale of substantially identical property, (b) acquired an option to sell substantially identical property at a fixed price, or (c) to the extent expected to be provided in future regulations, entered into any other transaction that substantially reduces the taxpayer’s risk of loss from holding the qualified small business stock.²

Taxpayers should note that certain offsetting short positions (e.g., a short sale) may also result in constructive sale treatment under the rules of IRC Section 1259. While the IRC does not specifically address the impact of IRC Section 1259 on IRC Section 1202, it would appear that if the requirements of IRC Section 1202(j) are otherwise met, the exclusion provided under IRC Section 1202 would not be lost merely because the taxpayer may be required to immediately recognize gain under IRC Section 1259.

8625. Under what circumstances may a noncorporate taxpayer roll over gain from the sale or exchange of qualified small business stock that is held for six months or more?

Generally, a noncorporate taxpayer, including certain partnerships and S corporations, may elect to roll over gain from the sale or exchange of qualified small business stock held more than six months to the extent that the taxpayer purchases other qualifying small business stock within 60 days of the sale of the original stock.³

If the taxpayer elects to roll over gain on the sale of qualified small business stock, gain will be recognized only to the extent that the amount realized on the sale exceeds (1) the cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date of the sale, reduced by (2) any portion of such cost previously taken into account under this rollover provision. The rollover provisions of IRC Section 1045 will not apply to any gain that is treated as ordinary income.⁴

Rules similar to those applicable to rollovers of gain by an individual from certain small business stock⁵ will apply to the rollover of such gain by a partnership or S corporation.⁶ Thus, for example, the benefit of a tax-free rollover with respect to the sale of small business stock by a partnership will flow through to an “eligible partner”—meaning a partner who is not a corporation and who held his partnership interest at all times during which the partnership held the small business stock.⁷ (A similar rule applies to S corporations and their shareholders.)⁸

1. IRC Sec. 1202(j)(1).

2. IRC Sec. 1202(j)(2).

3. See IRC Sec. 1045(a).

4. IRC Sec. 1045(a).

5. IRC Sec. 1202.

6. IRC Sec. 1045(b)(5).

7. See Treas. Regs. §§1.1045-1(b)(1), 1.1045-1(g)(3)(i).

8. General Explanation of Tax Legislation Enacted in 1998 (JCS-6-98), p. 167 (the 1998 Blue Book).

For the rules regarding (1) the deferral of gain on a partnership's sale of qualified small business stock followed by an eligible partner's acquisition of qualified replacement stock, and (2) the deferral of gain on a partner's sale of qualified small business stock distributed by a partnership, see Treasury Regulation Section 1.1045-1.¹

Any gain not recognized because of a rollover of qualified small business stock will be applied to reduce (in the order acquired) the basis for determining gain or loss of any qualified small business stock purchased by the taxpayer during the 60-day rollover period.²

Ordinarily, the holding period of qualified small business stock purchased in a rollover transaction will include the holding period of the stock sold; but for purposes of determining whether the nonrecognition of gain applies to the stock that is sold, the holding period for the replacement stock begins on the date of purchase. In addition, only the first six months of the taxpayer's holding period for the replacement stock will be taken into account for purposes of determining whether the active business requirement is met.³

Practice Point: The taxpayer must make an election under IRC Section 1045 by the due date (including extensions) for filing the income tax return for the taxable year in which the qualified small business stock is sold.⁴ The election is made by (1) reporting the entire gain from the sale of qualified small business stock on Schedule D; (2) writing "IRC Section 1045 rollover" directly below the line on which the gain is reported; *and* (3) entering the amount of the gain deferred under IRC Section 1045 on the same line as (2), above, as a loss, in accordance with the instructions for Schedule D.⁵

If a taxpayer has more than one sale of qualified small business stock in a taxable year that qualifies for the IRC Section 1045 election, the election can be made for any one or more of those sales. An IRC Section 1045 election is revocable only with the Commissioner's consent.⁶

8626. Under what circumstances can a taxpayer roll over the gain from a sale of stock in a specialized small business investment company?

Individual taxpayers and C corporations that invest in a specialized small business investment company (SSBIC, see below) may elect to roll over capital gain (within limits) on publicly-traded securities sold within 60 days of the SSBIC purchase. In order to defer the taxation of gain from such a sale, the individual or corporation must use the proceeds from the sale to purchase common stock or a partnership interest in a SSBIC within 60 days of the date of sale.⁷

The amount of gain that may be rolled over for any taxable year by an individual is limited to the lesser of (a) \$50,000 or (b) \$500,000, reduced by any gain previously excluded under this rollover provision. Thus, the most an individual may roll over during his lifetime

1. TD 9353, 2007-2 CB 721.

2. IRC Sec. 1045(b)(3).

3. IRC Secs. 1045(b)(4), 1223(15).

4. Rev. Proc. 98-48, 1998-2 CB 367.

5. Rev. Proc. 98-48, 1998-2 CB 367.

6. Rev. Proc. 98-48, 1998-2 CB 367.

7. IRC Sec. 1044.

is \$500,000.¹ (The limits are \$25,000 and \$250,000, respectively, for married taxpayers filing separately.)

In the case of C corporations, the gain that may be deferred may not exceed the lesser of (a) \$250,000 or (b) \$1,000,000, reduced by any gain excluded in previous taxable years.²

To the extent that gain from the sale of publicly-traded securities exceeds the cost of the SSBIC common stock or partnership interest subsequently purchased, such gain will be taxed in the year of sale. Any gain that is characterized as ordinary income is not eligible for rollover treatment. In addition, gain previously rolled over under this provision may not be rolled over again.³

Basis in the SSBIC common stock or partnership interest is generally reduced by the amount of gain that is rolled over. Despite this, the basis of any SSBIC stock is not reduced for purposes of calculating the gain eligible for the 50 percent exclusion for qualified small business stock (see Q 8623).⁴

A “specialized small business investment company” is defined as any partnership or corporation that is licensed by the Small Business Administration under Section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.⁵

Estates, trusts, partnerships, and S corporations are not eligible to take advantage of this rollover provision.⁶

1. IRC Sec. 1044(b)(1).

2. IRC Sec. 1044(b)(2).

3. IRC Sec. 1044(a).

4. IRC Sec. 1044(d).

5. IRC Sec. 1044(c)(3).

6. IRC Sec. 1044(c)(4).

PART V: INVESTOR LOSSES

8627. What is a tax shelter?

In the traditional sense, a tax shelter is simply a method that a taxpayer uses to generate tax deductions and credits by participating in certain “investment activities” that often are not expected to generate any real profits. Historically, taxpayers specifically entered into these transactions with the anticipation of producing losses that could be used to offset a taxpayer’s otherwise taxable gains.

The basic concept is presented in the example below, which illustrates the potential results of tax shelters that were available to investors before the enactment of legislation designed to curb the use of these shelters.

Example: Simon has annual income of \$450,000 and dividend income of \$30,000. He invests \$40,000 in a 10 percent interest in ABC partnership (“ABC”), which is in the business of breeding racehorses (Simon had no active role in ABC’s business). ABC, through the use of \$800,000 in nonrecourse financing and \$200,000 in cash, purchased several horses as a part of this breeding program. After depreciation, interest and other deductions relating to the breeding program, ABC experiences a loss of \$500,000. Simon’s share of the loss is \$50,000 (10 percent). Even though Simon only actually invested \$40,000 in the partnership (and could have only lost \$40,000 if the investment subsequently became completely worthless), he would have been entitled to deduct his entire \$50,000 share in ABC’s loss.

Although characteristics of a tax sheltered investment may vary depending on the form and type of vehicle employed, several common features are:

- (1) *Leverage.* This refers to the maximization of investment return through the use of borrowed capital (see Q 8645 for a discussion of the current limitations imposed on the deductibility of investment interest expenses);
- (2) *Depreciation and Depletion.* The tax shelter vehicle, such as an equipment leasing venture, may use the accelerated cost recovery system or accelerated depreciation with respect to the cost of the property. This is true even though all or part of the cost of the asset has been financed by other parties;

A depletion deduction may be available for an investment in natural resources such as oil, gas, timber and minerals. Although deductions for depreciation and depletion may create a loss from a tax standpoint, the investment’s cash flow may still be positive. Thus, the investor may benefit from both a currently deductible loss and the receipt of cash flow for other investment or business endeavors;

- (3) *Deferral.* If an investment is made in a venture which initially operates at a loss, the loss may be available to shield other income from current taxation. The tax liability is effectively deferred to later years when the investment is producing income.

Timing is important in this regard to avoid having deferred income taxed at a steeper rate in a later taxable year. Obviously, it is desirable that deductions are available in current high-income years while gain or investment income is realized in later low bracket years.

In recent years, the IRS has enacted legislation designed to prevent the use of tax shelters as vehicles that operate solely for the purpose of tax avoidance (see “abusive tax shelters,” Q 8628), but one of the key elements of tax shelter partnerships prior to this legislative reform was the allocation of annual operating losses among the partners in such a manner that the investors seeking tax shelter were allocated losses that were disproportionately greater than their true relative economic interest in the partnership.

IRC Section 704(a) generally permits a partner’s distributive share of income, gain, loss or deduction to be determined by the partnership agreement. IRC Section 704(b)(2), however, provides that a partnership agreement’s allocation provisions that are different from the partners’ “interests in the partnership” (taking into account all facts and circumstances) will be effective only in situations in which the allocations have “substantial economic effect.”¹ The IRS has developed an extensive set of economic effect tests and a definition of “substantiality” in the final regulations interpreting Section 704.²

8628. What is an abusive tax shelter?

While Congress has recognized that the loss of revenue is an acceptable side effect of special tax provisions designed to encourage taxpayers to make certain types of “tax shelter” investments that yield tax benefits, losses from tax shelters often produce little or no benefit to society, or produce tax benefits that are exaggerated beyond those intended. These cases are called “abusive tax shelters,” and are described by the IRS in Publication 550 as follows:

“Abusive tax shelters are marketing schemes involving artificial transactions with little or no economic reality. They often make use of unrealistic allocations, inflated appraisals, losses in connection with nonrecourse loans, mismatching of income and deductions, financing techniques that do not conform to standard commercial business practices, or mischaracterization of the substance of the transaction. Despite appearances to the contrary, the taxpayer generally risks little.

Abusive tax shelters commonly involve package deals designed from the start to generate losses, deductions, or credits that will be far more than present or future investment. Or, they may promise investors from the start that future inflated appraisals will enable them, for example, to reap charitable contribution deductions based on those appraisals. They are commonly marketed in terms of the ratio of tax deductions allegedly available to each dollar invested. This ratio (or “write-off”) is frequently said to be several times greater than one-to-one.”³

1. IRC Sec. 704(b)(2).

2. IRC Secs. 465, 704(d), 704(e)(2), 706(d). See also Treas. Reg. §1.704-1(b).

3. IRS Publication 550, Investment Income and Expenses (2013).

The IRS has taken steps to combat abusive tax shelters and transactions. A comprehensive strategy is in place to:

- Identify and deter promoters of abusive tax transactions through audits, summons enforcement and targeted litigation;
- Keep the public advised by publishing guidance on transactions and shelters that are determined to be abusive;
- Promote disclosure by those who market and participate in abusive transactions; and
- Develop and implement alternative methods for resolving abusive transactions claimed by taxpayers.

Planning Point: An investment that is considered a tax shelter is subject to restrictions, including the requirement that it be disclosed and registered. The regulations require taxpayers to disclose certain reportable transactions involving abusive tax shelters in which they participate. These transactions include transactions that are the same as, or substantially similar to, a transaction specifically identified by the IRS or state tax agency as a tax avoidance transaction (a so-called “listed transaction”).¹

8629. What are the “at risk” rules with respect to investor losses?

The at risk rules are a group of provisions in the IRC and regulations that limit the current deductibility of “losses” generated by tax shelters (see Q 8627) and certain other activities to the amount that the taxpayer actually has “at risk” (i.e., in the economic sense) in the tax shelter. “Loss” for purposes of the at risk rules means the excess of allowable deductions for the tax year (including depreciation or amortization allowed or allowable and disregarding the at risk limits) over the taxpayer’s income from the activity for the tax year.²

Historically, the primary targets of the at risk rules have been limited partners and the non-recourse financing of a limited partner’s investment in the tax shelter (which was once common in tax shelters, see the example in Q 8627 for an illustration).

Despite this, the rules also apply to certain corporations and general partners in both limited and general partnerships and to non-leveraged risk-limiting devices (e.g., guaranteed repurchase agreements) designed to generate tax deductions in excess of the amount for which the investor actually bears a risk of loss in a shelter.³

Other at risk provisions of the IRC limit the availability of the investment tax credit with respect to property acquired for purposes of the tax shelters or other activities.⁴

1. IRC Secs. 6707A(c)(2) and 6664(d)(2)(A); Treas. Reg. 1.6011-4.

2. IRC Sec. 465(d); IRS Pub. 925, *Passive Activity and At-Risk Rules* (2013).

3. See Sen. Rep. 94-938, 1976-3 CB (vol. 3) 57 at 83.

4. IRC Secs. 49(a)(1), 49(a)(2).

8630. What types of investment activities apply to the “at risk” rules?

The “at risk” rules apply to each of the following activities when engaged in by an individual (including partners and S corporation shareholders, see Q 8631) as a trade or business or for the production of income:

- (1) holding, producing, or distributing motion picture films or video tapes;
- (2) farming (including raising, shearing, feeding, caring for, training, or management of animals);
- (3) leasing of depreciable personal property (and certain other “IRC Section 1245” property);
- (4) exploring for, or exploiting, oil and gas reserves;
- (5) exploring, or exploiting, geothermal deposits;
- (6) holding real property.¹

8631. Who is subject to the at risk rules? Do the at risk rules apply to partnerships and S corporations?

Generally, the at risk rules apply to individuals, estates, trusts, and certain closely-held C corporations.² A C corporation is considered to be closely-held, and thus subject to the at risk rules, if more than 50 percent of its stock is owned, directly or indirectly, by five or fewer individuals.³

In the case of pass-through entities (such as partnerships and S corporations), the at risk rules will apply at the individual taxpayer level (e.g., to the partner or S corporation shareholder), rather than directly to the entity itself.

8632. How does a taxpayer subject to the at risk rules determine how much is “at risk” in an investment?

In the most general terms, an individual has amounts “at risk” to the extent the individual is not protected against the loss of the money or other property contributed to the activity. If the individual borrows the money contributed to the activity, the individual is “at risk” only to the extent the individual is not protected against the loss of the borrowed amount (i.e., to the extent of the individual’s personal liability for repayment of such amount).⁴ See Q 8633 for a discussion of when borrowed amounts will be considered “at risk.”

1. IRC Secs. 465(c); 464(c).

2. IRC Sec. 465(a); IRS Pub. 925, *supra*.

3. IRC Sec. 465(a), 542(a)(2).

4. Prop. Treas. Reg. §1.465-6.

A partner's "amount at risk" is not affected by a loan made to the partnership by any other partner.¹ Payment by a purchaser to the seller for an interest in an activity is treated by the purchaser as a "contribution" to the activity.²

More specifically, an individual has an amount "at risk" in an activity equal to the sum of the following:

- (1) The amount of money and the adjusted basis of any property that the taxpayer contributes to the activity; and
- (2) Amounts that the taxpayer has borrowed with respect to the activity, to the extent the taxpayer (i) is personally liable for the repayment of the loan proceeds or (ii) has pledged property (other than property otherwise used in the activity) as security on the loan (to the extent of the fair market value of the taxpayer's interest in that property).³ See Q 8633 and Q 8634 for a detailed discussion of the rules applicable when the taxpayer borrows the amounts contributed to the activity.

In the case of a partnership, amounts required to be contributed under the partnership agreement are not "at risk" until the partner actually makes the contribution. Similarly, a partner's amount at risk does not include the amount of a note that is payable to the partnership and on which the partner is personally liable until such time as the proceeds are actually applied to the activity.⁴

An individual is not considered "at risk" with respect to any amount that is protected against loss through guarantees, stop loss agreements, nonrecourse financing (other than qualified nonrecourse financing of real estate described in Q 8634), or other similar arrangements.⁵ An investor is *not* at risk with respect to a note that may be satisfied by transferring to the creditor property that is derived from the activity if there is no obligation on the part of the investor-borrower to pay the difference should the value of the property transferred be less than the amount of the note.⁶

In any case, if a taxpayer engages in a pattern of conduct or utilizes a device that is not within normal business practice, or that has the effect of avoiding the "at risk" limitations, the taxpayer's amount at risk may be adjusted to more accurately reflect the amount that is actually at risk. For example, if considering all the facts and circumstances, it appears that an event that results in an increased amount at risk at the close of one year will be accompanied by an event that will decrease the amount at risk after the year ends, these amounts may be disregarded, unless the taxpayer can establish a valid business purpose for the events and establish that the resulting increases and decreases are not a device for avoiding the at risk limitations in the earlier

1. Prop. Treas. Reg. §1.465-7.

2. Prop. Treas. Reg. §1.465-22(d).

3. IRC Sec. 465(b).

4. Prop. Treas. Reg. §1.465-22(a).

5. IRC Sec. 465(b)(4). See Rev. Rul. 78-413, 1978-2 CB 167; Rev. Rul. 79-432, 1979-2 CB 289.

6. Rev. Rul. 85-113, 1985-2 CB 150.

year.¹ In effect, the increased amount of risk at the close of the year would be ignored under the proposed regulations except in limited circumstances.²

A partner's amount at risk is increased by the amount of the partner's share of undistributed partnership income and the partner's share of any tax-exempt proceeds.³ It is reduced by distributions of taxable income and by losses deducted.⁴ It is also reduced by nondeductible expenses relating to production of tax-exempt income of the activity.⁵

8633. What rules apply in determining a taxpayer's amount "at risk" when the taxpayer has borrowed the funds contributing to the activity?

In general, if an individual borrows the money contributed to an activity (or, in the case of a limited partnership, the money with which the interest is purchased), the individual is "at risk" only to the extent the individual is personally liable to repay such amounts, or to the extent property is pledged that is not otherwise used in the activity as security for the loan.⁶

If the individual borrowed funds to purchase the property contributed to the activity, the individual is "at risk" with respect to such property only to the extent that the individual would have been "at risk" had the borrowed funds themselves been contributed instead of the purchased property.⁷

If an individual is personally liable for amounts borrowed in the conduct of the activity, the individual is "at risk" to the extent of such amounts even if property used in the activity is also pledged as security for such amounts.⁸ The fact that the partnership or other partners are in the chain of liability does not reduce the amount a partner is "at risk" if the partner bears ultimate responsibility.⁹

If the individual is initially personally liable for the borrowed amounts (i.e., as in recourse liabilities), but after the occurrence of some event or lapse of a period of time the liability will become nonrecourse, the individual is considered "at risk" during the period of recourse liability if both of the following are true:

- (a) the borrowing arrangement was motivated primarily for business reasons and not tax avoidance; and
- (b) the arrangement is consistent with the normal commercial practice of financing the activity for which the money was borrowed.¹⁰

1. Prop. Treas. Reg. §1.465-4.

2. Prop. Treas. Reg. §1.465-4(a).

3. Prop. Treas. Reg. §1.465-22(c)(1).

4. Prop. Treas. Regs. §§1.465-22(b), 1.465-22(c)(2).

5. Prop. Treas. Reg. §1.465-22(c)(2).

6. Treas. Reg. §1.465-20; Prop. Treas. Regs. §§1.465-6, 1.465-25.

7. See Prop. Treas. Reg. §1.465-23.

8. See Let. Rul. 7927007.

9. *Pritchett v. Comm.*, 87-2 USTC ¶9517 (9th Cir. 1987).

10. Prop. Treas. Reg. §1.465-5. See Rev. Rul. 82-123, 1982-1 CB 82; Rev. Rul. 81-283, 1981-2 CB 115.

If amounts are borrowed for use in the activity and the individual is not personally liable for repaying those amounts, but the individual pledges property that is not used in the activity as *security* for repayment, the individual is “at risk” only to the extent that the amount of the liability does not exceed the fair market value of the pledged property. If the fair market value of the security changes after the loan is made, the taxpayer must redetermine the amount at risk using the new fair market value.¹

Property cannot be treated as security if such property itself is financed (directly or indirectly) by loans secured with property contributed to the activity.²

Even if an individual is personally liable or has pledged security for borrowed funds, borrowed amounts cannot (unless it is eventually provided in future regulations) be considered at risk (1) if they are borrowed from a person who has an interest (other than as a creditor) in the activity, or (2) if they are borrowed from a person who is related to another person (other than the taxpayer) having an interest in the activity.³

For this purpose, a “related” person includes the following: members of a family (i.e., an individual and brothers, sisters, spouse, ancestors, and lineal descendants); a partnership and any partner owning, directly or indirectly, 10 percent of the capital or profits interests in such partnership; two partnerships in which the same persons own, directly or indirectly, more than 10 percent of the capital or profits interest; an individual and a corporation in which such individual owns, directly or indirectly, more than 10 percent in value of the outstanding stock; two corporations that are members of the same controlled group; a grantor and a fiduciary of the same trust; fiduciaries of trusts that have a common grantor; a fiduciary of a trust and the beneficiaries of that trust, or beneficiaries of another trust if both trusts have the same grantor; a fiduciary of a trust and a corporation if more than 10 percent in value of outstanding stock is owned, directly or indirectly, by the trust or by the grantor of the trust; a person and a tax-exempt organization controlled by such person or family of such person; a corporation and a partnership in which the same person owns a more-than-10 percent interest (by value of stock in the case of the corporation and by capital or profits interest in the case of the partnership); two or more S corporations if more than 10 percent of the stock (by value) of each is owned by the same person; an S corporation and a C corporation if more than 10 percent of the stock (by value) is owned by the same person; and an executor of an estate and a beneficiary of such estate (except in the case of a sale or exchange in satisfaction of a pecuniary bequest).⁴

Planning Point: Money borrowed to finance a contribution to an activity cannot increase the amount at risk by the contribution and by the amount borrowed to finance the contribution. The at-risk amount may be increased only once.⁵

See Q 8634 for the rules that apply when a taxpayer has obtained “qualified” nonrecourse financing with respect to an activity involving real property.

1. Prop. Treas. Reg. §1.465-25(a).

2. IRC Sec. 465(b)(2).

3. IRC Sec. 465(b)(3).

4. IRC Secs. 465(b)(3)(C), 267(b), 707(b)(1).

5. IRS Publication 925, *Passive Activity and At-Risk Rules* (2013).

8634. What rules apply for determining whether a taxpayer has amounts “at risk” when the taxpayer has received qualified nonrecourse financing with respect to the purchase of real property?

An investor in real estate (excluding mineral property) is considered at risk with respect to nonrecourse financing if:

- (a) no person is personally liable for repayment (except to the extent provided in regulations);
- (b) the financing is secured by real property used in the activity;
- (c) the financing is borrowed with respect to the activity of holding real property;
- (d) the financing is not convertible debt, and either (1) the financing is borrowed from a “qualified person” or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government, or (2) the financing is borrowed from a related person upon commercially reasonable terms that are substantially the same terms as loans involving unrelated persons.¹

A “qualified person” is one who is actively and regularly engaged in the business of lending money and who is *not* (1) related in certain ways to the investor, (2) the one from whom the taxpayer acquired the property (or related to such a person), or (3) a person who receives a fee with respect to the lessor’s investment in the real estate (or related to such a person).²

In the case of a partnership, a partner’s share of qualified nonrecourse financing of the partnership is determined on the basis of the partner’s share of such liabilities incurred in connection with the financing.³

8635. What are the passive loss rules?

The passive loss rules are a set of rules that are generally intended to prevent losses from passive activities from offsetting salaries, interest, dividends, and income from “active” businesses. They apply to individuals, estates, trusts, closely-held C corporations, and personal service corporations (see Q 8636).

Under the passive loss rules, aggregate losses from “passive” activities (see Q 8637) may generally be deducted in a tax year only to the extent they do not exceed aggregate income from passive activities in that year. Similarly, credits from passive activities may be taken against tax liability allocated only to passive activities.⁴ (In the case of certain publicly traded partnerships, aggregation is not permitted. See Q 8641 for details.) The passive loss rules generally apply to losses incurred in tax years beginning after 1986.

1. IRC Sec. 465(b)(6).

2. IRC Secs. 465(b)(6)(D)(i), 49(a)(1)(D)(iv).

3. IRC Sec. 465(b)(6)(C).

4. IRC Sec. 469.

An *individual* can also deduct a limited amount of losses (and the deduction-equivalent of credits) arising from certain rental real estate activities against nonpassive income. A *closely-held C corporation* (other than a personal service corporation) can deduct its passive activity losses against its net active income (other than its investment, or “portfolio,” income) and its passive credits can be applied against tax liability attributable to its net active income.¹

Generally, a corporation is considered to be closely-held if it has five or fewer shareholders who own more than 50 percent of the value of its stock.² A personal service corporation is a corporation the principal activity of which is the performance of personal services and these services are substantially performed by employee-owners.³

A taxpayer may elect to treat investment interest (see Q 8645) as a passive activity deduction if the interest was carried over from a year prior to 1987 and is attributable to property used in a passive activity after 1986.⁴ However, the interest deduction is not treated as being from a pre-enactment interest in a passive activity.⁵

8636. To which taxpayers do the passive rules apply?

IRC Section 469, governing the treatment of passive losses, applies to individual taxpayers, estates and trusts. Closely-held C corporations and personal service corporations are also subject to the passive loss rules in an attempt to prevent taxpayers from creating these entities solely to avoid the passive loss rules (see Q 8635).⁶

Planning Point: Even though the passive activity rules do not apply to grantor trusts, partnerships, and S corporations directly, they do apply to the owners of these entities.⁷

The passive loss rules apply to S corporations and partnerships indirectly, because income and losses flow through the entity to apply at the individual taxpayer level (e.g., to the S corporation’s shareholders or partnership’s partners). See Q 8836 and Q 8810 for a detailed discussion of the pass-through rules applicable to S corporations and partnerships, respectively.

8637. What is a passive activity for purposes of the passive loss rules?

A passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not “materially participate,” (see Q 8638) or is a rental activity, without regard to whether or to what extent the taxpayer participates in such activity.⁸

The IRC provides that regulations may define the term “trade or business” to include activities undertaken in connection with a trade or business or activities that are engaged in for the production of income under IRC Section 212.

1. IRC Sec. 469(c)(2).

2. IRC Sec. 469(j)(1).

3. IRC Sec. 469(j)(2).

4. TAMRA '88, Sec. 1005(c)(11).

5. Notice 89-36, 1989-1 CB 677.

6. IRC Sec. 469(a)(2).

7. Temp. Treas. Reg. §1.469-1T(b); IRS Pub. 925.

8. Temp. Treas. Reg. §1.469-1T(e)(1).

The regulations provide that the IRS will treat real property held for the production of income under IRC Section 212 as a trade or business for purposes of the rental real estate with material participation exception (see Q 8640).

The term “passive activity” does not include a working interest in an oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest.¹ It also does not include the activity of trading personal property (e.g., stocks or bonds) on behalf of the owners of interests in the activity.²

Planning Point: However, if the taxpayer’s interest in an oil and gas well would, but for the exception for wells drilled or operated pursuant to a working interest, be an interest in a passive activity for the year, and the well suffers a net loss for the year, then (1) the taxpayer’s disqualified deductions (under IRC Section 469(e)(4)) from the well for the year will be treated as passive activity deductions; and (2) a ratable portion of the taxpayer’s gross income from the well will be treated as passive activity gross income for the year.³

Whether an activity is passive or active with regard to a partner or an S corporation shareholder is determined at the level of the partner or shareholder, not at the level of the entity. This determination is made by considering the activities that took place during the entity’s taxable year (not the partner’s or shareholder’s taxable year).⁴

However, if a publicly traded partnership is taxed as a corporation, the partnership is the taxpayer, and apparently the partnership is not subject to the passive loss rules.⁵ In the case of a limited partnership interest in an electing large partnership, all passive loss limitation activities of the partnership are treated as a single passive activity.

8638. How is it determined whether a taxpayer materially participates in activity for purposes of determining whether an activity is active or passive?

In general, a taxpayer is considered to materially participate in an activity if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis.⁶ The material participation requirement is generally met by a taxpayer who is able to satisfy any one of the following five tests:

- (1) he does substantially all of the work required by the activity;
- (2) he participates in the activity for more than 500 hours during the year;
- (3) he participates in the activity for more than 100 hours during the year and meets certain other requirements;
- (4) the activity is a significant participation activity for the taxable year, and the individual’s total participation in all significant participation activities during such year exceeds 500 hours;

1. IRC Sec. 469(c)(3).

2. Temp. Treas. Reg. §1.469-1T(e)(6).

3. Temp. Treas. Reg. §1.469-1(T)(c)(4).

4. Temp. Treas. Regs. §1.469-2T(e)(1), 1.469-3T(b)(3).

5. IRC Sec. 469(a).

6. IRC Sec. 469(h)(1).

- (5) he has materially participated in the activity in five out of the ten preceding years (determined without regard to this test); or
- (6) he has materially participated in the activity, which involves the performance of personal services, in any three preceding years.

Planning Point: For purposes of (4) above, an activity is a significant participation activity if, and only if, the activity: (1) is a trade or business activity in which the individual significantly participates for the year; and (2) would be an activity in which the individual does not materially participate if material participation for the year were determined without regard to whether the individual's total participation in all significant participation activities during the year exceeded 500 hours.¹

An individual who is a limited partner is treated as materially participating only if the individual also owns a general partnership interest, or can meet tests (2), (5) or (6), above.²

In determining whether an individual materially participates, the participation of the individual's spouse is considered.³ Work done in the individual's capacity as an investor is not treated as participation unless the individual is involved in the day-to-day management or operations of the activity. The extent to which an individual participates may be shown by any reasonable means.⁴

A closely-held C corporation or a personal service corporation is considered to materially participate in an activity if either of the following are true:

- (a) one or more stockholders who owns more than 50 percent (by value) of the outstanding stock of the corporation materially participates; or
- (b) if the C corporation (other than a personal service corporation) has an active full-time manager throughout the year, at least three full-time non-owner employees whose services are directly related to the business of the corporation, and certain deductions of the business exceed 15 percent of the income for the year.⁵

Whether a trust materially participates in an activity is determined by reference to the persons who conduct the business activity on the trust's behalf, in addition to whether the trustee materially participates in the activity.⁶

8639. What happens if a taxpayer's passive losses for a tax year are disallowed?

Losses and credits that are disallowed under the passive loss rules may be carried over to offset passive income and the tax attributable to this income in later years.⁷ If passive losses (or credits) from a publicly traded partnership are carried forward, such losses (or credits) may only be offset by passive income (or tax attributable to passive income) from the same partnership.⁸

1. Temp. Treas. Reg. §1.469-5T(c).

2. Treas. Reg. §1.469-5T.

3. IRC Sec. 469(h)(5).

4. Temp. Treas. Reg. §1.469-5T(f).

5. IRC Sec. 469(h)(4).

6. *Carter Trust v. Commissioner*, 2003-1 USTC 50,418 (N.D. Tex. 2003).

7. IRC Sec. 469(b).

8. IRC Sec. 469(k)(1).

Suspended losses and credits of an activity may also offset the income and tax of that activity when the activity ceases to be passive or there is a change in status of a closely-held corporation or personal service corporation. For a discussion of the treatment of losses allowed upon disposition of an interest in a passive activity, see Q 8644.

The rules relating to the treatment of suspended losses and credits when the activity is disposed of require that losses and credits carried over from year to year be traceable to a particular activity. Because of this, where there are losses or credits from two or more activities which, in the aggregate, exceed passive gains from other passive activities, the amount disallowed and carried over must be allocated among the different activities and between capital and ordinary loss. Disallowed passive losses are allocated among activities in proportion to the loss from each activity. The disallowed loss allocated to an activity is then allocated ratably among deductions attributable to the activity. Disallowed credits are allocated ratably among all credits attributable to passive activities.

In identifying the deductions or credits that are disallowed, the taxpayer is only required to separately account for those items that, if separately taken into account by the taxpayer, would result in an income tax liability different from that which would result if such deduction were not taken into account separately. Deductions arising from a rental real estate activity, or in connection with a capital or IRC Section 1231 asset, must be accounted for separately. Credits (other than the low-income housing or rehabilitation credits) arising from a rental real estate activity must also be accounted for separately.¹

If an activity ceases to be passive (e.g., because the taxpayer begins to participate materially), its unused losses (or credits) from prior years continue to be passive, but may be used against the income (and tax liability) of that activity. If there is a change in the status of a closely-held C corporation or personal service corporation, its suspended losses from prior years will continue to be treated as if the status of the corporation had not changed.²

8640. What special passive activity rules apply to taxpayers who invest in rental real estate?

Except as provided below, a passive activity includes any rental activity, without regard to whether the taxpayer materially participates in the activity.³ A rental activity is any activity where rental payments are made principally for the use of tangible property.⁴

There are a number of exceptions to this rule. An activity is not treated as a rental activity if:

- (1) the average rental period is less than eight days;
- (2) the average rental period is less than 31 days and the owner of the property provides significant personal services in order to make it available for use by customers;

1. Temp. Treas. Reg. §1.469-1T(f).

2. IRC Sec. 469(f).

3. IRC Sec. 469(c)(2).

4. IRC Sec. 469(j)(8).

- (3) the rental of the property is incidental to the receipt of personal services or to a nonrental activity;
- (4) the taxpayer makes the property available on a nonexclusive basis during regular business hours;
- (5) the taxpayer rents property to a pass-through entity engaged in a nonrental activity, in his capacity as an owner of that entity; or
- (6) the personal use of a residence that is also rented out exceeds the greater of 14 days or 10 percent of the rental days.¹

Planning Point: For purpose of (2) above, in determining if a property owner's rental services are significant, all relevant facts and services—including the frequency of the services, type and amount of labor needed to perform them, and their value relative to the amount charged for the property's use—are taken into account.²

If an individual actively participates in a rental real estate activity subject to the passive activity rules, the individual may use up to \$25,000 of losses and the deduction-equivalent of credits to offset nonpassive income. An individual need not actively participate in a rental real estate activity to obtain the \$25,000 rental real estate exemption with respect to taking the low-income housing credit or rehabilitation tax credit.

If the investment is in real estate which is not rental property, the real estate activity will generally be considered a passive activity subject to the passive loss rule unless the taxpayer materially participates in the activity. The \$25,000 rental real estate exemption is not available with respect to nonrental property.

8641. How are the passive activities of publicly-traded partnerships treated under the passive loss rules?

Special restrictions apply to publicly traded partnerships under the passive loss rules. A publicly traded partnership is a partnership that is traded on an established securities market or is readily tradable on a secondary market (or the substantial equivalent thereof).³

The rules are applied separately to items attributable to a publicly traded partnership, meaning that income, losses, and credits attributable to the partnership may not be aggregated with other income, losses, and credits of the taxpayer-partner for purposes of the passive loss rules.⁴ Net passive loss from a publicly traded partnership will be treated as passive, while net passive income from a publicly traded partnership is to be treated as investment income.⁵

Generally, net passive loss from a publicly traded partnership is carried forward until the partner has additional passive income from the partnership or the partner disposes of the

1. Treas. Reg. §1.469-1T(e)(3), IRC Sec. 469(j)(10).

2. Temp Treas. Reg. §1.469-1T(e)(3)(iv).

3. IRC Sec. 469(k).

4. IRC Sec. 469(k)(1).

5. Notice 88-75, 1988-2 CB 386.

partnership interest. Also, the \$25,000 rental real estate exemption (see Q 8640) is available with respect to a publicly traded partnership only in connection with the low-income housing credit and the rehabilitation investment credit.

Furthermore, a taxpayer will not be treated as having disposed of the taxpayer's entire interest in an *activity* of a publicly-traded partnership until the taxpayer has disposed of the entire interest in the partnership. It would seem that if a publicly traded partnership is taxed as a corporation, the partnership is not a taxpayer subject to the passive loss rules.¹

8642. Do the passive loss rules apply to casualty losses?

An exception to the passive loss restrictions is applied to certain casualty losses (see Q 8649 to Q 8660) resulting from unusual events (including fire, storm, shipwreck, and earthquake). Losses from such casualties are generally not subject to the passive loss rules.²

Likewise, passive activity income does not include reimbursements for such losses if both of the following are true:

- (1) the reimbursement is includable in gross income under Treasury Regulation Section 1.165-1(d)(2)(iii) as an amount the taxpayer had deducted in a prior taxable year; and
- (2) the deduction for the loss was not a passive activity deduction.

In other words, both the losses and the reimbursement should be taken into account in the calculation of the partnership's gross income, not its passive activity gross income.³

The exception does not apply to losses that occur regularly in the conduct of the activity, such as theft losses from shoplifting in a retail store, or accident losses sustained in the operation of a rental car business.⁴

8643. How do the passive loss rules interact with the at-risk rules?

When determining whether a loss deduction will be allowed, the taxpayer must first apply the at-risk rules. If a deduction is disallowed in one year under the at-risk rules (see Q 8629 to Q 8634), it generally cannot be deducted as a loss under the passive activity rules.⁵ Therefore, the loss will be suspended under the at-risk rules, and can be carried forward to the succeeding tax year if the taxpayer has sufficient amounts "at risk" in that later tax year.

1. See IRC Sec. 469(a).

2. Treas. Regs. §§1.469-2T(d)(2), 1.469-2(d)(2)(xi).

3. Treas. Regs. §§1.469-2T(c)(7), 1.469-2(c)(7)(vi).

4. TD 8290, 1990-1 CB 109.

5. Temp. Treas. Reg. §1.469-2T(d)(6)(i).

8644. What are the tax results when a taxpayer disposes of interests in a passive activity?

If a taxpayer disposes of his interests in a passive activity in a fully taxable transaction, losses from the activity will receive *ordinary loss treatment* (i.e., they may generally be used to offset other income of the taxpayer) to the extent that they exceed net income or gain from all passive activities (determined without regard to the losses just discussed) for the year. This treatment applies both to current year losses as well as losses carried over from previous years, with respect to the activity disposed of. The IRS has been given the authority to issue regulations that will take income or gain from previous years into account to prevent the misuse of this rule.¹

For the purpose of determining gain or loss from a disposition of property, the taxpayer may elect to increase the basis of the property immediately before disposition by an amount equal to the part of any unused credit that reduced the basis of the property for the year the credit arose.² If the passive interest disposed of is sold under the installment method, previously disallowed passive losses are allowed as a deduction in the same proportion as gain recognized for the year bears to gross profit from the sale.³

If the disposition of the passive interest is to a related person in an otherwise fully taxable transaction, suspended losses remain with the taxpayer and may continue to offset other passive income of the taxpayer. The taxpayer is considered to have disposed of an interest in a transaction described in the preceding sentence when the related party later disposes of the passive interest in a taxable transaction to a party unrelated to the taxpayer.⁴

If the disposition is by death, the carried over losses may be deducted only to the extent the losses exceed the step-up in basis of the interest in the passive activity.⁵ If the disposition is by gift, the losses are not deductible. Instead, the donor's basis just before the transfer is increased by the amount of the disallowed losses allocable to the interest.⁶ However, where a donor makes a gift of less than his or her entire interest in property, a portion of the carried over losses is allocated to the gift and increases the donor's basis. A portion of the losses will continue to be treated as passive losses attributable to the interest that the donor has retained.⁷

If a trust or estate distributes an interest in a passive activity, the basis of such interest immediately before the distribution is increased by the amount of passive losses allocable to the interest, and such losses are never deductible.⁸

A taxpayer is not treated as having disposed of the entire interest in an *activity* of a publicly-traded partnership until the taxpayer disposes of the entire interest in the partnership.⁹

1. IRC Sec. 469(g)(1).

2. IRC Sec. 469(j)(9).

3. IRC Sec. 469(g)(3).

4. IRC Sec. 469(g)(1)(B).

5. IRC Sec. 469(g)(2).

6. IRC Sec. 469(j)(6).

7. Sen. Rep. 99-313, 1986-3 CB (vol. 3) 713, 726.

8. IRC Sec. 469(j)(12).

9. IRC Sec. 469(k)(3).

Planning Point: IRS Publication 925 (Passive Activity and At-Risk Rules) contains a number of examples of, and various scenarios relating to, passive activities and losses, and includes worksheets and filing instructions necessary for the completed reporting of passive activities.

8645. Can a taxpayer deduct interest expenses incurred in relation to property the taxpayer holds for investment?

Yes, within limits. Because of the substantial tax benefits that can result when a taxpayer's interest expenses are large compared to the amount of income realized from the investments at issue, Congress has taken steps to limit the amount of investment interest that a taxpayer can deduct in any tax year.

Therefore, a noncorporate taxpayer is permitted to deduct interest expenses incurred in funding the purchase of investment assets, but only to the extent that the taxpayer's interest expenses exceed net investment income (see below) for the year.¹ Any other investment interest expense is considered excess interest and is disallowed.

"Net investment income" for purposes of the interest expense deduction means the excess of investment income over investment expenses.² "Investment income" means the sum of the following four items:

- (1) Gross income derived from property held for investment *other than* gain derived from the disposition of that property (e.g., income from interest, dividends, annuities and royalties not derived in the ordinary course of the taxpayer's trade or business);
- (2) The excess, if any, of (i) "net gain" attributable to the disposition of property held for investment over (ii) the "net capital gain" determined by taking into account gains and losses from dispositions of property held for investment;
- (3) The taxpayer's net capital gain determined by only taking into account gains and losses derived from the disposition of investment property *or* the taxpayer's net gain attributable to disposition of property held for investment, whichever is lower, but only to the extent the taxpayer *elects* to treat such income as investment income for purposes of Section 163; and
- (4) Qualified dividend income, to the extent the taxpayer elects to treat such income as investment income for purposes of Section 163.³

In other words, net investment income, for purposes of the interest expense deduction, generally does not include net capital gain from the disposition of investment property *unless* the taxpayer makes the election to do so (see Q 8647 for the tax consequences of this election).

1. IRC Sec. 163(d).

2. IRC Sec. 163(d)(4)(A).

3. IRC Sec. 163(d)(4)(B).

The term “investment expenses” means deductions (other than the interest deduction) that are directly connected with the production of investment income.¹

The Tax Court has held that net gain for purposes of IRC Section 163(d)(4)(B)(ii) means the excess (if any) of total gains over total losses, including capital loss carryovers, from the disposition of property held for investment. The Court further held that calculation of net gain required inclusion of the taxpayers’ capital losses and capital loss carryovers for purposes of calculating the IRC Section 163(d)(1) limit on the investment interest expense deduction.²

The IRS has ruled privately that:

- (1) The term “property” (under IRC Section 163(d)(5)(A)(i)) includes interest-free loans (which are deemed to yield gross income as a result of interest imputed under IRC Section 7872) to a tax-exempt foundation;
- (2) Any imputed interest income that is deemed to be received by the taxpayer on the potential loan from the line of credit to the foundation is “investment income” (under IRC Section 163(d)(4)(B)(i)); and
- (3) Any interest paid by the taxpayer on the line of credit used to make the potential loan to the foundation is “investment interest” (under IRC Section 163(d)(3)(A)).³

See Q 8646 for a discussion of the treatment of disallowed interest expenses and Q 8648 for a discussion of how the interest expense deduction is impacted by the passive loss rules.

8646. What is the result if a taxpayer has interest expenses that exceed net investment income for the tax year?

If a taxpayer has interest expenses that exceed his or her net investment income for the year, those expenses are considered excess interest and the deduction is disallowed. However, disallowed interest expenses from one year can be carried forward to the succeeding tax year.⁴

A taxpayer’s investment interest expenses that are disallowed because of the investment income limitation in one year will be treated as investment interest paid or accrued in the succeeding tax year.⁵ The IRS has issued guidance that provides it will not limit the carryover of a taxpayer’s disallowed investment interest to a succeeding tax year to the taxpayer’s taxable income for the tax year in which the interest is paid or accrued.⁶ Prior to the issuance of this guidance, several federal courts had held that no taxable income limitation existed on the amount of disallowed investment interest that could be carried over.⁷

1. IRC Sec. 163(d)(4)(C).

2. *Gorkes v. Commissioner*, TC Summ. Op. 2003-160.

3. Let. Rul. 200503004.

4. IRC Sec. 163(d)(2).

5. IRC Sec. 163(d)(2).

6. Rev. Rul. 95-16, 1995-1 CB 9.

7. See, for example, *Sharp v. U.S.*, 94-1 USTC 50,001.

8647. What are the tax consequences when a taxpayer elects to treat all or a portion of capital gain or qualified dividend income as investment income when calculating the allowable investment interest deduction?

Net investment income, for purposes of the interest expense deduction, generally does not include net capital gain from the disposition of investment property or qualified dividend income *unless* the taxpayer elects to treat this income as investment income. See Q 8645.

If the taxpayer makes this election, any net capital gain or qualified dividend income treated as investment income are not eligible to be taxed at the capital gains rates and will be subject to the taxpayer's ordinary income tax rate for that tax year, rather than the special lower tax rates that otherwise apply to these types of income (see Q 8561 for a discussion of the currently applicable tax rates for capital gains and qualified dividend income).¹

The advantage of making the election is that a taxpayer may increase the amount of investment income against which investment interest is deducted, thus receiving the full benefit of the deduction.²

Example: Shawn incurred \$15,000 in interest expenses related to investment property in 2014. His investment income included \$6,000 of interest income, \$2,000 received as qualified dividends and a \$5,000 net capital gain on the sale of securities held for investment. If Shawn does not elect to treat his income from net capital gains and dividends as investment income, his investment income is \$6,000 (i.e., only the interest income he realized for the year). He would, therefore, have \$9,000 of disallowed interest expenses for the year. While he could carry those expenses forward to 2015 (see Q 8646), if he does make the election, his investment income would equal \$13,000 and he would only carry \$2,000 forward.

The election to treat net capital gain and qualified dividend income as investment income must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized, or the qualified dividend income is received, respectively.³ The IRS has, however, privately ruled that a taxpayer was permitted to make a late election to treat capital gains as investment income based on the IRS' conclusion that the taxpayer had acted reasonably and in good faith, and that granting the extension would not prejudice the interests of the government.⁴

The elections are made on Form 4952, "Investment Interest Expense Deduction" and may not be revoked for that year, except with IRS permission.⁵ The IRS has ruled privately that certain taxpayers who were properly classified as securities traders were permitted to revoke their election because such gains should have been treated as investment interest anyway (based on their status as professional securities traders). Therefore, allowing them to revoke their election did not prejudice the government or cause undue administrative burdens.⁶

1. Treas. Reg. §1.163(d)-1(a).

2. See IRC Sec. 163(d)(4).

3. Treas. Reg. §1.163(d)-1(b).

4. Let. Rul. 200033020. See also Let. Rul. 200303013.

5. Treas. Regs. §§1.163(d)-1(b), 1.163(d)-1(c).

6. Let. Rul. 200146018.

A taxpayer can elect to treat capital gain or dividend income as investment income in one year without any obligation to make the election in any other tax year.¹

8648. Is the determination of a taxpayer's allowable investment interest deduction coordinated with the passive loss rules?

The investment interest limitation is coordinated with the passive loss rules (see Q 8635 to Q 8644), so that interest and income subject to the passive loss rules are not taken into consideration under the investment interest limitation.² Interest expense incurred to purchase an interest in a passive activity is allocated to that passive activity and is not investment interest.³

However, portfolio income of a passive activity and expense (including interest expense) allocable to it is considered investment income and expense, not passive income and expense.⁴

Investment interest expense and investment income and expenses do not include items from a trade or business in which the taxpayer materially participates. The IRS has determined that interest on a loan incurred to purchase stock in a C corporation was investment interest (where the purchaser was not a dealer or trader in stock or securities), even though the purchaser acquired the stock to protect his employment with the C corporation.⁵

In a decision citing Revenue Ruling 93-68, the Tax Court held that interest on indebtedness incurred to purchase a taxpayer's share of stock in a family-owned mortuary business was subject to the investment interest limitation, despite the fact that the taxpayer purchased the stock to conduct business full time and the fact that no dividends had been paid on the stock.⁶

Temporary regulations provide that, for purposes of the investment interest and passive loss rules, interest expense is generally allocated on the basis of the use of the proceeds of the underlying debt.

1. Treas. Reg. §1.163(d)-1(c).

2. IRC Secs. 163(d), 469.

3. Temp. Treas. Reg. §1.163-8T(a)(4)(B).

4. IRC Sec. 469(e)(1).

5. Rev. Rul. 93-68, 1993-2 CB 72.

6. *Russon v. Commissioner*, 107 TC 263 (1996).

PART VI: CASUALTY AND THEFT LOSS

8649. What is a casualty loss?

A casualty loss is a loss that an individual taxpayer suffers as a direct result of an event that meets the following criteria:

- (1) It is identifiable;
- (2) It is damaging to property; and
- (3) It is sudden, unexpected and unusual in nature.¹

IRC Section 165 specifically permits a casualty loss deduction for fire, storm, shipwreck or “other casualty.”² The term “other casualty” has been interpreted to include damage sustained as a result of, among other events, floods³ and sudden freezing.⁴ Other deductible casualty losses, specifically allowed by the IRS, include damage caused by fire, earthquake, government ordered demolition or relocation of a home rendered unsafe due to a disaster, mine cave-ins, shipwrecks, sonic booms, storms, terrorist attacks, vandalism and volcanic eruptions.⁵

The Tax Court allowed a taxpayer’s casualty loss deduction for damage caused by blasting operations when the damage caused by the particular blast was unusual and heavier than the blasting that had occurred on a day-to-day basis in the area.⁶ The Tax Court has also permitted a casualty loss deduction for damage sustained due to vandalism, because the vandalism in question was caused by persons outside of the taxpayers’ control, was sudden in nature and destructive in effect.⁷

Damage to property created by termite infestation was *not* considered to be a casualty loss, because the damage was created by a progressive deterioration of property resulting from a steady cause operating over time—essentially, the casualty loss deduction was denied because the event that caused the destruction was not “sudden” in nature.⁸

A taxpayer was not entitled to claim a casualty deduction for losses sustained as a result of the worthlessness of currency held by the taxpayer. The Tax Court found that “other casualty” must be interpreted to mean an event similar to “fire, storm or shipwreck” and that a decrease in currency value was not a similar event. Further, the Court noted that the taxpayers actually still held the currency at issue—and thus, it was not technically damaged.⁹

1. See *Fay v. Helvering*, 120 F.2d 253 (2nd Cir. 1941), *Torre v. Commissioner*, TC Memo 2001-218, *Matheson v. Commissioner*, 54 F.2d 537 (2nd Cir. 1931).

2. IRC Sec. 165(c)(3).

3. *Finkbinder v. United States*, 788 F.2d 723 (11th Cir. 1986).

4. *United States v. Barret*, 202 F.2d 804 (5th Cir. 1953).

5. IRS Pub. 547, Casualties, Disasters and Thefts (2013)

6. *Durden v. Commissioner*, 3 TC 1 (1944).

7. *Davis v. Commissioner*, 34 TC 586 (1960).

8. *Fay v. Helvering*, above.

9. *Billman v. Commissioner*, 73 TC 139 (1979).

Further, costs incurred by a taxpayer in order to *prevent* a potential casualty loss are not deductible under IRC Section 165 as casualty losses. According to the courts, such preventative steps are not sudden and unexpected in nature, and thus do not qualify as events giving rise to casualty loss treatment.¹

Special rules apply if a taxpayer suffers a casualty loss within a federally declared disaster area. (see Q 8659).

Generally, casualty losses are deductible during the taxable year that the loss occurred (see Q 8652).²

8650. What is a theft loss?

A theft loss is a loss sustained as a result of (among other things) larceny, embezzlement or robbery.³ The taking of property must be illegal under the law of the state where it occurred and it must have been done with criminal intent. A conviction does not need to occur, however, to show a theft loss.⁴

The definition of “theft” is given a broad meaning and, therefore, a theft loss deduction may often be allowed in situations that do not involve the straightforward theft of property. For example, the IRS has allowed a theft loss deduction when a publicly-traded company misrepresented its financial condition in a business transaction in which the company traded its common stock in a tax-free reorganization and that stock subsequently became worthless. The IRS analogized the situation to “larceny by false pretenses” in that the company’s officers knew that their representations were false.⁵

In Revenue Ruling 66-355, the IRS held that a theft occurred when a taxpayer’s employee pledged shares of the taxpayer-employer’s stock as collateral to secure a personal loan. When the bank later sold the stock, the taxpayer-employer was able to treat the property as stolen, and the proceeds obtained in the employer’s settlement of the lawsuit against that employee were considered proceeds obtained as a result of an involuntary conversion (see Q 8651).⁶

The decline in the market value of stock is not deductible as a theft loss where the stock was acquired on the open market if the decline is caused by accounting fraud or other illegal misconduct by the officers or directors of the corporation that issued the stock. However, the loss sustained when stock is sold or exchanged, or becomes completely worthless, is deductible as a capital loss reportable on Schedule D of Form 1040.⁷

1. See *Austin v. Commissioner*, 74 TC 1334 (1980).

2. IRS Pub. 547, above.

3. Treas. Reg. §1.165-8(d).

4. IRS Pub. 547, Casualties, Disasters and Thefts (2013)

5. Let. Rul. 8947032.

6. Rev. Rul. 66-355, 1966-2 CB 302.

7. IRS Pub. 547.

8651. How do the rules governing theft and casualty losses interact with the rules governing involuntary conversions of property?

The rules governing theft losses frequently intersect with the IRC Section 1033 provisions governing involuntary conversions (see Q 8611 to Q 8614). The rules on involuntary conversions govern the treatment of any reimbursement that a taxpayer receives as a result of a loss, such as a casualty or theft loss.

Therefore, if a taxpayer receives insurance proceeds, for example, that exceed the amount lost as a result of a casualty or theft, the taxpayer would look to the rules on involuntary conversions for determining whether the gain must be recognized.¹ In these circumstances, the gain is characterized as stemming from an involuntary conversion because the casualty in effect causes the damaged property to suddenly be converted into cash from the insurance proceeds. The rules for determining what gain is and is not subject to taxation in involuntary conversions may differ for federally declared disasters.²

8652. When is a taxpayer entitled to take a deduction for a theft loss?

A taxpayer who sustains a theft loss may take the deduction for the tax year in which the taxpayer discovers the loss, rather than the year in which the loss was sustained (as is the general rule for casualty losses).³

The reasonable prospect of recovery doctrine (see Q 8656) applies in the case of theft losses, so that the taxpayer will not be entitled to take a deduction if there is a claim for reimbursement against a third party that may fully or partially compensate the taxpayer for the theft loss, and there is a reasonable prospect that the taxpayer will recover these amounts.⁴ These rules do not apply to a theft loss discovered through a shortage in the inventories of a business.⁵

The amount of the taxpayer's theft loss deduction is determined using the same method applicable to casualty loss deductions (see Q 8653).

Example: Denise purchased a watch for \$15,000 in 2011. In 2012, the watch, which now has a fair market value of \$13,500, is stolen. Denise does not discover that the watch is missing until 2013. Though the watch was insured against theft, the insurance company challenges its liability for the loss. Despite this challenge, Denise has a reasonable prospect of recovering from the insurance company in 2013. In 2014, Denise settles with the insurance company and receives \$12,000 in insurance proceeds to cover the theft loss. Denise is not permitted to take a deduction in 2012 or 2013, but in 2014, she is permitted a theft loss deduction for \$1,500. The computation is made as follows:

1. See IRS Publication 225.

2. AICPA Casualty Loss Practice Guide (July 2012).

3. IRC Sec. 165(e), Treas. Reg. §1.165-8(a)(2).

4. Treas. Reg. §1.165-8(a)(2).

5. Treas. Reg. § 1.165-8(e).

Value of property immediately before theft	\$13,500
Less: value of property immediately after theft	\$0
Balance	\$13,500
Loss to be taken into account for purposes of Section 165(a)	\$13,500
Less: insurance received in 2014	\$12,000
Deduction allowable for 2014	\$1,500

8653. How is the amount of a taxpayer's allowable casualty or theft loss deduction determined?

If a taxpayer has suffered a casualty (or theft) loss, regardless of whether the loss is personal in nature or is related to trade or business activities, the taxpayer may be entitled to deduct the lesser of the following amounts:

- (1) The fair market value immediately before the casualty *minus* the fair market value of the property immediately after the casualty; or
- (2) The adjusted basis of the property that would be used for determining the taxpayer's gain or loss if the property was sold or otherwise disposed of.¹

Planning Point: Although the regulations use the term "immediately after" when referring to the post-casualty value, the IRS recognizes that taxpayers' ability to determine the decrease in the fair market values of their properties, as a result of a disaster, may be restricted by lack of access to the properties and the need to remove water from flooded properties. Under these circumstances, the decrease in fair market value would take into account additional damage sustained to the property as a result of delays due to legal and physical restrictions to taxpayers' access to their property and the need to remove standing water from the properties.²

The fair market value of the property must be ascertained by appraisal, and this appraisal must consider the impact of any general market decline affecting undamaged property (as well as damaged property) that may have occurred at the same time as the casualty, so that the casualty loss is limited to the actual loss caused by the casualty.³

The taxpayer claiming the casualty loss may use the actual cost of repairs to the property as evidence of the amount of loss if the following conditions are met:

- (1) The repairs are necessary to restore the property to its condition immediately before the casualty;
- (2) The cost of the repairs is not excessive;
- (3) The repairs only fix the damage suffered as a result of the casualty; and
- (4) The repairs do not cause the value of the property to exceed the value of the property immediately before the casualty.⁴

1. Treas. Reg. §1.165-7(b)(1).

2. IRS FAQs for Disaster Victims-Casualty Loss (Valuations and Section 165(i), July 5, 2013).

3. Treas. Reg. §1.165-7(a)(2)(i).

4. Treas. Reg. §1.165-7(a)(2)(ii); [http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/FAQs-for-Disaster-Victims-Casualty-Loss-\(Valuations-and-Sections-165-\(i\)\)](http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/FAQs-for-Disaster-Victims-Casualty-Loss-(Valuations-and-Sections-165-(i))).

The cost of repairs may, in certain cases, be used to measure the decline in fair market value, but it cannot be used by itself to determine the amount of the loss. When the cost of repairs is determined to be a fair measure of the decline in fair market value, then the fair market value of the property before the casualty is reduced by the cost of repairs to arrive at the fair market value after the casualty.¹

If the property at issue was used in a trade or business (or otherwise held for the production of income) and was totally destroyed by the casualty, the taxpayer may use the adjusted basis to determine the amount of loss if the fair market value of the property immediately before the casualty is less than the adjusted basis.²

When property used in a taxpayer's trade or business (or otherwise held for profit) is destroyed, each single, identifiable piece of property must be considered separately in computing the amount of loss.³

Example: Chase owns a marina comprised of a large storage building and a boat docking area. The marina is badly damaged in a hurricane. In determining the fair market value of the property for purposes of determining loss, Chase must measure the decrease in value by taking the building and the docks into account separately, rather than together as two integral pieces of the property as a whole. In other words, he must determine the losses separately for the building and the docks.

However, where separate property is considered to be an integral piece of the property as a whole (for example, ornamental trees and shrubs on residential property), no separate calculation is made.⁴

8654. What limitations apply to the amount a taxpayer is able to claim as a casualty or theft loss deduction?

Casualty and theft losses are deductible whether the loss relates to property held by the taxpayer (i) for use in a trade or business, (ii) for investment purposes or (iii) for use that is purely personal.⁵ However, if the property involved is not held for a business or profit-generating purpose, the amount of the deduction is limited as follows:

- (1) each loss is reduced by \$100 and any insurance received (prior to 2010, the \$100 limitation was \$500);⁶ and
- (2) the aggregate of such adjusted losses is deductible only to the extent that it exceeds 10 percent of adjusted gross income.⁷

If the taxpayer sustains more than one loss from a single casualty event, only one \$100 reduction is made. Conversely, a separate reduction of \$100 is made for losses from *each* casualty

1. IRS FAQs, above.

2. Treas. Reg. §1.165-7(b)(1) (flush language).

3. Treas. Reg. §1.165-7(b)(2).

4. See *Western Products Co. v. Commissioner*, 28 TC 1196 (1957).

5. IRC Sec. 165.

6. IRC Sec. 165(h)(1).

7. IRC Sec. 165(h)(2).

or theft event. The 10 percent limit applies to the *total* of all of the taxpayer's losses from all casualty events occurring in the same tax year.¹

When casualty and theft losses exceed income for the tax year, the excess is considered a net operating loss and may be carried back to offset income of prior years and carried forward to offset income of future years under the net operating loss provisions. All casualty and theft losses qualify even though the property is personal.

As discussed in Q 8653, the amount of the loss which can be deducted above the \$100 floor is limited to the lesser of (1) the difference between the fair market value of the property immediately before the casualty and the fair market value immediately after the casualty, or (2) the adjusted basis of the property.² (For a description of what the IRS considers to constitute "immediately after," see Q 8653.) This amount is further reduced by any insurance or other indemnification received. In addition, as discussed above, such loss is deductible only to the extent it exceeds 10 percent of AGI.

Example 1: In June, Pete and Karen discovered their house had been burglarized. Their loss after insurance reimbursement was \$2,000. Their adjusted gross income for the tax year was \$29,500. To determine their theft loss deduction, Pete and Karen must first apply the \$100 rule and then the 10 percent rule. Their theft loss deduction is calculated as follows:

1. Amount of loss	\$2,000
2. Subtract \$100	(100)
3. Loss after \$100 rule	1,900
4. Subtract 10 percent of \$29,500 (AGI)	(2,950)
Theft loss deduction	-0-

Pete and Karen will not be allowed a theft loss deduction because their loss (\$1,900) is less than 10 percent of their AGI.

Example 2: Cathy and Bernardo owned a group of apartment buildings that were damaged by flooding. Before the flood, the adjusted basis in the apartment buildings was \$672,000. The fair market value of the property immediately prior to the flood was \$2 million, and immediately after the flood was \$750,000. Cathy and Bernardo received \$767,000 from insurance coverage. Although the \$1,250,000 decline in market value far exceeded the insurance recovery, no casualty loss deduction is allowable, since the insurance proceeds exceeded the adjusted basis in the property.³

8655. When will a taxpayer's otherwise allowable casualty loss deduction be disallowed? How does a taxpayer's eligibility to file an insurance claim with respect to the loss impact the availability of the deduction?

In general, a casualty loss deduction is only allowable to the extent that the taxpayer is not otherwise compensated for the loss by insurance or reimbursement from another third party.

1. See IRS Publication 547.

2. Treas. Reg. §1.165-7(b)(1).

3. See *Lafavre v. Commissioner*, TC Memo 2000-297.

However, if a taxpayer's casualty loss *would have* been covered by insurance, but the taxpayer fails to file a timely insurance claim with respect to the loss, the casualty loss deduction will be disallowed regardless of whether the taxpayer actually receives any insurance proceeds as compensation for the loss.¹ Thus, if a taxpayer chooses not to file an insurance claim with respect to a loss, the casualty loss deduction will be limited to the portion of the loss that would *not* have been covered by insurance.

Further, a taxpayer is not entitled to deduct an otherwise allowable casualty loss if the loss has already been claimed for estate tax purposes on an estate tax return.²

8656. Can a casualty loss be spread over more than one tax year? What is the reasonable prospect of recovery doctrine?

Generally, a taxpayer is required to claim a casualty loss deduction for the tax year in which the loss was sustained. A taxpayer is considered to have sustained a casualty loss in the year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in the year.³

The fact that a taxpayer is unable to determine the extent of the damage caused or the cost of repairing the damage is insufficient to allow the taxpayer to carry a casualty loss deduction into a succeeding tax year. The Tax Court has determined that an expert appraisal is sufficient to determine the level of damage sustained at the time the casualty loss occurred even if the extent of the damage was not immediately apparent.⁴

Despite this, the reasonable prospect of recovery doctrine will actually prohibit a taxpayer from claiming a casualty loss in the year the casualty occurs if the taxpayer has a claim for reimbursement with respect to which the taxpayer may reasonably be expected to recover all or a portion of the casualty loss.⁵ The portion of the casualty loss to which the potential for reimbursement relates will be disallowed until it can be ascertained "with reasonable certainty" whether or not the reimbursement will be received.

Example: Brent's cottage, which had an adjusted basis of \$100,000, is completely destroyed by a fire in 2013. His only claim for reimbursement was an insurance claim for \$80,000, which he settled in 2014. Brent sustained a loss of \$20,000 for 2013. If the cottage was destroyed due to the negligence of a third party, and there is a reasonable prospect that the third party can be held liable for the entire amount of the damage, Brent cannot take a loss deduction until it is determined whether or not he can recover damages from that third party.⁶

Whether a "reasonable prospect of recovery" exists is a question of fact that is determined based on an examination of all of the facts and circumstances of the particular loss being claimed.⁷

1. IRC Sec. 165(h)(5)(E).

2. IRC Sec. 165(h)(5)(D).

3. Treas. Reg. §1.165-1(d)(1).

4. See *Allen v. Commissioner*, 49 TCM 238 (1984).

5. Treas. Reg. §1.165-1(d)(2).

6. Treas. Reg. §1.165-1(d)(2)(ii).

7. Treas. Reg. §1.165-1(d)(2)(i).

If a taxpayer takes a casualty loss deduction for a loss sustained in one year, but receives reimbursement for that loss in a subsequent tax year, the taxpayer is not required to file an amended return for the year in which the deduction was erroneously claimed. Instead, the taxpayer must include the reimbursed amount in gross income for the year it is received.¹

A special rule applies in the case of casualty losses sustained in a federally declared disaster area. If the taxpayer's casualty loss was sustained in a disaster area, the taxpayer may elect to take the casualty loss deduction in the year immediately preceding the year in which the loss was sustained.² See Q 8659 for a detailed discussion of the treatment of casualty losses that occur in a disaster area.

The reasonable prospect of recovery doctrine also applies in the case of theft losses (see Q 8652).

8657. Is a business-related casualty loss treated differently than a personal casualty loss?

If a taxpayer sustains a casualty loss with respect to property used in the taxpayer's trade or business, the taxpayer will not be subject to the \$100 floor or 10 percent of adjusted gross income limitations described in Q 8516. The taxpayer who sustains a casualty loss in connection with a trade or business can take the deduction as a business deduction.

Taxpayers who used the property and sustain a casualty or theft loss in performing services as an *employee* can deduct the casualty or theft loss as a miscellaneous itemized deduction subject to the 2 percent limit on these deductions (see Q 8525).³ If the property subject to the loss was investment-type property held for profit, the deduction will not be subject to the 2 percent limit on miscellaneous itemized deductions.⁴ This kind of investment-type property includes stocks, notes, bonds, gold, silver, vacant lots, and works of art.⁵

8658. What are the tax consequences to a taxpayer who has both personal (nonbusiness) casualty (or theft) gains and losses for the same tax year?

If a taxpayer has both personal casualty (or theft) gains and losses for the tax year, the taxpayer is required to offset (net) those casualty losses with any casualty gains for the year.

If a taxpayer has casualty or theft gains as well as losses to personal-use property, the taxpayer must compare his total gains to his total losses after he has reduced each loss by any reimbursements and by \$100, but before he has reduced the losses by 10 percent of his adjusted gross income.

If the taxpayer's personal casualty losses for the year exceed personal casualty gains for the year, a deduction is allowable to the extent of the sum of the following:

1. Treas. Reg. §1.165-1(d)(2)(iii).

2. IRC Sec. 165(i), Treas. Reg. §1.165-1(d)(1).

3. See IRS Publication 529.

4. IRS Publication 529, above.

5. IRS Publication 529, above.

- (1) The amount of personal casualty gains for the tax year; plus
- (2) So much of the excess as exceeds 10 percent of the taxpayer's adjusted gross income for the tax year.¹

If the taxpayer's casualty gains for the tax year exceed casualty losses, the gain or loss is treated as though it resulted from the sale or exchange of capital assets (see Q 8560).² As such, any gains will be taxed at the rates applicable to short-term capital assets or long-term capital assets, depending upon how long the taxpayer held the asset (see Q 8567).

If the taxpayer's casualty losses for the tax year exceed casualty gains, all gains and losses are treated as ordinary gains or losses.

These rules apply to both casualty losses and theft losses.³

8659. What special rules apply to taxpayers who suffer casualty losses within a federally-declared disaster area?

In recognition of the fact that taxpayers who sustain casualty losses as a result of disasters often have an immediate need for relief, the IRC contains provisions that accelerate the recognition of tax benefits to which disaster victims are entitled.

As such, disaster victims are entitled to claim casualty losses on their tax returns for the year *before* the disaster actually occurred.⁴ This treatment is elective, so the taxpayer may choose to claim the casualty loss in the manner otherwise prescribed by IRC Section 165 (see Q 8656).

Planning Point: An election to claim a deduction for the preceding year must be made by filing a return, an amended return, or a claim for refund clearly showing that the election has been made. In general, the return or claim should specify the date or dates of the disaster which gave rise to the loss, and the city, town, county, and state in which the property which was damaged or destroyed was located at the time of the disaster. An election for a loss resulting from a particular disaster occurring after December 31, 1971, must be made by the later of (1) the due date for filing the income tax return (without regard to any filing extensions) for the year in which the disaster actually occurred, or (2) the due date for filing the return (determined with regard to any filing extension) for the taxable year immediately preceding the year in which the disaster actually occurred. The election is irrevocable 90 days after the date on which it's made.⁵

If the due date (including extensions) for filing the taxpayer's prior year tax return has not expired, the taxpayer can claim the deduction when the taxpayer files that return. If the due date has passed, the taxpayer can file an amended return to reflect the casualty loss deduction on the prior year's tax return.⁶

1. IRC Sec. 165(h)(2)(A).

2. IRC Sec. 165(h)(2)(B).

3. IRC Sec. 165(h)(4)(A).

4. IRC Sec. 165(i).

5. Treas. Reg. § 1.165-11(e).

6. Treas. Reg. § 1.165-11(e).

The special treatment described in this question applies to taxpayers who have sustained a loss:

- (1) Arising from a disaster in an area where the President of the United States determines that assistance is warranted by the federal government under the Disaster Relief Act of 1974;
- (2) Occurring after December 31, 1971;
- (3) That otherwise constitutes a loss allowable under IRC Section 165(a) and the regulations.¹

A taxpayer is entitled to claim a loss under these provisions if the taxpayer's residence is located in a federally declared disaster area that has been declared unsafe for use as a residence because of the disaster, and the taxpayer is ordered to demolish or relocate the residence within 120 days after the area is declared to be a disaster area.²

The \$100 floor and adjusted gross income limitations do not apply in the case of certain hurricanes and other natural disasters if specifically exempted. For example, victims of Hurricanes Katrina, Rita and Wilma were exempt from these limitations.³

8660. What is a qualified insolvent financial institution loss? Can a taxpayer treat such a loss as a casualty loss?

A taxpayer may choose to treat a qualified insolvent financial institution loss as a casualty loss if it can be ascertained with reasonable certainty that there is a loss on a qualified individual's deposit in a qualified financial institution and that the loss is caused by the bankruptcy or insolvency of that institution.⁴ "Deposit" for this purpose means any deposit, withdrawable account or withdrawable or repurchasable share.⁵

The term "qualified individual" is defined by exclusion as any individual *other than* an individual who:

- (1) owns at least 1 percent of the outstanding stock of the qualified institution;
- (2) is an officer of the qualified institution; or
- (3) is related to a person described in (1) or (2), above.⁶

A "qualified financial institution" is a bank, mutual savings bank, credit union (if its deposits are insured or protected under federal or state law) or any similar institution that is chartered and supervised under either federal or state law.⁷

1. Treas. Reg. §1.165-11(b).

2. IRC Sec. 165(k).

3. IRC Sec. 1400S(b).

4. IRC Sec. 165(l)(1).

5. IRC Sec. 165(l)(4).

6. IRC Sec. 165(l)(2).

7. IRC Sec. 165(l)(3).

If the taxpayer elects to treat a qualified insolvent financial institution loss as a casualty loss, the election applies to all losses in that same financial institution for the tax year. The election can only be revoked with the consent of the Secretary.¹

In the alternative, a taxpayer may elect to treat the loss as an ordinary loss in order to avoid the limits on the casualty loss deduction discussed in Q 8654. However, with respect to each financial institution, the taxpayer is only permitted to elect an ordinary loss deduction of up to \$20,000 (\$10,000 for married taxpayers filing separately). The taxpayer may *not* elect ordinary loss treatment if the deposit in question was federally insured.²

An election to treat a qualified insolvent financial institution loss as a casualty loss precludes treating the loss as a bad debt.³

1. IRC Sec. 165(l)(6).

2. IRC Sec. 165(l)(5).

3. IRC Sec. 165(l)(7).

PART VII: EMPLOYEES VS. INDEPENDENT CONTRACTORS

8661. Who is an “employee” for employment tax purposes?

Employers are often concerned with the classification of workers as employees or independent contractors because, among other reasons, the employer is responsible for paying one-half of an *employee’s* employment taxes. Conversely, an independent contractor is liable for the entire sum of employment taxes (see Q 8663 for further discussion of the self-employment tax).

Generally, for employment tax purposes, the IRC defines “employee” to include the following taxpayers:

- (1) Any officer of a corporation;
- (2) Any individual who is an employee under the common law rules (see Q 8662); or
- (3) Any individual who performs services as
 - a. A driver who distributes certain products (meat, vegetables, fruit, bakery products, beverages (other than milk), or laundry or dry cleaning services);
 - b. A full-time life insurance salesperson; (but see below and Q 8671);
 - c. A home worker performing work pursuant to the specifications given by the person for whom the services are performed; or
 - d. A traveling salesperson who, on a full-time basis, solicits orders on behalf of a principal from wholesalers, retailers, contractors, or operators of hotels, restaurants or similar establishments for merchandise for resale or supplies for use in their business.¹

However, an individual will not be an “employee” for purposes of (3) above if the individual has a substantial investment in facilities used in connection with the performance of services (other than an investment in transportation facilities), or if the services are in the nature of a single transaction that is not part of a continuing relationship with the person for whom the services are performed.² For these purposes the term “substantial investment” refers to substantial facilities being furnished by the worker for conducting the business. All of the facts of each case must be considered to determine whether the facilities furnished by the worker are substantial. For factors considered in making these determinations, see Exhibit 4.23.5-3 (Statutory Employees) of the Internal Revenue Manual.

Despite this enumeration, the IRS has ruled that a full-time life insurance salesperson is not an “employee” for purposes of IRC Section 62 (deduction of trade or business expenses)

1. IRC Sec. 3121(d).

2. IRC Sec. 3121(d)(3).

and IRC Section 67 (2 percent floor on miscellaneous itemized deductions), even though he is treated as a “statutory employee” for Social Security tax purposes.¹

See Q 8662 for a detailed discussion of the factors that are relevant in determining employment status. See Q 8671 to Q 8674 for a discussion of the tax treatment of life insurance salespersons.

8662. How is it determined whether a taxpayer is an independent contractor or a common law employee?

Generally speaking, an individual will be considered an employee under the common law rules if the person or organization for which the individual performs services has the right to control and direct the individual’s work, not only as to the result to be accomplished, but also as to the details and means by which that result is accomplished.² In other words, an individual will be classified as an employee if the employer has the right to control not only *what* will be done, but also *how* that work will be accomplished. On the other hand, if the individual performing the work is only under the control of another to the extent of the end result that must be delivered, that individual will be classified as an independent contractor.

It is important to note that the employer does not actually have to direct and control the manner of an individual’s work in order for that individual to be classified as an employee. The individual will be classified as an employee if an employer has the *right* to direct and control the manner in which that employee’s work is accomplished even if the employer does not actually exercise this right.³

The parties’ classification of the relationship as anything other than an employer-employee relationship is immaterial if the facts and circumstances show that the individual is performing services as an employee.⁴ The IRS has developed three categories of control: behavioral control, financial control, and the type of relationship that exists between the parties.⁵ Additionally, the IRS has developed a 20 factor test that is often applied in determining whether an individual is performing services as an employee or an independent contractor. These 20 factors include the following:

- (1) *Instructions.* If the individual is required to comply with another person’s instructions about when, where and how he or she works, that individual is usually an employee.
- (2) *Training.* If an individual is trained alongside a more experienced employee or is required to attend training meetings, this indicates that the person for whom services are performed wants the individual to perform those services in a certain manner, making it more likely that an employer-employee relationship exists.
- (3) *Integration.* When the success or failure of the business is significantly dependent upon the performance of services by the individual, the individual performing those

1. Rev. Rul. 90-93, 1990-2 CB 33.

2. Treas. Reg. §31.3121(d)-1(c)(2).

3. Treas. Reg. §31.3121(d)-1(c)(2).

4. Rev. Rul. 87-41, 1987-23 IRB 7.

5. IRS Pub 15-A, Employer’s Supplemental Tax Guide (2013).

services must necessarily be subject to a certain degree of control by the business owner, indicating that an employer-employee relationship exists.¹

- (4) *Services Rendered Personally.* If the services must be rendered personally, it is presumed that the person for whom the services are performed is interested in the methods used to accomplish the work, as well as the end results.
- (5) *Hiring, Supervising and Paying Assistants.* If the person for whom the services are performed hires, supervises, and pays assistants, it can generally be shown that he or she exercises control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.
- (6) *Continuing Relationship.* A continuing relationship between the individual performing the services and the person for whom they are performed indicates an employer-employee relationship.
- (7) *Set Hours of Work.* If the person for whom services are performed sets the individual's hours of work, this factor indicates an employer-employee relationship.
- (8) *Full-Time Schedule Required.* If the individual must dedicate substantially all of the individual's time to the work, the person for whom the services are performed has control over the amount of time the worker spends working and *impliedly* restricts the individual from taking other work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.
- (9) *Work on the Employer's Premises.* If work is performed on an employer's premises, control is suggested, especially if the work could be done elsewhere. Work done off premises indicates freedom from control, but is not sufficient, on its own, to show that the individual is not an employee.
- (10) *Order or Sequence Set.* If the individual must complete the work in a certain order, this factor shows that it is likely that another is controlling his or her pattern of work.
- (11) *Oral or Written Reports.* If oral or written reports must be submitted by the individual completing the work, it is likely that another is controlling his or her work.
- (12) *Payment by Hour, Week or Month.* Payment by the hour, week, or month usually indicates an employer-employee relationship, provided that the payment method is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.

1. See, for example, *United States v. Silk*, 331 U.S. 704 (1947).

- (13) *Payment of Business or Traveling Expenses.* If another pays the individual's business or traveling expenses, an employer-employee relationship is indicated because the employer, in order to control the individual's expenses, generally must have the right to direct the individual's business activities.
- (14) *Furnishing Tools and Materials.* If the person for whom services are performed furnishes significant tools and material, this tends to show an employer-employee relationship.
- (15) *Significant Investment.* If the individual invests in facilities that are usually used by workers in performing services, but are not typically maintained by employees (such as office space), the factor indicates that the individual is an independent contractor. Special scrutiny is applied in the case of home offices.
- (16) *Realization of Profit and Loss.* An individual who can realize profit or loss as a result of his or her services is generally an independent contractor. The IRS uses the example of an individual who has a risk of loss with respect to liability for expenses, such as payment to unrelated employees (indicating independent contractor status), and distinguishes this type of risk from the risk that the individual will not receive payment for services (which is common to both employees and independent contractors).
- (17) *Working for more than One Firm at a Time.* If an individual performs more than de minimis services for more than one firm at a time, this factor indicates that the individual is an independent contractor.
- (18) *Making Services Available to General Public.* If an individual makes services available to the general public on a regular and consistent basis, this factor indicates that the individual is an independent contractor.
- (19) *Right to Discharge.* The right to discharge an individual suggests an employer-employee relationship is present. An independent contractor, on the other hand, cannot be fired so long as the individual produces the end result that meets the contract specifications.
- (20) *Right to Terminate.* If the individual has the right to terminate the relationship without incurring liability, this indicates an employer-employee relationship is present.¹

All of the facts and circumstances of the relationship must be considered in weighing these factors to determine whether the relationship is an employer-employee relationship or an independent contractor relationship. No one factor will be determinative in making the correct classification.

1. Rev. Rul. 87-41, 1987-23 IRB 7.

8663. What is the self-employment tax? Who is liable for paying it?

An individual whose net earnings from self-employment as an independent contractor equal \$400 or more for the taxable year must pay the self-employment tax.¹

In 2014, an individual who is liable for the self-employment tax must file a Schedule SE and pay Social Security taxes on up to \$117,000 of self-employment income (\$113,700 for 2013). The hospital insurance tax is imposed on all of a taxpayer's self-employment income.

Despite this, an above-the-line deduction is permitted for one-half of the self-employment tax paid by an individual and attributable to a trade or business carried on by the individual as an independent contractor (not as an employee).² If the individual also works in covered employment as an *employee*, his self-employment income (subject to the self-employment tax) is only the difference, if any, between his "wages" as an employee and the maximum Social Security earnings base.

See Q 8547 for a detailed discussion of the Social Security tax as it applies to self-employed individuals and Q 8549 for a discussion of estimated tax payments.

8664. How are employment expenses treated differently based on whether a taxpayer is an employee or an independent contractor?

An employer is entitled to deduct amounts paid as reasonable compensation to its employees.³ Therefore, whether an individual is classified as an employee or as an independent contractor is important to an employer in determining whether or not that employer is entitled to deduct amounts paid to that individual as compensation.

If an individual is properly classified as an independent contractor, the individual is entitled to deduct business-related expenses without regard to the 2 percent floor on miscellaneous itemized deductions (see Q 8525) that would otherwise apply. Conversely, the business expense deductions of an employee are limited based on whether or not the employee is reimbursed for the expense.⁴

8665. Can a self-employed individual participate in a retirement savings plan?

While employers are often required to include all employees in fringe benefit plans and retirement plans, the same requirement does not apply with respect to independent contractors. If an employer includes non-employees (including independent contractors) in a qualified plan, that plan may lose its qualified status by violating the "exclusive benefit" rule of IRC Section 401(a). Therefore, most self-employed individuals who operate as independent contractors will be ineligible to participate in retirement savings plans maintained by another taxpayer-entity.

1. IRC Sec. 6017.

2. IRC Sec. 164(f).

3. IRC Sec. 162.

4. IRC Sec. 62(c), Treas. Reg. §1.162-17(b)(2), 1.162-17(c).

For plan qualification purposes, a self-employed individual, as an owner-employee, is considered an “employee” for purposes of qualified plans established by that owner-employee.¹ An “owner-employee” is an employee who owns the entire interest in an unincorporated trade or business or, in the case of a partnership, owns more than 10 percent of either the capital interest or the profit interest in the partnership.²

Even if a partnership agreement does not specify that there exists a “more than 10 percent interest in profits” for any partner, if the formula for dividing profits (e.g., based on a partner’s earnings productivity during the year) in *operation* produced a distribution at the end of the year of more than 10 percent of profits to a partner, the Tax Court has ruled that the partner is an owner-employee for the year.³

An individual who owns the entire interest in an unincorporated trade or business is treated as his or her own employer.⁴ Thus, a proprietor or sole practitioner who has earned income (including “self-employment income”) can establish a qualified plan under which the individual is both employer *and* employee.

A partnership is treated as the employer of each partner who is an employee.⁵ Thus, partners individually cannot establish a qualified plan for a firm, but the partnership can establish a plan in which the partners can participate.

Individuals who are classified as independent contractors (see Q 8662) are able to set up their own retirement plans, including IRAs and Roth IRAs, so long as they have compensation (whether in the form of self-employment income, alimony or income earned as an employee in some capacity) and did not attain age 70½ during the year in which the account is established.⁶ To establish a Roth IRA, the same income limitations apply to self-employed taxpayers as apply to employees, so that the self-employed taxpayer must not have adjusted gross income in excess of the annual income thresholds. For 2014, those thresholds are: (a) \$191,000 or above in the case of a taxpayer filing a joint return; (b) \$129,000 or above in the case of a taxpayer filing a single or head-of-household return; or (c) \$10,000 or above in the case of a married individual filing separately.⁷

8666. If a self-employed owner-employee establishes a qualified retirement plan, is that plan entitled to ERISA protections that are normally granted to employees who participate in similar plans?

In some instances, a plan established by an owner-employee (see Q 8665) will be entitled to ERISA protections (such as rules regarding the vesting of benefits and ERISA’s anti-alienation provisions), but in other cases, participants in such a plan will not be entitled

1. IRC Sec. 401(c).

2. IRC Sec. 401(c)(3).

3. *Hill, Farrer & Burrill v. Commissioner*, 67 TC 411 (1976), *aff’d*, 594 F.2d 1282 (9th Cir. 1979).

4. IRC Sec. 401(c)(4).

5. IRC Sec. 401(c)(4).

6. IRC Secs. 219, 408A.

7. IR-2013-86 (Oct. 31, 2013).

to the same protections as are available to traditional employees. The answer turns on whether employees *other than* the self-employed individual and the individual's spouse also participate in the plan.

Regulations promulgated by the Department of Labor provide that an owner-employee and spouse are *not* considered employees of a business that is wholly owned by those individuals.¹ Therefore, if only the owner-employee and spouse participate, the plan will not be subject to ERISA. Accordingly, Section 514(a) of Title I of ERISA would not preempt state regulation of the arrangement.²

However, the Supreme Court has ruled that if the owner-employee and spouse allow additional employees to participate in the plan, that plan will be subject to ERISA and entitled to its protections. In this case, both the employees *and* the owner-employee and spouse are entitled to ERISA protection.³

Planning Point: In some instances, it may be desirable for a qualified plan to become subject to ERISA's rules and protections rather than the state law provisions that may be found to apply if ERISA does not preempt state law. In other instances, state law provisions that would otherwise govern may be preferable.

8667. Is a taxpayer classified as an independent contractor, and thus self-employed, entitled to deduct the cost of health insurance coverage?

A self-employed individual is generally entitled to deduct the cost of health insurance coverage. The IRS has ruled that a self-employed individual may deduct the medical care insurance costs for himself and his spouse and dependents under a health insurance plan established for his trade or business up to the net earnings of the specific trade or business with respect to which the plan is established.

In determining this deduction limit under IRC Section 162(l)(2)(A), a self-employed individual may not combine the net profits from all his trades and businesses. However, if a self-employed individual has more than one trade or business, the individual may deduct the medical care insurance costs of the self-employed individual and his spouse and dependents under *each* specific health insurance plan established under *each* specific business up to the net earnings of that specific trade or business.⁴

According to the IRS, a self-employed individual may not deduct the costs of health insurance on Schedule C. The deduction under IRC Section 162(l) must be claimed as an adjustment to gross income on the front of Form 1040.⁵

Partners and sole proprietors are self-employed individuals, not employees. However, the deduction is not available to a partner or sole proprietor for any calendar month in which the

1. DOL Reg. §2510.3-3(c)(1).

2. Labor Dept. Advisory Opinion 92-21A (10/19/1992).

3. *Raymond B. Yates Profit Sharing Plan v. Hendon*, 541 U.S. 1 (2004).

4. CCA 200524001.

5. CCA 200623001.

individual is eligible to participate in any subsidized health plan maintained by any employer of the self-employed individual or spouse.¹

Beginning in 2003, 100 percent of amounts paid during a taxable year for long-term care insurance up to the annual limits (see below) for an individual or spouse, or dependents can be deducted by a self-employed individual.² Sole proprietors, partners, and S corporation shareholders owning more than 2 percent of an S corporation's shares generally may take advantage of this deduction.

The deduction for eligible long-term care premiums that are paid during any taxable year for a qualified long-term care insurance contract³ is subject to an annual dollar amount limit that increases with the age of the insured individual. In 2014, for taxpayers age forty or less, the limit is \$370. For ages forty-one through fifty, the limit is \$700. For ages fifty-one through sixty, the limit is \$1,400. For ages sixty-one through seventy, the limit is \$3,720. For those over age seventy, the limit is \$4,660.⁴ The age is the individual's attained age before the close of the taxable year. The limits are indexed annually for increases in the medical care cost component of the CPI (this is the so-called Medical Care Cost Adjustment)⁵

8668. What are the consequences if an employer wrongly characterizes an employee as an independent contractor?

The proper classification of individuals by an employer as either employees or independent contractors is important in many areas, and an employer who misclassifies its workers will be responsible for the consequences of the misclassification.

An employer who misclassifies an employee as an independent contractor may be liable for that employee's Social Security taxes because, in an employer-employee relationship, the employer is responsible for one-half of the tax owed, and the employer is responsible for deducting the employee's portion of the tax from wages.⁶ Independent contractors, on the other hand, are liable for the entire amount of the tax, but are entitled to deduct one-half of the taxes paid (see Q 8663).

The IRS has ruled that if an employer wrongly classifies an individual as an independent contractor, the IRS can offset the refund of any self-employment taxes paid by that individual, but only with the employee portion of the employment taxes that would have been owed had the employee been properly classified.⁷

Therefore, if an employer hires an independent contractor who is later found to be an employee, the employee can claim a refund for the self-employment taxes paid while the employee was erroneously believed to be an independent contractor. The IRS, when processing the refund, can reduce the amount refundable to the employee by the employment taxes the

1. IRC Sec. 162(l).

2. IRC Sec. 162(l)(1)(B).

3. See IRC Sec. 7702B(b).

4. Rev. Proc. 2009-50, 2009-45 IRB 617, as modified by Rev. Proc. 2010-24, 2010-25 IRB 764. Rev. Proc. 2013-35, 2013-47 IRB 537.

5. IRC Sec. 213(d)(10).

6. Treas. Reg. §31.3102-1(a).

7. See *Beane v. Commissioner*, TC Memo 2009-152 (2009) and IRS ECC 201315023.

employee would have paid with proper classification. The employer, however, remains liable for the remaining balance that was refunded to the employee.

Further, an employee who has been wrongly classified as an independent contractor may be entitled to claim benefits under the benefit plans that the employer has established for traditional employees. For example, the Ninth Circuit has held that certain “leased” employees that an employer leased from an employment agency, and sought to classify as independent contractors, could claim their rights to benefits under that employer’s employee benefit plans (including health insurance coverage) if they qualified as employees under the 20-factor test laid out by the IRS in Revenue Ruling 87-41 (see Q 8662).¹

Similarly, in *Vizcaino v. Microsoft Corp.*, the Ninth Circuit held that individuals whom the employer sought to characterize as independent contractors may have had rights under the employer’s benefit plans after an IRS audit found that the individuals were common law employees, and the employer conceded that it had mischaracterized the individuals.²

In contrast, the Tenth and Eleventh Circuits have held that the contract language of the employer’s benefit plans will control. In these circuits, “leased” employees that met the 20-factor test to qualify as employees were *not* permitted to claim benefits under the employer’s benefit plans when the plan language specifically excluded temporary and leased employees.³ This was the case even though the leased employees at issue performed substantially similar services as the employer’s common law employees who qualified for plan benefits.

Until this split in the circuits is resolved, it seems that the question of whether an employee who is wrongly characterized as an independent contractor is entitled to employment related benefits under the employer’s benefit plans will be answered based on where the question is litigated.

Planning Point: Upon a request by a firm or worker, the IRS will determine whether a specific individual is an employee or independent contractor, provided the request is submitted for a tax year for which the statute of limitations on the tax return has not expired. A request is made by filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. Form SS-8 is filed to request a determination of the status of a worker for purposes of federal employment taxes and income tax withholding. A Form SS-8 determination may be requested only in order to resolve federal tax matters.⁴

8669. Are there any safe harbor provisions that an employer can use in order to ensure that its independent contractors are properly classified so that they will not retroactively be deemed employees?

Although it has not been incorporated into the Internal Revenue Code, Section 530 of the Revenue Act of 1978 provides a limited safe harbor for employers to prevent the IRS from retroactively reclassifying certain independent contractors as employees.⁵ The purpose of the

1. *Burrey v. Pacific Gas and Electric Co.*, 159 F.3d 388 (1998).

2. 97 F.3d 1187 (9th Cir. 1996).

3. See *Bronk v. Mountain States Telephone & Telegraph*, 140 F.3d 1335 (10th Cir. 1998), *Wolf v. Coca-Cola Co.*, 200 F.3d 1337 (11th Cir. 2000).

4. IRS Tax Topics No. 762.

5. Section 530 of the Revenue Act of 1978, P.L. 95-600 (as made permanent by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P.L. 97-248).

safe harbor rule is to prevent reclassification in situations where an employer has a reasonable basis for classifying an individual as an independent contractor.

An employer must satisfy three tests in order to qualify for relief under the Section 530 safe harbor:

- (1) The employer must have a reasonable basis for treating the individual as an independent contractor (the “reasonable basis” requirement (see Q 8670));
- (2) The employer must consistently treat all similarly-situated workers as independent contractors (the “substantive consistency” requirement); and
- (3) All tax returns must have been filed on a basis consistent with independent contractor classification (the “reporting consistency” requirement).¹ The Tax Court has found that the untimely filing of a taxpayer’s Forms 1099 would *not* preclude relief under Section 530.²

Whether the requirements of Section 530 have been satisfied is a question of fact to be decided by the courts. The employer has the burden of proof in showing that it is entitled to relief pursuant to the safe harbor provision.

8670. How can an employer show that it had a reasonable basis for classifying its workers as independent contractors, rather than employees, in order to qualify for the Section 530 safe harbor?

An employer can avoid IRS reclassification of its independent contractors as employees if it is able to prove, among other requirements (see Q 8669), that it had a reasonable basis for its classification of workers.

The courts have found that the “reasonable basis” requirement is satisfied when the employer relies on one or more of the following:

- (i) judicial precedent, published rulings or IRS letter rulings to the taxpayer (IRS rulings addressed to other taxpayers have been found insufficient);³
- (ii) a past IRS audit of the employer where there was no assessment attributable to the treatment of individuals holding positions similarly situated to the individual at issue for employment tax purposes;
- (iii) a longstanding recognized practice of a significant section of the industry in question;⁴ or
- (iv) as a catch-all, any other reasonable basis for not treating an individual as an employee.

1. See, for example, *303 West 42nd St. Enterprises, Inc. v. IRS*, 181 F.3d 272 (1999).

2. *Medical Emergency Care Associates v. Commissioner*, 120 TC 436 (2003).

3. See *Darrell Harris, Inc. v. United States*, 770 F. Supp. 1492 (1991) (in which the taxpayer was not entitled to rely upon a letter ruling to satisfy the reasonable basis requirement because it was not issued directly to the taxpayer).

4. See *Nu-Look Design v. Commissioner*, 356 F.3d 290 (2004), *Greco v. United States*, 380 F. Supp. 2d 598 (2005).

The courts have found the reasonable basis requirement to be satisfied even in cases where the employer relied upon an IRS audit of one class of workers to justify independent contractor status for a second class. For example, the courts have allowed an employer to rely upon an audit of the classification of its landscaping staff in order to provide a reasonable basis for that same employer's treatment of its janitorial staff as independent contractors.¹ The relevant inquiry was into the relationship between the employer and the workers, in terms of control and supervision, rather than the actual type of work that was being performed.

An employer can also rely upon a "longstanding" custom used by a "significant section" of the industry to establish a reasonable basis for the workers' classification. The practice must be longstanding, and, under Section 530, an industry practice is longstanding if it has been in existence for at least 10 years (the statute does not *require* that the custom be in use for 10 years, but does preclude the courts from requiring a longer time period).²

A "significant section" of the industry means 25 percent of the industry, excluding the employer in question, though a lower percentage may apply if the facts and circumstances of the particular case show that such percentage is appropriate.³ The taxpayer is not required to look to the practices in the industry on a nationwide basis. Instead, the courts have permitted taxpayers to look to the segment of the industry in which they practice, using factors such as the size of the employer and the geographic region in which it operates to determine the relevant comparison.⁴

Even if the employer has no precedential opinion, past IRS audit or industry custom to rely upon, it can still establish that it had a reasonable basis for classifying its workers as independent contractors if it can show that it had some *other* reasonable basis for the classification.⁵ For example, employers who have relied upon professional advice (such as from an accountant or attorney) in classifying workers as independent contractors may be able to use this advice as a reasonable basis for the classification.⁶

Some courts have also found that a reasonable basis for the classification existed when the common law factors (see Q 8662) weighed in favor of independent contractor classification.⁷

Planning Point: An IRS determination of a particular classification, made in response to a request made by a firm or worker on Form SS-8 (see Q 8668), would also constitute a reasonable basis for the classification under "(i)" above. A determination letter applies only to a worker (or a class of workers) requesting it, and the decision is binding on the IRS.

Note that in certain cases a formal determination will not be issued. Instead, an information letter may be issued. Although an information letter is advisory only and is not binding on the IRS, it may be used to assist the worker to fulfill his or her federal tax obligations.⁸

1. *Lambert's Nursery and Landscaping, Inc. v. U.S.*, 894 F.2d 154 (1990).

2. Section 530(e)(2)(C)(i). See also, IRS Publication on the history of Section 530, available at: http://www.irs.gov/pub/irs-utl/irpac-br_530_relief_-_appendix_natrm_paper_09032009.pdf (last accessed May 28, 2014).

3. Section 530(e)(2)(C)(ii).

4. *General Inv. Corp. v. United States*, 823 F.2d 337 (1987), *J & J Cab Service, Inc. v. United States*, 75 AFTR 2d 618 (1995).

5. Rev. Proc. 85-18, 1985-13 IRB 27.

6. *Smoky Mountain Secrets v. United States*, 910 F. Supp. 1316 (1995).

7. *In re Critical Care Support Services, Inc.*, 138 BR 378 (1992), *American Institute of Family Relations v. United States*, 79-1 USTC ¶9364 (1979).

8. General Instructions to IRS Form SS-8.

8671. Is a life insurance agent typically an employee or an independent contractor? How does this classification impact the agent's ability to deduct business expenses?

The amount of the deduction for a life insurance agent's expenses is directly related to the agent's status either as an independent contractor or an employee. Typically, whether an insurance agent is considered an independent contractor or employee is determined on the basis of all the facts and circumstances involved. The IRS uses the same 20 factors discussed in Q 8662 in determining an individual's status as employee or self-employed person.¹

Under the common law rules, most life insurance agents are self-employed individuals, and this is their status generally for tax purposes. Thus, in the usual case, a life insurance agent reports his income as an independent contractor, using Schedule C of Form 1040 for his business income and deductions. This means that he may deduct *most* of his business expenses directly from gross income.²

However, even a life insurance agent who is an *employee* under the common law rules may be permitted to deduct certain business expenses directly from gross income. This rule is limited to those expenses for which reimbursement has been included in the agent's gross income. Work expenses which are not fully reimbursed are generally deductible as miscellaneous itemized deductions; thus, they are permitted only to the extent that the aggregate exceeds 2 percent of adjusted gross income.³

The IRS has ruled that a full-time life insurance salesperson is not an "employee" for purposes of IRC Sections 62 and 67, even though he is treated as a "statutory employee" for Social Security tax purposes.⁴

On the other hand, the IRS has found that a district manager of an insurance company was an employee of the company, and not an independent contractor.⁵ The IRS found that regional and senior sales vice presidents of an insurance company (but who were not officers of the company) were independent contractors and not employees of the insurance company.⁶

The courts have also made decisions in various cases concerning an insurance agent's classification as an employee or independent contractor. As with other employment situations, where an employer has the right to control the manner and the means by which the agent performs services, an employer-employee relationship will generally be found.⁷

However, according to decisions from the Sixth and Eleventh Circuits, the fact that an insurance agent received certain employee benefits did not preclude his being considered an independent contractor, based on all the other facts and circumstances of the case. The Sixth Circuit

1. Rev. Rul. 87-41, 1987-1 CB 296.

2. IRC Sec. 62(a)(1).

3. IRC Secs. 62, 67.

4. Rev. Rul. 90-93, 1990-2 CB 33.

5. TAM 9342001.

6. TAM 9736002.

7. See *Butts v. Commissioner*, TC Memo 1993-478, Let. Rul. 9306029.

rejected the IRS claim that a discharge provision in an agreement between agent and insurance company guaranteeing that the agent would not be fired for unsatisfactory performance unless he was first given notice that his work was unsatisfactory and his job in jeopardy, and was given the chance to bring his performance up to satisfactory levels, provided the company with the “right to control” the manner in which the agent performed his work. The court ruled that the provision simply reflected both the importance the company attached to sales productivity and its willingness to provide low -producing agents with a chance to bring productivity to acceptable levels before being terminated.¹

Planning Point: Certain types of full-time insurance salesmen may qualify as “statutory employees” under IRC section 3121(d)(3), rather than “common law employees,” and, as such, may use schedule C of form 1040 to determine net profit or loss.² To qualify as a statutory employee under section 3121(d)(3), the taxpayer must show: (1) that his entire or principal business activity was devoted to the solicitation of life insurance or annuity contracts; (2) that he did not have a substantial investment in the facilities used in connection with the performance of his services; and (3) that he is not a common law employee.³

8672. How are renewal commissions received by a life insurance agent taxed?

First year and renewal commissions are taxable to the agent as ordinary income. If the agent works on commission with a drawing account, the amount reported depends upon his contract with the insurance company. If the drawing account is a loan that must be repaid if he leaves, the agent reports only commissions actually received. If the drawing account is guaranteed compensation, he reports this compensation and any commissions received in excess of the amount that offsets his draw. This rule applies even if the agent uses the accrual method of accounting.⁴

Under certain circumstances an agent will not be required to recognize taxable income upon the sale of a life insurance policy. It has been held that an agent who is required to remit only “net premiums” (gross premium less the “basic commission” the company would allow him) to an insurance company, and who is under a contract with an insured to collect only an amount equal to the net premiums due, is not in constructive receipt of commissions usually earned on the sale of that policy. As a result, the agent is not taxed on the foregone commissions that would have been earned if a gross premium was collected.⁵

If the agent is not unconditionally obligated to repay advances, and any excess of advances over commissions earned would be recovered by the insurance company only by crediting earned commissions and renewals against such advances, amounts advanced to the agent are included in income in the year of receipt.⁶ A life insurance agent’s advance commissions received in previous years are taxable in the year the obligation to pay is discharged.⁷

1. *Butts v. Comm*, above. See also *Ware v. United States*, 67 F.3d 574 (6th Cir. 1995).

2. Rev. Rul. 90-93, 1990-2 CB 33.

3. *In the Matter of Appeal of M and L Tofig*, No. 91R-0742-JV (California Board of Equalization 10/28/1993).

4. Rev. Rul. 75-541, 1975-2 CB 195, *Security Associates Agency Insurance Corp. v. Commissioner*, TC Memo 1987-317, *Dennis v. Commissioner*, TC Memo 1997-275.

5. *Worden v. Commissioner*, 2 F.3d 359 (1993).

6. *George Blood Enterprises, Inc. v. Commissioner*, TC Memo 1976-102, Rev. Rul. 83-12, 1983-1 CB 99.

7. *Cox v. Commissioner*, TC Memo 1996-241.

With respect to commissions on credit life insurance, an accrual basis loan company which receives commissions on credit life insurance, but which may be required to refund a portion of the commission later if the loan is repaid and insurance coverage terminated before the end of the original term, includes the entire commission as income in the year the coverage was arranged. It may not spread the accrual over the term of the loan.¹

When an agent purchases a policy for himself – on his own life or on the life of another – the agent must report the commissions as taxable income even though the commissions were never received. Such commissions are considered compensation and not a reduction in the cost of the policy.² This rule applies to brokers as well as to other life insurance salesmen. The agent or broker, or by whatever name he be called, is to receive or retain a percentage of the premiums on policies procured by him, called commissions, as compensation for his service to the company in obtaining the particular business for it. As such, the commissions were income within the meaning of IRC Section 61(a)(1).³

Similarly, if an agent sells a policy to a friend and waives his commissions, the agent must nevertheless report the commissions as taxable income.⁴

8673. How is the sale of a life insurance agent's renewal commissions taxed?

Generally, a bona fide, arm's length sale of a right to receive renewal commissions can successfully transfer the federal income tax liability on an insurance agent's renewal commissions to the purchaser. If an agent sells the right to renewal commissions, the agent must report the entire sale price as ordinary income in the year the sale is made.⁵

Renewals cannot be converted to capital gain by sale to a third party.⁶ In addition, the Tax Court has held that amounts received by a district manager upon the termination of his agency contract are treated as ordinary income and not capital gain resulting from the sale of a capital asset, if the money received was compensation for the termination of the right to receive future income in the form of commissions.⁷

Apparently, the buyer must amortize his cost. In other words, the buyer can exclude from gross income in any year only that portion of the purchase price which the renewals received in that year bear to the total amount of anticipated renewals. The issue of whether the amount of deductible amortization is correctly determined requires consideration only of the contracts under which the buyer purchased the right to be general agent or purchased rights to renewal commissions.⁸

1. Rev. Rul. 75-541, 1975-2 CB 195.

2. *Ostheimer v. United States*, 264 F.2d 789 (1959), Rev. Rul. 55-273, 1955-1 CB 221.

3. *Commissioner v. Minzer*, 279 F.2d 338 (1960), *Bailey v. Commissioner*, 41 TC 663 (1964).

4. *Mensik v. Commissioner*, 37 TC 703 (1962), *aff'd*, 328 F.2d 147 (7th Cir. 1964).

5. See *Cotlov v. Commissioner*, 228 F.2d 186, *Turner v. Commissioner*, 38 TC 304 (1962).

6. *Remington v. Commissioner*, 9 TC 99 (1947), *Davidson v. Commissioner*, 43 BTA 576 (1941).

7. *Clark v. Commissioner*, TC Memo 1994-278.

8. *Latendresse v. Commissioner*, 243 F.2d 577 (1957).

8674. Are there any circumstances where an insurance agent's commissions may be taxable to a company rather than to the agent?

Where an individual agent owns or controls a corporation which is related to the agent's insurance activities, questions may arise as to the proper allocation of income and deductions between the individual and his corporation.

Typically, income is taxed to the individual who earns it, and the income earner cannot avoid the result by assigning income or the right to receive it either before or after the income has been earned.¹

In one situation, a life insurance agent assigned his commissions to his wholly owned pension consulting corporation, for which he worked as an employee. He did not (could not, under the insurer's rules) assign his agency contract. Since neither the corporation nor any of its other employees were authorized under the contract to submit applications, none of them had the right under the contract to earn commissions. All applications developed through the sales efforts of all employees were submitted through the agent and the insurance company paid the commissions under the assignment to the consulting firm. The IRS considered the arrangement an assignment of future income and ruled that the commissions were includable in the agent's gross income.

However, the agent was allowed to deduct (as a business expense) a part of the assigned commissions. Since the services of other employees of the corporation helped produce the commissions, part of the assigned commissions was treated as compensation to the corporation for its services and taxed to the corporation. The balance of the assigned commissions was treated as contributions to capital instead of income.²

The IRS distinguished this situation from one in which the corporation was held to have earned the income,³ because there the agreements between the agent and insurance company were assigned to the corporation.

In another case, a corporate life insurance agency tried to assign a contract to service a group medical insurance plan to its subsidiary, also an insurance agency. The parent corporation assigned the insurance commissions and service fees to the subsidiary, as well. However, the parent agency continued to perform all services to the group plan under the agreement, used its own office facilities and employees and paid all operating expenses. The subsidiary was unable to perform the agreement because of lack of staff, equipment and financing.

The Tax Court held that the parent earned the fees and commissions since it performed the services, and the subsidiary was unable to perform them. The parent agency argued that the assignment was of the agreement, as distinguished from the income. The argument failed because the parent was unable to submit proof. However, the court suggested that it would be hard to show an actual assignment of the agreement in view of the nature of the agreement,

1. *Helvering v. Horst*, 311 U.S. 112 (1940).

2. Rev. Rul. 77-336, 1977-2 CB 202.

3. Rev. Rul. 54-34, 1954-1 CB 175.

since it was one calling for performance of future services which the alleged assignee would be unable to perform.¹

In *Davidson v. Commissioner*, the taxpayer was a successful salesman who specialized in estate planning sales. He formed a corporation to which he sold his insurance business, including all assets and good will, and provided in the instrument of transfer that all business done by him thereafter would be done for the benefit of the corporation. The taxpayer was to turn over to the corporation all of his first year commissions, keep his renewal commissions and be paid a salary as general manager of the corporation. The corporation carried on estate planning services acting through agents and employees other than the taxpayer, though the taxpayer worked jointly with some of these agents and personally received all commissions not retained by the other agents. The taxpayer endorsed over to the corporation commissions received by him pursuant to his agreement with the corporation, and did not include the commissions in his gross income, but did include them in the corporation's gross income in its return.²

Despite all these elaborate arrangements, the Tax Court held that all the commissions received by the taxpayer were taxable to him personally, not to the corporation. The court also rejected the taxpayer's argument that the commissions endorsed over to the corporation should be considered payments for services rendered by the corporation, and thus deductible as a business expense. The court held that the only amount deductible on such a basis would be an amount considered reasonable payment for such services had the taxpayer and the corporation bargained at arm's length.

In *American Savings Bank v. Comm.*, two individuals formed an insurance partnership authorized to solicit mortgage and credit life insurance in connection with loans made by banks in which they had interests. Insurance was sold on the bank premises primarily by officers of the banks who were individually licensed as insurance agents. By agreement between the partnership and the agents, commissions were divided 50-50 between the agents and the partnership. Later, the insurance business which, to that point had been conducted as a partnership, was transferred to a corporation formed by the two partners. Commissions thenceforth were divided between the corporation and the agents just as had been done between the partnership and the agents. The issue in the case was whether the commissions received by the corporation were taxable to the corporation or to the two individuals.³

The court examined all surrounding facts and circumstances, and concluded that control over the company's earnings rested with the corporation. The court noted that nearly all commissions were generated by other agents of the company and the contracts authorizing sales of insurance were with the corporation rather than with the individuals. Therefore, the commissions were taxable to the corporation rather than to the two individuals.

In *Shaw v. Comm.*, the taxpayer owned and managed two corporations. He was also licensed as an insurance agent to sell credit life and health insurance to customers of his companies.

1. *Millette and Associates, Inc. v. Comm.*, TC Memo 1978-180.

2. 43 BTA 576 (1941).

3. 56 TC 828 (1971).

Insurance was sold by employees to the corporations and applications were submitted in the taxpayer's name. Commissions on the insurance sold were paid to the taxpayer, who in turn endorsed the checks over to the corporations. In reaching its determination whether the commissions should be taxed to the taxpayer or to his corporations, the court first observed that the result would not be affected by the fact that, under state law, the corporations were prohibited from acting as insurance agents. Such a circumstance would not prevent the court from finding that the corporations should be taxed on the commissions if it determined that the corporations were actually in control of the insurance-selling enterprise. However, the court believed the facts of the case indicated that the taxpayer "was himself in the insurance business (admittedly to benefit his corporations) and used the corporations as his agents in the carrying out of the business of selling insurance." The court found, therefore, that the taxpayer, not his corporations, had earned the commission income and was liable for the taxes associated with it. However, the court recognized the fact that the corporations had performed services and expended funds in producing the insurance, and so allowed the taxpayer to deduct a large part of the commissions turned over to the corporations as a business expense.¹

8675. Are partners and members of LLCs considered independent contractors or employees?

A general partner is treated as self-employed and income received from the partnership is, accordingly, treated as self-employment income.² Income received by a *limited* partner, on the other hand, is generally not treated as self-employment income *unless* that income represents a guaranteed payment to the limited partner within the meaning of IRC Section 707(c).³ A payment will be considered "guaranteed" under Section 707(c) if it is made without regard to the income of the partnership.⁴

If an LLC is taxed as a partnership, its members are treated as partners for tax purposes (including determining whether their income represents self-employment income).⁵ Despite this, in the case of an LLC member, if a member who has contributed both services and capital to the organization receives a distribution, the distribution should represent self-employment income insofar as it relates to the *services* contributed by the member. The difficulty arises in determining whether a distribution relates to the services or a return of capital.

The Tax Court recently held that payments received by a taxpayer through his LLC were guaranteed payments, rather than partnership distributions, that gave rise to ordinary income tax liability because the payments were made without regard to the partnership's income and were made in exchange for the taxpayer's services, not as a return of partnership capital.

In this case, after the taxpayer's employer refused to treat him as an independent contractor, the taxpayer resigned and formed an LLC through which he could perform the same services as a subcontractor for his former employer. The taxpayer received all payments for these services

1. 59 TC 375 (1972).

2. See IRC Sec. 1402(a).

3. IRC Sec. 1402(a)(13).

4. IRC Sec. 707(c).

5. Let. Rul. 9432018.

through the conduit LLC, which was taxed as a partnership, and labeled them as partnership distributions—arguing that the payments were made in exchange for the use of capital.

The IRS disagreed with this characterization and instead reasoned that these payments represented guaranteed payments for services under IRC Section 707(c) and, therefore, generated ordinary income tax liability. The Tax Court agreed with the IRS, finding that the taxpayer here performed all services on behalf of the LLC, employed no employees and could not present any evidence that the payments, which were determined without regard to the partnership's income, were made in exchange for the use of partnership capital. As a result, the taxpayer was required to include the payments in calculating his ordinary income tax liability.¹

While the IRS proposed regulations on the issue (see below), in 1997 Congress provided that the regulations would not be made final and the IRS has not proposed further regulations.² Because of this, it is uncertain whether a distribution to an LLC member will be subject to the self-employment tax (see Q 8663) in a situation where the distribution cannot be apportioned to show whether it relates to the member's services or capital contribution. Even in such a situation, the members of an LLC may still qualify as owner-employees for purposes of retirement plan qualification under the rules discussed in Q 8665.

Planning Point: Proposed Treasury Regulation section 1.1402(a)-2 was originally issued by the IRS in 1997. However, because of controversy over the self-employment tax treatment of limited partners who are active in a partnership's business, Congress prohibited the IRS from making the regulations final before July 1, 1998, believing instead that Congress should formulate such rules. Since the expiration of the moratorium, neither Congress nor the IRS has acted to clarify the self-employment tax treatment of LLC members, leaving the proposed regulations as the only administrative guidance on the matter. Thus, while the proposed regulations are not precedential, they can be relied on to avoid a penalty under IRC section 6406(f). There is also judicial precedent, in *Elkins* 81 T.C. 669 (1983), to reasonably conclude that the courts will sustain the position of a taxpayer who relies on proposed regulations.

1. *Seismic Support Services v. Comm.*, TC Memo 2014-78.

2. TRA 97, Sec. 935.

PART VIII: BUSINESS EXPENSE DEDUCTIONS

8676. What is a business expense deduction?

A business expense deduction is a deduction allowed for ordinary and necessary expenses paid or incurred in connection with an individual's trade, business or profession.¹ The deduction allowed under IRC Section 62(a)(1) for expenses of a trade or business is the provision which technically allows for business income to be taxed on a net income basis, whether it be a corporate business or the business of individual taxpayers operating as sole proprietors or partners. In the case of a sole proprietorship or partnership, IRC Section 62(a)(1) operates to assure that all trade or business expenses, deductible as delineated under specific IRC Sections, are effectively allowed as above-the-line deductions, rather than itemized deductions. In the case of a sole proprietor, all but a few of these expenses are deducted in Schedule C of Form 1040.

For purposes of determining whether an expense may be deducted as a business expense, an expense is considered to be "ordinary" if it is one that is commonly incurred in the trade or occupation of the taxpayer. An expense is "necessary" if it is found to be appropriate or helpful to the taxpayer's business or occupation. Among the common expenses in this category are: employees' salaries; office rent; interest on business loans; the cost of supplies and utilities; traveling; entertainment; advertising; and automobile expenses.

Generally, business expenses of a self-employed individual (sole proprietor, independent contractor, or professional) may be deducted from gross income to arrive at adjusted gross income. The deductions are taken on Schedule C of Form 1040 in computing the net gain or loss from the taxpayer's business or profession.

The IRS has ruled that a full-time life insurance salesperson who is treated as a "statutory employee" for FICA purposes is *not* an "employee" for purposes of IRC Sections 62 and 67. Such individuals may thus treat unreimbursed business expenses as "above the line" deductions. This ruling was issued in part to clarify that taxpayers who are treated as "statutory employees" for FICA purposes (as are life insurance salespersons) are not necessarily treated as "employees" for other purposes.² The term "statutory employee" refers to certain individuals described in IRC Section 3121(d)(3)(B), who are subject to FICA withholding requirements (see Q 8661). The ruling's effect was essentially limited to those individuals.

See Q 8677 to Q 8692 for a detailed discussion of the various types of business expenses commonly deducted by taxpayers.

8677. Is a taxpayer entitled to deduct business travel expenses?

Generally, a taxpayer is entitled to deduct travel expenses when those expenses are incurred while the taxpayer is "away from home" for business reasons.³ This is the case even though those travel expenses would otherwise be personal expenses (such as food or lodging). There are three

1. IRC Sec. 162(a).

2. Rev. Rul. 90-93, 1990-2 CB 33.

3. IRC Sec. 162(a)(2).

basic requirements that must be met before a taxpayer will be entitled to deduct business-related travel expenses:

- (1) The expense must be a reasonable and necessary traveling expense;
- (2) The expense must be incurred while “away from home;” and
- (3) The expense must be incurred “in the pursuit of business.”¹

For an expense to be incurred in the pursuit of business, it must be directly connected to the trade or business of the taxpayer, and the expense must be necessary or appropriate to developing or pursuing the taxpayer’s business or trade.²

Interpretation of the “away from home” requirement has been litigated extensively. Under the IRS interpretation, “away from home” for these purposes means that the taxpayer must be away from the taxpayer’s principal place of business—not personal residence.³ Several courts, however, have agreed with the contrasting opinion that the taxpayer’s “home” is the taxpayer’s residence.

Planning Point: If the taxpayer is engaged in business at two or more separate locations, the “tax home” for purposes of section 162(a)(2) is located at the principal place of business during the taxable year.⁴

See Q 8678 for a detailed discussion of the “away from home” requirement as it applies to taxpayers who travel frequently for business.

8678. When is a taxpayer considered to be “away from home” for purposes of deducting business travel expenses? What if the taxpayer is away from the taxpayer’s residence for an extended period of time for business reasons?

As discussed in Q 8677, the IRS requires that a taxpayer be away from the company’s principal place of business, rather than a residence, in order to deduct business travel expenses that would otherwise be personal in nature (such as food and lodging). The IRS has ruled that a taxpayer’s tax “home”—meaning principal place of business—is not limited to a specific building or work-site, but instead encompasses the entire city or general area in which the business is located.⁵

In cases where a taxpayer is required to take extended business trips, determining the location of a taxpayer’s primary place of business becomes difficult, though for most taxpayers, the determination is simple because many taxpayers maintain a residence in the general vicinity of their primary place of business. For taxpayers who are required to travel often for business, such extended business travel raises the question as to where that taxpayer’s tax “home” is located.

1. *Commissioner v. Flowers*, 326 U.S. 465 (1946), *Robertson v. Commissioner*, 190 F.3d 392 (1999).

2. Rev. Rul. 54-147, 1954-1 CB 51.

3. See Rev. Rul. 75-432, 1975-2 CB 60.

4. *Markey v. Commissioner*, 490 F.2d 1249 (6th Cir. 1974), Rev. Rul. 60-189, 1960-1 CB 60.

5. Rev. Rul. 56-49, 1956-1 CB 152.

Generally, in order for the taxpayer to deduct business-related travel expenses, the travel must be temporary in nature (“temporary” for these purposes has been statutorily interpreted to mean an employment period not exceeding one year¹).

In other words, if a taxpayer is assigned to a new work location for an *indefinite* period of time, the taxpayer’s principal place of business—and tax “home” for travel expense deduction purposes—is transferred to that new location.²

Often, the analysis of whether a taxpayer who travels for business has acquired a second “tax home” turns upon whether or not it would be reasonable to expect that taxpayer to relocate. For example, the Second Circuit has held that the real issue in a case where the taxpayer resided in Colorado, but had committed to a two year position in New York, was whether or not a reasonable person in her position would have relocated her residence to New York.³

Congress has clarified the issue so that Section 162 now specifically provides that a taxpayer will *not* be temporarily “away from home” for any period of employment that exceeds one year for tax years beginning after 1992.⁴ If the taxpayer can show that the business travel was realistically expected to last for one year or less, and that travel in fact does last for one year or less, the travel will be considered temporary. On the other hand, if the travel is realistically expected to last for more than one year, or there is no realistic expectation that the travel will last for *less* than one year, the travel will be considered indefinite *regardless of whether it actually lasts for more than one year*.⁵ A very narrow exception to this rule exists for federal employees who are traveling in connection with the investigation or prosecution of a federal crime.⁶

This statutory rule applies for taxpayers travelling for business reasons to a *single location* for more than one year. The distinction between indefinite and temporary business travel remains important in situations where the taxpayer’s business travel may include *multiple* travel locations over a period that exceeds one year.

In *Wilson v. Commissioner*, for example, the taxpayer, who was from Idaho, was assigned by his employer to a series of temporary construction jobs in various locations in California over a period of time that exceeded one year. He claimed that, because each of these jobs was temporary, his principal place of business was in Idaho so that he should have been entitled to deduct his travel expenses while working in California. The Tax Court disagreed, finding that, while construction jobs are temporary by nature, all of the facts and circumstances had to be examined to determine whether the business travel was in fact indefinite. In this case, the overarching employment relationship was important and demonstrated an indefinite relationship so that the taxpayer could not reasonably argue that his travel could be segmented into individual construction jobs.⁷

1. Chief Counsel Memo 106447-98 (08-06-1998), Energy Policy Act of 1992 (1938), Pub. L. No. 102-486.

2. See *Peurifoy v. Commissioner*, 358 U.S. 59 (1958).

3. *Six v. United States*, 450 F.2d 66 (1971).

4. IRC Sec. 162(a) (flush language).

5. Rev. Rul. 93-86, 1993-2 CB 71.

6. IRC Sec. 162(a) (flush language).

7. *Wilson v. Commissioner*, TC Memo 2001-301.

8679. Can a taxpayer deduct business travel expenses if the taxpayer travels so frequently that it is found that the taxpayer has no “tax home” for determining whether the “away from home” requirement of Section 162 is met?

Yes. If a taxpayer travels constantly for business, it is possible that the taxpayer has no tax home for purposes of determining the deductibility of business travel expenses under Section 162.

For example, in *McNeill v. Commissioner*, the taxpayer was a truck driver who was travelling so frequently that the Tax Court found he had no principal place of business. Further, no significant expenses were incurred in connection with maintaining a principal residence, as he paid approximately \$1,000 a year for a mobile home until he owned it in full and, for the tax years in question, the taxpayer only spent approximately 20 days per year in the mobile home. Though the taxpayer attempted to deduct all travel and meal expenses while he was “on the road,” the Tax Court denied the deductions, finding that, in a case like this, the taxpayer was *never* “away from home” for tax purposes and, therefore, was not entitled to deduct any business travel expenses.¹

Similarly, in *James v. United States*, the taxpayer was a traveling salesperson who spent so much time in traveling that the Ninth Circuit found there were insufficient contacts with any location to determine a tax home. In this case, the court discussed whether a taxpayer was required to maintain a physical residence in order to *ever* be considered “away from home” for purposes of Section 162. Because the intent of Congress in allowing the deduction was to prevent the taxpayer from incurring duplicate (lodging) or higher (meal and lodging expenses tend to be higher in travel) expenses during business travel, the court found that the deduction should only apply in cases where the taxpayer has a “home” and must expend funds to maintain this home. Further, if a taxpayer has no permanent home, and must therefore obtain food and shelter in public restaurants and hotels whether or not the taxpayer is traveling, there is no justification for allowing the deduction for business travel expenses.²

Therefore, in rare cases, it is possible that the taxpayer will never be allowed to deduct business travel expenses whether or not they are incurred in the pursuit of a trade or business, because the taxpayer will never actually be “away from home.” In other words, if a taxpayer is constantly on the move due to his work, he is never “away” from home.³

8680. Are business-related travel expenses deductible if a taxpayer resides in a location that is far from the taxpayer’s principal place of business?

A taxpayer is entitled to deduct business travel expenses, but is not entitled to deduct the costs incurred in *commuting* between the taxpayer’s principal residence and place of business.⁴

When a taxpayer chooses to reside in a location that is far from the taxpayer’s principal place of business, the issue is not whether the taxpayer is “away from home” when travelling

1. TC Memo 2003-65.

2. *James v. United States*, 308 F.2d 204 (1962).

3. *Deamer v. Commissioner*, 752 F.2d 337, 338 (8th Circuit 1985), affg. T.C. Memo 1984-63.

4. See, for example, *United States v. Tauferner*, 407 F.2d 243 (1969); *Sanders v. Commissioner*, 439 F.2d 296 (1971).

between a residence and place of business, but whether or not the travel expenses are sufficiently connected to a trade or business as to be deductible under Section 162.

For example, the Tax Court has denied the taxpayer's travel expense deductions in a situation where the taxpayer maintained a residence in Tennessee with the taxpayer's family. The taxpayer was unable to find employment in Tennessee and accepted employment in North Carolina. The family continued to reside in Tennessee and the taxpayer incurred duplicate living expenses as a result, which he attempted to deduct as business travel expenses. The Tax Court denied the deductions, finding that the taxpayer's choice in maintaining his personal residence far from his principal place of business was not a business expense that was reasonable and necessarily connected to his business. Rather, these duplicate living expenses were the result of the taxpayer's personal choice to maintain a residence in Tennessee.¹

Similarly, a postal employee who lived and worked in New York, but was promoted to a position (national president of the post office) that required him to spend approximately 300 hours per year in Washington, D.C., was unable to deduct his travel expenses between New York and Washington D.C. The taxpayer's wife continued to live in their New York residence and the taxpayer stayed in hotels and took his meals there while in Washington D.C. Even though the position required that the taxpayer spend significant time in Washington D.C., it did not require that he continue to maintain a residence in New York. Because of this, the expenses that he incurred while residing in Washington D.C. were found to be personal living expenses, rather than business travel expenses.²

8681. Is a taxpayer entitled to a deduction for travel expenses when the taxpayer has multiple places of business?

If a taxpayer regularly conducts business in more than one location, a determination must be made as to which location is the "principal" place of business. This determination must be made by examining all the facts and circumstances of the particular case, but the IRS has identified the following factors as important:

- (1) The total time spent at each of the business locations;
- (2) The degree of business activities at each location; and
- (3) Whether the financial return in each location is significant or insignificant.³

Though all three factors are important, the IRS generally considers the amount of time spent at each location to be the most important factor.⁴

For example, the Tax Court has held that a taxpayer who maintained a business in New York and another in Massachusetts was entitled to deduct expenses while travelling in

1. *Tucker v. Commissioner*, 55 TC 783 (1971).

2. *McAvoy v. Commissioner*, TC Memo 1965-289.

3. Rev. Rul. 54-147, 1954-1 CB 51.

4. See Rev. Rul. 63-82, 1963-1 CB 33, Rev. Rul. 61-67, 1961-1 CB 25.

New York because the taxpayer spent more of his time in Massachusetts.¹ In situations where the taxpayer's time is relatively evenly divided, all of the facts and circumstances will be analyzed to determine which place of business constitutes the taxpayer's "principal" place of business.²

Once the taxpayer's principal place of business is determined, the general rules applicable in determining whether travel expenses are deductible are applied. Thus, a taxpayer can deduct expenses for meals and lodging while conducting business in a secondary business location if an overnight trip is required. Transportation expenses can be deducted between the principal and secondary places of business even if an overnight stay is not required.³ Expenses incurred while the taxpayer is in the vicinity of his principal place of business are not deductible.

8682. Can a taxpayer deduct travel expenses for a trip that has both business and personal elements?

The deduction for otherwise personal expenses incurred while a taxpayer is away from home for business purposes is only allowed to the extent that the travel is reasonable and necessary for a taxpayer's trade or business. However, because there have been many instances where a taxpayer attempts to deduct expenses for what essentially constitutes a personal vacation, the IRS has developed rules that govern a trip that combines both business and personal elements.

If the primary purpose behind a taxpayer's trip is personal, no travel expense deductions for expenses incurred in traveling to and from the destination will be permitted even if the taxpayer does, in fact, engage in some business activities during the course of the trip. However, if a trip has both business and personal elements, the taxpayer may deduct those expenses that are properly allocated to the business portion of the trip even if unable to deduct the expense of traveling to and from the destination because it is found that the trip was primarily undertaken for personal reasons.⁴

Whether a trip is primarily business-related or primarily personal is a question of fact. Though all facts and circumstances must be considered, the IRS has provided that an important factor is the amount of time spent on business compared to the amount of time spent on the taxpayer's personal activities.

Planning Point: If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.⁵

Travel expenses for the taxpayer's spouse (or other family member) to accompany the taxpayer on a business-related trip are not deductible unless the taxpayer is able to show that there

1. *Sherman v. Commissioner*, 16 TC 332 (1951).

2. See, for example, *Bernard v. United States*, 87-1 USTC 1092 (1971).

3. Rev. Rul. 63-82, above.

4. Treas. Reg. §1.162-2(b)(1).

5. Treas. Reg. §1.162-2(b)(2).

is a bona fide business purpose for the spouse or family member's presence. This is the case even if it is found that the taxpayer's trip is primarily business-related.¹

Similar rules apply in the case of a taxpayer's travel expenses related to attendance at a convention—meaning that the expenses are not deductible if the reason for attending is not sufficiently related to the taxpayer's trade or business. However, the rules make clear that the fact that the taxpayer's attendance is voluntary will not impede the taxpayer's ability to deduct related travel expenses—even if the taxpayer actually uses vacation days in order to attend—so long as attendance at the convention is motivated by business reasons.²

8683. Do any special rules apply for a taxpayer who wishes to deduct business-related travel expenses for travel that takes place outside the United States?

Yes. IRC Section 274 applies to reduce the amount of otherwise allowable business travel deductions for taxpayers travelling for business outside of the United States unless one of the following are true:

- (1) the trip has a duration of one week or less, or
- (2) less than 25 percent of the trip is spent pursuing personal, nonbusiness activities.³

“One week” for this purpose means seven consecutive days, *not* including the day that travel begins but including the day that the taxpayer travels home.⁴

Unless the taxpayer establishes a more clear method of allocation that satisfies the IRS, whether or not the taxpayer spends less than 25 percent of the trip on personal activities must be determined on a per-day basis, meaning that each day will be considered a “business day” or a “nonbusiness day.”⁵

“Transportation days,” meaning days during which the taxpayer was engaged in travelling from the U.S. to a foreign destination in pursuit of business, are counted as business days unless the taxpayer does not take a reasonably direct route. If the taxpayer takes an indirect route for nonbusiness purposes, only the amount of time that would have been spent to travel by direct route using the same type of transportation will be considered business days.⁶

If the taxpayer is specifically required to be in the foreign location for a business purpose for the day in question (for example, to attend a business meeting), that day will be counted as a business day.⁷ Further, if the taxpayer was primarily engaged in business activities during normal working hours, that day will be counted as a business day.⁸ An intervening weekend

1. Treas. Reg. §1.162-2(c).

2. Treas. Reg. §1.162-2(d).

3. IRC Sec. 274(c).

4. Treas. Reg. §1.274-4(c).

5. Treas. Reg. §1.274-4(d)(2).

6. Treas. Reg. §1.274-4(d)(2)(i).

7. Treas. Reg. §1.274-4(d)(2)(ii).

8. Treas. Reg. §1.274-4(d)(2)(iii).

day or holiday can be counted as a business day even if no business was conducted on that day (see example 3, below).

Example 1: Mel leaves for a foreign business trip on Wednesday and returns the following Wednesday. She is considered to have been away from home for seven days. Because she has not been away from home for more than one week, the special rules applicable to foreign travel do not apply.

Example 2: Same facts as above, except Mel returns on the following Thursday. She is considered to have been away from home for eight days, so must allocate her travel expenses between business and personal expenses to determine the percent of time spent on personal activities. The day spent travelling on Wednesday will be counted as either a business or nonbusiness day in determining whether Mel meets the 25 percent test.

Example 3: Mel leaves for Paris on a Wednesday and returns the following Sunday. Mel attends business meetings on Thursday and Friday, and the following Monday through Friday, when her business concludes. The first weekend will be counted as business days even if no business is conducted because they are “intervening”—her business had not yet concluded at the beginning of the weekend. Her second Saturday in Paris will be counted as a personal day because her business had concluded the day before.

If Section 274 applies, the taxpayer’s travel expense deduction will be disallowed to the extent of nonbusiness travel. The taxpayer will be required to multiply the total amount of travel expenses by a fraction, the numerator of which is the number of nonbusiness days occurring during the trip, and the denominator of which is the total number of days (business and nonbusiness) spent on the trip.¹

Taxpayers who have no substantial control over arranging the business trip, such as in a case where the employer arranges a trip for an employee, may allocate all expenses of the trip to business travel (control over only the timing of the trip is not considered substantial control). Likewise, anyone traveling on an employer’s behalf under a reimbursement or other expense allowance arrangement is considered not to have substantial control over arranging the trip provided the individual is neither a managing executive of the employer with authority to decide on the trip’s business necessity, nor related to the employer within the meaning of IRC Section 267(b) (i.e., family members, an individual and his or her more-than-50 percent owned corporation, two corporate controlled-group members).²

8684. Can a taxpayer deduct business-related transportation expenses incurred when the taxpayer is not travelling away from home on business?

A taxpayer who is not considered to be “away from home” for purposes of deducting business-related travel expenses (see Q 8677 to Q 8683) may still be entitled to claim a deduction for business-related transportation expenses. A taxpayer is generally *not* entitled to deduct the cost of commuting from the taxpayer’s residence to the taxpayer’s primary place of business. However, business-related transportation costs other than commuting costs may be deducted as business expenses. Examples of such expenses include the following:

- (1) Travelling from one business place to another business place within the general area that is considered a taxpayer’s “tax home” (see Q 8678 and Q 8679);
- (2) Visiting clients and customers;

1. Treas. Reg. §1.274-4(f)(1).

2. Treas. Reg. §1.274-4(f)(5)(i).

- (3) Travelling to a business meeting outside of the taxpayer's principal place of business;
- (4) Travel from the taxpayer's residence to a *temporary* workplace if the taxpayer has one or more *regular* workplaces. A work location is considered temporary if it is realistically expected to last (and does last) for one year or less, unless the circumstances indicate otherwise.¹

If a taxpayer's residence is also the taxpayer's principal place of business, that taxpayer may deduct the costs of commuting between the residence and another place of business, whether or not that second place of business is considered "regular" or "temporary."²

Example: Brent is a representative for a cheese manufacturing company and works out of his home. He has no permanent office, but regularly must drive to visit clients who have questions about his company's cheese products. Brent may deduct the cost of driving between his home and client sites, even though these visits occur on a regular basis. If Brent were required to travel outside of his regular area of business on an overnight trip, those costs would be deductible as travel expenses, *not* transportation expenses. Because Brent travels by car, he can either deduct the actual costs of his car *or* the standard mileage rate for the year (56 cents per mile in 2014).³

As stated above, expenses incurred for commuting from the taxpayer's residence to place of business are generally nondeductible. This is the case even though the taxpayer works during the commute—for example, by taking work-related calls or discussing business while carpooling with a business associate

8685. When is a taxpayer entitled to deduct moving expenses?

If certain conditions are met, a taxpayer may deduct reasonable moving expenses incurred in connection with beginning work at a new principal place of business, whether as an employee or self-employed person.⁴ The following general requirements apply:

- (1) The taxpayer must have incurred moving expenses;
- (2) Those moving expenses must be related to the taxpayer's start of work at a new principal place of work;
- (3) The taxpayer's new principal place of work must be at least 50 miles further from his principal residence than his former principal place of work *or*, if the taxpayer had no former principal place of work, at least 50 miles from his former residence;⁵ and
- (4) The taxpayer must work in the general location of the new principal place of work for a specified period. Specifically, this means that the taxpayer is either:
 - a. a full-time employee in the general location of the new principal place of work for at least 39 weeks during the 12-month period following his or her arrival *or*,

1. See IRS Publication 463, available at <http://www.irs.gov/publications/p463/ch04.html> (last accessed June 2, 2014).

2. IRS Pub. 463.

3. IR-2013-95 (Dec. 6, 2013).

4. IRC Sec. 217(a).

5. IRC Sec. 217(c)(1).

- b. in the 24-month period following arrival, a full-time employee or self-employed individual (on a full-time basis) in the general location of the new principal place of work during at least 78 weeks (39 weeks must be in the first 12-month period). See Q 8661 and Q 8662 for a discussion of when a taxpayer is considered to be self-employed.¹

For moving expenses that meet the requirements above to be “qualified,” and thus deductible, they must relate to the expenses described below (the distinction also becomes important for determining whether the employee must include the costs of any employer-reimbursement in gross income, see Q 8686). “Qualified moving expenses” are:

- (1) the costs incurred to move the taxpayer’s household items from the first location to the second location; and
- (2) the travel expenses (excluding meals, but including lodging) incurred by the taxpayer in travelling from the first location to the second location.²

The expenses described in (1), above, may include costs such as those related to packing, disconnecting and connecting utilities, and in-transit storage and insurance if incurred in the 30 day period after moving the goods from the taxpayer’s former residence. The IRS specifically excludes costs such as losses sustained upon ending membership in clubs, wasted tuition fees, costs incurred in buying property or losses sustained upon selling property because of the move.³

Travel expenses described in (2), above, must be reasonable based on the facts and circumstances of the particular situation. Though the route travelled must usually be the shortest and most direct route, the taxpayer does not lose the deduction if the taxpayer incurs expenses that increase the cost of the move and are personal in nature. Instead, the deduction is reduced by the additional costs incurred for personal reasons.⁴ The deduction is further reduced by any expenses deemed to be lavish or extravagant under the circumstances.

Example: Jeff is moving from Michigan to California for business reasons. He intends to drive but, rather than directly making the trip, he decides to stop and visit friends in St. Louis and Las Vegas along the way. Jeff is entitled to deduct the cost of moving from Michigan to California, minus any additional costs he incurs while visiting friends in other cities for personal reasons.

Planning Point: Travel expenses from the former to the new residence are deductible for one trip only. The trip must be made by the taxpayer and members of the taxpayer’s household. It is not necessary, however, that the taxpayer and all household members travel together or at the same time.⁵ The cost of traveling from a former home to a new one should be by the shortest, most direct route available using conventional transportation.⁶

1. IRC Sec. 217(c)(2).

2. IRC Sec. 217(b)(1).

3. Treas. Reg. §1.217-2(b)(3).

4. Treas. Reg. §1.217-2(b)(2).

5. Treas. Reg. §1.217-2(b)(4).

6. IRS Pub 521, Moving Expenses (2013).

A taxpayer is also entitled to deduct the moving expenses of other members of his household, provided that the household member's principal place of residence was both at the first location and at the second location.¹

Generally, moving expenses are treated as an "above the line" deduction; thus, if allowable, such expenses are deductible directly from gross income.²

8686. Can an employer deduct moving expenses for which it reimburses its employees? Are reimbursed moving expenses included in the taxpayer-employee's gross income?

Generally, if an employer reimburses an employee for business-related moving expenses (see Q 8685), that employer is entitled to deduct the reimbursed amount as an ordinary and necessary business expense under IRC Section 162.

If a taxpayer is reimbursed by the employer for non-qualified moving expenses (see Q 8685), the taxpayer must include those reimbursed amounts in gross income as compensation for services rendered.³ A taxpayer is not required, however, to include amounts reimbursed for "qualified moving expenses" in gross income (see Q 8685). These qualified moving expenses are instead treated as a fringe benefit that is specifically excluded from an employee's income.⁴

In order for a moving expense reimbursement to be excludable from the employee's gross income, the reimbursement must be related to an expense that would be deductible by the employee (if the employee had paid it directly, see Q 8685) under IRC Section 217. If the employee actually did deduct the expense in a prior year, reimbursement for the expense is not excludable under Section 132.⁵

8687. Is a taxpayer entitled to claim a deduction for business-related education expenses?

An employee is generally entitled to deduct education-related expenses that meet the following requirements:

- (1) The expense must relate to education that is designed to maintain or improve skills used by the taxpayer in his or her trade or business; or
- (2) The education must be specifically required by the employer, or under applicable law or regulations, in order for the taxpayer to retain an established employment relationship, status or compensation level.⁶

1. IRC Sec. 217(b)(2). See also, *Shah v. United States*, 450 F. Supp. 1136 (1978).

2. IRC Sec. 62(a)(15).

3. IRC Sec. 82.

4. IRC Sec. 132(a)(6).

5. IRC Sec. 132(g).

6. Treas. Reg. §1.162-5(a).

Despite this, there are circumstances under which a taxpayer's educational expense deduction will not be permitted even if the qualifications described in (1) and (2) above are satisfied. Educational expenses will be considered personal, nondeductible expenses if:

- (1) The expense is incurred in obtaining the minimum educational requirements for qualification in the taxpayer's business (for example, obtaining a law degree) though, once the employee has met the minimum educational standards upon entering his trade or business, he will be treated as continuing to meet those standards even if they are eventually changed;

Example: New Jersey requires all secondary school teachers to have a bachelor's degree that includes 30 credit hours of professional education courses. In New Jersey, if a school can certify that a qualified secondary school teacher with the requisite degree cannot be found, that school is permitted to hire a secondary school teacher who has completed at least 90 semester hours of college-level work, though such an individual is required to complete his or her degree within 3 years of hire to retain the position.

Annelise begins teaching in New Jersey with a bachelor's degree and 30 credit hours in professional education. Two years later, New Jersey adds the requirement that a secondary school teacher must complete a fifth year of education within 10 years of beginning his or her employment to maintain certification. Annelise completes her fifth year of education three years later and obtains the required certificate. The fifth year of education is not part of the minimum educational requirements for secondary school teachers, so Annelise is entitled to deduct her expenses in obtaining the certificate.

Example: Same facts as above, except Annelise is hired during a period where there is a shortage of teachers and she has not yet completed her bachelor's degree. She completes her bachelor's degree within her first two years of employment. The expenses are not deductible, because a bachelor's degree is one of the minimum qualification requirements for secondary school teachers in New Jersey.¹

- (2) The expense is incurred in obtaining education that will qualify the taxpayer for entering a new trade or business. A "change of duties" does not constitute a new trade or business if the new duties involve the same general type of work involved in the taxpayer's present employment. For this purpose, all teaching and related duties are considered to involve the same general type of work.²

Example: Annelise is an elementary school teacher and, during the course of her employment, takes the classes necessary to qualify as a secondary school teacher. The educational expenses are deductible because they do not qualify Annelise for entering a new trade or business. Her husband, Kevin, is self-employed as an accountant and taking law school courses in the evenings. Kevin's education expenses are nondeductible, because they qualify him for entering a new trade or business.

8688. What special rules apply when a taxpayer deducts business-related entertainment expenses and meals?

Special restrictions apply when a taxpayer deducts business meal and entertainment expenses. A taxpayer is generally entitled to deduct the cost of a business meal if (a) the meal is not lavish or extravagant and (b) the taxpayer (or employee of the taxpayer) is present at the meal.³

1. Treas. Reg. §1.162-5(b)(2)(iii), Ex. 1.

2. Treas. Reg. §1.162-5(b)(3)(i).

3. IRC Sec. 274(k).

Entertainment expenses are typically only deductible if the taxpayer establishes that the activity is directly related to or associated with the taxpayer's trade or business.¹

Generally, the deduction for the ordinary and necessary cost of business meals (i.e., those expenses which are not lavish and extravagant), are reduced by half, so that only 50 percent of allowable costs are deductible.² For certain taxpayers who are employed in the transportation industry, and are frequently required to have meals away from home (such as flight crews, interstate truck drivers, etc.), 80 percent of the cost of business meals is deductible for tax years beginning after 2007.³

In order to deduct the cost of business-related meals, taxpayers must also establish that the meal was either "directly related" or "associated with" the taxpayer's business (i.e., the taxpayer must show that the expense was incurred directly before, during, or after a bona fide business discussion) in order to deduct the cost.⁴

The deduction for business entertainment expenses is also generally limited to 50 percent of otherwise allowable costs.⁵

If the amount of the allowable deduction is reduced because the expense is found to be lavish or extravagant, the 50 percent limitation is applied *after* the cost has been reduced by the portion that is deemed to be unacceptable.⁶

If an employee is fully reimbursed for the expense of business meals and entertainment, such expenses are fully deductible by the employer, although the 50 percent limitation will apply to the employer's deduction.⁷ However, if the expenses are not reimbursed, the employee is subject to the 50 percent limitation described above. Furthermore, the unreimbursed expenses that are deductible after that limitation are then subject to the 2 percent floor on miscellaneous itemized deductions.⁸

8689. When is a business-related entertainment or meal expense "ordinary and necessary" so that it may be deducted?

Whether a business-related entertainment or meal expense is ordinary and necessary is generally a question of fact. The courts have recognized that the taxpayer is entitled to exercise a certain degree of discretion in determining whether an expense is ordinary and necessary in the taxpayer's particular business.⁹

1. IRC Sec. 274(a).

2. IRC Sec. 274(n).

3. IRC Sec. 274(n)(3).

4. IRC Sec. 274(a)(1)(A).

5. IRC Sec. 274(n).

6. H.R. Rep. No. 841, 99th Cong., 2d Session at II-25 (1986).

7. IRC Sec. 274(n)(2)(A).

8. IRC Secs. 274(n)(1), 67(b).

9. *Cravens v. Commissioner*, 272 F.2d 895 (1959).

Expenditures are generally found to be sufficiently necessary if, based on all the facts and circumstances, they are “appropriate and helpful” to the taxpayer’s business.¹ Expenditures are generally found to be sufficiently ordinary if they are made for “sound and normal” business expenses of a nature and amount determined by general commercial standards.²

The Tax Court has allowed a deduction for entertainment expenses incurred by a bank that paid for private dinner parties at a country club (hosted by the bank’s officers) for its significant customers (“key people” from among the bank’s top five hundred clients and prospective clients in the upper echelon of the financial community).³ The court noted that, in this case, there was evidence that these customers were not being reached by more direct methods, so it was not unreasonable for the bank to resort to private entertainment in order to entice their business.

On the other hand, when a public defender who supervised several attorneys attempted to deduct the cost of taking those attorneys to lunches at the public defender’s country club, the Tax Court denied the deduction on the grounds that such expenses were not ordinary and necessary for a taxpayer who is engaged in the business of being a public defender. This was the case even though the court recognized that the lunches tended to boost morale and encourage efficient work. Also important was the Tax Court’s recognition that these expenses might have been found to be ordinary and necessary were they incurred by a partner operating in a private law firm.⁴

8690. What limitations apply to prevent a taxpayer from deducting lavish or extravagant business-related entertainment expenses?

The prohibition on the deductibility of lavish or extravagant business-related expenses is tied to the notion that the expense must be reasonable in order to be deducted—a determination that is made based on the facts and circumstances of each individual case. Based on this premise, the courts have allowed taxpayers to deduct expenses that might be considered unreasonable in other contexts.

For example, the Tax Court has upheld a taxpayer’s deduction for expenses incurred in using a chauffeured Cadillac to provide local transportation for securities analysts and investment advisors in New York.⁵

Conversely, the Tax Court has disallowed deductions for lease payments made on a Rolls Royce by a plastic surgeon. The court’s opinion reflects the importance of whether the expense is reasonable, rather than the level of extravagance displayed. In this case, the taxpayer-surgeon claimed that the Rolls Royce was used in advertising and promoting the quality of his services, and that he only used the car for business travel between the hospital and medical conventions. The Tax Court rejected the petitioner’s argument that the Rolls Royce would attract customers,

1. *First National Bank v. United States*, 276 F. Supp. 905 (1967).

2. *Byers v. Commissioner*, 199 F.2d 273 (1952).

3. See *First National Bank*, above.

4. *Wells v. Commissioner*, TC Memo 1977-419.

5. See *Denison v. Commissioner*, TC Memo 1977-430.

finding that it had no reasonable relationship to his skill and performance as a plastic surgeon and that there was no evidence that any patients were attracted based on the leasing of the car.¹

8691. What substantiation requirements apply when a taxpayer deducts business-related entertainment and meal expenses?

In order for a taxpayer to deduct business-related entertainment and meal expenses, the taxpayer must maintain records adequate to provide the following information:

- (1) The amount of each separate entertainment (or meal) expense;
- (2) The time and date upon which the expense was incurred;
- (3) The name, address and/or location where the expense was incurred (if the location information does not make the type of entertainment apparent, the taxpayer must indicate whether it was a dinner, theater, sporting event, etc.);
- (4) The business reason for the entertainment or the business benefit expected to be derived from the event, and (except in the case of business meals furnished on employer premises), the nature of any business discussion or activity;²
- (5) A description of the business relationship between the taxpayer and the parties who were entertained (name, title or other description sufficient to establish the business relationship).³

The taxpayer's records must contain all of the above information or the deduction may be disallowed.⁴ However, if the taxpayer entertains a large group of individuals, the taxpayer is not required to provide a name, title and description for each individual—a general description, such as “directors of Company X,” will suffice if the group is homogeneous enough so that such a description will provide adequate identification. If, however, the taxpayer entertains a group that is so diverse that such a label will not identify the business relationship at issue, the IRS will require a listing on an individual basis.⁵

If a taxpayer holds season tickets for purposes of business entertaining, the event represented by each individual ticket must be treated as a separate entertainment event. For example, a taxpayer who holds season tickets for Boston Red Sox home baseball games must keep records providing the above information as it applies to each individual game.⁶

1. *Connelly v. Commissioner*, TC Memo 1994-436.

2. IRC Sec. 274(e).

3. Treas. Reg. §1.274-5T(b)(3).

4. See, for example, *Newman v. Commissioner*, TC Memo 1982-61 (deduction disallowed for insufficient substantiation because taxpayer failed to include location and business purpose information).

5. Rev. Proc. 63-4, 1963-1 CB 474.

6. Rev. Proc. 63-4, above, Q&A 17.

8692. When is a taxpayer entitled to deduct expenses incurred in maintaining a home office?

A taxpayer is only entitled to deduct expenses for a home office if the taxpayer is able to meet the restrictive requirements imposed by the IRC and the courts with regard to this business deduction. A deduction for use of a part of the taxpayer's residence as an office will not be allowed unless a portion of the dwelling is used exclusively and on a regular basis as (a) the principal place of business for any trade or business of the taxpayer; or (b) the place of business used by the taxpayer for meeting patients, clients or customers in the normal course of the taxpayer's business.¹ If the taxpayer uses a separate structure as a home office, the use requirements are less restrictive and the use must only be "in connection with" the taxpayer's trade or business.² A home office will qualify as a taxpayer's principal place of business if both of the following are true:

- (1) The taxpayer uses the home office exclusively and regularly for administrative or management activities of the trade or business; and
- (2) The taxpayer has no other fixed location for conducting substantial administrative or management activities of the trade or business.³

That a taxpayer chooses to have a third party perform administrative or management activities (such as billing) for the taxpayer will not, in itself, cause a disallowance of the deduction.

Example: Josh is an electrician who is self-employed. Most of his time is spent on-site with customers examining and repairing their electrical systems, but he maintains a small office in his home that is used exclusively and regularly for activities such as ordering supplies, calling his customers and keeping his books. Josh writes up estimates and records of work completed on-site at his customers' premises. He has engaged a local bookkeeping service for billing his customers, but he does not conduct any other substantial administrative or management activities outside of his home office. His home office will qualify for a home office deduction.

Planning Point: If the taxpayer is an employee and uses part of the taxpayer's home for business, the taxpayer must be able to show that, in addition to the requirements discussed above (1) the use is for the convenience of the employer and (2) no part of the home is rented to the employer and used to perform services as an employee for that employer.⁴

If the home office is merely appropriate and helpful, the deduction for home office expenses will be disallowed.⁵

For tax years beginning on or after January 1, 2013, the IRS has authorized an optional safe harbor method for calculating the amount of a taxpayer's home office deduction. The taxpayer calculates the home office deduction by multiplying the square footage of the home used for business purposes by a prescribed rate of \$5.00. Under this safe harbor, the maximum allowable portion of a home that may be used for qualified business purposes is 300 square feet, which results in a maximum allowable home office deduction of \$1,500.⁶

1. IRC Sec. 280A(c)(1).

2. IRC Sec. 280A(c)(1)(C).

3. IRS Publication 587, available at <http://www.irs.gov/pub/irs-pdf/p587.pdf> (last accessed July 18, 2013).

4. IRS Pub. 587, Business Use of Your Home (2012).

5. IRS Pub. 587, above.

6. Rev. Proc. 2013-13, 2013-6 IRB 478.

8693. How does an employer's reimbursement or failure to reimburse an employee's expenses impact a taxpayer's business expense deductions?

The tax treatment of an employee's business expenses depends on whether the employee is reimbursed for them by the employer. The IRC provides that expenses paid or incurred by the taxpayer, in connection with the performance of services as an employee, under a reimbursement or other expense allowance arrangement with the employer are deductible in full from gross income, to arrive at adjusted gross income, so long as the expenses otherwise qualify as business expense deductions.¹ Generally, this deduction will be available only to the extent that the reimbursement is includable in the employee's gross income.²

Employers are generally required to report certain employee reimbursements for business expenses on Form W-2. The reporting requirements apply to the following groups:

- (1) employers who do not require substantiation (or whose employees fail to substantiate expenses);
- (2) employers who advance amounts for expenses and do not require the return of (or do not receive) unused amounts; and
- (3) employers who reimburse a per diem or other fixed amount that exceeds government specified rates.

The rules, thus, generally apply only to reimbursements for unsubstantiated expenses and unreturned excess amounts.³

It is not uncommon for an employee to incur expenses in connection with work that are not reimbursed by the employer. Examples include an employee's use of his own automobile or subscriptions to work-related professional journals. In general, the same business expenses that are deductible by a self-employed person are deductible if incurred by an employee, but in the case of an employee, the deduction is allowable only as an itemized deduction. As such, it is treated as a so-called "miscellaneous itemized deduction."⁴

Miscellaneous itemized deductions are allowed only to the extent that the aggregate of such deductions exceeds 2 percent of the taxpayer's adjusted gross income.⁵

An employee cannot choose to forego reimbursement for a business expense for which his employer would pay and claim a deduction. "[A] business expense deduction is not allowable to an employee to the extent that the employee is entitled to reimbursement from the employer for an expenditure related to his status as an employee."⁶

1. IRC Sec. 62(a)(2).

2. IRC Sec. 62(c), Treas. Regs. §§1.162-17(b)(2), 1.162-17(c).

3. Treas. Reg. §1.62-2.

4. Treas. Reg. §1.67-1T(a)(1)(i).

5. IRC Sec. 67.

6. *Lucas v. Commissioner*, 79 TC 1 (1982).

PART IX: BAD DEBT AND WORTHLESS SECURITIES

8694. When can a taxpayer deduct losses sustained as a result of a bad debt? What is the difference between a business bad debt and a nonbusiness bad debt?

A bad debt is a specific obligation which can be deemed with reasonable certainty to have become totally or partially worthless. If this is the case, the creditor-taxpayer may be entitled to a deduction corresponding to the amount of the worthless debt.¹

There are two kinds of bad debt deductions: (1) business bad debts and (2) nonbusiness bad debts. A business bad debt, as the name suggests, is a debt that is incurred in the conduct of the taxpayer's trade or business. A nonbusiness bad debt is defined, by exclusion, in IRC Section 166(d)(2) as a bad debt *other than* a debt (a) created in the conduct of the taxpayer's business² or (b) the loss from the worthlessness of which was incurred in the conduct of the taxpayer's trade or business.³ The second exclusionary rule allows a taxpayer who was not the original creditor to claim a worthless debt that he acquired in the conduct of his business.

The classification as either a business or nonbusiness bad debt is important because only a business bad debt can be treated as a deduction from ordinary income, while nonbusiness bad debts receive a capital loss treatment.⁴ Further, a taxpayer can claim a deduction for wholly or partially worthless business bad debts, while nonbusiness bad debts must be completely worthless for the deduction to be allowed (see Q 8697).⁵

Whether a debt is incurred in relation to a taxpayer's trade or business, so as to be classified as a business bad debt, is a question of fact.⁶ In making the determination, it is important to note that a taxpayer is not restricted to one type of business and that there is no requirement that the loss be incurred in conducting the business in which the taxpayer spends the majority of taxpayer's time.⁷

A deduction for a loss sustained as the result of a bad debt will only be permitted in cases where there is a valid debt and a true debtor-creditor relationship (see Q 8695). Whether a valid debt or a true debtor-creditor relationship exists is also a question of fact.⁸

A bad debt deduction will not be allowed in a situation where the debt is secured by collateral and the creditor has foreclosed on the collateral due to nonpayment.⁹

1. Treas. Reg. §1.166-1.

2. IRC Sec. 166(d)(2)(A); Treas. Reg. §1.166-5(b)(1).

3. IRC Sec. 166(d)(2)(B); Treas. Reg. §1.166-5(b)(2).

4. IRC Sec. 166(a) and (d).

5. IRC Sec. 166(d)(1).

6. *Commissioner v Smith*, 203 F.2d 310 (1953), *Nicholson v Commissioner*, 218 F.2d 240 (1954).

7. *Gliptis v United States*, 120 F. Supp. 3 (1954).

8. *Leuthold v. Commissioner*, 54 TCM 1308 (1987); *Lane v. United States*, 83-2 USTC 9524 (1983).

9. *Rose v Commissioner*, TC Memo 1987-19.

Bad debts of corporations, except for S corporations, are always classified as business bad debts.¹ An S corporation is required to separately state its nonbusiness bad debt, which is taxed under the rules applicable to short-term capital losses (see Q 8589).²

A discharge of one's obligation as a guarantor is considered a nonbusiness bad debt. The loss sustained by a guarantor unable to recover from the debtor is by its very nature a loss from a bad debt to which the guarantor becomes subrogated upon discharging his liability as guarantor.³

If the debt fails to qualify as a business bad debt, it can, in many cases, be treated as a non-business bad debt.⁴ If the taxpayer fails to establish that a debt qualifies as a business bad debt under IRC Section 166, he must be satisfied with treatment as a non-business bad debt under that same section and may not look to IRC Section 165 (see Q 8699) for an alternative means of treating loss on the debt as an ordinary loss deduction.⁵

8695. When is a taxpayer entitled to claim a bad debt deduction?

A taxpayer may claim a bad debt deduction (whether it is a business bad debt or a non-business bad debt, see Q 8694) for debt owed when the debt is a bona fide debt that has become worthless.⁶

A "bona fide debt" is one that arises from a creditor-debtor relationship involving a valid and enforceable agreement to pay a specific sum of money.⁷ An agreement is considered to be a valid and enforceable agreement if it includes an unconditional promise by a debtor to pay the creditor.⁸

A taxpayer's voluntary undertaking to pay another debtor's obligations does not give rise to a valid and enforceable agreement for this purpose. Despite this, if the taxpayer volunteers to pay another person's obligation for a business purpose, and that debt subsequently becomes worthless, the taxpayer may be entitled to deduct the amount of the loss as a business expense under IRC Section 162.⁹

A bad debt can arise under a contractual agreement to pay a specific sum of money¹⁰ or under an obligation created by law.¹¹ The requirements for determining whether a bad debt exists must be strictly met in order for the taxpayer to be entitled to claim the deduction.¹²

1. IRS Publication 535.

2. See Rev. Rul. 93-36; 1993-1 CB 187, Treas. Reg. §301.7701-2.

3. *Putnam v. Commissioner*, 352 US 82 (1956).

4. See *Krasnow v. United States*, 508 F. Supp. 1099 (1981).

5. *Alsobrook v. United States*, 431 F. Supp. 1122 (E.D. Ark.), aff'd 566 F.2d 628 (6th Circuit 1977).

6. *Anderson v. Commissioner*, 5 TC 482 (1945), aff'd, 156 F.2d 591 (1946).

7. Treas. Reg. §1.166-1(c). See, also, *Kavanaugh v. United States*, 575 F. Supp. 41 (1983), *Hynard v. IRS*, 233 F. Supp.2d 502 (2002), *Schneider v. Commissioner*, 42 TCM 1449 (1981); *Edgar v. Commissioner*, 39 TCM 816 (1979), *Fryer v. Commissioner*, 33 TCM 403 (1974); *Holman v. Commissioner*, 32 TCM 1323 (1973).

8. *Wortham Mach. v. United States*, 521 F.2d 160 (1975).

9. *Lutz v. Commissioner*, 282 F.2d 614 (1960).

10. *Community Research and Dev. Corp. v. Commissioner*, TC Memo 1979-264.

11. See Rev. Rul. 72-505, 1972-2 CB 102, Rev. Rul. 69-458 1969-2 CB 33.

12. *Robinson-Davis Lumber Co. v. Crooks*, 50 F.2d 638 (1931).

Since it must be determined with reasonable certainty that the bad debt has become worthless, a bad debt deduction is typically not permitted if the creditor voluntarily forgives the debt.

A legal action is not required to establish that a debt is worthless or unrecoverable. Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action would in all probability not result in payment, a showing of these facts and circumstances will be sufficient evidence of the worthlessness of the debt.¹

In determining whether a debt is worthless in whole or in part the IRS will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.²

A taxpayer must make a reasonable inquiry, however, to ascertain whether the debt can be collected before claiming the bad debt deduction.³

Planning Point: The parameters of what constitutes a “reasonable inquiry” into the collectability of a debt have certainly changed since the 1938 court decision establishing that a “reasonable inference from information thus obtainable” satisfies the requirement. In today’s digital age, apparently no less than a comprehensive credit check of the debtor and an assessment of economic conditions affecting the debtor’s industry would likely suffice.

A bad debt deduction is claimed for the tax year in which the taxpayer determines that the debt is worthless, not in the year that the debt actually became worthless.⁴ For example, if a debtor stopped making payments in 2013, but it was not until 2014 that the creditor-taxpayer determined that there was no reasonable chance that the debt would be paid, the bad debt deduction is properly claimed in 2014. A debtor’s declaration of bankruptcy is generally treated as an indication that the debt has become at least partially worthless if the debt is unsecured and not a preferred debt.⁵

If a taxpayer finds that a debt is worthless, but later discovers that he may be able to recover all or a portion of the debt, the bad debt deduction is not invalidated.⁶ Despite this, if a taxpayer has claimed a bad debt deduction, and subsequently finds that some amounts of the debt can be collected, the taxpayer is required to report any amounts collected on the debt as income.⁷

IRC Section 166(b) provides that the allowable deduction cannot exceed the creditor’s basis in the debt as provided under Treasury Regulation Section 1.1011-1 (which outlines the rules for determining adjusted basis for purposes of calculating gain or loss). Though a taxpayer’s basis in a debt may be equal to the face value of the debt, this is not always the case. The regulations identify certain situations where the deduction will not equal the face value of the debt

1. Treas. Reg. §1.166-2(b).

2. Treas. Reg. 1.662-2(a).

3. See *Freeman-Dent-Sullivan Co. v United States*, 21 F. Supp. 972 (1938).

4. See *Courier Journal Job Printing Co. v Glenn*, 37 F. Supp. 55 (1941).

5. Treas. Reg. §1.166-2(c).

6. See *Hamlen v Welch*, 116 F.2d 413 (1940).

7. Treas. Reg. §1.166-1(f).

(for instance, the deduction for worthless receivables is based on the price paid by the purchaser of the receivables and not on their face value).¹

8696. What accounting methods are available for a taxpayer to use in accounting for bad debts?

Because the Tax Reform Act of 1986 repealed the reserve method of accounting for most taxpayers,² all taxpayers, except for certain financial institutions, must use the specific charge-off method in accounting for bad debts. Financial institutions may still be permitted to use the reserve method in accounting for bad debts.

Under the specific charge-off method, the taxpayer deducts amounts that were charged off on its books during the tax year in question. To “charge-off” an item, a taxpayer can use any method that shows the intent to remove the debt as an asset.³ The taxpayer must be the creditor both at the time that the worthlessness was determined *and* at the time the debt was charged-off⁴ (to allow otherwise would permit the taxpayer to claim a deduction for a loss that he did not own).

A debt that is “significantly modified” is deemed charged off.⁵ A *modification* means any alteration of a lender’s or borrower’s legal rights or obligations, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. A modification includes any total or partial deletion or addition to such rights or obligations, but excludes an alteration that occurs by operation of the terms of a debt instrument (i.e., the annual resetting of an interest rate). As a general rule, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.⁶ Treasury Regulation Section 1.1001-3(e)-(f) provides rules for determining when specific modifications are significant.⁷

The taxpayer must file a statement of facts substantiating the deduction along with the tax return containing the claim for the bad debt deduction.⁸

Financial institutions are also entitled to use the reserve method to account for losses resulting from bad debts. Instead of deducting specific bad debts from gross income, a financial institution can choose to deduct a reasonable amount as a reserve for bad debts. An account must be maintained for the bad debt reserves.⁹ The reasonableness of the amount claimed is a question of fact. Factors that are often considered in making the reasonableness determination include the type of business involved and the amount of the bad debt.¹⁰ What is reasonable in one business can vary from that which is reasonable for another business or in a different geographical area.

1. Treas. Reg. §1.166-1(d)(2)(i)(b).

2. P.L. 99-514, §805(a).

3. *Rubinkam v Commissioner*, 118 F.2d 148 (1941).

4. *Wachovia Bank & Trust Co. v United States*, 288 F.2d 750 (1961).

5. Treas. Regs. §§1.166-3(3) and 1.1001-3 (definition of significantly modified debt).

6. Treas. Reg. 1.1001-3(e)(1).

7. Treas. Reg. §1.1001-3(c).

8. Treas. Reg. §1.166-1(b).

9. Treas. Reg. §1.166-4.

10. Treas. Reg. §1.166-4(b).

In using the reserve method, the taxpayer must file a statement of facts in support of the claim for the bad debt deduction. The statement must contain the following information:

- (1) the amount of charge sales or other business transactions for the year and the percentage of the reserve from these sales;
- (2) the total amount of the business' notes and accounts receivable at both the beginning and at the end of the tax year;
- (3) the amount of debts that has become wholly or partially worthless and the amounts charged against the reserve account; and
- (4) how the additional amount to the reserve account was determined.¹

Special rules apply to certain banks claiming bad debt deductions.²

If a claim for a bad debt deduction is disallowed during one tax year, but subsequently the debt actually does become worthless, the taxpayer has seven years to file a claim for refund for the year that the debt actually became worthless.³ This extension applies both to losses claimed under the specific charge-off method and under the reserve method⁴. This extended period does *not* apply to partially worthless debt (see Q 8697).⁵

8697. Is a bad debt deduction permitted when a debt is only partially worthless?

Certain taxpayers are entitled to claim a deduction for business bad debts that become only partially worthless during the tax year.⁶ The allowable deduction cannot exceed the amount of the debt charged-off (see Q 8696) during the tax year.⁷ The taxpayer must be able to clearly show the portion of the debt that has become partially worthless and must also show that the entire debt did not become worthless during the taxable year.

Despite this, a taxpayer is not *required* to charge-off and deduct partially worthless debts each year. Taxpayers are permitted to delay the bad debt deduction until the year in which the debt has become completely worthless.

Planning Point: Though a taxpayer is not required to claim a bad debt deduction in years when the debt is only partially worthless, the taxpayer is not permitted to claim the deduction for tax years beginning after the year in which the debt becomes *completely* worthless.⁸

1. Treas. Reg. §1.166-4(c).

2. Treas. Reg. §1.166-4(d), See Treas. Regs. §§1.585-1 through 1.585-3.

3. IRC Sec. 6511(d)(1).

4. *Smith Elec. Co. v. United States*, 461 F.2d 790 (1972).

5. Treas. Reg. §301.6511(d)-1(c).

6. IRC Sec. 166(a)(2), Treas. Reg. §1.166-3.

7. Treas. Reg. §1.166-3(a)(2)(iii).

8. See IRS Publication 535.

If a taxpayer chooses to claim the deduction for partial worthlessness, the taxpayer's deduction in the year in which the debt becomes completely worthless is limited to the remaining basis in the debt.¹

Not all taxpayers can claim a bad debt deduction if the debt is only partially worthless. IRC Section 166(d)(1) prohibits taxpayers "other than a corporation" from claiming a deduction for partially worthless *nonbusiness* debts.

If a debtor and a creditor reach a compromise agreement pursuant to which the creditor agrees to accept a lesser amount than what is owed, it is arguable that a partially worthless debt would result. However, the IRS has consistently refused to grant a deduction for partially worthless debts resulting from compromise agreements and the courts have agreed with this position.²

8698. Is a bad debt deduction permitted when a loan made between related parties becomes worthless?

A bad debt deduction may still be allowed in situations where the bad debt results from a loan made between related parties. The analysis of whether a worthless loan made between related parties gives rise to an allowable bad debt deduction is not the same as the analysis undertaken under IRC Section 267, however, which disallows certain losses on sales between related parties.³

Intrafamily transactions are subject to rigid scrutiny, and transfers from husband to wife are presumed to be gifts. However, this presumption may be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness.⁴

The relevant inquiry in the bad debt context is whether the transaction was a valid loan or was instead a gift made between related parties. In making the determination, the courts examine all of the relevant facts and circumstances of the specific case.⁵

In connection with this facts and circumstances inquiry, it is important that both parties must intend and agree to treat the transaction as a loan, rather than as a disguised gift. Proper documentation of the transaction, while not strictly required, is helpful in proving the parties' intentions.⁶ Regardless of whether the loan would have been extended had the parties not been related, the deduction should be sustained if, at the time the loan is made, there is a true intention amongst the parties that the debt will eventually be repaid.⁷ See also Treasury Regulation Section 1.262-1(c)(4), which cites the IRC Section 166 bad debt deduction as one deduction that may be allowable despite the personal nature of the transaction.

1. IRC Sec. 166(b) and Treas. Reg. §1.166-3(a)(2)(iii), (b).

2. *Raffold Process Corp. v. Comm.*, 153 F.2d 168 (1946); *Bingham v. Comm.*, 105 F.2d 971 (1939); *Haskel v. Comm.*, TC Memo 1980-243. See *D'Alonzo v. Comm.*, 10 TCM 817 (1951); *Bohn v. Comm.*, 43 BTA 953 (1941).

3. See IRC Sec. 267 (disallowing certain losses on property sales and exchanges between related parties).

4. *Van Anda Est. v. Comm.* (1949), aff'd per curiam, 192 F.2d 391 (2nd Circuit 1951).

5. *Van Anda Est. v. Comm.*, 12 TC 1158, Ibid.; *Mercil v. Comm.*, 24 TC 1150 (1955).

6. *Caligiuri v. Comm.*, 549 F.2d 1155 (8th Cir. 1977), aff'g TC Memo 1975-319. See also *Mellen v. Comm.*, TC Memo 1968-94, and *Cole v. Comm.*, TC Memo 1954-224.

7. *Oatman v. Comm.*, TC Memo 1982-684.

Planning Point: In the context of related-party transactions, it is important to note that the worthless debt will likely be classified as a nonbusiness debt. Completely worthless nonbusiness bad debts can only be claimed as short-term capital losses (see Q 8567).¹

8699. When is a deduction permitted if a taxpayer owns securities that become worthless?

While IRC Section 166 does not apply to worthless securities,² IRC Section 165 allows a deduction for losses incurred based on ownership of securities that have become completely worthless during the year. The term “security” for purposes of IRC Section 165 includes shares of stock, stock rights or evidence of indebtedness issued by a corporation or a government.³ The worthlessness of the security is a question of fact⁴ and the loss will be disallowed unless the taxpayer is able to furnish proof of the original cost of the security.⁵

There are no fixed rules that apply when determining whether a security is completely worthless. The taxpayer is required to make a reasonable inquiry, and what is reasonable here is based on the inquiry that a reasonable person would make in order to determine the worthlessness of the securities.⁶ Worthlessness must be determined objectively.⁷

The securities do not have to be sold to establish worthlessness,⁸ but it is insufficient to show that the securities would have no value if sold.⁹ Diminution in value is also not enough to establish worthlessness.¹⁰

Worthless securities also include securities that the taxpayer abandons after March 12, 2008. To abandon a security, all rights in the security must be permanently surrendered and relinquished and no consideration received in exchange for the security. All the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.¹¹

Instead, the worthlessness of securities is generally established by a showing that an identifiable event (or series of events)¹² occurred, and that it is reasonably certain the event (or events) rendered the securities completely worthless. An identifiable event has been judicially defined as “... an incident or occurrence that points to or indicates a loss—an evidence of a loss. The evidence, though, may vary according to circumstances and conditions.”¹³ The Board of Tax Appeals also defined identifiable events as “... such events as would clearly evidence to the person of average

1. See Form 8949, Sales and Other Dispositions of Capital Assets; see also IRS Publication 550.

2. IRC Secs. 166(e), 165(g)(2)(C), Treas. Reg. §1.166-1(g).

3. IRC Sec. 165(g)(2); Treas. Reg. §1.165-5(a).

4. *Coyle v. Comm.*, 142 F.2d 580 (1944); *Superior Coal Co. v. Comm.*, 145 F.2d 597 (1944).

5. *Jankowsky v. Comm.*, 56 F.2d 1006 (1932).

6. *Green v. Comm.*, 133 F.2d 76 (1943).

7. *Beaudry v. Comm.*, 150 F.2d 20 (1945).

8. *De Loss v. Comm.*, 28 F.2d 803 (1928); *Peyser v. United States*, 58 F Supp 331 (1944); *Moyer v. Comm.*, 35 BTA 1155 (1937).

9. *Bullard v. United States*, 146 F.2d 386 (1944).

10. *Wyoming Inv. Co. v. Comm.*, 70 F.2d 191 (1934).

11. IRS Pub. 550, Investment Income and Expense (2013).

12. *Rosing v. Corwin*, 88 F.2d 415 (1937).

13. *Industrial Rayon Corporation v. Comm.*, 94 F.2d 383 (1938).

intelligence, under the circumstances, that no probability of realization of anything of value from this investment, by sale, liquidation, or otherwise, thereafter existed.”¹ The identifiable event may be an actual cancellation of the debt or it may be an event the applicable entity is required, solely for purposes of reporting to the IRS, to treat as a cancellation of debt.²

8700. Is a loss sustained as a result of worthless securities treated as an ordinary loss or a capital loss?

Generally, securities are classified as capital assets and any loss resulting from their disposal will receive a capital loss treatment.³ As a capital loss, the loss is considered to have occurred on the last day of the taxable year, which may allow the conversion of a loss that otherwise would have been treated as short-term loss into long-term loss (see Q 8567 and Q 8689 for a discussion of capital loss treatment and the holding period requirement).⁴

Despite this, IRC Section 165(g)(3) allows domestic corporate taxpayers to treat losses sustained on worthless securities as ordinary losses if an affiliated corporation issued the securities. An “affiliated corporation” is one that meets the following ownership test:

- (1) the corporate taxpayer owns at least 80 percent of the voting stock and value of the corporation;⁵ and
- (2) more than 90 percent of the affiliated corporation’s aggregate gross receipts for all taxable years has been derived from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock and securities.

If the taxpayer is a bank which directly owns at least 80 percent of the stock of another bank, the stock will not be treated as a capital asset. Hence, any loss incurred on disposition of these stocks will be treated as ordinary loss.⁶

See Q 8701 for the special treatment of losses sustained upon the sale of certain small business stock.

8701. What special rules apply to the deductibility of losses incurred on small business stock?

Generally, shareholders will receive either a capital gain or loss from the sale or disposition of their stock (see Q 8700). However, the taxpayer treats the loss as an ordinary loss if it results from the disposition of certain small business stock under IRC Section 1244.⁷ The loss could either arise from the sale of the small business stock, or from a determination that the stock is worthless. This ordinary loss treatment is applicable for both common and preferred stock.

1. *John H. Watson, Jr.*, 38 BTA 1026 (1938).

2. IRS Pub. 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (2013).

3. IRC 165(g).

4. Treas. Reg. §1.165-5(c).

5. IRC Sec 1504(a)(2).

6. See IRC Secs. 165(m)(1) and 582(b).

7. Treas. Reg. §1.1244(a)-1.

Even though an individual may be entitled to ordinary loss treatment upon the sale of Section 1244 stock, the section does not apply to gains. Therefore, if a taxpayer realizes *gain* on the sale of Section 1244 stock, the gain is treated as a capital gain.

In a taxable year, the maximum amount of ordinary loss that can be claimed by a taxpayer under these provisions is \$50,000 (or \$100,000 for a married couple filing a joint tax return).¹ Any excess is treated as capital loss (see Q 8575 for a detailed explanation of the treatment of capital losses).

Stock in a domestic corporation is considered Section 1244 stock if the following requirements are met:²

- (1) at the time the stock is issued, the corporation was a small business corporation (defined below);
- (2) the stock was issued by the corporation in exchange for money or other property (excluding other stock and securities); and
- (3) the corporation, during its five most recent tax years ending before the date the loss was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.³

A corporation qualifies as a small business corporation if the amount received by the corporation for stock does not exceed \$1 million.⁴

Ordinary loss treatment is permissible if (1) the taxpayer was the shareholder to whom the stock of the small business corporation was issued and (2) the taxpayers are individual taxpayers who are partners in a partnership at the time the partnership acquired stocks in a small business corporation.⁵

Corporations (including S Corporations), trusts, and estates are not entitled to ordinary loss treatment under Section 1244 regardless of how the stock was acquired.⁶ Individual taxpayers, other than the original holders of the stock, are also not entitled to ordinary loss treatment under Section 1244.⁷ Stock is considered to have been issued once it has been fully paid for by the shareholder whether or not a certificate is prepared and delivered to the stockholder.⁸

Small business corporations should maintain adequate records to support any shareholder claims for ordinary loss treatment. The records should be sufficient to show:⁹

1. IRC Secs. 1244(b); 6013.

2. IRC Sec. 1244(c)(1); Treas. Reg. §1.1244(c)-1.

3. See *Snedeker v. Comm.*, TC Memo 1983-675.

4. IRC Sec. 1244(c)(3); Treas. Reg. §1.1244(c)-2.

5. Treas. Reg. §1.1244(a) 1(b).

6. See *Rath v. Comm.*, 101 TC 196 (1993).

7. *Rath v. Comm.*, above.

8. *Oppenheim v. Comm.*, TC Memo 1973-12; *Wesley H. Morgan*, 46 TC 878 (1966).

9. Treas. Reg. §1.1244(e)-1 (a)(2).

- (1) the persons to whom stock was issued, the date of issuance to these persons, and a description of the amount and type of consideration received from each;
- (2) If the consideration received is property, the basis in the hands of the shareholder and the fair market value of the property when received by the corporation;
- (3) The amount of money and the basis in the hands of the corporation of other property received for its stock, as a contribution to capital, and as paid-in surplus;
- (4) Financial statements of the corporation, such as its income tax returns, that identify the source of the gross receipts of the corporation for the period consisting of the five most recent taxable years of the corporation, or, if the corporation has not been in existence for five taxable years, for the period of the corporation's existence; and
- (5) Information relating to any tax-free stock dividend made with respect to Section 1244 stock and any reorganization in which stock is transferred by the corporation in exchange for Section 1244 stock.

In addition, a person who owns Section 1244 stock in a corporation must maintain records sufficient to distinguish such stock from any other stock he or she may own in the corporation.¹

1. Treas. Reg. 1244(e)-1(b).

PART X: BUSINESS LIFE INSURANCE

8702. What is business life insurance?

As the name suggests, business life insurance is life insurance that is owned by a business, regardless of whether the business is organized as a sole proprietorship, partnership, or corporation. The insurance can serve a number of different purposes.

For example, business life insurance is often used to insure the life of a key employee, in order to mitigate the negative impact that the employee's death would have on the business. Business life insurance is also commonly used in the context of a buy-sell agreement, where the business is obligated to purchase the ownership interest of an owner who dies. The insurance also could be used to fund a non-qualified retirement package for a single employee or a number of employees.

8703. What is the income tax treatment to the insured of the premiums paid on business life insurance?

If the life insurance policy at issue is purchased for the benefit of the business and the insured has no ownership interest in the policy, the premiums generally are not taxable to the insured. Thus, premiums paid on key person life insurance, where an employer is both owner and beneficiary of the policy, are not taxable to the insured employee.¹

If life insurance premiums are paid by an employer on a policy insuring the life of an employee and the proceeds are payable to the employee's beneficiary, there generally is some taxable income to the employee.

8704. What rules govern the deductibility of payment of the premiums on business life insurance?

Life insurance premiums generally are not deductible if the premium payer has any interest in the policy or proceeds.

Under IRC Section 264(a)(1), no deduction is allowed for premiums paid on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract. Where Section 264(a)(1) applies, the premiums are not deductible even though they otherwise would be deductible as ordinary and necessary business expenses.²

The rule under Section 264(a)(1) is an all or nothing rule, meaning that the entire premium will be nondeductible even though a premium payer has a right to receive only a portion of the proceeds. The deduction cannot be divided, and will either be allowed or disallowed in its entirety.³ The rule under Section 264(a)(1) applies regardless of the form

1. *Casale v. Comm.*, 247 F.2d 440 (2d Cir. 1957); *Lacey v. Comm.*, 41 TC 329 (1963), *acq.* 1964-2 CB 6; Rev. Rul. 59-184, 1959-1 CB 65.

2. Treas. Reg. §1.264-1(a).

3. Rev. Rul. 66-203, 1966-2 CB 104.

of insurance, so it makes no difference whether premiums are paid on term, ordinary life, or endowment policies.

Section 264(a)(1) clearly prohibits the deduction for premiums paid where a taxpayer is the premium payer and is also designated as the policy beneficiary. For example, premiums paid on key person insurance, where an employer normally is both owner (and premium payer) and beneficiary of a policy, are nondeductible under IRC Section 264(a)(1).

The deduction is also denied under Section 264(a)(1) where a premium payer is only indirectly a beneficiary under a policy. Thus, the deduction will be denied where a taxpayer, even though not a named beneficiary, has some beneficial interest in a policy, such as the right to change the beneficiary, to make loans, to surrender the policy for cash, or to draw against proceeds held in trust for the insured's spouse.¹

An employer is permitted to deduct premiums paid on insurance covering the life of an employee if the employer is not directly or indirectly a beneficiary under the policy and the premiums represent additional reasonable compensation for services rendered by the employee. Thus, if an employer has no ownership rights or beneficial interest in a policy and proceeds are payable to an employee's estate or personal beneficiary, the employer may ordinarily deduct the premiums as additional compensation paid to the employee.² The deduction will not be denied merely because an employer may derive some indirect benefit, such as from the increased efficiency of the employee.³

8705. Can a corporation deduct the premiums it pays on a life insurance policy insuring the life of an employee or stockholder?

Based on the IRC Section 264(a)(1) prohibition, a corporation is not permitted to deduct the premiums it pays on a policy insuring the lives of its employee or stockholder if it either is directly or indirectly a beneficiary under the policy. The deduction is denied even if the corporation has only a partial beneficial interest in a policy.⁴

A corporation cannot deduct premiums it pays on key person insurance or on a policy insuring the life of a stockholder purchased to fund the corporation's redemption of the insured's stock. Normally, in these instances, the corporation is both owner and beneficiary of a policy, so a deduction is not allowed by reason of IRC Section 264(a)(1). If the policy proceeds are to be used to pay for stock that is to be surrendered to the corporation, that corporation cannot deduct the premiums even though it may have no right to the cash value of a policy and no right to name or change the beneficiary. In this case, the deduction is not allowed because the premium payments are treated as capital expenditures, rather than ordinary and necessary business expenses, because they are payments for the acquisition of a corporate asset: treasury stock.⁵

1. Rev. Rul. 70-148, 1970-1 CB 60; Rev. Rul. 66-203, *supra*.

2. IRC Sec. 162(a); Treas. Reg. §1.162-7.

3. Treas. Reg. §1.264-1(b).

4. *National Indus. Investors, Inc. v. Comm.*, TC Memo 1996-151.

5. Rev. Rul. 70-117, 1970-1 CB 30; Rev. Rul. 74-503, 1974-2 CB 117.

Conversely, if a corporation purchases life insurance for an employee and the corporation has no ownership rights or beneficial interest in the policy, premiums are ordinarily deductible as additional compensation for the employee's services.¹

To be deductible, however, the premium payments must represent *reasonable* compensation.² The question of whether compensation is reasonable often arises in the case of a stockholder-employee of a closely-held corporation. If the total amount paid to and on behalf of a stockholder-employee is found to represent an unreasonable return for services, the IRS may treat the premium payments as a distribution of profits or dividends rather than as compensation. This also may be the result where the corporation has kept insufficient records so that there is no evidence, such as board of directors' minutes, to show that premium payments were intended as compensation.³

If the surrounding circumstances are sufficient to show that the premiums were not paid as compensation, the deduction will be disallowed. In *Atlas Heating & Ventilating Co. v. Comm.*,⁴ for example, evidence showed that premiums actually were paid to fund a stock purchase agreement between individual stockholders. Consequently, the premiums were not compensation, but dividends. The policies were owned by the stockholder-employees and proceeds were payable to their personal beneficiaries. The insured individuals had agreed that, on each of their deaths, an amount of stock equal to the proceeds received by the deceased insured's beneficiaries would be turned in to the corporation and then distributed pro rata to the surviving stockholders.

For a discussion of the treatment of premiums paid by an S corporation on behalf of its shareholders or employees, see Q 8710.

8706. When a corporation owns a life insurance policy insuring the life of a key employee, are the premiums paid by the corporation taxable to the key employee?

No.⁵ In *Casale v. Comm.*, the insured was president of the corporation and owned 98 percent of its stock. The corporation was both owner and beneficiary of a retirement income contract on the insured's life, which the corporation had purchased to hedge its obligation to the insured under a deferred compensation agreement. The Tax Court required the insured to include premiums paid by the corporation in his income. The Second Circuit reversed the Tax Court opinion, however, on the grounds that the corporation's separate entity could not be ignored and that the insured had received no current economic benefit that would constitute taxable income.

However, see *Goldsmith v. U.S.*, where the taxpayer, an independent contractor, was required to include the death and disability insurance features of a deferred compensation agreement in his income based on the court's finding that (a) those features conferred a current economic

1. IRC Sec. 162(a).

2. Treas. Reg. §1.162-7.

3. *Boecking v. Comm.*, TC Memo 1993-497; *Est. of Worster v. Comm.*, TC Memo 1984-123; *Champion Trophy Mfg. Corp. v. Comm.*, TC Memo 1972-250.

4. 18 BTA 389 (1929).

5. *Casale v. Comm.*, 247 F.2d 440 (2d Cir. 1957); Rev. Rul. 59-184, 1959-1 CB 65.

benefit on the taxpayer and (b) the current economic benefit of the insurance components were capable of valuation.¹

The IRS, however, has agreed to follow the Second Circuit's decision as precedent in dealing with similar cases.²

8707. Are premiums paid by a corporation on life insurance to fund a stock redemption agreement taxable to an insured stockholder?

No. Even if the stockholder has the right to designate the policy beneficiary, the premiums are not income to the stockholder, provided that the beneficiary's right to receive the proceeds is conditioned on the transfer of stock to the corporation.³

Similarly, premiums are not taxable income to an insured stockholder when a trustee is named beneficiary, provided that the trustee is obligated to use the proceeds to purchase the insured's stock for transfer to the corporation.⁴

8708. Are life insurance premiums paid by an employer taxable income to an insured employee if the proceeds are payable to the employee's estate or personal beneficiary and the policy is owned by the employee?

Yes.⁵ However, if dividends are applied to reduce current premiums, only the net premium must be included in the employee's taxable income.⁶

The premium payments are generally treated as additional compensation paid to the employee and are, therefore, deductible by the employer. However, if the employer is a closely-held corporation and the employee a stockholder, the IRS may challenge the arrangement on the grounds that the premiums are disguised dividends taxable to the insured, but not deductible by the corporation (See Q 8704).

Even where an insured employee and owner of the corporation was not the owner of the policy, but the employee's son or spouse was owner and beneficiary, payment of premiums on the policy was found to confer an economic benefit to the employee and, as such, was includable in the employee's gross income.⁷

Where a stockholder-employee argued that premiums paid by the corporation on the employee's personal insurance were merely loans, the premiums were treated as taxable dividends. This will be the result unless the employee can produce evidence to show that the employee intended to reimburse the corporation for the premium payments.⁸

1. 41 AFTR 2d 978 (Ct. Cl. 1978).

2. Rev. Rul. 59-184, *supra*. See also: *U.S. v. Leuschner*, 11 AFTR 2d 782 (S.D. Cal. 1962); *Lacey v. Comm.*, 41 TC 329 (1963), *acq.*, 1964-2 CB 6.

3. *Sanders v. Fox*, 253 F.2d 855 (10th Cir. 1958); *Prunier v. Comm.*, 248 F.2d 818 (1st Cir. 1957); Rev. Rul. 59-184, 1959-1 CB 65.

4. Rev. Rul. 70-117, 1970-1 CB 30.

5. Treas. Reg. §1.61-2(d)(2)(ii)(A); *Canaday v. Guitteau*, 86 F.2d 303 (6th Cir. 1936); *Yuengling v. Comm.*, 69 F.2d 971 (3rd Cir. 1934).

6. *Weeks v. Comm.*, 16 TC 248 (1951); *Sturgis v. Comm.*, TC Memo 1951, 10 TCM (CCH) 136.

7. *Brock v. Comm.*, TC Memo 1982-335; *Champion Trophy Mfg. Corp. v. Comm.*, TC Memo 1972-250; see IRC Sec. 301(c).

8. *Schwartz v. Comm.*, TC Memo 1963-340; *Jameson v. Comm.*, TC Memo 1942.

8709. Are life insurance premiums paid by an employer taxable income to an insured employee if the proceeds are payable to the employee's estate or personal beneficiary and the corporation owns the policy?

The tax results of an arrangement whereby an employer pays the premiums on a policy insuring the life of an employee are uncertain when the corporation owns the policy, unless the insured is a stockholder and the insurance is to be used to fund an agreement for the purchase of the insured's stock. The regulations provide: "Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee."¹ This suggests that the entire premium is taxable to the employee.

However, the final regulations associated with the taxation of split dollar life insurance arrangements indicate that where an employer pays all or any portion of the premiums on a life insurance contract insuring the employee and the beneficiary of all or a portion of the death benefit is designated by the employee or is any person whom the employee would reasonably be expected to designate as the beneficiary, the employee must include the amount of the "economic benefit" associated with the life insurance coverage provided in the employee's income.² This economic benefit generally will be the cost of current life insurance provided to the employee as calculated using Table 2001 rates or using a carrier's alternative term rates.³ The split dollar regulations are effective for split dollar arrangements entered into (or contracts that are materially modified) after September 17, 2003.⁴

8710. How are life insurance policy premiums paid by an S corporation to insure a shareholder or employee taxed?

An S corporation generally does not pay taxes at the entity level. Instead, items of income, deduction, loss, and credit are passed through to shareholders and taxes are calculated at the individual level. Payment of premiums by an S corporation should be characterized as a non-deductible expense, as deductible compensation, or as a nondeductible distribution of profits under the same general rules applicable to regular (C) corporations. However, the resulting tax treatment of the shareholders would differ in some instances.

If the premium payment is treated as a nondeductible expense, as it would be if a corporation were both owner and beneficiary of a key person policy, shareholders will be required to reduce the basis in their shares by their proportionate portion of the nondeductible expense.⁵

If particular premium payments are treated as employee compensation, such as in a case where an employee owns a policy or has a beneficial interest in it, the amount of compensation would be deductible in determining the S corporation's income or loss that is reported pro

1. Treas. Reg. §1.61-2(d)(2)(ii)(A).

2. Treas. Regs. §§1.61-22(b)(2)(ii); 1.61-22(d).

3. Treas. Reg. §1.61-22(d)(2)(i); Notice 2002-8, 2002-1 CB 398.

4. Treas. Reg. §1.61-22(j).

5. IRC Sec. 1367(a)(2)(D).

rata by each shareholder. The amount of compensation then must be included in income by the insured employee.¹

When a premium payment is found to be a distribution with respect to stock to an individual shareholder, the tax treatment depends on whether the corporation has accumulated earnings and profits. If a corporation has no accumulated earnings and profits, the payment is treated first as a return of investment and then as capital gain. If a corporation has accumulated earnings and profits, part of the distribution might be treated as a dividend.² For example, an S corporation may have accumulated earnings and profits from years when it was a C corporation or as the result of a corporate acquisition.

The IRS has provided guidance on the effects of premiums paid by an S corporation on an employer-owned life insurance (EOLI) contract (See Q 8716) and the benefits received by reason of death of the insured on its accumulated adjustments account (AAA) under IRC Section 1368. The IRS ruled that premiums paid by an S corporation on an EOLI contract when the S corporation is directly or indirectly a beneficiary do not reduce the S corporation's AAA. Further, it ruled that benefits received by reason of the death of the insured from an EOLI contract that meets an exception under IRC Section 101(j)(2) do not increase the S corporation's AAA.³

8711. Are life insurance policy premiums deductible if paid by a partnership or an individual partner on the life of a copartner?

No. This is true regardless of who is named as policy beneficiary. Premiums paid for any life insurance, or endowment or annuity contract, are not deductible if a taxpayer is directly or indirectly a beneficiary under the policy or contract.⁴ The premium paying partner will derive a benefit from the policy even if the insurance is purchased as a key person policy or to finance the purchase of an insured's partnership interest.⁵

The general rules governing the deductibility of life insurance premiums (see Q 8704) apply in the case of insurance purchased by a partnership on the life of an employee who is not a partner.

8712. Are life insurance premiums paid by a partner for insurance on the partner's own life deductible by the partner if the proceeds are payable to a partnership or to a copartner?

No, because of the general rule that premiums paid on any life insurance policy, or endowment or annuity contract, are not deductible if a taxpayer is directly or indirectly a beneficiary under the policy or contract.⁶ When a policy is purchased as key person insurance or to finance the purchase of an insured's partnership interest, the insured's estate and, therefore, the insured, will benefit from the policy.

1. IRC Secs. 1363, 1366.

2. IRC Sec. 1368.

3. Rev. Rul. 2008-42, 2008-30 IRB 175.

4. IRC Sec. 264(a)(1).

5. Treas. Reg. §1.264-1.

6. IRC Sec. 264(a)(1).

Even if a partner takes out insurance on the partner's own life and irrevocably designates a copartner as beneficiary to induce the copartner to leave the copartner's investment in the firm, the insured partner is *indirectly* a beneficiary under the policy, and so the premiums cannot be deducted.¹

8713. Can a sole proprietor deduct life insurance premiums paid for insurance on the sole proprietor's own life?

No. This is true regardless of who is beneficiary under the policy. In the case of a sole proprietorship, premium payments are treated as nondeductible personal expenses because a sole proprietor and the business are considered one and the same for tax purposes.²

The general rules governing the deductibility of life insurance premiums (see Q 8704) apply in the case of insurance purchased by a sole proprietor on the life of an employee.

8714. Can an employee of a sole proprietor deduct life insurance premiums the sole proprietor pays to insure the life of the sole proprietor?

No. The premiums are nondeductible because they either are personal expenses or expenses allocable to tax-exempt income (the death proceeds).³

8715. Are death proceeds of business life insurance exempt from income tax? Could receipt of tax-exempt income from insurance proceeds reduce an otherwise tax-deductible capital loss?

The general rules applicable to life insurance contracts also apply in the case of business life insurance. As such, the entire lump sum payable at an insured's death is exempt from regularly calculated income tax regardless of whether the beneficiary is an individual, a corporation, a partnership, a trust, or the insured's estate.⁴

See Q 8716 for rules pertaining to employer-owned life insurance contracts issued after August 17, 2006.

A portion of the death proceeds may be taxable if the proceeds are paid out under a life income or other installment option. In this case, the amount payable at death may be prorated and recovered from the payments in equal tax-free amounts over the payment period, but the interest earned on the proceeds over the distribution period is taxable.

Proceeds received by a partnership or by an S corporation retain their tax-exempt character when passed on to individual partners or shareholders. Proceeds received tax-free by a regular (C) corporation are, when paid out, usually taxable to the recipients as compensation or dividends.

Despite the general rule, there are some circumstances where death proceeds paid out in a lump sum are not wholly tax-exempt. For example, the IRC expressly provides that proceeds

1. Treas. Reg. §1.264-1.

2. IRC Sec. 262(a); Treas. Reg. §1.262-1(b)(1).

3. IRC Secs. 262(a), 265(a)(1); see *Whitaker v. Comm.*, 34 TC 106 (1960).

4. IRC Sec. 101(a); Treas. Reg. §1.101-1(a).

are taxable, under some circumstances, where a policy has previously been sold or otherwise transferred for a valuable consideration (see Q 8717 to Q 8720).

Under Section 101(a), in the case of proceeds payable under qualified pension or profit sharing plans, only the amount in excess of the cash surrender value is tax-exempt. The same rule applies to proceeds received under a tax sheltered annuity and proceeds received under individual retirement endowment contracts.

In some cases, the exemption may not be available because proceeds are not considered to be received as life insurance proceeds. These include proceeds that are taxable as dividends or compensation, proceeds that are taxable because of lack of insurable interest, proceeds taxable as a return of embezzled funds, and proceeds of creditor insurance.

Where liquidation of a business after a partner's death resulted in a loss, but life insurance on that partner had been purchased by the other partner for the purpose of protecting his capital investment in the business, the court ruled that because the loss was compensated for by insurance, it was not deductible. IRC Section 165(a) provides that "[t]here shall be allowed as a deduction any loss sustained during the taxable year *and not compensated for by insurance or otherwise*" (emphasis added).¹

8716. For employer-owned life insurance contracts issued after August 17, 2006, are there any special requirements that must be met in order for the proceeds to be exempt from income tax?

An employer-owned life insurance contract is defined as a life insurance contract owned by a person or entity engaged in a trade or business under which that person or entity, or certain related persons, is a beneficiary under the contract, if the contract covers the life of an insured who is an employee when the contract is issued.² For life insurance contracts entered into after August 17, 2006, certain requirements must be met for death proceeds of an employer-owned life insurance contract to be received income-tax free.

First, before an employer-owned life insurance contract is issued, the employer must meet the following notice and consent requirements:

- (1) The employer must notify the insured employee in writing that the employer intends to insure the employee's life;
- (2) The employer must provide notice of the maximum face amount the employee's life could be insured for at the time the contract is issued;
- (3) The employer must state that the policy owner will be the beneficiary of the death proceeds of the policy; and
- (4) The insured also must give written consent to be the insured under the contract and consent to coverage continuing after the insured terminates employment.³

1. *Johnson v. Comm.*, 66 TC 897 (1976), *aff'd*, 78-1 USTC ¶9367 (4th Cir. 1978).

2. IRC Sec. 101(j)(3)(A).

3. IRC Sec. 101(j)(4).

Another set of requirements relates to an insured's status with an employer. The insured must have been (i) an employee at any time during the twelve month period before his or her death, or (ii) a director or highly compensated employee at the time the contract was issued. A "highly compensated employee" is one who is classified as highly compensated under the qualified plan rules of IRC Section 414(q) (except for the election regarding the top paid group), or under rules regarding self-insured medical expense reimbursement plans of IRC Section 105(h), except that the highest paid 35 percent instead of 25 percent will be considered highly compensated.¹

In the alternative, death proceeds of employer-owned life insurance will not be included in an employer's income, assuming the notice and consent requirements are met, if the proceeds are paid to any of the following:

- (1) A member of an insured's family, defined as a sibling, spouse, ancestor, or lineal descendent;
- (2) Any individual who is the designated beneficiary of the insured under the contract (other than the policy owner);
- (3) A trust that benefits a member of the family or designated beneficiary; or
- (4) The estate of the insured.

Additionally, the proceeds will not be included in an employer's income if death proceeds are used to purchase an equity interest from a family member, beneficiary, trust, or estate.² The Pension Protection Act of 2006 ("PPA 2006") also imposes new reporting requirements on all employers owning one or more employer-owned life insurance contracts. Final reporting regulations were issued in November 2008.³

Further, the IRS released Notice 2009-48, which provides guidance on certain issues that may arise when dealing with employer-owned life insurance contracts with respect to IRC Section 101(j)'s notice and consent requirements and IRC Section 6039I's information reporting requirements. The guidance, which is presented in a question-and-answer format, is effective June 15, 2009, but the IRS has announced that it will not challenge a taxpayer who made a good faith effort to comply with IRC Section 101(j) based on a reasonable "interpretation of the provision before that date."

Reporting Requirements

All employers who own one or more life insurance contracts on the life of any employee that are considered employer-owned contracts under IRC 101(j) must file with the IRS an informational return, which includes the following information:

- (1) The number of employees of the "applicable policy holder" (e.g. the employer) at the end of the year;

1. IRC Sec. 101(j)(2)(A).

2. IRC Sec. 101(j)(2)(B).

3. IRC Sec. 6039I; Treas. Reg. §1.6093I-1.

- (2) The number of employees insured by employer-owned contracts at the end of the year;
- (3) The total amount of insurance in force at the end of the year under such contracts,
- (4) The name, address, and taxpayer ID number for the applicable policyholder and the type of business in which the policyholder is engaged; and
- (5) That the applicable policyholder has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained).¹

These reporting requirements became effective for tax years ending after November 6, 2008. To comply with the reporting requirements, the applicable policyholder must provide the requested information by attaching Form 8925 to the policyholder's income tax return by the due date of that return.²

8717. When will the sale of a life insurance policy cause the loss of the income tax exemption for death proceeds? What is the transfer for value rule?

Under IRC Section 101(a)(2), if a life insurance policy or any interest in a policy is transferred for a valuable consideration, the death proceeds generally will be exempt only to the extent of the consideration paid by the transferee and net premiums, if any, paid by the transferee after the transfer. Any interest paid or accrued by the transferee on indebtedness with respect to the policy is added to the exempt amount if the interest is not deductible under IRC Section 264(a)(4).³ This provision regarding interest paid or accrued applies to contracts issued after June 8, 1997. Further, for purposes of this provision, any material increase in a death benefit or other material change in a contract shall be treated as a new contract with certain limited exceptions.⁴

After subtracting the permissible exclusions outlined above, the balance of the death proceeds is taxable as ordinary income. This is known as the "transfer for value rule." If a sale or other transfer for value comes within any of the following exceptions to the transfer for value rule, the exemption is available despite the sale or other transfer for value:

- (1) The sale or other transfer for value is to the insured individual;⁵
- (2) The sale or other transfer for value is to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is an officer or shareholder.⁶ Members of a limited liability company ("LLC") taxed as a partnership are considered to be partners for this purpose;⁷ or

1. IRC Sec. 6093I; Treas. Reg. §1.6093I-1.

2. Treas. Reg. §1.6093I-1.

3. IRC Sec. 101(a)(2).

4. TRA '97, Sec. 1084(d).

5. IRC Sec. 101(a)(2)(B).

6. IRC Sec. 101(a)(2)(B).

7. Let. Rul. 9625013.

- (3) If the basis for determining gain or loss in the hands of the transferee is determined in whole or in part by reference to the basis of the transferor. This occurs, for example, where a policy is transferred from one corporation to another in a tax-free reorganization, where a policy is transferred between spouses, or where a policy is acquired in part by gift.¹

See Q 8718 for a more thorough discussion of when a life insurance policy is considered to have been transferred for value. See Q 8719 for a more thorough discussion of the exceptions to the transfer for value rule.

8718. When is a life insurance policy transferred for value?

A “transfer for value” occurs upon any transfer for a valuable consideration of a right to receive all or part of the proceeds of a life insurance policy. As such, the transfer for value rule extends far beyond straightforward sales of policies. The naming of a beneficiary in exchange for any kind of valuable consideration would constitute a transfer for value of an interest in the policy. Even the creation by a separate contract of a right to receive all or part of the proceeds would constitute a transfer for value.²

On the other hand, a transfer for value does not occur upon a mere pledging or assignment of a policy as collateral security.³

A corporation’s transfer of a policy to a stockholder as a distribution in liquidation is a transfer for value.⁴ A transfer for value can occur even though the policy transferred has no cash surrender value.⁵ Even if there is no actual purchase price that is paid for the policy or interest in the policy, a transfer will be considered a transfer for value, provided the transferor receives some other valuable consideration.⁶

In one case, two policies were purchased on the life of an officer-stockholder, one by the insured and the other by the corporation. Subsequently, the insured entered into an agreement with two employees for the purchase of his stock at his death. The policies were transferred to a trustee for use in partially financing the agreement and the employees took over the payment of premiums. Upon the insured’s death, the proceeds were applied to the purchase of his stock. The court held that the employees were transferees for value even though they had paid no purchase price for the policies. Their agreement to make premium payments and to purchase the stock constituted a valuable consideration. As a result, the employees were taxed on the difference between the premiums they had paid and the proceeds applied toward their purchase of the insured’s stock.⁷

1. IRC Sec. 101(a)(2)(A); Rev. Rul. 69-187, 1969-1 CB 45; Let. Rul. 8951056.

2. Treas. Reg. §1.101-1(b)(4).

3. Treas. Reg. §1.101-1(b)(4).

4. *Lambeth v. Comm.*, 38 BTA 351 (1938).

5. *James F. Waters, Inc. v. Comm.*, 160 F.2d 596 (9th Cir. 1947).

6. *Monroe v. Patterson*, 8 AFTR 2d 5142 (N.D. Ala. 1961).

7. *Monroe v. Patterson*, *supra*.

A transfer for value occurred where two shareholders assigned to each other existing policies that had no cash values on their own lives to fund a cross-purchase agreement.¹

Similarly, where a partnership named two partners as cross-beneficiaries on policies owned by the partnership, a transfer for value was found.² In that case, however, an exception to the transfer for value rule was present (i.e. the partnership exception) to exclude insurance proceeds from gross income.

On the other hand, if a transferor receives no valuable consideration whatsoever, there is no transfer for value.³

Because a transfer of a policy subject to a nonrecourse loan discharges the transferor of his or her obligation under the loan, the transferor is treated as receiving an amount equal to the discharged obligation.⁴ Thus, there may be a transfer for value when a life insurance contract that is subject to a policy loan is transferred. Nonetheless, where the value of a policy exceeded the outstanding loan, a transfer was ruled in part a gift and within one of the exceptions to the transfer for value rule because the basis of the policy in the hands of the transferee was, in part, determined by reference to the basis of the policy in the hands of the transferor.⁵

The IRS has ruled that the gratuitous transfer of a policy subject to a nonrecourse loan was partially a gift and partially a sale. Because the transferor's basis was greater than the amount of the loan, the basis of the policy in the hands of the transferee was the basis in the hands of the transferor at the time of transfer. As a result, the transfer fell within the same exception to the transfer for value rule.⁶

The transfer of a policy to a grantor trust treated as owned by the transferor was not a transfer for value where the insured individuals, terms, conditions, benefits, and beneficial interests other than naming the trustee as beneficiary and nominal owner did not change.⁷

The transfer of a life insurance policy from one grantor trust to another grantor trust, where both trusts were treated as owned by the same taxpayer, will not be treated as a transfer for value.⁸

The replacement of a jointly owned policy with two separately owned policies is also not a transfer for value.⁹

1. Let. Rul. 7734048.

2. Let. Rul. 9012063.

3. *Haverty Realty & Investment Co. v. Comm.*, 3 TC 161 (1944).

4. Treas. Reg. §1.1001-2(a).

5. Rev. Rul. 69-187, 1969-1 CB 45.

6. Let. Rul. 8951056. But see Let. Rul. 8628007.

7. Let. Rul. 9041052.

8. Rev. Rul. 2007-13, 2007-11 IRB 684.

9. Let. Rul. 9852041.

8719. What are the exceptions to the transfer for value rule that will permit a policy to be sold or otherwise transferred for value without the loss of the income tax exemption for death proceeds?

Several exceptions exist to allow proceeds of a life insurance contract to maintain their tax-exempt status even if there has been a transfer for value. If a sale or other transfer for value comes within any of the following exceptions to the transfer for value rule, the exemption from gross income is available despite the sale or other transfer for value:

- (1) The sale or other transfer for value is to the insured individual;¹
- (2) The sale or other transfer for value is to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is an officer or shareholder.² Members of a limited liability company (“LLC”) taxed as a partnership are considered to be partners for this purpose;³ or
- (3) If the basis for determining gain or loss in the hands of the transferee is determined in whole or in part by reference to the basis of the transferor. This occurs, for example, where a policy is transferred from one corporation to another in a tax-free reorganization, where a policy is transferred between spouses, or where a policy is acquired in part by gift.⁴

For example, if a corporation purchases a policy insuring a key person and later sells it to the insured, the proceeds will be received wholly tax-exempt by the beneficiary despite the sale to the insured.⁵

Moreover, a transfer to a trust that is treated as owned wholly or in part by the insured comes within the exception as a transfer to the insured to the extent the insured is treated as owner.⁶ An individual is treated as owner of a trust where the individual retains control over property the individual has transferred to the trust so that the income on that property is taxable to the individual under IRC Sections 671-679.

Where a policy is transferred more than once but the last transfer, or the last transfer for value, is to the insured, a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer, the proceeds will be wholly tax-exempt regardless of any previous sale or other transfer for value.⁷ If the insured transfers the policy for a valuable consideration, and the transfer does not come within any of the exceptions to the transfer for value rule, the proceeds again will lose their tax-exempt status.

1. IRC Sec. 101(a)(2)(B).

2. IRC Sec. 101(a)(2)(B).

3. Let. Rul. 9625013.

4. IRC Secs. 101(a)(2)(A); 1041; Rev. Rul. 69-187, 1969-1 CB 45; Let. Rul. 8951056.

5. See Let. Rul. 8906034.

6. Rev. Rul. 2007-13; *Swanson v. Comm.*, 75-2 USTC ¶9528 (8th Cir. 1975).

7. Treas. Reg. §1.101-1(b)(3)(ii).

Example: X Corporation purchases an insurance policy for a single premium of \$500 with a face amount of \$1,000 upon the life of A, one of its employees, naming the X Corporation as beneficiary. The X Corporation transfers the policy to the Y Corporation in a tax-free reorganization (the policy having a basis for determining gain or loss in the hands of the Y Corporation determined by reference to its basis in the hands of the X Corporation). The Y Corporation later transfers the policy to the Z Corporation for \$600. The Z Corporation receives the proceeds of \$1,000 upon the death of A. The amount which the Z Corporation can exclude from its gross income is limited to \$600 plus any premiums paid by the Z Corporation subsequent to the transfer of the policy to it.

If Z Corporation, however, before A's death, transfers the policy to the N Corporation, in which A is a shareholder, the N Corporation would receive the \$1,000 proceeds upon A's death free from income taxes.¹

8720. If an employer (or the employer's qualified plan) sells or distributes a policy that insures an employee's life to the insured's spouse or other family member, will the transfer cause the loss of the income tax exemption for death proceeds?

Yes, generally, unless the transferee is a partner of the insured. The exceptions to the transfer for value rule will not exempt this type of transaction from the general rule. Therefore, if a sale is involved, the death proceeds will be taxable to the extent that they exceed the consideration paid by the purchaser plus net premiums, if any, paid after the sale. Any interest paid or accrued by the transferee on policy indebtedness may be added to the exempt amount under certain circumstances.

Even if a spouse or family member pays nothing for a policy, a transfer may be considered a transfer for value based on the idea that the employee's past or promised future services constituted a valuable consideration for the transfer. The proceeds then probably would be taxable to the extent that they exceed the value of the contract at the time of transfer plus any subsequent premium payments and certain policy indebtedness.

The transfer for value rule would not cause taxation of the proceeds of a policy that is (i) transferred to an insured, followed by a gift from the insured to the insured's spouse or family member, or (ii) a sale to the insured's spouse after July 18, 1984.² A federal appeals court refused to treat a direct transfer by an employer to the wife of an insured employee for a consideration as two transfers merged into one: a transfer to the insured employee and then a gift from him to his wife.³

8721. What is a Section 79 plan?

IRC Section 79 allows an employer to provide up to \$50,000 of tax-free group-term life insurance coverage to each of its employees.⁴ More specifically, the employee may exclude the value of the group-term life insurance that does not exceed the sum of (a) \$50,000 and (b) any amount paid by the employee toward the purchase of the insurance.⁵

1. Treas. Reg. §1.101-1(b)(5), Examples (3) and (5).

2. IRC Sec. 1041.

3. *Est. of Rathb v. U.S.*, 79-2 USTC ¶9654 (6th Cir. 1979).

4. IRC Sec. 79(a)(1).

5. IRC Sec. 79(a).

Group-term life insurance that is excludable under Section 79 can also be offered through a cafeteria plan (see Q 8787).¹

See Q 8722 for a discussion of how it is determined whether the value of the insurance exceeds the \$50,000 limit and Q 8723 for a discussion of situations in which the \$50,000 limit may not apply. See Q 8724 for the nondiscrimination requirements applicable to Section 79 plans.

8722. How is it determined whether the cost of group-term life insurance provided under a Section 79 plan exceeds the \$50,000 excludable limit?

The cost of up to \$50,000 of group-term life insurance coverage generally is tax-exempt under IRC Section 79 (see Q 8721). The cost of coverage in excess of \$50,000 is taxable to the employee in most situations (see Q 8723 for a discussion of the exceptions).

In calculating the cost of coverage, an employee who has more than one employer must combine all group-term coverage and is entitled to exclude only \$50,000 of the combined coverage. If an employee contributes toward the cost of the insurance, all of the employee's contribution for coverage will be subtracted from the amount that would otherwise be taxable.² The employee cannot carry over any unused portion of his or her contributions from year to year.

The taxable cost of coverage in excess of \$50,000, must be calculated on a monthly basis. The steps are as follows:

- (1) Determine the total amount of group-term life insurance coverage for the employee in each calendar month of the employee's taxable year, and if a change occurs during any month, take the average at the beginning and end of the month;
- (2) subtract \$50,000 from each month's coverage;
- (3) apply the appropriate rate from the applicable tables of monthly premium rates (reproduced below) to the balance, if any, for each month;
- (4) subtract total employee contributions for the year, if any, from the sum of the monthly costs.³

The cost is determined on the basis of the life insurance protection provided to an employee during the employee's tax year, without regard to when the premiums are paid by an employer. The rates in the table provided immediately below should be used to compute the cost of excess group-term life insurance coverage.⁴

1. Prop. Treas. Reg. §1.125-1(k).

2. IRC Sec. 79.

3. Treas. Reg. §1.79-3.

4. Treas. Reg. §1.79-3(d)(2).

*Uniform Premiums for \$1,000 of Group-Term Life Insurance Protection**
 Rates Applicable to Cost of Group-Term Life Insurance Provided
 After June 30, 1999

5-Year Age Bracket	Cost per \$1,000 of Protection for One-Month Period
Under 25	\$0.05
25 to 29	.06
30 to 34	.08
35 to 39	.09
40 to 44	.10
45 to 49	.15
50 to 54	.23
55 to 59	.43
60 to 64	.66
65 to 69	1.27
70 and above	2.06

*In using the above table, the age of the employee is the employee's attained age on the last day of the employee's taxable year.

8723. Are there any exceptions to the general rule that an employee may only exclude the first \$50,000 of group-term life insurance provided under a Section 79 plan?

Yes. There are certain exceptions to the \$50,000 ceiling on tax-exempt coverage. The cost of group-term life insurance, even for amounts over \$50,000, is tax-exempt in the following situations:

- (1) the insurance is provided to a former employee who:
 - (a) has terminated his or her employment as an employee with the employer and has become permanently disabled,
 - (b) has terminated his or her employment on or before January 1, 1984, and was covered by the plan or by a predecessor plan when he or she retired if the plan was in existence on January 1, 1984, or the plan is a comparable successor to such a plan, or
 - (c) has terminated employment as an employee after January 1, 1984, having attained age fifty-five on or before January 1, 1984, and having been employed by the employer at any time during 1983 if the plan was in existence on January 1, 1984, or the plan is a comparable successor to such a plan, *unless* the individual retired under the plan after 1986 and the plan is discriminatory

after that date, not taking into account insurance provided to employees who retired before January 1, 1987;

- (2) if a charitable organization is designated as policy beneficiary, where this designation may be made with respect to all or any portion of the proceeds, but no charitable contributions deduction is allowable for such a designation; or
- (3) if an employer is beneficiary (directly or indirectly), unless the employer is required to pay proceeds over to an employee's estate or beneficiary.¹

Any contribution toward group-term life insurance, but not toward permanent benefits, made by an employee during a taxable year generally reduces, dollar for dollar, the amount that otherwise would be included in the employee's gross income for term insurance. This reduction is not permitted, however, if the employee makes a prepayment for coverage after retirement or for payments allocable to insurance where the cost is not taxed because of one of the exceptions outlined above.²

The exemption of the cost of up to \$50,000 of group-term life is not available with respect to group-term insurance purchased under a qualified employees' trust or annuity plan. The provisions of IRC Section 72(m)(3) and Treasury Regulation Section 1.72-16 apply to the cost of the protection purchased under qualified plans and no part of the cost is excludable from an employee's gross income.³

Premiums for supplemental insurance in excess of \$50,000 provided by an employer under a group-term insurance plan are not taxable to an insured employee when paid by a family member to whom the employee has assigned the insurance.⁴ If the cost of the coverage in excess of \$50,000 is shared by an employer and assignee, the employer's portion of the cost is includable in the insured employee's gross income.⁵

8724. Do any nondiscrimination requirements apply to Section 79 plans?

Yes. If a Section 79 plan covers any key employees and the plan discriminates in favor of them either as to eligibility to participate or with respect to the kind or amount of benefits, the key employees may not exclude the cost of the first \$50,000 of coverage (see Q 8721). If a plan is found to be discriminatory, the key employee must include the higher of the actual cost for such insurance or the cost as specified in the uniform premium Table I (see Q 8722). Employees who are not key employees may exclude the cost of \$50,000 of coverage even if a plan is discriminatory.⁶

1. IRC Sec. 79(b); Treas. Reg. §1.79-2; TRA '84 Sec. 223(d), as amended by TRA '86, Sec. 1827(b)(1); Temp. Treas. Reg. §1.79-4T, A-1. See also Let. Rul. 9149010.

2. Treas. Regs. §§1.79-2(a)(2), 1.79-3(g)(2).

3. IRC Sec. 79(b)(3); Treas. Reg. §1.79-2(d).

4. Rev. Rul. 71-587, 1971-2 CB 89.

5. Rev. Rul. 73-174, 1973-1 CB 43.

6. IRC Sec. 79(d).

A plan is considered discriminatory in favor of key employees with respect to eligibility to participate *unless*:

- (1) it benefits at least 70 percent of all employees;
- (2) at least 85 percent of participants are not key employees;
- (3) the plan benefits a class of employees found by the IRS not to be discriminatory; or
- (4) if the plan is part of a cafeteria plan, the requirements for cafeteria plans are met (see Q 8787).¹

Individuals who do not need to be counted for the purposes of determining whether a plan is discriminatory include:

- (1) employees with fewer than three years of service;
- (2) part-time and seasonal employees;
- (3) employees excluded from a plan who are covered by a collective bargaining agreement if group-term life insurance was the subject of good faith bargaining, and
- (4) certain nonresident aliens.²

Benefits are discriminatory unless all benefits that are made available to key employee participants are available to all other participants.³ Benefits are not discriminatory if the plan provides a fixed amount of insurance that is the same for all covered employees or merely because the amount of insurance bears a uniform relationship to the total compensation of employees, or to their basic or regular rate of compensation.⁴ In other circumstances, the determination of whether a plan is nondiscriminatory will be based on all the facts and circumstances.⁵

For purposes of determining whether an employer's group-term insurance plan is discriminatory, all policies providing group-term life insurance to a key employee or key employees carried directly or indirectly by an employer will be treated as a single plan. An employer may treat two or more policies that do not provide group-term life insurance to a common key employee as a single plan.⁶

Who are Considered Key Employees?

A key employee is an employee who, at any time during the employer's tax year was:

1. IRC Sec. 79(d)(3)(A).

2. IRC Sec. 79(d)(3)(B).

3. IRC Sec. 79(d)(4).

4. IRC Sec. 79(d)(5); Treas. Reg. §1.79-4T, A-9.

5. Treas. Reg. §1.79-4T, A-9.

6. Treas. Reg. §1.79-4T, A-5.

- (1) an officer of an employer having annual compensation greater than \$160,000 in 2011, \$165,000 in 2012 and 2013, and \$170,000 in 2014. No more than the greater of (a) three individuals or (b) 10 percent of employees need to be treated as officers, but in any event no more than fifty individuals may be considered officers;
- (2) a more-than-5 percent owner of an employer; or
- (3) a more-than-1 percent owner, determined without considering those employees who are not counted in testing for discriminatory eligibility, having an annual compensation from an employer of more than \$150,000.¹

A key employee also is any former employee who was a key employee when he or she retired or separated from service.²

For purposes of determining corporate ownership, the attribution rules of IRC Section 318 apply. Rules similar to the attribution rules apply to determine non-corporate ownership. In calculating attribution from a corporation, a 5 percent ownership test will apply rather than a 50 percent test.

In determining the percentages of ownership, only the particular employer is considered; other members of a controlled group of corporations or businesses under common control and other members of an affiliated service group are not aggregated. They are aggregated for purposes of determining the employee's compensation and in testing for discrimination.³

Exemption for Church Plans

The nondiscrimination requirements discussed above do not apply to church plans for church employees. A church plan generally is one established by a church or convention or association of churches that is tax-exempt under IRC Section 501(c)(3). A church employee includes a minister, or an employee of an organization that is tax-exempt under IRC Section 501(c)(3), but does not include an employee of an educational organization above the secondary level, other than a school for religious training, or an employee of certain hospital or medical research organizations.⁴

1. IRC Secs. 79(d)(6), 416(i).

2. IRC Sec. 79(d)(6).

3. IRC Sec. 414(t); see also Temp. Treas. Reg. §1.79-4T, A-5.

4. IRC Sec. 79(d)(7).

PART XI: EMPLOYER-SPONSORED ACCIDENT & HEALTH INSURANCE BENEFITS

8725. May an employer deduct as a business expense the cost of premiums paid for accident and health insurance for employees?

An employer generally can treat accident and health insurance as a business expense, and can therefore deduct the cost of all premiums paid for employees' coverage. This includes premiums for medical expense insurance, dismemberment and sight loss coverage for the employee, the employee's spouse and dependents, disability income for the employee, and accidental death coverage.

The employer is entitled to deduct these premiums regardless of whether coverage is provided under a group policy or under individual policies. Despite this, the deduction will be disallowed if benefits are payable to the employer—the deduction for health insurance is allowable only if benefits are payable to employees or their beneficiaries.¹ However, if the employer's spouse is a bona fide employee and the employer is covered as a family member based on the spouse-employee's coverage, the premium is deductible.²

A corporation can deduct premiums it pays on group hospitalization coverage for commission salespersons, regardless of whether they are technically treated as employees or independent contractors.³ The premiums paid, however, must qualify as additional reasonable compensation to the insured employees.⁴

A different rule applies for certain accrual basis employers that provide medical benefits to employees directly instead of through insurance or an intermediary fund. In this case, the employer may not deduct amounts estimated to be necessary to pay for medical care provided in the year, but for which no claims have been filed with the employer by the end of the year, if filing a claim is necessary to establish the employer's liability for payment.⁵

8726. What credit is available for small employers for employee health insurance expenses?

Eligible small employers may take advantage of a tax credit for employee health insurance expenses for taxable years beginning after December 31, 2009, provided the employer offers health insurance to its employees and makes a non-elective contribution on behalf of each employee who participates in the plan.⁶

An eligible small employer is defined as an employer that has no more than twenty-five full time employees, the average annual wages of whom do not exceed \$50,800 (as adjusted for inflation in 2014; in 2010 to 2013 the amount was \$50,000).⁷

1. Treas. Reg. §1.162-10(a); Rev. Rul. 58-90, 1958-1 CB 88; Rev. Rul. 56-632, 1956-2 CB 101.

2. Rev. Rul. 71-588, 1971-2 CB 91; TAM 9409006.

3. Rev. Rul. 56-400, 1956-2 CB 116.

4. *Ernest Holdeman & Collet, Inc. v. Comm.*, TC Memo 1960-10. See Rev. Rul. 58-90, *supra*.

5. *U.S. v. General Dynamics Corp.*, 481 U.S. 239 (1987).

6. IRC Sec. 45R, as added by PPACA 2010.

7. IRC Secs. 45R(d), as added by PPACA 2010; IRC Sec 45R(d)(3)(B), as amended by Section 10105(e)(1) of PPACA 2010.

In order to qualify, the employer must have a contribution arrangement for each employee who enrolls in the health plan offered by the employer through an exchange that requires that the employer make a non-elective contribution in an amount equal to a uniform percentage, not less than 50 percent, of the premium cost.¹

Subject to phase-out² based on the number of employees and average wages, the amount of the credit is equal to 50 percent, and 35 percent in the case of tax exempt organizations, of the lesser of the following:

- (1) the aggregate amount of non-elective contributions made by the employer on behalf of its employees for health insurance premiums for health plans offered by the employer to employees through an exchange; or
- (2) the aggregate amount of non-elective contributions the employer would have made if each employee had been enrolled in a health plan that had a premium equal to the average premium for the small group market in the ratings area.³

For years 2010 through 2013, the following modifications apply in determining the amount of the credit:

- (1) the credit percentage is reduced to 35 percent (25 percent in the case of tax exempt entities);⁴
- (2) the amount under (1) is determined by reference to non-elective contributions for premiums paid for health insurance, and there is no exchange requirement;⁵ and
- (3) the amount under (2) is determined by the average premium for the state small group market.⁶

The credit also is allowed against the alternative minimum tax.⁷

Planning Point: Proposed regulations explain how to calculate employer tax credits after 2013.⁸ The regulations propose that the maximum credit for taxable years after 2014 (available for only 2 years) increase to 50 percent (35 percent for tax exempt organizations), with some adjustments. There is a proposed phase out for small employers with more than 10 employees or whose average annual wages exceed \$25,000 (adjusted for inflation). In addition, the proposed regulations clarify that employer contributions to an HRA, FSA, and HSA are not considered premium payments⁹ (See Q 8759).

1. IRC Sec. 45R(d)(4), as added by PPACA 2010.

2. IRC Sec. 45R(c), as added by PPACA 2010.

3. IRC Sec. 45(b), as added by PPACA 2010.

4. IRC Sec. 45R(g)(2)(A), as added by PPACA 2010.

5. IRC Secs. 45R(g)(2)(B), 45R(g)(3), as added by PPACA 2010.

6. IRC Sec. 45R(g)(2)(C), as added by PPACA 2010.

7. IRC Sec. 38(c)(4)(B), as amended by PPACA 2010. The IRS has issued guidance; see IRS Notice 2010-44, 2010-22 IRB 717; IRS Notice 2010-82, 2010-51 IRB 1.

8. 2013 IRB LEXIS, 2013-38 IRB 211 (modifying IRS Notice 2010-44, 2010-22 IRB 717; IRS Notice 2010-82, 2010-51 IRB 1).

9. Prop. Treas. Reg. §1.45R-3.

8727. Is the value of employer-provided coverage under accident or health insurance taxable income to an employee?

Generally, no. This includes medical expense and dismemberment and sight loss coverage for the employee, the employee's spouse and dependents, and coverage providing for disability income for the employee. Unlike the exclusion for group-term life insurance, there is no specific limit on the amount of employer-provided accident or health coverage that may be excluded from an employee's gross income. Further, coverage is tax-exempt to an employee whether it is provided under a group or individual insurance policy.¹ Similarly, the employee is not taxed on the value of critical illness coverage.

Accidental death coverage apparently also is excludable from an employee's gross income under IRC Section 106(a).²

The IRS has ruled privately that the value of consumer medical cards purchased by a partnership for its employees was excludable from the employees' income under IRC Section 106(a).³

Where an employer applies salary reduction amounts to the payment of health insurance premiums for employees, the salary reduction amounts are excludable from gross income under IRC Section 106.⁴

If an employee pays the premiums on personally-owned medical expense insurance and is reimbursed by the employer, IRC Section 106 similarly allows the reimbursement to be excluded from the employee's gross income.⁵ On the other hand, an employee must include in income payments received from an employer that *may* be used to pay the accident and health insurance premiums if those amounts are not *required* to be used for that purpose.⁶

Where a taxpayer's contribution to a fund providing retiree health benefits is deducted from the taxpayer's after-tax salary, it is considered an employee contribution and is includable in the taxpayer's income under IRC Section 61. In contrast, where an employer increases or grosses up a taxpayer's salary and then deducts the fund contribution from the taxpayer's after-tax salary, the contribution is considered to be an employer contribution that is excludable from the gross income of the taxpayer under IRC Section 106.⁷

The IRS has ruled privately that a return of a premium rider on a health insurance policy was a benefit in addition to accident and health benefits, so that the premium paid by the employer had to be included in the employee's taxable income.⁸

1. IRC Sec. 106(a). See also Treas. Reg. §1.106-1; Rev. Rul. 58-90, 1958-1 CB 88; Rev. Rul. 56-632, 1956-1 CB 101.

2. See Treas. Reg. §1.106-1; Treas. Reg. §1.79-1(f)(3); Let. Ruls. 8801015, 8922048.

3. Let. Rul. 9814023.

4. Rev. Rul. 2002-03, 2002-1 CB 316.

5. See Rev. Rul. 61-146, 1961-2 CB 25; see *Larkin v. Comm.*, 48 TC 629 (1967), fn.3, *aff'd* 394 F.2d 494 (1st Cir. 1968); Let. Rul. 9840044.

6. Rev. Rul. 75-241, 1975-1 CB 316, Let. Rul. 9022060. See also Let. Rul. 9104050.

7. Let. Rul. 9625012.

8. Let. Rul. 8804010.

For purposes of determining the tax treatment of employer-provided accident and health insurance, full time life insurance salespersons are treated as employees if they are employees for Social Security purposes.¹ Coverage for other commission salespersons is taxable income to the salespersons, unless an employer-employee relationship exists.²

Discrimination generally does not affect exclusion of the value of coverage. Even if a self-insured medical expense reimbursement plan discriminates in favor of highly compensated employees, the value of coverage is not taxable; only reimbursements are affected.

For a discussion of the considerations applicable to S corporations, see Q 8835 to Q 8842.

8728. Is the value of employer-provided coverage under accident or health insurance taxable income to an employee if the employee has a choice as to whether to receive coverage or a higher salary?

Outside of the context of cafeteria plans, if an employer offers an employee a choice between a lower salary and employer-paid health insurance or a higher salary and no health insurance, the employee must include the full amount of the higher salary in income regardless of the employee's choice. If the employee selects the health insurance option, the IRS will deem the employee to have received the higher salary and, in turn, paid a portion of the salary equal to the health insurance premium to the insurance company.³

However, a federal district court faced with a similar fact situation ruled that for employees who accept employer-paid health insurance coverage, the difference between the higher salary and the lower one is not subject to FICA and FUTA taxes or to income tax withholding.⁴

8729. Is the value of employer-provided coverage under accident or health insurance taxable income to an employee when the coverage is provided for the employee's spouse, children or dependents?

Employer-provided accident and health coverage for an employee and the employee's spouse and dependents, both before and after retirement, and for the employee's surviving spouse and dependents after the employee's death, does not have to be included in gross income by the active or retired employee or, after the employee's death, by the employee's survivors.⁵

In 2010, the Affordable Care Act ("ACA"), expanded the exclusion from gross income for amounts expended on medical care to include employer-provided health coverage for any adult child of the taxpayer if the adult child has not attained the age of twenty-seven as of the end of the taxable year. The IRS has released guidance indicating that the exclusion applies regardless of whether the adult child is eligible to be claimed as a dependent for tax purposes.⁶

1. IRC Sec. 7701(a)(20).

2. Rev. Rul. 56-400, 1956-2 CB 116; see also IRC Sec. 3508.

3. Let. Rul. 9406002. See also Let. Rul. 9513027.

4. *Express Oil Change, Inc. v. U.S.*, 25 F. Supp. 2d 1313 (N.D. Ala. 1996), *aff'd*, 162 F.3d 1290 (11th Cir. 1998).

5. Rev. Rul. 82-196, 1982-2 CB 53; GCM 38917 (11-17-82).

6. IRC Sec. 105(b), as amended by the Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Reconciliation Act of 2010. Notice 2010-38, 2010-20 IRB 682.

8730. When will amounts received by an employee under employer-provided accident and health insurance be taxable income to the employee?

Amounts received by an employee under employer-provided accident or health insurance, group or individual, that reimburse the employee for hospital, surgical, and other medical expenses incurred for care of the employee or spouse and dependents are generally tax-exempt without limit.

Despite this, if the employee deducted the expense in a prior year and is later reimbursed, the reimbursement must be included in gross income. Moreover, if reimbursements exceed actual expenses, the excess must be included in gross income to the extent that it is attributable to employer contributions.¹

Where an employer reimburses employees for salary reduction contributions applied to the payment of health insurance premiums, these amounts are not excludable under IRC Section 105(b) because there are no employee-paid premiums to reimburse.²

Similarly, where an employer applies salary reduction contributions to the payment of health insurance premiums and then pays the amount of the salary reduction to employees regardless of whether the employee incurs expenses for medical care, these so-called “advance” reimbursements or loans are not excludable from gross income under IRC Section 105(b) and are subject to FICA and FUTA taxes.³

Critical Illness Benefits

If the value of an employer-provided critical illness insurance policy was not includable in the employee’s gross income, amounts later received by the employee under the policy are includable in that employee’s gross income. The exclusion from gross income under IRC Section 105(b) applies only to amounts paid specifically to reimburse medical care expenses. Because critical illness insurance policies pay a benefit irrespective of whether medical expenses are incurred, these amounts are not excludable under IRC Section 105(b).⁴

Wage Continuation and Disability Income

Sick pay, wage continuation payments, and disability income payments, both preretirement and postretirement, generally are fully includable in gross income and taxable to an employee.⁵

Sight Loss and Dismemberment

An employee is only entitled to exclude payments not related to absence from work for the permanent loss, or loss of use, of a member or function of the body, or permanent disfigurement

1. IRC Sec. 105(b); Treas. Reg. §1.105-2; Rev. Rul. 69-154, 1969-1 CB 46.

2. Rev. Rul. 2002-3, 2002-1 CB 316.

3. Rev. Rul. 2002-80, 2002-2 CB 925.

4. See Treas. Regs. §§1.105-2, 1.213-1(c).

5. See Let. Ruls. 9103043, 9036049.

of the employee or spouse or a dependent, if the amounts paid are computed with reference to the nature of the injury.¹

An employee was entitled to exclude a lump-sum payment for incurable cancer under a group life-and-disability policy based upon this provision.²

However, if the benefits are determined based upon length of service rather than type and severity of injury, the exemption will not apply.³ Similarly, if the benefits are determined as a percentage of the disabled employee's salary, rather than by the nature of the employee's injury, they are not excludable from income.⁴ An employee who has permanently lost a bodily member or function, but who continues to work and draw a salary, cannot exclude a portion of that salary as payment for loss of the member or function if that portion was not computed with reference to the loss.⁵

8731. Are benefits paid under an employer-sponsored plan by reason of the employee's death received tax-free?

Accidental death benefits under an employer's plan are received income tax-free by an employee's beneficiary under IRC Section 101(a) as life insurance proceeds payable by reason of the insured's death.⁶ Death benefits payable under life insurance contracts issued after December 31, 1984, are excludable if the contract meets the statutory definition of a life insurance contract in IRC Section 7702. See Q 8702 to Q 8724 for a detailed discussion of the tax treatment of life insurance death proceeds.

Survivors' Benefits

Benefits paid to a surviving spouse and dependents under an employer accident and health plan that provided coverage for an employee and the employee's spouse and dependents both before and after retirement, and to the employee's surviving spouse and dependents after the employee's death, are excludable to the extent that they would be if paid to the employee.⁷

8732. Are benefits provided under an employer's noninsured accident and health plan excludable from an employee's income?

Although there is no particular legal form of plan required, uninsured benefits must be received under some sort of accident and health plan established by the employer for its employees in order to be tax-exempt on the same basis as insured plans.⁸ An Ohio federal District Court described the "plan" requirement as follows: "there is no legal magic to a form; the essence of the arrangement must determine its legal character."⁹

1. IRC Sec. 105(c).

2. Rev. Rul. 63-181, 1963-2 CB 74.

3. *Beisler v. Comm.*, 814 F.2d 1304 (9th Cir. 1987); *West v. Comm.*, TC Memo 1992-617. See also *Rosen v. U.S.*, 829 F.2d 506 (4th Cir. 1987).

4. *Colton v. Comm.*, TC Memo 1995-275; *Webster v. Comm.*, 870 F. Supp. 202, 94-2 USTC ¶50,586 (M.D. Tenn. 1994).

5. *Laverty v. Comm.*, 61 TC 160 (1973) *aff'd*, 523 F.2d 479, 75-2 USTC ¶9712 (9th Cir. 1975).

6. Treas. Reg. §1.101-1(a).

7. Rev. Rul. 82-196, 1982-2 CB 53; GCM 38917 (11-17-82).

8. IRC Sec. 105(c).

9. *Epmeier v. U.S.*, 199 F.2d 508, 511 (7th Cir. 1959).

A formal contract of insurance is not required if it is clear that, for an adequate consideration, the company has agreed and has become liable to pay and has paid sickness benefits based upon a reasonable plan of protection established for the benefit of its employees. For example, a provision for disability pay in an employment contract has been held to satisfy the condition.¹

For tax purposes, it is not necessary for the plan to be in writing or even that an employee's rights to benefits under the plan be enforceable. For example, a plan has been found based on an employer's custom or policy of continuing wages during disability, which was generally known to employees.²

If an employee's rights are not enforceable, the employee must have been covered by a plan or a program, policy, or custom having the effect of a plan when the employee became sick or injured, and notice or knowledge of the plan must have been readily available to the employee.³ Further, for a plan to exist an employer must commit to certain rules and regulations governing payment and these rules must be made known to employees as a definite policy before accident or sickness arises. *Ad hoc* payments that are made at the complete discretion of an employer do not qualify as a plan.⁴

The plan must be for employees. A plan may cover one or more employees and there may be different plans for different employees or classes of employees.⁵ A plan that is found to cover individuals in a capacity other than their employee status, even though they are employees, is not a plan for employees. For purposes of determining the excludability of employer-provided accident and health benefits, self-employed individuals and certain shareholders owning more than 2 percent of the stock of an S corporation are not treated as employees.⁶

Further, uninsured medical expense reimbursement plans for employees must meet nondiscrimination requirements for medical expense reimbursements to be tax-free to highly compensated employees. See Q 8733 for a discussion of the nondiscrimination requirements applicable to employer-provided health insurance plans.

8733. What nondiscrimination requirements apply to employer-provided health insurance plans?

Under current law, employer-provided health insurance plans are subject to nondiscrimination rules concerning discrimination based on health status under HIPAA '96. Though the HIPAA rules generally apply to both insured and uninsured plans, a plan that provides health benefits through an accident or health insurance policy need not meet the nondiscrimination requirements of IRC Section 105(h), which applies to amounts paid to highly compensated

1. *Andress v. U.S.*, 198 F. Supp. 371 (N.D. Ohio, 1961).

2. *Niekamp v. U.S.*, 240 F. Supp. 195 (E.D. Mo. 1965); *Pickle v. Comm.*, TC Memo 1971-304.

3. Treas. Reg. §1.105-5(a).

4. *Est. of Kaufman*, 35 TC 663 (1961), *aff'd*, 300 F.2d 128 (6th Cir. 1962); *Lang v. Comm.*, 41 TC 352 (1963); *Levine v. Comm.*, 50 TC 422 (1968); *Est. of Chism v. Comm.*, TC Memo 1962-6, *aff'd*, 322 F.2d 956 (9th Cir. 1963); *Burr v. Comm.*, TC Memo 1966-112; *Frazier v. Comm.*, TC Memo 1994-358; *Harris v. U.S.*, 77-1 USTC ¶9414 (E.D. Va. 1977).

5. Treas. Reg. §1.105-5(a); *Andress*, 198 F. Supp. 371.

6. IRC Sec. 105(g); Treas. Reg. §1.105-5(b).

employees for coverage under *self-insured plans*, for covered employees to enjoy the tax benefits described in Q 8736.

For plan years beginning on or after September 23, 2010, which was six months after the date of enactment of the Affordable Care Act (ACA), insured plans that are not grandfathered were expected to become subject to the same nondiscrimination requirements as self-insured plans. On December 22, 2010, however, the IRS announced in Notice 2011-1 that compliance with nondiscrimination rules for health insurance plans will be delayed until regulations or other administrative guidance has been issued.¹ The IRS indicated that the guidance will not apply until plan years beginning a specified period after guidance is issued.

Affordable Care Act Rules

The ACA requires that a group health plan that is not a self-insured plan satisfy the requirements of IRC Section 105(h)(2). More specifically, the ACA provides that rules similar to the rules in IRC Section 105(h)(3) (nondiscriminatory eligibility classifications), Section 105(h)(4) (nondiscriminatory benefits), and Section 105(h)(8) (certain controlled groups) apply to insured plans. The term “highly compensated individual” has the meaning given that term by IRC Section 105(h)(5).² A detailed discussion of the applicable definition of highly compensated individual under Section 105 is provided in Q 8737.

A plan that reimburses employees for premiums paid under an insured plan does not have to satisfy nondiscrimination requirements.

8734. What is a self-insured health plan?

A self-insured plan is one in which reimbursement of medical expenses is not provided under a policy of accident and health insurance.³ According to regulations, a plan underwritten by a cost-plus policy or a policy that, in effect, merely provides administrative or bookkeeping services is considered self-insured.⁴

An accident or health insurance policy may be an individual or a group policy issued by a licensed insurance company, or an arrangement in the nature of a prepaid health care plan regulated under federal or state law including an HMO. A plan will be found to be self-insured unless the policy involves shifting of risk to an unrelated third party.

A plan is not considered self-insured merely because prior claims experience is one factor in determining the premium.⁵ Further, a policy of a captive insurance company is not considered self-insurance if, for the plan year, premiums paid to a captive insurer by unrelated companies are equal to at least one-half of the total premiums received and the policy is similar to those sold to unrelated companies.⁶

1. 2011-1 CB 259.

2. Sec. 2716 of the Public Health Service Act, as added by Section 1001(5) of PPACA 2010, as amended by Section 10101(d) of PPACA 2010.

3. See IRC Sec. 105(h)(6).

4. Treas. Reg. §1.105-11(b).

5. See, for example, Let. Rul. 8235047.

6. Treas. Reg. §1.105-11(b).

Withholding

An employer does not have to withhold income tax on an amount paid for any medical care reimbursement made to or for the benefit of an employee under a self-insured medical reimbursement plan within the meaning of IRC Section 105(h)(6).¹

8735. Are reimbursements attributable to employee contributions to a self-insured health plan taxable to the employee?

Generally, reimbursements attributable to employee contributions are received tax-free. However, an employee must include any reimbursed amount to the extent that the employee has taken a deduction for the expense.

Amounts attributable to employer contributions are determined based on the ratio that employer contributions bear to total contributions for the calendar years immediately preceding the year of receipt (up to three years may be taken into account). If the plan has been in effect for less than a year, then the determination may be based upon the portion of the year, or such determination may be made periodically (such as monthly or quarterly) and used throughout the succeeding period.²

For example, if an employee leaves employment on April 15, 2014, and 2014 is the first year the plan was in effect, the determination may be based upon the contributions of the employer and the employees during the period beginning with January 1 and ending with April 15, or during the month of March, or during the quarter consisting of January, February, and March.

8736. What nondiscrimination requirements apply to self-insured health plans?

The nondiscrimination requirements set forth in IRC Section 105(h) apply to self-insured health benefits, although the IRS announced in Notice 2011-1 on December 22, 2010, that compliance with nondiscrimination rules for other health insurance plans will be delayed until regulations or other administrative guidance has been issued. The IRS indicated that the guidance will not apply until plan years beginning in a specified period after guidance is issued.

Benefits received pursuant to a self-insured plan are generally excludable from an employee's gross income. Despite this, if a self-insured medical expense reimbursement plan or the self-insured part of a partly-insured medical expense reimbursement plan discriminates in favor of highly compensated individuals, certain amounts paid to the highly compensated individuals will be taxable to those highly compensated individuals.

A medical expense reimbursement plan cannot be implemented retroactively because, if this were permitted, the nondiscrimination requirements of IRC Section 105 would be ineffective.³

1. IRC Sec. 3401(a)(20).

2. Treas. Reg. §1.105-11(i).

3. *Wallenburgh v. U.S.*, 75 F. Supp. 2d 1032, 1035 n.2 (D. Neb. 1999) (noting that "An employer can choose to benefit or hurt certain employees with much greater precision, with the benefit of hindsight."); *American Family Mut. Ins. Co. v. U.S.*, 815 F. Supp. 1206 (W.D. Wisc. 1992). See also Rev. Rul. 2002-58, 2002-38 IRB 541.

A self-insured plan may not discriminate in favor of highly compensated individuals either with respect to eligibility to participate or benefits.

Eligibility

A plan discriminates as to eligibility to participate unless the plan benefits the following:

- (1) 70 percent or more of all employees, or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all employees are eligible to benefit under the plan; or
- (2) employees who qualify under a classification set up by the employer and found by the IRS not to be discriminatory in favor of highly compensated individuals.¹

For purposes of these eligibility requirements, an employer is not required to consider those employees who:

- (1) have not completed three years of service at the beginning of the plan year; however, years of service during which an individual was ineligible under (2), (3), (4), or (5) below must be counted for this purpose;
- (2) have not attained age twenty-five at the beginning of the plan year;
- (3) are part-time or seasonal employees;
- (4) are covered by a collective bargaining agreement if health benefits were the subject of good faith bargaining; or
- (5) are nonresident aliens with no U.S.-source earned income.²

Part-time and Seasonal Workers

Part-time employees include those employees who are customarily employed for fewer than thirty-five hours per week. Seasonal employees are those who are customarily employed for fewer than nine months per year. In determining whether an employee is part-time or seasonal, the IRS will consider whether similarly situated employees of the employer or in the same industry or location are employed for substantially more hours or months, as applicable. A safe harbor rule provides that employees customarily employed for fewer than twenty-five hours per week or seven months per year may automatically be considered part-time or seasonal.³

Benefits

A plan discriminates as to benefits unless all benefits provided for participants who are highly compensated individuals are provided for all other participants.⁴ If some participants

1. IRC Sec. 105(h)(3)(A).

2. IRC Sec. 105(h)(3)(B).

3. Treas. Reg. §1.105-11(c).

4. IRC Sec. 105(h)(4).

become eligible for benefits immediately and others only after a waiting period, benefits are not considered to be available to all participants.¹ Benefits available to dependents of highly compensated employees must be equally available to dependents of all other participating employees. The test is applied to benefits subject to reimbursement, rather than to actual benefit payments or claims.

Any maximum limit on the amount of reimbursement must be uniform for all participants and for all dependents, regardless of years of service or age. Further, if the type or amount of benefits subject to reimbursement is offered in proportion to compensation and highly compensated employees are covered by the plan, the plan will be found to discriminate with regard to benefits.

A plan will not be considered discriminatory in operation merely because highly compensated participants use a broad range of plan benefits to a greater extent than other participants.²

The nondiscrimination rules are not violated merely because benefits under the plan are offset by benefits paid under a self-insured or insured plan of the employer, of another employer, or by benefits paid under Medicare or other federal or state law. A self-insured plan may take into account benefits provided under another plan only to the extent that the benefit is the same under both plans.³ Benefits provided to a retired employee who was highly compensated must be the same as benefits provided to all other retired participants.

For purposes of applying the nondiscrimination rules, all employees of a controlled group of corporations, or employers under common control, and of members of an affiliated service group are treated as employed by a single employer.⁴

Highly Compensated Individual

An employee is a highly compensated individual if the employee falls into any one of the following three classifications:

- (1) The employee is one of the five highest paid officers;
- (2) The employee is a shareholder who owns, either actually or constructively through application of the attribution rules, more than 10 percent in value of the employer's stock; or
- (3) The employee is among the highest paid 25 percent, rounded to the nearest higher whole number, of all employees other than excludable employees who are not participants and not including retired participants.⁵ Fiscal year plans may determine compensation on the basis of the calendar year ending in the plan year.

1. Let. Ruls. 8411050, 8336065.

2. Treas. Reg. §1.105-11(c)(3).

3. Treas. Reg. §1.105-11(c)(1).

4. IRC Sec. 105(h).

5. IRC Sec. 105(h)(5).

A participant's status as officer or stockholder with respect to a particular benefit is determined at the time when the benefit is provided.¹ See Q 8737 for a discussion of the tax consequences to a self-insured plan that is found to be discriminatory under these rules.

8737. What are the tax consequences for amounts paid by an employer to highly compensated employees under a discriminatory self-insured medical expense reimbursement plan?

If a self-insured medical reimbursement plan is found to be discriminatory in favor of highly compensated employees, those highly compensated employees may be taxed on reimbursed amounts provided under the plan. The taxable amount of payments is the "excess reimbursement."² The two situations discussed below will produce an excess reimbursement.

The first situation occurs when a benefit is available to a highly compensated individual but not to all other participants, or if the benefit otherwise discriminates in favor of highly compensated individuals. In this case, the total amount reimbursed under the plan to the employee with respect to that benefit is an excess reimbursement.

The second situation occurs when a plan discriminates as to participation, even though all benefits are available to all other participants and are not otherwise discriminatory. If this is the case, the excess reimbursement is determined by multiplying the total amount reimbursed to the highly compensated individual for the plan year by a fraction. The numerator of this fraction is the total amount reimbursed to all participants who are highly compensated individuals under the plan for the plan year and the denominator is the total amount reimbursed to all employees under the plan for such plan year. In determining the fraction, any reimbursement attributable to a benefit not available to all other participants is not taken into account.³

Multiple plans may be designated as a single plan for purposes of satisfying nondiscrimination requirements. If an employee elects to participate in an optional HMO offered by the plan, that employee is considered benefited by the plan only if the employer's contributions with respect to the employee are at least equal to what would have been made to the self-insured plan and the HMO is designated, with the self-insured plan, as a single plan.

Unless a plan provides otherwise, reimbursements will be attributed to the plan year in which payment is made. Accordingly, they will be subject to tax in an individual's tax year in which a plan year ends.

Amounts reimbursed for medical diagnostic procedures for employees, but not dependents, performed at a facility that provides only medical services are not considered a part of a plan and do not come within these rules requiring nondiscriminatory treatment.⁴

1. Treas. Reg. §1.105-11(d).

2. IRC Sec. 105(h)(1).

3. IRC Sec. 105(h)(7).

4. Treas. Reg. §1.105-11(g).

8738. Are premiums paid by a taxpayer for personal health insurance deductible?

A taxpayer may deduct premiums paid for medical care insurance (including hospital, surgical, and medical expense reimbursement coverage) as a medical expense to the extent that, when added to all other unreimbursed medical expenses, the total exceeds 10 percent of a taxpayer's adjusted gross income (7.5 percent for tax years beginning before 2013). The threshold is also 10 percent for alternative minimum tax purposes.

The Affordable Care Act increased the threshold to 10 percent of a taxpayer's adjusted gross income for taxpayers who are under the age of sixty-five effective in tax years beginning January 1, 2013. For taxpayers over the age of sixty-five, the threshold for deductibility will remain at the 7.5 percent level from years 2013 to 2016.

A taxpayer must itemize his or her deductions in order to take a deduction for medical care premiums or any other medical expenses.¹ The reduction of itemized deductions for certain high-income individuals is not applicable to medical expenses deductible under IRC Section 213.²

The only premiums deductible as a medical expense are for medical care insurance. Premiums for non-medical benefits, such as disability income, accidental death and dismemberment, and waiver of premium under a life insurance policy, are not deductible.

The definition of "medical care" generally includes amounts paid for any qualified long-term care insurance contract or for qualified long-term care services and, thus, these expenses may be deducted, subject to certain limitations.³

Mandatory contributions to a state disability benefits fund are not deductible under the provisions applicable to medical expense deductions, but are deductible as taxes.⁴ Employee contributions to an alternative employer plan providing disability benefits required by state law are nondeductible personal expenses.⁵

If a policy provides both medical and non-medical benefits, a deduction will be allowed for the medical portion of the premium only if the medical charge is reasonable in relation to the total premium. In order to take advantage of this bifurcated approach, the medical portion must be stated separately in either the policy or in a statement furnished by the insurance company.⁶

Similarly, where a premium provides for medical care for individuals other than the taxpayer, spouse and dependents (such as with automobile insurance), a deduction will not be allowed unless the policy separately states the portion that is applicable to the taxpayer, spouse and dependents.⁷

1. IRC Sec. 213(a).

2. IRC Sec. 68(c).

3. IRC Sec. 213(d)(1).

4. *McGowan v. Comm.*, 67 TC 599 (1976); *Trujillo v. Comm.*, 68 TC 670 (1977).

5. Rev. Rul. 81-192, 1981-2 CB 50 (citing N.Y. law); Rev. Rul. 81-193, 1981-2 CB 52 (citing N.J. law); Rev. Rul. 81-194, 1981-2 CB 54 (citing Cal. law).

6. IRC Sec. 213(d)(6).

7. Rev. Rul. 73-483, 1973-2 CB 75.

If a policy provides only indemnity for hospital and surgical expenses, premiums qualify as medical care premiums even though the benefits are stated amounts that will be paid without regard to the actual amount of expense incurred by the taxpayer.¹ Premiums paid for a hospital insurance policy that provides a specific payment for each week the insured is hospitalized, not to exceed a specified number of weeks, regardless of whether the insured receives other payments for reimbursement, do not qualify as medical care premiums and are not deductible.²

Because the benefit under a critical illness insurance policy is payable regardless of any actual medical expenses incurred or reimbursement received, the premiums paid for this type of policy would appear not to be deductible.³

A deduction also will be denied for employees' contributions to a plan that provides that employees absent from work because of sickness are to be paid a percentage of wages earned on that day by co-employees.⁴

A taxpayer may deduct premiums paid for a policy that reimburses the taxpayer for the cost of prescription drugs as medical care insurance premiums.⁵

Medicare premiums, paid by persons age sixty-five or older, under the supplementary medical insurance or prescription drug programs are deductible as medical care insurance premiums. However, the taxes paid by employees and self-employed individuals for basic hospital insurance under Medicare are not deductible.⁶

If a taxpayer prepays premiums before the taxpayer is sixty-five for insurance that will cover medical care for the taxpayer, spouse, and dependents *after* the taxpayer is sixty-five, these premiums are deductible when paid provided they are payable on a level-premium basis for ten years or more or until age sixty-five, but in no case for fewer than five years.⁷

Payments made to an institution for the provision of lifetime care are deductible under IRC Section 213(a) in the year paid to the extent that the payments are properly allocable to medical care, even if the care is to be provided in the future or possibly not provided at all.⁸ The IRS has stated that its rulings should not be interpreted or expanded to permit a current deduction of payments for future medical care (including medical insurance provided beyond the current tax year) in situations where future lifetime care is not of the type associated with the ruling at issue.

1. Rev. Rul. 58-602, 1958-2 CB 109, modified by Rev. Rul. 68-212, 1968-1 CB 91.

2. Rev. Rul. 68-451, 1968-2 CB 111.

3. See Treas. Reg. §1.213-1(c)(4).

4. Rev. Rul. 73-347, 1973-2 CB 25.

5. Rev. Rul. 68-433, 1968-2 CB 104.

6. IRC Sec. 213(d)(1)(D); Rev. Rul. 66-216, 1966-2 CB 100.

7. IRC Sec. 213(d)(7).

8. Rev. Rul. 76-481, 1976-2 CB 82; Rev. Rul. 75-303, 1975-2 CB 87; Rev. Rul. 75-302, 1975-2 CB 86.

8739. Are benefits received under a personal health insurance policy taxable income?

No. All kinds of benefits from personal health insurance generally are entirely exempt from income tax. This exemption applies to disability income, dismemberment and sight loss benefits, critical illness benefits,¹ and hospital, surgical, and other medical expense reimbursement. The taxpayer is not limited as to the amount of benefits, including the amount of disability income that he or she can receive tax-free under personally paid health insurance or under an arrangement having the effect of accident or health insurance.² However, courts have held that the IRC Section 104(a)(3) exclusion will be denied where a taxpayer's claims for insurance benefits were not made in good faith and were not based on a true illness or injury.³

If a health insurance policy provides for accidental death benefits, the proceeds of these death benefits may be tax-exempt to the policy beneficiary as death proceeds of life insurance.⁴ A taxpayer may exclude from gross income disability benefits received for loss of income or earning capacity under no fault insurance.⁵ The exclusion also has been applied where the policies were provided to the insured taxpayer by a professional service corporation in which the insured was the sole stockholder.⁶

Health insurance benefits are also tax-exempt if received by a person who has an insurable interest in the individual insured by the policy, rather than by that individual himself.⁷

Medical expense reimbursement benefits will impact the amount that a taxpayer is allowed to deduct for medical expenses. Because only unreimbursed expenses are deductible, the total amount of medical expenses paid during a taxable year must be reduced by the total amount of reimbursements received in that taxable year.⁸

Similarly, if the taxpayer deducts medical expenses in the year they are paid and then receives reimbursement in a later year, the taxpayer (or the taxpayer's estate, where the deduction is taken on the decedent's final return but later reimbursed to the taxpayer's estate) must include the reimbursement, to the extent of the prior year's deduction, in gross income for the later year.⁹

Where the value of a decedent's right to reimbursement proceeds, which is income in respect of a decedent,¹⁰ is included in the decedent's estate, an income tax deduction is available for the portion of estate tax attributable to such value.

1. See, e.g., Let Rul. 200903001.

2. IRC Sec. 104(a)(3); Rev. Rul. 55-331, 1955-1 CB 271, *modified by* Rev. Rul. 68-212, 1968-1 CB 91; Rev. Rul. 70-394, 1970-2 CB 34.

3. *Dodge v. Comm.*, 981 F.2d 350 (8th Cir. 1992).

4. IRC Sec. 101(a); Treas. Reg. §1.101-1(a).

5. Rev. Rul. 73-155, 1973-1 CB 50.

6. Let. Rul. 7751104.

7. See IRC Sec. 104; *Castner Garage, Ltd. v. Comm.*, 43 BTA 1 (1940), *acq.* 1941-1 CB 11.

8. Rev. Rul. 56-18, 1956-1 CB 135.

9. Treas. Regs. §§1.104-1, 1.213-1(g); Rev. Rul. 78-292, 1978-2 CB 233.

10. See Rev. Rul. 78-292, above.

Disability income is not treated as reimbursement for medical expenses and, therefore, does not offset such expenses.¹

Example: Ryan, whose adjusted gross income for 2014 was \$25,000, paid \$4,000 in medical expenses during that year. On his 2014 return, he deducted medical expenses totaling \$1,500 [\$4,000 - \$2,500 (10 percent of his adjusted gross income)]. In 2015, Ryan receives the following benefits from his health insurance: disability income of \$1,200 and reimbursement for 2014 doctor and hospital bills of \$400. He must report \$400 as taxable income on his 2015 return. Had Ryan received the reimbursement in 2014, his medical expense deduction for that year would have been limited to \$1,100 (\$4,000 - \$400 [reimbursement] - \$2,500 [10 percent of adjusted gross income]). Otherwise, he would have received the entire amount of insurance benefits, including the medical expense reimbursement, tax-free.

8740. How are accident or health benefits taxed for stockholder employees of a closely-held C corporation?

An employer's accident or health plan must be established for *employees* in order to provide tax-free coverage and benefits.² The same is true with respect to amounts received under a state's sickness and disability fund under IRC Section 105(e)(2).

If a plan covers only stockholder-employees, the IRS can challenge tax benefits claimed under the plan on the ground that the plan is not for employees. The challenge for the closely-held C corporation is in establishing that the stockholder-employees are covered as employees, rather than in their capacity as stockholders. If this cannot be established, then premiums or benefits are likely to be treated as dividends. The result is that the premiums will be nondeductible by the corporation and the premiums or benefits will be includable in the gross incomes of covered stockholder-employees.³

Courts have found, however, that the tax benefits of employer-provided health insurance are available in a plan that covers only stockholder-employees. This is the case only if the plan covers a class of employees that can be segregated rationally from other employees, if any non-stockholder employees exist, on a criterion other than their being stockholders.⁴

The *Bogene*, *Smith*, *Seidel*, and *Epstein* cases, which were decided in favor of the taxpayers, all involved plans that covered only active and compensated officers of the corporation who also were stockholders. In *Smith* and *Seidel*, the officer-shareholders also were the only employees, though in *Bogene* and *Epstein* the corporations also employed other employees who were not shareholders and who were not covered by the plans.

The plan in *American Foundry*, where the plan was found to not be a plan for employees, covered only two of five active officers of a family corporation.⁵

1. *Deming v. Comm.*, 9 TC 383 (1947), acq. 1948-1 CB 1.

2. IRC Sec. 105(e).

3. *Larkin v. Comm.*, 48 TC 629 (1967), aff'd 394 F.2d 494 (1st Cir. 1968); *Levine v. Comm.*, 50 TC 422 (1968); *Smithback v. Comm.*, TC Memo 1969-136; *Est. of Leidy v. Comm.*, 77-1 USTC ¶9144 (4th Cir. 1977).

4. *Bogene, Inc. v. Comm.*, TC Memo 1968-147, acq. 1968 AOD LEXIS 272; *Smith v. Comm.*, TC Memo 1970-243, acq. 1970 AOD LEXIS 245; *Seidel v. Comm.*, TC Memo 1971-238, acq. 1972 AOD LEXIS 15; *Epstein v. Comm.*, TC Memo 1972-53, acq. 1972 AOD LEXIS 124; *Oleander Co., Inc. v. United States*, 82-1 USTC ¶9395 (E.D.N.C. 1981); *Giberson v. Comm.*, TC Memo 1982-338; *Est. of Leidy*, above; *Wigutow v. Comm.*, TC Memo 1983-620.

5. *American Foundry v. Comm.*, 76-1 USTC ¶9401 (9th Cir. 1976), acq. 1974-2 CB 1.

The plan in *Sturgill* covered four officer-stockholders of a family corporation. Two of the four were not active or compensated as officer-employees and the plan was held not to be one for employees.¹

The plan in *Leidy* covered only the president, who was the sole stockholder, and the vice president, who was no longer active in the company.

In *American Foundry* and in *Sturgill*, courts allowed the corporations to deduct reimbursement payments to the active officers as reasonable compensation, even though the payments were not excludable by shareholder-employees under IRC Section 105.

8741. How is health insurance coverage for partners and sole proprietors taxed?

Partners and sole proprietors are self-employed individuals, not employees, and the rules for personal health insurance, rather than employer-provided health insurance, usually apply. Partners and sole proprietors, are, therefore, entitled to deduct 100 percent of amounts paid during a taxable year for insurance that provides medical care for the individual, spouse, and dependents during the tax year.

The insurance can also cover a child who was under age 27 at the end of the tax year, even if the child did not qualify as the taxpayer's dependent. A "child" for this purpose is defined to include a taxpayer's child, stepchild, adopted child, or foster child. A foster child is any child placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

In addition, certain premiums paid for long-term care insurance are eligible for this deduction.²

A partner or sole proprietor is not entitled to this deduction for any calendar month in which the partner or proprietor is eligible to participate in any subsidized health plan maintained by any employer of the self-employed individual or spouse. This rule is applied separately to plans that include coverage for qualified long-term care services or are qualified long-term care insurance contracts, and plans that do not include that coverage and are not those kinds of contracts.³

The deduction is allowable in calculating adjusted gross income and is limited to the self-employed individual's earned income for the tax year that is derived from the trade or business with respect to which the plan providing medical care coverage is established. Earned income means, in general, net earnings from self-employment with respect to a trade or business in which the personal services of the taxpayer are a material income-producing factor.

Any amounts paid for this kind of insurance may *not* be taken into account in computing:

- (1) the amount of a medical expense deduction under IRC Section 213; and

1. *Charlie Sturgill Motor Co. v. Comm.*, TC Memo 1973-281, *acq.* 1974 AOD LEXIS 151.

2. IRC Secs. 162(l); 213(d)(1).

3. IRC Sec. 162(l).

- (2) net-earnings from self-employment for the purpose of determining the tax on self-employment income.¹

Additional considerations may apply in the case of a partnership. If a partnership pays accident and health insurance premiums for services rendered by partners in their capacity as partners and without regard to partnership income, premium payments are considered to be “guaranteed payments” under IRC Section 707(c). As such, the premiums are deductible by the partnership under IRC Section 162, subject to IRC Section 263, and must be included in partners’ income under IRC Section 61.

A partner is not entitled to exclude premium payments from income under IRC Section 106 but may deduct payments to the extent allowable under IRC Section 162(l), as discussed above.² For partners, a policy can be either in the name of the partnership or in the name of the partner. The partner can either self-pay the premiums, or the partnership can pay them and report the premium amounts on Schedule K-1 (Form 1065) as guaranteed payments to be included in the partner’s gross income. However, if the policy is in the partner’s name and the partner self-pays the premiums, the partnership must reimburse the partner and report the premium amounts on Schedule K-1 (Form 1065) as guaranteed payments to be included in the partner’s gross income. Otherwise, the insurance plan will not be considered to be established under the business.

The IRS has found that the cost of consumer medical cards purchased for partners is not deductible by the partners under either IRC Section 162(l) or IRC Section 213. This conclusion was based on the rationale that consumer medical cards that provide discounts on certain medical services and items are not actually insurance products.³

The IRS has also concluded that payments from a self-funded medical reimbursement plan set up by a partnership, and made to partners and their dependents, are excludable from partners’ income. Premiums paid by partners for coverage under a self-funded plan are deductible, subject to the limits of IRC Section 162(l).⁴

There is no limit on the amount of benefits a partner or sole proprietor can receive tax-free.⁵

The IRS has also found that coverage purchased by a sole proprietor or partnership for non-owner-employees, including an owner’s spouse, generally are subject to the same rules that apply in any other employer-employee situation.⁶

The IRS has issued settlement guidelines addressing whether a self-employed individual (“employer-spouse”) may hire his or her spouse as an employee (“employee-spouse”) and provide family health benefits to the employee-spouse, who then elects family coverage including

1. IRC Sec. 162(l).

2. Rev. Rul. 91-26, 1991-1 CB 184.

3. Let. Rul. 9814023.

4. Let. Rul. 200007025.

5. Rev. Rul. 56-326, 1956-2 CB 100; Rev. Rul. 58-90, 1958-1 CB 88.

6. Rev. Rul. 71-588, 1971-2 CB 91; TAM 9409006.

the employer-spouse. The IRS position is that if an employee-spouse is a bona fide employee, the employer-spouse may deduct the cost of the coverage and the value of the coverage also is excludable from the employee-spouse's gross income.

However, the IRS will closely examine the situation to determine whether an employee-spouse qualifies as a bona fide employee. Part-time employment does not negate employee status, but nominal or insignificant services that have no economic substance or independent significance will be challenged.¹

8742. How is health insurance coverage taxed for S corporation shareholders?

A shareholder-employee who owns more than 2 percent of the outstanding stock or voting power of an S corporation (based on direct ownership as well as attributed ownership) will be treated as a partner, not an employee (see Q 8741 for the rules applicable to partners).² Therefore, accident and health insurance premium payments for more-than-2 percent shareholders paid in consideration for services rendered are treated as guaranteed payments made to partners. The result is that an S corporation can deduct premiums under IRC Section 162 and a shareholder-employee must include premium payments in income under IRC Section 61. The shareholder-employee cannot exclude them under IRC Section 106, but may deduct the cost of the premiums to the extent permitted by IRC Section 162(l), as discussed in Q 8741.³

With respect to coverage purchased by an S corporation for employees who do not own any stock and for shareholder-employees who own 2 percent or less of the outstanding stock or voting power, the same rules apply as in any other employer-employee situation.

8743. What is a health reimbursement arrangement (HRA) and how is it taxed?

The IRS defines an HRA as an arrangement that:

- (1) is solely employer-funded and not paid for directly or indirectly by salary reduction contributions under a cafeteria plan; and
- (2) reimburses employees for substantiated medical care expenses incurred by the employee and the employee's spouse and dependents, as defined in IRC Section 152, up to a maximum dollar amount per coverage period.

A taxpayer is entitled to carry forward any unused amounts in the individual's account to increase the maximum reimbursement amount in subsequent coverage periods.⁴ HRAs are not available for self-employed individuals.

1. IRS Settlement Guidelines, 2001 TNT 222-25 (Nov. 16, 2001); see also *Peyda v. Comm.*, TC Summary Opinion 2001-91.

2. IRC Sec. 1372.

3. Rev. Rul. 91-26, 1991-1 CB 184.

4. Notice 2002-45, 2002-2 CB 93; Rev. Rul. 2002-41, 2002-2 CB 75. See also IRS Publication 969 (2013) "Health Savings Accounts and Other Tax-Favored Health Plans."

Employer-provided coverage and medical care reimbursement amounts under an HRA are excludable from an employee's gross income under IRC Section 106 and IRC Section 105(b), assuming all requirements for HRAs are met.¹

Reimbursements for medicine are limited to doctor-prescribed drugs and insulin for tax years beginning after December 31, 2010. Consequently, over-the counter medicines are no longer qualified expenses unless prescribed by a doctor after 2010.²

An HRA is not permitted to offer cash-outs at any time, even on an employee's termination of service or retirement. However, it may continue to reimburse former employees for medical care expenses after such events even if the employee does not elect COBRA continuation coverage.³ An HRA is a group health plan and, thus, is subject to COBRA continuation coverage requirements.

HRAs may, on a one-time basis per HRA, make a qualified HSA distribution. A qualified HSA distribution is a rollover made before January 1, 2012 to a health savings account (see Q 8744), of an amount not exceeding the balance in the HRA as it existed on September 21, 2006.⁴

HRAs may not be used to reimburse expenses that were either incurred before the HRA was in existence or that are deductible under IRC Section 213 for a prior taxable year. An unreimbursed claim incurred in one coverage period may be reimbursed in a later coverage period, so long as the individual was covered under the HRA when the claim was incurred.⁵

The IRS has approved the use of employer-issued debit and credit cards to pay for medical expenses as incurred provided that the employer requires subsequent substantiation of the expenses or has in place sufficient procedures to substantiate the payments at the time of purchase.⁶

An employee may not be reimbursed for the same medical care expense by both an HRA and an IRC Section 125 health FSA (see Q 8753). Technically, ordering rules from the IRS specify that the HRA benefits must be exhausted before FSA reimbursements may be made. Despite this, HRAs can be drafted to specify that coverage under the HRA is available only after expenses exceeding the dollar amount of an IRC Section 125 FSA have been paid. Thus, an employee could exhaust FSA coverage, because FSA funds may only be carried over if the FSA specifically permits a carry over (and even then only up to \$500 per year can be carried forward), before tapping into HRA coverage, which can be carried over.⁷

Employer contributions to an HRA may not be attributable in any way to salary reductions. Thus, an HRA may not be offered under a cafeteria plan, but may be offered in connection with

1. Notice 2002-45, 2002-2 CB 93; Rev. Rul. 2002-41, 2002-2 CB 75.

2. IRC Sec. 106(f), as added by PPACA 2010.

3. Notice 2002-45, above.

4. IRC Sec. 106(e).

5. Notice 2002-45, 2002-2 CB 93.

6. Notice 2006-69, 2006-31 IRB 107; Rev. Proc. 2003-43, 2003-21 IRB 935, supplemented by Rev. Proc. 2007-62; 2007-2 CB 786. See also Notice 2007-2, 2007-2 IRB 254.

7. Notice 2002-45, 2002-2 CB 93.

a cafeteria plan. Where an HRA is offered in connection with another accident or health plan funded by a salary reduction plan, a facts and circumstances test is used to determine if salary reductions are attributable to the HRA. If a salary reduction amount for a coverage period to fund a non-HRA accident or health plan exceeds the actual cost of the non-specified accident or health plan coverage, the salary reduction will be attributed to the HRA. An example of the application of this rule can be found in Revenue Ruling 2002-41.¹

Because an HRA may not be paid for through salary reduction, the following restrictions on health FSAs are not applicable to HRAs:

- (1) the ban against a benefit that defers compensation by permitting employees to carry over an unlimited amount of unused elective contributions or plan benefits from one plan year to another plan year;
- (2) the requirement that the maximum amount of reimbursement must be available at all times during the coverage period;
- (3) the mandatory twelve month period of coverage; and
- (4) the limitation that medical expenses reimbursed must be incurred during the period of coverage.²

8744. What is a health savings account (HSA) and how is it taxed?

A health savings account (HSA) is a trust created exclusively for the purpose of paying the qualified medical expenses of an account beneficiary.³

An HSA must be created by a written governing instrument that states:

- (1) except in the case of certain rollover contributions, no contribution will be accepted:
 - a. unless it is in cash;
 - b. to the extent that the contribution, when added to previous contributions for the calendar year, exceeds the contribution limit for the calendar year;
- (2) the trustee is a bank, an insurance company, or a person who satisfies IRS requirements for administering the trust;
- (3) no part of trust assets will be invested in life insurance contracts;
- (4) trust assets will not be commingled with other property, with certain limited exceptions; and
- (5) the interest of an individual in the balance of his or her account is non-forfeitable.⁴

1. 2002-2 CB 75.

2. Notice 2002-45, 2002-2 CB 93.

3. IRC Sec. 223(d)(1).

4. IRC Sec. 223(d)(1).

HSAs are available to any employer or individual for an account beneficiary who participates in a high deductible health insurance plan. An eligible individual or an employer may establish an HSA with a qualified HSA custodian or trustee without IRS permission or authorization. As mentioned above, any insurance company or bank can act as a trustee and, additionally, any person already approved by the IRS to act as an individual retirement arrangement ("IRA") trustee or custodian automatically is approved to act in the same capacity for HSAs.¹

HSAs are similar to IRAs in some respects although a taxpayer cannot use an IRA as an HSA, nor can a taxpayer combine an IRA with an HSA.²

Contributions to an HSA generally may be made either by an individual, by an individual's employer, or by both. If contributions are made by an individual taxpayer, they are deductible from income.³ Contributions made by an employer are excluded from the employee's income.⁴ The HSA itself is also exempt from income tax as long as it remains an HSA.⁵ HSA contributions may be made through a cafeteria plan under IRC Section 125 (see Q 8743).⁶

HSA distributions used exclusively to pay qualified medical expenses are not includable in gross income. Distributions used for other purposes are includable in gross income and may be subject to a penalty, with some exceptions.⁷

An employer's contributions to an HSA are not treated as part of a group health plan subject to COBRA continuation coverage requirements.⁸ Therefore, a plan is not required to make COBRA continuation coverage available with respect to an HSA.⁹

According to IRS guidance, a levy to satisfy a tax liability under IRC Section 6331 extends to a taxpayer's interest in an HSA. A taxpayer is liable for the additional 10 percent tax (20 percent after December 31, 2010, under PPACA 2010) on the amount of the levy unless the taxpayer has attained age sixty-five or is disabled at the time of the levy.¹⁰

8745. Who is an eligible individual for purposes of maintaining an HSA?

An "eligible individual" for purposes of maintaining an HSA is an individual who, for any month, is covered under a high deductible health plan (HDHP) as of the first day of that month and is not also covered under a non-high deductible health plan providing coverage for any benefit covered under the HDHP.¹¹

1. Notice 2004-50, 2004-2 CB 196, A-72; Notice 2004-2, 2004-1 CB 269, A-9, A-10.

2. See Notice 2004-2, above.

3. IRC Sec. 223(a).

4. See IRC Sec. 106(d)(1).

5. IRC Sec. 223(e)(1).

6. IRC Sec. 125(d)(2)(D).

7. IRC Sec. 223(f).

8. See IRC Secs. 106(b)(5), 106(d)(2).

9. See Treas. Reg. §54.4980B-2, A-1 regarding Archer MSAs.

10. CCA 200927019.

11. IRC Sec. 223(c)(1)(A).

Individuals who are enrolled in Medicare Part A or Part B are not eligible to contribute to an HSA.¹ Mere *eligibility* for Medicare does not preclude HSA contributions.²

If an individual has received medical benefits through the Department of Veterans Affairs within the previous three months, the individual may not contribute to an HSA for the current month. Mere eligibility for VA medical benefits will not disqualify an otherwise eligible individual from making HSA contributions.³

If an individual is covered by a separate prescription drug plan that provides any benefits before a required high deductible is satisfied, the individual normally does not qualify as an eligible individual.⁴ Despite this general rule, the IRS has ruled that if an individual's separate prescription drug plan does not provide benefits until an HDHP's minimum annual deductible amount has been met, then the individual will be an eligible individual under Section 223(c)(1)(A). For calendar years 2004 and 2005 only, the IRS provided transition relief such that an individual would not fail to be an eligible individual solely by virtue of coverage by a separate prescription drug plan.⁵

If an individual is covered under an Employee Assistance Program, disease management program, or wellness program, that individual will not fail to be an eligible individual based solely on this coverage if the program does not provide significant benefits in the nature of medical care or treatment.⁶

Certain types of insurance are not considered in determining whether an individual is eligible for an HSA. Specifically, insurance for a specific disease or illness, hospitalization insurance paying a fixed daily amount, and insurance providing coverage that relates to certain liabilities are disregarded.⁷

In addition, coverage provided by insurance or otherwise for accidents, disability, dental care, vision care, or long-term care will not adversely impact HSA eligibility.⁸

If an employer contributes to an eligible employee's HSA, in order to receive an employer comparable contribution the employee must:

- (1) establish the HSA on or before the last day in February of the year following the year for which the contribution is being made and;
- (2) notify the appropriate contact person of the HSA account information on or before the last day in February of the year described in (1) above and specify and provide HSA account information (such as the account number, name and address

1. IRC Sec. 223(b)(7).

2. Notice 2004-50, 2004-2 CB 196, A-3.

3. Notice 2004-50, 2004-2 CB 196, A-5.

4. Rev. Rul. 2004-38, 2004-1 CB 717, modified by Rev. Proc. 2004-22; 2004-1 CB 727.

5. Rev. Proc. 2004-22, 2004-1 CB 727.

6. Notice 2004-50, 2004-2 CB 196, A-10.

7. IRC Sec. 223(c)(3).

8. IRC Sec. 223(c)(1)(B).

of trustee or custodian, etc.) as well as the method by which the account information will be provided (whether in writing, by e-mail, on a certain form, etc.).¹

An eligible employee that establishes an HSA and provides the information required as described in (1) and (2) above will receive an HSA contribution, plus reasonable interest, for the year for which contribution is being made by April 15 of the following year.²

8746. Can an individual participate in both an HSA and a health FSA?

The IRS has issued guidance providing that taxpayers who participate in health flexible spending accounts (FSAs) that reimburse all qualified medical expenses are ineligible to also contribute to health savings accounts (HSAs) because participation in the FSA constitutes “other coverage” prohibited by the rules applicable to HSAs. This is the case even if the individual only participates in the FSA during the tax year because of a permitted carryover from the prior tax year.

In order to be eligible to contribute to an HSA, a taxpayer must have a high deductible health plan (HDHP), and can also have certain other types of permitted insurance and coverage, as well as preventative care coverage, but not “other coverage.” For these purposes, a taxpayer is not eligible to contribute to an HSA if he or she is covered under a health plan that is not an HDHP that provides coverage for any benefit covered under the HDHP. A health FSA that reimburses for all qualified medical expenses falls within this prohibition.

This is the result even if participation in the FSA for the year is only because of a permitted carryover of up to \$500 from the preceding tax year. The ineligibility for HSA contributions continues throughout the entire tax year, even if the carried over amounts are exhausted early in the year.

However, a taxpayer can elect to have unused FSA funds carried over into an HSA-compatible FSA (which is either a limited purpose FSA, a post-deductible FSA or a combination of the two). In this case, a taxpayer will be eligible to contribute to an HSA for the year.³

8747. What is a high deductible health plan for purposes of an HSA?

The requirements for a high deductible health plan (“HDHP”) differ depending on whether individual or family coverage is provided. In this context, family coverage includes any coverage other than self-only coverage.⁴

For 2013 and 2014, an HDHP is a plan with an annual deductible of not less than \$1,250 for self-only coverage (\$1,300 in 2015), or \$2,500 for family coverage (\$2,600 for 2015), but annual out-of-pocket expenses that do not exceed \$6,450 for self-only coverage (\$6,650 for 2015), or \$12,700 for family coverage (\$12,900 for 2015).⁵ These annual deductible amounts and out-of-pocket expense amounts are adjusted for cost of living. Increases are made in multiples of \$50.⁶

1. Treas. Reg. §54.4980G-4 A-14(c).

2. TD 9393, 2008-20 IRB.

3. ILM 201413005.

4. IRC Sec. 223(c)(5).

5. Rev. Proc. 2012-26; Rev. Proc. 2013-25, 2013-21 IRB 1; Rev. Proc. 2014-30, 2014 IRB LEXIS 313.

6. IRC Sec. 223(g).

Deductible limits for HDHPs are based on a twelve month period. If a plan deductible may be satisfied over a period longer than twelve months, the minimum annual deductible under IRC Section 223(c)(2)(A) must be increased on a pro-rata basis to take the longer period into account.¹

An HDHP may impose a reasonable lifetime limit on benefits provided under the plan as long as the lifetime limit on benefits is not designed to circumvent the maximum annual out-of-pocket limitation.² A plan with no limitation on out-of-pocket expenses, either by design or by its express terms, does not qualify as a high deductible health plan.³

An HDHP may provide preventive care coverage without application of the annual deductible.⁴ The IRS has provided guidance and safe harbor guidelines on what constitutes preventive care. Pursuant to the IRS safe harbor, preventive care includes, but is not limited to, periodic check-ups, routine prenatal and well-child care, immunizations, tobacco cessation programs, obesity weight-loss programs, and various health screening services. Preventive care may include drugs or medications taken to prevent the occurrence or reoccurrence of a disease that is not currently present.⁵

Notice 2013-57 clarifies that a health plan will not fail to qualify as an HDHP merely because it provides preventative services under the ACA without requiring a deductible.⁶

For months before January 1, 2006, a health plan would not fail to qualify as an HDHP solely based upon its compliance with state health insurance laws that mandate coverage without regard to a deductible or before the high deductible is satisfied.⁷ This transition relief only applied to disqualifying benefits mandated by state laws that were in effect on January 1, 2004. This relief extended to non-calendar year health plans with benefit periods of twelve months or less that began before January 1, 2006.⁸

Out-of-pocket expenses include deductibles, co-payments, and other amounts that a participant must pay for covered benefits. Premiums are not considered out-of-pocket expenses.⁹

8748. What are the contribution limits to an HSA?

An eligible individual may deduct the aggregate amount paid in cash into an HSA during the taxable year up to the annual limitation amount. In 2014, an individual can deduct up to \$3,300 for self-only coverage and \$6,550 for family coverage.¹⁰ For 2015, these contribution limits increase to \$3,350 for self-only coverage, and \$6,650 for family coverage.¹¹

1. Notice 2004-50, 2004-2 CB 196, A-24.

2. Notice 2004-50, 2004-2 CB 196, A-14.

3. Notice 2004-50, 2004-2 CB 196, A-17.

4. IRC Sec. 223(c)(2)(C).

5. Notice 2004-50, 2004-2 CB 196, A-27; Notice 2004-23, 2004-1 CB 725.

6. 2013 IRB LEXIS 465.

7. Notice 2004-43, 2004-2 CB 10.

8. Notice 2005-83, 2005-2 CB 1075.

9. Notice 2004-2, 2004-1 CB 269, A-3; Notice 96-53, 1996-2 CB 219, A-4.

10. IRC Secs. 223(a), 223(b)(2); Rev. Proc. 2012-26.

11. Rev. Proc. 2013-25, 2013-21 IRB 1; Rev. Proc. 2014-30, 2014 IRB LEXIS 313.

For years prior to 2007, the allowable contribution and deduction were limited to the lesser of the deductible under the applicable HDHP or the indexed annual limits for self-only coverage or family coverage.¹

The determination of whether a plan offers self-only or family coverage is made as of the first day of the month. The limit is calculated on a monthly basis and the allowable deduction for a taxable year cannot exceed the sum of the monthly limitations. See Q 8749 for a discussion of the individual requirements for HSA eligibility. An example illustrating calculation of the HSA contribution limit is provided below.

Example: Lola has self-only coverage under an HDHP in 2014 and wishes to contribute to an HSA. She has been an eligible individual for all of 2014, so her monthly contribution for self-only coverage is calculated by dividing the 2014 annual limit (\$3,300) by the 12 months in her eligibility period. Lola can contribute \$275 per month in 2014. If Lola was only an eligible individual for the first eight months of 2014, she still must first calculate her monthly contribution based on a 12-month year. However, her annual contribution limit is prorated to \$2,200 (her monthly \$275 limit multiplied by the eight months of eligibility). Although the annual contribution level is determined for each month, Lola is entitled to contribute her entire annual contribution amount in a single payment, if desired.² If Lola had been an eligible individual for the last month of 2014, she would have been treated as though she were an eligible individual for the entire year.

Individuals who attain age fifty-five before the close of a taxable year are eligible for an additional “catch-up” contribution amount over and above that calculated under IRC Section 223(b)(1) and IRC Section 223(b)(2). The additional contribution amount is \$1,000 for 2009 and later years.³ In 2015, this would allow individuals age fifty-five and older to contribute up to \$4,350 and the total contribution for a family would be \$7,650.

An individual who becomes an eligible individual after the beginning of a taxable year and who is an eligible individual for the last month of the taxable year is treated as being an eligible individual for the entire taxable year. For example, a calendar-year taxpayer with self-only coverage under an HDHP who became an eligible individual for December 2015 would be able to contribute the full \$3,350 to an HSA in that taxable year. If a taxpayer fails at any time during the following taxable year to be an eligible individual, the taxpayer must include in his or her gross income the aggregate amount of all HSA contributions made by the taxpayer that could not have been made under the general rule. The amount includable in gross income also is subject to a 10 percent penalty tax.⁴

For married individuals, if either spouse has family coverage, then both spouses are treated as having family coverage and the deduction limit is divided equally between them, unless they agree on a different division. If both spouses have family coverage under different plans, both spouses are treated as having only the family coverage with the lowest deductible.⁵

An HSA may be offered in conjunction with a cafeteria plan. Both a HDHP and an HSA are qualified benefits under a cafeteria plan.⁶

1. IRC Sec. 223(b)(2), prior to amendment by TRHCA 2006.

2. IRC Sec. 223(b); Notice 2004-2, 2004-1 CB 269, A-12.

3. IRC Sec. 223(b)(3).

4. IRC Sec. 223(b)(8).

5. IRC Sec. 223(b)(5).

6. IRC Sec. 125(d)(2)(D).

Employer contributions to an HSA are treated as employer-provided coverage for medical expenses to the extent that contributions do not exceed the applicable amount of allowable HSA contributions.¹ Further, an employee is not required to include any amount in income simply because the employee may choose between employer contributions to an HSA and employer contributions to another health plan.²

An individual may not deduct any amount paid into an HSA. Instead, that amount is excludable from gross income under IRC Section 106(d).³

No deduction is allowed for any amount contributed to an HSA with respect to any individual for whom another taxpayer may take a deduction under IRC Section 151 (on dependency exemptions) for the taxable year.⁴ See Q 8749 to Q 8753 for the rules governing employer contributions to employee HSAs. See Q 8756 for a discussion of the treatment of HSA distributions.

8749. What rules govern employer contributions to employee HSAs? Must an employer who offers HSAs to its employees contribute the same amount for each employee?

An employer offering HSAs to its employees is required to make comparable contributions to the HSAs for all comparable participating employees for each coverage period during the calendar year.⁵ IRC Section 4980G incorporates the comparability rules of IRC Section 4980E by reference.⁶

“Comparable contributions” for this purpose are contributions that either are the same amount or the same percentage of the annual deductible limit under a high deductible health plan (“HDHP”).⁷ “Comparable participating employees” include all employees who are in the same category of employee and have the same category of coverage.

Category of employee refers to full-time employees, part-time employees, and former employees.⁸ Category of coverage refers to self-only coverage and family-type coverage. Family coverage may be subcategorized as self plus one, self plus two, and self plus three or more. Subcategories of family coverage may be tested separately, but an employer may not contribute less to a category of family coverage with more covered persons than to another category with fewer covered persons.⁹

For years beginning in 2007 and thereafter, participating highly compensated employees may not be treated as comparable to non-highly compensated employees.¹⁰

1. IRC Sec. 106(d)(1).

2. IRC Secs. 106(b)(2), 106(d)(2).

3. See IRC Sec. 223(b)(4).

4. IRC Sec. 223(b)(6).

5. IRC Secs. 4980E, 4980G.

6. Treas. Reg. §54.4980G-1, A-1.

7. IRC Sec. 4980E(d)(2); Treas. Reg. §54.4980G-4, A-1.

8. Treas. Reg. §54.4980G-3, A-5.

9. IRC Sec. 4980E(d)(3); Treas. Reg. §§54.4980G-1, A-2, 54.4980G-4, A-1.

10. IRC Sec. 4980G(d), as added by TRHCA 2006.

Employer contributions made to HSAs through a cafeteria plan, including matching contributions, are not subject to the comparability rules, but are instead subject to IRC Section 125 nondiscrimination rules.¹

An employer may make contributions to HSAs of all eligible employees either:

- (1) at the beginning of a calendar year;
- (2) monthly, on a pay-as-you-go basis; or
- (3) at the end of a calendar year, taking into account each month that an employee was a comparable participating employee.

An employer must use the same contribution method for all comparable participating employees.²

If an employer does not prefund HSA contributions, regulations provide that it may accelerate all or part of its contributions for an entire year to HSAs of employees who incur, during the calendar year, qualified medical expenses exceeding the employer's cumulative HSA contributions to date. If an employer permits accelerated contributions, the accelerated contributions must be available on a uniform basis to all eligible employees under reasonable requirements.³ See Q 8750 for a detailed discussion of the rules that apply when an employee does not participate in the employer's HSA for the entire year.

8750. What are the contribution rules for employers who establish HSAs for employees when an employee has not established an HSA at the time the employer makes contributions or is not eligible to participate for the entire year?

If there are employees who have not established an HSA at the time the employer makes contributions, the employer must provide each such eligible employee a written notice containing certain information no later than January 15. The notice must explain that if the employee, by the last day of February, (a) establishes an HSA and (b) notifies the employer that he or she has done so, the employee will receive a comparable contribution to that HSA for the prior calendar year. This notice may be delivered electronically.

The employer must then make comparable contributions by April 15, taking into account each month that the employee was a comparable participating employee, for each eligible employee that notifies an employer that he or she has established an HSA. These retroactive comparable contributions must also include reasonable interest.⁴

There is a maximum contribution permitted for all employees who are eligible individuals during the last month of the taxable year. An employer may contribute up to the maximum annual contribution amount for the calendar year based on the employees' HDHP coverage

1. Notice 2004-50, 2004-2 CB 196, A-47; IRC Sec. 125 (b), (c), and (g); Treas. Reg. §1.125-1, A-19.

2. IRC Sec. 4980E(d)(3); Treas. Reg. §§54.4980G-4, A-4.

3. IRC Sec. 4980E(d)(3); Treas. Reg. §§54.4980G-4, A-15.

4. IRC Sec. 4980E(d)(3); Treas. Reg. §§54.4980G-4, A-14.

to HSAs of all employees who are eligible individuals on the first day of the last month of the employees' taxable year. This rule also applies to employees who worked for the employer for less than the entire calendar year and employees who became eligible individuals after January 1 of the calendar year. For example, contributions may be made on behalf of an eligible individual who is hired after January 1 or an employee who becomes an eligible individual after January 1.¹

Employers are only required to provide a pro rata contribution based on the number of months that an individual was an eligible individual and employed by the employer during the year. If an employer contributes more than a pro rata amount for a calendar year to an HSA of any eligible individual who is hired after January 1 of the calendar year, or any employee who becomes an eligible individual any time after January 1 of the calendar year, the employer must contribute that same amount on an equal and uniform basis to HSAs of all comparable participating employees who are hired or become eligible individuals after January 1 of the calendar year.²

Similarly, if an employer contributes the maximum annual contribution amount for the calendar year to an HSA of any eligible individual who is hired after January 1 of the calendar year or any employee who becomes an eligible individual any time after January 1 of the calendar year, the employer also must contribute the maximum annual contribution amount on an equal and uniform basis to HSAs of all comparable participating employees who are hired or become eligible individuals after January 1 of the calendar year.³

An employer who makes the maximum calendar year contribution or more than a pro rata contribution to HSAs of employees who become eligible individuals after the first day of the calendar year or to eligible individuals who are hired after the first day of the calendar year does not fail to satisfy comparability merely because some employees will have received more contributions on a monthly basis than employees who worked the entire calendar year.⁴

8751. Are there any exceptions to the comparability rules that govern employer contributions to employee HSAs?

Yes, the IRC provides an exception to comparability rules that allows, but that does not require, employers to make larger contributions to HSAs of non-highly compensated employees than to HSAs of highly compensated employees.⁵

Regulations provide that employers may make larger HSA contributions for non-highly compensated employees who are comparable participating employees than for highly compensated employees who are comparable participating employees.⁶ However, the reverse does not apply: employer contributions to HSAs for highly compensated employees who are comparable participating employees may *not* be larger than employer HSA contributions for non-highly compensated employees who are comparable participating employees.⁷

1. Treas. Reg. §54.4980G-4.

2. Treas. Reg. §54.4980G-4.

3. Treas. Reg. §54.4980G-4.

4. Treas. Reg. §54.4980G-4.

5. IRC Sec. 4980G(d); Preamble, TD 9457, 74 Fed. Reg. 45994, 45995 (9-8-2009); see Treas. Reg. §54.4980G-6.

6. Treas. Reg. §54.4980G-6, Q&A-1.

7. Treas. Reg. §54.4980G-6, Q&A-2.

Comparability rules continue to apply with respect to contributions to HSAs of all non-highly compensated employees and all highly compensated employees. Thus, employers must make comparable contributions for a calendar year to the HSA of each non-highly compensated comparable participating employee and each highly compensated comparable participating employee.¹

8752. Is there a penalty if an employer fails to meet the HSA comparability requirements with respect to contributions to employee HSAs?

If an employer fails to meet comparability requirements (see Q 8749), a penalty tax is imposed, equal to 35 percent of the aggregate amount contributed by an employer to HSAs of employees for their taxable years ending with or within the calendar year.²

8753. Can employers allow employees to roll funds into their HSAs from HRAs or FSAs? What is a qualified HSA distribution?

Employers may offer a rollover, known as a qualified HSA distribution, from a health reimbursement arrangement (HRA) or a health flexible spending arrangement (FSA) for any employee. However, if the employer offers a rollover option to one employee, it must offer a rollover to any eligible individual covered under an HDHP of the employer. Otherwise, the comparability requirements of IRC Section 4980G do not apply to qualified HSA distributions.³

There are special comparability rules for qualified HSA distributions contributed to HSAs on or after December 20, 2006, and before January 1, 2012. Effective January 1, 2010, the comparability rules of IRC Section 4980G do not apply to amounts contributed to employee HSAs through qualified HSA distributions.

To satisfy comparability rules, if an employer offers qualified HSA distributions to any employee who is an eligible individual covered under any HDHP, the employer must offer qualified HSA distributions to all employees who are eligible individuals covered under any HDHP. If an employer offers qualified HSA distributions only to employees who are eligible individuals covered under an employer's HDHP, the employer is not required to offer qualified HSA distributions to employees who are eligible individuals but are not covered under the employer's HDHP.⁴

8754. What is the penalty for making excess contributions to an HSA? How does an excess contribution impact the taxation of distributions from the HSA?

If an HSA receives excess contributions for a taxable year, distributions from the HSA are not includable in income to the extent that the distributions do not exceed the aggregate excess contributions to all HSAs of an individual for a taxable year if the following are true:

1. Treas. Reg. §54.4980G-6, Q&A-1.

2. IRC Secs. 4980E(a), 4980E(b), 4980G(b). For filing requirements for excise tax returns, see Treas. Regs. §§54.6011-2 (general requirement of return), 54.6061-1 (signing of return), 54.6071-1(c) (time for filing return), 54.6091-1 (place for filing return), and 54.6151-1 (time and place for paying tax shown on return).

3. IRC Sec. 106(e)(5).

4. Treas. Reg. §54.4980G-7, Q&A-1.

- (1) the distribution is received by the individual on or before the last day for filing the individual's income tax return for the year including extensions; and
- (2) the distribution is accompanied by the amount of net income attributable to the excess contribution. Any net income must be included in an individual's gross income for the taxable year in which it is received.¹

Excess contributions to an HSA are subject to a 6 percent tax. However, the penalty tax may not exceed 6 percent of the value of the account, as determined at the close of the taxable year.²

Excess contributions are defined, for this purpose, as the sum of the following:

- (1) the aggregate amount contributed for the taxable year to the accounts, excluding rollover contributions, which is neither excludable from gross income under IRC Section 106(b) nor allowable as a deduction under IRC Section 223; and
- (2) the amount calculated in (1), above, for the preceding taxable year *reduced by* the sum of (x) the distributions from the accounts that were included in gross income under IRC Section 223(f)(2), and (y) the excess of the maximum amount allowable as a deduction under IRC Section 223(b)(1), for the taxable year, over the amount contributed for the taxable year.³

For these purposes, any excess contributions distributed from an HSA are treated as amounts not contributed.⁴

8755. How are funds accumulated in an HSA taxed prior to distribution?

Funds accumulated in an HSA are generally exempt from income tax unless the account ceases to be an HSA.⁵

In addition, rules similar to those applicable to individual retirement arrangements ("IRAs") regarding the loss of the income tax exemption for an account where an employee engages in a prohibited transaction⁶ and those regarding the effect of pledging an account as security⁷ apply to HSAs. Any amounts treated as distributed under these rules will be treated as not used to pay qualified medical expenses.⁸

8756. How are amounts distributed from HSAs taxed?

If a distribution from an HSA is used exclusively to pay the qualified medical expenses of an account holder, the distributed amount is not includable in gross income.⁹ In contrast, any distribution from an HSA that is not used exclusively to pay qualified medical expenses of an account holder must be included in the account holder's gross income.¹⁰

1. IRC Sec. 223(f)(3)(A).

2. IRC Sec. 4973(a).

3. IRC Sec. 4973(g).

4. IRC Sec. 4973(g).

5. IRC Sec. 223(e)(1).

6. See IRC Sec. 408(e)(2).

7. See IRC Sec. 408(e)(4).

8. IRC Sec. 223(e)(2).

9. IRC Sec. 223(f)(1).

10. IRC Sec. 223(f)(2).

In addition, a penalty tax applies to any distribution that is includable in income because it was not used to pay qualified medical expenses.¹ The penalty tax is 10 percent of includable income for a distribution from an HSA.² For distributions made after December 31, 2010, the additional tax on nonqualified distributions from HSAs is increased to 20 percent of includable income.³

The penalty tax does not apply to includable distributions received after an HSA holder becomes disabled within the meaning of IRC Section 72(m)(7), dies, or reaches the age of Medicare eligibility.⁴

“Qualified medical expenses” are amounts paid by the account holder for medical care⁵ for the individual, his or her spouse, and any dependent to the extent that expenses are not compensated by insurance or otherwise.⁶ For tax years beginning after December 31, 2010, medicines constituting qualified medical expenses are limited to doctor-prescribed drugs and insulin. As a result, over-the-counter medicines are no longer qualified expenses unless prescribed by a doctor after 2010.⁷

With several exceptions, the payment of insurance premiums is not a qualified medical expense. The exceptions include any expense for coverage under a health plan during a period of COBRA continuation coverage, a qualified long-term care insurance contract⁸ or a health plan paid for during a period in which the individual is receiving unemployment compensation.⁹

An account holder may pay qualified long-term care insurance premiums with distributions from an HSA even if contributions to the HSA were made by salary reduction through a cafeteria plan. Amounts of qualified long-term care insurance premiums that constitute qualified medical expenses are limited to the following age-based limits in 2014, which are adjusted annually:¹⁰

- (1) for persons age forty or less, the limit is \$370,
- (2) for ages forty-one through fifty, the limit is \$700;
- (3) for ages fifty-one through sixty, the limit is \$1,400;
- (4) for ages sixty-one through seventy, the limit is \$3,720; and
- (5) for those over age seventy, the limit is \$4,660.¹¹

The age is the individual’s attained age before the close of the taxable year.

1. IRC Sec. 223(f)(4)(A).

2. IRC Sec. 223(f)(4)(A).

3. IRC Sec. 223(f)(4)(A), as amended by PPACA 2010, as further amended by HCERA 2010.

4. IRC Secs. 223(f)(4)(B), 223(f)(4)(C).

5. As defined in IRC Section 213(d).

6. IRC Sec. 223(d)(2).

7. IRC Sec. 106(f), as added by PPACA 2010.

8. As defined under IRC Section 7702B(b).

9. IRC Sec. 223(d)(2).

10. Notice 2004-50, 2004-2 CB 196, A-40.

11. Rev. Proc. 2013-35, 2013-47 IRB 537.

An HSA account holder may make tax-free distributions to reimburse qualified medical expenses from prior tax years as long as the expenses were incurred after the HSA was established. There is no time limit on when a distribution must occur.¹

HSA trustees, custodians, and employers need not determine whether a distribution is used for qualified medical expenses. This responsibility falls on individual account holders.²

8757. What is the Affordable Care Act? When do its provisions become effective?

The Affordable Care Act is a comprehensive health care reform law that President Obama signed into law on March 23, 2010.³ The Patient Protection and Affordable Care Act significantly amends the IRC, ERISA, and the Public Health Service Act. The new law, known as the PPACA, ACA, or Affordable Care Act, focuses on expanding health care coverage, controlling health care costs, and improving the health care delivery system. It attempts to accomplish these goals in a variety of ways, as described in Q 8758 to Q 8764.

In many ways, the ACA is only a broad outline of the reforms that will take place over the coming years, with the details expected to be filled in by regulators. The Department of Labor, the Department of Treasury, the IRS, and the Department of Health & Human Services have all proposed regulations, or will propose regulations, that outline the more detailed requirements of the ACA.

The ACA goes into effect between 2010 and 2018. The bulk of the provisions are effective beginning in 2011 through 2014. One provision, the tax on so-called “Cadillac” health care plans, goes into effect in 2018.

8758. What kinds of health plans are governed by the Affordable Care Act?

The ACA covers insured and self-funded comprehensive medical health plans. In effect, the ACA governs major medical insurance and self-insured major medical plans.

Certain excepted benefits, which include standalone vision, standalone dental, cancer, long-term care insurance, Medigap insurance, certain flexible spending accounts (“FSAs”), and accident and disability insurance that make payments directly to individuals, are generally not regulated under the ACA.

Similarly, plans that only impact retirees (“retiree-only plans”) are not impacted by the ACA. Although the ACA removed the exemption for retiree-only plans and excepted benefit plans from the PHS Act, it left those exemptions in the IRC and ERISA. The preamble and footnote 2 of interim final grandfathered plan regulations explain that the exemption for retiree-only plans and excepted benefit plans still applies for those plans subject to the IRC and ERISA.

1. Notice 2004-50, 2004-2 CB 196, A-39.

2. Notice 2004-2, 2004-1 CB 269, A-29, A-30.

3. Patient Protection and Affordable Care Act (P.L. 111-148).

Federal regulators have determined that, with respect to retiree-only and excepted benefit plans, even though those provisions were removed by the ACA, they will read the PHS Act as if an exemption for retiree-only and excepted benefit plans were still in effect. Federal regulators have encouraged state insurance regulators to do the same, although in any given state it is possible, although unlikely, that regulators will decide to enforce the ACA mandates on all fully insured plans.

8759. What tax credit is available for employers who purchase health insurance? When does the credit become available?

The health insurance tax credit applies to for-profit and non-profit employers meeting certain requirements (see Q 8760). From 2010 through 2013, the amount of the credit for for-profit employers is 35 percent (25 percent for non-profit employers) of qualifying health insurance costs. The credit is increased for any two consecutive years beginning in 2014 to 50 percent of a for-profit employer's qualifying expenses and 35 percent for non-profit employers.¹

The new tax credit is effective for 2010 and thereafter. Beginning in 2014, it is only available for two consecutive years. Thus, the maximum number of years that an employer can take advantage of this tax credit is six, namely 2010 through 2013, plus any two consecutive years beginning in 2014.²

8760. What employers are eligible for the new tax credit for health insurance under the Affordable Care Act?

The new health insurance tax credit³ is designed to help approximately four million small for-profit businesses and tax-exempt organizations that primarily employ low and moderate-income workers. The credit is available to employers that both:

- (1) have twenty-four or fewer eligible full time equivalent (FTE) employees, and
- (2) pay wages averaging under \$50,000 per employee per year.⁴

IRC Section 45R provides a tax credit beginning in 2010 for a business with twenty-five or fewer eligible FTEs. Eligible employees do not include seasonal workers who work for an employer 120 days a year or fewer, owners, and owners' family members, where average compensation for the eligible employees is less than \$50,000 and where the business pays 50 percent or more of employee-only (single person) health insurance costs. As a result, the compensation of owners and family members is not counted in determining average compensation, and the health insurance cost for these people is not eligible for the health insurance tax credit.⁵

1. <http://www.ncsl.org/documents/health/SBtaxCredits.pdf> (last accessed June 5, 2014). See also 2013 IRB LEXIS, 2013-38 IRB 211 (modifying IRS Notice 2010-44, 2010-22 IRB 717; IRS Notice 2010-82, 2010-51 IRB 1).

2. <http://www.ncsl.org/documents/health/SBtaxCredits.pdf> (last accessed June 5, 2014).

3. IRC Sec. 45R.

4. <http://www.irs.gov/newsroom/article/0,,id=223666,00.html> (last accessed June 5, 2014).

5. <http://www.irs.gov/newsroom/article/0,,id=220839,00.html> (last accessed June 5, 2014).

The credit is largest if there are ten or fewer employees and average wages do not exceed \$25,000. The amount of the credit phases out for business with more than ten eligible employees or average compensation of more than \$25,000 and under \$50,000. The amount of an employer's premium payments that counts for purposes of the credit is capped by the average premium for the small group market in the employer's geographic location, as determined by the Department of Health and Human Services.¹

Example: In 2015, a qualified employer has nine FTEs (excluding owners, owners' family members, and seasonal employees) with average annual wages of \$24,000 per FTE. The employer pays \$75,000 in health care premiums for these employees, which does not exceed the average premium for the small group market in the employer's state, and otherwise meets the requirements for the credit. The credit for 2015 equals \$37,500 (50 percent x \$75,000).²

8761. How does the Affordable Care Act impact the use of health savings accounts (HSAs)?

The ACA amended IRC Section 223(d)(2)(A) with respect to health savings accounts (HSAs), which now provides that, for amounts paid after December 31, 2010, a distribution from an HSA for a medicine or drug is a tax-free qualified medical expense only if the medicine or drug:

- (1) requires a prescription;
- (2) is an over-the-counter medicine or drug and the individual obtains a prescription; or
- (3) is insulin.

If amounts are distributed from an HSA for any medicine or drug that does not satisfy these requirements, the amounts are treated as though they were distributed to pay for nonqualified medical expenses. Nonqualified medical expenses are includable in gross income and generally are subject to a 20 percent additional tax. This change does not affect HSA distributions for medicines or drugs made before January 1, 2011, nor does it affect distributions made after December 31, 2010, for medicines or drugs purchased on or before that date.

The IRS has provided guidance which makes it clear that these rules do not apply to items that are not medicines or drugs, including equipment such as crutches, supplies such as bandages, and diagnostic devices such as blood sugar test kits. These items may qualify as medical care if they otherwise meet the definition of medical care in IRC Section 213(d)(1), which includes expenses for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

Expenses for items that are merely beneficial to the general health of an individual, such as expenditures for a vacation, are not expenses for medical care.³

1. <http://www.irs.gov/newsroom/article/0,,id=220839,00.html> (last accessed June 5, 2014).

2. Additional examples can be found online at http://www.irs.gov/pub/irs-utl/small_business_health_care_tax_credit_scenarios.pdf.

3. Treas. Reg. §1.213-1(e)(1)(ii).

8762. What penalties are imposed by the Affordable Care Act for employers who violate the health insurance nondiscrimination rules?

The health insurance nondiscrimination rules (see Q 8733 to Q 8735), the effective date of which has been delayed until regulations have been released and a new effective date has been announced by the IRS, have different sanctions than those applicable to self-insured plans that fall under IRC Section 105(h).

For discriminatory self-insured plans, highly compensated employees have taxable income based on the benefits paid by their employer. By contrast, with respect to the new health insurance nondiscrimination requirements, the sanction under IRC Section 4980D is a \$100 per day excise tax on affected employees.¹

Although the IRS has not yet issued regulations on the penalty, its request for comments indicates that the term “affected employees” means those who are not highly compensated. Thus, if an employer has an insured health plan that is not grandfathered and that violates these new nondiscrimination rules for a plan year beginning on or after September 23, 2010, and if that employer has twenty non-highly compensated employees, the penalty will be \$2,000 per day as a result of having a discriminatory non-grandfathered health insurance plan.

IRC Section 4980(D)(d)(1) contains an exception to the excise tax for small employers, but the language is somewhat ambiguous. It states, “In the case of a group health plan of a small employer which provides health insurance coverage solely through a contract with a health insurance issuer, no tax shall be imposed by this section on the employer on any failure (other than a failure attributable to section 9811) which is solely because of the health insurance coverage offered by such issuer.” It is not clear whether this exception applies to the new nondiscrimination rules or simply to a health insurance policy that does not meet federal requirements. For the purpose of this exception, a small employer is defined as two to fifty employees.²

There also is a 10 percent cap on the excise tax, that is, 10 percent of aggregate premiums paid by an employer, for inadvertent violations of the nondiscrimination rules.³

8763. What is the penalty if an employer fails to provide the required health insurance under the Affordable Care Act?

As of the date of publication, the shared responsibility provisions outlined below had been delayed by the administration by one year. Therefore, these penalty provisions will not become effective until January 1, 2015, absent further government action. This delay is a result of the corresponding delay in the information reporting requirements applicable to certain employers, because that information was to be used to calculate the amount of an employer’s shared responsibility payment.⁴

1. IRC Sec. 4980D.

2. IRC Sec. 4980D(d)(1).

3. IRC Sec. 4980D(e)(3).

4. Notice 2013-45, 2013 IRB Lexis 372.

Employers with at least fifty full-time equivalent employees (FTEs) must offer health insurance coverage meeting specified requirements or pay a \$2,000 per full-time worker penalty (after its first thirty employees) if any of its FTEs receive a federal premium subsidy through a state health insurance exchange (which would occur because the employee was not being offered sufficient coverage through the employer).

A different penalty applies for employers of at least fifty FTEs that offer some type insurance coverage that is not sufficient to meet federal requirements. In this case, the penalty is \$3,000 per full-time employee who gets government assistance and buys coverage through an exchange, subject to a maximum penalty of \$2,000 times the number of full-time employees in excess of the first thirty. Proposed regulations provide that an employer with a non-calendar year plan in existence on December 27, 2012 that offers employees affordable coverage, which satisfies the minimum value requirement by the first day of the plan year starting in 2014, will not be assessed a shared responsibility penalty for any period in 2014 prior to the beginning of the next plan year.¹

The shared responsibility penalty on employers for failing to provide minimum essential health insurance excludes excepted benefits under Public Health Service Act 2971(c), including long-term care as well as standalone vision and standalone dental plans.

On June 28, 2012, the Supreme Court, in *National Federation of Independent Business v. Sebelius*,² upheld the constitutionality of the Affordable Care Act, with only minor changes to certain Medicaid provisions.

8764. What is the penalty if an individual fails to obtain the required health insurance under the Affordable Care Act?

Health care reform requires most Americans to have health insurance beginning in 2014, or there is a monetary penalty.

Unless exempt, Americans must have major medical health coverage provided by their employer or that they purchase themselves, or they must pay a fine that is the greater of a flat amount, or a percentage of income (above the tax filing threshold). The amounts are as follows:

- (1) \$95 or 1 percent of income in 2014;
- (2) \$325 or 2 percent of income in 2015; and
- (3) \$695 or 2.5 percent of income in 2016.³

Families will pay half the penalty amount for children under eighteen, up to a cap of \$2,085 per family. After 2016, penalties are indexed to the Consumer Price Index.

1. 78 Fed. Reg. 218 (2013).

2. 132 S. Ct. 2566 (2012).

3. IRC Sec. 5000A(c).

Exemptions from the individual penalty will be granted for financial hardship, religious objections, American Indians, those without coverage for fewer than three months, undocumented immigrants, incarcerated individuals, those for whom the lowest cost plan option exceeds 8 percent of an individual's income, and those with incomes below the tax filing threshold.¹

8765. When may a taxpayer be exempt from the rule that every taxpayer must obtain a certain level of health coverage or pay a penalty?

Beginning in 2014, taxpayers must obtain a certain minimum level of health coverage or pay a penalty (known as the shared responsibility provision) for failure to obtain minimum essential coverage unless the individual is statutorily exempted from this requirement. In general, the following exemptions may be applicable:

1. *Religious Exemption.* A taxpayer will be exempt from the shared responsibility provision if (a) a member of a recognized religious sect, the teachings of which render the taxpayer conscientiously opposed to accepting benefits provided by any public or private insurance provider that makes payments toward the expenses of obtaining medical care and (b) adheres to the established tenets or teaching of that sect.² The religious sect must have been in existence on December 31, 1950 and must be recognized by the Social Security Administration as one that is conscientiously opposed to accepting insurance benefits, including Medicare and Social Security.
2. *Foreign Persons Exemption.* A taxpayer will be exempt from the shared responsibility provision if not a citizen or national of the United States or an alien lawfully present in the United States.³
3. *Exemption for Incarcerated Individuals.* A taxpayer will be exempt from the shared responsibility provision during any month incarcerated, other than incarceration while awaiting the disposition of the charges that are pending against the taxpayer.⁴
4. *Affordability Exemption.* If an individual's required contribution for health coverage for the month exceeds 8 percent of the taxpayer's household income for the year (see Q 8768), the taxpayer will not be subject to the shared responsibility provision.⁵
5. *Exemption for Individuals not Required to File a Tax Return.* Individuals who are not required to file a federal tax return for the year because their income does not exceed the applicable filing thresholds (see Q 8501) are not subject to the shared responsibility provision.⁶

1. IRC Sec. 5000A(d), (e).

2. IRC Secs. 5000A(d)(2), 1402(g)(1).

3. IRC Sec. 5000A(d)(3).

4. IRC Sec. 5000A(d)(4).

5. IRC Sec. 5000A(e)(1).

6. IRC Sec. 5000A(e)(2).

6. *Membership in an Indian Tribe.* Members of recognized Indian tribes are not subject to the shared responsibility provision.¹
7. *Exemption for Short Coverage Gaps.* An individual will not be subject to the shared responsibility provision if there is a gap in health coverage for a period that is less than three months. However, if there is more than one such gap in coverage during the tax year, the exemption applies only to the first coverage gap.²
8. *Hardship Exemption.* The Secretary of Health and Human Services may allow exemptions from the shared responsibility provision on a case-by-case basis if it is determined that an individual has suffered a hardship and is thereby unable to obtain the required coverage.³

Both children and senior citizens are subject to the shared responsibility provision. If a child who can be claimed as a dependent does not qualify for an exemption, the taxpayer who can claim that child as a dependent is required to make the shared responsibility payment with respect to the child's failure to obtain the requisite coverage.⁴ See Q 8766 for information on how to claim an applicable exemption.

8766. How does a taxpayer who may be exempt from the Affordable Care Act requirements obtain the exemption?

An individual who may be exempt from the shared responsibility provision can often obtain a certificate of exemption from the health insurance exchanges. With respect to the religious and hardship exemptions, this is the only method of claiming the exemption. Individuals claiming the exemption based upon membership in an Indian tribe or incarceration may either obtain a certificate of exemption from the exchanges or claim the exemption on the federal tax return when the return is filed in the subsequent tax year. Exemptions for lack of affordable coverage, a short coverage gap, and certain hardships must be claimed on the taxpayer's federal income tax return.

Individuals who are exempt from the shared responsibility provision because their income for the year falls below the filing threshold, so that they are not required to file a federal tax return for the year, do not need to take any action in order to obtain the exemption.⁵

8767. What are the requirements to claim the premium assistance tax credit under the Affordable Care Act?

The premium assistance tax credit is a subsidy that can be claimed by certain low-to-moderate income taxpayers in order to offset the cost of health insurance coverage. In order to

1. IRC Sec. 5000A(e)(3).

2. IRC Sec. 5000A(e)(4).

3. IRC Sec. 5000A(e)(5).

4. IRS Q&A on the Individual Shared Responsibility Provision, available at: <http://www.irs.gov/uac/Questions-and-Answers-on-the-Individual-Shared-Responsibility-Provision> (last accessed June 10, 2014).

5. See IRS Q&A on the Individual Shared Responsibility Provision, available at: <http://www.irs.gov/uac/Questions-and-Answers-on-the-Individual-Shared-Responsibility-Provision> (last accessed June 10, 2014).

be eligible to claim the premium assistance tax credit, a taxpayer must meet all of the following requirements:¹

1. The taxpayer must purchase health insurance through the health insurance marketplace (also known as the health insurance exchanges);
2. The taxpayer must have income that falls within certain ranges (see Q 8768);
3. The taxpayer must not be able to obtain affordable coverage through an employer-provided health plan that provides minimum value (see Q 8775 for a discussion of what constitutes “affordable coverage” and Q 8776 for a discussion of plans that provide “minimum value”);
4. The taxpayer must be ineligible for government-sponsored health care programs, such as Medicaid and Medicare;
5. Generally, a taxpayer who is married must file a joint return (though exceptions exist for certain victims of domestic violence²);
6. No other person may claim a dependency exemption with respect to the taxpayer for the tax year.

Individuals with household income (see Q 8768) that falls between 100 and 400 percent of the poverty line (as adjusted based on family size) may be eligible for the premium tax credit. The federal poverty guidelines that exist as of the first day of the annual open enrollment period are used to determine whether an individual is eligible for the credit, so that the 2014 guidelines are used to determine a taxpayer’s credit for 2015.³ For example, in 2014 the federal poverty guidelines for the 48 contiguous states (including Washington, D.C.) are as follows:

- \$11,670 (100 percent) to \$46,680 (400 percent) for an individual;
- \$15,730 (100 percent) to \$62,920 (400 percent) for a family of two;
- \$19,790 (100 percent) to \$79,160 (400 percent) for a family of three;
- \$23,850 (100 percent) to \$95,400 (400 percent) for a family of four.⁴

The federal poverty line is modified for taxpayers living in Alaska and Hawaii. If a taxpayer’s primary residence during the tax year changes to a state with a different federal poverty line, or if married taxpayers reside in states with different federal poverty lines, the poverty line that applies is the higher of the two guidelines.⁵

1. IRC Sec. 36B.

2. Notice 2014-23, 2014-16 IRB 942.

3. IRC Sec. 36B(d)(5).

4. See the Department of Health & Human Services website for the federal poverty guidelines that apply for families larger than four and the figures for Alaska and Hawaii, available at: <http://aspe.hhs.gov/poverty/14poverty.cfm> (last accessed June 11, 2014).

5. Treas. Reg. §36B-1(h).

8768. What is “household income” and how does it determine whether an individual is eligible for a premium assistance tax credit?

For purposes of the premium assistance tax credit, household income is a taxpayer’s modified adjusted gross income (MAGI, see below) plus the aggregate modified adjusted gross income of any other individual who was both (1) taken into account in determining the taxpayer’s family size for purposes of determining qualification for the credit and (2) required to file a federal tax return for the tax year in question.¹ Because the taxpayer’s family size is determined by counting any individual whom the taxpayer was entitled claim as a dependent to for the tax year,² it is essentially the case that any income of the taxpayer’s dependents who are required to file a return for the year is included in calculating the taxpayer’s MAGI.

A taxpayer’s MAGI is the adjusted gross income shown on the taxpayer’s federal income tax return for the year plus any excluded foreign income, nontaxable Social Security benefits and tax-exempt interest accrued or received during the tax year.³ Supplemental Social Security income is not included in a taxpayer’s MAGI.⁴

8769. If a taxpayer is eligible for the premium assistance tax credit, what happens if the household income level or family size changes during the tax year?

The amount of the allowable premium assistance tax credit varies based upon a taxpayer’s annual household income and family size. If either the household income level or family size change throughout the tax year, the taxpayer’s allowable credit will increase or decrease accordingly. This becomes important when a taxpayer has chosen to take the premium tax credit in advance (where the credit is paid directly to the insurance company to reduce premiums), rather than retroactively (where the credit is claimed on the taxpayer’s federal income tax return for the year).⁵

If the actual allowable credit is less than the advance credit claimed, the difference will be deducted from the taxpayer’s overpayment (tax refund) or added to the amount that the taxpayer owes to the IRS if no tax refund is forthcoming. If the actual allowable credit is more than the advance credit claimed, the reverse is true, so that the difference will be added to the taxpayer’s refund or subtracted from the balance due to the IRS.⁶

The IRS has released guidance that advises taxpayers to notify the health insurance exchanges if any changes in circumstances have occurred that will alter the amount of the allowable credit in order to reduce the significance of the difference between the advance credit and actual allowable credit.⁷ Changes in circumstances that can give rise to such a difference include the following:

1. IRC Sec. 36B(d)(2).

2. IRC Sec. 36B(d)(1).

3. IRC Sec. 36B(d)(2)(B).

4. See IRS Questions and Answers on the Premium Tax Credit, available at: <http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-the-Premium-Tax-Credit> (last accessed May 28, 2014).

5. See IRS Pub. 5121 (2013).

6. Treas. Reg. §36B-4(a).

7. IRS Pub. 5120 (2013).

1. Increases or decreases in household income;
2. Marriage;
3. Divorce;
4. Birth or adoption of a child;
5. Gaining or losing eligibility for government or employer-sponsored health insurance.¹

See Q 8768 for a discussion of how household income is calculated for purposes of the premium assistance tax credit.

8770. Can a taxpayer still qualify for a premium assistance tax credit if exempt from the shared responsibility penalty under the Affordable Care Act?

Whether a taxpayer who is otherwise exempt from the shared responsibility penalty remains eligible to claim the premium assistance tax credit depends upon the type of exemption that applies. According to IRS guidance, taxpayers who are exempt because they are incarcerated or not lawfully present in the U.S. are not eligible to claim the premium tax credit. This is the case, however, because these exempt individuals are not permitted to enroll in a health plan through the health insurance exchanges. Individuals who are exempt for other reasons, such as because a religious exemption or affordability exemption applies, will still be eligible to claim the premium tax credit if they otherwise meet the requirements for eligibility.²

See Q 8765 for a detailed discussion of the various exemptions that may apply. See Q 8767 for a discussion of the qualification requirements that apply in determining whether a taxpayer is generally eligible to claim the premium tax credit.

8771. Is a taxpayer eligible for a premium assistance tax credit if enrolled in an insurance plan offered through an employer?

No. According to IRS guidance, a taxpayer is not eligible to receive a premium assistance tax credit even if enrolled in an employer-sponsored plan that is unaffordable or fails to provide minimum value.³

8772. How does an eligible taxpayer obtain the premium assistance tax credit?

When a taxpayer applies for health coverage through an exchange, the exchange itself estimates the amount of credit that the taxpayer may be eligible to claim. The taxpayer then

1. See IRS Questions and Answers on the Premium Tax Credit, available at: <http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-the-Premium-Tax-Credit> (last accessed May 28, 2014).

2. See IRS Questions and Answers on the Individual Shared Responsibility Provision, available at: <http://www.irs.gov/uac/Questions-and-Answers-on-the-Individual-Shared-Responsibility-Provision> (last accessed June 10, 2014).

3. See IRS Questions and Answers on the Premium Tax Credit, available at: <http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-the-Premium-Tax-Credit> (last accessed May 28, 2014).

determines whether to apply the credit in advance (meaning that it is sent directly to the insurance company in order to offset premium payments) or retroactively (meaning that the taxpayer claims the premium credit on the federal tax return for the year).¹

A taxpayer who receives a premium tax credit is required to file a federal tax return for the year in order to claim the credit. This is true even if the taxpayer would not otherwise be required to file a return because income does not exceed the applicable filing threshold (see Q 8501) for the tax year.²

On this return, the taxpayer must report the amount of premiums paid and any advance premium tax credit payments that have been forwarded to the insurance company on the taxpayer's behalf. If the taxpayer enrolls in a health insurance plan through the exchanges, the exchange will send the taxpayer a document that shows the amount of the taxpayer's annual premiums and any advance credit payments by January 31 of the year following the year of coverage.³

8773. If taxpayer changes health coverage during a year and has a gap in coverage will the taxpayer be subject to the shared responsibility penalty?

A taxpayer is treated as having minimum essential health coverage for the month if covered for at least one day during that month. Therefore, if the coverage gap is less than one month, the taxpayer will not be treated as having a gap in coverage and will not be subject to the shared responsibility penalty.⁴

Further, an individual will not be subject to the shared responsibility penalty if the gap in coverage lasts for less than three months (see Q 8765). However, this exemption applies only to the first three-month gap in the tax year. If the taxpayer has more than one three-month coverage gap in the same tax year, he or she will be subject to the shared responsibility penalty with respect to the second coverage gap.⁵

8774. Are U.S. citizens who are not U.S. residents subject to the shared responsibility penalty?

In general, yes. However, if a taxpayer may be exempt if qualifying for the foreign earned income exclusion under IRC Section 911. Therefore, if a U.S. citizen who is living abroad has not been physically present in the U.S. for at least 330 full days within a 12 month period, the individual will be treated as having obtained minimum essential coverage for that 12 month period. Further, U.S. citizens who are bona fide residents of foreign countries for an entire tax year will be treated as having obtained minimum essential coverage for the year.⁶

1. See IRS Questions and Answers on the Premium Tax Credit, available at: <http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-the-Premium-Tax-Credit> (last accessed May 28, 2014).

2. IRS Pub. 5120 (2013).

3. See IRS Questions and Answers on the Premium Tax Credit, available at: <http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-the-Premium-Tax-Credit> (last accessed May 28, 2014).

4. See IRS Questions and Answers on the Individual Shared Responsibility Provision, available at: <http://www.irs.gov/uac/Questions-and-Answers-on-the-Individual-Shared-Responsibility-Provision> (last accessed June 10, 2014).

5. IRC Sec. 5000A(c)(4).

6. IRC Sec. 911(d), TD 9632.

U.S. citizens who do not meet the tests outlined above are required to maintain minimum essential health coverage (which can include group health coverage provided by a foreign employer), qualify for an otherwise applicable exemption (see Q 8765) or make the shared responsibility payment.

8775. What determines whether health coverage offered by an employer is “affordable” under the Affordable Care Act?

For purposes of the premium assistance tax credit (see Q 8767), employer-provided health coverage is deemed to be “affordable” if the taxpayer’s required contribution toward the annual premium cost of self-only coverage does not exceed 9.5 percent of the taxpayer’s household income (see Q 8768).¹ Any additional premium contributions that the taxpayer is required to make for family coverage are not included in determining whether the health coverage is affordable.

If an employer offers multiple health plan options, the affordability test applies to the lowest cost plan in which the taxpayer is eligible to participate.²

8776. When does employer-sponsored health coverage provide “minimum value” for purposes of the Patient Protection and Affordable Care Act?

Employer-sponsors health coverage provides “minimum value,” so that it also provides minimum essential coverage, if the plan covers at least 60 percent of the total allowed costs of benefits provided under the plan.³ Beginning in 2014, an employer that offers health coverage to its employees is required to provide each employee with a Summary of Benefits and Coverage, which is a document that explains the benefits provided under the plan and must also include a statement as to whether the plan provides minimum value.

If an employee enrolls in a plan that does not provide minimum value, that employee is ineligible to claim the premium assistance tax credit even though the plan fails to provide the required coverage.

8777. Is there any transition relief for individuals with respect to the shared responsibility penalty provisions effective in 2014?

Yes. If an individual is eligible to enroll in an employer-sponsored health plan that has adopted a plan year that is not a calendar year, the individual is eligible for transition relief from the shared responsibility penalty if the plan year begins in 2013 and ends in 2014. The transition relief begins in January 2014 and continues through the month in which the plan year ends.⁴ This rule is particularly important because many employer-sponsored health plans do not allow an employee to enroll in a plan after the beginning of the plan year. In the case of a 2013-2014 non-calendar year health plan, eligible employees would not be permitted to obtain the employer-sponsored coverage until after the start of 2014, when the shared responsibility penalty provision

1. IRC Sec. 38B(c)(2)(C)(i).

2. IRS Questions and Answers on the Premium Tax Credit, available at: <http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-the-Premium-Tax-Credit> (last accessed May 28, 2014).

3. IRC Sec. 38B(c)(2)(C)(ii).

4. Notice 2013-42, 2013-29 IRB 61.

has already become effective. The transition relief prevents these taxpayers from becoming liable for the shared responsibility provision until the next plan year begins in 2014.

The IRS has also provided relief for taxpayers who are covered under certain limited-benefit government-sponsored health plans which may not provide minimum essential coverage (examples of this type of coverage include optional family planning coverage and pregnancy-related services that are offered through Medicaid). This transition relief applies to months in 2014 in which an individual is covered by one of the specifically enumerated plans that does not provide minimum essential coverage.¹

1. Notice 2014-10, 2014-9 IRB 605.

PART XII: EMPLOYEE FRINGE BENEFITS

8778. How are funds provided to employees through an educational assistance program taxed?

An employee may generally exclude from income amounts received pursuant to an employer-sponsored Educational Assistance Program (EAP) that was established in order to fund employee education-related expenses, subject to the maximum limitation discussed below.¹ This exclusion was made permanent by EGTRRA 2001 following a number of extensions in preceding years. Amounts received under an EAP may be excluded whether or not the educational expenses are job related.² An employee cannot exclude from income more than \$5,250 in educational assistance benefits in any calendar year.³

8779. What requirements must an education assistance program (EAP) meet in order to receive tax-preferred treatment?

The following requirements must be met by an employer-sponsored educational assistance program (EAP) to receive tax-preferred treatment:

1. *Written plan*: the program must be a separate written plan of the employer providing educational assistance for the exclusive benefit of the company's employees.⁴ A sole proprietor may treat himself as employer and employee and a partnership will be treated as the employer of all self-employed partners.⁵
2. *Nondiscrimination*: the program must benefit employees who qualify under a classification set up by the employer that does not discriminate in favor of highly compensated employees, as defined in Code section 414(q). Generally, highly compensated employees are 5 percent owners or members of the top-paid group of employees. Employees covered by a collective bargaining agreement may be excluded if educational assistance benefits were the subject of good faith bargaining.⁶
3. *More than 5 percent owners*: the class of shareholders and their spouses and dependents, each of whom owns more than five percent of the employer's stock, cannot receive more than 5 percent of the educational benefit amounts.⁷
4. *Employee choice*: a program cannot offer employees a choice between educational assistance and other benefits that are includable in income.⁸

1. IRC Sec. 127(a)(1).

2. Treas. Reg. §1.127-2(c)(4).

3. IRC Sec. 127(a)(2).

4. IRC Sec. 127(b)(1).

5. IRC Sec. 127(c)(3).

6. IRC Sec. 127(b)(2).

7. IRC Sec. 127(b)(3).

8. IRC Sec. 127(b)(4).

5. *Funding*: an educational assistance program may be funded or unfunded.¹
6. *Notification*: eligible employees must receive reasonable notification of the program's availability and benefits.²

A plan will still be considered in compliance with these requirements even though different types of educational assistance are used more than others or because successful completion of the course or obtaining a certain grade is required or considered in the process of obtaining reimbursement under the plan.³

Further, a plan will continue to meet the requirements of Section 127(b) even if it provides benefits to former employees. Included in the category of former employees are retirees, persons who were unable to work due to disability, persons whose positions were terminated due to a corporate downsizing, persons who left the employer voluntarily and employees who were involuntarily terminated from their positions.⁴

8780. What types of “educational assistance” may be provided on a tax-preferred basis through an employer-provided educational assistance program?

“Educational assistance,” for purposes of an employer-sponsored educational assistance program (EAP), is generally defined in IRC Section 127 as an employer’s payment of expenses incurred by an employee for education. Expenses such as tuition, fees, books, supplies, equipment and employer-provided courses of instruction including books, supplies and equipment are all included within this definition.⁵

Educational assistance does not include payments for tools or supplies that the employee may keep after finishing the course of instruction, as well as meals, lodging and transportation. Payment for any course or education involving sports, games or hobbies is not considered to be “educational assistance.”⁶

The IRS, in interpreting the IRC definition, has defined a graduate level course as “... any course taken by an employee who has a bachelor’s degree or is receiving credit toward a more advanced degree, if the particular course can be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree.”⁷

According to IRS guidance, a course will be considered to begin on the first regular day of class for the courses offered during that term. The date upon which a student registers for a course has no effect on the date the course is considered to have started for purposes of the Section 127 exclusion.

1. IRC Sec. 127(b)(5).

2. IRC Sec. 127(b)(6).

3. IRC Sec. 127(c)(5).

4. Treas. Reg. §1.127-2(h)(1); Rev. Rul. 96-41, 1996-2 CB 8.

5. IRC Sec. 127(c)(1).

6. IRC Sec. 127(c)(1).

7. Notice 96-68, 1996-2 CB 236.

8781. What reporting requirements apply to employers who provide assistance to employees through an educational assistance program?

Until 2002, an employer who maintains an Educational Assistance Program under IRC Section 127 was required to file an information return (Schedule F to the Form 5500) for each year that the program is in effect. The information return had to include the number of employees currently working, the number of employees eligible to participate in the plan, the number of employees actually participating, the total plan cost, and the number of highly compensated employees. In addition, the employer must identify itself and state the type of business in which it is engaged.¹

Notice 2002-24, however, suspended these reporting requirements with respect to EAPs and certain other employee fringe benefits. Employers are relieved of the obligation to file under Section 3039D until the IRS provides further notice.²

Notice 2002-24 superseded Notice 90-24, which exempted plans under Section 127 from furnishing the additional information concerning highly compensated employees that was required by the TRA '86 amendments to Section 6039D.

This reporting relief applies to any plan year that begins prior to the issuance of further guidance on this subject by the IRS.³

8782. What is a dependent care assistance program?

A dependent care assistance program is a separate written plan of an employer for the exclusive benefit of providing employees with payment for or the provision of services that, if paid for by the employee, would be considered employment-related expenses under IRC Section 21(b)(2).⁴

“Employment-related expenses” are amounts incurred to permit the taxpayer to be gainfully employed while he or she has one or more dependents under age thirteen (for whom he or she is entitled to a personal exemption deduction under IRC Section 151(c)) or a dependent or spouse who cannot care for themselves. The expenses may be for household services or for the care of the dependents.⁵

The plan is not required to be funded.⁶ A dependent care program may also be provided through a cafeteria plan.⁷ See Q 8783 for a discussion of the tax treatment of employer contributions to a dependent care assistance program. See Q 8785 on the limitations to the amounts that an employee may exclude from income.

1. IRC Sec. 6039D.

2. 2002-16 IRB 785.

3. Notice 90-24, 1990-1 CB 355.

4. IRC Secs. 129(d)(1), 129(e)(1).

5. IRC Sec. 21(b)(2).

6. IRC Sec. 129(d)(5).

7. See Notice 2005-42, 2005-23 IRB 1204.

8783. Is dependent care assistance provided by an employer as a fringe benefit taxable income to the employee? Do any nondiscrimination requirements apply in order for these benefits to be received tax-free?

Non-highly compensated employees are permitted to exclude limited amounts (see Q 8785) received under an employer-sponsored dependent care assistance program for each tax year.¹ For highly compensated employees to enjoy the same income tax exclusion, the program must meet the following additional requirements:

- (1) Plan contributions or benefits must not discriminate in favor of highly compensated employees as defined in IRC Section 414(q) or their dependents;
- (2) The program must benefit employees in a classification that does not discriminate in favor of highly compensated employees or their dependents;
- (3) No more than 25 percent of the amounts paid by the employer for dependent care assistance may be provided for the class of shareholders and owners, each of whom owns more than 5 percent of the stock or of the capital or profits interest in the employer (certain attribution rules under IRC Section 1563 apply);
- (4) Reasonable notification of the availability and terms of the program must be provided to eligible employees;
- (5) The plan must provide each employee, on or before January 31, with a written statement of the expenses or amounts paid by the employer in providing such employee with dependent care assistance during the previous calendar year; and
- (6) The average benefits provided to non-highly compensated employees under all plans of the employer must equal at least 55 percent of the average benefits provided to the highly compensated employees under all plans of the employer.²

The dependent care assistance plan may disregard any employee with compensation less than \$25,000 for purposes of the 55 percent test if benefits are provided through a salary reduction agreement.³ For this purpose, compensation is defined in IRC Section 414(q)(4), but regulations may permit an employer to elect to determine compensation on any other nondiscriminatory basis.⁴

For purposes of the eligibility and benefits requirements (described in items (2) and (6) above), the employer may exclude the following employees from consideration:

- (1) employees who have not attained age 21 and completed one year of service (provided all such employees are excluded), and
- (2) employees covered by a collective bargaining agreement (provided there is evidence of good faith bargaining regarding dependent care assistance).⁵

1. IRC Sec. 129(d)(1).

2. IRC Sec. 129(d).

3. IRC Sec. 129(d)(8)(B).

4. IRC Sec. 129(d)(8)(B).

5. IRC Sec. 129(d)(9).

A program will not fail to meet the requirements above, other than the 25 percent test applicable to more than 5 percent shareholders, or the 55 percent test applicable to benefits, merely because of the utilization rates for different types of assistance available under the program. The 55 percent test may be applied on a separate line of business basis.¹

8784. Is the employer entitled to a deduction for amounts paid to employees under a dependent care assistance program?

Yes. The employer's expenses incurred in providing benefits under a dependent care assistance program generally are deductible to the employer as ordinary and necessary business expenses under IRC Section 162.

8785. Is there a limit to the amount that an employee may exclude for payments paid by an employer under a dependent care assistance program?

An employee may exclude up to \$5,000 paid by the employer for dependent care assistance provided during a tax year.² The excludable amount is reduced to \$2,500 for a married individual filing separately. Additionally, the excludable amount cannot exceed the earned income of an unmarried employee or the lesser of the earned income of a married employee or the earned income of the employee's spouse.³

An employee cannot exclude from gross income any amount paid to an individual with respect to whom the employee or the employee's spouse is entitled to take a personal exemption deduction under IRC Section 151(c) or who is a child of the employee under nineteen years of age at the close of the taxable year, or the spouse.⁴

If the dependent care assistance is provided by way of on-site facilities (such as an on-site day care center), the amount of dependent care assistance excluded is based on a dependent's use of the facilities and the value of the services provided with respect to that dependent.⁵

The amount of employment-related expenses available in calculating the dependent care credit of IRC Section 21 is reduced by the amount excludable from gross income under IRC Section 129.⁶

8786. What reporting requirements apply in connection with amounts paid by an employer under a dependent care assistance program?

The employee must identify on the tax return all persons or organizations that provide care for the employee's dependent. This includes the name, address, and taxpayer identification number of the person (name and address in the case of a tax-exempt 501(c)(3) organization) providing the services. If the employee does not have the information, then the employee can use

1. See IRC Sec. 414(r).

2. IRC Sec. 129(a). See IRS Pub. 503.

3. IRC Sec. 129(b).

4. IRC Sec. 129(c).

5. IRC Sec. 129(e)(8).

6. IRC Sec. 21(c).

form W-10, Dependent Care Provider's Identification and Certification to request this information from the provider. The IRS may disallow a credit to an employee who fails to provide this information unless the taxpayer can show that he or she exercised due diligence in attempting to obtain the information. To show due diligence, the taxpayer should attach a statement explaining that the provider refused to complete the W-10.¹

As is the case with employer-provided educational assistance programs, the IRS has suspended the reporting requirements that are otherwise applicable to dependent care programs until further notice.²

Prior to this suspension, IRC Section 6039D generally required an employer maintaining a dependent care assistance plan to file an information return with the IRS that provided the following information:

- (1) its number of employees;
- (2) the number of employees eligible to participate in the plan;
- (3) the number of employees participating in the plan;
- (4) the number of highly compensated employees ("HCEs") of the employer;
- (5) the number of HCEs eligible to participate in the plan;
- (6) the number of HCEs actually participating in the plan;
- (7) the cost of the plan;
- (8) the identity of the employer; and
- (9) the type of business in which it is engaged.

8787. What is a cafeteria plan? What information must an employer provide in order to establish a cafeteria plan for its employees?

A cafeteria plan (or "flexible benefit plan") is a written plan that gives employees the option of choosing between cash and "qualified benefits." With certain limited exceptions, a cafeteria plan cannot provide for deferred compensation, which generally means that the taxpayer-employee must use all benefits within the tax year.³

Some cafeteria plans provide for salary reduction contributions by the employee and others provide benefits in addition to salary. In either case, the employee-participants are given the opportunity to purchase certain benefits with pre-tax dollars.

1. IRC Sec. 129(e)(9).

2. Notice 2002-24, 2002-16 IRB 785; Notice 90-24, 1990-1 CB 335.

3. IRC Sec. 125(d).

A plan may provide for automatic enrollment whereby an employee's salary is reduced to pay for "qualified benefits" unless the employee affirmatively elects cash.¹

Under the 2007 proposed regulations (effective for plan years beginning on or after January 1, 2009), the written plan document must contain the following:

- (1) a specific description of the benefits, including periods of coverage;
- (2) the rules regarding eligibility for participation;
- (3) the procedures governing elections;
- (4) the manner in which employer contributions are to be made, such as by salary reduction or non-elective employer contributions;
- (5) the plan year;
- (6) the maximum amount of employer contributions available to any employee stated as (a) a maximum dollar amount or maximum percentage of compensation or (b) the method for determining the maximum amount or percentage;
- (7) a description of whether the plan offers paid time off, and the required ordering rules for use of non-elective and elective paid time off;
- (8) the plan's provisions related to any flexible spending arrangements (FSA) included in the plan;
- (9) the plan's provisions related to any grace period offered under the plan; and
- (10) the rules governing distributions from a health FSA to employee health savings accounts (HSAs), if the plan permits such distributions (see Q 8753).²

The plan document need not be self-contained, but may incorporate by reference separate written plans.³

Participants should note that, under the Patient Protection and Affordable Care Act, for purchases made in 2011 and thereafter, the cost of an over-the-counter medicine or drug cannot be reimbursed from FSAs (Q 8792), HRAs (Q 8743) or HSAs (Q 8744) unless a prescription is obtained.⁴ These new rules do not affect insulin, even if purchased without a prescription, or other health care expenses such as medical devices, eye glasses, contact lenses, co-pays and deductibles. FSA and HRA participants may continue using debit cards to buy prescribed over-the-counter medicines, if certain requirements are met (see Q 8743).⁵ In addition, starting in 2013, there are new rules about the \$2,500 limit on the amount that can be contributed to an

1. Rev. Rul. 2002-27, 2002-1 CB 925.

2. Prop. Treas. Reg. §1.125-1(c), 72 F.R. 43938 (Aug. 6, 2007).

3. Prop. Treas. Reg. §1.125-1(c)(4).

4. P.L. 111-148.

5. IRS News Release IR-2010-128 (Dec. 23, 2010).

FSA (see Q 8792) and, beginning in 2014, the new optional \$500 carryover provision that can be incorporated into a health FSA.¹

Former employees may participate in an employer's cafeteria plan (although the plan may not be established predominantly for their benefit), but self-employed individuals may not.² A full-time life insurance salesperson who is treated as an employee for Social Security purposes will also be considered an employee for cafeteria plan purposes (see Q 8671).³

See Q 8788 for an explanation of benefits that may be offered through cafeteria plans. See Q 8789 for a discussion of the nondiscrimination requirements that apply to cafeteria plans. See Q 8790 for a discussion of "simple" cafeteria plans.

8788. How can a cafeteria plan be used by employers to offer employee benefits?

An employer may offer employees who are participants in a cafeteria plan a choice among two or more benefits consisting of cash and qualified benefits.⁴ A cash benefit is not strictly limited to cash, but includes a benefit that may be purchased with after-tax dollars or the value of which is generally treated as taxable compensation to the employee (provided the benefit does not constitute deferred compensation).⁵

A qualified benefit is a benefit that is not includable in the gross income of the employee because of an express statutory exclusion and because the benefit constitutes deferred compensation. Contributions to Archer Medical Savings Accounts, qualified scholarships, educational assistance programs, or excludable fringe benefits are not qualified benefits. Products that are advertised, marketed, or offered as long-term care insurance similarly do not qualify as qualified benefits.⁶

When insurance benefits, such as those provided under accident and health plans and group term life insurance plans, are provided through a cafeteria plan, the benefit is the coverage under the plan. Accident and health benefits are qualified benefits to the extent that coverage is excludable under IRC Section 106.⁷ Accidental death coverage offered in a cafeteria plan under an individual accident insurance policy is excludable from the employee's income under IRC Section 106.⁸

Group term life insurance coverage on employee-participants can be offered through a cafeteria plan. Coverage may be offered through the plan even if it exceeds the \$50,000 excludable limit under IRC Section 79.⁹ The application of IRC Section 79 to group term life insurance and IRC Section 106 to accident or health benefits is explained in Q 8727 to Q 8730.

1. Notice 2012-40, 2012-26 IRB 1046.

2. Prop. Treas. Reg. §1.125-1(g)(2).

3. IRC Sec. 7701(a)(20); Prop. Treas. Reg. §1.125-1(g)(1)(iii).

4. IRC Sec. 125(d)(1)(B).

5. Prop. Treas. Reg. §1.125-1(a)(2).

6. IRC Sec. 125(f); Prop. Treas. Reg. §1.125-1(q).

7. Prop. Treas. Reg. §1.125-1(h)(2).

8. Let. Ruls. 8801015, 8922048.

9. Prop. Treas. Reg. §1.125-1(k).

Accident and health coverage, group term life insurance coverage, and benefits under a dependent care assistance program are still counted as “qualified” benefits even if they must be included in income because a nondiscrimination requirement has been violated.¹

For tax years beginning after 2012, a health flexible spending arrangement (FSA) offered under a cafeteria plan is not a qualified benefit unless the plan limits employees to no more than \$2,500 in salary reduction contributions for each tax year.² Beginning in 2014, up to \$500 of the balance of a health FSA may be carried forward to the subsequent tax year if the FSA incorporates a provision that permits such a carryover.

A cafeteria plan generally cannot provide for deferred compensation, permit participants to carry over unused benefits or contributions from one plan year to another, or permit participants to purchase a benefit that will be provided in a subsequent plan year. A cafeteria plan, however, may permit a participant in a profit sharing, stock bonus, or rural cooperative plan that has a qualified cash or deferred arrangement to elect to have the employer contribute on the employee’s behalf to the plan.³ After-tax employee contributions to an IRC Section 401(m) qualified plan are permissible benefits under a cafeteria plan, even if the employer makes matching contributions.⁴

A cafeteria plan may permit a participant to elect to have the employer contribute to a health savings account (HSA) on the participant’s behalf (see Q 8744 to Q 8756).⁵ Unlike other benefits, HSA balances may be carried over from one year to another even if they are funded through a cafeteria plan.

Generally, life, health, disability, or long-term care insurance with an investment feature, such as whole life insurance, or an arrangement that reimburses premium payments for other accident or health coverage extending beyond the end of the plan year cannot be provided under a cafeteria plan.⁶ Supplemental health insurance policies that provide coverage for cancer and other specific diseases are not treated as providing deferral of compensation and are properly considered accident and health benefits under IRC Section 106.⁷

Participants in a cafeteria plan maintained by an educational organization described in IRC Section 170(b)(1)(A)(ii) (i.e., one with a regular curriculum and an on-site faculty and student body) can be permitted to elect postretirement term life insurance coverage. The postretirement life insurance coverage must be fully paid up on retirement and must not have a cash surrender value at any time. Postretirement life insurance coverage meeting these conditions will be treated as group term life insurance under IRC Section 79 (see Q 8621 to Q 8624).⁸

1. IRC Sec. 129(d); Prop. Treas. Reg. §1.125-1(b)(2).

2. IRC Sec. 125(i).

3. IRC Sec. 125(d)(2).

4. Prop. Treas. Reg. §1.125-1(o)(3)(ii).

5. IRC Sec. 125(d)(2)(D).

6. Prop. Treas. Reg. §1.125-1(p)(1)(ii).

7. TAM 199936046.

8. IRC Sec. 125(d)(2)(C).

Under the Affordable Care Act, plans and issuers that offer dependent coverage must make this coverage available until a child reaches the age of 26.¹ Even if a cafeteria plan has not yet been amended to provide coverage for children under age 27, the ACA allows employers with cafeteria plans to permit employees to immediately make pre-tax salary reduction contributions to provide coverage for these children in order to assist with implementation of the expanded coverage requirements.

Both married and unmarried children qualify for this coverage. This rule applies to all plans in the individual market and to new employer plans, as well as to existing employer plans unless the adult child has another offer of employer-based coverage. Beginning in 2014, children up to age 26 can stay on their parent's employer plan even if they have another offer of coverage through an employer.

Employees are eligible for the new tax benefit beginning March 30, 2010 and thereafter if the children are already covered under the employer's plan or are added to the employer's plan at any time. For this purpose, a child includes a son, daughter, stepchild, adopted child, or eligible foster child. This "up to age 26" standard replaces the lower age limits that applied under prior tax law, as well as the requirement that a child generally qualify as a dependent for tax purposes.

8789. What nondiscrimination requirements apply to cafeteria plans that provide benefits to highly compensated or key employees?

If a cafeteria plan discriminates in favor of highly compensated individuals as to eligibility to participate or as to contributions or benefits, highly compensated participants will be considered in constructive receipt of the available cash benefit, which will prevent these employees from excluding the amounts from income.²

"Highly compensated" individuals are officers, shareholders owning more than 5 percent of the voting power or value of all classes of stock, those who are "highly compensated," and any of their spouses or dependents. For this purpose, "highly compensated" means (1) any individual or participant who, for the preceding plan year (or the current plan year in the case of the first year of employment), had compensation from the employer in excess of the compensation amount specified in IRC Section 414(q)(1)(B) (\$115,000 for 2012-2014), and, (2) if elected by the employer, also was in the top-paid group of employees (determined by reference to Section 414(q)(3)) for such preceding plan year (or for the current plan year in the case of the first year of employment).³

Participation will be nondiscriminatory if the following requirements are satisfied:

- (1) the plan benefits a classification of employees found by the Secretary of Treasury not to discriminate in favor of employees who are officers, shareholders, or highly compensated;

1. See IRC Sec. 105(b); Notice 2010-38, 2010-1 CB 682.

2. IRC Sec. 125(b)(1); Prop. Treas. Reg. §1.125-7(m)(2).

3. IRC Sec. 125(e); Prop. Treas. Reg. §1.125-7(a)(3); IRS News Release IR-2011-103 (Oct. 20, 2011), IR-2012-77 (Oct. 18, 2012); IR-2013-86 (Oct. 31, 2013).

- (2) no more than three years of employment are required for participation and the employment requirement for each employee is the same; and
- (3) eligible employees begin participation by the first day of the first plan year after the employment requirement is satisfied.¹

Under the proposed regulations, a cafeteria plan does not discriminate in favor of highly compensated individuals if the plan benefits a group of employees who qualify under a reasonable classification established by the employer and the group of employees included in the classification satisfies the safe harbor percentage test or the unsafe harbor percentage test.²

If a cafeteria plan offers health benefits, the plan is not discriminatory as to contributions and benefits if:

- (1) contributions for each participant include an amount that either:
 - (x) equals 100 percent of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants who are similarly situated (e.g., same family size); or
 - (y) equals or exceeds 75 percent of the cost of the most expensive health benefit coverage elected by any similarly-situated participant; and
- (2) contributions or benefits in excess of (1) above bear a uniform relationship to compensation.³

A plan is considered to satisfy all discrimination tests if it is maintained under a collective bargaining agreement between employee representatives and one or more employers.⁴

Further, a “key employee,” as defined for purposes of the top-heavy rules, is treated as though he or she is in constructive receipt of the available cash benefit option in any plan year in which nontaxable benefits provided under the plan to key employees exceed 25 percent of the aggregate of such benefits provided to all employees under the plan. In making this calculation, excess group term life insurance coverage that is includable in income (see Q 8721 and Q 8722) is not considered a nontaxable benefit.⁵

Employees of a controlled group of corporations, employers under common control, or members of an “affiliated service group” are treated as employed by a single employer.⁶

Employer contributions include amounts that the employer contributes to a cafeteria plan pursuant to a salary reduction agreement to the extent that the agreement relates to compensation that has not been actually or constructively received by the employee as of the date of

1. IRC Sec. 125(g)(3); Prop. Treas. Reg. §1.125-7(b).

2. Prop. Treas. Reg. §1.125-7(b)(1).

3. IRC Sec. 125(g)(2); Prop. Treas. Reg. §1.125-7(e).

4. IRC Sec. 125(g)(1).

5. IRC Sec. 125(b)(2).

6. IRC Sec. 125(g)(4).

the agreement if such compensation does not subsequently become currently available to the employee.¹

See Q 8790 for the application of the nondiscrimination requirements to simple cafeteria plans.

8790. What is a simple cafeteria plan for small businesses?

A “simple cafeteria plan” is a cafeteria plan that is established and maintained by an eligible employer and with respect to which contribution, eligibility, and participation requirements are met.²

For years beginning in 2011 and thereafter, the Patient Protection and Affordable Care Act (ACA) creates a safe harbor “simple cafeteria plan” under which an “eligible employer” (generally an employer with fewer than 100 employees) is treated as meeting any applicable nondiscrimination requirements (Q 8789) for the year.³

The employer is required to make contributions on behalf of each “qualified employee” in an amount equal to the following:

- (1) a uniform percentage (not less than 2 percent) of the employee’s compensation; or
- (2) an amount not less than the lesser of (x) 6 percent of the employee’s compensation for the plan year, or (y) twice the amount of salary deduction contributions of each qualified employee.⁴

Contribution requirement option (2) is not met if the rate of contributions with respect to the salary contributions of any highly compensated or key employee at any rate of contribution is greater than that with respect to an employee who is not a highly compensated or key employee.⁵

All employees with at least 1,000 hours of service during the preceding plan year must be eligible to participate. Further, each employee who is eligible to participate must be able to select any benefit available under the plan.⁶ An employee can be excluded if the employee:

- (1) is under age twenty-one;
- (2) has less than one year of service;
- (3) is covered by a collective bargaining agreement and the benefits of the cafeteria plan were the subject of good faith bargaining; or
- (4) the employee is a nonresident alien working outside of the United States.⁷

1. Prop. Treas. Reg. §1.125-1(r).

2. IRC Sec. 125(j)(2), as added by PPACA 2010; IRS Publication 15-B.

3. IRC Sec. 125(j)(1), as added by PPACA 2010.

4. IRC Sec. 125(j)(3)(A), as added by PPACA 2010.

5. IRC Sec. 125(j)(3)(B), as added by PPACA 2010.

6. IRC Sec. 125(j)(4)(A), as added by PPACA 2010.

7. IRC Sec. 125(j)(4)(B), as added by PPACA 2010.

To implement a simple cafeteria plan, an employer must be an “eligible employer,” which is, with respect to any year, any employer that employed an average of 100 or fewer employees on business days during either of the two preceding years.¹ An employer that initially qualifies for a simple cafeteria plan ceases to qualify in the year after the number of employees reaches 200.²

A qualified employee is any employee who is eligible to participate in the cafeteria plan and who is not a highly compensated or key employee.³

8791. What are the tax benefits that can be realized by providing employee benefits through a cafeteria plan?

As a general rule, a participant in a cafeteria plan is not treated as being in constructive receipt of taxable income solely because he has the opportunity – before a cash benefit becomes available – to elect among cash and “qualified” benefits (generally, nontaxable benefits).⁴

A participant must elect the qualified benefits before the cash benefit becomes currently available in order to avoid taxation. That is, the election must be made before the specified period for which the benefit will be provided begins—generally, the plan year.⁵

A cafeteria plan may, but is not required to, provide default elections for one or more qualified benefits for new employees or for current employees who fail to timely elect between permitted taxable and qualified benefits.⁶

Benefits provided under a cafeteria plan through employer contributions to a health flexible spending arrangement (FSA) are not treated as qualified unless the plan provides that an employee may not elect to have salary reduction contributions in excess of \$2,500 made to the FSA for any tax year.⁷ Under IRS Notice 2012-40:

- (1) the \$2,500 limit does not apply for plan years that begin before 2013;
- (2) the term “taxable year” in IRC Section 125(i) refers to the plan year of the cafeteria plan, as this is the period for which salary reduction elections are made;
- (3) plans may adopt the required amendments to reflect the \$2,500 limit at any time through the end of calendar year 2014;
- (4) in the case of a plan providing a grace period (which may be up to two months and fifteen days), unused salary reduction contributions to the health FSA for plan years beginning in 2012 or later that are carried over into the grace period for that plan year will not count against the \$2,500 limit for the subsequent plan year; and

1. IRC Sec. 125(j)(5)(A), as added by PPACA 2010.

2. IRC Sec. 125(j)(5)(C), as added by PPACA 2010.

3. IRC Sec. 125(j)(3)(D), as added by PPACA 2010.

4. IRC Sec. 125; Prop. Treas. Reg. §1.125-1.

5. Prop. Treas. Reg. §1.125-2.

6. Prop. Treas. Reg. §1.125-2(b).

7. IRC Sec. 125(i).

- (5) unless a plan's benefits are under examination by the IRS, relief is provided for certain salary reduction contributions exceeding the \$2,500 limit that are due to a reasonable mistake and not willful neglect, and that are corrected by the employer.

Under IRS Notice 2013-71, health FSAs may now be amended so that \$500 of unused amounts remaining at the end of the plan year may be carried forward to the next plan year. However, plans that incorporate the carry forward provision may not also offer the grace period that would otherwise allow FSA participants an additional period after the end of the plan year to exhaust account funds.¹

8792. What is a health flexible spending arrangement (FSA)?

Editor's Note: The Affordable ("ACA") imposes a new annual limitation on contributions to a health FSA. For taxable years beginning after 2012, FSA contributions will not be treated as a qualified benefit unless the cafeteria plan provides that an employee may not elect for any taxable year to have salary reduction contributions in excess of \$2,500 made to the arrangement. The limit will be indexed for inflation.²

A health flexible spending arrangement (FSA) is a program that is established under IRC Section 125 to provide for the reimbursement of certain expenses that have already been incurred. This benefit may be provided as a stand-alone plan or as part of a traditional cafeteria plan.

Health coverage under an FSA is not required to be provided under commercial insurance plans, but the coverage that is provided must demonstrate the risk shifting and risk distribution characteristics of insurance. Reimbursements under a health FSA must be paid specifically to reimburse medical expenses that have been incurred previously.

A health FSA cannot provide coverage only for periods during which the participants expect to incur medical expenses if the period is shorter than a plan year. Further, the maximum reimbursement amount must be available at all times throughout the period of coverage (properly reduced for prior reimbursements for the same period of coverage).

This must be true without regard to the extent to which the participant has paid the required premiums for the coverage period, and without a premium payment schedule based on the rate or amount of covered claims incurred in the coverage period.³ Though there was no statutory limit on contributions to a health FSA prior to 2013, most employers imposed a limit to protect themselves against large claims that had not yet been funded by salary reductions.

The period of coverage must be 12 months, or in the case of a short first plan year, the entire first year (or the short plan year where the plan year is changed). Elections to increase or decrease coverage may not be made during a coverage year, but prospective changes may be allowed consistent with certain changes in family status.

1. Notice 2013-71, 2013-47 IRB 532.

2. IRC Sec. 125(i), as added by PPACA 2010; Notice 2012-40, 2012-1 CB 1046.

3. Prop. Treas. Reg. §1.125-5(d).

The plan may permit the period of coverage to be terminated if the employee fails to pay premiums, provided that the terms of the plan prohibit the employee from making a new election during the remaining period of coverage. The plan may permit revocation of existing elections by an employee who terminated service.¹

As is the case with a cafeteria plan, a health FSA may provide a grace period of no more than 2½ months following the end of the plan year for participants to incur and submit expenses for reimbursement. The grace period must apply to all participants in the plan. Plans may adopt a grace period for the current plan year by amending the plan document before the end of the current plan year.²

For tax years beginning in 2014 and beyond, a health FSA may be amended so that \$500 of unused amounts remaining at the end of the plan year may be carried forward to the next plan year. However, plans that incorporate the carry forward provision may not also offer the grace period.³

The plan may not reimburse premiums paid for other health plan coverage, but it may reimburse medical expenses of the kind described under IRC Section 213(d).⁴ Beginning in 2011, reimbursements for medicine are limited to doctor-prescribed drugs and insulin. Over-the-counter medicines are no longer qualified expenses unless the participant obtains a doctor's prescription.⁵

The reimbursed medical expenses must be expenses incurred to obtain medical care during the period of coverage. The employee must provide substantiation that the expense claimed has been incurred and is not reimbursable under other health coverage.⁶ The IRS has approved the use of employer-issued debit and credit cards to pay for medical expenses as incurred, provided that the employer requires subsequent substantiation of the expenses or has in place sufficient procedures to substantiate the payments at the time of purchase.⁷ On a one-time basis, a plan may allow a qualified HSA distribution (see Q 8753).

An employee must include the value of employer-provided coverage for qualified long-term care services provided through an FSA in gross income.⁸

8793. What is a dependent care flexible spending arrangement (FSA)?

A dependent care flexible spending arrangement (FSA) is a program that is established under IRC Section 125 to provide for the reimbursement of certain expenses related to dependent care that have already been incurred. This benefit may be provided as a stand-alone plan or as part of a traditional cafeteria plan.

1. Prop. Treas. Reg. §1.125-5(e).

2. Prop. Treas. Reg. §1.125-1(e); Notice 2005-42, 2005-1 CB 1204; Notice 2012-40, 2012-1 CB 1046.

3. Notice 2013-71, 2013-47 IRB 532.

4. Prop. Treas. Reg. §1.125-5(k).

5. IRC Sec. 106(f), as added by PPACA 2010.

6. Prop. Treas. Reg. §1.125-6(b); Rev. Proc. 2003-43, 2003-1 CB 935; superseded and modified by Notice 2013-30, 2013 IRB LEXIS 418. See *Grande v. Allison Engine Co.*, 2000 U.S. Dist. LEXIS 12220 (S.D. Ind. 2000).

7. Notice 2006-69, 2006-2 CB 107. See also Notice 2007-2, 2007-1 CB 254.

8. IRC Sec. 106(c)(1).

Substantially, the same rules apply to dependent care FSAs as health FSAs (see Q 8792), except that the maximum amount of reimbursement need not be available throughout the entire period of coverage. A plan may limit a participant's reimbursement to amounts that were actually contributed to the plan and that are still available in the participant's account.¹ Contributions to a dependent care FSA may not exceed \$5,000 (or \$2,500 for a married individual filing a separate return) during a taxable year.²

Like a health FSA, a dependent care FSA may permit a grace period of no more than 2½ months following the end of the plan year for participants to incur and submit expenses for reimbursement.³ A dependent care FSA may not, however, permit the same \$500 carryforward option that is now permitted in the context of health FSAs.

The IRS has also approved the use of employer-issued debit and credit cards to reimburse for recurring dependent care expenses. Because expenses may not be reimbursed until the dependent care services are provided, reimbursements through debit cards must flow in arrears of expenses incurred.⁴

8794. Is a surviving spouse of an employee taxed on the value of death benefits paid under a plan of the employer?

A surviving spouse, who receives death benefits payable under a contract, or pursuant to an established plan of the employer, must include such amounts in income.⁵ However, if the employee death benefits are payable because of the death of certain terrorist attack victims or astronauts, they may be excluded from gross income.⁶

Frequently, death benefits are funded by insurance on the life of the employee, with the insurance owned by and payable to the employer. These death benefits do not become tax-exempt to the employee's surviving spouse simply because the proceeds of the insurance policy are received tax-free by the employer. While the employer receives the proceeds as life insurance proceeds, the surviving spouse receives them as compensation payments from the employer.⁷ As a result, employee death benefits rarely qualify as life insurance benefits wholly excludable under IRC Section 101(a).⁸ Death benefits payable to an employee's surviving spouse under a split-dollar arrangement, however, may be received free of income tax obligations.

Contractual death benefits are treated as "income in respect of a decedent."⁹ As a result, where an estate tax has been paid, the recipient of the death payments is entitled to an income tax deduction for that portion of the estate tax attributable to the value of the payments.

1. Prop. Treas. Reg. §1.125-5.

2. IRC Sec. 129(a)(2)(A); Notice 2012-40, 2012-1 CB 1046.

3. Notice 2005-42, 2005-1 CB 1204; Notice 2012-40, 2012-1 CB 1046.

4. Notice 2006-69, 2006-2 CB 107.

5. *Simpson v. U.S.*, 261 F.2d 497 (7th Cir. 1958); *Robinson v. Comm.*, 42 TC 403 (1964).

6. IRC Sec. 101(i).

7. *Essenfeld v. Comm.*, 311 F.2d 208 (2d Cir. 1962).

8. See *Edgar v. Comm.*, TC Memo 1979-524.

9. *Est. of Wright v. Comm.*, 336 F.2d 121 (2d Cir. 1964).

8795. What types of benefits can an employer provide in the form of services that do not require an employee to include the value of the benefit in income?

Generally, fringe benefits not expressly excluded from income by the Code must be included in gross income for income tax purposes and in wages for purposes of FICA and FUTA.¹ IRC Section 132 provides that certain fringe benefits that are classified as “no-additional-cost-service” may be excluded from income.²

As the name suggests, a “no-additional-cost-service” is one offered by the employer at no substantial additional cost (including foregone revenue) to the employer for providing such service to the employee and such service is offered to customers in the ordinary course of the line of business of the employer in which the employee is working.

For example, the cost of a flight provided to an airline employee traveling on a space-available basis is an excess capacity service and is eligible for treatment as a no-additional-cost-service. In addition, the services of a flight attendant and the cost of in-flight meals given to the airline employee traveling on a space-available basis are merely incidental to the services being provided (i.e. the flight) and, thus, the employee does not have to include them in income.³ Reciprocity is allowed between unrelated employers if certain conditions are met.⁴

The no-additional-cost services exclusion applies to services provided to retired and disabled employees, spouses and dependent children, as well as to current employees. Widowers and widows of employees who died while employed also qualify for the exclusion.⁵ A partner who performs services for a partnership will be considered employed by the partnership.⁶

The no-additional-cost services exclusion is not available to highly compensated employees unless the service is provided on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees.⁷ For this purpose, “highly compensated employee” has the same meaning as provided in Code section 414(q) for qualified plans.⁸ Generally, a highly compensated employee is any employee:

- (1) who was a five percent owner at any time during the year or the preceding year;
or
- (2) for the preceding year had compensation in excess of \$80,000 (as indexed, \$115,000 in 2014) and was in the top-paid group of employees for the preceding year.

1. IRC Sec. 61(a)(1).

2. IRC Sec. 132.

3. Treas. Reg. §1.132-2(a)(5).

4. See Treas. Reg. §1.132-2(b).

5. IRC Sec. 132(h).

6. Treas. Reg. §1.132-1(b).

7. IRC Sec. 132(j)(1).

8. IRC Sec. 132(j)(6).

8796. What types of tax-preferred transportation-related fringe benefits can an employer provide to its employees?

A “qualified transportation fringe” is a benefit provided by an employer to employees, and includes the following:

- (1) transportation in a commuter highway vehicle that is used in connection with travel between an employee’s home and place of work;
- (2) any transit pass; or
- (3) qualified parking.¹

A cash reimbursement from an employer to an employee for one of these items also falls within the qualified transportation fringe definition.² Self-employed individuals and owner-employees are not considered employees for purposes of qualified transportation fringes.³

Code section 132 places a limit on the amount that may be excluded from income for a qualified transportation fringe. These limitation amounts are adjusted for inflation.⁴

For 2014, an employee can exclude up to \$130 per month in (combined) employer-provided transportation in a commuter vehicle or for transit passes. An employee may exclude \$250 per month for qualified parking expenses.⁵ The limits are indexed for inflation annually.

For purposes of Section 132, a “commuter highway vehicle” is defined as any highway vehicle that seats at least six persons and which is used at least 80 percent of the time for transporting employees between their homes and places of work.⁶

A “transit pass” is any pass, token, fare card, voucher or similar item which entitles an individual to transportation on mass transit facilities or in commuter highway vehicles.⁷

“Qualified parking” is defined as parking provided to an employee on or near the employer’s business location or near a location from which an employee commutes to work by mass transit, commuter highway vehicle, or carpool. It does not include any parking near the employer’s place of business that the employee uses for residential parking.⁸

8797. Can an employee exclude from income the value of employee discounts offered by the employer?

The “qualified employee discount” exclusion applies to employee discounts provided by the employer on any property (other than real property or personal property of a kind held for investment) or services which are offered for sale to customers in the ordinary course of the

1. IRC Sec. 132(f)(1).

2. IRC Sec. 132(f)(3).

3. IRC Sec. 132(f)(5)(E).

4. IRC Sec. 132(f)(6).

5. IRC Sec. 132(f)(2), IRS Publication 15-B.

6. IRC Sec. 132(f)(5)(B).

7. IRC Sec. 132(f)(5)(A).

8. IRC Sec. 132(f)(5)(C).

line of business of the employer for which the employee works. For the benefit to be excludable from income, the discount may not exceed:

- (1) the gross profit percentage of the price at which the property is being offered by the employer to customers in the case of property; or
- (2) 20 percent of the price at which services are offered by the employer to customers, in the case of services.¹

For purposes of this provision, an insurance policy or a commission or similar fee charged by a brokerage house or an underwriter on sales of securities is considered a service.² The qualified employee discount will generally be available for employees of leased sections of department stores.³ The same nondiscrimination rules apply to qualified employee discounts as apply to no-additional-cost services (see Q 8795).⁴

8798. What is a “working condition” fringe benefit?

A “working condition fringe” benefit is defined as property or services provided by the employer to the extent that, if the employee paid for such property or services, he would be able to deduct the expenses as a business expense.⁵

For example, qualified automobile demonstration is considered to be a working condition fringe benefit and is defined as the use of an auto by a full-time auto salesman in the area where the dealer’s sales office is located provided that the auto is used to aid the salesman in his job and personal use is substantially restricted.⁶

This exclusion is generally available to any current employee, any partner who performs services for the partnership, any director of the employer, and any independent contractor who performs services for the employer.⁷ There is no nondiscrimination requirement.

8799. What is a “de minimis” fringe benefit?

The “de minimis fringe” exception allows an employee to exclude from income any property or services provided by the employer, if the value of such property or services is so small as to make accounting for it unreasonable or administratively impractical.⁸

For example, an employer-operated eating facility is considered a de minimis fringe if it is located on or near the business premises and the revenue from the facility equals or exceeds its operating costs. These rules are applicable to highly-compensated employees only if access to the facility is available on substantially the same terms to each member of a group of employees

1. IRC Sec. 132(c).

2. Treas. Reg. §1.132-2(a)(2).

3. IRC Sec. 132(j)(2).

4. IRC Sec. 132(j)(1).

5. IRC Sec. 132(d).

6. IRC Sec. 132(j)(3).

7. Treas. Reg. §1.132-1(b)(2).

8. IRC Sec. 132(e)(1).

which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees (see Q 8795).¹

The frequency with which the employer provides the benefit at issue must be taken into account in determining whether the value is de minimis. The benefits provided must be calculated on a per-employee basis. For example, if an employer provides one meal to only one employee on a daily, the value of the free daily meal would not be de minimis to that individual employee, even though the provision of one daily meal to one employee would be de minimis with respect to the employer's entire workforce.²

If, however, it would be administratively difficult to determine the frequency with which the employer provides the fringe benefit to an individual employee, the employer may measure frequency based on the frequency for the provision of the fringe benefit to all employees. The regulations use the example of an employer who uses reasonable means to restrict use of employer-provided copy machines to business-related use and is successful in ensuring that 85 percent of the copying is for business use. Any personal use of the copy machine by a particular employee will be considered a de minimis fringe because it would be administratively difficult for the employer to measure usage on a per-employee basis.³

An employer may provide meals, money for meals or local transportation fare as de minimis benefits if the following conditions are satisfied:

- (1) The benefit is provided on an occasional basis, determined by examining the availability of the benefit and the regularity with which the benefit is provided to the employee. If an employer provides one of these benefits, or a combination of the three benefits, on a regular or routine basis, they are not provided on an occasional basis;
- (2) The benefit is provided because of overtime work that requires an extension of the employee's work schedule, even if the conditions giving rise to the need for overtime are reasonably foreseeable;
- (3) In the case of a meal or meal money, the benefit is provided to enable the employee to work overtime hours.

Meal money and local transportation fare will not qualify as de minimis benefits if the amounts provided are calculated based on the number of hours that the employee works.⁴

8800. How is the value of a fringe benefit that is not excludable under IRC Section 132 determined for purposes of determining the amount that must be included in the employee's income?

A fringe benefit not excludable under the rules discussed in Q 8795 to Q 8799 (no-additional-cost, transportation, employee discount and de minimis fringe benefits) is included in the gross income of the employee to the extent that the fair market value of the benefit exceeds

1. IRC Sec. 132(c)(2).

2. Treas. Reg. §1.132-6(b)(1).

3. Treas. Reg. §1.132-6(b)(2).

4. Treas. Reg. §1.132-6(d)(2).

the sum of (a) the amount, if any, paid by the employee for the benefit and (b) the amount, if any, specifically excluded by some other section of the IRC.¹

Therefore, if the employee pays fair market value for the benefit, no amount must be included in gross income.²

The fair market value of a fringe benefit is determined on the basis of objective facts and circumstances. The amount that an individual would have to pay for the fringe benefit in an arm's length transaction is considered in determining the fair market value.³ The regulations specifically provide that in calculating fair market value, any special relationship that exists between the employer and employee must be disregarded.⁴

Special optional rules are available for determining the fair market value of employer-provided automobiles. Specifically, the fair market value is based on the amount that the employee would be required to pay in order to lease the same or comparable vehicle, under comparable conditions (for example, taking use restrictions into consideration) in an arm's length transaction in the same geographic area.⁵

8801. Can an employer provide employee fringe benefits through a stock bonus plan?

Yes, an employer can provide employees with benefits through a stock bonus plan. Generally, a stock bonus plan is a profit sharing plan that holds employer securities and generally distributes those securities to participants when benefits are paid.⁶

Stock bonus plans can be funded through an employer's contribution of employer securities, cash, or both. Traditionally, the IRS has taken the position that the distribution must be in the form of employer stock (except for the value of a fractional share).⁷ The Tax Court has agreed with the IRS position.⁸ A stock bonus plan may provide for payment of benefits in cash if certain conditions are met (see Q 8802). For the purpose of allocating contributions and distributing benefits, the plan is subject to the same requirements as a profit sharing plan.

8802. What special requirements apply to a stock bonus plan offered by an employer?

In addition to meeting all of the requirements of IRC Section 401(a) and the requirements outlined below, employee stock bonus plans must meet certain distribution (Q 8803) and voting (Q 8804) requirements as to employer stock that is held by the plan.⁹

1. Treas. Reg. §1.61-21(b)(1).

2. Treas. Reg. §1.61-21(b)(1).

3. Treas. Reg. §1.61-21(b)(2).

4. Treas. Reg. §1.61-21(b)(2).

5. Treas. Reg. §1.61-21(b)(4).

6. Treas. Reg. §1.401-1(a)(2)(iii).

7. Rev. Rul. 71-256, 1971-1 CB 118.

8. *Miller v. Comm.*, 76 TC 433 (1981).

9. IRC Secs. 401(a)(23), 4975(e)(7).

If the employer securities held within the plan are not readily traded on a public market, any transactions involving stock require an independent valuation of the stock for that transaction. A stock bonus plan generally is required to give participants the right to demand benefits in the form of employer securities. If employer securities are not readily tradable on an established market, the participant must be given the right to require the employer (not the plan) to repurchase employer securities under a fair valuation formula (a “put option”).¹

The requirement that participants have the right to demand benefits in the form of employer securities does not apply in situations where the charter or bylaws of the employer restrict the ownership of substantially all outstanding employer securities to employees, to a qualified plan trust, or to an S corporation.²

The employer must make this put option available for at least sixty days following distribution of the stock and, if it is not exercised within that time, it must be made available for another sixty day period (at a minimum) in the following year.³

The plan may repurchase the stock instead of the employer, but the plan cannot be required to do so. Certain banks that are prohibited by law from redeeming or purchasing their own shares are not subject to the requirement that they give participants a put option.⁴

If, pursuant to a put option, an employer is required to repurchase securities distributed to an employee as part of a “total distribution,” the amount paid for the securities must be paid in substantially equal periodic payments (at least annually), over a period beginning within thirty days after the exercise of the put option, and not exceeding five years. The employer must provide adequate security and reasonable interest must be paid on any unpaid amounts. A total distribution is a distribution to the recipient within one taxable year of the balance to the credit in his or her account.⁵ If an employer is required to repurchase securities distributed to an employee as part of an “installment distribution,” the amount paid for the securities must be paid within thirty days after the put option is exercised.⁶

8803. What rules govern distributions from an employer-sponsored stock bonus plan?

Distributions from a stock bonus plan are subject to mandatory 20 percent withholding, unless the employee elects a direct rollover.⁷ The mandatory withholding requirement does not apply to any distribution that consists only of securities of the employer corporation and cash of up to \$200 that is received in lieu of stock. The maximum amount to be withheld under the mandatory withholding rules may not exceed the sum of the amount of money received and the fair market value of property other than securities of the employer corporation received in the distribution.⁸

1. IRC Sec. 409(h).

2. IRC Sec. 409(h)(2)(B).

3. IRC Sec. 409(h)(4).

4. IRC Sec. 409(h)(3).

5. IRC Sec. 409(h)(5).

6. IRC Sec. 409(h)(6).

7. IRC Sec. 3405(c).

8. IRC Sec. 3405(e)(8).

The plan must provide that if a participant, with the consent of his or her spouse, so elects, the distribution of the account balance will begin within one year after the plan year:

- (1) in which the participant separates from service by reason of attainment of the normal retirement age under the plan, disability, or death; or
- (2) which is the fifth plan year following the plan year in which the participant otherwise separated from service.

Distribution under (2) will not be required if the participant is re-employed by the employer before distributions actually begin under (2).¹

The plan also must provide that, unless the participant elects otherwise, distribution of the participant's account balance will be made in substantially equal periodic payments (at least annually) over a period not longer than the greater of (1) five years, or (2) in the case of a participant with an account balance in excess of \$1,050,000 as indexed in 2014 (up from \$1,035,000 in 2013), five years plus one additional year (not to exceed five additional years) for each \$210,000 in 2014 (up from \$205,000 in 2013), or fraction thereof, by which the employee's account balance exceeds \$1,050,000.²

Planning Point: An employer whose stock is not publicly traded, and therefore is subject to the employer's potential obligation to repurchase its stock from terminating plan participants, should be concerned about the impact that obligation could have on its cash flow. The employer should consider writing its plan to take the maximum time allowed, generally five years, to begin the process of distributing stock from the plan and then repurchasing that stock from former employees. *Martin Silfen, J.D., Brown Brothers Harriman Trust Co., LLC.*

Notwithstanding these requirements, if the general rules for commencement of distributions from qualified plans require distributions to begin at an earlier date, those general rules control.³

8804. Does participation in an employer's stock bonus plan entitle the employee-participant to voting privileges?

A stock bonus plan is required to pass through certain voting rights to participants or beneficiaries. If an employer's securities are "registration-type," each participant or beneficiary generally must be entitled to direct the plan as to how securities allocated to him are to be voted.⁴ "Registration-type" securities are securities that must be registered under Section 12 of the Securities and Exchange Act of 1934 or that would be required to be registered except for an exemption in that law.⁵

If securities are not "registration-type" and more than 10 percent of a plan's assets are invested in securities of the employer, each participant (or beneficiary) must be permitted to direct voting rights under securities allocated to his or her account with respect to approval of

1. IRC Sec. 409(o)(1)(A).

2. IRC Sec. 409(o)(1)(C); IR-2012-77 (Oct. 18, 2012); IR-2013-86 (Oct. 31, 2013).

3. See General Explanation of TRA '86, p. 840.

4. IRC Secs. 401(a)(28), 4975(e)(7), 409(e)(2).

5. Sec. 12(g)(2)(H).

corporate mergers, consolidations, recapitalizations, reclassifications, liquidations, dissolutions, sales of substantially all of the business's assets, and similar transactions as provided in future regulations.¹

If the plan contains non-registration-type securities, the plan satisfies this requirement if each participant is given one vote with respect to an issue and the trustee votes the shares held by the plan in a proportion that takes this vote into account.²

1. IRC Sec. 409(e)(3).

2. IRC Secs. 401(a)(22), 409(e)(3), 409(e)(5).

PART XIII: CHOICE OF ENTITY AND THE SMALL BUSINESS

8805. What is a sole proprietorship and how is it formed?

A sole proprietorship is an unincorporated business entity that is owned by a single business owner. The primary distinguishing feature of the sole proprietorship is that only one person owns and manages the business. The business exists as an extension of the proprietor.¹

Because of this, the structure of the sole proprietorship is simple and relatively easy to establish. The proprietor usually need only buy some stock-in-trade, possibly rent some business space, and open his door for business. In some states it will be necessary for the proprietor to file or record what is commonly called a “fictitious business name”; d/b/a or “doing business as”; or “assumed name” registration if the business owner intends to operate the business under a different name than the owner’s name. The proprietor may also be required to obtain state and local licenses, if any are applicable to the business.

However, the owner largely avoids the complexity and expense involved in organizing a partnership (see Q 8807), limited liability company (see Q 8843), S corporation (see Q 8835) or C corporation (see Q 8823). A proprietor is not required to draft a partnership agreement, LLC operating agreement or articles of incorporation and bylaws. Therefore, the sole proprietor can avoid the cost of attorney’s fees, filing, publication, and recording and annual administrative maintenance costs.

In some cases, however, these advantages are outweighed by the risk of increased liability, an important disadvantage to the proprietorship structure. Since the business is an extension of the proprietor and not a separate legal entity, the liabilities or losses of the business are the personal liabilities and losses of the proprietor. No legal distinction is made between a proprietor’s personal liabilities and those created as a proprietor. Therefore, liability for these business obligations is unlimited and unshared. If business assets are insufficient to cover these business liabilities, creditors may reach the proprietor’s personal assets to satisfy their claims. A sole proprietorship can also be more difficult to transfer in that the ownership can not be divided.

8806. How is a sole proprietorship taxed?

Legally, a sole proprietorship is not an entity separate from its owner (see Q 8805). As a result, for tax purposes, the proprietor and the enterprise are treated as one indivisible unit. The proprietorship, as such, is not a tax paying entity.

The proprietor reports income and expenses on an individual return (Form 1040). For this purpose, a separate Schedule C is filed, including total proprietorship receipts, inventory, costs, and deductions, to arrive at proprietorship net profit or loss. This net profit or loss from Schedule C is carried to Form 1040, and included in taxable income.²

1. See *Williams v. McGowan*, 152 F.2d 570 (1945).

2. See IRS Guidance on Sole Proprietorships, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Sole-Proprietorships> (last accessed June 5, 2014).

In addition to the regular income tax applicable to the proprietorship net income, the Schedule C net income is also subjected to a separate self-employment tax (on Schedule SE), which is intended as a substitute for the Social Security taxes which would have been imposed if the income had been salary or wages paid by an employer (see Q 8547 and Q 8550). Since a sole proprietor is, in effect, both employer and employee, the self-employment tax encompasses both the employer and employee portions of the Social Security taxes on wages.

The estate of a sole proprietor is treated in the same manner as the estate of any other decedent. Unless specific assets pass by trust, contract or survivorship, they will be included in the proprietor's estate and potentially subject to estate taxation. Since the proprietor's business is not a separate entity, the business assets and liabilities also are subject to the estate administration process. This can be of a particular concern if the estate owns some assets which may be risky from a liability perspective.

A "qualified joint venture" that is carried out by a husband and wife may elect to treat their business as two sole proprietorships and not as a partnership for tax purposes. A qualified joint venture is any joint venture conducting a trade or business where the only owners are two spouses, both spouses materially participate in the business, and both spouses elect to opt out of the partnership taxation rules. Items of income, gain, loss, deduction, and credit must be divided between the spouses according to their respective interests in the business.¹ See Q 8810 to Q 8821 for a discussion of the tax treatment of partnerships.

8807. What is a partnership and how is it formed?

A partnership is an arrangement in which two or more parties join together, usually for some profit-motivated activity. Whereas a corporation is recognized as an independently functioning legal entity, separate and apart from its owners (stockholders), the status of a partnership falls somewhere in between that of a separate independent entity and a mere contractual association between participants. It is analogous to a sole proprietorship with multiple owners.

For tax purposes, however, the partnership is not treated as a separately taxable entity (even though it will still have to file a tax return). Instead, the income or loss realized by a partnership is passed through and taxed directly to the parties who are the partners of the partnership at their individual level.² This basic approach is the same as the tax treatment of S corporations (see Q 8836 and Q 8837). As is the case with S corporations, the pass-through approach eliminates the double-taxation effect of taxing the same income at the entity level and again when it is distributed to the owners of the entity. Many of the issues which arise in applying this pass-through approach are common to both S corporations and partnerships.

For tax purposes, the term "partnership" may include a general partnership, limited partnership, joint venture, limited liability company, or other unincorporated organization. Beginning in 1997, the IRS replaced the complicated set of rules that existed for use in for determining whether an association or entity was to be treated as a corporation or as a partnership for

1. IRC Sec. 761(f).

2. IRC Sec. 701.

tax purposes with a single taxpayer election approach, known as a “check the box” approach. As a result, non-corporate organizations may file an election to be treated as a corporation or as a partnership for purposes of determining the tax rules to which they will be subject. This is done on IRS Form 8832.

A partnership is formed under an agreement known as the “partnership agreement”. The partnership agreement is a written agreement between the partners, covering the organization, conduct, and termination of their common enterprise. This partnership agreement typically also governs the method that will be used for allocating partnership income, loss, deductions and credits among the individual partners. It may also include many provisions associated with a buy-sell agreement (see Q 8852).

8808. How does a partner acquire interests in a partnership? Is the allocation of income amongst partners impacted if a partner acquires a partnership interest by gift?

A person becomes a partner in a partnership through the ownership of a capital interest in a partnership in which capital is a material income-producing factor, whether the interest is acquired by purchase or gift. Generally, such a person will be taxable on his share of partnership profits or losses. If capital is not an income-producing factor in the partnership, the transfer of a partnership interest to a family member may be disregarded as an ineffective assignment of income, rather than an assignment of property from which income is derived.

Generally, the partnership agreement will provide how income and losses will be allocated. However, where an interest is acquired by gift (an interest purchased by one family member from another is considered to have been acquired by gift), the allocation of income, as set forth in the partnership agreement, will not control to the extent that:

- (1) it does not allow a reasonable salary for the donor of the interest; or
- (2) the income attributable to the capital share of the donee is proportionately greater than the income attributable to the donor’s capital share.¹

The transfer must be complete and the family member donee must have control over the partnership interest consistent with the status of partner. If the donee is not old enough to serve in the capacity of partner, the interest must be controlled by a fiduciary for his benefit.

8809. Is a partnership entitled to deduct its organizational expenses?

A partnership may deduct up to \$5,000 of organizational expenses in the year the partnership begins business. The \$5,000 amount is reduced (but not below zero) by the amount of organizational expenses that exceed \$50,000. If any organizational expenses remain, they may be deducted over a 180-month period beginning with the month that the partnership begins business.²

1. IRC Sec. 704(e).

2. IRC Sec. 709(b).

Organizational expenses that may typically be deducted include legal fees for services incident to organization, fees for establishment of the partnership accounting system, and necessary filing fees.¹

The determination of the date the partnership begins business is a question of fact, but ordinarily it begins when the partnership starts the business operations for which it was organized. For example, the acquisition of operating assets that are necessary to the type of business to be carried on by the partnership may constitute “beginning business.” The mere signing of a partnership agreement, however, is not sufficient to show the beginning of business.²

8810. How is a partnership taxed?

With the exception of certain publicly traded partnerships, a partnership is not taxed at the entity level.³ Despite this, the partnership must file an information return on Form 1065 that shows its taxable ordinary income or loss and capital gain or loss. Unlike in the case of a sole proprietorship (see Q 8805), the partnership is regarded as a separate entity for the purpose of computing taxable income, and business expenses of the partnership may be deducted.

In general, a partnership calculates taxable income in the same manner as individuals, except that the standard deduction, personal exemptions, and expenses of a purely personal nature are not allowed.⁴ The partnership may also be entitled to a deduction for production activities. Each partner must report his share of partnership profits, whether distributed or not, on his individual return.

In general, after the partnership calculates its taxable income, items of income, gain, loss, deduction or credit are allocated among the partners pursuant to the partnership agreement’s provisions, and the partners are taxed on those distributions individually.⁵ These tax items are commonly allocated among the partners in direct proportion to their respective percentage ownership interests in the partnership (see Q 8811).

Planning Point: As part of the partnership’s income tax return, the partnership is required to issue a Form K-1 to each of the partners. This Form advises each partner how income, loss and other “pass through” items should be reported on the partner’s personal income tax return. Therefore, if an individual owns an interest in a partnership (or other “flow through entity”, such as an S Corporation or LLC), the individual cannot file their personal income tax return until after the partnership return has been completed.

The situation becomes more complicated, however, when the partnership provides for allocation of income and other cash distributions or losses in a manner which differs from the partners’ relative percentage interests in capital. Limited partnerships have long been used as a vehicle for so-called tax-sheltered investments. These ventures are typically structured to

1. Treas. Reg. §1.709-2(a).

2. Treas. Reg. §1.709-2(c).

3. IRC Sec. 701.

4. IRC Secs. 703(a), 63(c)(6)(D).

5. IRC Sec. 704(a).

produce losses and/or tax credits, through liberal use of deductions for depreciation, natural resources depletion or exploration, and other provisions. The partnership agreements spell out the method for allocation of these tax benefits among the various classes of partners.

Thus, depending upon the objectives of the various partners, the tax allocation provisions of the partnership agreement might be drafted in order to allocate tax losses and/or credits to a particular partner or class of partners. Typically, the general partner(s), who are the organizers and managers of a venture will be treated differently from the limited partners, who are the principal providers of capital to the project. Prior to extensive reforms enacted in 1986 (see Q 8627), these types of tax shelter partnerships were widely promoted, with the partnerships' typically substantial tax losses being allocated primarily, if not exclusively, to the passive investors.

Under current law, the allocation specified under the agreement must have a "substantial economic effect." Essentially, this means that the IRS will scrutinize and revise the allocation of tax items among the partners to the extent necessary to be in accordance with each partner's true economic interest in the partnership.¹ See Q 8811 for a detailed discussion of the allocation of income and loss among partners.

Special allocation rules apply where the partner's interest changes during the year.²

A partnership which is traded on an established securities market, known as a publicly traded partnership, is taxed differently than a partnership in some instances (see Q 8818 and Q 8819).³ See Q 8817 for special considerations that may apply in the context of a family partnership.

8811. How is partnership income and loss allocated among partners? What is the "substantial economic effect test"?

The partnership agreement often provides for the allocation of separately stated items of partnership income, gain, loss, deductions and credits among the partners (known as a partner's distributive share), and sometimes provides for an allocation system that is disproportionate to the capital contributions of the partners (a so-called "special allocation"). Despite this, if the method of allocation lacks "substantial economic effect" (or if no allocation is specified), the distributive shares will be determined in accordance with the partner's interest in the partnership, based on all the facts and circumstances.⁴

The substantial economic effect test exists in order to "prevent use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes."⁵ Under the regulations, generally, an allocation will not have economic effect unless the partners' capital accounts are maintained properly, liquidation proceeds are required to be distributed based on the partners' capital account balances and, following distribution of such proceeds, partners are required to restore any deficits in their capital accounts to the partnership. Further, the

1. Treas. Reg. §1.704-1(b).

2. IRC Secs. 706(d), 704(b).

3. IRC Sec. 7704.

4. IRC Secs. 704(a), 704(b).

5. Sen. Fin. Comm. Report No. 938, 94th Cong., 2d Sess. 100 (1976).

economic effect will generally not be considered substantial unless the allocation has a reasonable possibility of substantially impacting the dollar amounts received by partners, independent of tax consequences. Allocations are also insubstantial if they merely shift tax consequences within a partnership tax year or are likely to be offset by other allocations in subsequent tax years.¹

If a partner contributes property to a partnership, allocations must generally be made to that partner to reflect any variation between the basis of the property to the partnership and its fair market value at the time of contribution.² When contributed property is distributed to a partner who did not contribute that property, the contributing partner must recognize gain or loss upon distributions occurring within seven years of the contribution.³ A contributing partner, however, is treated as receiving property which the partner contributed (and no gain or loss will therefore be recognized on the distribution) if the property contributed is distributed to another partner and like-kind property is distributed to the contributing partner within the earlier of (1) 180 days after the distribution to the other partner, or (2) the partner's tax return due date (including extensions) for the year in which the distribution to the other partner occurs.⁴

For contributions of property made after October 22, 2004, if the property has a built-in loss, the loss is considered only in determining the items allocated to the contributing partner. Also, when determining items allocated to other partners, the basis of the property is its fair market value at the time it was contributed to the partnership.⁵

The IRS is entitled to reallocate income and deductions attributable to distributions of property from a partnership to an individual and the individual's controlled corporation to prevent distortions of income.⁶ See Q 8812 for special rules that apply to allocations attributable to nonrecourse allocations.

8812. How are partnership losses and deductions attributable to non-recourse obligations allocated among partners?

Special rules apply to the allocation of losses and deductions attributable to nonrecourse obligations after 1991. If, however, the partnership agreement has not been substantially modified after 1991, transitional rules may permit the use of the earlier regulations under certain circumstances.⁷ See below for a discussion of the rules that applied prior to 1992.

For purposes of this discussion, the term "nonrecourse debt" refers to the traditional concept of nonrecourse—where a creditor's right to repayment is limited to one or more assets of the partnership. Nonrecourse liability, on the other hand, means partnership liability with respect to which no partner bears the economic risk of loss. If a partner bears the economic risk of loss

1. Treas. Reg. §1.704-1(b)(2).

2. IRC Sec. 704(c)(1)(A).

3. IRC Sec. 704(c)(1)(B).

4. IRC Sec. 704(c)(2).

5. IRC Sec. 704(c)(1)(C).

6. IRC Sec. 482; *Dolese v. Commissioner*, 811 F.2d 543, 87-1 USTC ¶9175 (10th Cir. 1987).

7. See Treas. Reg. §1.704-2(l).

with respect to nonrecourse debt, deductions and losses allocable to such nonrecourse debt must be allocated to such partner.¹

Special rules have been developed to govern the treatment of nonrecourse liabilities in the partnership context, because an allocation of a loss or deduction attributable to the nonrecourse liabilities of a partnership (“nonrecourse deductions”) cannot have economic effect with respect to a partner. This is because it is the nonrecourse lender, rather than the partner, that bears the risk of economic loss with respect to the deductions.² The amount of nonrecourse deductions for a partnership year is equal to the excess, if any, of the net increase in “partnership minimum gain”³ for the year over the amount of any distributions of proceeds of nonrecourse liabilities allocable to an increase in “partnership minimum gain.”

“Partnership minimum gain” is the amount of gain which would be realized in the aggregate if the partnership were to sell each property that is subject to a nonrecourse liability for an amount equal to the nonrecourse liability.⁴

Generally, nonrecourse deductions will be considered to have been allocated in accordance with the partners’ interests in the partnership (and the allocation will therefore be honored), if the following requirements are met:

- (1) Nonrecourse deductions are allocated in a manner that is consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse financing;
- (2) All other material allocations and basis adjustments either have economic effect or are allocated in accordance with the partners’ interests in the partnership;
- (3) The partners’ capital accounts are maintained properly;
- (4) Liquidation proceeds are required to be distributed based upon the partners’ capital account balances;
- (5) Following distribution of liquidation proceeds, partners are required to either (a) restore any deficits in their capital accounts to the partnership or (b) allocate income or gain sufficient to eliminate any deficit;
- (6) If there is a net decrease in partnership minimum gain during a year, each partner must be allocated items of partnership income and gain (“minimum gain charge-back”) for that year equal to that partner’s share of the net decrease in partnership minimum gain. (This requirement does not apply to the extent that a partner’s share of the net decrease in minimum gain is caused by a guarantee, refinancing, or other change in the debt instrument causing it to become partially or wholly recourse

1. Treas. Reg. §1.704-2(i).

2. Treas. Reg. §1.704-2(b)(1).

3. Treas. Reg. §1.704-2(c).

4. Treas. Reg. §1.704-2(d).

debt or partner nonrecourse debt, and the partner bears the risk of economic loss for the liability. Further, it does not apply to the extent that a partner contributes capital to the partnership to repay the nonrecourse liability and the partner's share of net decrease in minimum gain results from the repayment).¹

Years Beginning After December 29, 1988 and Before December 28, 1991

For those partnerships which qualified under the 1989-1991 rules and which choose to remain grandfathered under such rules, nonrecourse debt is treated under the rules described above.² Nonrecourse deductions will be deemed to be allocated in accordance with the partners' interests in the partnership if the requirements (1)-(4) and part (a) of the fifth of the requirements, described above, are met, and if the partnership agreement contains a clause complying with the minimum gain chargeback requirements contained in former Temporary Treasury Regulation Section 1.704-1T(b)(4)(iv). Those requirements provide that if there is a net decrease in partnership minimum gain during a year, each partner must be allocated a minimum gain chargeback equal to the greater of (1) the partner's share of the net decrease in minimum gain attributable to a disposition of property securing nonrecourse liabilities, or (2) the partner's deficit capital account.³

Years Beginning Before December 30, 1988

For partnerships which qualified under the rules that applied before December 30, 1988, and choose to remain grandfathered under such rules, nonrecourse debt is treated under the rules described in former Temporary Treasury Regulation Section 1.704-1T(b)(4)(iv),⁴ except that:

- (1) The amount of nonrecourse deductions for a partnership year is equal to the net increase in partnership minimum gain for the year. There is no reduction for certain distributions as there was under the former temporary regulations;
- (2) Nonrecourse deductions need not be allocated in accordance with the partners' interests in the partnership if current requirements (1) through (4) are met and either: (1) following distribution of liquidation proceeds, partners are required to restore any deficits in their capital accounts to the partnership; or (2) if there is a net decrease in partnership minimum gain during a year, each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain.

8813. How is the tax treatment of a partner's distributive share determined? When does a partner report income and loss?

The character of any item of income, gain, loss, deduction, or credit in the hands of a partner is determined as if such item were realized directly from the source from which it was

1. Treas. Regs. §§1.704-2(b)(1); 1.704-2(e); 1.704-2(f).

2. Former Treas. Reg. §1.704-1T(b)(4)(iv).

3. Former Treas. Reg. §1.704-1T(b)(4)(iv).

4. Former Treas. Reg. §1.704-1(b)(4)(iv).

realized by the partnership, or incurred in the same manner as incurred by the partnership. For example, a partner's distributive share of gain that stems from the sale of depreciable property used in the trade or business of the partnership is treated as though it was gain from the sale of the depreciable property in the hands of the partner. Similarly, a partner's distributive share of partnership "hobby losses"¹ or his distributive share of the partnership's charitable contributions retains such character in the hands of the partner.²

Where it is necessary to determine the amount or character of a partner's gross income, the partner's gross income includes the partner's distributive share of the gross income of the partnership. This means the amount of partnership gross income from which the partner's distributive share of partnership taxable income or loss was derived (including the various items listed above). For example, a partner is required to include his distributive share of partnership gross income in measuring his gross income for purposes of determining whether a partner is required to file a return.³

A partner's distributive share of partnership loss (including capital loss) is deductible only to the extent of the adjusted basis of such partner's interest in the partnership (see Q 8814). Any excess of such loss over such basis may be deducted only if and when the excess is actually repaid to the partnership.⁴

The partner must include the distributive share of partnership items of income, gain, loss, deductions, and credits on his return for the partnership year that ends in or at the same time as the partner's own individual tax year. Since most individuals report on a calendar year basis, an individual partner generally includes partnership income for the same calendar year as a partnership that reports on the calendar year basis. If the partnership uses a non-calendar fiscal year, the calendar year partner includes partnership income, gains, losses, deductions, and credits for the partnership year that *ends* in the partner's calendar year.⁵

8814. How is a partner's basis in the partnership calculated?

A partner's "basis" in the partnership interest is the partner's interest in the partnership for tax purposes. It is used to determine the tax imposed upon cash distributions, gain or loss on sale, and the limit on loss deduction (see Q 8813).

Initially, the partner's basis is the amount of money and the adjusted basis of any property the partner has contributed to the partnership, though it is subject to various adjustments thereafter.⁶ The basis is increased by any further contributions and by the partner's distributive share of taxable income, tax-exempt income, and the excess of the deductions for depletion over the basis of the property subject to depletion.⁷ The basis is decreased (but not below zero) by current distributions from the partnership, by the partner's distributive share of losses and

1. IRC Sec. 702.

2. Treas. Reg. §1.702-1(b).

3. IRC Sec. 6012(a).

4. IRC Sec. 704(d).

5. IRC Sec. 706(a); Treas. Reg. §1.706-1(a).

6. IRC Secs. 722, 705.

7. IRC Sec. 705(a)(1), Treas. Reg. §1.705-1(a)(2).

nondeductible expenditures not properly chargeable to capital and by the amount of the partner's deduction for depletion with respect to oil and gas wells.¹

A partner's basis also includes his or her share of partnership liabilities (see Q 8815). Basis is increased by any increase in the share of partnership liabilities, as though the partner had made an additional cash contribution.² A partner is deemed to receive a cash distribution to the extent that the partner's share of partnership liabilities decreases. As a result, basis decreases if the share of partnership liabilities decreases.³

If a limited partner contributes a personal note to the partnership, the basis in the partnership interest is not increased, however, because it is treated as a contribution of property in which the partner has no basis.⁴ When the note is paid, the amount becomes an additional contribution that is added to basis.

Planning Point: A partner's basis is very much of a "moving target" and must be reexamined every time the owner wants to engage in tax planning.

8815. What liabilities are included in determining a partner's adjusted basis in a partnership interest?

A partner's basis includes the partner's share of partnership liabilities.⁵ An economic risk of loss analysis is used to determine which liabilities are included in a partner's adjusted basis.

A partnership liability is treated as a recourse liability to the extent that any partner bears the economic risk of loss for that liability.⁶ A partner bears the economic risk of loss for a partnership liability to the extent that the partner (or certain related parties) would be obligated to make a payment to any person or make a contribution to the partnership with respect to a partnership liability (and would not be entitled to reimbursement by another partner, certain parties related to another partner, or the partnership) if the partnership were to undergo a "constructive liquidation."

A "constructive liquidation" would treat:

- (1) all of the partnership's liabilities as due and payable in full;
- (2) all of the partnership assets (including money), except those contributed to secure a partnership liability, as worthless;
- (3) all of the partnership assets as disposed of in a fully taxable transaction for no consideration (other than relief from certain liabilities);

1. IRC Secs. 705(a)(2), 705(a)(3).

2. IRC Secs. 752(a), 705(a).

3. IRC Secs. 752(b), 705(a)(2).

4. *Oden v. Comm.*, TC Memo 1981-184; Rev. Rul. 80-235, 1980-2 CB 229.

5. IRC Secs. 752, 705(a).

6. Treas. Reg. §1.752-1(a)(1).

- (4) all items of partnership income, gain, loss, and deduction for the year as allocated among the partners; and
- (5) the partner's interests in the enterprise as liquidated.¹

If one or more partners (or related persons) guarantee the payment of more than 25 percent of the interest that will accrue on a partnership nonrecourse liability over its remaining term, the loan will be deemed to be recourse with respect to the guarantor to the extent of the present value of the future interest payments if it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed interest if the partnership fails to do so.²

An obligation will be considered recourse with respect to a partner to the extent of the value of any property that the partner (or related party in the case of a direct pledge) directly or indirectly pledges as security for the partnership liability.³ Further, if a partner (or related party) makes a nonrecourse loan, or obtains an interest in such a loan to the partnership and the economic risk of loss is not borne by another partner, the obligation will be considered recourse as to that partner.⁴

A recourse liability allocated to a partner under these rules is included in the partner's basis.

However, a limited partner generally does not bear the economic risk of loss for any partnership recourse liability because limited partners are not typically obligated to make additional contributions and do not typically guarantee interest, pledge property, or make loans to the partnership. Otherwise, a limited partner can include a share of a partnership liability in his basis only if it is nonrecourse liability (see below).

A partnership liability is treated as a *nonrecourse* liability if no partner bears the economic risk of loss (see above) for that liability. Generally, partners share nonrecourse liability in the same proportion as they share profits. However, nonrecourse liabilities are first allocated among partners to reflect each partner's share of (1) any partnership minimum gain or (2) IRC Section 704(c) minimum gain.

Partnership minimum gain is the amount of gain that would be realized if the partnership were to sell all of its property that is subject to nonrecourse liabilities in full satisfaction of such liabilities and for no other consideration. IRC Section 704(c) minimum gain is the amount of gain that would be allocated under IRC Section 704(c) to a partner who contributed property to the partnership if the partnership were to sell all of its property that is subject to nonrecourse liabilities in full satisfaction of such liabilities and for no other consideration.⁵

1. Treas. Reg. §1.752-2(b)(1).

2. Treas. Reg. §1.752-2(e).

3. Treas. Reg. §1.752-2(h).

4. Treas. Reg. §1.752-2(c).

5. Treas. Regs. §§1.752-3(a), 1.704-2(d).

These rules apply to any liability incurred on or after December 28, 1991, except for those incurred or assumed pursuant to a written binding contract that was effective before that date and at all times thereafter. A partnership may elect to apply the provisions of the regulations to liabilities incurred or assumed prior to December 28, 1991, as of the beginning of the first taxable year ending on or after that date.¹

Similar rules apply to liabilities incurred or assumed by a partnership after January 29, 1989, and before December 28, 1991, unless the liability was incurred or assumed pursuant to a written binding contract that was effective prior to December 29, 1988 and at all times thereafter.² They also apply to partner loans and to guarantees of partnership liabilities that were incurred or assumed by a partnership after February 29, 1984, and before December 28, 1991, beginning on the later of March 1, 1984, or the first date on which the partner bore the economic risk of loss with respect to a liability because of his status as a creditor or guarantor of such liability.³ A partnership could elect to extend application of the temporary regulations to all of its liabilities as of the beginning of its first taxable year ending after December 29, 1988, and before December 28, 1991, subject to certain consistency rules.⁴

8816. How is a sale of partnership interests taxed?

As a practical matter, limited partnership interests are often not freely transferable because there is a lack of a market for the interests. However, in the event that an interest is sold, gain recognized by a limited partner on the sale of an interest is taxed as a long-term capital gain (see Q 8562). Any portion of that gain that is attributable to a limited partner's share of the partnership's IRC Section 751 "unrealized receivables" and "substantially appreciated inventory" items is subject to treatment as ordinary income.

In addition to any requirements in the partnership agreement that must be met upon the transfer of an interest, the IRC requires the transferor-partner to promptly notify the partnership of a transfer of a unit that occurs at a time when the partnership holds unrealized receivables or inventory items that have substantially appreciated in value. A penalty is imposed for a failure to make this notification, unless the failure is due to reasonable cause and not to willful neglect. Once the partnership has been notified, it is required to inform the buyer, the seller and the IRS of the names, addresses and taxpayer identification numbers of the parties to the transfer.

Upon the sale or exchange of, or certain distributions, with respect to a partnership unit, the partnership will be treated as owning its proportionate share of the property owned by any other partnership in which it is a partner. Therefore, if gain is realized upon the sale or exchange of, or certain distributions with respect to, a unit, a portion of the gain may be treated as ordinary income rather than capital gain to the extent it is attributable to unrealized receivables and substantially appreciated inventory held, not only by the partnership, but also by any partnership in which the partnership holds an interest.

1. Treas. Reg. §1.752-5.

2. Temp. Treas. Reg. §1.752-4T(a), prior to removal by TD 8380.

3. Temp. Treas. Reg. §1.752-4T(b), prior to removal by TD 8380.

4. Temp. Treas. Reg. §1.752-4T(c), prior to removal by TD 8380.

If it is found that a limited partner holds an interest primarily for sale to customers in the ordinary course of business, rather than for investment purposes, all gain recognized by that partner upon sale is taxable as ordinary income under the theory that the units are actually inventory held for sale in the ordinary course of business.

The amount of gain recognized by a limited partner on the sale of partnership units is equal to the excess of: (a) the amount realized on the sale of a unit, over (b) the adjusted tax basis of the interest. The amount realized includes cash, the fair market value of other property received on the sale and the partners' share of any qualifying nonrecourse liability of the partnership. Because nonrecourse liabilities must generally be taken into account, it is possible for a partner to be subject to a tax liability that exceeds the actual proceeds received upon the sale of a partnership interest.

The partnership agreement may permit the general partner to make a special election under IRC Section 754 to adjust the basis of partnership property when there is a transfer of a unit or a distribution of partnership assets that takes into account the basis in the partnership unit. If the value of the partnership property has increased, this election would result in the transferee partner having an increased basis in the allocable share of partnership assets and, therefore, the partner would receive more favorable tax treatment (greater cost recovery) if the partnership filed the Section 754 election. A general partner may choose *not* to make this election, however, because of the complexities and added expenses of the tax accounting required. In some cases, this may adversely affect the marketability of partnership interests and the price that a prospective purchaser would be willing to pay for a partnership unit. However, when a partner dies, a Section 754 election allows for a step up in basis for the partner's interest in the partnership's assets. This can be a valuable tax benefit for estates which own interests in partnerships.

Planning Point: In the event a partner in a partnership were to die, the partnership agreement should be examined to determine if a Sec. 754 election is authorized or required. Next, the general partner should be contacted to determine if an election is already in effect. Once an election is in effect under Section 754, it remains in effect for future years and can only be revoked with the consent of the IRS.¹

8817. What is a family partnership? What special considerations apply in the context of a family partnership?

In the income tax context, a business owner may wish to reduce tax liability by allocating a portion of the business income to minor children, essentially engaging in "income shifting". To this effect, the owner may form a family partnership between the parent and the children in which the children own an interest in the partnership that entitles them to specified portions of the partnership's income.

In theory, if this income was taxable to the children separately, it would be taxed at a lower rate bracket. Today, however, this tax reduction technique has very limited applicability because of the so-called "kiddie tax" (see Q 8557). The kiddie tax requires that "unearned" income of a child under age eighteen, or twenty-four for certain students, be taxed at the parent's tax rate.

1. Treas. Reg. §1.754-1(c).

“Unearned income” is essentially any income other than that received for personal services rendered by the child.

Generally, family partnerships will be recognized for tax purposes only if the following special requirements are met:

- (1) A family member, in general, will be deemed to be a partner only if the family member owns a capital interest in partnership property (such as machinery and equipment, real property or inventory) where the business of the partnership is such that capital is a material income-producing factor.¹ If the partnership business is such that personal services are a material income-producing factor, a family member who regularly renders valuable personal service to the business will generally be eligible for partner status for tax purposes. Where a capital interest is required by the underlying nature of the business, the interest may be acquired either by gift or by purchase;²
- (2) Where the partner receives the partnership interest as a gift, and capital is a material income-producing factor, the donee’s distributable partnership share will be included in taxable income except to the extent of:
 - a. The donor’s reasonable compensation for services rendered to the partnership; and
 - b. A proportionately greater distributive share attributable to donated capital compared to the donor’s capital.³ Thus, although a proportionate share of income attributable to a gifted capital interest may be shifted to a family member, compensation for personal services may not be shifted in such a manner, nor may distributive shares based on capital interests be arbitrarily realigned without proportional reference to the underlying capital interest. This means that where the donor-partner performed all or nearly all of the personal services rendered in connection with partnership activities, income allocated to the donee would be reduced (and taxed to the partner who performed the services) by the reasonable value of the services;
- (3) Where an interest in a family partnership is acquired by purchase from another family member, the interest is treated as if it was acquired by gift from the seller unless it can be shown that the sale was a bona fide arm’s-length transaction.⁴ If the transfer is a gift, the purchaser’s (donee’s) basis in the interest is limited to the fair market value of the interest and not the purchase price.

For purposes of applying these rules to “family” partnerships, IRC Section 704(e)(3) defines the “family” as including only a spouse, ancestors (including an individual’s parents and

1. IRC Sec. 704(e)(1).

2. Treas. Reg. §1.704-1(e)(1)(ii).

3. IRC Sec. 704(e)(2); Treas. Reg. §1.704-1(e)(3).

4. IRC Sec. 704(e)(3), Treas. Reg. §1.704-1(e)(4).

grandparents), lineal descendants (including children and grandchildren); and trusts, if the primary beneficiaries are any of the above.

As a general rule, a family partnership may consist of two or more of the following: a husband, a wife, children, grandchildren, grandparents, or a trust for the benefit of any of those individuals. A partnership formed only by siblings, in-laws, or uncles and aunts is subject only to the rules applicable to partnerships in general, and are not limited by the more restrictive rules imposed on family partnerships.

Although as a general rule, minor children will not be afforded treatment as partners for purposes of Section 704(e), two narrow and limited exceptions do exist for children age 18 and older:

- (1) If the minor child can be shown to be competent to manage and own property and to participate in the partnership activities in a manner consistent with the management of such property interests, partnership status may be afforded with the result that the child's distributive share of partnership income will be taxed to the child rather than, for example, to a parent-partner.¹
- (2) Where the exception above cannot be shown to exist, a minor child may still qualify as a partner to the extent partnership income is "earned income."

8818. What is a publicly traded partnership?

A publicly traded partnership is a partnership that is either (1) traded on an established securities market, or (2) readily tradable on a secondary market or the substantial equivalent thereof (discussed below).²

Generally, a partnership that is not traded on an established securities market will be treated as readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market. This occurs if any of the following are true:

- (1) partnership interests are regularly quoted by any person making a market in the interests;
- (2) any person regularly makes bids or offers quotes pertaining to the interests available to the public and stands ready to effect buy or sell transactions regarding same for itself or on behalf of others;
- (3) a partnership interest holder has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or

1. Treas. Reg. §1.704-1(e)(2)(viii).

2. IRC Sec. 7704(b).

- (4) prospective buyers and sellers have the opportunity to buy, sell, or exchange partnership interests in a time frame and with the regularity and continuity that is comparable to that described in (1)-(3) above.¹

Despite this, interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof unless (1) the partnership participates in the establishment of the market or the inclusion of its interests thereon, or (2) the partnership recognizes transfers made on that market.²

Generally, both general and limited partnership interests are included in calculations of percentage of partnership interests. However, if at any time during the taxable year, the general partner (and certain related persons under IRC Section 267(b) or IRC Section 707(b)(1)) own more than 10 percent of the outstanding interests in partnership capital and profit, the calculations are made without regard to interests owned by the general partner and the related persons.³

The percentage of partnership interests that are traded in a tax year is equal to the sum of the monthly percentages. The percentage of partnership interests traded during a month is determined by reference to partnership interests outstanding during the month. Any monthly convention may be used (e.g., first of month, 15th of month, end of month), so long as it is reasonable and used consistently.

In the case of “block transfers,” the determination of percentage of partnership interests traded during a thirty day period is made with reference to partnership interests outstanding immediately prior to the block transfer.⁴ A block transfer occurs when a partner transfers interests exceeding 2 percent of total interests in partnership capital and profit during a 30 day period.

These rules apply to the taxable years of a partnership beginning after December 31, 1995, unless the partnership was actively engaged in an activity before December 4, 1995. In that case, these rules apply to taxable years beginning after December 31, 2005, unless the partnership added a substantial new line of business⁵ after December 4, 1995, in which case these rules apply to taxable years beginning on or after the addition of the new line of business.⁶ Different transitional rules applied to certain pre-1996 partnerships.⁷

8819. What special rules apply in the tax treatment of a publicly traded partnership?

A publicly traded partnership will be taxed as a corporation unless 90 percent of the partnership’s income is passive-type income and has been passive-type income for all taxable years beginning after 1987 during which the partnership (or any predecessor) was in existence.

1. Treas. Reg. §1.7704-1(c).

2. Treas. Reg. §1.7704-1(d).

3. Treas. Reg. §1.7704-1(k)(1).

4. Treas. Reg. §§1.7704-1(k)(2) to 1.7704-1(k)(4).

5. Treas. Reg. §1.7704-2.

6. Treas. Reg. §1.7704-1(l). Notice 88-75, 1988-2 CB 386, (see below) generally applies to partnerships exempted from the rules in this section.

7. See Notice 88-75, 1988-2 CB 386.

For this purpose, a partnership (or a predecessor) is not treated as being “in existence” until the taxable year in which it is first publicly traded (see Q 8817).¹

On the first day that a publicly traded partnership is treated as a corporation under these rules, the partnership is treated as though it transferred all assets (subject to its liabilities) to a new corporation in exchange for stock in the corporation, followed by a distribution of the stock to its partners in liquidation of their partnership interests.²

In general, “passive-type income” includes interest, dividends, real property rents, gain from the sale of real property, income and gain from certain mineral or natural resource activities, and gain from sale of a capital or IRC Section 1231 asset.³ (“Passive-type income” for these purposes is different from income derived from a passive activity under the passive activity loss rules, see Q 8637).

The passive-type income exception is not available if the partnership would be treated as a regulated investment company⁴ if the partnership were a domestic corporation. The IRS has the authority to provide otherwise if the principal activity of the partnership involves certain commodity transactions.⁵

A partnership that fails to meet the passive-type income requirement may be treated as continuing to meet the requirement if the following are true:

- (1) the IRS finds that the failure was inadvertent;
- (2) steps are taken so that the partnership once more meets the passive-type income requirement within a reasonable time after the discovery of the failure; and
- (3) the partnership and each individual holder agree to make whatever adjustments or pay whatever amounts that the IRS may require with respect to the period in which the partnership inadvertently failed to meet the requirement.⁶

A grandfather rule provided that partnerships that were publicly traded, or for which registrations were filed with certain regulatory agencies, on December 17, 1987 (“existing partnerships”), were exempt from treatment as a corporation until tax years beginning after 1997. Adding a substantial line of business to an existing partnership after December 17, 1987 would terminate the exemption. For purposes of the 90 percent passive-type income requirement above, an existing partnership is not treated as being in existence before the earlier of (1) the first taxable year beginning after 1997 or (2) such a termination of exemption due to the addition of a substantial new line of business. This means that an existing partnership was not

1. IRC Sec. 7704(c)(1); Notice 98-3, 1998-1 CB 333.

2. IRC Sec. 7704(f).

3. IRC Sec. 7704(d)(1).

4. See IRC Sec. 851(a).

5. IRC Sec. 7704(c)(3).

6. IRC Sec. 7704(e).

required to meet the 90 percent requirement while it was exempt under the transitional rules in order to meet the 90 percent requirement when its exemption expired.¹

A publicly traded partnership taxed as a corporation under the above rules is treated, in general, as a taxable entity and tax benefits are taken at the entity level. Individual investors, therefore, are unable to realize certain tax benefits, such as depreciation deductions and tax credits, on their individual tax returns.

A publicly traded partnership that is taxed as a corporation should not be subject to the “at risk” rules (see Q 8697) or the “passive loss” rules (see Q 8635). Also, a publicly traded partnership would not qualify to make an election to be treated as an S corporation (see Q 8835).

See Q 8820 for safe harbor rules that can allow a partnership to avoid taxation as a publicly traded partnership. See Q 8825 for the tax rules that apply to corporations.

8820. Are there any safe harbor provisions that allow a partnership to avoid taxation as a publicly traded partnership based on a finding that its shares are traded on a secondary market (or the equivalent thereof)?

Several safe harbors exist that allow a partnership to avoid taxation as a publicly traded partnership. Under the “*Private Transfers Safe Harbor*,” certain transfers not involving trading (private transfers) are disregarded in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof.² These transfers include:

- (1) transfers in which the basis of the partnership interest in the hands of the transferee is determined by reference to the transferor’s basis or is determined under IRC Section 732;
- (2) transfers at death, including transfers from an estate or testamentary trust;
- (3) transfers between family members, as defined in IRC Section 267(c)(4);
- (4) the issuance of partnership interests for cash, property, or services;
- (5) distributions from a qualified retirement plan or individual retirement account;
- (6) a partner’s transfer of interests exceeding 2 percent of total interests in partnership capital and profit during a 30 day period (“block transfers”);
- (7) transfers under redemption or repurchase agreements that can only be exercised upon:
 - (a) death, disability, or mental incompetence of the partner, or
 - (b) the retirement or termination of service of a person actively involved in managing the partnership or in providing full time services to the partnership;

1. TRA ’87, Sec. 10211(c), as amended by TAMRA ’88, Sec. 2004(f)(2).

2. Treas. Reg. §1.7704-1(e).

- (8) transfers of an interest in a closed end partnership pursuant to a redemption agreement if the partnership does not issue any interest after the initial offering (and substantially identical investments are not available through the general partner or certain related parties under IRC Section 267(b) and IRC Section 707(b)(1));
- (9) transfers of at least 50 percent of the total interests in partnership capital and profits in one transaction or a series of related transactions; and
- (10) transfers not recognized by the partnership.

The “*Redemption and Repurchase Agreements Safe Harbor*” allows transfers involving redemption and repurchase agreements (other than those described in (7) and (8) of “Private Transfers Safe Harbor,” above) to be disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof if the following requirements are met:

- (1) the agreement provides that the partner must give written notice to the partnership at least 60 days prior to the redemption or repurchase date;
- (2) either (a) the agreement provides that the redemption or repurchase price cannot be established until at least 60 days after such notification, or (b) the redemption or repurchase price is not established more than four times during the partnership’s taxable year; and
- (3) no more than 10 percent of partnership interests are traded during a taxable year (disregarding only private transfers, see above).¹

The “*Private Placement Safe Harbor*” provides that interests in a partnership will not be treated as publicly traded if: (1) all interests in such partnership were issued in transactions that were not required to be registered under the Securities Act of 1933, and (2) the partnership has 100 partners or fewer at all times during the taxable year. Each person indirectly owning an interest in the partnership through a partnership, S corporation, or grantor trust is treated as a partner if (1) substantially all of the value of the owner’s interest in the entity is attributable to its interest in the partnership, and (2) a principal purpose of the tiered arrangement is to satisfy the 100 partner limitation.²

A “*Two Percent Safe Harbor*” provides that interests are not tradable on a secondary market or the substantial equivalent thereof if less than 2 percent of the percentage interests in partnership capital or profits are transferred during the taxable year (disregarding certain transfers involving private transfers, those involving qualified matching services, and certain redemption and repurchase agreements).³

1. Treas. Reg. §1.7704-1(f).

2. Treas. Reg. §1.7704-1(h).

3. Treas. Reg. §1.7704-1(j).

8821. What is an LLP? How is an LLP taxed?

Many state laws now provide for so-called limited liability partnerships (LLP), a form of partnership which is particularly well-suited for professional partnerships (such as partnerships of attorneys or doctors). To organize as an LLP, the partnership must file a statement of qualification with the relevant state agency.¹

The LLP form is particularly useful to professional partners because, as the name suggests, it limits the liability of the partners. Traditional partnerships involve unlimited liability of all general partners personally for the obligations and liabilities of the partnership. In a professional partnership of attorneys, for example, this would potentially subject partner A to personal liability for malpractice even though the malpractice is committed by partner B. It is important to understand that while this structure does provide some protection, it does not provide protection from a partner's own malpractice.

If the state in which the partnership operates has an LLP statute, the partnership may choose to register as a LLP in order to eliminate the liability of the general partners for acts or omissions of the other partners, though the general partners will remain liable for their own wrongful acts.²

LLPs are taxed in the same manner as a traditional partnership, in that the partners are taxed at the individual level, rather than at the entity level.

Another variation of the LLP is the limited liability limited partnership (LLLLP), which provides the typical limited liability to the limited partners, but also limits the liability of the general partners in the same manner (meaning that the assets of those partners are not reachable by creditors of the partnership). However, only certain states authorize creation of the LLLP.³

8822. What is a C corporation?

A corporation is a business entity that is treated as an artificial "person" created under state law and granted the right to engage in business by a charter issued by the state.

Planning Point: The corporation will have a "corporate designator" in its name so that people who do business with the entity will know it is a corporation. Some corporate designators include: incorporated, corporation, company, limited, or an abbreviation thereof. These designators must appear at the end of the corporate name. The idea is to let people who are doing business with an entity know the form of entity with which they are dealing.

As a person, the corporation may sue and be sued, it may buy, sell, and own property in its corporate name, and it may carry on any activities appropriate to the conduct of its business. Thus, property of the corporation along with its debts and liabilities are those of the corporation—not those of the stockholders who own it. As a result, the corporation is also taxed as a separate entity—its tax liabilities are separate and distinct from its stockholder-owners.⁴

1. Revised Uniform Partnership Act ("RUPA"), Secs.101(5), 1001.

2. RUPA, Sec. 306(c).

3. See, for example, Del. Code Ann., Title 6, §17-1105.

4. See IRC Sec. 11.

The corporation's existence is separate from the individuals who own and manage it. It has only the powers expressly or impliedly conferred upon it by the state. A corporation is considered to be a "C" corporation if it is an entity that is incorporated under the laws of one or more states *unless* it has filed an election to be treated as an "S" corporation (see Q 8835). In general, this discussion will refer to C corporations as "corporations" and S corporations as "S corporations." Whether a corporation is a C corporation or an S corporation depends upon a tax election. The non-tax characteristics of these two types of corporations are the same.

Both publicly traded and closely held corporations may be organized as C corporations. A closely held corporation (also referred to as a "close" or "closed" corporation) is one that is owned by one individual or a small number of individuals. The stock of a closely held corporation has a very limited market and will not ordinarily change hands except at the death or retirement of a stockholder or in case of some other major realignment within the company.

The opposite of the closely held corporation is the "publicly held corporation." A publicly held corporation is owned by a substantial number of shareholders, most of whom take no part in the active management of the corporation. Typically, a publicly held corporation is a large corporation whose stock is traded on a stock exchange or on the over-the-counter market.

See Q 8823 for a discussion of the formation of a corporation. Q 8825 discusses the tax treatment of a corporation. See Q 8835 to Q 8842 for a discussion of issues specifically applicable to S corporations.

8823. How is a C corporation formed?

The requirements that apply in forming a corporation vary from state to state. Several states have adopted the Model Business Corporation Act, which can serve to illustrate the basic provisions generally found in individual state statutes.

While a partnership is governed by its partnership agreement, a corporation is governed by its certificate of incorporation (also known as its charter) and bylaws. In the past, for the protection of investors and the general public, business conducted by the corporation was limited strictly to those types of transactions specifically authorized by the corporate charter. Today, most states only require that the purpose of the business, as stated in the charter, be to engage in any lawful business activity. Subject to state law and the terms of the charter, most basic corporate activities are governed by an official set of bylaws.

Planning Point: The by-laws set forth the mechanics as to how the corporation is to function. For example, how directors are elected; how meetings are called and whether business can be conducted without the formality of a meeting. The by-laws can set forth the specific authority of the directors and the officers. Typically, the statutes for the state where the corporation is formed will fill in any gaps which the by laws may not address.

To obtain the authority to conduct business as a corporation, the person organizing the corporation must file certain information with the state of incorporation. Generally, filing requirements include articles of incorporation, a filing fee and written appointment of a statutory agent (for service of process) within the state of incorporation. Most states will provide copies of the

relevant forms on a governmental website. Delaware, which is an extremely common state for corporate formations partially because of its well-developed case law and streamlined formation process, provides links to PDF documents that must be filed based on the type of corporation that will be formed (e.g., stock corporations, public benefit corporations, close corporations, non-profit corporations).¹

The following elements typically must be included in the articles of incorporation, however, each state may vary this information to some extent:

- (1) Name of corporation. The selected corporate name must not be in present use within the state, and must be one which connotes a corporate status (e.g., ABC Company, Inc.; XYZ Corporation). Many states provide a separate process by which a corporation may reserve a corporate name;
- (2) Place of business. The complete address of the principal place of business and, often, the address of a registered agent within the state of formation, must be included;
- (3) Purpose of business. The essential purpose of the business can be briefly stated (with reliance upon broadly-written state statutes, which generally grant broad operating authority), or a lengthy description of numerous operations may be included. Generally, it seems advisable to add to the present business purpose those closely related operations that might reasonably be entered into at some future date. As a result, should the corporation later broaden its activities, such operations will not constitute *ultra vires* acts of the corporation, nor serve as a basis for dissenting minority stockholder suits. The Delaware forms pre-fill this information with “any lawful act or activity for which corporations may be organized.” Other states permit similar approaches;
- (4) Number of authorized shares. This means the number of shares that the corporation is permitted to authorize. This does not mean “issued” shares or sold shares, but rather the total number of shares that can be issued at a later date. Often times, the documentation may authorize 1,000 shares and have 100 shares being issued at the inception of the corporation. The 100 issued shares allow the ownership to be held in percentage increments, and there are still 900 shares which can be issued at a later date if necessary. This clause should further state whether the authorized shares carry a par or non-par value;
- (5) Minimum stated capital. Some state statutes prescribe a minimum stated capital for the business, usually \$500, before the corporation can commence business. Operating before this stated capital is deposited exposes incorporators to personal liability.

1. Delaware filing forms may be accessed at <http://corp.delaware.gov/corpformscorp09.shtml> (last accessed June 5, 2014).

Optional Provisions

In addition to the essential information that must be included in a filing, in some states, the additional information may be optional, and is most commonly provided in the corporation's bylaws:

- (1) Express terms of shares. Where all of the authorized shares are common stock, it is unnecessary to define their terms. However, if there is more than one class of stock, it is important that the following terms be defined (often in the corporation's bylaws): rights to dividends; voting rights; preference on liquidation; preemptive rights to purchase additional stock;
- (2) Self-dealing of stockholders. In a closely held business, it is not unusual for stockholders or directors to sell property to or purchase property from the corporation. To preclude dissenting minority stockholder suits, specific authority for such acts should be included in the Articles;
- (3) Corporate authority to purchase its own shares. Though many state statutes permit the corporation to purchase its own shares, by director action, these permitted purchases are rather narrowly defined. To add flexibility for the stockholders, specific language can be added providing broad authority for such purchases.

8824. Is a corporation entitled to a deduction for the expenses it incurs in organizing as a corporation?

A corporation's expenses of organization (such as filing fees and attorney costs) are not deductible when incurred. However, the corporation may treat these as deferred expenses and deduct them ratably over the 180 month period beginning when the corporation starts business.¹

8825. How is a C corporation taxed?

Unlike in the partnership context, a corporation is required to file a tax return and pay taxes at the entity level. The owners of the corporation (its shareholders) also pay taxes at the individual level based on any distributions received as dividend income based on stock ownership.

A corporation pays tax according to a graduated rate schedule, which can result in a lower tax rate for corporations with relatively modest earnings. The corporate tax rates range from 15 percent to 35 percent. The first \$50,000 of a corporation's earnings is taxed at the 15 percent rate, but the next \$25,000 of earnings is taxed at 25 percent. Earnings above \$75,000, but below \$10,000,000, are subject to a 34 percent rate. A 35 percent rate applies to corporate earnings above the \$10,000,000 level.²

Taxable income is computed for a corporation in much the same way as for an individual. Generally, a corporation may take the same deductions as an individual, except those of a personal

1. IRC Sec. 248; Reg. §1.248-1.

2. IRC Sec. 11(b).

nature (such as deductions for medical expenses and the personal exemptions). A corporation also does not receive a standard deduction.

Some deductions are allowed specifically for corporations, however, including a deduction equal to 70 percent of dividends received from other domestic corporations, 80 percent of dividends received from a 20 percent owned company, and 100 percent for dividends received from affiliated corporations (see Q 8826 for a detailed discussion of the deductions available with respect to dividends).¹ A corporation may deduct contributions to charitable organizations to the extent of 10 percent of taxable income (with certain adjustments).² Generally, charitable contributions in excess of the 10 percent limit may be carried over for five years.³

A corporation is also allowed a deduction for production activities. This deduction is equal to nine percent of a taxpayer's qualified production activities income (or, if less, the taxpayer's taxable income). The deduction is limited to 50 percent of the W-2 wages paid by the taxpayer for the year. The definition of "production activities" is broad and includes construction activities, energy production, and the creation of computer software.⁴

Capital gains and losses are netted for a corporation in the same manner as for an individual (see Q 8573) and net short-term capital gain, to the extent it exceeds net long-term capital loss, if any, is taxed at the corporation's regular tax rates.

A corporation reporting a net capital gain (where net long-term capital gain exceeds net short-term capital loss) is taxed under one of two following methods, depending on which produces the lower tax:

1. *Regular method.* Net capital gain is included in gross income and taxed at the corporation's regular tax rates; or
2. *Alternative method.* First, a tax on the corporation's taxable income, exclusive of net capital gain, is calculated at the corporation's regular tax rates. Then a second tax on the net capital gain (or, if less, taxable income) for the year is calculated at the rate of 35 percent. The tax on income exclusive of net capital gain and the tax on net capital gain are added to arrive at the corporation's total tax. For certain gains from timber, the maximum rate is 15 percent.⁵

8826. What is the corporate dividend exclusion?

A corporation, as a legal entity, may own shares in other corporations in the same manner as individuals, and is entitled to receive any dividends on such shares.

However, in computing its taxable income, a corporation, unlike an individual, may deduct 80 percent of dividends received from domestic corporations if it owns at least 20 percent but less

1. IRC Sec. 243.

2. IRC Sec. 170(b)(2).

3. IRC Sec. 170(d)(2).

4. IRC Sec. 199.

5. IRC Secs. 1201, 1222.

than 80 percent of the stock.¹ For corporations that own less than 20 percent of the distributing corporation the deduction is limited to 70 percent of the dividends received.² Dividends received are 100 percent deductible if the recipient is a small business investment company operating under the Small Business Investment Act, or, subject to certain conditions, if the recipient is a member of the same affiliated group of corporations as the issuer of the dividends (generally meaning 80 percent or more common ownership).³

In order to prevent abuse of the dividends-received deduction through extremely short-term investments designed only to capture imminent dividends on a tax-free basis, the deduction is available only if the stock is held for a minimum period, depending on the type of stock involved.

Dividends from Foreign Corporations

Dividends received by a domestic corporation which owns at least 10 percent of a foreign corporation are subject to a domestic corporation deduction only to the extent that the dividends are deemed attributable to U.S. source income of the foreign corporation. This is computed by applying to the dividends received a ratio equal to the ratio of U.S. source income to total income of the foreign corporation. Once the U.S.-source portion is determined, the deduction is then limited, depending on the percentage ownership of the foreign corporation. If the domestic corporation owns at least 10 percent, but less than 20 percent, the deduction is 70 percent of the U.S.-source portion of the dividends received. If the percentage ownership is at least 20 percent, the portion deductible increases to 80 percent of the U.S.-source dividends received.

A 100 percent deduction is allowed for dividends received from a foreign wholly-owned subsidiary of a domestic corporation, provided that all of the subsidiary's income is effectively connected with a U.S. trade or business. Special rules apply in the case of dividends received from certain foreign sales corporations (FSCs).⁴

Debt-Financed Portfolio Stock

The dividends-received deduction is further limited with respect to dividends received from debt-financed portfolio stock. In general, the otherwise allowable deduction (after applying the other limitations) must be reduced by a percentage equal to the percentage of the cost of the dividend-yielding stock which was debt-financed.⁵

8827. How is a C corporation shareholder taxed upon the sale of the shareholder's stock in the corporation?

Generally, a shareholder who sells or exchanges stock for other property realizes a capital gain or loss.⁶ Whether such gain or loss is short-term or long-term usually depends on how long

1. IRC Sec. 243(c).

2. IRC Sec. 243(a)(1).

3. IRC Sec. 243(a)(3).

4. IRC Secs. 245 and 922.

5. IRC Sec. 246(a).

6. See IRC Secs. 1221, 1222.

the shareholder held the stock before selling (or exchanging) the stock.¹ For an explanation of how the holding period is calculated, see Q 8568; for the treatment of capital gains and losses, including the current tax rates applicable for capital gains, see Q 8561 to Q 8576.

When shares of stock are sold, the amount of gain (or loss) is the difference between the selling price and the shareholder's tax basis in the shares at the time of sale. If the shares are exchanged for property, or for property and cash, the amount of gain (or loss) is the difference between the fair market value of the property plus the cash received in the exchange and the shareholder's tax basis.²

Despite this, if common stock in a corporation is exchanged for common stock in the same corporation, or if preferred stock is exchanged for preferred stock in the same corporation, gain or loss is generally not recognized unless cash or other property is also received. In this case, the exchange is taxed in substantially the same manner as a "like-kind" exchange.

The exchange of shares of different corporations and exchanges of common for preferred do *not* qualify for the general "like-kind" exchange rules, even if the shares are similar in all respects.³ The nonrecognition rules of IRC Section 1036 apply to exchanges of common stock for common stock in the same corporation, even though the shares are of a different class and have different voting, preemptive, or dividend rights.⁴

For an explanation of "like-kind" exchanges, see Q 8606. See Q 8828 for considerations that apply in determining a stockholder's basis in corporate stock.

8828. What special considerations apply in determining a stockholder's basis in securities, such as corporate stock?

If an individual's holdings in a particular security were all acquired on the same day and at the same price, there is little difficulty in establishing the tax basis and holding period of the securities subject to the sale or exchange. When an individual sells or otherwise transfers securities from holdings that were purchased or acquired on different dates or at different prices (or at different tax bases), the process becomes more difficult. See Q 8565 for a discussion of the general rules applicable in determining a taxpayer's basis in an asset.

In the context of corporate securities, the individual must generally be able to identify the lot from which the transferred security originated in order to determine tax basis and holding period. Unless the individual can "adequately identify" the lot from which the securities being sold originated, the securities sold will be deemed to have come from the earliest of such lots purchased or acquired, by a "first-in, first-out" (FIFO) method.⁵ However, in cases involving mutual fund shares, the selling shareholder may be permitted to use an "average basis" method to determine tax basis and holding period in the securities transferred.

1. See IRC Secs. 1222, 1223.

2. See IRC Sec. 1001.

3. IRC Sec. 1036; Treas. Reg. §1.1036-1. See IRC Sec. 1031(a).

4. Rev. Rul. 72-199, 1972-1 CB 228. See Treas. Reg. §1.1036-1.

5. Treas. Reg. §1.1012-1(c)(1).

Generally, identification is determined by the certificate delivered to the buyer or other transferee. The security represented by the certificate is deemed to be the security sold or transferred. This is true even if the taxpayer intended to sell securities from another lot or instructed a broker to sell securities from another lot.¹

The following are exceptions to the general rule of adequate identification:

- (1) The securities are left in the custody of a broker or other agent. If the seller specifies to the broker which securities to sell or transfer, and if the broker or agent sends a written confirmation of the specified securities within a reasonable time, then the specified securities are the securities sold or transferred, even though different certificates are delivered to the buyer or other transferee;²
- (2) The taxpayer holds a single certificate representing securities from different lots. If the taxpayer sells part of the securities represented by the certificate through a broker, adequate identification is made if the taxpayer specifies to the broker which securities to sell, and if the broker sends a written confirmation of the specified securities within a reasonable time. If the taxpayer sells the securities, then there is adequate identification if there is a written record identifying the particular securities intended for sale;³
- (3) The securities are held by a trustee, or by an executor or administrator of an estate. An adequate identification is made if the trustee, executor, or administrator specifies in writing in the books or records of the trust or estate the securities to be sold, transferred, or distributed. In the case of a distribution, the trustee, executor, or administrator must give the distributee a written document specifying the particular securities distributed. Here, the specified securities are the securities sold, transferred, or distributed, even if certificates from a different lot were delivered to the purchaser, transferee, or distributee.⁴

In the case of stock which is inherited, the basis is equal to the value of the stock on the date of the decedent's death (and subject to certain exceptions, including the election to apply the alternate valuation date).⁵ Since the new basis is generally equal to the date of death value of the stock, this adjustment can result in either a step up or a step down in basis. Therefore, unrealized gains and losses disappear at the time of death.

8829. What is the accumulated earnings tax that a C corporation may be subject to? When does the tax apply?

In addition to the graduated tax rate schedule outlined in Q 8825, a corporation will be subject to a penalty tax if, for the purpose of preventing the imposition of income tax upon

1. Treas. Reg. §1.1012-1(c)(2).

2. Treas. Reg. §1.1012-1(c)(3)(i).

3. Treas. Reg. §1.1012-1(c)(3)(ii).

4. Treas. Reg. §1.1012-1(c)(4).

5. IRC Sec. 1014, 2032.

its shareholders, it accumulates earnings instead of distributing them as dividends.¹ The tax is 20 percent of the corporation's *accumulated taxable income* (15 percent for tax years beginning prior to 2013).²

"Accumulated taxable income" is taxable income for the year (after certain adjustments) minus the federal income tax, dividends paid to stockholders (during the taxable year or within 2½ months after the close of the taxable year), and the "accumulated earnings credit."³

A corporation is permitted to retain amounts required to meet the reasonable needs of the business—the tax will only be imposed upon amounts in excess of these amounts. To facilitate this permitted retention, an accumulated earnings credit is allowed. A corporation must demonstrate a specific, definite and feasible plan for the use of the accumulated funds in order to avoid the tax.⁴

The use of accumulated funds for the personal use of a shareholder and family is evidence that the accumulation was to prevent the imposition of income tax upon its shareholders.⁵ In deciding whether a family owned bank was subject to the accumulated earnings tax, the IRS took into account the regulatory scheme the bank was operating under to determine its reasonable needs.⁶

Most corporations are allowed a minimum accumulated earnings credit equal to the amount by which \$250,000 (\$150,000 in the case of service corporations in health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting) exceeds the accumulated earnings and profits of the corporation at the close of the previous taxable year.⁷ Consequently, an aggregate of \$250,000 (or \$150,000) may be accumulated for any purpose without danger of incurring the penalty tax.

Tax-exempt income is not included in the accumulated taxable income of the corporation, but will be included in earnings and profits in determining whether there has been an accumulation beyond the reasonable needs of the business.⁸ However, a distribution in redemption of stock to pay death taxes which is treated as a dividend does not qualify for the "dividends paid" deduction (Q 8826) in computing accumulated taxable income.⁹

The accumulated earnings tax applies to all C corporations, without regard to the number of shareholders in taxable years beginning after July 18, 1984.¹⁰

1. IRC Secs. 531-537; *GPD, Inc. v. Comm.*, 75-1 USTC ¶9142 (6th Cir. 1974).

2. IRC Sec. 531, as amended by ATRA.

3. IRC Sec. 535.

4. *Eyefull Inc. v. Comm.*, TC Memo 1996-238.

5. *Northwestern Ind. Tel. Co. v. Comm.*, 127 F.3d 643, 97-2 USTC ¶50,859 (7th Cir. 1997).

6. TAM 9822009.

7. IRC Sec. 535(c)(2).

8. Rev. Rul. 70-497, 1970-2 CB 128.

9. Rev. Rul. 70-642, 1970-2 CB 131.

10. IRC Sec. 532(c).

8830. What is the personal holding company tax that a C corporation may be subject to? When does the tax apply?

In addition to the typical corporate tax rates (Q 8825) and accumulated earnings penalty tax (Q 8829), a second penalty tax, called the personal holding company (PHC) tax, may be imposed to prevent shareholders from avoiding personal income taxes on securities and other income-producing property placed in a corporation to avoid higher personal income tax rates. The PHC tax is 20 percent (15 percent for tax years beginning prior to 2013) of the corporation's undistributed PHC income (taxable income adjusted to reflect its net economic income for the year, minus dividends distributed to shareholders), if the corporation meets both the "stock ownership" and "PHC income" tests.¹

A corporation meets the "stock ownership" test if more than 50 percent of the value of its stock is owned, directly or indirectly, by or for not more than 5 shareholders.² Certain stock owned by families, trusts, estates, partners, partnerships, and corporations may be attributed to individuals for purposes of this rule.³

A corporation meets the "PHC income" requirement if 60 percent or more of its adjusted ordinary gross income is PHC income, generally defined to include the following: (1) dividends, interest, royalties, and annuities; (2) rents; (3) mineral, oil, and gas royalties; (4) copyright royalties; (5) produced film rents (amounts derived from film properties acquired before substantial completion of the production); (6) compensation from use of corporate property by shareholders; (7) personal service contracts; and (8) income from estates and trusts.⁴

8831. Are C corporations subject to the alternative minimum tax? How is the corporate alternative minimum tax calculated?

A corporate taxpayer must calculate its liability under the regular tax and a tentative minimum tax, and then add to its regular tax the amount of tentative minimum tax as exceeds the regular tax. The amount added is the corporate alternative minimum tax (AMT).⁵

To calculate its AMT, a corporation first calculates its "alternative minimum taxable income" (AMTI), as explained below.⁶ The corporation must then calculate its "adjusted current earnings" (ACE), also explained below. The corporation increases its AMTI by 75 percent of the amount by which ACE exceeds AMTI (or reduces its AMTI by 75 percent of the amount by which AMTI exceeds ACE).⁷ The tax itself is a flat 20 percent rate, applied to the corporation's AMTI after it is adjusted based on ACE.⁸

1. IRC Secs. 541, as amended by ATRA, 542, 545.

2. IRC Sec. 542(a)(2).

3. IRC Sec. 544.

4. IRC Secs. 542(a)(1), 543(a).

5. IRC Secs. 55-59.

6. IRC Sec. 55(b)(2).

7. IRC Sec. 56(g).

8. IRC Sec. 55(b)(1)(B).

Each corporation receives a \$40,000 exemption, similarly to the AMT exemption applicable to individuals (see Q 8555). The corporate exemption amount, however, is reduced by 25 percent of the amount by which AMTI exceeds \$150,000 (phasing out completely at \$310,000).¹

AMTI is regular taxable income determined with certain adjustments and increased by tax preferences.² “Tax preferences” for corporations are the same as for other taxpayers. Adjustments to income include the following:

- (1) property is generally depreciated under a less accelerated or a straight line method over a longer period, except that a longer period is not required for property placed in service after 1998;
- (2) mining exploration and development costs are amortized over 10 years;
- (3) a percentage of completion method is required for long-term contracts;
- (4) net operating loss deductions are generally limited to 90 percent of AMTI (although some relief was available in 2001 and 2002);
- (5) certified pollution control facilities are depreciated under the alternative depreciation system except those that are placed in service after 1998, which will use the straight line method; and
- (6) the adjustment based on the corporation’s ACE.³

To calculate ACE, a corporation begins with AMTI (determined without regard to ACE or the AMT net operating loss) and makes additional adjustments. These adjustments include adding certain amounts of income that are includable in earnings and profits but not in AMTI (including income on life insurance policies and receipt of key person insurance death proceeds). The amount of any such income added to AMTI is reduced by any deductions that would have been allowed in calculating AMTI had the item been included in gross income. The corporation is generally not allowed a deduction for ACE purposes if that deduction would not have been allowed for earnings and profits purposes, though a deduction is allowed for certain dividends received by a corporation. Generally, for property placed into service after 1989 but before 1994, the corporation must recalculate depreciation according to specified methods for ACE purposes. For ACE purposes, earnings and profits are adjusted further for certain purposes such as the treatment of intangible drilling costs, amortization of certain expenses, installment sales, and depletion.⁴

A corporation subject to the AMT in one year may be allowed a minimum tax credit against regular tax liability in subsequent years. The credit is equal to the excess of the adjusted net minimum taxes imposed in prior years over the amount of minimum tax credits allowable in prior years.⁵ However, the amount of the credit cannot be greater than the excess of the corporation’s

1. IRC Secs. 55(d)(2), 55(d)(3).

2. IRC Sec. 55(b)(2).

3. IRC Secs. 56(a), 56(c), 56(d).

4. IRC, Sec. 56(g); the tax is reported on Form 4626.

5. IRC Sec. 53(b).

regular tax liability (reduced by certain credits such as certain business related credits and certain investment credits) over its tentative minimum tax.¹

8832. Are there any exceptions to the rule that corporations may be subject to the alternative minimum tax? Can small corporations be exempt from AMT requirements?

Certain small corporations are deemed to have a tentative minimum tax of zero and are, therefore, exempt from the AMT.² To qualify, the corporation must meet a \$5 million gross receipts test for its first taxable year beginning after 1996, under which average annual gross receipts for the previous three years must not exceed \$5 million. If the corporation has not existed for three full years, the years the corporation was in existence are substituted for the three years (with annualization of any short taxable year). The corporation must continue to meet this test in each subsequent tax year to remain exempt, but with \$7.5 million substituted for \$5 million.³

Gross receipts means those receipts properly recognized under the taxpayer's method of accounting for federal income tax purposes. Gross receipts include total sales (net of returns and allowances) and all amounts received for services. It also includes all investment income such as interest, dividends, rents and royalties. Gross receipts are generally reduced by the adjusted basis of capital assets or property sold in a trade or business.⁴

If a corporation loses its AMT exemption, certain adjustments used to determine the corporation's AMTI will be applied for only those transactions entered into or property placed in service in tax years beginning with the tax year in which the corporation ceases to be a small corporation and tax years thereafter.⁵

A corporation exempt from the AMT because of the small corporation provision may be limited in the amount of credit it may take for AMT paid in previous years. In computing the AMT credit, the corporation's regular tax liability (reduced by applicable credits) used to calculate the credit is reduced by 25 percent of the amount that such liability exceeds \$25,000.⁶

8833. What is a controlled group of corporations?

The controlled group rules aggregate several entities (this rule applies to corporations, but also to proprietorships and partnerships) into a single employer for meeting various qualification requirements of the IRC. In general, the determination of whether a group is a controlled group of corporations or under common control considers stock ownership by value or voting power. All employees of a group of employers that are members of a controlled group of corporations or, in the case of partnerships and proprietorships, are under common control will be treated as employed by a single employer.⁷

1. IRC Sec. 53(c).

2. IRC Sec. 55(e).

3. IRC Secs. 55(e)(1), 448(c).

4. Treas. Reg. §1.448-1T(f)(2)(iv).

5. IRC Sec. 55(e)(2).

6. IRC Sec. 55(e)(5).

7. IRC Secs. 414(b), 414(c).

A controlled group may be a parent-subsidary controlled group, a brother-sister controlled group, or a combined group, as follows:¹

- (1) A parent-subsidary controlled group is composed of one or more chains of subsidiary corporations connected through stock ownership with a common parent corporation. A parent-subsidary group exists if at least 80 percent of the stock of each subsidiary corporation is owned by one or more of the other corporations in the group and the parent corporation owns at least 80 percent of the stock of at least one of the subsidiary corporations. When determining whether a parent owns 80 percent of the stock of a subsidiary corporation, all stock of that corporation owned directly by other subsidiaries is disregarded;
- (2) A brother-sister controlled group is two or more corporations in which five or fewer individuals, estates, or trusts own stock consisting of 80 percent or more of each corporation, and more than 50 percent of each corporation when taking into account each stockholder's interest only to the extent each stockholder has identical interests in each corporation. For purposes of the 80 percent test, a stockholder's interest is considered only if the stockholder owns some interest in each corporation of the group;²
- (3) A combined group is three or more corporations, each of which is a member of a parent-subsidary group or a brother-sister group (above) and one of which is both a parent of a parent-subsidary group and a member of a brother-sister group.³

Special rules apply for determining stock ownership, including special constructive ownership rules, when determining the existence of a controlled group.⁴ Community property rules, where present, also apply.⁵

For purposes of qualification, the test for a controlled group is strictly mechanical. Once the existence of a group is established, aggregation of employees is required and will not be negated by showing that the controlled group and plans were not created or were manipulated for the purpose of avoiding the qualification requirements.⁶

8834. How is the treatment of transactions between corporations impacted by membership in a controlled group? How are corporate members of a controlled group taxed?

IRC Section 482 allows the IRS to distribute, apportion or allocate income, deductions, credits or allowances among a controlled group of corporations (see Q 8833) in order to prevent tax evasion or to more accurately reflect the actual income of the entity. While the provision

1. Treas. Reg. §1.414(b)-1.

2. *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982); Treas. Reg. §1.1563-1(a)(3).

3. IRC Secs. 414(b), 1563; Treas. Reg. §1.414(b)-1.

4. IRC Sec. 1563(d); Treas. Reg. §1.414(b)-1.

5. *Aero Indus. Co., Inc. v. Comm.*, TC Memo 1980-116.

6. *Fujinon Optical, Inc. v. Comm.*, 76 TC 499 (1981).

applies to all entities, it is especially relevant in the context of a corporation that may engage in transactions with other corporations in the controlled group that are not considered to be arm's length. In such a situation, special rules may govern transactions that take place between members of the controlled group.

To reflect the fact that such a sale or exchange between members of a controlled group may not have resulted from arm's length negotiations, loss on a sale or exchange (other than of inventory) between two corporations that are members of the same controlled group (using a 50 percent test instead of 80 percent, see Q 8833), though generally not denied, is deferred until the property is transferred outside the controlled group.¹

Further, the controlled group rules prevent a single business owner from taking advantage of the graduated rate schedule that applies to corporations through use of multiple corporations that would spread taxable income among corporations in order to cause all income to become subject to the low 15 percent corporate tax rate.² Similarly, a controlled group of corporations is entitled to only one accumulated earnings tax credit (Q 8829) and only one \$40,000 AMT exemption (Q 8831).³

8835. What is an S corporation and how is it formed?

An S corporation is a corporation that files an election to be treated as an S corporation, which, generally, means that it will be treated as a pass-through entity that is taxed similarly to a partnership, thus avoiding most tax at the corporate level.⁴ To be eligible to make the election, a corporation must meet certain requirements as to the kind and number of shareholders (Q 8840), classes of stock (Q 8841), and sources of income. However, the decision to be an S corporation is a tax election. Therefore, an S Corporation will be treated the same as any other corporation for purposes of the applicable state corporation law.

An S corporation must be a domestic corporation with only a single class of stock and may have up to 100 shareholders (none of whom are nonresident aliens) who are individuals, estates, and certain trusts. An S corporation may not be an ineligible corporation.

An ineligible corporation is one of the following: (1) a financial institution that uses the reserve method of accounting for bad debts; (2) an insurance company; (3) a corporation electing (under IRC Section 936) credits for certain tax attributable to income from Puerto Rico and other U.S. possessions; or (4) a current or former domestic international sales corporation (DISC). Qualified plans and certain charitable organizations may be S corporation shareholders.⁵

While an S corporation can only have one class of stock, it is permitted to have a second class of stock if the only difference is the ability to vote.⁶

1. IRC Sec. 267(f).

2. IRC Sec. 1561(a)(1).

3. IRC Sec. 1561(a)(2), (3).

4. See IRC Secs. 1361, 1362, 1363.

5. IRC Sec. 1361.

6. IRC Sec. 1361(c)(4).

Planning Point: In order to qualify as an S corporation, an election must be filed in order to be treated as such. These elections are made on IRS Form 2553, and must be made within two months and fifteen days after the effective date of the election. The IRS has recently issued Revenue Procedure 2013-30, which will extend this time period for up to three years for certain situations.

8836. How is an S corporation taxed? When may S corporation income be taxed at the corporate level?

An S corporation is generally not subject to tax at the corporate level.¹ However, a tax is imposed at the corporate level under certain circumstances. When an S corporation disposes of property within 10 years after the S election was made, gain attributable to pre-election appreciation of the property (built in gain) is taxed at the corporate level to the extent such gain does not exceed the amount of taxable income imposed on the corporation if it were not an S corporation.² However, ARRA 2009 provides that, in the case of a taxable year beginning in 2011, no tax is imposed on the built in gain if the fifth taxable year of the 10-year recognition period precedes such taxable year.

For S elections made after December 17, 1987, a corporation switching from C corporation status to S corporation status may also be required to recapture certain amounts at the corporate level in connection with goods previously inventoried under a LIFO method.³

In addition, a tax is imposed at the corporate level on *excess* “net passive income” of an S corporation (passive investment income reduced by certain expenses connected with the production of such income) but only if the following are true:

- (1) The corporation, at the end of the tax year, has accumulated earnings and profits (either carried over from a year in which it was a nonelecting corporation or due to an acquisition of a C corporation).
- (2) Passive investment income exceeds 25 percent of gross receipts.

The highest corporate tax rate (currently 35 percent) applies.⁴ “Passive investment income” for means rents, royalties, dividends, interest, and annuities.⁵ The following items are excluded from the definition of passive investment income for this purpose:

- (1) rents for the use of corporate property if the corporation also provides substantial services or incurs substantial cost in the rental business;⁶
- (2) interest on obligations acquired from the sale of a capital asset or the performance of services in the ordinary course of a trade or business of selling the property or performing the services;

1. IRC Sec. 1363(a).

2. IRC Sec. 1374.

3. IRC Sec. 1363(d).

4. IRC Sec. 1375(a).

5. IRC Secs. 1362(d)(3), 1375(b)(3).

6. See Let. Ruls. 9837003, 9611009, 9610016, 9548012, 9534024, 9514005.

- (3) gross receipts derived in the ordinary course of a trade or business of lending or financing; dealing in property; purchasing or discounting accounts receivable, notes, or installment obligations; or servicing mortgages;¹ and
- (4) if an S corporation owns 80 percent or more of a C corporation, dividends from the C corporation to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.²

If amounts are subject to tax both as built-in gain and as excess net passive income, an adjustment will be made in the amount taxed as passive income.³

Also, tax is imposed at the corporate level if investment credit attributable to years for which the corporation was not an S corporation is required to be recaptured.⁴

Furthermore, an S corporation may be required to make an accelerated tax payment on behalf of its shareholders if the S corporation elects not to use a required taxable year.⁵ The corporation is also subject to estimated tax requirements with respect to the tax on built-in gain, the tax on excess net passive income and any tax attributable to recapture of investment credit.⁶

8837. How is the shareholder of an S corporation taxed?

Like a partnership, an S corporation computes its taxable income similarly to an individual, with the exception that certain personal and other deductions are allowed to the S corporation shareholder, but not to the S corporation itself. Further, the S corporation may elect to amortize organizational expenses (see Q 8824).⁷

Each shareholder then reports on his individual return the shareholder's proportionate share of the corporation's items of income, loss, deductions and credits. These items retain their character when they are passed through from the S corporation to the shareholder.⁸

Planning Point: The shareholder receives a Form K-1 from the S corporation every year which states the shareholder's proportionate share of such items. The individual shareholder cannot complete their personal income tax return until they receive the Form K-1 from the corporation.

Certain items of income, loss, deduction or credit must be passed through as separate items because they may have an effect on each individual shareholder's tax liability. For example, net capital gains and losses pass through as such to be included with the shareholder's own net capital gain or loss. Any gains and losses on certain property used in a trade or business are passed through separately to be aggregated with the shareholder's other IRC Section 1231 gains and losses. (Gains passed through are reduced by any tax at the corporate level on gains, see Q 8836).

1. Treas. Reg. §1.1362-2(c)(5).

2. Treas. Reg. §1.1362-8(a).

3. IRC Sec. 1375(b)(4).

4. IRC Sec. 1371(d).

5. IRC Sec. 7519.

6. IRC Sec. 6655(g)(4).

7. IRC Sec. 1363(b).

8. IRC Secs. 1366(a), 1366(b).

Miscellaneous itemized deductions pass through to be combined with the individual's miscellaneous deductions for purposes of the 2 percent floor on such deductions. Charitable contributions pass through to shareholders separately subject to the individual shareholder's percentage limitations on deductibility.

Tax-exempt income passes through as such. Items involving determination of credits pass through separately.¹ Before pass-through, each item of passive investment income is reduced by its proportionate share of the tax at the corporate level on excess net passive investment income (see Q 8836).²

Items that do not need to be passed through separately are aggregated on the corporation's tax return and each shareholder reports his share of such nonseparately computed net income or loss on the shareholder's individual return.³ Items of income, deductions, and credits (whether or not separately stated) that flow through to the shareholder are subject to the "passive loss" rule (see Q 8635 to Q 8644) if the activity is passive with respect to the shareholder. Items taxed at the corporate level are not subject to the passive loss rule unless the corporation is either closely held or a personal service corporation.

Thus, whether amounts are distributed to them or not, shareholders are taxed on the corporation's taxable income. Shareholders take into account their shares of income, loss, deduction and credit on a per-share, per-day basis.⁴ The S corporation income must also be included on a current basis by shareholders for purposes of the estimated tax provisions.⁵

The Tax Court determined that when an S corporation shareholder files for bankruptcy, all the gains and losses for that year flowed through to the bankruptcy estate. The gains and losses should not be divided based on the time before the bankruptcy was filed.⁶

8838. What special considerations apply in determining a shareholder's basis in S corporation stock?

The basis of each shareholder's stock is *increased* by his share of items of separately stated income (including tax-exempt income), any nonseparately computed income, and by any excess of deductions for depletion over basis in property subject to depletion.⁷

An S corporation shareholder may *not* increase tax basis due to excluded discharge of indebtedness income.⁸ The basis of each shareholder's stock is *decreased* (not below zero) by the following:

- (1) items of distributions from the corporation that are not includable in the income of the shareholder;

1. IRC Sec. 1366(a)(1).

2. IRC Sec. 1366(f)(3).

3. IRC Sec. 1366(a).

4. IRC Sec. 1377(a).

5. Let. Rul. 8542034.

6. *Williams v. Comm.*, 123 TC 144 (2004).

7. IRC Sec. 1367(a)(1).

8. IRC Sec. 108(d)(7)(A).

- (2) separately stated loss and deductions and nonseparately computed loss;
- (3) any expense of the corporation not deductible in computing taxable income and not properly chargeable to capital account; and
- (4) any depletion deduction with respect to oil and gas property to the extent that the deduction does not exceed the shareholder's proportionate share of the property's adjusted basis.

For tax years beginning after 2005 and before 2014, if an S corporation made a charitable contribution of property, each shareholder's basis was reduced by the pro rata share of basis in the property.¹ If the aggregate of these amounts exceeds the basis in his stock, the excess reduced the shareholder's basis in any indebtedness of the corporation to the shareholder.² A shareholder may not take deductions and losses of the S corporation that, when aggregated, exceed the basis in S corporation stock plus his basis in any indebtedness of the corporation to the shareholder.³ Such disallowed deductions and losses may be carried over.⁴ In other words, the shareholder may not deduct in any tax year more than the shareholder has "at risk" in the corporation.

8839. How are S corporation distributions taxed?

Generally, earnings of an S corporation are not treated as earnings and profits. However, an S corporation may have accumulated earnings and profits for any year in which a valid election was not in effect or as the result of a corporate acquisition in which there is a carry-over of earnings and profits under IRC Section 381.⁵ Corporations that were S corporations before 1983 but were not S corporations in the first tax year after 1996 are able to eliminate earnings and profits that were accumulated before 1983 in their first tax year beginning after May 25, 2007.⁶

A distribution from an S corporation that does not have accumulated earnings and profits lowers the shareholder's basis in the corporation's stock.⁷ Any excess is generally treated as gain.⁸

If the S corporation does have earnings and profits, distributions are treated as distributions by a corporation without earnings and profits, to the extent of the shareholder's share of an accumulated adjustment account (i.e., post-1982 gross receipts less deductible expenses, which have not been distributed).

Any excess distribution is treated under the usual corporate rules. That is, the distribution is treated as a dividend up to the amount of the accumulated earnings and profits. Any excess is applied to reduce the shareholder's basis. Finally, any remainder is treated as a gain.⁹ However,

1. IRC Sec. 1367(a)(2), as amended by TEAMTRA 2008 and ATRA.

2. IRC. Sec. 1367(b)(2)(A).

3. IRC Sec. 1366(d)(1).

4. IRC Sec. 1366(d)(2).

5. IRC Sec. 1371(c).

6. SBWOTA 2007 Sec. 8235.

7. IRC Sec. 1367(a)(2)(A).

8. IRC Sec. 1368(b).

9. IRC Sec. 1368(c).

in any tax year, shareholders receiving the distribution may, if all agree, elect to have all distributions in the year treated first as dividends to the extent of earnings and profits and then as return of investment to the extent of adjusted basis and any excess as capital gain.¹ If the IRC Section 1368(e)(3) election is made, it will apply to all distributions made in the tax year.²

Certain distributions from an S corporation in redemption of stock are treated as a sale or exchange. Generally, only gain or loss, if any, is recognized in a sale. In general, redemptions that qualify for “exchange” treatment include redemptions that are not essentially equivalent to a dividend, substantially disproportionate redemptions of stock, complete redemptions of stock, certain partial liquidations, and redemptions of stock to pay estate taxes.³

If the S corporation distributes appreciated property to a shareholder, gain will be recognized by the corporation as if the property had been sold at fair market value, and the gain will pass through to shareholders like any other gain.⁴

8840. Who can be a shareholder in an S corporation? What restrictions apply to 2 percent shareholders in an S corporation?

An S corporation may have up to 100 shareholders (none of whom are nonresident aliens) who are individuals, estates, and certain trusts.

Members of a family are treated as one shareholder. “Members of a family,” for this purpose, means “the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor.” Generally, the common ancestor may not be more than six generations removed from the youngest generation of shareholders who would be considered members of the family.⁵

Only certain trusts can qualify as S corporation shareholders. These trusts include: (1) a trust all of which is treated as owned by an individual who is a citizen or resident of the United States under the grantor trust rules; (2) a trust that was described in (1) above immediately prior to the deemed owner’s death that continues in existence after such death may continue to be an S corporation shareholder for up to two years after the owner’s death; (3) a trust to which stock is transferred pursuant to a will may be an S corporation shareholder for up to two years after the date of the stock transfer; (4) a trust created primarily to exercise the voting power of stock transferred to it; (5) a qualified subchapter S trust (QSST), see below; (6) an electing small business trust (ESBT), see below; and (7) in the case of an S corporation that is a bank, an IRA or Roth IRA.⁶ An estate can continue to be an eligible shareholder during the reasonable period of administration. This can continue for the duration of payments being made under Sec. 6166 (relating to the deferral of the estate tax relating to closely held business).⁷

1. IRC Sec. 1368(e)(3).

2. Let. Rul. 8935013.

3. See IRC Secs. 302, 303.

4. IRC Secs. 1371(a), 311(b).

5. IRC Sec. 1361(c)(1).

6. IRC Secs. 1361(c)(2), 1361(d).

7. IRC Sec. 1361(b)(1)(B); Rev. Rul 76-23; Plr 200226031.

A QSST is a trust that has only one current income beneficiary (who must be a citizen or resident of the U.S.), all income must be distributed currently, and the trust corpus may not be distributed to anyone else during the life of such beneficiary. The income interest must terminate upon the earlier of the beneficiary's death or termination of the trust. If the trust terminates during the lifetime of the income beneficiary, all trust assets must be distributed to that beneficiary. The beneficiary must make an election for the trust to be treated as a QSST.¹

An ESBT is a trust in which all of the beneficiaries are individuals, estates, or charitable organizations.² Each potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 100 shareholder limitation.³ A potential current beneficiary is generally, with respect to any period, someone who is entitled to, or in the discretion of any person may receive, a distribution of principal or interest of the trust. In addition, a person treated as an owner of a trust under the grantor trust rules is a potential current beneficiary.⁴ If there is no potential current beneficiary of an ESBT during any period, the ESBT itself is treated as the S corporation shareholder.⁵ Trusts exempt from income tax, QSSTs, charitable remainder annuity trusts, and charitable remainder unitrusts may not be ESBTs. An interest in an ESBT may not be obtained by purchase.⁶ If any portion of the basis in the beneficiary's interest is determined under the cost basis rules, the interest is treated as though it was acquired by purchase.⁷ An ESBT is taxed at the highest individual income tax rate (39.6 percent in 2013 and beyond).⁸

8841. What restrictions apply to an S corporation's ability to issue stock?

An S corporation must be a domestic corporation with only a single class of stock.

A corporation will be treated as having one class of stock if all of its outstanding shares confer identical rights to distribution and liquidation proceeds.⁹ Also, it is permissible to have two classes of stock if the only difference between the two classes is the ability to vote.¹⁰ "Bona fide agreements to redeem or purchase stock at the time of death, disability or termination of employment" will be disregarded for purposes of the one-class rule unless a principal purpose of the arrangement is to circumvent the one-class rule.

Similarly, bona fide buy-sell agreements will be disregarded unless a principal purpose of the arrangement is to circumvent the one-class rule and they establish a purchase price that is not substantially above or below the fair market value of the stock. Agreements that provide for a purchase price or redemption of stock at book value or a price between book value and fair market value will not be considered to establish a price that is substantially above or below fair market value.¹¹

1. IRC Sec. 1361(d).

2. IRC Sec. 1361(e).

3. IRC Sec. 1361(c)(2)(B)(v).

4. Treas. Reg. §1.1361-1(m)(4).

5. Treas. Reg. §1.1361-1(h)(3)(i)(F).

6. IRC Sec. 1361(e).

7. Treas. Reg. §1.1361-1(m)(1)(iii).

8. IRC Secs. 641(c), 1(e).

9. Treas. Reg. §1.1361-1(l)(1).

10. IRC Sec. 1361(c)(4).

11. Treas. Reg. §1.1361-1(l)(2)(iii). See IRC Secs. 1361, 1362.

Agreements triggered by divorce and forfeiture provisions that cause a share of stock to be substantially nonvested are disregarded in determining whether a corporation's shares confer identical rights to distribution and liquidation proceeds.¹

Planning Point: The application of the second class of stock rules can sometimes arise in unexpected situations. For example, employment agreements or buy sell agreements may contain provisions which establish a different purchase/sale price for different shareholders or situations. These contractual rights could potentially be construed to violate the prohibition against having a second class of stock. Therefore, care must be given to the consequences which one agreement may have upon another.

8842. What is a qualified subchapter S subsidiary (QSSS)?

An S corporation may own a qualified subchapter S subsidiary (QSSS). A QSSS is a domestic corporation that is not an ineligible corporation (see Q 8835), if 100 percent of its stock is owned by the parent S corporation and the parent S corporation elects to treat it as a QSSS.

A QSSS is generally not treated as a separate corporation and its assets, liabilities, and items of income, deduction, and credit are treated as those of the parent S corporation.² If the S corporation or its QSSS is a bank, special rules provide for the recognition of a QSSS as a separate entity for tax purposes.³ A QSSS will also be treated as a separate corporation for purposes of employment taxes and certain excise taxes.⁴ For tax years beginning after 2014, a QSSS will be treated as a separate corporation for purposes of the shared responsibility payments under the Affordable Care Act.⁵

If a QSSS ceases to meet the above requirements, it will be treated as a new corporation acquiring all assets and liabilities from the parent S corporation in exchange for its stock. If the corporation's status as a QSSS terminates, the corporation is generally prohibited from being a QSSS or an S corporation for five years.⁶ In certain cases following a termination of a corporation's QSSS election, the corporation may be allowed to elect QSSS or S corporation status without waiting five years if, immediately following the termination, the corporation is otherwise eligible to make an S corporation election or QSSS election, and the election is effective immediately following the termination of the QSSS election. For example, this rule may apply when an S corporation sells all of its QSSS stock to another S corporation, or an S corporation distributes all of its QSSS stock to its shareholders, and the former QSSS makes an S election.⁷

8843. What is an LLC and how is an LLC formed?

A limited liability company (LLC) is a noncorporate business entity. There are no provisions that provide for LLCs in the IRC, as there are with respect to partnerships and corporations. An

1. Treas. Reg. §1.1361-1(l)(2)(iii)(B).

2. IRC Sec. 1361(b)(3).

3. Treas. Reg. §1.1361-4(a)(3).

4. Treas. Reg. §1.1361-4(a)(7) and §1.1361-4(a)(8).

5. Treas. Reg. §1.1361-4(a)(8)(E).

6. IRC Sec. 1361(b)(3).

7. Treas. Reg. §1.1361-5(c).

LLC is created strictly at the state level with the enactment by the state legislature of an LLC Act or Code.

An LLC, by its nature, provides limited liability for its members, absent personal guarantees. Generally, all members may participate in the management of an LLC. Most state statutes provide that an LLC must have at least two members, although a few states allow one-member LLCs. An LLC is formed by drafting a document called the articles of organization and filing it with the appropriate state agency. This initiating document is similar in scope to a C corporation's articles of incorporation (see Q 8823).

The LLC will also create an operating agreement that generally dictates how the organization will be operated and sets out the rules that govern interaction between its members. The contents of both documents set out the framework for the LLC. The way these documents are drafted becomes especially critical in states that have flexible LLC statutes, since the wording of these documents may determine whether the entity will be classified as a partnership or a corporation for federal tax purposes.

The operating agreement, unlike the articles of organization, generally is not filed with a state agency. The operating agreement is similar in scope to a partnership agreement or limited partnership agreement in that it sets out the rights, duties and responsibilities of the members. It provides the guidelines by which the LLC will operate on a day to day basis.

The contents of the operating agreement have proven crucial in determining whether an LLC lacks a preponderance of corporate characteristics and may be afforded partnership tax treatment. Revenue Procedure 95-10¹ provides valuable guidance in drafting an operating agreement so as to avoid a preponderance of the corporate characteristics. In states with flexible LLC statutes, the IRS will look to the particular LLC's operating agreement in order to determine the existence or nonexistence of the corporate characteristics.

The operating agreement will typically contain provisions relating to:

- name, purpose and term of the LLC;
- names and addresses of the members;
- rights, powers and duties of the members and their scope of authority;
- scope of authority of the managers and how the managers are to be chosen;
- capital contributions of members;
- approval of transactions;
- allocation of income, profits, losses, expenses, equity and distributions;
- compensation of members and/or managers;

1. 1995-3 IRB 20.

- provisions for holding meetings, voting and other formalities;
- how fiscal matters such as books, records, accounting methods, etc., will be handled;
- how interests in the LLC may or may not be transferred;
- limitation of liability and indemnification;
- any other provisions applicable to the operation of the organization.

One of the unique characteristics of an LLC is that it is a business entity that may provide for management by all of its members. Unlike an S corporation, an LLC has no restrictions on the number or types of owners and multiple classes of ownership are generally permitted. Management status may be determined by the particular state's LLC act, but most likely will be determined by the LLC's operating agreement.

Planning Point: It is also possible to structure the entity to be "manager managed." Under this approach, certain individuals are designated to manage the entity. This is analogous to having voting and non-voting stock in the corporate context or with a limited partnership (which is managed solely by its general partner).

If the LLC is treated as a partnership, it combines the liability shield of a corporation with the tax advantages of a partnership (see Q 8810).

8844. How is an LLC taxed? How is it determined whether an LLC is taxed as a partnership or corporation?

An LLC may be treated as either a corporation (see Q 8825), partnership (see Q 8810), or sole proprietorship (see Q 8806) for tax purposes. An *eligible entity* (a business entity not subject to automatic classification as a corporation, see below) may elect corporate taxation by filing an entity classification form, otherwise it will be taxed as either a partnership or sole proprietorship depending upon how many owners are involved. Eligible entities can elect how they would like to be classified for tax purposes on IRS Form 8832.

Certain entities, such as corporations organized under a federal or state statute, insurance companies, joint stock companies, and organizations engaged in banking activities, are automatically classified as corporations. An LLC with only one owner will be considered a corporation or a sole proprietorship. In order to be classified as a partnership, the entity must have at least two owners.¹

If a newly-formed domestic eligible entity with more than one owner does not elect to be taxed as a corporation, it will be classified as a partnership. Likewise, if a newly-formed single-member eligible entity does not elect to be taxed as a corporation, it will be taxed as a sole proprietorship with its profit and loss being reported on Schedule C of the owner's personal income tax return. Therefore, no separate federal return is required. But even though there

1. Treas. Reg. §301.7701-2.

is no federal return, some states may still require a separate tax return.¹ Also, under most circumstances, a corporation in existence on January 1, 1997 does not need to file an election in order to retain its corporate status.²

If a business entity elects to change its classification, rules are provided for how the change is treated for tax purposes.³

Revenue Ruling 95-37⁴ provides that a partnership converting to a domestic LLC will be treated as a partnership-to-partnership conversion (and therefore be “tax-free”) provided that the LLC is classified as a partnership for federal tax purposes. The partnership will not be considered terminated under IRC Section 708(b) upon its conversion to an LLC so long as the business of the partnership is continued after the conversion. Further, there will be no gain or loss recognized on the transfer of assets and liabilities so long as each partner’s percentage of profits, losses and capital remains the same after the conversion. The same is true for a limited partnership converting to an LLC.⁵

An LLC formed by two S corporations was classified as a partnership for federal tax purposes.⁶ An S corporation may merge into an LLC without adverse tax consequences provided the LLC would not be treated as an investment company under IRC Section 351 and the S corporation would not realize a net decrease in liabilities exceeding its basis in the transferred assets pursuant to Treasury Regulation Section 1.752-1(f). Neither the S corporation nor the LLC would incur gain or loss upon the contribution of assets by the S corporation to the LLC in exchange for interests therein pursuant to IRC Section 721.⁷ A corporation will retain its S election when it transfers all assets to an LLC, which is classified as a corporation for federal tax purposes due to a preponderance of corporate characteristics (see below), provided the transfer qualifies as a reorganization under IRC Section 368(a)(1)(F) and the LLC meets the requirements of an S corporation under IRC Section 1361.⁸

An LLC that was in existence prior to January 1, 1997, may continue under its previous claimed classification if it meets the following requirements: (1) it had a reasonable basis for the classification; (2) the entity and its members recognized the consequences of any change in classification within the sixty months prior to January 1, 1997; and (3) neither the entity nor its members had been notified that the classification was under examination by the IRS.⁹

Prior to January 1, 1997, whether an LLC was treated as a corporation or partnership for federal income tax purposes depended on the existence or nonexistence of a preponderance of six corporate characteristics: (1) associates; (2) an objective to carry on a business and divide

1. See instructions for form SS-4.

2. Treas. Reg. §301.7701-3.

3. Treas. Reg. §301.7701-3(g).

4. 1995-1 CB 130.

5. Let. Rul. 9607006.

6. Let. Rul. 9529015.

7. Let. Rul. 9543017.

8. Let. Rul. 9636007.

9. Treas. Reg. §301.7701-3(h)(2).

the gains from it; (3) limited liability; (4) free transferability of interests; (5) continuity of life; and (6) centralized management.¹

Characteristics (1) and (2) above are common to both corporations and partnerships and were generally discounted when determining whether an organization was treated as a corporation or partnership.² These former regulations provided an example of a business entity that possessed the characteristics of numbers (1), (2), (4) and (6) above, noting that since numbers (1) and (2) were common to both corporations and partnerships, these did not receive any significant consideration. The business entity did not possess characteristics (3) and (5) above and, accordingly, was labeled a partnership.³

8845. What is a professional service corporation (PSC)? Is there any difference between the tax treatment of C corporations and PSCs?

Organizations of physicians, lawyers, and other professional people organized under state professional corporation or association acts are generally treated as corporations for tax purposes.⁴ However, to be treated as a corporation, a professional service organization must be both organized and *operated* as a corporation.⁵ Although professional corporations are generally treated as corporations for tax purposes, they are not generally taxed in the same manner as regular C corporations (Q 8825). Note that if a professional corporation has elected S corporation status, the shareholders will be treated as S corporation shareholders (see Q 8835).

Although a professional corporation is recognized as a taxable entity separate and apart from the professional individual or individuals who form it, the IRS may under some circumstances reallocate income, deductions, credits, exclusions, or other allowances between the corporation and its owners in order to prevent evasion or avoidance of tax or to properly reflect the income of the parties.

Under IRC Section 482, such reallocation may be made only where the individual owner operates a second business distinct from the business of the professional corporation. Reallocation may not be made where the individual works exclusively for the professional corporation.⁶

8846. What is a B corporation?

A B corporation is a relatively new type of corporation that has gained popularity in recent years. A “B” corporation, also known as a “benefit corporation,” is a corporation that is formed with the express purpose of fulfilling some type of socially responsible mission that is intended to create a general public benefit. Not all states have passed legislation that makes the benefit corporation a separate legal entity that taxpayers can consider in their choice of entity analysis.

1. Treas. Reg. §301.7701-2(a)(1), as in effect prior to January 1, 1997.

2. Treas. Reg. §301.7701-2(a)(2), as in effect prior to January 1, 1997.

3. Treas. Reg. §301.7701-2(a)(3), as in effect prior to January 1, 1997.

4. Rev. Rul. 77-31, 1977-1 CB 409.

5. *Roubik v. Comm.*, 53 TC 365 (1969).

6. *Foglesong v. Comm.*, 82-2 USTC ¶9650 (7th Cir. 1982).

Maryland, California, Hawaii, New Jersey, New York, Vermont and Virginia are among those that have passed legislation.¹

A B corporation is not a unique type of entity—rather; it is a corporation where the charter provides that it will be operated as a benefit corporation. The charter will typically provide the specific socially responsible purpose that the B corporation exists to fulfill. Essentially, the B corporation's officers and directors will be liable not only for operating the corporation in order to achieve a profit, but also to fulfill the specified social purpose.

Although not required at formation, since a B corporation is essentially formed as a C corporation, several nonprofit groups exist to provide certification, as well as guidance and assistance in determining the public benefit structure of a B corporation. One of these, a nonprofit group called "B Labs" provides an assessment test that the corporation takes in order to determine its social and environmental impact and goals.² Once the corporation "passes" this test, as long as it meets all of the legal requirements applicable to validly formed corporations (Q 8823) and signs a declaration that it will operate as a B corporation, it becomes certified.

Some state statutes provide for a cause of action by the B corporation, directly or through its shareholders, against a B corporation's officers and directors for failure to pursue the public benefit purpose that is specified in its charter.³ Further, state statutes require the B corporation to describe its activities relating to the specified public benefit in its annual report to shareholders. As such, a B corporation is essentially a type of C corporation that is subject to certain additional requirements, which vary by state, related to the performance of some public good.

8847. How is a B corporation taxed?

The IRS has yet to provide guidance as to the tax treatment of B corporations. As such, a B corporation is subject to the same tax rules that govern C corporations (see Q 8822 to Q 8834), until the IRS releases guidance to the contrary.

8848. How might the losses that may be incurred during operation of a business impact choice of entity decisions?

For many business owners, the opportunity to limit personal liability may be the most attractive feature of the corporate form. This can be an advantage and even a necessity for a business that faces substantial liability for the actions of its agents, the hazardous nature of its business, or the liability exposure of its products. Also, any venture has an inherent risk of loss, especially in the early years. Shareholders in a corporation (as well as members of a limited liability company and limited partners in a limited partnership) are not liable for the corporation's actions beyond

1. The nonprofit group that exists to certify B corporation status, "B Labs," provides updates on B corporation legislation as it is passed, available at <http://www.bcorporation.net/what-are-b-corps/legislation> (last accessed July 30, 2013). Delaware passed its legislation pertaining to B corporations as recently as July 17, 2013, so the rules pertaining to B corporations are still in the very early developmental phases.

2. See "Performance Requirements," available at <http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/performance-requirements> (last accessed June 5, 2014).

3. See, for example, Article 1 of New Jersey legislation authorizing B corporations, available at http://www.njleg.state.nj.us/2010/Bills/A4000/3595_11.PDF (last accessed June 5, 2014).

the amount of their capital contribution to the corporation. However, there are still important considerations that must be noted, because limited liability is not absolute.

First, the corporation and its shareholders must follow strict state law requirements relating to shareholder meetings, election of a board of directors, directors' meetings, and other matters of internal governance required by the corporation's articles of incorporation and the state of incorporation's laws. These are not mere formalities—a corporation which fails to follow these rules may lose its status as a corporation and limited liability in a process known as “piercing the corporate veil.” However, many states have close corporation statutes relaxing these rules and giving shareholders in a closely held corporation greater freedom to determine their own internal governance.

Second, a shareholder's limited liability may be illusory for bank financing, because most lending institutions demand that stockholders personally guarantee close corporation indebtedness.

Finally, potential incorporators who wish to do business under an umbrella of limited liability can find other ways to do so without incorporating. One way to do so may be to set up a limited partnership with an existing corporation or S corporation as the general partner.

8849. What considerations regarding transferability of interests in an entity should be taken into account when choosing the business entity form?

Free transferability of interests is a factor that must be considered when a business owner is determining which business entity structure to choose. Shares in a corporation may be simpler to transfer than an interest in a partnership or a proprietorship. This can be attractive if, for example, an older shareholder wishes to dispose of his interest to finance his retirement, but younger members want to keep operating the business (see Q 8852 to Q 8883, which addresses issues in business succession planning). A corporation can also be recapitalized to freeze the value of an estate and pass a family business to a younger generation. As is the case with limited liability, free transferability of interests, particularly in a closely held corporation, is not absolute.

First, there may be a limited market for minority interests in a closely-held or family business, even one that is organized as a corporation. Prospective investors may simply refuse to risk being frozen out of management decisions and profits, and may be reluctant to upset the balance of personalities and interests already existing in any company. Second, it may be extremely difficult to value the shares in the business. Third, a sale to an inappropriate shareholder may jeopardize a business's status as an S corporation. The solution to many of these problems is to restrict transferability of shares to those within a family, those approved by all other shareholders, or those who would not jeopardize the business' S corporation election. These restrictions, of course, destroy the same free transferability of interests that some incorporators may find attractive.

Finally, increased prestige and image may be a factor to consider. A new corporation may find it easier to attract bank financing and venture capital than a partnership or proprietorship, even if the shareholders must personally guarantee the debt. This advantage comes, however, at the higher price of establishing a corporation than for a partnership or proprietorship. State filing

fees and attorney and accountant's fees all add to the cost of starting the venture. However, a corporation may amortize its organizational expenses over 60 months from the month in which the corporation begins business.¹

8850. Can the treatment of employment benefits in an entity structure impact choice of entity?

While S corporations and partnerships are able to offer many of the same employment type benefits, such as qualified pension and profit-sharing plans and accident and health insurance, the tax treatment differs in some cases. Many of the IRC provisions that create tax preferences for employment benefits do so only for plans that provide benefits for *employees*. Partners in a partnership are generally subject to different rules. Rather than being treated as employees, 2 percent shareholders in an S corporation are treated as partners for certain employment benefit purposes.²

For example, premiums paid for accident and health insurance paid on behalf of 2 percent shareholders and partners are deductible by the entity, but are includable in the recipient's gross income.³ This is because in order for premiums paid by the employer on behalf of the recipient to be excludable from that recipient's income, he or she must be considered an employee. For purposes of determining the excludability of employer-provided accident and health benefits, self-employed individuals and certain shareholders owning more than 2 percent of the stock of an S corporation are not treated as employees.⁴

Despite this, sole proprietors, partners, and 2 percent shareholder-employees of an S corporation may generally deduct up to 100 percent of their health insurance premiums on their individual returns.⁵

See Q 8725 to Q 8777 for a discussion of the treatment of various health-related benefits provided in an employment context. Q 8778 to Q 8804 discusses the treatment of various employment "fringe" benefits.

8851. When can estate planning considerations impact a choice of entity decision?

Both C corporations and S corporations may take advantage of opportunities to provide liquidity and reduce estate taxes at a shareholders death. These techniques include:

Section 303 stock redemptions. IRC Section 303, designed to provide liquidity and prevent the forced sale of businesses to pay income and estate taxes, provides that income from certain partial redemptions of stock to pay death taxes will be treated as a sale of stock rather than a dividend. Where stock included in the adjusted gross estate of a shareholder (without regard to family attribution-of-ownership rules) equals a certain percentage of the gross estate, the

1. IRC Sec. 248.

2. IRC Sec. 1372.

3. Rev. Rul. 91-26, 1991-1 CB 184.

4. IRC Sec. 105(g); Treas. Reg. §1.105-5(b).

5. IRC Sec. 162(l).

corporation can redeem from the estate a quantity of stock equal in value to the total of the deceased's federal estate tax, state death taxes, and funeral and administrative taxes.

Gifts of stock. Because corporate ownership is easily divisible, shareholders can give close corporation stock to family members, charities, etc. These gifts can shift income to lower-bracket family members, remove future appreciation from the shareholder's future estate, and even provide an income tax deduction in the case of charitable gifts. S corporation shareholders must take care to insure that such gifts do not jeopardize S corporation eligibility.

Planning Point: When making gifts of stock, it is important to review any shareholders agreements which may exist in order to make sure the stock is transferable in the desired manner. It may be necessary to obtain certain consents from the corporation or other shareholders in order to complete the transfer.

Planning Point: Since, however, it is permissible for an S corporation to issue non-voting stock, estate planning opportunities exist whereby the non-voting stock can be transferred without relinquishing control. Also, since the transferred stock in this context is non-voting, it is entitled to an adjustment to reflect the lower value associated with this type of stock.

Estate freeze techniques. Some shareholders in closely-held corporations may reduce their eventual taxable estate by recapitalizing the corporation to "freeze" the value of stock included in their estates and pass future appreciation on to family members. Interests transferred in this fashion will be treated as gifts and valued according to special valuation rules (see Q 8895).

See Q 8852 to Q 8883 for a discussion of business succession techniques, including buy-sell agreements and redemptions, that may be useful in the small business context.

Planning Point: If, however, an S corporation is going to pass through an estate, consideration should be given as to whether the stock is going to pass into a trust. If so, the trust must qualify as either a QSST or ESBT.

PART XIV: BUSINESS SUCCESSION PLANNING

8852. What is a buy-sell agreement?

Buy-sell agreements are often used in business succession planning where the business is owned by a relatively small group of owners who would otherwise have a limited market in which to sell their business interests. A buy-sell agreement can provide the remaining shareholders or co-owners with the option of purchasing the business interests of a deceased or withdrawing co-owner before the business interest is sold to a third party. Business entities such as closely held corporations (Q 8822), LLCs (Q 8843), and partnerships (Q 8807) frequently rely upon buy-sell agreements when creating future business succession plans. A buy-sell agreement is essentially a contract to buy and sell a departing business owner's interests in a business at some point in the future, usually upon the occurrence of one or more specified events.¹

A buy-sell agreement is typically structured as either a cross-purchase agreement or a redemption agreement. A cross-purchase agreement is an agreement among co-owners to purchase each other's business interests upon the death or other withdrawal of one or more owners from the business. These agreements typically specify a predetermined purchase price and, in some cases, are funded by life insurance purchased to insure the lives of the various business owners.

A redemption agreement allows the business entity to purchase the interest of a deceased or withdrawing business owner upon the occurrence of previously agreed upon "triggering events." See Q 8859 for a discussion of the different considerations that apply depending upon whether the agreement is structured as a cross-purchase or redemption agreement.

It is also possible to structure a buy-sell agreement so that it combines features of the cross-purchase agreement and redemption agreement.² In addition, the buy-sell agreement can involve a contract to sell to a third party or another entity.

See Q 8853 for a discussion of the importance of buy-sell agreements in business succession planning. Q 8854 outlines the primary methods for funding a buy-sell agreement and Q 8855 outlines the use of life insurance in funding the agreement. Q 8859 to Q 8861 provide an in-depth analysis of the differences between the redemption and the cross-purchase forms of agreements.

8853. Why are buy-sell agreements often used in business succession planning?

Use of a buy-sell agreement in the business succession planning context can mean the difference between the orderly withdrawal of a partner, whether by death or otherwise, and possible loss of control over a business by the remaining co-owners.³ In general, business succession planning is intended to ensure that the following goals are met:

- (1) Preserving a deceased co-owner's wealth and providing liquidity for his or her estate;

1. *Stephenson v. Drever*, 16 Cal. 4th 1167 (1997).

2. See *Jacobs v. Commissioner*, TC Memo 1981-81, Rev. Rul. 69-608, 1969-2 CB 42.

3. See Treas. Reg. §20.2031-2(h); *True v. Comm.*, TC Memo 2001-167.

- (2) Providing the remaining owners with the security of knowing they will maintain control of the business without unwanted third-party intervention;
- (3) Ensuring business continuity, if so desired by the remaining business owners;
- (4) Fixing the value¹ of the business interest for estate tax purposes to avoid potential IRS intervention.

Interests in closely held corporations, LLCs, partnerships and sole proprietorships can have very limited markets for sale. This is particularly problematic when a deceased co-owner either has no heirs to inherit the deceased owner's interest or has heirs who are poorly equipped or unwilling to take over the business. If the deceased business owner passes the interests to children who are not interested in continuing the business, they may be forced to sell their inherited interests at a discounted price to a third party. Executing a buy-sell agreement ensures that the business owner controls the disposition of business interests by allowing that owner to choose the buyer in advance. This type of succession planning also protects the value of the business as a whole and ensures that this value will pass to the owner's estate without the need for protracted post-death negotiation.

Use of a buy-sell agreement can also ensure that the remaining business owners can continue the business without interference from a deceased owner's heirs or the need for a third party investor following that owner's death or early withdrawal from the business. The existence of the agreement will prevent a small business owner from selling the owner's interests to outside investors who may not share the business vision of the remaining co-owners.

8854. How is a buy-sell agreement funded?

A buy-sell agreement can be funded through the use of the prospective buyer's own funds, accumulated earnings, debt instruments or insurance (either life or disability).

While self-funding on the part of the buyer is possible, many selling business owners may prefer the certainty that is provided through other funding methods. Self-funding presents the possibility that the buyer may be unable to obtain the funds upon the selling owner's death or withdrawal.

As a result, many buy-sell agreements are funded through insurance. The type of insurance that is required will depend upon the triggering events specified in the buy-sell agreement itself (see Q 8858). If a right to purchase under the agreement is triggered by the seller's death, the buyer or business may fund the agreement by purchasing life insurance that insures the life of the selling business owner (see Q 8855). Death, however, is not the only type of event that may trigger a buy-sell agreement. If the triggering event is the selling owner's disability or retirement from the business, funding may be provided more effectively through a disability insurance policy or a permanent life insurance policy that provides the potential for tax-free loans during the life of the insured. It is also common to treat an "involuntary transfer" as a triggering event. Essentially, this will become applicable if a creditor of an owner attempts to seize an interest

¹ See IRC Sec. 2031 and Treas. Reg. §20.2031-2(h).

in the business in pursuit of the collection of a debt. This can occur if an actual debt is owed to a third party or if one of the owners is subject to a divorce proceeding and the interest in the business is being transferred to a spouse who is not an owner. In the event that an involuntary transfer is a triggering event, insurance will not likely be available to fund the purchase.

If the parties have entered into a cross-purchase agreement, insurance funding is accomplished by the business owners purchasing insurance on the lives of each participating co-owner.

The entity itself may also set aside accumulated earnings to fund a buy-sell agreement. In a closely held corporation, however, it might be difficult to set aside adequate funds when the operation of the business could benefit from the use of these funds. Further, in case of a C corporation, accumulated earnings above \$250,000 can be subject to the accumulated earnings penalty tax (see Q 8829).¹ While accumulation of earnings and profits to meet the reasonable needs of the corporation is permissible, the parties must carefully evaluate the strategy to avoid the penalty tax, which may prove time consuming.²

If insurance funding or accumulation of earnings has not been accomplished in advance, and the buying owners have insufficient cash on hand to fund the buy-sell agreement upon occurrence of a triggering event, a debt instrument can be used. The buying owners may be able to negotiate a series of payments to the selling owner or the estate. In choosing this option, the owners must consider whether the sale will be taxed under the installment sale rules³ and the possible taxation (or deductibility) of the interest payments (see Q 8867 for a discussion of the installment sale rules).⁴

Planning Point: It is also important to consider the terms of the promissory notes. Examples include how long the term will extend, if there will be security for the note (i.e. a pledge of the stock being purchased) and if the note is due upon the sale of the business by the remaining owners. It is often good practice to attach a sample of a proposed note to be used for the payout.

8855. What types of insurance can be used to fund a buy-sell agreement?

Many business owners who structure a buy-sell agreement prefer to use insurance to fund the agreement. The insurance provides certainty that the purchase price will be funded, as it can be structured to pay out upon the occurrence of the triggering event(s), usually the death, retirement or permanent disability of the seller. A buy-sell agreement funded through insurance can raise several tax and nontax issues, however.

Various types of insurance can be used to fund a buy-sell agreement, including the following:

- (1) *Term life insurance.* Term life insurance, which provides life insurance coverage for a set amount of time, is a possible funding mechanism, but because the insured may outlive the pre-set term of the policy, it may not present the best option for

1. IRC Sec. 533(c)(1), *United States v. Donruss Co.*, 393 US 297 (1969).

2. IRC Sec. 537(a)(2).

3. See IRC Sec. 453, *American Taxpayer Relief Act of 2012*, Pub. L. No. 112-240 (which increased the maximum tax rate for long-term capital gains from 15 to 20 percent).

4. IRC Sec. 163(a).

younger business owners. If the insured outlives the term, the policy may expire and the investment may be lost.

- (2) *Cash value life insurance.* Various types of permanent life insurance that allow for a build-up of cash value within the policy may be used to fund a buy-sell agreement, and may be especially useful where the triggering event is *not* the departing business owner's death. This type of insurance provides for a build up of cash value over time and permits the policy owner to withdraw a portion of the cash value tax-free. As a result, if the buy-sell agreement is triggered by an event such as the departing owner's retirement or disagreement over S corporation dividend distributions, for example, the remaining owners can still access the cash value to fund the purchase.
- (3) *Disability insurance.* Disability insurance can be used to fund a buy-sell agreement where the triggering event is the disability of the departing business owner.¹

Q 8702 through Q 8724 provide an in-depth discussion of the tax treatment of the use of life insurance in a business context. Q 8706 discusses the tax treatment of the policy from the standpoint of the insured-employee, and Q 8704 and Q 8705 outline the deductibility of premiums paid by the employer-business entity.

See Q 8858 for a discussion of some of the various triggers that may be used in the context of a buy-sell agreement.

8856. Can the use of life insurance to fund a cross-purchase buy-sell agreement cause the premiums to be treated as constructive dividends to shareholders in a closely-held C corporation? How can this result be avoided?

Unless the transaction is properly structured, funding a cross-purchase agreement with life insurance can result in adverse tax consequences to if the corporation pays the policy premiums. In the case of a cross-purchase buy-sell agreement between individual shareholders, a shareholder will often purchase life insurance on the lives of the other shareholders in order to fund the agreement (see Q 8855). In many cases, however, the premiums are paid out of corporate resources.

In the C corporation context, these premium payments may be treated as distributions with respect to stock in the corporation for tax purposes. As a result, the shareholders will be taxed on the premiums paid as though the premiums were dividends that were constructively received by those shareholders.²

To avoid this result, as long as the corporation itself has no ownership rights or beneficial interest in the policy, it is possible that the corporation could instead pay the policy premium to the policy owner in the form of a bonus. In this case, the shareholders can avoid the constructive dividend tax issue and the corporation will be able to deduct the cost of the premiums

1. See *Oak Rd. Family Dentistry, P.C. v. Provident Life & Accident Ins. Co.*, 370 F. Supp. 2d 1317(2005).

2. See, for example, *Johnson v. Comm.*, 74 TC 1316 (1980).

paid so long as the payments can be characterized as “reasonable compensation.”¹ Reasonable compensation is “such amount as would ordinarily be paid for like services by like enterprises under like circumstances.”² A salary that exceeds what is customarily paid for such services is considered unreasonable or excessive.

If the total amount paid to and on behalf of a stockholder-employee is an unreasonable return for his or her services, the IRS may treat the premium payments as a distribution of profits or dividends rather than as compensation. This also may be the result where there is no evidence, such as board of directors’ minutes, to show that premium payments were intended as compensation.³

The deduction will be disallowed where surrounding circumstances affirmatively show that premiums were not paid as compensation. In *Atlas Heating & Ventilating Co. v. Comm.*,⁴ for example, evidence showed that premiums actually were paid to fund a stock purchase agreement between individual stockholders. Consequently, they were not compensation, but dividends. The policies were owned by the stockholder-employees and proceeds were payable to their personal beneficiaries. The insured individuals had agreed that, on each of their deaths, an amount of stock equal to the proceeds received by the deceased insured’s beneficiaries would be turned in to the corporation and then distributed pro rata to the surviving stockholders.

See Q 8852 to Q 8859 for a discussion of buy-sell agreements in the context of C corporations generally.

8857. What potential tax consequences arise if the corporation owns the life insurance policy on a majority shareholder’s life that is used to fund a buy-sell agreement, but the named beneficiary is a party other than the corporation?

Potential adverse estate tax consequences may result if a life insurance policy used to fund a buy-sell agreement is actually owned by the corporation itself, but the policy beneficiary is someone other than the corporation. If, at the time of his or her death, the insured owns more than 50 percent of the corporation’s voting stock, the entire value of the death benefit paid out under the policy may be included in the insured’s estate.⁵ This is because, as a majority shareholder in the corporation that owns the actual policy, the insured will be deemed to have retained incidents of ownership in the policy that are sufficient to warrant inclusion of the death benefit in his or her estate.

These adverse tax consequences only exist if three circumstances are present: (1) the corporation is the named owner of the policy, (2) the insured owns more than a 50 percent interest at death and (3) the policy beneficiary is *not* the corporation.

1. IRC Sec. 162(a), Treas. Reg. §1.162-7.

2. Treas. Reg. §1.162-7(b)(3).

3. See, for example, *Boecking v. Comm.*, TC Memo 1993-497; *Est. of Worster v. Comm.*, TC Memo 1984-123; *Champion Trophy Mfg. Corp. v. Comm.*, TC Memo 1972-250.

4. 18 BTA 389 (1929).

5. Treas. Reg. §20.2042-1(c)(6).

In order to avoid the inclusion of the death benefit in the insured's estate, the corporation could name itself as policy beneficiary or could take steps to ensure that the insured owns less than 50 percent of the corporation's voting stock upon his or her death.

8858. When is a buy-sell agreement triggered? What are the differences between mandatory and optional buyout triggers?

A buy-sell agreement is triggered upon the occurrence of certain specified "triggering events." The parties to the agreement may build one or more triggering events into their particular buy-sell agreement, depending upon the anticipated succession issues.¹ Typical triggering events include the death, loss of required professional license, retirement or disability of an owner or shareholder, or an involuntary transfer.

If the buy-sell agreement is triggered by an owner's disability, the owners should include a definition of "disability" in the agreement to minimize disagreement between the buying and selling owners. Further, if using disability insurance to fund the agreement, the policy itself should contain a corresponding definition of disability that all parties understand.

Planning Point: This can also be done by reference. For example, the agreement could provide that the definition of disability will be as set forth within certain specified disability insurance policies.

This minimizes the risk that the buy-sell agreement will be triggered in the minds of the parties, but the insurance will not cover the disability that has actually occurred. Both the Uniform Probate Code and the Social Security Administration provide definitions of "disability" that may provide useful information to small business owners negotiating contract provisions.²

Buy-sell agreements are perhaps most frequently triggered by the death or retirement of a business owner in the small business context (see Q 8853 for a discussion of the motivations behind using a buy-sell agreement to plan for these triggering events).

A triggering event can be either mandatory or optional. After the triggering events have been determined, the parties must determine whether they wish to provide that occurrence of the event makes purchase mandatory, or merely creates a right or an option to purchase under the buy-sell agreement. Like any other contract, the parties have freedom to negotiate the contract terms in a buy-sell agreement in order to reflect the specific needs of the business. There are three common rights that are negotiated in the context of buy-sell agreements, including (1) mandatory purchase requirements, (2) "call"-type options and (3) "put"-type options.

As the name suggests, if the parties provide for a mandatory purchase, all parties to the agreement will be obligated to complete the sale once the triggering event has occurred.³

1. E.g., *Maxx Private Invs., LLC v. Drew/Core Dev., LLC*, 24 Mass. L. Rep. 456, 2008 Mass. Super. LEXIS 298 (2008).

2. See Uniform Probate Code §5-103(f), Social Security Law 42 USCA §416(i)(1).

3. *True v. Comm.*, TC Memo 2001-167, 2001 TCM LEXIS 199 (2001).

The agreement can also provide for a call-type option, under which the buyer is given the *option* to purchase upon the occurrence of the triggering event. In this case, if the buyer exercises the option, the selling owner is required to sell the interests.

Conversely, the agreement can provide for a “put” type option, under which the *seller* is given the option to sell upon the occurrence of a triggering event, and the buyer will then be required to purchase the interests.

In any of these three situations, the triggering event will be crucial to determining whether the provisions of the buy-sell agreement are activated.¹ The parties must consider the fact that, as in any other option contract, if the rights are structured similarly to put or call options, the party giving the option will be free to exercise the option or *not to* exercise the option upon occurrence of the triggering event. On the other hand, the party who gave the option is *bound* to perform once the option is exercised within the terms of the agreement.²

8859. What is the “redemption” type buy-sell agreement? How is this different from a cross-purchase buy-sell agreement?

A “redemption” type agreement is structured so that it is the business entity (usually a corporation), rather than the individual owners, that agrees to purchase the business interests of an owner under a buy-sell agreement.³ A cross-purchase agreement is an agreement among owners to purchase the business interests of another co-owner.⁴

In many respects, structuring a redemption-style buy-sell agreement may be much simpler because there is only one buyer, the corporation or business entity. Conversely, in a cross-purchase agreement, multiple buyers may be involved, depending on the number of co-owners involved in the business. Funding a cross-purchase agreement can also prove more complicated than in a redemption context, especially if the agreement is funded by insurance policies owned by multiple shareholders, rather than the entity itself.

Choosing between a redemption or cross-purchase style agreement may trigger many non-tax issues. For example, state laws may restrict a corporation’s redemption of its own stock⁵ in cases where the redemption can risk the corporation’s insolvency or impair its capital.⁶ Conversely, there are no similar restrictions upon the sale of one stockholder’s shares to another stockholder under a cross-purchase agreement.

Sale of stock between the shareholders of a corporation under a cross-purchase agreement creates the same tax consequences as would the sale of the securities in any other context (see Q 8827 and Q 8728).

1. E.g., *Thomas by & Through Schmidt v. Thomas*, 532 N.W.2d 676 (1995).

2. *Fries v. Fries*, 470 N.W.2d 232 (1991), *Wessels v. Whetstone*, 338 N.W.2d 830 (1983).

3. E.g., *Glacier State Electric Supply Co. v. Comm.*, 80 TC 1047 (1983), IRC Sec. 302.

4. E.g., *Rodeo Family Enters., LLC v. Matte*, 2011 N.Y. Misc. LEXIS 2004 (2011).

5. See Revised Model Business Corp. Act. §6.40 (1984); Del. Code Ann. tit. 8, §160 (1974).

6. See, e.g., Fla. Stat. Ch. 607.06401, N.C. Gen. Stat. §55-6-40, 11 Vt. Stat. Ann. 11A, §6.40.

However, if the corporation participates in the purchase, as it does in a redemption agreement, the purchase may be treated as a dividend distribution.¹ See Q 8860 for a discussion of IRC Section 302 redemptions and Q 8861 for a discussion of IRC Section 303 redemptions.

As a general rule, any payment by a corporation other than an S corporation to a shareholder will be treated as a dividend rather than a capital transaction even if the payment is made to redeem stock.²

In the context of closely held corporations, characterization as a stock redemption is important for at least two additional reasons. First, if a redemption is treated as a sale or exchange, the basis of the shares retained by the seller, if any, is unaffected by the transaction. If redemption is treated as a dividend, the basis of the shares redeemed is added to the basis of the shares retained.³

Second, if redemption is treated as a sale or exchange, the part of the distribution properly chargeable to earnings and profits is an amount not in excess of the ratable share of earnings and profits of the corporation attributable to the redeemed stock.⁴ If a redemption is treated as a dividend, earnings and profits of the corporation are reduced by the amount of money or other property distributed by the corporation.⁵

8860. What is an IRC Section 302 stock redemption?

One of the exceptions to dividend treatment (discussed in Q 8859) is contained in IRC Section 302(b)(3). IRC Section 302(b)(3) provides that if a corporation redeems all of a shareholder's remaining shares so that a shareholder's interest in the corporation is terminated, the amount paid by the corporation will be treated as a payment in exchange for the stock, not as a dividend. In other words, the redemption will be treated as a capital transaction (See Q 8560 to Q 8576).⁶

There will be no taxable dividend, then, if a corporation redeems all of its stock owned by an estate. In determining what stock is owned by an estate, the constructive ownership or attribution-of-ownership rules contained in IRC Section 318 must be applied.

Consequently, to achieve non-dividend treatment under IRC Section 302(b)(3), a corporation must redeem not only all of its shares actually owned by an estate, but also all of its shares constructively owned by the estate.

One of these constructive ownership rules provides that shares owned by a beneficiary of an estate are considered owned by the estate. For example, assume that a decedent owned 250 shares of Corporation X's stock, so that the decedent's estate now actually owns 250 shares. Assume further that a beneficiary of the decedent's estate owns 50 shares. Because the estate constructively owns the beneficiary's 50 shares, the estate is deemed to own a total of 300 shares.

1. See IRC Sec. 304(a)(1).

2. IRC Sec. 301(a), Rev. Rul. 55-515, 1955-2 CB 222.

3. Treas. Reg. §1.302-2(c).

4. IRC Sec. 312(n)(7).

5. IRC Secs. 312(a), 316(a).

6. Rev. Rul. 77-455, 1977-2 CB 93.

Redemption of the 250 shares actually owned, therefore, will not affect a redemption of all the stock owned by the estate.

Further, stock owned by a close family member of a beneficiary of an estate may be attributed to an estate beneficiary, because of the family constructive ownership rules, and through the estate beneficiary to the estate. An estate beneficiary would be considered to own, by way of family attribution rules, shares owned by the decedent's spouse, children, grandchildren, and parents.¹ There are two ways in which the family attribution rules can be addressed.

First, the First Circuit has held that where, because of hostility among family members, a redeeming shareholder is prevented from exercising control over stock that the individual would be deemed to own constructively under attribution rules, the attribution rules will not be applied to the individual.²

On the other hand, the IRS has indicated it will not follow this decision and has ruled that the existence of family hostility will not affect its application of attribution rules.

If certain conditions are met, however, the IRS will not apply the ruling to taxpayers who have acted in reliance on the IRS's previously announced position on this issue.³ The Fifth Circuit also has taken the position that the existence of family hostility does not prevent application of attribution rules, thus creating disagreement between the two circuit courts that have ruled on the question.⁴ The Tax Court consistently has held that hostility within a family does not affect application of attribution rules.⁵

The second way in which the family attribution rules can be addressed is if the sale of the departing owner's interest qualifies as a complete termination of the shareholder's interest.⁶

Constructive ownership rules are complicated and their application requires expert legal advice. It generally may be said that a danger of dividend tax treatment exists in every case involving a family-owned corporation engaging in a stock redemption. There are, however, means available in some cases to avoid the harsh operation of the rule. A partial redemption may be able to escape dividend tax treatment even in a family-owned corporation.

8861. What is an IRC Section 303 stock redemption? How is a Section 303 redemption useful in the context of a closely-held corporation?

IRC Section 303 was enacted expressly to help solve the liquidity problems frequently faced by estates that are comprised largely of stock in a closely-held corporation, and to protect small businesses from forced liquidations or mergers due to the impact of estate taxes. Within the limits of IRC Section 303, surplus can be withdrawn from the corporation income tax-free.

1. IRC Sec. 318(a).

2. *Robin Haft Trust v. Comm.*, 75-1 USTC ¶9209 (1st Cir. 1975).

3. Rev. Rul. 80-26, 1980-1 CB 66; IRC Sec. 7805(b).

4. *David Metzger Trust v. Comm.*, 82-2 USTC ¶9718 (5th Cir. 1982), cert. den., 463 U.S. 1207 (1983).

5. See *Cerone v. Comm.*, 87 TC 1 (1986).

6. IRC Sec. 302(b)(3); see IRC Sec. 302(c)(2) for situations in which constructive ownership rules of IRC Sec. 318(a)(1) will not apply.

In certain instances, stock of a public corporation also may be redeemed under IRC Section 303.

Any payments by a corporation to a shareholder generally are treated as dividends (see Q 8859). Despite this, under certain circumstances IRC Section 303 allows a corporation to redeem part of a deceased stockholder's shares without the redemption being treated as a dividend. Instead, the redemption price will be treated as payment in exchange for the stock in a capital transaction.

An IRC Section 303 redemption can safely be used in connection with the stock of a family-owned corporation because the constructive ownership rules (see Q 8860) are not applied in an IRC Section 303 redemption.¹

The following conditions must be met if a stock redemption is to qualify under IRC Section 303 for non-dividend treatment:

- (1) The stock that is to be redeemed must be includable in the decedent's gross estate for federal estate tax purposes;
- (2) The value for federal estate tax purposes of all stock of a redeeming corporation that is includable in a decedent's gross estate must comprise more than 35 percent of the value of the decedent's adjusted gross estate.² The "adjusted gross estate" for this purpose is the gross estate less deductions for estate expenses, indebtedness and taxes³ and for unreimbursed casualty and theft losses.⁴ The total value of all classes of stock includable in a gross estate is taken into account to determine whether this 35 percent test is met, regardless of which class of stock is to be redeemed.⁵

IRC Section 303(b) provides that a corporate distribution in redemption of stock will qualify as IRC Section 303 redemption if all the stock of the corporation that is included in determining the value of a gross estate exceeds 35 percent of the adjusted gross estate. Although most gifts made by a donor within three years of death are not brought back into the donor's gross estate under IRC Section 2035, certain kinds of gifts are brought back. These are the "first kind of exception" gifts. Gifts of corporate stock that fall within this classification are part of a gross estate for purposes of computing the 35 percent requirement (or the 20 percent requirement discussed below) and a corporation's redemption of this stock will qualify as a sale or exchange if all other requirements of IRC Section 303 are satisfied. IRC Section 2035(c)(1)(A) states generally that the three year rule will apply for the purposes of IRC Section 303(b). This is generally interpreted as follows: If a decedent makes a gift of any kind of property within three years of his or her death, the value of the property given will be included in the decedent's gross estate for purposes of determining whether the value of the corporate stock in

1. IRC Secs. 318(a)-(b).

2. IRC Sec. 303(b)(2)(A).

3. IRC Sec. 2053.

4. IRC Sec. 2054.

5. Treas. Reg. §1.303-2(c)(1).

question exceeds 35 percent of the value of the gross estate, but a distribution in redemption of that stock will not qualify as an IRC Section 303 redemption unless the stock redeemed actually is a part of the decedent's gross estate.¹

The stock of two or more corporations will be treated as that of a single corporation, provided that 20 percent or more of the value of all of the outstanding stock of each corporation is includable in a decedent's gross estate.² Only stock directly owned is taken into account in determining whether the 20 percent test has been met; constructive ownership rules do not apply even when they would benefit a taxpayer.³ Stock that, at a decedent's death, represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common is considered to be includable in a decedent's gross estate for the purpose of meeting the 20 percent requirement.⁴ The 20 percent test is not an elective provision, meaning that if a distribution in redemption of stock qualifies under IRC Section 303 only by reason of the application of the 20 percent test and also qualifies for sale treatment under another section of the IRC, the executor may not elect to have only the latter section of the IRC apply and thus retain the undiminished IRC Section 303 limits for later use. All distributions that qualify under IRC Section 303 are treated as IRC Section 303 redemptions in the order they are made;⁵

- (3) The dollar amount that can be paid out by a corporation under protection of IRC Section 303 is limited to an amount equal to the sum of (x) all estate taxes, including the generation-skipping transfer tax imposed by reason of the decedent's death, and federal and state inheritance taxes attributable to a decedent's death, plus interest, if any, collected on these taxes, and (y) funeral and administration expenses allowable as estate deductions under IRC Section 2053.⁶
- (4) The stock must be redeemed not later than (x) three years and ninety days after the estate tax return is filed (the return must be filed within nine months after a decedent's death), (y) sixty days after a Tax Court decision on an estate tax deficiency becomes final, or (z) if an extension of time for payment of tax is elected under IRC Section 6166, the time determined under the applicable section for payment of the installments. For any redemption made more than four years after a decedent's death, however, capital gains treatment is available only for a distribution in an amount that is the lesser of the amount of the qualifying death taxes and funeral and administration expenses that are unpaid immediately before the distribution, or the aggregate of these amounts that are paid within one year after the distribution;⁷

1. Rev. Rul. 84-76, 1984-1 CB 91.

2. IRC Sec. 303(b)(2)(B).

3. *Est. of Byrd v. Comm.*, 21 AFTR 2d 313 (5th Cir. 1967).

4. IRC Sec. 303(b)(2)(B).

5. Treas. Reg. §1.303-2(g); Rev. Rul. 79-401, 1979-2 CB 128.

6. IRC Secs. 303(a), 303(d).

7. IRC Secs. 303(b)(1), 303(b)(4).

- (5) The shareholder from whom stock is redeemed must be one whose interest is reduced directly, or through a binding obligation to contribute, by payment of qualifying death taxes and funeral and administration expenses, and the redemption will qualify for capital gains treatment only to the extent of that reduction.¹ That is, “the party whose shares are redeemed [must actually have] a liability for estate taxes, state death taxes, or funeral and administration expenses in an amount at least equal to the amount of the redemption.”²

The stock of any corporation, including an S corporation, may qualify for IRC Section 303 redemption. Moreover, any class of stock may be redeemed under IRC Section 303. Thus, a nonvoting stock, common or preferred, issued as a stock dividend or issued in a lifetime or post-death recapitalization can qualify for the redemption.³

8862. How are interests subject to a buy-sell agreement valued?

One of the most difficult areas in negotiating a buy-sell agreement is determining the purchase price for the interests that are the subject of the agreement. Advance agreement upon the purchase price, or the method for determining the purchase price, is important, because failure to include pricing terms may make enforcement of the agreement problematic. There are three common methods used in determining the purchase price. The parties may either (1) set a fixed price; (2) use a formula to determine price; or (3) obtain an independent appraisal.

The valuation provided under the buy-sell agreement is not always determinative of the parties' final tax liabilities, however, especially in the case of a closely-held company where the IRS could argue that the interests were undervalued and attempt to impose penalties under Section 6662.⁴ Use of an independent appraiser can help to alleviate this concern for some companies.

However, if the valuation in the buy-sell agreement complies with the “price term control test,” the purchase price in the buy-sell agreement will generally control the value of the asset for estate tax purposes.⁵ For the terms of the buy-sell agreement to control for estate tax purposes, therefore, it is important that the agreement prohibit the decedent from transferring shares outside of the buy-sell agreement for any other price than that which is specified in the agreement. Further, the parties must be able to demonstrate that, based on the specific circumstances of the case, the buy-sell agreement represents a legitimate business arrangement, rather than a disguised scheme to pass the shares at an artificially low value to the deceased owner's children or other natural beneficiaries.⁶

It is also necessary to address the requirements of IRC Section 2703. Under Section 2703, the IRS will disregard the price established in the buy-sell agreement for establishing the fair

1. IRC Sec. 303(b)(3).

2. H.R. Rep. No. 94-1380 at 35 (Estate and Gift Tax Reform Act of 1976), *reprinted in* 1976-3 CB (Vol. 3) 735 at 769.

3. Treas. Reg. §1.303-2(d).

4. See also *True v. Comm.*, 2001 TCM LEXIS 199 (2001) for an illustration of understatement penalties that may apply.

5. See Treas. Reg. §20.2031-2(h); *True v. Comm.*, above.

6. Treas. Reg. §20.2031-2(h).

market value of the interest being sold unless certain requirements are met. Specifically, (i) the agreement must be a bona fide business arrangement, (ii) the agreement must not be a device to transfer property to members of the decedent's family for less than full and adequate consideration, and (iii) the terms must be comparable to similar arrangements entered into by persons in an arms' length transaction.¹

Planning Point: While using a fixed price may be the simplest method for the parties, it is important that the agreement is reviewed at regular intervals to ensure that the price still accurately reflects the value of the business to avoid IRS intervention. On a practical level, clients frequently fail to update these stipulated values.

If the parties develop a formula to determine the pricing under a buy-sell agreement² it is important that they clearly define all terms necessary to determine the price under that formula. Further, they should be aware that the courts may set aside the formula in certain cases, including cases where the formula was not determined in an arm's length negotiation or is found to be against public policy.³

Planning Point: Some agreements provide for a stipulated value; however, if the stipulated value is not updated with a specified period of time (i.e., 2 years), then a formula is used to determine the value.

See Q 8863 for a discussion of the use of so-called "showdown clauses" in pricing under a buy-sell agreement.

8863. What is a "showdown clause" in the context of a buy-sell agreement? When should one be used?

A showdown clause, also known as "shoot out," "slice-of-the-pie," "Russian roulette" or "Chinese wall" clauses, essentially allows one party to name a price upon the occurrence of a triggering event under a buy-sell agreement. Upon occurrence of the triggering event, one party specifies a price at which the party would buy (or sell) the business interests at issue, and the others decide whether to buy the interests (or sell their interests) to the naming party.

When a business owner invokes a showdown clause, this is essentially expressing a decision to exit the business. This provision works best if both sides are in an equal financial position because, if the parties are on unequal footing, the clause may provide a route for one owner to unjustifiably "chase out" a co-owner from the business. A showdown clause is frequently invoked in a situation where a deadlock in management or another similar issue exists among the various business owners that cannot be resolved through other methods.⁴

In *Wilcox v. Styles*,⁵ a showdown clause was enforced by the courts, leading to an eventual dissolution of the business due to a deadlock over management issues that occurred between the

1. IRC Sec. 2703(b).

2. See e.g., *Anderson v. Comm.*, 1970 TCM LEXIS 10 (1970).

3. See e.g., *Hendrix v. Comm.*, TC Memo 2011-133 (in this case the pricing was upheld, but the court discussed the circumstances that might cause it to be set aside).

4. *RS & P/WC Fields Ltd. Partnership v. BOSP Invs.*, 829 F. Supp. 928 (1993).

5. 127 Or. App. 671 (1994).

two business owners of a closely-held corporation. The court upheld both the agreement containing the showdown clause and the pricing specified under the agreement, which was supported in part by an independent expert appraisal. The court in this case emphasized the importance of the written agreement—a mere oral agreement would be insufficient.¹

Generally, offers made pursuant to a showdown clause cannot be used to establish the value of the business interest for estate tax purposes. By their nature, showdown clauses involve voluntary lifetime transfers of property, and do not prevent the interests from being sold at a higher price than that specified in the buy-sell agreement (see Q 8862).

8864. How can the fact that a business owner holds a minority or majority interest in an entity impact the use of a buy-sell agreement?

Control premiums and minority discounts are especially important in the small business context where the business is owned by a small group of individuals who may also be significantly involved in the day-to-day operations of the business. Control and minority issues may be important in establishing the value of business interests that are subject to a buy-sell agreement.

Normally, an interest in a business is valued in proportion to the entire value of the business. However, application of a premium that reflects one owner's (or a group of owners') ability to control business affairs, including the ability to withdraw business assets, has been recognized in many cases.² In other cases, premium pricing has been found appropriate in a context where one owner functions as the "swing vote" within the business, in recognition of the substantial influence that the owner has over the business' affairs.³

A premium is not always available, however in the swing vote context, as it involves a fact-intensive analysis. For example, the Ninth Circuit did not allow a premium for swing vote status in the case of *Simplot v. Commissioner*, reversing the Tax Court's determination of value that was based largely on scenarios constructed by the court to prove the value of the particular owner's influence and control. The Ninth Circuit found that it was an error for the Tax Court to base value on fictional potential purchasers, rather than concrete facts.⁴

A valuation discount has often been applied in the context of minority ownership interests in order to reflect the *lack* of control that these owners may influence over business affairs.⁵ In certain cases, a minority discount is combined with a discount for lack of

1. *Bruce v. Cole*, 854 So.2d 47 (2003).

2. On control premiums generally, see *Estate of Bright v. United States*, 658 F.2d 999 (1981); *Estate of Desmond v. Comm.*, TC Memo 1999-76 (majority stock interest in an S corporation was subject to a control premium); *Rakow v. Comm.*, TC Memo. 1999-177 (controlling interest in corporation was subject to a control premium).

3. *Estate of Winkler v. Comm.*, TC Memo. 1989-231 and Let. Rul. 9436005.

4. *Estate of Simplot v. Comm.*, 249 F.3d 1191 (2001), rev'g 112 TC 130 (1999).

5. See, e.g., *Knott v. Comm.*, TC Memo 1987-597; *Estate of Berg v. Comm.*, TC Memo 1991-279; *Moore v. Comm.*, TC Memo 1991-546 (minority interest in a general partnership). But see also *Abmanson Found. v. United States*, 674 F.2d 761 (1981); *Estate of Curry v. United States*, 706 F.2d 1424 (1983); *Citizens Bank & Trust Co. v. Comm.*, 839 F.2d 1249 (1988) (no discount for nonvoting interest if the same decedent hold majority of voting interest).

marketability that is generally found in the small business context.¹ (It should be noted that the discount for lack of marketability is often available even for majority interests in a closely-held business.)²

Minority discounts will generally be disallowed, however, in the context of larger companies, where securities are marketable and there are multiple business owners.³

Planning Point: It becomes a client decision as to whether or not the valuation approach should account for any premiums or discounts associated with a minority or controlling interest in the business. For example, the agreement can be drafted to determine a value for the overall business, with this value to be multiplied by the percentage interest in the business being sold. This approach does not reflect any premium or discount. In the alternative, the valuation can be calculated to reflect the value of a specific percentage interest of the business (i.e. the fair market value of a 30 percent interest in the business). This approach will take into account discounts or premiums.

8865. What is a right of first refusal? What is the difference between a right of first refusal and a buy-sell agreement?

A right of first refusal requires that a selling business owner give his or her co-owners or the business entity itself the opportunity to purchase certain business interests at the same price that he or she is able to obtain from a third party investor.⁴ The co-owners will be given the option of matching the terms of the competing offer before the selling owner is able to sell his or her interests to a third party. Though the agreed upon price may not fix the value of the interest for estate and gift tax purposes,⁵ it can be considered as one of the factors that could determine its value.⁶

While a right of first refusal may provide comfort to all business owners in that they know they will have a right to purchase a departing business owner's shares before third parties are given the right, business owners must remember that in the context of a closely-held business, there is often a very limited market for the shares. Even if a business owner is able to find a third party buyer, the remaining business owners will then be forced to come up with a matching purchase offer, which may prove difficult in the small business context when funds are more limited.

Further, a right of first refusal often gives a departing business owner the power to find a willing buyer that the remaining business owners may be forced to accept in the event that they are unable to match the purchase price. As the departing business owner will no longer be involved in the business' operations, he or she may not be the person best suited to choose a replacement owner.

1. *Estate of Hecksher v. Comm.*, 63 TC 485 (1975); *Estate of Titus v. Comm.*, TC Memo 1989-466; *Moore v. Comm.*, TC Memo 1991-546 (minority discount); *Mandelbaum v. Comm.*, TC Memo 1995-255 (lack of marketability discount) and *McCormick Estate v. Comm.*, TC Memo 1995-371 (minority discount and lack of marketability discount); *Gross v. Comm.*, TC Memo 1999-254 (minority interest in S corporation was given a combined minority and lack of marketability discount).

2. *Estate of Bennett v. Comm.*, TC Memo 1993-34; *Estate of Andrews v. Comm.*, 79 TC 938 (1982).

3. *Snyder v. Commissioner*, 93 TC 529 (1989); *Estate of Dougherty v. Commissioner*, TC Memo. 1990-274, *Citizens Bank & Trust Co. v. Commissioner*, 839 F.2d 1249 (1988).

4. See *True v. Comm.*, 390 F.3d 1210 (2004); *Oldcastle Materials, Inc. v. Roblin*, 343 F. Supp. 2d 762 (2004).

5. *Fry Est. v. Comm.*, 9 TC 503 (1947).

6. *James v. United States*, 148 F.2d 236 (1945).

In the context of a buy-sell agreement, if the triggering event is the withdrawal of one business owner, only the remaining owners or entity itself have the right to purchase the departing owner's interests. The price or method for determining the price will be fixed by the agreement, and the agreement has often been pre-funded with insurance or accumulated earnings in order to ensure that the remaining owners are able to make the purchase. Therefore, the buy-sell agreement is often the more advantageous method for planning a departing business owner's transition.

8866. What special considerations apply when an S corporation uses a buy-sell agreement?

Owners of S corporations, like C corporations, can execute buy-sell agreements to provide for the transition of a business owner's interests based upon one or more triggering events. The S corporation also may choose to structure the agreement as either a cross-purchase or redemption agreement. In addition to the factors that are important to any business, S corporations must consider the following factors: (1) preservation of the S corporation status; (2) requiring distributions to ensure shareholders have adequate funds to pay for the S corporation's income taxes at the shareholder level; and (3) protecting its fiscal year.

When an S corporation¹ fails to qualify it automatically becomes a C corporation.² Because S corporation qualification is tied to the number and types of shareholders, the use of a properly structured buy-sell agreement may be critical to protecting the business' qualification as an S corporation.³ Provisions prohibiting certain transfers and acts should be included in the buy-sell agreement, including the following:⁴

- (1) Prohibitions on the transfer of stock to a prohibited S corporation shareholder, such as a corporation, foreign individual or ineligible trust; and
- (2) Prohibitions on the transfer of stock to an additional new shareholder if the transfer would bring the total number of shareholders above the permitted number (currently 100).

Further, an S corporation buy-sell agreement may contain different triggering events than those commonly used for a C corporation or partnership. An S corporation must make a variety of elections that can impact all of its shareholders. The fact that an S corporation is limited to issuing one class of stock (see Q 8841) often means that distribution requirements must be uniform for all shareholders so that variances are not found to create a second class of stock and disqualify the S corporation from its status.⁵ A buy-sell agreement could be structured so that remaining business owners have the right to purchase the interests of a shareholder who disagrees with the rights created with respect to the S corporation's single class of stock.

1. IRC Sec. 1361(b).

2. IRC Sec. 1362(d).

3. *Hunt v. Data Mgmt. Resources, Inc.*, 985 P2d 730 (1999).

4. See *Minton v. Comm.*, TC Memo 2007-372 (example of binding shareholder agreement).

5. Treas. Reg. §1.1361-1(l)(2)(iv), (Ex. 6).

Because S corporations are taxed at the individual shareholder level, rather than at the entity level, regardless of whether the S corporation actually distributes dividends, a buy-sell agreement can be used to ensure the shareholders' ability to pay their income tax liabilities.¹ A provision that triggers a buyout upon failure of the S corporation to meet its dividend obligations could be used to protect the interests of less wealthy shareholders.

Buy-sell agreements may also be useful in protecting the fiscal year of the S corporation. Generally, an S corporation is required to observe a calendar year as its tax year unless it can establish a valid reason for adopting a fiscal year.² If more than 50 percent of the S corporation's shares are transferred, it must change to a calendar year or reestablish its entitlement to a fiscal year.³ To prevent this occurrence, an S corporation's buy-sell agreement should contain provisions that would prevent shareholders from transferring enough shares to disqualify the S corporation from its current use of a fiscal year, if desired.

8867. How can an installment sale be used to “fund” a buy-sell agreement?

Any disposition of property where at least one payment will be received after the close of the tax year of its disposition may be treated as an installment sale.⁴ Generally, however, the installment method of taxation (see below) is not available for sales between certain related parties unless they can clearly establish that the transaction was not intended to avoid tax.⁵

Installment sales are often used in the context of a buy-sell agreement where the business owners have not planned in advance to fund the purchase through the use of insurance or otherwise (see Q 8854 and Q 8855). Though installment sales may be used to purchase the interests of a departing business owner, they do not provide the immediate liquidity to the retiring owner or deceased owner's estate that can be realized through a life insurance strategy or by using accumulated earnings to purchase the interest outright. Practically, an installment sale may be the only means of purchasing a departing business owner's interests if the buy-sell agreement was not funded in another manner.

Essentially, an installment sale requires the corporation (or shareholders if the buy-sell agreement is structured as a cross-purchase agreement, see Q 8859) to purchase the interests of the departing business owner using a note, under which it will pay for the interests over time. The departing business owner (or that owner's estate) reports gain on the sale using the “installment method,” which means that the gain for any given year equals the part of the gain that is actually received (or considered to have been received) during that tax year. The departing business owner must also report as income the amount of the payments received in the year that are deemed to represent interest income. The portion that is deemed to be a return of the

1. IRC Secs. 7519, 444.

2. IRC Sec. 1378. See also Rev. Proc. 87-57, 1987-2 CB 687, Rev. Proc. 87-32, 1987-2 CB 396, regarding what constitutes a sufficient business purpose for adopting a fiscal year that does not end on December 31.

3. Tax Reform Act of 1986, Pub. L. No. 99-514, Sec. 806(e).

4. IRC Sec. 453(b)(1).

5. IRC Sec. 453(g)(2). If the buyer disposes of the asset within 2 years of the purchase, there are additional restrictions in IRC Sec. 453(e), also called the anti-Rushing Rule, see *Rushing v Comm.*, 441 F.2d 593 (1971).

owner's adjusted basis in the interests is excluded as in any other sale.¹ See Q 8565, Q 8814 and Q 8828 for a discussion of determining basis in various contexts.

The departing owner can elect out of the installment sale method and report the entire amount of gain in the year of sale, even though he or she has not yet received all of the proceeds.

The installment method cannot be used if the business interests at issue are securities that are publicly traded on an established market.²

8868. What are the tax consequences of using an asset sale to liquidate a C corporation, rather than transitioning the business through some other form of succession planning?

Liquidation is the winding down of a corporation's affairs until it is completely divested of all assets.³ If a corporation decides that the best option is to liquidate, rather than transition ownership of the company through another form of succession planning, there are a variety of methods that can be used in such liquidation.

Similarly to the corporation's taxation while operating as an active business, the liquidated company is generally subject to double taxation because both corporation and shareholders will be liable for taxes on the sale proceeds. In an asset sale, the corporation sells all of its assets to a buyer, recognizing gain on the transaction as the difference between its basis in the assets and the amount realized.⁴ After taxes and expenses, the corporation distributes any excess to its shareholders, who are then subject to tax at the individual level.⁵

The asset sale can also be structured as an installment asset sale, which allows the buyer to purchase the company over a period of time using a note or other debt obligation (see Q 8867 for a discussion of the installment method of taxation).⁶ Despite this, if the entire business is sold through an installment sale, a special rule applies that requires the business to allocate the selling price and payments between three classes of assets: (1) assets sold at a loss, (2) real and personal property eligible for the installment method of taxation, and (3) property that is ineligible to be sold in an installment sale, such as publicly traded securities and inventory. Gain on the sale of property that is ineligible for the installment method of taxation must be reported in the year of sale, rather than over the time period in which the installment payments are made.⁷

8869. What tax considerations make the liquidation of an S corporation different than the liquidation of a C corporation?

IRC Section 1371 provides that an S corporation is subject to the same rules that apply in the context of a C corporation unless there is a specific rule that has been developed for

1. See IRS Publication 537.

2. IRS Pub. 537, above.

3. Treas. Reg. §1.332-2(c).

4. IRC Sec. 336(a).

5. IRC Sec. 331(a).

6. IRC Sec. 453B(a).

7. See IRS Pub. 537.

S corporations. Despite this, one of the primary differences between an S corporation and a C corporation is their basic tax treatment, which has an important impact upon the issues that the entity will face during liquidation. Because S corporations are taxed at a single level, taxation of a sale or other liquidation of the business will usually occur only at the individual level, unlike in the context of the C corporation, where the corporation itself will be required to pay taxes on any gain before passing the profits through to shareholders, who will also be taxed on the amounts they receive.

Many S corporation shareholders will have a higher stock basis than that of a C corporation shareholder. This is because the basis of an S corporation shareholder's stock is increased by any earnings of the S corporation that are passed through for tax purposes.¹ Depending upon how long the corporation had existed as an S corporation, and the level of earnings that were passed through to shareholders, S corporation shareholders may have substantially higher tax basis upon sale. Because tax basis decreases the amount of gain that the shareholders are required to recognize upon sale, the S corporation shareholder's total tax liability will often be lower than the C corporation shareholder's upon liquidation of the company.

If the S corporation was ever a C corporation, however, the S corporation will be required to account for any built-in gains, which are taxed at the highest rate applicable to C corporations (see Q 8825).² The tax on built-in gains is designed to preserve a part of the double tax structure for certain S corporations that were formerly C corporations. The built-in gains tax applies if the S corporation sells an asset within a ten year period following its S corporation election.³ The tax on built-in gains is imposed at the S corporation level, in addition to any taxes that are paid by the S corporation's shareholders. This tax will only apply in situations where the S corporation was formerly a C corporation and liquidates within ten years of making its S election.

8870. What gift tax concerns apply in the family business context when planning for business succession?

In many cases, the retiring business owner in a family owned small business will want to transition the business to the owner's children using a gifting strategy, rather than a traditional sale. Because the American Taxpayer Relief Act increased the top estate and gift tax rate to 40 percent for tax years beginning after 2012, avoiding this tax will often be a top priority for small business owners.⁴

Each taxpayer is allowed to exclude \$5.34 million (in 2014, as indexed for inflation) from transfer taxation during the taxpayer's lifetime (gifts made during life and post-mortem are aggregated for purposes of determining the exempted amount).⁵ Further, a \$14,000 (in 2013 and 2014, up from \$13,000 for 2011 and 2012) annual exclusion is available for present interest gifts on a per donor/donee basis.

1. IRC Secs. 1367(a), 1366(a)(1)(A).

2. IRC Sec. 1374(b)(1).

3. IRC Sec. 1374(d)(7).

4. American Taxpayer Relief Act of 2012, Pub. Law No. 112-240, Sec. 101.

5. Rev. Proc. 2013-35, 2013-47 IRB 537.

Establishing value for purposes of the exemption and exclusion amounts will be a primary concern for many exiting business owners because, in the small business context, there is often no established market value for the interests being transferred. In the context of the family owned business, the transfer of business interests from one generation to the next is often not accomplished as a result of arm's length negotiations that result in a purchase price that reflects any actual market value of the company.

Thus, when a business owner transfers his ownership interests, a valuation will be required to determine the worth of company shares and the applicable amount of taxes upon the transfer of those shares. Often, however, the lack of established market makes it difficult to accurately determine the value of the transferred interests, opening the business owner to IRS' challenge and potential future gift tax liability for undervalued shares.

Wandry vs. Commissioner was a case where taxpayers were able to establish the value of business interests that were transferred to their children by creating a transaction that capped the annual gift at the annual exclusion amount, rather than specifying a percentage or number of interests subject to transfer. Because the value of the business had not yet been ascertained, the taxpayers specified that the gifts were not to exceed the annual exclusion amount in the documents governing the transfers of the business interests. The taxpayers used their existing gift tax exemption in making the gifts. In *Wandry*, the court approved a formula gift clause that viewed the gift as being of a fixed dollar amount with this fixed dollar amount being expressed as a percentage of the business value. To the extent that the valuation was not correct, the gifted interests were reallocated among the owners of the business. Part of the significance of the case is that the court noted that with respect to the reallocation of the partnership interests, it did not matter if some of the reallocated interests went back to the grantor.

Outright gifts are not the only type of transaction that can give rise to gift tax concerns in the family business context, however. Shareholders of nonparticipating preferred stock in profitable family held corporations have been held to have made gifts to the common stockholders (typically descendants of the preferred shareholder) by waiving payment of dividends or simply by failing to exercise conversion rights or other options available to a preferred stockholder to preserve his position.¹ The Tax Court has held that the failure to convert non-cumulative preferred stock to cumulative preferred stock did not give rise to a gift, but that thereafter a gift was made each time a dividend would have accumulated. However, the failure to exercise a put option at par plus accumulated dividends plus interest was not treated as a gift of foregone interest.²

A transaction involving the nonexercise of an option by a son under a cross-purchase buy-sell agreement followed by the sale of the same stock by the father to a third party when the fair market value of the stock was substantially higher than the option price was treated as a gift from the son to the father.³ Also, a father indirectly made a gift to his son to the extent that the fair market value of stock exceeded its redemption price when the father failed to exercise his

1. TAMs 8723007, 8726005.

2. *Snyder v. Comm.*, 93 TC 529 (1989).

3. Let. Rul. 9117035.

right under a buy-sell agreement to have a corporation redeem all of the available shares held by his brother-in-law's estate and the stock passed to the son.¹

8871. How can a grantor retained annuity trust be used in family business succession planning?

Trust entities can be useful in business succession planning, whether the trusts are revocable or irrevocable. The two forms of trust are not mutually exclusive, and in many instances, a succession plan may contain more than one trust entity. The decision to have one or both depends on the business owner's goals, how much control the senior generation wants, when the assets will be disposed to the heirs and other restraints that are imposed.

A grantor retained annuity trust (GRAT) is an irrevocable trust to which the business owner transfers shares in his business while retaining the right to a fixed annual annuity payout for a stated term of years. At the end of the term, the property remaining in the GRAT (the appreciation and income in excess of the annuity amount that is to be paid to the business owner) will pass to the trust beneficiaries (often the owner's children or grandchildren). Only the value of the remainder interest is subject to gift tax.

The amount of the taxable gift to the beneficiaries can be reduced by structuring the trust with a larger annuity payout or a longer stated term. Further, the value is dependent on the IRS Section 7520 interest rate in effect at the time the trust is established—a lower interest rate can also reduce the value of the taxable gift.

A GRAT may be structured so that there is little or no gift tax payable on the value of the remainder interest that passes to the trust beneficiaries. For gift tax purposes, this is known as a “zeroed-out” GRAT. If the zeroed-out GRAT produces a return in excess of the annuity amount payable to the business owner, the GRAT will succeed in passing on the remainder interest (the trust's excess income and appreciation) to the trust beneficiaries at little or no gift tax cost to the business owner. If the zeroed-out GRAT fails to produce a return in excess of the annuity amount and the remainder beneficiaries receive nothing, there is minimal downside risk since there was little or no gift tax cost to the business owner upon establishing the zeroed-out GRAT. The primary risk of using a GRAT (especially a short term GRAT) to transfer business interests is that if the business owner fails to survive the stated term, the GRAT may be included in his estate and subject to estate taxes.

See Q 8872 for a discussion of the use of intentionally defective grantor trusts in family business succession planning.

8872. How can an intentionally defective grantor trust be used in family business succession planning?

A trust structure called an intentionally defective grantor trust (IDGT) is another trust structure that can be used by a small business owner to transfer business interests to the next

1. TAM 9315005.

generation. In using this strategy, the business owner actually sells his interests in the business to the IDGT, naming his children or other heirs as beneficiaries of the trust.

An IDGT is an irrevocable trust that is valid for estate tax purposes, but “defective” for income tax purposes. This means the business owner (as the grantor of the IDGT) is the owner of the IDGT for income-tax purposes, but is not treated as the owner of the IDGT for estate tax purposes. Since the business interests are sold to the IDGT, there are no gift taxes.

Further, there are no capital gains taxes to the business owner because sales between a grantor and an IDGT are disregarded for income tax purposes. Typically, the business owner will structure the sale so that there is no down payment by the IDGT, annual interest payments are at the lowest rate permitted by the IRS, and a balloon principal payment is due in nine or more years. This technique is similar to a GRAT, but without the mortality risk. The value of the business is taken outside of the business owner’s estate for estate tax purposes, because future appreciation and interest are sheltered within the IDGT. The business owner’s estate is also reduced by the income and capital gains taxes he must pay on the IDGT’s income. In other words, the business owner is not taxed separately on the interest payments but instead is taxed on all of the capital gains and income realized by the IDGT. The taxes paid by the business owner on the IDGT’s income and capital gains are effectively tax-free gifts to the beneficiaries of the IDGT.

8873. What are self-cancelling installment notes (SCINs)? How can SCINs be used in family business succession planning?

Under a self-cancelling installment note (SCIN), the selling business owner agrees to sell property to a buyer (often, the owner’s children or other beneficiaries) in exchange for an installment note that expires either when the seller receives the maximum price for the property or upon the occurrence of a cancellation event, such as the seller’s death. This is a form of installment sale transaction (see Q 8867). It allows the seller to secure the purchase for the business interest, while still retaining the ability to defer part of the gain.¹ In turn, the buyer can claim an interest deduction with respect to the payments made.²

Under a SCIN, if the cancelling event is the selling business owner’s death, all remaining payments under the note are canceled upon the seller’s death, similar to a private annuity. Typically, the purchaser pays a premium for this cancellation feature in the form of either a higher interest rate or a larger purchase price. Gain under a SCIN is recognized by the selling business owner as payments are received. However, when the seller dies, any unrecognized (i.e., cancelled) gain at the seller’s death under the SCIN is reportable either on the seller’s final IRS form 1040 or on the seller’s estate’s IRS form 1041.

In order for the IRS to recognize the SCIN, the term of the note must be shorter than the seller’s life expectancy at the time of the sale, based on IRS mortality tables.³ The advantage of

1. IRC Sec. 453(f)(3).

2. IRC Sec. 163(d)(5), Treas. Reg. §1.163-8T(b)(3) (investment interest).

3. GCM 39503.

using a SCIN, as opposed to other installment sale methods or an intentionally defective grantor trust (see Q 8872), is that the unpaid balance is not included in the seller's estate.¹

However, if no payments are made under the SCIN before the death of the seller, the IRS may argue that the value of the SCIN is zero and should only reduce the value of the note.² A SCIN signed by a family member is presumed to be a gift rather than a bona fide transaction.³

SCINs are particularly useful if the seller has a relatively short remaining life expectancy because if the selling owner outlives the term of the note, the estate tax benefit will have been lost and the owner may actually have incurred additional expenses in the form of higher income taxes or gift tax liability.

8874. Are there any special provisions available to allow the estate of a small business owner to defer payment of estate taxes?

Section 6166 was added to the Internal Revenue Code to allow estates to pay estate taxes attributable to substantial closely-held business interests in installments. Prior to that time, the IRS had discretion to permit installment payments, but such discretion was rarely exercised. Consequently, Congress acted to provide certain estates with the right to defer estate tax payments if the requirements of Section 6166 were met.

In general, IRC Section 6166 provides for an elective five-year deferral, ten-year installment payment method of liquidating the estate tax liability. An estate is eligible for the Section 6166 election if the value of a closely-held business that is includible in the gross estate exceeds 35 percent of the adjusted gross estate.⁴

If the Section 6166 election is made, no payments of the tax are required for an initial five-year period, though interest payments must be made.⁵ The estate tax liability itself may then be paid in ten equal annual installments in years six through fifteen, with interest continuing to run on the unpaid balance. Interest on the deferred amount is 2 percent (subject to a limitation discussed below).

This deferral treatment is allowed only for estates comprised of "interests in a closely-held business." Whether or not the business interests contained in an estate meet this standard is determined by the "business interest test," which is satisfied as follows:

- (1) If the decedent was a sole proprietor the business interest test is satisfied;
- (2) If the business was a partnership, the business interest test is satisfied only if either of the following are true:
 - (i) there were no more than 45 partners in the partnership, or
 - (ii) the decedent's interest in partnership capital was at least 20 percent;

1. See *Frane vs. Comm.*, 998 F.2d 567 (1993), *Moss v. Comm.*, 74 TC 1239 (1980).

2. See *Estate of Costanza v. Comm.*, 320 F.3d 595 (2003), *Robert Dallas*, TC Memo 2006-212.

3. *Estate of Costanza v. Comm.*, 320 F.3d 595 (2003); *Estate of Labombarde v. Comm.*, 58 TC 745 (1972).

4. IRC Sec. 6166(a)(1).

5. IRC Sec. 6166(a)(3), (f)(1).

- (3) If the business was a corporation, the business interest test is satisfied only if either:
- (i) there were no more than 45 shareholders, or
 - (ii) the decedent's ownership of voting stock was at least 20 percent.

Interests or shares owned by the decedent's spouse, siblings, ancestors, and descendants are treated as owned by the decedent for purposes of applying the 45 partner or shareholder test. Interests owned jointly by a husband and wife are counted as one partner or shareholder.

In applying the 20 percent interest test, the estate may elect to have interests owned by the decedent's spouse, siblings, ancestors, and descendants counted as part of the decedent's interest. However, if this is the method through which decedent's interest qualifies for the deferral, then

- (1) the five-year deferral period is lost (i.e., the ten-year payment period starts immediately), and
- (2) the favorable 2 percent interest rate is not available on deferred amounts.

The value of the business interest must be more than 35 percent of the "adjusted gross estate." The adjusted gross estate is the gross estate minus deductions for expenses, debts, taxes, and losses.

8875. What issues arise when a family partnership is considering its small business succession strategy?

The preferred solution to the problem of transferring family partnership interests at death depends upon the particular type of family partnership and the circumstances surrounding it. A family partnership may be between two spouses, a parent and his or her adult child or children, the entire family, or the parent and a trustee or trustees, the latter acting for minor children. In some instances, disposition of the partnership interests by will may be a satisfactory solution. In most instances, a buy-sell agreement will be the preferred solution. Except in the case of two spouses, the income tax savings that result from the family partnership, by reason of spreading the business income, will more than pay the premiums on the life insurance used to finance the agreement.

When a family partnership has been formed by two spouses, it is sometimes assumed that there is no need for a buy-sell agreement to take effect at death. They may take the position that a buy-sell agreement is unnecessary because the survivor (assuming there are no children or other heirs) will take the interest in the business from the first one to die under the intestacy laws of the state in the absence of a will. Moreover, in most states, each has a statutory right to one-third of the property owned at death by the other, which right cannot be eliminated even by a will to the contrary.

Notwithstanding the circumstances that exist so far as inheritance is concerned between the spouses, a buy-sell agreement is practical and in some instances may be necessary in order to avoid serious problems upon the death of the first to die. See Q 8876 for a detailed discussion of the use of buy-sell agreements in the context of a family partnership.

Where two spouses are partners in a partnership business, they may execute wills leaving their interests in the business to each other. This procedure will sometimes eliminate any liquidation problems at death because the surviving spouse will own the entire business by virtue of the duly executed will, and it eliminates any doubts or problems so far as the surviving spouse's rights are concerned.

There are several major problems, however, that require serious consideration, even though the spouses have executed wills leaving their business interests to each other. The decedent may have personal creditors pressing claims against the estate. Such claims must be satisfied before the surviving spouse can take over the decedent's business interest.

Aside from personal creditors of the decedent, the business itself may be faced with substantial liabilities. Any such claims, if pressed for settlement, will need to be satisfied by the surviving spouse.

There is always the chance that the decedent's will may be contested by heirs, and if set aside will leave the surviving spouse in the same position as if no will had ever been executed. Consequently, if the will is set aside for one reason or another, the surviving spouse will then take under the intestacy laws of the particular state involved, which may give a large portion of the decedent's business interest to heirs other than the surviving spouse. And if any of these heirs are minors, liquidation of the business could become necessary.¹

8876. How can a buy-sell agreement be useful in transitioning a family partnership?

If a family partnership is formed between two spouses, in order to eliminate the possible problems and uncertainties that may arise, a buy-sell agreement should be formed between the partners. Moreover, each spouse should be assured he or she will have ample capital in order to purchase the decedent's business interest. This may become necessary through failure of the decedent's will (see Q 8875), or if no will had been executed, or through a change in a previously executed will, or because of claims being pressed by creditors.

One of the advantages of the buy-sell agreement is that the value of the business may be established through a valuation formula contained in the agreement. If properly established, the stated value should be accepted for federal estate tax purposes. A recommended method in the case of a family partnership is to have an independent certified public accountant establish and certify the true value, and to attach this certificate to the buy-sell agreement. See Q 8886 for a detailed discussion of valuation issues that arise in the context of a buy-sell agreement.

Adequate life insurance is as essential in financing the buy-sell agreement, as would be the case were the parties unrelated. Since the spouses are partners in the business, each should carry life insurance upon the life of the other.

If the surviving spouse is to carry on the business after the death of the first-to-die as legatee, rather than as purchaser under a buy-sell agreement, insurance on his or her life payable

1. *Spivak v. Bronstein*, 79 A. 2d 205 (1951).

to the surviving spouse for business purposes is advisable, if not essential. Without a special fund available to satisfy partnership creditors and to hire the assistance necessary to do some of the work previously performed by the first-to-die, the surviving spouse may find it difficult to continue the business. With adequate life insurance proceeds at his or her disposal, and with adequate experience in the business gained as an active partner, the surviving spouse is given an opportunity to continue the business successfully.

8877. What special considerations arise when developing a business succession plan for a family partnership that is formed between a parent and adult children?

In this type of partnership, disposition of partnership interests by will on the death of a partner is seldom a satisfactory solution. In the case of a married child, a bequest of his or her partnership interest often would be made to a surviving spouse, and in many instances might lead to the liquidation of the business as being preferable to taking the surviving spouse into the firm. The same result could follow should the parent bequeath his partnership interest to his or her surviving spouse. On the other hand, if the parent bequeaths his or her interest to the children and such interest comprises the major part of his estate, the surviving spouse may be able to elect to take against the will and thereby upset the bequest of the partnership interest.

A specially designed buy-sell agreement usually will be a desirable solution. Under such an agreement the children will agree to purchase their parent's partnership interest upon his or her death and to maintain insurance on his or her life with which to finance the purchase. The insurance proceeds will be collected by the children, or by a trustee acting for them, and paid over to the executor of the parent's estate to meet the cash needs of estate administration and to fulfill bequests to the surviving spouse of the balance of the funds.

Thus, the surviving spouse will be assured adequate income and will not be able to upset the plan, even though there is little other estate property. Where division of the estate is not a problem and the parent wishes to leave something to the children, the plan may be modified by giving the children a bargain price in the agreement, or by having them purchase a portion of the parent's interest while he or she bequeaths the remaining portion to them.

In the case of a partnership between a parent and his married child, in most instances there should be a traditional cross-purchase agreement (see Q 8852 to Q 8859). Where there are at least two children as partners with their parent, the parent may not desire to increase his or her interest in the firm if a child dies first. In this case, the agreement should provide for a cross-purchase between the children in the event of the death of one of them.

8878. How can the existence of preferred stock complicate business succession planning in the context of a family-owned business?

In the context of a family-owned business, many business owners may consider creating a class of preferred stock to help provide for a smooth transition of business ownership to the next generation of family members. This can actually create problems that will actually complicate the transition process.

First, small business owners must be advised that the creation of a second class of stock can cause a currently existing S corporation to lose its S corporation status, because S corporations are only permitted to issue a single class of stock.¹ Secondly, if a currently existing corporation wishes to convert to S corporation status in the future, the existence of the class of preferred stock will make the conversion impossible unless all existing preferred shareholders agree to exchange those shares for a single class of stock that is generally available to all shareholders.

Further, the rules contained in IRC Section 2701 can thwart a business owner's plans to transfer interests gift tax-free to family members by setting the value of any retained preferred business interest (known as an "applicable retained interest," see below) that does not contain a right to receive a "qualified payment" at zero if there is a transfer of a common equity interest in the business to a family member.²

Essentially, these rules require that the transferring family member treat the retained preferred stock interests as a taxable gift to the family member to whom the common stock interests are sold. The rules imposed under IRC Section 2701 are designed to prevent a scenario where the older generation creates a class of preferred shares (which he or she retains) in order to avoid paying gift taxes on common shares (which he or she transfers to the younger generation).

For example, before the enactment of Section 2701, a business owner may have created a class of preferred shares with a value that was equal to the current value of the business, retaining these preferred shares. The business owner could then transfer a class of common shares to his or her child that had no current value, and thus generated no gift tax liability. By fixing the value of an applicable retained interest at zero (in the absence of a qualified payment right), Section 2701 seeks to prevent this result. Essentially, the rules provide that the taxable gift can only be avoided if the parent who retains the preferred stock receives a qualified dividend payment (which will establish the value of the preferred stock) on a fixed basis (either as a set amount or specified percentage of the stock value) going forward, and that such dividends are actually paid. This can create additional tax liability for the parent and also reduce the operating capital of the company itself.

Where an applicable retained interest includes a distribution right which consists of the right to receive a qualified payment and there are one or more liquidation, put, call, or conversion rights with respect to such interest, the value of all such rights is to be determined by assuming that each such liquidation, put, call, or conversion right is exercised in a manner which results in the lowest value.³ IRC Section 2701 does not apply to distribution rights with respect to qualified payments where there is no liquidation, put, call, or conversion right with respect to the distribution right.⁴

1. IRC Sec. 1361(b)(1)(D).

2. IRC Sec. 2701(a)(3).

3. IRC Sec. 2701(a)(3)(B).

4. IRC Sec. 2701(a)(3)(C).

The rules imposed under IRC Section 2701 also do not apply if, for either the transferred interest or the applicable retained interest, market quotations are readily available (as of the date of transfer) on an established securities market. Further, the rules do not apply if the applicable retained interest is of the same class as the transferred interest, or if the applicable retained interest is proportionally the same as the transferred interest (disregarding nonlapsing differences with respect to voting in the case of a corporation, or with respect to management and limitations on liability in the case of a partnership).¹ An exception from the rules is also provided for a transfer of a vertical slice of interests in an entity (defined as a proportionate reduction of each class of equity interest held by the transferor and applicable family members in the aggregate).²

Definitions

An “applicable retained interest” is any interest in an entity with respect to which there is (1) a distribution right and the transferor and his or her family members control the entity immediately before the transfer, or (2) a liquidation, put, call, or conversion right (i.e., rights commonly granted to holders of preferred stock).³

A “qualified payment” means any dividend payable on a periodic basis at a fixed rate (including rates tied to specific market rates) on any cumulative preferred stock (or comparable payment with respect to a partnership). With respect to the transferor, an otherwise qualified payment is to be treated as such unless the transferor elects otherwise. With respect to applicable family members, an otherwise qualified payment is not to be treated as such unless the family member so elects. A transferor or a family member can make an irrevocable election to treat any distribution right (which is otherwise not a qualified payment) as a qualified payment, payable at such times and in such amounts as provided in the election (such times and amounts not to be inconsistent with any underlying legal instruments creating such rights).⁴ The value assigned to a right for which an election is made cannot exceed fair market value (determined without regard to IRC Section 2701).⁵

A “member of the transferor’s family” includes the transferor’s spouse, lineal descendants of the transferor or transferor’s spouse, and the spouse of any such descendant.⁶ An “applicable family member” with respect to a transferor includes the transferor’s spouse, an ancestor of the transferor or transferor’s spouse, and the spouse of any such ancestor.⁷ An individual is treated as holding interests held indirectly through a corporation, partnership, trust, or other entity.⁸ In the case of a corporation, “control” means 50 percent ownership (by vote or value) of the stock. In the case of a partnership, “control” means 50 percent ownership of the capital or profits interests, or in the case of a limited partnership, the ownership of any interest as a general

1. IRC Sec. 2701(a)(2).

2. Treas. Reg. §25.2701-1(c)(4).

3. IRC Sec. 2701(b).

4. IRC Sec. 2701(c)(3).

5. Treas. Reg. §25.2701-2(c)(2).

6. IRC Sec. 2701(e)(1).

7. IRC Sec. 2701(e)(2).

8. IRC Sec. 2701(e)(3).

partner.¹ When determining control, an individual is treated as holding any interest held by an applicable family member (see above), including (for this purpose) any lineal descendant of any parent of the transferor or the transferor's spouse.²

8879. How can the existence of voting stock create adverse estate tax consequences in the context of a transfer of stock in a controlled corporation?

When a taxpayer transfers property in which he or she retains certain rights, the value of that property will be included in his or her estate for estate tax purposes.³ IRC Section 2036 specifically provides that retaining the right to vote shares in certain corporations constitutes a right that will generate estate tax inclusion even if the shares themselves are actually transferred. This is the case whether the right to vote is retained directly or indirectly (such as through the use of a trust entity or informal agreement).⁴

In order for the value of transferred voting stock to be included in the original shareholder's estate, the corporation must be considered a "controlled corporation." A corporation is a controlled corporation if, at any time after the transfer and during the three-year period ending on the date of the decedent's death, the decedent-transferor owned at least 20 percent of the combined voting power of all classes of the corporation's stock. In determining the 20 percent ownership test, the family attribution rules of IRC Section 318 apply.⁵

As a result, the transferring owner will be treated as though he or she owns (1) any stock owned (either directly or indirectly) by his or her spouse, children, grandchildren or parents, (2) a proportionate share of any stock owned by a partnership or estate in which the transferor is either a partner or beneficiary, (3) a proportionate share of any stock owned by a trust of which he or she is a beneficiary or grantor and (4) stock owned by a corporation if he or she owns 50 percent or more of the value of that corporation. These broad attribution rules expand the reach of IRC Section 2036, making the transfer of nonvoting stock the most effective way to avoid the risk that the value of the shares will eventually be included in the transferor's estate.

8880. Can a qualified terminable interest property (QTIP) trust be useful in reducing the estate tax burden in a family business' succession plan?

In the context of a family-owned business owned by one spouse, a qualified terminable interest property trust is a tool that may be used in reducing the estate tax burden upon the death of the first-to-die spouse if the business interests would otherwise be included in the taxable estate. Essentially, this strategy is used to remove a portion of the first-to-die spouse's interests from his or her estate so that the value of that estate is reduced to below the applicable estate tax exemption amount (\$5.34 million in 2014).

1. IRC Sec. 2701(b)(2).

2. IRC Sec. 2701(b)(2)(C).

3. IRC Sec. 2036(a).

4. IRC Sec. 2036(b).

5. IRC Sec. 2036(b)(2).

A qualified terminable interest property trust is a trust containing “qualified terminable interest property” (QTIP), which is property (1) which passes from the decedent, (2) in which the surviving spouse has a “qualifying income interest for life,” and (3) as to which the executor makes an irrevocable election on the federal estate tax return to have the marital deduction apply.

The surviving spouse has a “qualifying income interest for life” if (1) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and (2) no person has a power to appoint any part of the property to any person other than the surviving spouse unless the power is exercisable only at or after the death of the surviving spouse.¹ Apparently, the last requirement is violated even if it is the surviving spouse who is given the lifetime power to appoint to someone other than the surviving spouse.²

Importantly, this strategy allows the spouse who actually controlled the business to direct how the *principal* (the actual business shares) will be disposed of after the death of the surviving spouse. However, if the QTIP trust is funded with a minority interest in the business, and the estate contains a controlling interest, it is possible that a control premium and minority discount (see Q 8894) may impact the valuation of the shares for estate tax purposes. In this case, the shares that form the controlling interest may be given a higher value than anticipated (and the shares included in the QTIP trust may be given a *lower* value than anticipated), thus increasing the estate value while correspondingly decreasing the value of the marital deduction that will result from the use of the QTIP strategy.

As a result, the business owner should consider the impact of the control premium and minority discount valuation issues, and either (1) transfer additional assets from the estate to the QTIP trust in order to reduce the value of the estate to below the exemption level or (2) ensure that sufficient shares are transferred into the QTIP trust so that the estate will not be deemed to hold a controlling interest in the business.

See Q 8881 for a discussion of the implications of using a QTIP trust to transfer small business interests in the context of a buy-sell agreement.

8881. Can a qualified terminable interest property (QTIP) trust be used in a family business succession plan if the business interests at issue are subject to a buy-sell agreement?

Using a qualified terminable interest property (QTIP) trust where the business interests at issue are subject to a buy-sell agreement can create estate tax problems if the stock value set by the buy-sell agreement does not meet the requirements of IRC Section 2703 (see Q 8886). Generally, if the requirements of Section 2703 are satisfied, the price specified under the buy-sell agreement will control for estate tax purposes.³

1. IRC Sec. 2056(b)(7).

2. TAM 200234017.

3. See, for example, *Slocum v. U.S.*, 256 F. Supp. 753 (S.D.N.Y. 1966).

If the requirements are not satisfied, however, the price may be adjusted so that it reflects the true fair market value of the stock. As a result, if the value is adjusted upward, the shareholders who are subject to the buy-sell agreement may be deemed to have received an economic benefit from the surviving spouse's QTIP because those shareholders were granted the right to purchase the shares at a lower price.

To qualify as QTIP property, no person may be given a power to appoint any part of the property to any person other than the surviving spouse unless the power is exercisable only at or after the death of the surviving spouse (see Q 8880).¹ If a third party is given the power to purchase shares that would otherwise be QTIP at a price that is eventually found to be lower than fair market value, the QTIP trust may be ineligible for QTIP treatment because, effectively, the difference between the lower price specified in the buy-sell agreement and the higher true fair market value is treated as income that is derived from the shares and granted to a party other than the surviving spouse.²

Similarly, if the buy-sell agreement prohibits the QTIP trust from selling the stock without the consent of a third party, the shares will likely fail to qualify as QTIP. One of the essential requirements of a QTIP trust is that it must entitle the surviving spouse to receive all of the income derived from the trust principal. In order to give effect to this requirement, the regulations provide that the surviving spouse must be given the power to require that the trustee convert any unproductive property into income-producing property.³ If stock contained in a QTIP trust cannot be sold without the permission of a third party, the surviving spouse's income rights are not absolute and the property may fail to qualify for the marital deduction.⁴

8882. Should the transfer of stock to a successor generation pursuant to a family business succession plan be structured as gifts or compensation?

While each small business is different, many family-owned businesses prefer to structure the transfer of stock to the next generation as compensation, rather than making the transfer by gifts.

The compensation structure, while generating taxable income for the successor generation, offers a tax deduction to the company that will often offset any income tax liability that is created.⁵ While the income tax liability may be deferred under IRC Section 83 if the transferred stock is subject to a substantial risk of forfeiture, in the family business context, the income tax liability incurred by the successor-employee can often be eliminated through a bonus or other additional compensation.

The compensation structure may be preferable to transferring stock to the successor generation via gifts because the successor-employee will receive a basis in the stock that is equal

1. IRC Sec. 2056(b)(5).

2. See TAM 9147065, where it was found that the first-to-die spouse granted an option for his sons to grant themselves the excess of the fair market value of the shares over the option price, thus defeating the property's QTIP status.

3. Treas. Reg. §20.2056(b)-5(f)(4).

4. Let. Rul. 9147065.

5. IRC Secs. 83(a), 83(h), 162(a).

to its fair market value on the date of transfer.¹ Conversely, if the transaction is structured as a gift, the successor-employee will receive a basis in the stock that is equal to its basis in the hands of the transferor (a carryover basis).² For stock that has appreciated with time, this can reduce any gains that the successor would be required to recognize should the stock eventually be transferred again in the future.

Further, the compensation structure eliminates any gift tax liability that would be incurred if the transfer were made through gifts. By structuring the transfer of company stock as compensation, the parent generation is not required to use up any of its gift tax annual exclusion or lifetime exemption amount by making the transfer—leaving it free to reduce its taxable estate further by making other gifts of property to the successor generation.

8883. How can a three-year grantor retained income trust (GRIT) be used in family business succession planning?

A grantor retained income trust (GRIT) is an irrevocable trust created by the grantor allowing him or her to retain an income interest for a term of years. At the end of the term, the property held in trust is distributed to or remains in trust for the named beneficiaries. If the grantor survives beyond the retained income term, then the property transferred in trust—the remainder interest in the trust property—is not included in the grantor's estate. Although the transfer of a remainder interest is a taxable gift—a gift tax is due when the transfer is made—a GRIT can reduce a grantor's overall transfer tax liability because the gift tax is based on the value of the remainder when transferred. Thus, any appreciation in the remainder property (from the date of the gift to the date of the grantor's death) is effectively transferred estate tax-free. However, if the grantor dies before the retained income period expires, the trust property is included in the grantor's estate and will be subject to estate tax.

A three-year GRIT is simply a GRIT whose specified term is three years—a time period that stems from the general rule that gifts that are made within three years of a donor's death will be brought back into the donor's estate.³ In this context, a gift of stock is transferred to a GRIT that provides that all income from the trust will be paid to the parent generation for a period of three years. Because this income right is not a fixed amount or fixed percentage of the fair market value of the stock transferred, it is not a "qualified interest,"⁴ so that the value of the income interest—or the "retained interest"—will be zero.⁵ This means that, for gift tax purposes, the value of the interest that remains at the end of the term will be the entire value of the stock transferred.⁶ Effectively, this strategy is most valuable when the parent generation has determined that it is willing to pay the gift taxes on the stock transfer currently in order to avoid the inclusion of the appreciated stock in their estate.

1. IRC Sec. 1012, Treas. Reg. §1.83-4(b).

2. IRC Sec. 1015(a).

3. IRC Sec. 2035.

4. Treas. Reg. §25.2702-3(b).

5. Treas. Reg. §25.2702-1.

6. IRC Sec. 2702, Treas. Reg. §25.2702-1(b).

At the end of the three-year period, the stock will pass to the next generation. The risk of this strategy is that, if the parent generation dies within the three-year period, the value of the stock (including any appreciation that occurs within the three-year period) and all gift taxes paid will be included in the parent's estate (although the estate will receive a credit for the gift taxes already paid). If the parent outlives the three-year period, this risk is eliminated and any appreciation in the stock is transferred estate tax-free.

PART XV: SMALL BUSINESS VALUATION

8884. How is the value of a small business determined? Why is valuing a small business different from valuation in other business contexts?

Small business value, as in other valuation contexts, is usually defined in terms of “market value” or “fair market value,” which means the amount a willing buyer would pay a willing seller for property (the individual business interests) or a business enterprise, assuming that each party to the transaction has reasonable knowledge of all material facts and that neither is under a compulsion to buy or sell. In the small business context, valuation is often problematic because, typically, there is no established secondary market in which the business interests are bought and sold, whereas a larger entity may be traded on an established market so that its fair market value is easily established by current trading prices.

Further, the business owners are typically very involved in the day-to-day operations and management of a small business—meaning that the current owners’ exit from the business can dramatically impact the business’ future operations and, thus, its current value.

Often, valuation issues in the small business context become important when the owner-managers seek to transfer their interests in the business to related parties—typically children or grandchildren. Even if these business succession plans are structured as bona fide sales, rather than outright gifts, the IRS is more likely to closely scrutinize the transaction in order to ensure that the interests were valued based on their market value, however limited, to avoid transitioning the business using artificially low values in order to disguise a gift transaction.

Similarly, estate tax valuation is often important in the small business context because of the lack of an established market to provide an objective valuation benchmark for determining the value that must be included in a deceased owner’s taxable estate.

Because of these factors, the IRS has recognized that there is no one exact formula that can be used in valuing a small business, and that the valuation process, by its nature, requires a fact intensive inquiry over which even independent expert appraisers might disagree.¹ Despite this, a series of general principles governing valuation of small business interests has emerged to provide guidance to the small business owner. At a high level, three methods of business valuation exist: asset valuation, income valuation and market valuation. The asset valuation approach (an asset sale) is often the default if no action is taken by the business owner and/or if the business owner dies while in business. Although the details can get complicated as it applies to specific fact situations, this method simply involves taking the sum of the assets and subtracting the liabilities to find the value of the business. This method is not appropriate for certain types of businesses. In the case of professional service organizations comprised of professionals such as attorneys, doctors, accountants and financial planners, the business’ tangible assets can be of negligible value, which could cause a vast undervaluation of the business.

Income valuation and market valuation are discussed at Q 8888 and Q 8889.

1. Rev. Rul. 59-60, 1959-1 CB 237.

General valuation principles are discussed in Q 8885, while Q 8886 outlines the potential impact of a buy-sell agreement upon valuation. Q 8887 addresses some of the more specific issues that arise when the business interests are composed of corporate stock.

Special estate tax valuation rules are discussed in Q 8895. See Q 8852 to Q 8883 for a discussion of business succession planning in general.

8885. What general principles govern small business valuation for estate and gift tax purposes?

The fair market value of any interest in an “unmarketable business,” whether it is structured as a partnership, corporation, limited liability company, or a proprietorship, is the amount that a willing buyer, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. The net value is determined on the basis of all relevant factors, including the following:

- (1) The value of all the assets of the business, tangible and intangible, including goodwill (see Q 8890 and Q 8891);
- (2) The demonstrated earning capacity of the business; and
- (3) The other factors set forth in the regulations¹ relating to valuation of corporate stock, to the extent applicable.

Adequately determining the value of a small business’ “goodwill” requires special attention, as it is an especially fact intensive determination. Complete financial and other data upon which the valuation is based should be submitted with the relevant tax return, including copies of reports of examinations of the business made by accountants, engineers, or any technical experts as close to the applicable valuation date as possible.²

Professional appraisers, courts and the IRS generally follow the principles laid out in Revenue Ruling 59-60 when valuing the stock of a closely-held corporation or the stock of corporations where market quotations are not readily available. The factors outlined in Revenue Ruling 59-60 also apply in valuing interests of other business entities, such as closely-held partnerships or LLCs, for gift tax or estate tax purposes.

Typically, in a valuation challenge today, the courts will adopt a “winner take all” approach, rather than seeking a compromise position between the two parties’ competing valuation proposals. This is because the Tax Court has found that the “compromise the difference” approach that was historically used by the courts merely encouraged the parties to assert extreme values, forcing the courts to determine a reasonable middle ground between those two extreme positions.

1. See Treas. Regs. §§20.2031-2(f), 20.2031-2(h), 25.2512-2(f).

2. Treas. Regs. §§20.2031-3, 25.2512-3.

The Tax Court adopted its “winner take all” approach in a 1980 valuation decision, *Buffalo Tool & Die Manufacturing Company, Inc. v. Commissioner*,¹ finding that the parties were fully capable of reaching an agreement themselves in order to avoid the judicial process (and the related expenses) altogether. Therefore, the court reasoned that the threat that the other party’s valuation approach would be adopted in its entirety would motivate more careful analysis by the parties before resulting to judicial intervention. This is the approach that the majority of courts now take with respect to valuation decisions.²

8886. How does the existence of a buy-sell agreement impact small business valuation?

As discussed in Q 8852 to Q 8867, a buy-sell agreement can function as an important business succession planning tool, as it allows the business owners to plan for the orderly withdrawal of one or more business owners and will specify a predetermined method for determining the price of the business interests. Despite this, IRC Section 2703 provides that the value of any interest must be determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to the option, agreement, or other restrictions) or any restriction on the right to sell or use the property (i.e., buy-sell agreement), unless the agreement meets the following requirements:

- (1) It is a bona fide business arrangement;
- (2) It is not a device to transfer the property to members of the decedent’s family for less than full or adequate consideration; and
- (3) It has terms comparable to those entered into by persons in an arm’s length transaction.³

Assuming these requirements are met, it is possible that the *estate tax* value of a business interest (including closely-held stock) may be controlled by the price or formula contained in a buy-sell agreement.

Though the facts of each case must be examined to determine whether the agreement price will be accepted for estate tax purposes,⁴ case law has established that if the following conditions are met, the agreement price will hold, even though the fair market value of the business interest may be substantially more at the valuation date than the agreement price:

- (1) The estate must be obligated to sell at death (under either a mandatory purchase agreement or an option held by the designated purchaser, see Q 8858);

1. 74 TC 441.

2. *Est. of McGill v. Comm.*, TC Memo 1984-292 (voting trust certificates); *Est. of Gallo v. Comm.*, TC Memo 1985-363 (closely held stock); *Est. of Gillet v. Comm.*, TC Memo 1985-394 (closely held stock); *Est. of Rubish v. Comm.*, TC memo 1985-406 (ranch); *Est. of Watts v. Comm.*, TC Memo 1985-595 (partnership interest).

3. IRC Sec. 2703.

4. Treas. Regs. §§20.2031-2(h), 20.2031-3; Rev. Rul. 59-60, 1959-1 CB 237.

- (2) The agreement must prohibit the owner from disposing of his interest during his lifetime at a price higher than the contract or option price;
- (3) The price must be fixed by the terms of the agreement or the agreement must contain a formula or method for determining the price; and
- (4) The agreement must be an arm's length business transaction and not a gift. Thus, the purchase price must be fair and adequate at the time the agreement is made, particularly if the parties are closely related.¹

Therefore, the price set in a buy-sell agreement was found to control valuation issues in a number of cases involving estate tax valuation where these requirements were satisfied.² For gift tax purposes, however, an agreement restricting lifetime sale will be considered with all other pertinent factors, and may tend to lower the value of the business interest.³

If a business purchase agreement calls for shares to be purchased from an estate with installment purchase notes bearing a rate of interest lower than the market rate at the date of death, an executor may be allowed to discount the value of the shares by the difference between the interest rate called for in the buy-sell agreement and the prevailing rate at the date of death.⁴

A first-offer agreement, under which survivors have no enforceable right to purchase the business interest and can purchase the interest only if the executor wishes to sell, does not fix the value of the interest for estate tax purposes.⁵

If an agreement is between closely related persons and is found to be merely a scheme for avoiding estate taxes, the price set in the agreement will not control.⁶ A buy-sell agreement is not binding unless it represents a bona fide business agreement and is not testamentary in nature.⁷ An agreement may be found to be a scheme for avoiding estate taxes, however, even if it also serves a bona-fide business purpose.⁸

No effect will be given to an option or contract under which a decedent is free to dispose of the interest or shares at any price he or she chooses during life.⁹

1. *Slocum v. U.S.*, 256 F.Supp. 753 (S.D.N.Y. 1966).

2. *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955); *May v. McGowan*, 194 F.2d 396 (2nd Cir. 1952); *Comm. v. Child's Estate*, 147 F.2d 368 (2nd Cir. 1952); *Comm. v. Bensel*, 100 F.2d 639 (3rd Cir. 1939); *Lomb v. Sugden*, 82 F.2d 166 (2nd Cir. 1936); *Wilson v. Bowers*, 57 F.2d 682 (2nd Cir. 1932); *Mandel v. Sturr*, 266 F.2d 321 (2nd Cir. 1959); *Fiorito v. Comm.*, 33 TC 440, acq. 1960-1 CB 4; *Est. of Littick*, 31 TC 181, acq. in result, 1984-2 CB 1; *Est. of Weil*, 22 TC 1267, acq. 1955-2 CB 10; *Est. of Salt*, 17 TC 92, acq. 1952-1 CB 4; *Est. of Maddock*, 16 TC 324, acq. 1951-2 CB 3. See also Treas. Regs. §§20.2031-2(h), 20.2031-3.

3. *Est. of James v. Comm.*, 148 F.2d 236 (2nd Cir. 1945); *Kline v. Comm.*, 130 F.2d 742 (3rd Cir. 1942); *Krauss v. U.S.*, 140 F.2d 510 (5th Cir. 1944); *Comm. v. McCann*, 146 F.2d 385 (2nd Cir. 1944); *Spitzer v. Comm.*, 153 F.2d 967 (8th Cir. 1946); Rev. Rul. 189, 1953-2 CB 294.

4. Let. Rul. 8245007.

5. *Worcester County Trust Co. v. Comm.*, 134 F.2d 578 (1st Cir. 1943); *City Bank Farmers Trust Co. v. Comm.*, 23 BTA 663 (1931), acq. 1932-1 CB 2; *Michigan Trust Co. v. Comm.*, 27 BTA 556 (1933).

6. *Slocum v. U.S.*, 256 F.Supp. 753 (S.D.N.Y. 1966).

7. *Est. of True v. Comm.*, 2004-2 USTC ¶60,495 (10th Cir. 2004).

8. *St. Louis County Bank v. U.S.*, 49 AFTR 2d ¶1509 (8th Cir. 1982).

9. *Est. of Caplan v. Comm.*, TC Memo 1974-39; *Est. of Gannon v. Comm.*, 21 TC 1073 (1954); *Est. of Trammell v. Comm.*, 18 TC 662 (1952), acq. 1953-1 CB 6; *Est. of Mathews v. Comm.*, 3 TC 525 (1944); *Hoffman v. Comm.*, 2 TC 1160 (1943); *Est. of Tompkins v. Comm.*, 13 TC 1054 (1949); Rev. Rul. 59-60, 1959-1 CB 237.

On the other hand, an agreement that restricts sale during life, but not at death, also will fail to fix the estate tax value.¹

8887. How are shares of stock valued in a closely-held corporation?

IRC Section 2031(b) governs valuation, for estate tax purposes, of unlisted stocks and securities. Essentially, this provision provides that the value of securities of corporations involved in the same or similar business may be considered in cases where the small business at issue has no readily available market price because its interests are neither listed on a public exchange nor frequently traded.

Revenue Ruling 59-60 contains a broad discussion of factors that the IRS believes should be considered in valuing shares of stock in closely-held corporations or in corporations where market quotations are either lacking or too scarce to be recognized.² The IRS has found that in these cases, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following nonexhaustive list of factors are important in this analysis:

- (1) The nature of the business and the history of the enterprise from its inception;
- (2) The economic outlook in general and the condition and outlook of the specific industry in particular (see Q 8892);
- (3) The book value of the stock and the financial condition of the business;
- (4) The business' earning capacity;
- (5) The business' dividend-paying capacity;
- (6) Any goodwill or other intangible value that can be attributed to the business (see Q 8890 and Q 8891);
- (7) Sales of the stock and the size of the block of stock to be valued (see Q 8894); and
- (8) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter (see Q 8888).³

In general, when valuing an operating company that sells goods and services, primary consideration is given to earnings, and when valuing a company that merely holds investments, primary consideration is given to asset values. However, if a company is not easily characterized as one or the other, both earnings and assets must be considered.⁴ For a discussion of the impact of a buy-sell agreement on valuation, see Q 8545.

1. *Land v. U.S.*, 303 F.2d 170 (5th Cir. 1962).

2. 1959-1 CB 237.

3. Rev. Rul. 59-60, Sec. 4.01.

4. *Martin v. Comm.*, TC Memo 1985-424.

8888. What is the market valuation approach used in valuing closely-held business interests?

The market valuation approach to valuing closely-held business interests attempts to determine the value of stock in a closely-held corporation by comparing it to the price of publicly traded shares in a comparable business. Revenue Ruling 59-60 guidelines (discussed in Q 8887) suggest that comparable business entities in the same or similar line of business must be identified as a starting point in this analysis. Once one or more comparable entities are located, their price/earnings (P/E) ratio must be determined. The P/E ratio is the price per share divided by the earnings of the applicable stock over the most recent 12 month period. This ratio illustrates the investor interest in the stock based on its current selling price on a recognized exchange or on the over-the-counter market.

When evaluating stock of a comparable publicly traded company, it should be remembered that only a small portion of the capital stock issued and outstanding is traded daily. As a result, such trades represent only minority-interest trading. Nevertheless, the P/E ratio of stock in a comparable publicly traded company is relevant because unlike closely-held shares, publicly traded stocks have daily marketability through their respective exchanges, so price is always a known factor.

P/E ratios may fluctuate due to special situations—extraordinary losses or gains may occur in one year or the sale of a subsidiary may cause fluctuations. Moderate P/E fluctuations should be disregarded. However, if a company exhibits wide variations due to extraordinary losses or gains, it may be too volatile to be used as a meaningful basis for comparison.

Marketability Discount

The discussion concerning market valuation assumes that what is being sold or purchased is some type of minority share value with daily marketability. However, there is rarely a ready market for shares in a closely-held company. In addition, most closely-held companies do not provide financial data to the public and may not even provide it to minority shareholders. Finally, closely-held companies frequently place restrictions on stock.

All these “unknowns” work to limit the marketability of closely-held stock and introduce a marketability discount. Such discounts may range anywhere from 10 percent to 50 percent or more. (The larger discounts usually apply to minority blocks as opposed to controlling interests.) Marketability discounts must be determined on a case by case basis. Ultimately, the exact amount of the discount may not be known until the seller and buyer agree on a price per share. Nonetheless, it should be remembered that closely-held stock will almost always be valued at a lower rate than comparable publicly traded stock because of the marketability discount associated with closely-held companies (see Q 8884). See Q 8894 for a detailed discussion of the application of control premiums and minority discounts in small business valuation.

8889. What is the income valuation approach that is used in valuing closely-held business interests?

The income approach to valuing closely-held business interests is primarily based on an estimation of future earnings capacity. The first step in the process of calculating future earnings

is to obtain any financial plans prepared by the company. The next step is to project the company's cash flow for a minimum of five years. These projections should be based on information about the recent past, including the company's profit-and-loss statements. Company sales and income are also frequently used to predict future cash flow.

In cases where the company has an erratic history of sales and earnings, the process may become more complex. In these situations, the reason behind the irregular financial past must be determined. An important element in this analysis involves determining whether the company is operating in a cyclical industry prone to yearly swings in sales and income. If so, other industry firms can be expected to show similar cyclical behavior. Recognizing an industry cycle should provide clues to future financial performance.

If the industry is non-cyclical, firm records must be reviewed to determine the specific reasons or events that caused the erratic history. Questions to ask include:

- (1) Does the company face heavy debt?
- (2) Is management lacking in experience or depth?
- (3) Have products not been brought to market in a timely manner?
- (4) Has growth been too rapid?
- (5) Was expansion poorly planned?

A problem in any of these areas may signal problems in the future as well.

When predicting cash flow, the standard practice is to forecast five years into the future and discount each year's cash flow back to present value, by using a market-indicated rate of return. Risks faced generally by the industry in which the company operates should also be factored into this equation. The fifth year value of the company must be estimated by capitalizing the fifth-year cash flow, using an appropriate rate of return that considers both company and industry risk. The fifth year value is translated into present value by using a discount rate derived from the market rate.

The sum of the discounted cash flows for five years and the present value of the capitalized fifth year results in the fair market value of the company under this valuation approach.

8890. How is "goodwill" important in valuing small business interests?

Goodwill is an intangible business asset that includes attributes such as the business' reputation, client and supplier relationships and potential for repeat business. In the closely-held business context, IRS Revenue Ruling 59-60 specifically identifies goodwill as a factor that must be valued in order to determine the company's overall fair market value.

An important consideration in determining the presence of goodwill, and whether this goodwill is transferable, involves whether the general performance of the business depends upon

a certain individual or a group of individuals. If this is the case, this goodwill may be lost if the business is sold without the continued participation of these individuals.¹

Though the IRS has recognized that the personal skill of one owner or a group of owners often cannot (or will not) be sold along with the business,² it has recognized that such skill can add substantially to the value of the business by enhancing the reputation of that business.³ However, in order for the value of the business to be increased by the goodwill established by departing business owners, the IRS requires that those departing owners relinquish all rights to that goodwill. Therefore, for example, if a business owner or group of owners sell their business without allowing the purchasers to use their existing business name, no goodwill has been transferred that would increase the value of the business.⁴

8891. What factors are used in determining the intangible value of a small business?

As is typical in small business valuation, the IRS has indicated that the extent to which a business' value is attributable to intangible value in the form of goodwill must be determined on a case by case basis.⁵ At its most basic level, the value that exceeds the value of the business' tangible assets is attributed to its goodwill. Goodwill is determined by deciding how much a purchaser would pay for this excess value, which is the product of intangibles such as reputation and market position (see Q 8890).

Because of the fact-intensive nature of the inquiry, there are no specific factors that must be considered in determining the goodwill of a small business. Often, the value of goodwill will depend upon the business' earning capacity and projected future earning capacity, but it can also include value attributable to the business' prestige, whether it owns a trademark or brand name and its record of successful operation over a prolonged period of time.⁶

A business that derives much of its success from the services provided by its owners, such as a group of doctors or accountants, will often assign significant value to the goodwill generated by the reputations of these professionals. Conversely, if the business is primarily asset-driven, where the physical equipment or structures producing a product may be more important than the personal services of a business owner, goodwill may be assigned a lesser value. However, even in a product-driven business, if the reputation of concrete products produced by the business provides motivation for repeat business, the business' goodwill should be assigned a higher value.

The courts have held that the value of personal relationships established by a shareholder-employee or other business owner are generally not corporate assets, and therefore may not be considered in determining the value of goodwill, unless the individual has committed

1. See *Zorniger v. Comm.*, 62 TC 435 (1974), *Akers v. Comm.*, 6 TC 693 (1946), *Norwalk v. Comm.*, T.C. Memo 1998-279.

2. See *Providence Mill Supply Co. v. Comm.*, 2 BTA 791 (1925).

3. Rev. Rul. 64-235, above.

4. Rev. Rul. 57-480, 1957-2 CB 47.

5. Rev. Rul. 64-235, above.

6. Rev. Rul. 59-60, 1959-1 CB 237.

to continuing services to the business, whether contractually or otherwise. In this context, non-compete agreements and traditional employment agreements may be useful in establishing such a commitment.¹

Because the standards for valuing goodwill are so amorphous, the IRS has proposed a formula that may be used to value goodwill in the event that the parties are unable to assign value based upon past earnings performance and perceived reputational value. Under this formulaic approach, the owners must first determine the return on the average annual value of the business' tangible assets over a period of time (the IRS recommends five years). The percentage of returns that are based on tangible assets is subtracted from the total average earnings of the business over the same period of time. The remaining value is considered to represent earnings from the business' intangible assets, including goodwill. This value is then capitalized (at a suggested rate of 15 to 20 percent, depending upon the individual level of business risk) to allocate a value to those intangible assets.²

Any abnormal years should be excluded from the period used for averaging under this formula. In determining the rate of capitalization that is most appropriate, the IRS has indicated that the owners must consider factors such as (1) the nature of the business, (2) the risks involved in the business and (3) the stability or irregularity of earnings.

It is important to note that the IRS only recommends use of this formula if the parties are unable to otherwise realistically assign value to a business' goodwill through another reasonable approach that is based on factors more specific to the particular business.

8892. What types of external risks are important in determining the value of a small business?

As in any other business context, the value of a small business may be substantially impacted by external pressures and risk factors. As such, the IRS recognizes that the general economic outlook and industry-specific risk factors must be considered in determining the overall value of the business.³

In this analysis, it is important to identify industry trends that have emerged, and whether the business' management is aware of these trends and planning to take advantage of them in their future business plans. While general economic outlook is an important consideration in assigning value to a business, the parties must also consider whether the small business in question tends to prosper in proportion to general economic conditions, or whether its performance is counter-cyclical. If the business' performance is counter-cyclical, valuation must account for the fact that a general market downturn could represent a period of growth within the industry that the business operates.

Investor perceptions toward the industry in which the business operates can also serve as a predictor of current and future business value. To this end, examination of comparable businesses that are traded more regularly can aid in determining the potential for increased value in the

1. *Martin Ice Cream Co. v. Comm.*, 110 TC 189 (1998).

2. Rev. Rul. 68-609, 1968-2 CB 327.

3. Rev. Rul. 59-60.

small business based on industry performance. The IRS, therefore, recognizes that the market prices of stocks of corporations engaged in the same or similar lines of business with actively traded stock, either on an exchange or over-the-counter, can be important in determining investor perceptions that can influence future value.¹

Further, it is important to identify the business' position in the industry with respect to its competitors. In this analysis, whether the individual business is more or less successful than competitors is important, but it is also important to determine whether the industry in which that business operates is competitive with respect to other industries. It must also be determined whether a company that is more successful than its competitors is poised to continue this success. For example, if a company's success is based largely upon the fact that it has developed a product that is new to the market, whether it can maintain this advantage is critical to anticipating future success.²

The courts have also made clear that, in any analysis that determines value partially based upon other business' performance, the comparable businesses that are selected must be appropriately comparable to the small business valuation at issue. For example, the performance of the securities of a holding company, where the primary issue is asset performance, are not appropriately comparable to the potential performance of an operating company, where the primary concern is earnings capacity, and thus should not be used to determine value.³

While there is no formula for determining the impact of various external factors upon the value of a particular small business, the fact-intensive inquiry generally includes an evaluation of the following nonexhaustive list of issues:

- (1) Status of the local labor market;
- (2) The company's reliance on other entities for goods or services;
- (3) The risk or anticipation of merger or acquisition;
- (4) The existence of pending or potential litigation,
- (5) The local, regional and national economies and forecasts; and
- (6) The nature and extent of competition within the company's field.⁴

Both the relevance and the weight accorded to any one of these factors will depend upon the nature of the business and the industry and geographic location in which it operates.

8893. How does the current management structure of a small business impact valuation?

Generally, a small business whose future prospects are completely dependent on the current management team is at a much greater risk and, as a result, less valuable than a company

1. See also the IRS' Business Valuation Guidelines IRM 4.48.4.2.3 (July 1, 2006).

2. Rev. Rul. 59-60.

3. *Estate of Ford v. Comm.*, TC Memo 1993-580.

4. Klaris, "Valuing the Family Business," 129 Tr. & Est. 18 (Feb. 1990).

with good management backup and a well organized system of delegation. The organizational structure of the small business and the degree of control that the business owners exercise over the actual operations are important in determining the impact that the current management structure will have on the value of the business.

As discussed in Q 8890 and Q 8891, in a business where emphasis is placed on the performance of services by specified individuals, rather than the supply of goods through use of tangible assets owned by the business, the presence or absence of these individuals has a much more substantial impact on the business' value.¹ Similarly, where, as many small businesses, operations are directed entirely by a small group, retention of these individuals can be key to maintaining the value of the business. The loss of individuals who have been key to a business' success can reduce the value that should be assigned to that business, especially if there is no succession plan in place.²

The IRS has recognized, however, that such losses can be offset, such as through the use of insurance funding, as in a buy-sell agreement where the company has purchased insurance to help sustain operations if a key owner dies or otherwise withdraws from the business (see Q 8855).³ Such an offset must, therefore, be taken into account when assigning weight to the valuation impact of the current management structure, whether through the retention or loss of certain individuals' services.

8894. How can a majority or minority interest impact the value of a small business interest?

If a block of stock represents a controlling interest in a corporation, a "control premium" may add to the value of the stock. If, however, the shares constitute a minority ownership interest, a "minority discount" is often applied to the value. For example, in *Martin v. Commissioner*,⁴ discounts were applied to shares of stock representing a minority interest in a holding company that, in turn, held minority interests in seven operating companies. In this case, lack of control over both the holding and operating companies, combined with a lack of marketability (see Q 8888), led the court to allow a combined 70 percent discount in valuing the interests.

A premium may also attach for swing vote attributes where one block of stock may exercise control by joining with another block of stock.⁵ The IRS has valued stock included in the gross estate at a premium as a controlling interest, while applying a minority discount to the marital deduction portion which passed to the surviving spouse.⁶

However, the fact that an interest being valued is a minority interest does not always mean that a minority discount is available. Courts have held that, even though the interests at issue are minority interests, a minority discount is not appropriate if there is nothing lost through the minority ownership position. For example, in a case where the decedent owned minority interests

1. See *Providence Mill Supply Co. v. Comm.*, 2 BTA 791 (1925), Rev. Rul. 64-235, above.

2. Rev. Rul. 59-60.

3. Rev. Rul. 59-60, above.

4. TC Memo 1985-424.

5. TAM 9436005.

6. TAM 9403005.

in five partnerships, no discount was available because the partnership agreement required the partnerships to distribute cash flow annually based on a predetermined formula. Therefore, the majority partners would not be able to prevent or alter the partnership distributions and there was no risk that the minority owner would not receive an annual payout.¹

If a donor transfers shares in a corporation to each of the donor's children, the IRS will no longer consider family control when valuing the gift under IRC Section 2512. Thus, a minority discount will not be disallowed solely because a transferred interest would be part of a controlling interest if such interest were aggregated with interests held by family members.² Accordingly, a minority discount has been allowed even when the person to whom the interest was transferred was already a controlling shareholder.³

The Tax Court has determined that an estate would not be allowed a minority discount where the decedent transferred a small amount of stock immediately prior to death for the sole purpose of reducing her interest from a controlling interest to a minority interest for valuation purposes.⁴ Also, a partnership or LLC may be included in the gross estate under IRC Section 2036 without the benefit of discounts if a decedent transfers all of his or her assets to the partnership or LLC and retains complete control over the income of the partnership or LLC.⁵

8895. What special estate tax valuation issues must be considered in the small business context?

In recognition of the limited marketability of closely-held family businesses, and in an effort to encourage the continued operation of these businesses after the death of the business owner, Congress enacted IRC Section 2032A to potentially ease the estate tax liability of successors to family businesses. If the family business includes ownership of real estate used in the business, the estate may be able to take advantage of this special use valuation provision in valuing the real property for inclusion in the gross estate.

Generally, real property is valued on the basis of its "highest and best use," which typically leads to a valuation that reflects the upper limit of the property's potential value. However, a "current use" approach is available for qualified real property used for farming purposes or in certain trades or businesses. "Qualified real property" used in a closely-held business may also qualify for special use valuation.⁶ An estate's executor can elect to value qualified real property used in a closely-held business on the basis of its *actual* use in the business, rather than its highest and best use, if the requirements of IRC Section 2032A, discussed below, are satisfied.

Planning Point: As it applies to real property, farmers and ranchers often feel asset rich and cash poor. The estate tax issues they face are significant and not easily solved. One option to consider are "land grant" non-profit organizations that preserve the ranching/farming heritage and avoid liquidation due to taxes.

1. *Godley v. Comm.*, 2002-1 USTC ¶60,436 (2002) (partnerships held housing projects subject to long-term government contracts).

2. Rev. Rul. 93-12, 1993-1 CB 202, revoking Rev. Rul. 81-253, 1981-2 CB 187.

3. TAM 9432001.

4. *Est. of Murphy v. Comm.*, TC Memo 1990-472.

5. *Est. of Strangi v. Comm.*, TC Memo 2003-145; *Kimbell v. U.S.*, 2003-1 USTC ¶60,455 (2003).

6. IRC Sec. 2032A(a)(1).

The aggregate decrease in the business value permitted through special use valuation under Section 2032A is \$1,090,000 for decedents dying in 2014, as indexed annually for inflation.¹

Section 2032A valuation may be elected if: (1) the qualified property is owned by a U.S. citizen or resident and (2) the executor makes the election under Section 2032A(d)(2).² Qualified real property is real property located in the United States where the following additional conditions are satisfied:

- (1) *Substantial and historical usage.* The IRC Section 2032A election is only available to estates in which a farming or other closely held business comprises a substantial part of the estate. The following requirements apply:
 - (a) (i) 25 percent or more of the adjusted value of the decedent's gross estate must consist of the adjusted value of real property used in the business, and (ii) 50 percent or more of the adjusted value of the gross estate must consist of the adjusted value of real or personal property used in the business;³ and
 - (b) During the eight years immediately preceding the decedent's death, the decedent, or a member of his family, must have (i) owned and used the property⁴ and (ii) materially participated in the business.⁵
- (2) *Future usage to prevent recapture.* Because IRC Section 2032A is intended to encourage continued future use of the property, each person with an interest in the property must sign a written consent to a special recapture tax set forth in 2032A(c).⁶ This requirement is imposed in furtherance of the goal of encouraging the decedent's heirs to continue the business rather than being forced to sell in order to meet tax liabilities.⁷

The recapture tax is imposed if the heir (1) disposes of any interest in the qualified small business property to a non-family member or (2) ceases to use the property for a qualified use (meaning use within the closely-held business) within 10 years of the death of the decedent and before the death of the qualified heir.⁸ Essentially, a "qualified heir" is an heir who is either (1) a surviving spouse; (2) an heir who has not yet reached the age of 21; (3) a disabled individual; or (4) a student.⁹

The numerous requirements imposed under IRC Section 2032A, along with its limited applicability in the estate tax context, naturally mean that the valuation approach will only be useful in limited circumstances.

1. See Rev. Proc. 2013-35, 2013-47 IRB 537.

2. IRC Sec. 2032A(b).

3. IRC Sec. 2032A(b)(1)(A) and (B).

4. IRC Sec. 2032A(b)(1)(C) and (A)(i); Treas. Reg. §20.2032A-3(c)(1) and (d).

5. IRC Sec. 2032A(e)(6) provides that material participation will be determined as under IRC Sec. 1402(a)(1).

6. IRC Sec. 2032A(d)(2).

7. See *Storvall v. Commissioner*, 101 TC 140 (1993).

8. IRC Sec. 2032A(c).

9. IRC Sec. 2032A(c)(7)(C).

PART XVI: ACCOUNTING

8896. What is an accounting period?

An accounting period is the taxable period that is used to determine a taxpayer's income tax liability.¹ An accounting period can be measured as either a calendar year² or a fiscal year.³ In either case, the taxable year cannot exceed a period of 12 months.⁴ Despite this, it is not sufficient for a taxpayer who is a business owner to merely begin his accounting period on the date the business began and end it 12 months later. This is because the accounting period does not end on the last day of December to qualify as a calendar year, does not end on the last day of the month to qualify as a fiscal year, and does not satisfy the 52-53 week requirements.⁵

Certain taxpayers are not permitted to choose their accounting period. The regulations require that most entities adopt a specific required tax year in order to prevent the manipulation of the tax year in order to artificially defer a taxpayer's tax liabilities.⁶

A calendar year accounting period is a period of 12 months that starts on January 1st and ends on December 31st. Any taxpayer can adopt the calendar year accounting period, though certain taxpayers are required to adopt a calendar year accounting period if any of the following are true:

- (1) the taxpayer keeps no books;
- (2) the taxpayer does not have an annual accounting period; or
- (3) the taxpayer has an annual accounting period, but such period does not qualify as a fiscal year.⁷

If the taxpayer maintains records that are sufficient to adequately reflect the taxpayer's income on the basis of an annual accounting period, the taxpayer is considered to have "kept books."⁸

A fiscal year is any 12 month period that ends on the last day of any month other than December. The taxpayer must keep accounts and report income and expenses using the same period that corresponds to the chosen fiscal year.⁹

1. IRC Sec. 441(c), 7701(a)(23), IRS Pub. 538.

2. IRC Sec. 441(d).

3. IRC Secs. 441(e), 7701(a)(24).

4. Treas. Reg. §1.441-1(a)(2).

5. IRC Sec. 441, Rev. Rul. 85-22, (1985)-1 CB 154.

6. Treas. Reg. §1.441-1(b)(2).

7. IRC Sec. 441 (g), IRS Pub. 538.

8. Treas. Reg. §1.441-1(b)(7).

9. IRC Secs. 441(e), 706 (b). See also IRS Pub. 538.

A taxpayer may also elect, as a variation of the fiscal year period, a tax year consisting of 52-53 weeks, where the annual accounting period varies between 52-53 weeks, but always ends on the same day of the week and, additionally, always ends on:

- (1) Whatever date this same day of the week last occurs in a calendar month; or
- (2) Whatever date this same day of the week falls that is nearest to the last day of the calendar month.¹

Planning Point: Cyclical businesses, like retail stores, may have several months (holiday season) with large sales but many months where expenses exceed sales. Quarterly tax payments still must be made off the entire year's estimated revenues and not increased (for example, in the Holiday season) and decreased as sales decrease. Moving the accounting period forward to the end of January (or later) enables retail stores to recognize the sales, less the returned items, and more accurately prepare for the upcoming year's tax obligations.

8897. How is a partnership's accounting period determined?

A partnership is one of the entities that is generally required to adopt a particular accounting period as specified under the regulations.² A partnership's accounting period is determined by reference to the partner's required accounting period(s).³ The partnership's "required taxable year" can either be:

- (1) The tax year of the majority partnership interest;
- (2) The tax year of all the principal partners; or
- (3) If it cannot be established based on the majority partnership interest or principal partners, a calendar year.⁴

For these purposes, when a partnership's accounting period is determined by reference to the majority interest, it means that it is determined based on the tax year of a partner or group of partners having an aggregate interest in partnership profits or capital of more than 50 percent.⁵

A "principal partner" is a partner who has an interest of 5 percent or more in partnership profits or capital.⁶ Once it is established that a partner is a principal partner, that principal partner is required to maintain the same calendar year established by the partnership unless that principal partner is able to demonstrate a valid business purpose for the deviation.

See Q 8900 for a discussion of the business purpose test that must be satisfied to allow a principal partner to adopt an alternate accounting period. This business purpose test must also be satisfied in order for the partnership to adopt an accounting period that deviates from the requirements set forth in (1)-(3), above.

1. IRC Sec. 441(f).

2. Treas. Reg. §1.1441-4(b)(2)(i)(G), IRC Sec. 706.

3. IRC Secs. 444, 706.

4. IRC Sec. 706(b). See also Treas. Reg. §1.706-1(b)(2).

5. IRC Sec. 706(b)(4).

6. IRC Sec. 706(b)(3).

8898. How is an S corporation's accounting period determined?

An S corporation is generally required to adopt a calendar year accounting period (meaning that its tax year ends on December 31, see Q 8896) unless it can establish a valid business purpose for adopting an alternate accounting period.¹

The business purpose test, applicable in the context of both partnerships and S corporations, is discussed in Q 8900.

8899. When can a partnership or S corporation elect an otherwise impermissible accounting period?

Partnerships and S corporations are entities that are generally required to adopt a taxable year in accordance with certain specified requirements, as set forth in the Internal Revenue Code and Treasury Regulations.² See Q 8897 (partnerships) and Q 8898 (S corporations) for the general rules applicable in establishing the accounting periods for these entities.

A partnership or S corporation is entitled to adopt an accounting period that varies from the otherwise specified requirements in the following cases:

- (1) The entity establishes a valid business purpose for adopting a different accounting period (see Q 8900);³
- (2) The entity elects a 52-53 week taxable year⁴ (see Q 8896);
- (3) The entity is entitled to use a grandfathered accounting period.

A grandfathered accounting period is an accounting period that either the partnership or S corporation has received permission to use on or before July 1, 1974 in an IRS letter ruling.⁵

The IRS will consider all of the facts and circumstances when determining whether to permit the adoption of an alternate tax year, including the tax consequences that would result from such a change.

In addition, a partnership or S corporation can elect to adopt a tax year other than its required year under Section 444 as long as the required accounting period is deferred for no more than three months.⁶ An entity that makes this election is required to make certain payments under Section 7519 that are based on a formula derived from the entity's income for the year and the highest tax rate currently applicable under IRC Section 1 (39.6 percent for 2013 and beyond).⁷

1. IRC Sec. 1378(b).

2. IRC Sec. 444(e).

3. IRC Secs. 706(b)(1)(C), 1378(b), Treas. Reg. §1.706-1(b)(2)(ii), (7).

4. Treas. Reg. §1.441-1(b)(2)(ii)(A).

5. Treas. Reg. §1.441-1(b)(6).

6. IRC Sec. 444(b).

7. IRC Sec. 7519(b).

8900. How does a partnership or S corporation establish that it has a valid business purpose for adopting an accounting period that deviates from its required accounting period?

A valid business purpose will generally be found to exist if the requested tax year coincides with the entity's ownership tax year (in the case of an S corporation) or natural business year.¹

An S corporation can establish an ownership tax year as the tax year that constitutes the tax year of an S corporation shareholder holding more than 50 percent of the corporation's issued and outstanding stock, disregarding certain shareholders who are tax-exempt under IRC Section 501.² A partnership or S corporation can establish the term of its natural business year by satisfying one of the tests discussed below.

In general, the IRS has developed three tests that are used in determining whether a valid business purpose has been established:

- (1) 25 percent gross receipts test;³
- (2) Annual business cycle test; and ⁴
- (3) Seasonal business test.⁵

If the entity is able to establish that its requested accounting period corresponds to a natural business year that is supported by the 25 percent gross receipts test, the IRS will automatically approve the requested accounting period under Revenue Procedure 2006-46. The annual business cycle test and seasonal business test are subject to discretionary approval.

To satisfy the 25 percent gross receipts test, a taxpayer⁶ must establish that it has earned at least 25 percent of its gross receipts from sales and services during the last two months of the requested accounting period, using its gross receipts for the preceding three years. The taxpayer must demonstrate that this 25 percent or more threshold is met by calculating the timing of its earnings as though the requested accounting period had been in effect for three years.⁷ However, even if the taxpayer's requested accounting period satisfies this 25 percent gross receipts test, the taxpayer must determine whether another accounting period would also satisfy the 25 percent gross receipts test. If any accounting period *other than* the requested accounting period would produce the aggregation of a higher percentage of the entity's earnings in the final two months of the period, then the requested accounting period cannot automatically qualify as the taxpayer's natural business year.⁸

1. Treas. Reg. §1.442-1(b)(2).

2. Rev. Proc. 2006-46, 2006-45 IRB 859.

3. Rev. Proc. 2006-46.

4. Rev. Proc. 2002-39, 2002-22 IRB 1046.

5. Rev. Proc. 2002-39.

6. Partnerships, S corporations or personal service corporations.

7. Rev. Proc. 2006-46, Rev. Proc. 2002-39.

8. Rev. Proc. 2006-46, Rev. Proc. 2002-39.

The taxpayer must use the same *method* as is used in filing that taxpayer's current tax return in calculating its gross receipts for purposes of the 25 percent gross receipts test. If an entity does not have at least a 47 month period of gross receipts, then it is not entitled to establish its natural business year under the gross receipts test.¹

Under the annual business cycle test, a taxpayer must demonstrate that its business operates cyclically, in that it is subject to peak and non-peak periods. The taxpayer's natural business year may be found to end at the conclusion of its highest peak period of business, or soon thereafter.² Rev. Proc. 2002-39 provides a safe harbor rule that treats one month after the end of a business' peak season as "soon after" the close of the peak season. A business that has steady income throughout the year will not be able to satisfy this test.

The seasonal business test applies to entities that operate only during part of the year for one reason or another (for example, because of weather conditions) so that the entity's gross receipts for periods outside of its operational season are found to be insignificant. Under the seasonal business test, the entity's natural business year is deemed to end at the end of, or soon after, its seasonal operation.³ If the entity earns 10 percent or less of its income outside of its operational season, such amounts are automatically deemed to be insignificant for purposes of this rule. One month after the end of the entity's operational season is deemed to be "soon after" the end of its season.

If a taxpayer is unable to satisfy any of the three tests described above, he may attempt to demonstrate a valid business purpose based on individual facts and circumstances by showing that there are compelling tax or non-tax reasons for adopting an alternative accounting period.⁴ However, it is insufficient that the non-tax reasons asserted merely create a tax year that is more convenient for the taxpayer. As such, reasons that are considered insufficient include:

- (1) The hiring patterns of the business;
- (2) Use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders; or
- (3) The fact that the business uses price lists or model years that change on an annual basis.

Further, if the tax consequences of the alternate period result in deferral or distortion, the requested change will often be denied unless the taxpayer is able to demonstrate compelling non-tax reasons for the change. The IRS has found that compelling non-tax reasons for an alternate accounting period exist in situations where the entity closed down operations for ten years for reasons beyond its control or when the entity's business was impacted by a strike, for example.⁵

1. Rev. Proc. 2006-46, Rev. Proc. 2002-39.

2. Rev. Proc. 2002-39.

3. Rev. Proc. 2002-39.

4. Rev. Proc. 2002-39. See also Rev. Rul. 87-57, 1987-2 CB 117, illustrating the application of this test.

5. Rev. Rul. 87-57.

Planning Point: Before changing accounting periods, a business owner should find out what the norm is for the business owner's industry. Changing accounting periods can also have unintended consequences. For example, accounting period changes can affect the calculations that go into the valuation of a business if the owner later chooses to sell it. Changing periods can also cause non-revenue generating paperwork for the acquirer which could affect negotiations.

8901. When is it permissible for a taxpayer to adopt an accounting period that is less than 12 months?

A taxpayer may adopt an accounting period that is less than a full 12 month period, known as a short period, in certain limited circumstances.¹ A taxpayer may adopt a short period if:

- (1) The taxpayer's short period has been specifically approved by the IRS;² or
- (2) The taxpayer was only in existence during part of what would otherwise constitute the applicable accounting period.³

If a taxpayer obtains approval to adopt a short period under (1), above, the taxpayer must annualize taxable income by determining annual income and dividing that amount by the number of months in the short period.⁴ Further, if the taxpayer is an individual, the amount of the taxpayer's personal exemption must be reduced so that it bears the same ratio to the full exemption as the number of months in the short period bears to 12.⁵

Option (2), above generally occurs in situations where a business entity only operated for a portion of the otherwise required tax year. For example, a business that liquidates before the close of its tax year is entitled to use the period of its existence during that accounting period as its short accounting period.⁶

8902. Can an accounting period be changed once chosen?

Yes. A taxpayer can change its accounting period if it has obtained the approval of the IRS unless the taxpayer is authorized under the Internal Revenue Code or the regulations to change the accounting period without prior approval.⁷

Individual taxpayers are entitled to change accounting periods (e.g., from a calendar year to a fiscal year) by filing Form 1128 with the IRS.⁸ Pass-through entities, such as partnerships and S corporations, are not entitled to change accounting periods using this form.

1. IRC Sec. 443(a).

2. IRC Sec. 443(a)(1).

3. IRC Sec. 443(a)(2).

4. IRC Sec. 443(b)(1).

5. IRC Sec. 443(c).

6. See IRC Secs 708 (termination of partnerships) and 1362 (termination of S corporation status).

7. IRC Sec. 442, Treas. Reg. §1.442-1(a).

8. Rev. Proc. 2002-39, Rev. Proc. 2003-62.

Partnerships and S corporations can obtain automatic approval to change to an alternate accounting period if the requirements set forth in Revenue Procedure 2006-46 are satisfied, meaning that the entity:¹

- (1) Is changing to a required taxable year (Q 8897 and Q 8898) or to a 52-53 week accounting period ending in reference to its required taxable year (Q 8896);
- (2) Satisfies the 25 percent gross receipts test (Q 8900);²
- (3) Is an S corporation (or is planning to make an S election) changing to its ownership tax year (Q 8900);
- (4) Wishes to change from a 52-53-week taxable year to a non-52-53-week taxable year that ends on the last day of the same calendar month that is an otherwise permitted taxable year, and vice versa.³

Typically, the IRS will establish conditions that the taxpayer must satisfy in order to change its accounting period when it consents to the change.⁴ In addition to any terms established by the IRS, the taxpayer will be required to maintain its records and compute its income based on the requested accounting period.

Generally the taxpayer must use Form 1128, "Application to Adopt, Change or Retain a Tax Year" to file for a change of accounting period. The taxpayer may not request to retroactively change an accounting period even to change to a required accounting period for a prior tax year.⁵

8903. What is the cash basis method of accounting?

The cash basis method of accounting is the most widely used accounting method for individual taxpayers, and is often used by many business entities, as well.⁶ Cash basis taxpayers recognize all gross income, whether in the form of cash, property or services, in the year that the income is actually or constructively received.⁷

"Constructive receipt" is considered to have occurred when income is made available to a taxpayer without restrictions.⁸ For example, a cash basis taxpayer cannot avoid reporting income simply because he refused to deposit a check. Conversely, if a taxpayer's employer provides the taxpayer with a stock bonus, but conditions are imposed so that the bonus is not available to the taxpayer until a future date, the corporation's reporting such bonus on its books does not constitute constructive receipt on the part of the taxpayer-employee.

1. Rev. Proc. 2006-46.

2. Rev. Proc. 2006-46.

3. Rev. Proc. 2006-46.

4. Rev. Proc. 2002-39.

5. Rev. Proc. 2006-45, 2006-45 IRB 851.

6. IRC Sec. 446(c)(1).

7. Treas. Reg. §1.446-1(c)(1)(i).

8. Treas. Reg. §1.451-2(a).

Similarly, a taxpayer is entitled to claim any deductions for the year in which the expenses that gave rise to the deduction were actually paid.¹ There is no “constructive payment” type doctrine that corresponds to the constructive receipt doctrine discussed above, however.²

Though a cash basis taxpayer’s receipt of income in the form of cash is simple to recognize, complications may arise when the income is received in the form of non-cash property or a right to receive income based on future services. As such, the IRS has developed the doctrines of “cash equivalence” and “economic benefit” to address the receipt of property and services. When income is received in the form of property, the cash basis taxpayer must include the fair market value of such property in income if rights to the income are (1) freely transferable, (2) readily marketable and (3) immediately convertible into cash.³

On the other hand, if a taxpayer contracts to perform services for a specified amount of income that will be received in installments over the period of service, the taxpayer does not report the value of the installment payments in the year the contract is entered. This is because the taxpayer does not receive a cash equivalent at the time of contracting, but rather obtains only the right to receive such cash payments in the future dependent on performance of the required services.⁴

Under the economic benefit theory, a taxpayer is required to recognize income if an economic benefit has been conferred upon the taxpayer, even if the taxpayer has no ability to currently access the cash or non-cash property providing such benefit.⁵ For the cash basis taxpayer to recognize income under the economic benefit theory, the property must be transferred for the benefit of the taxpayer⁶ and confer vested, nonforfeitable rights⁷ to the taxpayer. For example, a taxpayer was required to recognize income when his employer transferred certain amounts into a trust for his future benefit where the employer’s payment was irrevocable, even though the taxpayer was not currently able to access the funds in the trust.⁸ Therefore, unlike the cash equivalence theory, the property that is irrevocably transferred and held for the taxpayer’s benefit does not have to be transferrable by the taxpayer.⁹ The taxpayer is required to include the fair market value of non-cash property, or present value of any cash, that is transferred in income for the year such property or cash is transferred.¹⁰

Planning Point: Generally speaking, the cash basis method of accounting works best for organizations that prefer simplicity over predictability. Cash basis is like balancing a checkbook; if the money is there, then the money affects the tax obligations. Large and unanticipated increases in revenues can lead to large tax obligations—and potentially large cash outflows—that small business owners may not be prepared for. Quarterly estimated tax payments may be more difficult to predict in a cash basis business with large, infrequent sales.

1. Treas. Reg. §1.461-1(a)(1).

2. See *Massachusetts Mutual Life Insurance Co. v. U.S.*, 288 U.S. 269 (1933).

3. See Rev. Rul. 73-173, 1973-1 CB 40.

4. Rev. Rul. 73-173, *Shuster v. Helvering*, 121 F.2d 643 (1941).

5. See *Spoul v. Comm.*, 16 TC 244 (1951). See also *Thomas v. U.S.*, 45 F. Supp.2d 618 (1999).

6. Compare *Sproull, and Jacuzzi v. Comm.*, 61 TC 262 (1973) (economic benefit upon transfer to trust), with *Casale v. Comm.*, 247 F.2d 440, 445 (2d Cir. 1957) (no economic benefit), *Centre v. Comm.*, 55 TC 16 (1970), Rev. Rul. 72-25, 1972-1 CB 127 (no economic benefit).

7. See e.g., *Robertson vs. Comm.*, 6 TC 1060 (1946), acq., 1946-2 CB 4.

8. *Jacuzzi v. Comm.*, 61 TC 262 (1973).

9. *Hackett v. Comm.*, 159 F.2d 121 (1st Cir. 1946), *Brodie v. Comm.*, 1 TC 275 (1942).

10. *212 Corp. v. Comm.*, 70 TC 788 (1978), *Bell Est. v. Comm.*, 60 TC 469 (1973).

8904. What is the accrual method of accounting?

Taxpayers who use the accrual method of accounting generally report income in the year that it is earned, rather than in the year it is received.¹ Under this method, income is recognized in the year when (1) all events have occurred to fix the taxpayer's right to receive the income and (2) the amount of income that the taxpayer will be entitled to receive can be determined with reasonable accuracy. Because the relevant inquiry is when the income is *earned*, rather than when the income is *received*, compensation agreed upon with respect to the performance of future services is not recognized until those services have actually been performed (at the time the taxpayer has earned the compensation).²

Pursuant to the "all events test,"³ income is recognized when all of the events that are required for the taxpayer's right to the income to be vested have occurred so that the amount of the taxpayer's entitlement can be determined with reasonable certainty.⁴ It is possible for a taxpayer to report income although no payment has yet been received.⁵

Similarly, an accrual basis taxpayer's expenses are deductible for the taxable year in which the liability for payment becomes definite and the amounts payable become ascertainable with reasonable certainty, but only to the extent that economic performance with respect to the item has occurred.⁶

In general, an accrual basis taxpayer will include amounts in income upon the earliest of the following events: (1) payment is actually received, (2) the income amount becomes due to the taxpayer, (3) the taxpayer earns the income, or (4) title to property has passed to the taxpayer.⁷

An accrual basis taxpayer who enters into an agreement to provide future services may postpone reporting advance payments under the agreement if the services relate to property the taxpayer owns, leases, builds or installs, but only if the agreement relates to servicing property the taxpayer ordinarily owns, leases, builds or installs in the ordinary course of business *without* such a service agreement. Recognition of advance payments is not permitted when (1) the taxpayer will perform any part of the service after the end of the tax year immediately following the year of payment or (2) the service will be performed at an unspecified future date that *might* be after the end of the tax year immediately following the year of payment.⁸

Example: Scott owns a computer sales business. In 2014, he receives payment for a one year service contract on a computer that he sold. If Scott normally sells computers without the service contract, he can postpone until 2015 recognition of any income he did not earn in 2014 because, by the terms of the agreement, the services will be performed within one year.

1. IRC 446(c)(2).

2. Treas. Reg. §1.451-1(a).

3. IRC Sec. 448(h)(4).

4. Treas. Reg. §1.446-1(c)(1)(ii).

5. *Comm. v Hansen*, 360 U.S. 446 (1959).

6. IRC Sec. 461(h).

7. IRS Publication 538.

8. IRS Pub. 538.

Example 2: Lauren owns a dance studio and, on October 1, 2014, receives payment for a one year contract for 48 dance lessons. The one year period begins on October 1. Lauren gives 8 dance lessons in 2014. She is required to recognize one-sixth (8/48) of the advance payment in 2014, because she has earned that portion. Further, she is required to recognize the remainder of the income in 2015, even if she does not give all of the lessons in 2015.

If the accrual basis taxpayer must give up certain rights in order to receive the agreed upon amounts, accrual of that income will be prevented. For example, the courts have held that, in the case of an insurance claim resulting from property damage where the insured held two different insurance policies, a clause in policy A that prevented the payout unless the taxpayer agreed to forego his right to the proceeds of policy B prevented accrual. Even though all events that would give rise to the taxpayer's rights to the amounts receivable under policy A had occurred and the amount could be determined, attachment of the condition prevented accrual of the amounts involved.¹ The right to receive an amount must be enforceable by the recipient with no strings attached.

Planning Point: Generally speaking, the accrual method of accounting normalizes, or smooths out, the revenues and expenses of a business, making it easier to do year over year comparisons and forecasts. A company that wins a large deal may get paid an up-front cash amount for products that are delivered for years to come. Accrual tax accounting allows the tax obligations to be paid over longer periods of time, giving the business owner more choice and control over how, and when taxes are paid.

8905. Are there taxpayers required to use the accrual method of accounting, rather than the cash basis method?

Generally, C corporations, partnerships in which a C corporation is a partner and tax shelter arrangements (see Q 8627) are required to use the accrual basis method of accounting.²

However, several exceptions exist to permit certain C corporations and partnerships with C corporation shareholders to use the cash basis method. Farming businesses³ that are organized as C corporations are permitted to use the cash basis method of accounting. Similarly, small businesses organized as C corporations are permitted to use the cash basis method if the corporation (or partnership with C corporation shareholder) has annual gross receipts that do not exceed \$5,000,000.⁴

Certain personal service corporations are also permitted to use the cash basis method of accounting. Further, the IRS has specifically determined that the prohibition on C corporations using the cash basis accounting method does not apply to limited liability companies.⁵

Generally, taxpayers that maintain inventory are required to use the accrual basis method with respect to purchases and sales of that inventory unless the taxpayer obtains the IRS' consent to use the cash basis method. Typically, the IRS will consent to such a change if the cash basis

1. *Maryland Ship-building & Drydock Co. v. U.S.*, 409 F.2d 1363 (Ct. Cl. 1969).

2. IRC Sec. 448(a).

3. IRC Sec. 263A.

4. IRC Sec. 448(b).

5. Let. Ruls. 9328005, 9321007.

method clearly reflects the taxpayer's income.¹ See Q 8915 for a more specific discussion of the methods that may be used to account for inventory.

The cash basis method may also be used by most other taxpayers whose average annual gross receipts do not exceed \$1 million² and may be used by select taxpayers whose average annual gross receipts do not exceed \$10 million.³

8906. Can a taxpayer choose to use both the cash basis and accrual methods of accounting?

Under IRC Section 446(c), a taxpayer may use any combination of the permissible accounting methods to compute taxable income if the combination clearly reflects the taxpayer's income and is consistently used. For example, a taxpayer is permitted to use the cash basis method to account for income and expenses, but the accrual method to account for purchases and sales. Despite this, a taxpayer is *not* permitted to use one method to account for income and a different method to account for expenses.⁴

Though the regulations require that a taxpayer use the accrual method to account for purchases and sales if inventories are maintained, that taxpayer may wish to use the cash basis method for income and expenses because the required calculation may be simpler.⁵

A taxpayer is also permitted to use one accounting method to determine tax liability for income arising from a trade or business and another method to account for income that is not related to a trade or business.⁶ Taxpayers engaged in different trades or businesses can also use a different method of accounting for each trade or business in which the taxpayer participates.⁷

8907. Can a taxpayer change an accounting method once it has been chosen?

Though a taxpayer does not need IRS consent to choose its initial accounting period, generally, the taxpayer must seek the consent of the IRS to change its accounting method. This is the case even if the taxpayer's current accounting method is an impermissible one (for example, if a partnership with C corporation shareholders has chosen the cash basis method, see Q 8905).⁸ The IRS can also require the taxpayer to change its accounting method⁹ if it is determined that the chosen accounting method does not clearly and accurately reflect the taxpayer's income.¹⁰

Certain specific accounting changes do not require IRS consent. Revenue Procedure 2011-14 provides a list of circumstances in which automatic approval for changes in accounting

1. Treas. Reg. §1.446-1(c)(2)(i).

2. Rev. Proc. 2001-10, 2001-2 IRB 272.

3. Rev. Proc. 2002-28, 2002-18, IRB 815.

4. Treas. Reg. §1.446-1(c)(1)(iv), *Grider v Commissioner*, TC Memo 1999-417.

5. Treas. Reg. §1.446-1(a)(4)(i), Treas. Reg. §1.446-1(c)(2)(i). See also *Gustafson v Commissioner*, TC Memo 1988-82.

6. Treas. Reg. §1.446-1(c)(1)(iv)(b).

7. Treas. Reg. §1.446-1(d).

8. Treas. Reg. §1.446-1(e)(2)(i).

9. IRC Sec. 446(e), Treas. Reg. §1.446-1(e)(2)(i).

10. IRC Sec. 446(b).

methods will be granted. For example, a taxpayer who is improperly using the reserve method of accounting to account for bad debts may automatically switch to the specific charge-off method (see Q 8696).¹

In order to obtain IRS approval to change a taxpayer's current accounting method, the taxpayer must file Form 3115, "Application for a Change in Accounting Method" with the IRS. In addition to Revenue Procedure 2011-14, the instructions to Form 3115 provide a brief description of the situations in which a taxpayer may obtain automatic IRS approval for a change in accounting method.²

Once the taxpayer either determines that automatic change is available or obtains IRS consent to change from one method of accounting to another, the taxpayer is required to make any adjustments to items of income or expense that are necessary to prevent duplication or omission of amounts based on the change.³

Taxpayers may also wish to change the accounting for one or more material items of income or deduction, rather than the overall method of accounting.⁴ A "material item" is defined in the regulations as any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.⁵ Changing the accounting method for a material item, rather than the overall method of accounting, also requires that the taxpayer obtain consent if the change is not subject to automatic approval. For example, a taxpayer must obtain consent in order to change the method of depreciation or amortization of items, except for certain changes to the straight-line method depreciation that are subject to automatic approval under Revenue Procedure 2011-14.⁶

8908. What is the installment method of accounting and when is it used?

In cases where a taxpayer does not receive payment immediately after a sale, the taxpayer may be able to recognize the income from those sales over a period of time, rather than when the sale is made. The installment method may be used to account for gains (but not losses) if the taxpayer has sold property and will receive at least one payment with respect to that sale after the close of the tax year in which the sale occurs.⁷ Under the installment method, for each year in which payments are due, the taxpayer will recognize a proportionate amount of the payments as they are actually received over the payment term.⁸

Despite this, a taxpayer is not entitled to use the installment method of accounting if the transaction is a dealer disposition or involves the sale of property that is held as inventory in the ordinary course of the taxpayer's trade or business (see Q 8915 for a discussion of inventory

1. Rev. Proc. 2011-14, 2011-1 CB 330.

2. Instructions to Form 3115, available at <http://www.irs.gov/pub/irs-pdf/i3115.pdf> (last accessed June 8, 2014).

3. IRC Sec. 481(a).

4. Treas. Reg. §1.446-1(a)(1).

5. Treas. Reg. §1.446-1(c)(2)(ii).

6. See IRS Pub. 538.

7. IRC Sec. 453(b)(1).

8. IRC Sec. 453(c).

accounting).¹ A dealer disposition is a sale of personal property by a person who regularly sells or otherwise disposes of property using an installment plan or a disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of a trade or business.² Certain farm property and the sale of timeshares and residential lots are excluded from the definition of dealer disposition.³

Section 453 only affects the timing of income recognition and does not impact the characterization of the income (for example, as a capital gain or ordinary income).⁴

See Q 8867 for more information on using the installment method of accounting in the context of small business dispositions. Q 8910 discusses the special rules that apply in the context of related party sales under the installment method.

8909. What interest requirements apply when a taxpayer uses the installment method of accounting?

Generally, when a taxpayer uses the installment method of accounting (see Q 8908), if the sale price is over \$3,000 and any payment is deferred for more than one year, interest must be charged on payments due more than six months after the sale. Interest must be charged at a rate that is at least 100 percent of the “applicable federal rate,” (AFR) compounded semiannually, or interest will be imputed at that rate.⁵ However, the following exceptions to this general rule apply:

- (1) If less than 100 percent of the AFR, a rate of no greater than 9 percent, compounded semiannually, will be imputed in the case of sales of property (other than new IRC Section 38 property) if the stated principal amount of the debt instrument does not exceed \$5,557,200 in 2014 (as indexed annually for inflation);⁶
- (2) If less than 100 percent of the AFR, a rate of no greater than 6 percent, compounded semiannually, is imputed on aggregate sales of land during a calendar year between an individual and a member of the individual’s family (i.e., brothers, sisters, spouses, ancestors, and lineal descendants) to the extent the aggregate sales do not exceed \$500,000 (the general rule of 100 percent of the AFR, compounded semiannually, applies to the excess);⁷ and
- (3) A rate of 110 percent of the AFR, compounded semiannually, applies to sales or exchanges of property if, pursuant to a plan, the transferor or any related person leases a portion of the property after the sale or exchange (“sale-leaseback” transactions).⁸

1. IRC Sec. 453(b)(2).

2. IRC Sec. 453(l).

3. IRC Sec. 453(l)(2).

4. *Murray v. United States*, 192 Ct Cl 63 (1970).

5. IRC Sec. 483.

6. IRC Sec. 1274A, Rev. Rul. 2013-23, 2013-48 IRB 590.

7. IRC Sec. 483(e)(3).

8. IRC Sec. 1274(e).

The applicable federal rate applied will be the lowest of the AFRs in effect for any month in the 3-month period ending with the first calendar month in which there is a binding contract in writing.¹

All interest received by the taxpayer is taxed as ordinary income.² In some cases, depending on the property and amount involved, the interest (or imputed interest) to be paid over the period of the loan must be reported as “original issue discount” that accrues in daily portions; in other cases the interest is allocated among the payments and that much of each payment is treated as interest includable and deductible according to the accounting method of the buyer and seller.

8910. What special accounting rules apply in the installment context of related party sales?

Under IRC Section 453(e)(1), if a taxpayer (“first seller”) disposes of property to a related person in an installment sale (“first sale”), and the related party in turn sells the property in a second sale before the first seller receives all payments under the first sale, the amount realized in the second sale will be treated as received by the first seller. This is the case even though the first seller has actually not received all payments due with respect to the first sale.³

Essentially, the payments received from the second sale are treated as though they were used to pay off the first sale even if, in reality, the second seller has made no payments. The purpose of this treatment is to prevent a taxpayer from improperly deferring gain on the sale of property by using the installment method of accounting.

In order for the related party rules to apply, the second sale must occur within two years of the first sale unless the property at issue consists of marketable securities.⁴

For purposes of the installment sale rules, “related party” includes the seller’s siblings, ancestors, lineal descendants, certain controlled corporations (see Q 8833) and estates, trusts and partnerships in which the seller has an interest.⁵

If the second sale occurs as a result of an involuntary conversion under IRC Section 1033 (see Q 8611), the second sale will not be treated as a “second sale” under these rules if the first sale was made before the threat of the involuntary conversion arose.⁶ Further, a second sale will not be deemed to have occurred for purposes of these rules if the sale occurs after the death of either the first seller or the related party who acquires the property in the first sale.⁷ If the parties are able to prove that the sales were not motivated by tax avoidance, the related party rules will not apply.⁸

1. IRC Sec. 1274(d)(2)(B).

2. Treas. Reg. §1.483-1.

3. IRC Sec. 453(e).

4. IRC Sec. 453(e)(2).

5. IRC Secs. 453(f), 318(a), 267(b).

6. IRC Sec. 453(e)(6).

7. IRC Sec. 453(e)(6)(C).

8. IRC Sec. 453(e)(7).

8911. Is a taxpayer required to use the installment method to account for an installment sale?

In situations where the installment method applies, the taxpayer is required to use the installment method unless an election is made to opt out of this treatment. If the taxpayer does not affirmatively elect out, the installment method is the default method of accounting for transactions covered by the installment sale rules (see Q 8908 and Q 8910). The opt-out election must be made on or before the due date for filing the taxpayer's return for the year. Once the election is made, the taxpayer may only revoke the election with the IRS' consent.¹

8912. What types of contracts are considered "long-term contracts" for purposes of determining the proper method of accounting?

A long-term contract is any contract that provides for the manufacture, building, installation, or construction of property that will not be completed within the taxable year that the contract was executed.²

Despite this general definition, a manufacturing contract is only treated as a long-term contract if it provides for the manufacture of:³

- (1) Unique items which are not normally carried as finished goods inventory; or
- (2) Items which would normally require more than a 12 month production period to complete (regardless of the duration of the actual contract).⁴

An item is considered "unique" if it was designed to meet the needs of a specific customer and is generally not suitable for the use of other customers without significant modification.⁵ A taxpayer can use the IRS' safe harbor to show that a product is not unique in the following circumstances:

- (1) *Short production period.* If an item could normally be manufactured within 90 days or less, then it is not considered to be a unique item. If multiple orders are involved, this test is satisfied if each unit can be manufactured within 90 days;⁶
- (2) *Customized item.* An item is not considered unique if 10 percent or less of the total contract cost is attributed to the cost of customizing the item;⁷
- (3) *Inventoried item.* An item that might otherwise be considered unique ceases to be unique when the taxpayer begins to normally include similar items in its finished goods inventory.⁸

1. IRC Sec. 453(d).

2. IRC Sec. 460(f)(1), Treas. Reg. §1.460-1(b)(1).

3. IRC Sec. 460(f)(2), Treas. Reg. §1.460-2(a).

4. IRC Sec. 460(f)(2)(B), Treas. Reg. §1.460-2(a)(2).

5. Treas. Reg. §1.460-2(b)(1), *Sierracin Corp. v. Comm.*, 90 TC 341 (1988).

6. Treas. Reg. §1.460-2(b)(2)(i).

7. Treas. Reg. §1.460-2(b)(2)(ii).

8. Treas. Reg. §1.460-2(b)(2)(iii).

The item's production period begins when the taxpayer has incurred at least 5 percent of the total contract cost and ends when the item is ready for sale and all reasonably expected production activities have been completed.¹

Construction contracts, for this purpose, include the improvement or building of a real property, reconstruction or rehabilitation of real property, contracts for the installation of an integral component to real property, and contracts for the improvement of real property.²

See Q 8913 for the rules governing accounting for long-term contracts.

8913. How does a taxpayer account for revenue and costs under a long-term contract?

If the contract is found to be a long-term contract (see Q 8912), the taxpayer will be required to use the percentage of completion method to account for revenue under that contract, unless an exception applies to allow use of the completed contract method. Generally, the completed contract method may only be used for certain home construction and other real estate construction contracts (see Q 8914), so the exception is very limited.³

The percentage of completion method requires the taxpayer to include the portion of the total contract price that corresponds to the percentage of the entire contract that has been completed during that tax year.⁴ The aim of this method is to include a portion of income during each year as the work under the contract progresses.

To determine the income that must be recognized under a long-term contract, a taxpayer uses the following steps:⁵

- (1) The completion factor for the contract, which is the ratio of the cumulative allocable contract costs that the taxpayer has incurred through the end of the taxable year to the estimated total allocable contract costs that the taxpayer reasonably expects to incur under the contract, is computed;
- (2) The amount of cumulative gross receipts from the contract is computed by multiplying the completion factor by the total contract price;
- (3) The amount of current-year gross receipts is computed, which is the difference between the amount of cumulative gross receipts for the current taxable year and the amount of cumulative gross receipts for the immediately preceding taxable year (whether positive or negative); and
- (4) Both the current-year gross receipts and the allocable contract costs incurred during the current year are taken into account in computing taxable income.

1. Treas. Reg. §1.460-2(c)(1).

2. Treas. Reg. §1.460-3(a).

3. IRC Sec. 460 (a), Treas. Reg. §1.451-3(b).

4. IRC Sec. 460(b)(1), Treas. Reg. §1.460-4(b)(1).

5. Treas. Reg. §1.460-4(b)(2).

If this method does not result in the taxpayer including the total contract price in income by the time the contract is completed, the taxpayer must include any remaining amounts in income for the tax year following the year of completion.¹

A de minimis rule allows a taxpayer to defer recognition of income under a long-term contract for any year in which less than 10 percent of the estimated contract costs have been incurred by the end of the year. This income and related costs must then be recognized in a later year in which at least 10 percent of the contract has been completed.²

8914. Are there any exceptions to the rule that a taxpayer must use the percentage of completion method in accounting for long-term contracts?

Yes. The percentage of completion method (Q 8913) is not required to be used in the case of (1) construction contracts entered into by small contractors and (2) home construction contracts.³

The exemption for small contractors will apply if the following criteria are met:⁴

- (1) The long-term contract must be a construction contract;⁵
- (2) At the time the contract was entered into, it estimated that the contract will be completed within two years. However, if the contract takes longer than two years to complete due to factors beyond the taxpayer's control, the small contractor's exception may still be used;⁶ and
- (3) The contractor or its predecessor's average annual gross receipts for the three years preceding the year in which the construction contract was entered into is \$10 million or less.⁷

The home construction contract exemption applies to any construction contract under which at least 80 percent of the estimated total contract costs are reasonably attributed to the building construction, reconstruction or rehabilitation of: (1) dwelling units⁸ in a building containing four or fewer dwelling units or (2) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.⁹ If the construction involves both dwelling units and commercial units, costs must be reasonably allocated to determine the contract costs attributable to the dwelling units in order to determine whether the contract will qualify for the exemption.

1. Treas. Reg. §1.460-4(b)(3).

2. IRC Sec. 460(b)(5).

3. IRC Sec. 460(e).

4. IRC Sec. 460(e)(1)(B), Treas. Reg. §1.460-3(b)(1).

5. IRC Sec. 460(e)(4), Treas. Reg. §1.460-3(a).

6. Treas. Regs. §§1.460-3(b)(1)(ii), 1.460-1(f)(4).

7. IRC Sec. 460(e)(1)(B)(ii), Treas. Reg. §1.460-3(b)(3).

8. Dwelling unit is defined in IRC Sec. 168(e)(2)(A)(ii)(I).

9. IRC Sec. 460(e)(6)(A); Treas. Reg. §1.460-3(b)(2)(i).

8915. What is inventory accounting? What methods are generally used by taxpayers to account for inventory?

Inventory accounting is generally required in any case where the IRS feels it is necessary in order to accurately reflect a taxpayer's income. Inventory accounting usually becomes important in cases where the taxpayer's business involves the production and sale of goods or the purchase and resale of goods.

As a general principle, IRC Section 471 requires that a taxpayer's inventory accounting method must: (1) conform as closely as reasonably possible to the best accounting practice used in the taxpayer's business¹ and (2) clearly reflect the taxpayer's income.² Under the regulations, therefore, there is no one particular accounting method that must be used in all circumstances to account for inventory. Instead, the method chosen must reflect the realities of the taxpayer's business. As such, greater weight is given to consistency than to the actual valuation method chosen.³

There are various methods of inventory accounting, including first-in, first-out (FIFO), last-in, first-out (LIFO) and specific identification methods.

The FIFO method of accounting assumes that the first items of inventory purchased by the taxpayer are the first items that are sold. As such, the inventory that remains at the end of the taxpayer's accounting period is valued based on the most recent purchase price.⁴

Conversely, under the LIFO method, the most recent items of inventory that are purchased are considered to be the first items sold. Under the LIFO method, inventory is valued based on its cost, rather than its market value.⁵

Rather than focusing on the flow of inventory, the specific identification method requires that the taxpayer keep records so that it may assign a specific cost to each item of inventory.⁶

Certain taxpayers are either prohibited or are given the option to not use the inventory method of accounting. They include:

- (1) Real estate dealers – A tax payer that is in the business of selling real properties is not permitted to use the inventory method;⁷
- (2) Farmers – A taxpayer engaged in a farming business may use either the inventory or the cash method in reporting income;⁸

1. See *Geometric Stamping Co. v. Comm.*, 26 TC 301 (1956), acq., 1958-1 CB 4 (re: importance of consistency).

2. Treas. Reg. §1.471-2(c). See also *Walmart v. Comm.*, TC Memo 1997-1 (8th Cir. 1998) (upholding the estimate for inventory shrinkage).

3. Treas. Reg. §1.471-2(b).

4. See Treas. Reg. §1.471-2(d); ARB No. 43, Chapter 4, Statement 4 (AICPA, 1953) (FASB Accounting Standards Codification 330-10-30).

5. IRC Sec. 472(b)(2).

6. Treas. Reg. §1.471-2(d).

7. Rev. Rul. 69-536, 1969-2 CB 109, amplified in Rev. Rul. 86-149, 1986-2 CB 67; *Atlantic Coast Realty Co. v. Comm.*, 11 BTA 416 (1928), *Miller Development Co. v. Comm.*, 81 TC 619 (1983).

8. Treas. Reg. §1.471-6(a).

- (3) Real estate investment mortgage units are exclusively governed by Sections 860A through 860G.¹ These entities are not permitted to use the inventory methods under Section 471.

Though greater weight is given to consistency than to the method of inventory accounting chosen, certain inventory accounting methods are specifically prohibited under Treasury Regulation Section 1.471-2(f), including the following:

- (1) Deducting a reserve for price changes or an estimated depreciation in the value of inventory;
- (2) Carrying inventory at a nominal price or at less than its proper value;
- (3) Omitting portions of the inventory;
- (4) Using a base-stock method based on a normal quantity and constant price;
- (5) Including in-transit goods in inventory where title to such goods is not yet vested in the taxpayer;
- (6) Using a direct cost method by a manufacturer, under which only direct production costs and variable overhead costs are allocated to inventory; and
- (7) Using a prime cost method by a manufacturer, under which only direct production costs are allocated to inventory.

If a taxpayer has used a prohibited inventory method, IRS consent is still required to change the method unless automatic approval is available under Revenue Procedure 2011-14 (see Q 8902).²

Planning Point: FIFO or LIFO? Choosing LIFO is enticing in a capital-heavy business when the costs of the goods sold are increasing. This will reduce the current tax burden. However, LIFO often increases administrative time and paperwork. LIFO can affect valuation in the sale of a business as it postpones the inevitable until the sale of the business. Technology businesses often exist in a deflationary world, where the costs of their inventory decrease as computing power (and other technologies) increase year over year. FIFO is also accepted by the International Financial Reporting Standards Board (IFRS), and LIFO is not.

1. Rev. Rul. 95-81.

2. See Treas. Reg. §1.446-1(e)(2)(i).

PART XVII: CHARITABLE GIVING

8916. What deduction is an individual allowed to take with respect to gifts made to charitable organizations?

An individual may deduct certain amounts for charitable contributions.¹ The allowable deduction for a contribution of property other than money is generally equal to the fair market value of the property.² However, under certain circumstances, the deduction for a gift of property must be reduced (see Q 8928). See Q 8918 for a discussion of the fair market value determination.

The amount that may be deducted in any one year is subject to certain income percentage limits that depend on the type of property, the type of charitable organization to which the gift is made, and whether the contribution is made directly “to” the charity or “for the use of” the charity (see Q 8921). Taxpayers are required to itemize deductions in order to take a charitable deduction.

Generally, a gift of less than an individual’s entire interest in property is not deductible, though certain exceptions to this rule exist (see Q 8927 and Q 8928).

For a charitable contribution to be deductible, the charity must receive some benefit from the donated property.³ In addition, the donor cannot expect to receive an economic benefit (aside from the tax deduction) from the charity in return for the donation.⁴ For instance, if a taxpayer contributes substantially appreciated property, and later reacquires it from the charity under a prearranged transaction, or if the charity sells the appreciated property and uses the proceeds to purchase other property from the taxpayer under a similar arrangement, the taxpayer is required to recognize gain on the contribution.⁵ However, where there is no arrangement and no duty on the part of the charity to return the property to the donor, the taxpayer is entitled to the deduction. In addition, if the charity does return the property, the taxpayer receives a new basis in the property (i.e., the price he paid to reacquire it).⁶

In determining whether a payment that is partly in consideration for goods or services (i.e., a quid pro quo contribution) qualifies as a charitable deduction, the IRS has adopted the 2-part test set forth in *United States v. American Bar Endowment*.⁷ Under these circumstances, for a charitable contribution to be deductible, a taxpayer must:

- (1) Intend to make a payment in excess of the fair market value of the goods or services received; and
- (2) Actually make a payment in an amount that exceeds the fair market value of the goods or services.⁸

1. IRC Sec. 170(a).

2. Treas. Reg. §1.170A-1(c)(1).

3. See *Wintthrop v. Meisels*, 180 F.Supp. 29 (DC NY 1959), aff’d 281 F.2d 694 (2d Cir. 1960).

4. *Stubbs v. U.S.*, 70-2 USTC ¶9468 (9th Cir.), cert. den. 400 U.S. 1009 (1971).

5. *Blake v. Comm.*, 83-1 USTC ¶9121 (2nd Cir. 1982).

6. *Sheppard v. U.S.*, 361 F.2d 972 (Ct. Cl. 1966).

7. 477 U.S. 105 (1986).

8. Treas. Reg. §1.170A-1(h)(1).

The deduction amount may not exceed the excess of (1) the amount of any cash paid and the fair market value of the goods or services over (2) the fair market value of the goods or services provided in return.¹

The Tax Court has held that tuition payments paid by taxpayers to religious day schools for the secular and religious education of their children were not deductible as a charitable contribution, including amounts paid to one of the schools for after-school religious education classes.²

Certain goods or services received in return for a charitable contribution may be disregarded for purposes of determining whether a taxpayer has made a charitable contribution, the amount of any charitable contribution, and whether any goods or services have been provided that must be substantiated or disclosed.³ These items include goods or services that have an insubstantial value under IRS guidelines, certain annual membership benefits received for a payment of \$10.40 or less (in 2014, as indexed annually for inflation) and certain admissions to events.⁴

If a taxpayer makes an otherwise deductible charitable contribution to a university (or other institution of higher learning) that directly or indirectly entitles the donor to purchase tickets for athletic events in the institution's stadium, the contribution is only 80 percent deductible and to the extent that the contribution is not found to be a payment for the tickets themselves.⁵ The IRS has determined that the portion of the payment made to a state university's foundation was deductible under IRC Section 170(l) even though the donor (an S corporation) received the right to purchase tickets for seating in a skybox at events in an athletic stadium of the university. The IRS reasoned that the portion of the payment to the foundation for the right to buy the tickets for seating was considered as being paid for the benefit of the university and, as such, 80 percent of such portion was deductible. The IRS found that the remainder of the payment (consisting of the ticket purchase, the right to use the skybox, the passes to visit the skybox, and the parking privileges) was not deductible.⁶

The IRS has found that contributions made to a university for the purpose of constructing a building providing meeting space for campus organizations qualified for a charitable deduction under IRC Section 170. With the exception of the meeting rooms leased to individual sororities, the facilities in the building would be open to all students. Because the facts indicated that the contributions were indeed gifts to the college, and not gifts to the sororities using the college as a conduit, the IRS determined that the requirements of Revenue Ruling 60-367,⁷ which discussed the circumstances under which donations that benefitted a college fraternity would be considered a gift to an educational institution, had been satisfied.⁸

1. Treas. Reg. §1.170A-1(h)(2).

2. See *Sklar v. Comm.*, 125 TC 281 (2005); see also *Sklar v. Comm.*, 282 F.3d 610 (9th Cir. 2002), aff'g TC Memo 2000-118.

3. Treas. Regs. §§1.170A-1(h), 1.170A-13(f)(8).

4. Treas. Reg. §1.170A-13(f)(8). See also Rev. Proc. 2013-35, 2013-47 IRB 537.

5. IRC Sec. 170(l).

6. See TAM 200004001.

7. 1960-2 CB 73.

8. Let. Rul. 9829053. See also Let. Ruls. 200003013, 199929050.

8917. How is the value of property donated to charity determined?

Where property other than money is donated to charity, it is necessary to calculate the property's fair market value in order to determine the amount of the allowable charitable deduction.

As in other circumstances, fair market value for this purpose 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."¹ The willing buyer has often been viewed as a retail consumer, not a middleman.² However, there are certain circumstances where the retail consumer is not the proper benchmark. For example, in the case of unset gemstones, the ultimate consumer is generally a jeweler engaged in incorporating the gems into jewelry. Therefore, the fair market value is based on the price that a jeweler would pay a wholesaler to acquire such stones.³

Often, taxpayers rely on expert appraisals in determining the fair market value of property.⁴ For some gifts to charity, an appraisal is required (see Q 8918). However, the value assigned by an appraiser is not always controlling and the IRS or the Tax Court may consider factors in addition to those considered by the taxpayer's appraiser(s) which may reduce the value of the gift and, thus, the charitable deduction.⁵ The IRS has warned taxpayers that some promoters are likely to inflate the value of a charitable deduction for gemstones and lithographs, thus subjecting the taxpayer to higher taxes and possible penalties.⁶ Earlier case law has indicated that an auction price may be helpful in determining the value of art.⁷

The taxpayer claiming the charitable deduction has the burden of proof in establishing the fair market value of the property donated.⁸

Evidence of what an organization is willing to pay for copies of a manuscript may be used by the taxpayer as evidence of the value of the original manuscript, but it is not conclusive.⁹ Similarly, the price paid by a bankruptcy trustee may provide evidence of the fair market value, but in at least one case, the courts have found that the substantially higher value established by an appraiser was determinative of the property's value.¹⁰

For property that is transferred to a charity and subject to an option to repurchase, fair market value under IRC Section 170 is the value of the property upon the expiration of the option.¹¹

1. Treas. Reg. §1.170A-1(c); Rev. Rul. 68-69, 1968-1 CB 80.

2. See *Goldman v. Comm.*, 388 F.2d 476 (6th Cir. 1967).

3. *Anselmo v. Comm.*, 80 TC 872 (1983), aff'd 757 F.2d 1208 (11th Cir. 1985).

4. See *Tripp v. Comm.*, 337 F.2d 432 (7th Cir. 1964); *Est. of DeBie v. Comm.*, 56 TC 876 (1971), acq. 1972-2 CB 1 and 1972-2 CB 2.

5. See *Williford v. Comm.*, TC Memo 1992-450 (involving oversized artwork), *Doherty v. Comm.*, TC Memo 1992-98 (involving artwork of questionable quality and authenticity), *Arbini v. Comm.*, TC Memo 2001-141 (involving newspapers and holding that the appropriate market for purposes of determining the fair market value of the newspapers is the wholesale market).

6. IR 83-89.

7. *Mathias v. Comm.*, 50 TC 994 (1968), acq. 1969-2 CB xxiv. But see *McGuire v. Comm.*, 44 TC 801 (1965), acq. in result 1966-2 CB 6.

8. See *Weil v. Comm.*, TC Memo 1967-78; *Schapiro v. Comm.*, TC Memo 1968-44.

9. *Barringer v. Comm.*, TC Memo 1972-234. See also *Kerner v. Comm.*, TC Memo 1976-12.

10. *Herman v. U.S.* and *Brown v. U.S.* (consolidated actions), 99-2 USTC ¶50,889 (E.D. Tenn. 1999).

11. TAM 9828001.

Guidelines for valuing property generally can be found in Revenue Procedure 66-49,¹ and Announcement 2001-22.² See also *Crocker v. Comm.*³ (describing the three methods of determining fair market value of commercial real estate: (1) the replacement method, (2) the comparable sales method, and (3) the income capitalization method).

Planning Point: The fair market value of publicly traded securities is equal to the average value of the high and low stock values on the date of delivery of the stock multiplied by the number of shares given to charity. The date of delivery depends on how the stock was delivered: hand delivered, mailed or electronically transferred.

A taxpayer is not entitled to a charitable deduction for a contribution of clothing or a household item unless the property is in good used condition or better. A deduction for a contribution of clothing or a household item may be denied in circumstances where the donated item has minimal monetary value. These rules do not apply to a contribution of a single item if a deduction of more than \$500 is claimed and a qualified appraisal is included with the return. Household items include furniture, furnishings, electronics, linens, appliances, and similar items; but not food, art, jewelry, and collections.⁴

Planning Point: It is a good idea to take photographs of household items prior to donation to document that they are in good used condition or better.

Intellectual property. The American Jobs Creation Act of 2004 (AJCA 2004) provides strict rules for charitable donations of patents and intellectual property.⁵ For the temporary regulations providing guidance for the filing of information returns by donees relating to qualified intellectual property contributions, see Temporary Treasury Regulation Section 1.6050L-2T; TD 9206;⁶ and Announcement 2005-49.⁷

8918. What verification is required to substantiate a deduction for a charitable donation?

A charitable contribution is allowable as a deduction only if verified as required under regulations.⁸ The required substantiation varies based upon the type and value of the contribution.

A charitable deduction is not allowed for any contribution of a check, cash, or other monetary gift unless the donor retains a bank record or a written communication from the charity showing the name of the charity and the date and the amount of the contribution.⁹

A taxpayer who donates cash or property to charity that has a value of \$250 or more must obtain substantiation in the form of a contemporaneous written acknowledgment of

1. 1966-2 CB 1257, as modified by Rev. Proc. 96-15, 1996-2 CB 627.

2. 2001-11 IRB 895.

3. *TC Memo 1998-204*.

4. IRC Sec. 170(f)(16), as added by PPA 2006.

5. See IRC Secs. 170(e)(1)(B), 6050L; IRC Sec. 170(m). See also Rev. Rul. 2003-28, 2003-11 IRB 594; Notice 2005-41, 2005-23 IRB 1203; Notice 2004-7, 2004-3 IRB 310; and IRS News Release IR-2003-141 (12-22-2003).

6. 70 Fed. Reg. 29450 (5-23-2005).

7. 2005-29 IRB 119. See also Notice 2005-41, 2005-23 IRB 1203.

8. IRC Sec. 170(a)(1).

9. IRC Sec. 170(f)(17), as added by PPA 2006.

the contribution that is supplied by the charitable organization.¹ This acknowledgment must include the following information: (1) the amount of cash contributed and a description (excluding value) of any property contributed, (2) a statement of whether the charitable organization provided any goods or services in consideration for the contribution, and (3) a description and good faith estimate of the value of any such goods or services, or (4) a statement to the effect that the goods or services provided consisted solely of intangible religious benefits.² The acknowledgment will be considered “contemporaneous” if it is obtained by the taxpayer on or before the earlier of (1) the date the taxpayer files his return for the year, or (2) the due date (including extensions) for filing the return.³ Substantiation is not required if the information is reported on a return filed by the charitable organization.⁴ An organization can provide the acknowledgement electronically, such as via an e-mail addressed to the donor.⁵

For contributions of property other than money, the taxpayer is generally required to maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a description of the property. The value does not have to be stated on the receipt.⁶

If a taxpayer donates property with a value that exceeds \$500, the taxpayer must satisfy certain appraisal requirements in addition to the property description requirements outlined below.⁷ The appraisal requirements that generally apply to property valued at more than \$5,000 and at more than \$500,000 do not apply to readily valued property, such as cash, publicly traded securities and certain qualified vehicles for which an acknowledgement is provided. Further, the general appraisal requirement does not apply if the taxpayer can show that the failure was due to reasonable cause and not willful neglect.⁸ For purposes of the valuation thresholds, property (and all similar items of property) donated to one charity will be treated as one property.⁹

If the claimed value of the donated property exceeds \$500, the taxpayer must include with the tax return a *description of the property*.¹⁰ Specifically, the taxpayer must attach a completed Form 8283 to the relevant tax return (Noncash Charitable Contributions), which includes a property description and an acknowledgment by the organization of the amount and value of the gift. (The property description requirement does not apply to a C corporation that is not a personal service corporation or a closely-held C corporation). In addition, a *qualified appraisal* must be obtained when the claimed value of the property exceeds \$5,000 or \$500,000.¹¹ See Q 8919 for a detailed discussion of the appraisal requirements that must be satisfied for certain charitable donations.

1. IRC Sec. 170(f)(8)(A).

2. IRC Sec. 170(f)(8)(B); Treas. Reg. §1.170A-13(f)(2).

3. IRC Sec. 170(f)(8)(C); Treas. Reg. §1.170A-13(f)(3).

4. IRC Sec. 170(f)(8)(D).

5. Publication 1771.

6. Treas. Reg. §1.170A-13(b)(1).

7. IRC Sec. 170(f)(11)(A)(i).

8. IRC Sec. 170(f)(11)(A)(ii).

9. IRC Sec. 170(f)(11)(F).

10. IRC Sec. 170(f)(11)(B).

11. IRC Secs. 170(f)(11)(C), 170(f)(11)(D).

Under the special rule for pass-through entities (partnerships or S corporations), the above requirements will be applied at the entity level; however, the deduction will be denied at the partner or shareholder level.¹

8919. What appraisal requirements may be required in connection with substantiating a charitable deduction for donated property that exceeds certain valuation thresholds?

In addition to satisfying the requirements described in Q 8918, a qualified appraisal is required in connection with the charitable donation of certain highly valued property. The *qualified appraisal* requirement for contributions of property for which a deduction of more than \$5,000 is claimed is met if the individual, partnership, or corporation:

- (1) Obtains a qualified appraisal of the property; and
- (2) Attaches to the tax return information regarding the property and the appraisal (as the Secretary may require).²

Donors who claim a deduction for a charitable gift of property (except publicly traded securities) valued in excess of \$5,000 (\$10,000 for nonpublicly traded stock) are required to obtain a qualified appraisal report, attach an appraisal summary (containing the information specified in regulations) to their return for the year in which the deduction is claimed, and maintain records of certain information related to the contribution.³

If a taxpayer fails to obtain the required appraisal for a gift of nonpublicly traded stock, the IRS may deny the deduction even if it does not dispute the value of the gift.⁴ The Tax Court distinguished its holding in *Hewitt* from a 1993 decision in which it had permitted a deduction to a taxpayer who substantially, though not fully, complied with the appraisal requirement. In the earlier ruling, the taxpayer had obtained an appraisal from a qualified appraiser, completed and attached Form 8283, but had failed to include all the information required of an appraisal summary.⁵ The Fourth Circuit agreed with the Tax Court's analysis, stating that "*Bond* does not suggest that a taxpayer who completely fails to observe the appraisal regulations has substantially complied with them." The Fourth Circuit further found that a deduction may still be permitted in situations where the taxpayers make a good faith effort to comply with the appraisal requirements, but that the deduction will be denied for taxpayers who ignore the requirement entirely. (For more information about the appraisal and summary, see the instructions for Schedule A, Form 1040, and IRS Publication 526, Charitable Contributions).

A qualified appraiser must not be the taxpayer, a party to the transaction in which the taxpayer acquired the property, the donee, an employee of any of the above, any other person who might appear not to be totally independent, or one who is regularly used by the taxpayer,

1. IRC Sec. 170(f)(11)(G).

2. IRC Secs. 170(f)(11)(C), 170(f)(11)(E).

3. Treas. Reg. §1.170A-13(c)(2).

4. *Hewitt v. Comm.*, 109 TC 258 (1997), *aff'd*, 166 F.3d 332 (4th Cir. 1998).

5. See *Bond v. Comm.*, 100 TC 32 (1993).

a party to the transaction or the charity, and does not perform a majority of appraisals for other persons.¹ See, for example, *Davis v. Commissioner*,² where appraisals were upheld where the appraiser was determined to be financially independent of the donor, and no conspiracy or collusive relationship was established.

In *Wortmann v. Commissioner*,³ the Tax Court substantially reduced the taxpayers' charitable deduction (from \$475,000 to \$76,200) after it concluded that the property appraisal was dubious and not well supported by valuation methodology.

An appraisal will not be upheld if the appraiser bases his fee on a percentage of the appraisal value, unless the fee is based on a sliding scale that is paid to a generally recognized association regulating appraisers.⁴

If the donor gives similar items of property (such as books, stamps, paintings, etc.) to the same donee during the taxable year, only one appraisal and summary is required. If similar items of property are given during the same taxable year to several donees, and the aggregate value of the donations exceeds \$5,000, a separate appraisal and summary must be made for each donation.⁵ The appraisal summary must be signed and dated by the donee as an acknowledgment of the donation.⁶

Taxpayers making contributions of art appraised at \$50,000 or more may wish to request a "Statement of Value" from the IRS (which is the equivalent of a letter ruling as to the value of a particular transfer that is made at death, by inter vivos gift, or as a charitable contribution).⁷ The request must include specified information, including a description of the artwork, the cost, manner and date of acquisition, and a copy of an appraisal (which meets requirements set forth in Section 8 of the revenue procedure). The IRS charges a fee of \$2,500 for obtaining a Statement of Value that can cover up to three items of art.⁸

The regulations state that taxpayers are not required to obtain a qualified appraisal of securities whose claimed value exceeds \$5,000 if the donated property meets the definition of "publicly traded securities." Publicly traded securities are (1) listed on a stock exchange in which quotations are published on a daily basis or (2) regularly traded in a national or regional over-the-counter market for which published quotations are available.⁹

Securities that do not meet the above requirements may still be considered publicly traded securities if they meet the following five requirements:

- (1) The issue is regularly traded during the computational period in a market that is reflected by the existence of an interdealer quotation system for the issue;

1. Treas. Reg. §1.170A-13(c)(5)(iv).

2. TC Memo 1999-250.

3. TC Memo 2005-227.

4. Treas. Reg. §1.170A-13(c)(6).

5. Treas. Reg. §1.170A-13(c)(4)(iv)(B).

6. Treas. Reg. §1.170A-13(c)(4)(iii).

7. See Rev. Proc. 96-15, 1996-1 CB 627, as modified by Announcement 2001-22, 2001-11 IRB 895.

8. Rev. Proc. 96-15, above, Sec. 7.01(2).

9. Treas. Reg. §1.170A-13(c)(7)(ix)(A).

- (2) The issuer or its agent computes the issue's average trading price for the computational period;
- (3) The average price and total volume of the issue during the computational period are published in a newspaper of general circulation throughout the U.S. not later than the last day of the month following the end of the calendar quarter in which the computational period ends;
- (4) The issuer or its agent keeps books and records that list for each transaction during the computational period involving each issue covered by this procedure the date of the settlement of the transaction, the name and address of the broker or dealer making the market in which the transaction occurred, and the trading price and volume; and
- (5) The issuer or agent permits the IRS to review the books and records.¹

The "computational period" is weekly during October through December and monthly during January through September. Taxpayers who are exempted from obtaining a qualified appraisal because the securities meet these five requirements must attach a partially completed appraisal summary (section B of Form 8283) to the appropriate returns. The summary must contain the information required by parts I and II of the Form.²

For property contributions for which a deduction of more than \$500,000 is claimed, the individual, partnership, or corporation must attach the qualified appraisal of the property to the tax return for the taxable year.³

8920. Are the substantiation requirements impacted if the charity disposes of the donated property after the taxpayer has already claimed a charitable deduction?

If the charitable donee disposes of "charitable deduction property" that is subject to the rules set forth in Q 8919 within three years after its receipt, the donee must provide an information return to the IRS.

Charitable deduction property includes any property (other than publicly traded securities) for which a charitable deduction was taken under IRC Section 170 where the claimed value of the property (plus the claimed value of all similar items of property donated by the donor to one or more donees) exceeded \$5,000.⁴ The return must show the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the date of disposition, and the amount received on disposition. A copy of the return must be provided to the donor.

1. Treas. Reg. §1.170A-13(c)(7)(ix)(B).

2. Ann. 86-4, 1986-4 IRB 51.

3. IRC Secs. 170(f)(11)(D), 170(f)(11)(E).

4. IRC Sec. 6050L.

Example: If a charity accepts ownership of real estate worth \$300,000 in 2015 from a donor as a charitable gift and later sells the real estate to another party in 2017, the charity will need to provide IRS Form 8282 to the IRS and the donor with the required information.

Failure to file the return may subject the donee to a penalty.¹ However, donee reporting is not required upon disposition of donated property within three years of receipt if the value of the property (as stated in the donor's appraisal summary) was not more than \$5,000 at the time the donee signed the summary. In addition, no reporting will be required if the donee consumes or distributes property without receiving anything in exchange and the consumption or distribution is in furtherance of the donee's charitable purpose (such as the distribution of medical supplies by a tax-exempt relief agency).²

8921. What are the penalties if a taxpayer overvalues property donated to charity?

If a taxpayer underpays his tax because of a substantial valuation misstatement of property donated to charity, the taxpayer may be subject to a penalty of 20 percent of the underpayment attributable to the misstatement.³ However, this penalty applies only if the underpayment attributable to the misstatement exceeds \$5,000 (\$10,000 for a corporation other than an S corporation or a personal holding company).⁴ A "substantial valuation misstatement" exists if the value claimed is 150 percent or more of the amount determined to be correct.⁵ If the value claimed is 200 percent or more of the amount determined to be correct, there is a "gross valuation misstatement," which is subject to a 40 percent underpayment penalty.⁶

8922. What are the income percentage limits for deductions of a charitable contribution?

The amount of a taxpayer's allowable deduction for charitable contributions will depend upon the taxpayer's adjusted gross income (AGI), the type of asset donated, as well as the type of organization to which the donation is made. Further, the IRC distinguishes between gifts "to" a charitable organization and gifts "for the use of" a charitable organization (see below).

50 percent limit. Generally, an individual is allowed a charitable deduction of up to 50 percent of AGI for cash and certain other contributions (other than certain property, see Q 8925) to: churches, schools, hospitals or medical research organizations groups that normally receive a substantial part of their support from federal, state, or local governments or from the general public and that aid any of the above organizations as well as federal, state, and local governments. Also included in this list is a limited category of private foundations (i.e., private operating foundations and conduit foundations)⁷ that generally direct their support to public charities. The above organizations are often referred to as "50 percent-type organizations."⁸

1. IRC Sec. 6721; Treas. Reg. §1.6050L-1. See SCA 200101031.

2. Instructions for IRS Form 8282.

3. IRC Secs. 6662(a), 6662(b)(3).

4. See IRC Sec. 6662(d).

5. IRC Sec. 6662(e)(1)(A), as amended by PPA 2006.

6. IRC Sec. 6662(h)(2)(A)(i), as amended by PPA 2006.

7. See IRC Sec. 170(b)(1)(E).

8. IRC Sec. 170(b)(1)(A).

30 percent limit. The deduction for contributions of most long-term capital gain property to the above “50 percent-type organizations,” contributions *for the use of* any of the above organizations, as well as contributions (other than long-term capital gain property) *to or for the use of* any other types of charitable organizations (i.e., most private foundations) is limited to the lesser of (a) 30 percent of the taxpayer’s AGI, or (b) 50 percent of AGI minus the amount of charitable contributions allowed for contributions to the 50 percent-type charities.¹

20 percent limit. The deduction for contributions of long-term capital gain property to most private foundations is limited to the lesser of (a) 20 percent of the taxpayer’s AGI, or (b) 30 percent of AGI minus the amount of charitable contributions allowed for contributions to the 30 percent-type charities.²

Deductions denied because of the 50 percent, 30 percent, or 20 percent limits may be carried over and deducted over the next five years, retaining their character as 50 percent, 30 percent, or 20 percent type deductions.³

Gifts are “to” a charitable organization if made directly to the organization. Even though the gift may be intended to be used by the charity, and the charity may use it, if it is given *directly* to the charity, it is a gift to the charity and not “for the use of” the charity, for purposes of the deduction limits. Unreimbursed out-of-pocket expenses incurred on behalf of an organization (e.g., unreimbursed travel expenses of volunteers) are deductible as contributions “to” the organization if they are directly related to performing services for the organization (and, in the case of travel expenses, there is no significant element of personal pleasure, recreation, or vacation in such travel).⁴

“For the use of” applies to indirect contributions to a charitable organization.⁵ The term “for the use of” does not refer to a gift of the right to use property. Such a gift would generally be a nondeductible gift of less than the donor’s entire interest. See Q 8929 for a discussion of the permissible deduction when a taxpayer donates only the right to use property, rather than an ownership interest in such property.

8923. When is the deduction for charitable donations taken?

Generally, the deduction for a contribution is taken in the year the gift is made.⁶ However, if the contribution is a future interest in tangible personal property (such as stamps, artwork, etc.), the contribution is considered made (and the deduction allowable) only “when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired” or are held by parties unrelated to the donor.⁷

1. IRC Secs. 170(b)(1)(B), 170(b)(1)(C).

2. IRC Sec. 170(b)(1)(D).

3. IRC Secs. 170(d)(1), 170(b)(1)(D)(ii); Treas. Reg. §1.170A-10(b).

4. IRC Sec. 170(j); *Rockefeller v. Comm.*, 676 F.2d 35 (2nd Cir. 1982), aff’g 76 TC 178 (1981), acq. in part 1984-2 CB 2; Rev. Rul. 84-61, 1984-1 CB 39. See Rev. Rul. 58-279, 1958-1 CB 145.

5. See Treas. Reg. §1.170A-8(a)(2). See *Davis v. United States*, 495 U.S. 472 (1990).

6. IRC Sec. 170(a)(1).

7. IRC Sec. 170(a)(3). See also Treas. Reg. §1.170A-5.

Example: If a donor creates a charitable remainder trust and funds it with a piece of artwork, the donor may not take a charitable income tax deduction for the contribution to the charitable remainder trust until the year the trustee sells the artwork.

This rule does not apply to gifts of undivided present interests, or to gifts of future interests in real property or in intangible personal property.¹ A grant of stock options by a company to a charitable trust resulted in a deduction in the year in which the options were exercised.² Where real estate was transferred to a charity and subject to an option to repurchase, the IRS determined that fair market value under IRC Section 170 was equal to the value of the property *upon the expiration of the option*.³ A fixture that is to be severed from real property is treated as tangible personal property.⁴ The deduction for a charitable contribution made by an accrual basis (see Q 8904) S corporation is properly passed through to shareholders and taken in the year that the contribution is actually paid.⁵

See Q 8928 for an explanation of the treatment given to gifts of partial interests.

8924. Can an individual deduct the fair market value of appreciated real estate or intangible personal property such as stocks or bonds given to a charity?

If an individual makes a charitable contribution of real property or intangible personal property to a public charity, the sale of which would have resulted in long-term capital gain (see below), the taxpayer is generally entitled to deduct the full fair market value of the property. However, the deduction for the gift is limited to the lesser of 30 percent of adjusted gross income or the unused portion of the 50 percent limit (see Q 8922).⁶

A deduction denied because it exceeds 30 percent of the individual's adjusted gross income may be carried over and treated as a contribution of capital gain property in each of the next five years.⁷

Example: In 2014, Jaclyn had adjusted gross income of \$600,000. She made a charitable contribution of long-term capital gain stock worth \$200,000 to her church. Her deduction is limited to \$180,000 (30 percent of \$600,000). In 2015, Jaclyn's adjusted gross income is \$700,000. She contributes \$100,000 worth of long-term capital gain bonds to the church. She may deduct \$120,000 in 2015 (\$100,000 plus \$20,000 carried forward from 2014), since the total does not exceed 30 percent of her adjusted gross income for 2015 (\$210,000).

An individual may elect to take a gift of long-term capital gain property into account at its adjusted basis instead of its fair market value. If the taxpayer makes this election, the income percentage limit for the contribution is increased to 50 percent instead of 30 percent.

1. Treas. Regs. §§1.170A-5(a)(2), 1.170A-5(a)(3).

2. Let. Ruls. 200202034, 8849018.

3. TAM 9828001.

4. IRC Sec. 170(a)(3).

5. TAM 200004001. See also Rev. Rul. 2000-43, 2000-2 CB 333.

6. See IRC Sec. 170(b)(1)(C); Treas. Reg. §1.170A-8(d)(1).

7. IRC Secs. 170(b)(1)(C); Treas. Reg. §1.170A-10(c).

However, such an election applies to all such contributions made during the taxable year.¹ The election is generally irrevocable.²

If the charitable contribution consists of property that, if sold at the time of the contribution, would result in income that would not otherwise qualify for long-term capital gain treatment (such as short-term capital gain property), the deduction must be reduced by the amount of gain that would not be long-term capital gain.³ If the entire gain would be income other than long-term capital gain, the allowable deduction would be limited to the taxpayer's adjusted basis in the contributed property.

Special rules apply to charitable contributions of S corporation stock in determining whether gain on the stock would have been long-term capital gain if the stock were sold by the taxpayer.⁴

Donors making charitable contributions of the long-term capital gain portion of futures contracts must mark the contracts to market as of the dates the contracts are transferred to the donee and recognize the accrued long-term capital gains as income.⁵ The amount of taxable gain or deductible loss recognized by the transferor at the time of the charitable transfer equals the difference between the fair market value of the futures contract at the time of the transfer and the transferor's tax basis in the futures contract, as adjusted under IRC Section 1256(a)(2), to account for gains and losses already recognized in prior tax years under the mark to market rules.⁶

In one case, taxpayers who transferred appreciated stock to charitable organizations in the midst of an ongoing tender offer and merger were taxed on the gain on the stock under the "anticipatory assignment of income doctrine" where the charitable gifts occurred after the taxpayers' interests in a corporation had ripened into rights to receive cash.⁷ But where taxpayers assigned warrants to four charities after receiving a letter announcing that all issued and outstanding stock of the company would be purchased, the Tax Court held that under Revenue Ruling 78-197⁸ the IRS could treat the proceeds of the sales of the warrants by the charities as income to the donors *only if* at the time the assignments took place, the charitable donees were legally bound or could be compelled to sell the warrants.⁹

A taxpayer who donated stock to a supporting organization where the voting rights had been transferred for a business purpose to a third party many years ago, was permitted to claim a charitable deduction.¹⁰

1. IRC Secs. 170(b)(1)(C)(iii), 170(e)(1).

2. *Woodbury v. Comm.*, 90-1 USTC ¶50,199 (10th Cir. 1990), aff'g TC Memo 1988-272.

3. IRC Sec. 170(e)(1)(A); Treas. Reg. §1.170A-4(a).

4. IRC Sec. 170(e)(1).

5. *Greene v. U.S.*, 79 F.3d 1348 (2nd Cir. 1996).

6. *Greene v. U.S.*, 185 F.3d 67, 84 AFTR 2d 99-5415 (2nd Cir. 1999).

7. See *Ferguson v. Comm.*, 174 F.3d 997 (9th Cir. 1999).

8. 1978-1 CB 83.

9. *Rauenhorst v. Comm.*, 119 TC 157 (2002).

10. Let Rul. 200108012.

8925. Is a charitable deduction available for the donation of appreciated tangible personal property, such as art, stamps, coins and gems?

The amount of a deduction permitted for gifts of appreciated personal property depends on whether the use of the gift is *related* to the exempt purpose of the charity to which the property is given. Generally, if the sale of appreciated tangible personal property would result in long-term capital gain (see below), a taxpayer is entitled to deduct the property's full fair market value up to 30 percent of the individual's adjusted gross income, *if* the charity makes use of the property in a way that is related to its charitable purpose or function (i.e., it is a "related-use" gift).¹ The limit is generally 20 percent in the case of private foundations. However, if the use by the charity is unrelated to its charitable purpose or function, the amount of the charitable contribution taken into account is generally limited to the donor's adjusted basis in the donated property.²

The following example illustrates the meaning of "unrelated use": "[I]f a painting contributed to an educational institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use; but if the painting is sold and the proceeds used by the organization for educational purposes, the use of the property is an unrelated use." In addition, the regulations state that contributions of furnishings used by the charitable organization in its offices and buildings in the course of carrying out its functions will be considered a related use gift.³

Planning Point: The charitable organization will state on IRS Form 8283, Part IV (which the donor provides to the IRS as part of the donor's income tax return) whether it intends to use the item for an unrelated use.

The IRS has determined that a gift of seeds, plants, and greenhouses to an IRC Section 501(c)(3) school's plant science curriculum was a related use gift, and that a gift of a violin to a charitable organization whose exempt purpose included loaning instruments to music students was a related use gift.⁴ The IRS has also found that contributions of art to a Jewish community center for use in the center's recreational, educational, and social activities were related use gifts.⁵

If the taxpayer contributes long-term capital gain "related use" property to public charities, the taxpayer may elect to value the gift at its adjusted basis instead of its fair market value. If this election is made, the 30 percent of adjusted gross income limit does not apply. Instead, the donor may deduct the amount of his adjusted basis in the gift, up to 50 percent of adjusted gross income. If the taxpayer makes the election, it applies to all gifts of long-term capital gain property during the year.⁶ Such an election is generally irrevocable.⁷

1. IRC Sec. 170(b)(1)(C); Treas. Reg. §1.170A-8(d)(1).

2. IRC Sec. 170(e)(1)(B).

3. Treas. Reg. §1.170A-4(b)(3)(i).

4. Let. Ruls. 9131052, 9147049.

5. Let. Rul. 9833011.

6. IRC Secs. 170(b)(1)(C)(iii), 170(e)(1).

7. *Woodbury v. Comm.*, 900 F.2d 1457, 90-1 USTC ¶150,199 (10th Cir. 1990), aff'g TC Memo 1988-272.

The amount of the deduction for a contribution of tangible personal property must be reduced by the amount of gain that would *not* be long-term capital gain (gain on a capital asset held for more than one year, see Q 8567) if the contributed property had been sold at its fair market value at the time of the contribution. Thus, for example, if the entire gain would be ordinary income, the allowable deduction would be limited to the taxpayer's adjusted basis in the contributed property. It makes no difference whether or not the property is put to a related use.¹ Ordinary income property includes a work of art created by the donor.²

Planning Point: If an artist makes a charitable gift of the artist's own artwork, the artist will only be able to deduct the costs of creating the art (e.g., paper, paint, etc.).

The charitable deduction is recaptured by the donor on certain dispositions by the charity of tangible personal property identified by the charity as related use property for which a deduction in excess of basis was allowed. Unless the charity makes the appropriate certification, recapture applies if the charity disposes of the property after the taxable year the property was contributed, but before the end of the three-year period starting on the date of contribution (see Q 8920). The certification must be in writing and signed under penalty of perjury by an officer of the charity. The written statement must (1) certify that the use of the property was related and describe the use of the property or (2) state the intended use at the time of contribution and certify that the intended use has become impossible or infeasible to implement. The amount recaptured (included in income) in the year of disposition is equal to the amount of the charitable deduction minus the donor's basis in the property at the time of contribution.³

Example: Amy contributes a painting to an art museum in December 2014. The museum intends to display the painting. Amy claims a charitable deduction for the painting's fair market value of \$100,000 for 2014. Amy's basis in the painting was \$40,000. In 2015 (within three years of the contribution), the museum sells the painting. Amy must include \$60,000 (\$100,000 charitable deduction - \$40,000 basis) in income in 2015.

A charity is required to report any disposition of property (other than publicly traded securities) within three years after its receipt to the IRS, if the claimed value of the property (plus the claimed value of all similar items of property by the donor to one or more charities) exceeds \$5,000. A copy of the related use certification (see above) must be included with this return.⁴ Any person who identifies tangible personal property as related use property and knows that the property is not intended for such use is subject to a \$10,000 penalty.⁵

8926. How is the charitable contribution deduction computed when property is sold to a charity at a reduced price (in a "bargain sale")?

If property is sold to a charity for less than its fair market value (a bargain sale), the individual must first determine whether a charitable deduction is allowable under the general rules

1. See IRC Sec. 170(e)(1)(A); Treas. Reg. §1.170A-4(a).

2. Treas. Reg. §1.170A-4(b)(1).

3. IRC Sec. 170(e)(7), as added by PPA 2006.

4. IRC Sec. 6050L, as added by PPA 2006.

5. IRC Sec. 6720B, as added by PPA 2006.

governing charitable deductions (see Q 8916). The taxpayer must then determine the amounts of the allowable deduction and gain (if any) that will result from the transaction. The taxpayer first calculates the percentage of the property's fair market value that is being contributed and what percentage is being sold. (The fair market value of the contributed portion is the fair market value of the entire property less the amount realized on the sale.¹ The fair market value of the portion sold is the amount realized on the sale).

To determine the permissibility and the amount of the deduction for the contributed portion, the value of the contributed portion must be reduced by any gain that would *not* have been realized as long-term capital gain had the contributed portion been sold, taking into account the basis allocated to it.² If the sale of the contributed portion by the donor would have resulted in long-term capital gain (see example 2, below), no reduction is required unless the gift is tangible personal property and the use of the gift will be unrelated to the function of the charity.³

After any such reduction required by IRC Section 170(e)(1) has been made, the remaining amount of the contribution is the allowable deduction.

The taxpayer's adjusted basis in the property is then allocated to each portion in these proportions.⁴ It is allocated between the portions contributed and sold, based on their relative proportions of the property's fair market value.⁵ Gain is recognized on the sale portion to the extent the amount realized exceeds the allocated basis. However, no loss is recognized if the sale amount is less than the allocated basis of the sold portion.⁶ The amount of the deduction for the contributed portion is determined as if property having the allocated basis and allocated fair market value were given.

The end result of this analysis is that essentially two separate transactions take place: (1) a sale of property that may result in taxable income, and (2) a deductible contribution of property to the charity. In some cases, the application of these rules may result in a taxable gain in excess of the allowed deduction. If the property is subject to a liability, the amount of the liability is treated as an amount realized.⁷

Example 1: Dale sells ordinary income property to his church for \$4,000, which is the amount of his adjusted basis. The property has a fair market value of \$10,000. The contribution portion of the transaction has a value of \$6,000 (\$10,000 fair market value less \$4,000 amount realized) that represents 60 percent of the value of the property. The amount realized represents 40 percent of the value of the property (\$4,000/\$10,000). The adjusted basis (\$4,000) is therefore allocated as follows: 40 percent of it (\$1,600) becomes Dale's basis in the "sold" portion and 60 percent of it (\$2,400) becomes his basis in the "contributed" portion. The \$6,000 "contribution portion" of the transaction has an allocated basis of \$2,400. If it were sold, he would recognize \$3,600 of ordinary income. The deduction for the \$6,000 contribution is therefore reduced by \$3,600. Dale has a charitable deduction of \$2,400. Because Dale is receiving \$4,000

1. Treas. Reg. §1.170A-4(c)(3).

2. IRC Sec. 170(e)(1)(A); Treas. Reg. §1.1011-2(a).

3. IRC Sec. 170(e)(1)(B).

4. IRC Sec. 1011(b); Treas. Regs. §§1.170A-4(c)(2)(i), 1.1011-2.

5. IRC Secs. 170(e)(2), 1011(b); Treas. Reg. §1.170A-4(c)(2).

6. Treas. Reg. §1.1001-1(e).

7. Treas. Reg. §1.1011-2(a)(3).

for the “sold” portion and has an allocated basis in it of \$1,600, he recognizes \$2,400 of ordinary income with respect to the sale part of the transaction. The church’s basis in the property received will be \$6,400; this consists of the sum of the bargain sale price (\$4,000) and the amount of Dale’s basis (\$2,400) in the gift portion.¹

Example 2: The facts are the same as in Example 1, except that the property was long-term capital gain stock. Dale’s allocations of basis are the same as above; therefore, he recognizes \$2,400 on the sale portion of the transaction. However the contributed portion is not subject to a reduction; thus, he is permitted a deduction of \$6,000. The church’s basis in the stock will be \$6,400, determined the same way as in Example 1.

A taxpayer who makes charitable contributions of long-term capital gain property may elect to apply the provisions of IRC Section 170(e)(1) to all such contributions, thus using adjusted basis instead of fair market value to determine the value of the gifts. This election permits the individual to take a higher proportion of income as charitable deductions than would otherwise be allowed (see Q 8922).

In the context of a bargain sale, the Tax Court has found that the charitable deduction was properly claimed in the year that the sale was completed, because sufficient benefits and burdens of ownership had passed to the charitable organization in that year.² Bargain sale treatment was denied to a taxpayer who inflated his valuation to a figure that would enable him to recover his original investment in his property (in the form of cash plus tax savings from the inflated tax deduction).³

8927. How is the amount of a charitable contribution determined when a taxpayer donates property subject to a mortgage or other debt?

When property subject to a liability, such as a mortgage or other debt, is contributed to a charity, the amount of the liability is treated as an amount realized, even if the charity does not assume or pay the debt.⁴ The property is considered sold for the amount realized, and the contribution is subject to the bargain sale rules (see Q 8926).

If the charity assumes a liability or if property is donated that is subject to a liability, the amount of the charitable contribution may not include any interest paid (or to be paid) by the donor for any period after the contribution if the donor is allowed an interest deduction for the amount.⁵ If the property is a bond, the contribution must be reduced by the amount of interest paid by the taxpayer on indebtedness incurred to purchase or carry the bond that is attributable to any period before the making of the contribution. However, the amount of such a reduction is limited to the interest or interest equivalent (e.g., bond discount) on the bond that is not includable in the donor’s income.⁶

1. See Treas. Reg. §1.170A-4(d), Example 5.

2. See *Musgrave v. Comm.*, TC Memo 2000-285.

3. *Styron v. Comm.*, TC Sum. Op. 2001-64.

4. Treas. Reg. §1.1001-2; Rev. Rul. 81-163, 1981-1 CB 433. See Let. Rul. 9329017; *Guest v. Comm.*, 77 TC 9 (1981), acq. 1982-2 CB 1; *Crane v. Comm.*, 331 U.S. 1 (1947).

5. IRC Sec. 170(f)(5); Treas. Reg. §1.170A-3(a).

6. IRC Sec. 170(f)(5)(B); Treas. Reg. §1.170A-3(c).

Example: (a) On January 1, 2004, Jen, an individual using the cash receipts and disbursements method of accounting, purchased for \$9,280 a 5½ percent, \$10,000, 20-year Omega Corporation bond, the interest on which was payable semi-annually on June 30 and December 31. The Omega Corporation had issued the bond on January 1, 2004, at a discount of \$720 from the principal amount. On December 1, 2014, Jen donated the bond to a charitable organization, and, in connection with the contribution, the charitable organization assumed an indebtedness of \$7,000 that Jen had incurred to purchase and carry the bond.

(b) During the 2014 calendar year, Jen paid accrued interest of \$330 on the indebtedness for the period from January 1, 2014, to December 1, 2014, and an interest deduction of \$330 is allowable for such amount. Of the bond discount of \$36 a year (\$720 divided by 20 years), \$33 (11/12 of \$36) is includable in Jen's income. Of the \$550 of annual interest receivable on the bond, she will include in income only the June 30, 2014, payment of \$275.

(c) The market value of the Omega Corporation bond on December 1, 2014, was \$9,902. This value includes \$229 of interest receivable that had accrued from July 1 to December 1, 2014.

(d) The amount of the charitable contribution determined without regard to the reduction required by IRC Section 170(f)(5) is \$2,902 (\$9,902, the value of the property on the date of gift, less \$7,000, the amount of the liability assumed by the charitable organization). In determining the amount of the allowable charitable deduction, the value of the gift (\$2,902) must be reduced to eliminate from the deduction that portion for which Jen has been allowed an interest deduction. Although the amount of such interest deduction was \$330, the reduction required by this section is limited to \$229, since the reduction is not to exceed the amount of interest income on the bond that is not includable in Jen's income.¹

8928. Can a deduction be taken for a charitable contribution of less than the donor's entire interest in property?

Generally, a taxpayer may not deduct a charitable contribution that is less than the entire interest in property unless the contribution is made in trust. (A deduction of a partial interest will be allowed to the extent a deduction would be allowed if the interest had been transferred in trust.²) However, a taxpayer may deduct contributions of partial interests if they are made to each of several charities, with the result that the entire interest in the property has been given to charitable organizations. An individual may make a gift of a partial interest in property if that is the individual's entire interest, but not if partial interests were created to avoid the application of the rule prohibiting gifts of less than the individual's entire interest.³

Exceptions: A deduction is allowed for a contribution of less than the donor's entire interest in property in the following instances:

- (1) The taxpayer donates an irrevocable remainder interest in a personal residence or farm;⁴
- (2) The taxpayer makes a qualified conservation contribution;⁵ or
- (3) The taxpayer donates an undivided portion of his entire interest.⁶ An undivided portion is a fraction or percentage of each and every substantial interest or right

1. See Treas. Reg. §1.170A-3(d) Example (2).

2. IRC Sec. 170(f)(3)(A); Treas. Reg. §1.170A-7(a).

3. Treas. Reg. §1.170A-7(a)(2)(i).

4. IRC Sec. 170(f)(3)(B)(i); Treas. Regs. §§1.170A-7(b)(3), 1.170A-7(b)(4).

5. IRC Sec. 170(f)(3)(B)(iii).

6. IRC Sec. 170(f)(3)(B)(ii).

owned by the donor in property and the fraction or percentage extends over the entire term of the donor's interest in the property and in other property into which that property is converted.¹ The *right* to possession of an undivided portion of the taxpayer's entire interest has been held sufficient to constitute a charitable gift, even where the donee did not actually choose to take possession.² The possibility that a charity's undivided fractional interest may be divested upon the occurrence or nonoccurrence of some event has been determined not to defeat an otherwise deductible contribution where the possibility is deemed so remote as to be negligible.³

The IRS has also found that a charitable gift of an "overriding royalty interest" or a "net profits interest" in an oil and gas lease did not constitute an undivided portion of the donor's entire interest in an oil and gas lease where the donor owned a working interest under the lease.⁴

The IRS has ruled privately that a donor's transfer of a life insurance policy to a charity, where the donor retained bare legal title, was not a retention of a substantial interest for purposes of the partial interest rule. Thus, the donor did not violate the partial interest rule, and was allowed to claim the charitable contribution deduction on the first day following the end of the 30-day cancellation period.⁵

In a case involving the contribution of a patent to a qualified charity, the IRS found that no deduction is allowed if: (1) the taxpayer retains any substantial right in the patent; or (2) the taxpayer's contribution of a patent is subject to a conditional reversion, unless the likelihood of the reversion is so remote as to be negligible. On the other hand, a contribution of a patent subject to a license or transfer restriction will be deductible, but the restriction *reduces* what would otherwise be the fair market value of the patent at the time of the contribution and, therefore, *reduces* the amount of the charitable contribution.⁶

A charitable deduction is not allowed for a contribution of an undivided portion of the donor's entire interest in tangible personal property unless, before the contribution, all interests in the property were held by the donor or the donor and the charity. In the case of any additional contribution of interests in the same property, the fair market value (FMV) of such contributions will be equal to the lesser of (1) the FMV at the time of the initial fractional contribution, or (2) the FMV at the time of the additional contribution.⁷

Example: Mark contributed 10 percent of a painting valued at \$100,000 to an art museum in 2014 (a related use gift). The charitable deduction for the 10 percent interest was \$10,000 in 2014. In 2015,

1. Treas. Reg. §1.170A-7(b)(1). See Rev. Rul. 57-293, 1957-2 CB 153 (undivided $\frac{1}{4}$ ownership and $\frac{1}{4}$ possession of art object); Rev. Rul. 72-419, 1972-2 CB 104 (undivided 20% remainder interest which was the donor's only interest in the property). See also See Let. Ruls. 8145055, 8639019.

2. See *Winokur v. Comm.*, 90 TC 733 (1988), acq. 1989-1 CB 1. See also Let. Ruls. 200223013, 200223014 (the gift of a fractional interest in any work of the donors' collection accepted by the donee (subject to the gift and loan agreement) would qualify as a gift of an undivided portion of the donors' entire interest in the work, relying on *Winokur*, above; thus, the undivided fractional interest would be deductible).

3. Let. Rul. 9303007.

4. See Rev. Rul. 88-37, 1988-1 CB 522.

5. Let. Rul. 200209020.

6. Rev. Rul. 2003-28, 2003-1 CB 594.

7. IRC Sec. 170(o), as added by PPA 2006.

Mark contributes another 10 percent interest in the painting to the art museum when the painting is valued at \$110,000. However, for charitable deduction purposes, the fair market value of the painting cannot exceed the \$100,000 value at the time of the initial contribution. Therefore, the charitable deduction is limited to \$10,000 (10 percent of \$100,000) in 2015.

The charitable deduction for a contribution of an undivided portion of the donor's entire interest in tangible personal property is recaptured (plus interest) if the donor does not contribute all of the remaining interests in the property to charity within 10 years of the initial fractional contribution or before death, whichever is earlier. Recapture is also required if the charity did not have substantial physical possession or make related use of the property during that period. The income tax on the recaptured amount is increased by 10 percent of the amount recaptured.¹

8929. What deduction is available when a taxpayer only grants the charity the right to use property, rather than donating an ownership interest in the property?

The right to use property is less than the entire interest in property owned by an individual and is subject to the rules governing a charitable contribution of less than the donor's entire interest (see Q 8928).² Therefore, generally no deduction will be allowed.

Example: Stephen owns a beautiful vacation home on the beach. He typically rents it for \$3,000 per week. He offers his favorite nonprofit the right to use his vacation homes for a week-long board retreat. Stephen is not, however, able to deduct \$3,000 for the nonprofit's use of the vacation home for the week.

However, in some cases, a deduction has been allowed for the costs of repairing and maintaining property owned by the taxpayer but used by the charity. These deductions have been allowed as contributions "for the use of" the charity.³ Despite this, the IRS has denied a deduction for maintenance and repair costs in other situations.⁴ To be deductible, the costs must be unreimbursed expenses "directly attributable to the performance of ... volunteer services."⁵

A taxpayer was not permitted a deduction when he donated a week's use of his vacation home in connection with a charitable auction, the proceeds of which benefitted charitable organizations. The IRS also noted that the successful bidder would not be permitted a charitable deduction to the extent that valuable consideration is received in return (i.e., the bidder paid fair rental for a week's use of the home).⁶

Tenant-stockholders were allowed to exclude \$500,000 of gain from the disposition of their shares of stock in their cooperative apartment which was coordinated with a donation of the same shares to a charitable organization.⁷

1. IRC Sec. 170(o)(3)(B).

2. IRC Sec. 170(f)(3)(A).

3. See *Est. of Carroll v. Comm.*, 38 TC 868 (1962); Rev. Rul. 58-279, 1958-1 CB 145.

4. Rev. Rul. 58-279, above; Rev. Rul. 69-239, 1969-1 CB 198.

5. Rev. Rul. 58-279, above.

6. Rev. Rul. 89-51, 1989-1 CB 89.

7. See FSA 200149007.

8930. What are the tax consequences of a charitable contribution of a partnership interests?

A partnership interest is a capital asset that, if sold, would be given capital gain or loss treatment except to the extent of the partner's share of certain partnership property that, if sold by the partnership, would produce ordinary gain (i.e., the partner's share of "unrealized receivables" and "substantially appreciated inventory").¹ (See Q 8561 and Q 8562 regarding the treatment of capital gains and losses). Thus, if a taxpayer makes a charitable contribution of a partnership interest, and if the taxpayer has held the interest for long enough to qualify for long-term capital gain treatment (i.e., more than one year, see Q 8567), a deduction is permitted in the amount of the full fair market value of the interest less the amount of ordinary gain, if any, that would have been realized by the partnership for the partnership's share of "unrealized receivables" and "substantially appreciated inventory." (The deduction is subject to the applicable limits. See Q 8922.)

If the partnership interest includes a liability (mortgage, etc.), the amount of the liability is treated as an amount realized on the disposition of the partnership interest.² Thus, the contribution is subject to the bargain sale rules, and the transfer will be treated, in part at least, as a sale (see Q 8926).³ (If the partner's share of the partnership liabilities exceeds the fair market value of his partnership interest, the partner may have taxable income, but no deduction under the bargain sale rules.) In *Goodman v. United States*,⁴ the taxpayer contributed her partnership interest to charity, subject to her share of partnership debt. The district court held that the taxpayer recognized gain on the transfer that was equal to the excess of the amount realized over that portion of the adjusted basis of the partnership interest (at the time of the transfer) allocable to the sale under IRC Section 1011(b).⁵

The following steps must be taken to determine the taxpayer's taxable income and the amount of the charitable deduction under the bargain sale rules:

1. *Determine the taxable gain on the sale portion.* Under the bargain sale rules, part of the donor's basis is allocated to the portion sold. The basis allocated to the sold portion is the amount of basis that bears the same ratio to the entire basis as the amount realized bears to the market value of the property. Presumably, the sold portion includes the same proportionate part of the donor's share of unrealized receivables and substantially appreciated inventory as it does basis.

Example: Adam owns a 10 percent interest in a partnership that he has held for three years. The fair market value of his interest is \$100,000 and his adjusted basis is \$50,000. His share of a mortgage on partnership property is \$40,000, and his share of "unrealized receivables" (potential depreciation recapture on the mortgaged property) is \$5,000 in which the partnership's basis is zero. He donates his entire interest to charity. He is deemed to have received \$40,000, his share of partnership liabilities, on the transfer. In effect there are two transactions—a sale for \$40,000 and a contribution of \$60,000.

1. IRC Sec. 741.

2. Treas. Reg. §1.1001-2. See *Crane v. Comm.*, 331 U.S. 1 (1947).

3. Rev. Rul. 75-194, 1975-1 CB 80.

4. 2000-1 USTC ¶50,162 (S.D. Fl. 1999).

5. Citing Rev. Rul. 75-194 and Treas. Reg. §1.1001-2.

Of Adam's \$50,000 basis in his partnership interest, \$20,000 is allocated to the sale portion: $\$40,000$ (amount realized) / $\$100,000$ (fair market value) \times $\$50,000$ (total adjusted basis). The fair market value of the sold portion is \$40,000 (amount realized). Adam must recognize a gain of \$20,000 ($\$40,000$ realized less $\$20,000$ adjusted basis allocated to the sold portion). Of that gain, \$2,000 is allocable to unrealized receivables ($\$5,000$ unrealized receivables \times $\$40,000 / \$100,000$). Because the partnership has no basis in the unrealized receivables, the entire \$2,000 would be ordinary income. Adam must report a taxable long-term capital gain of \$18,000 and a taxable ordinary gain of \$2,000.

2. *Determine the charitable contribution deduction.* Generally, the fair market value of the portion given to charity is deductible except to the extent the property would have generated ordinary income if sold. Consequently, the allowable deduction for the gift portion must be reduced to the extent the portion of the partnership interest given to the charity would produce ordinary income if sold.

Example: The fair market value of Adam's gift to charity is \$60,000. Because 60 percent of the partnership interest was given to the charity ($\$60,000 / \$100,000$), 60 percent of Adam's share of partnership "unrealized receivables," or \$3,000 ($\$5,000 \times 60\% = \$3,000$), is considered included in the gift. The balance of the gift would be long-term capital gain on sale. Because \$3,000 would be ordinary income on a sale, Adam's contribution is reduced by \$3,000, and his charitable contribution deduction is \$57,000.

Other special rules may apply under certain circumstances, for example, if the partnership owns property subject to tax credit recapture, if it has made installment sales, or (as might occur in the case of an oil and gas partnership) if it is receiving income in the form of "production payments."

APPENDIX A

Income Tax Tables

(Tax Years Beginning in 2013 and beyond)

The American Taxpayer Relief Act of 2012 (ATRA) made the income tax brackets put into place under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) permanent and added a new top tax bracket for certain high income taxpayers. The permanence of the ATRA provisions eliminated much of the uncertainty faced by taxpayers in previous years.

Under ATRA, for tax years beginning after 2012, individual income tax rates are set at 10%, 15%, 25%, 28%, 33%, 35% and 39.6%.

Below are the 2014 income tax rate brackets. Whenever other decisions are made by Congress, you can find them at www.TaxFactsUpdates.com.

Individual 2014 Tax Rates

Taxable Income				
Tax Rate	Single	Married Filing Jointly	Married Filing Separately	Head of Household
10%	\$0 to \$9,075	\$0 to \$18,150	\$0 to \$9,075	\$0 to \$12,950
15%	\$9,975 – \$36,900	\$18,150 – \$73,800	\$9,075 – \$36,900	\$12,950 – \$49,400
25%	\$36,900 – \$89,350	\$73,800 – \$148,850	\$36,900 – \$74,425	\$49,400 – \$127,550
28%	\$89,350 – \$186,350	\$148,850 – \$226,850	\$74,425 – \$113,425	\$127,550 – \$206,600
33%	\$186,350 – \$405,100	\$226,850 – \$405,100	\$113,425 – \$202,550	\$206,600 – \$405,100
35%	\$405,100 – \$406,750	\$405,100 – \$457,600	\$202,550 – \$228,800	\$405,100 – \$432,200
39.6%	Over \$406,750	Over \$457,600	Over \$228,800	Over \$432,200

Estates and Trusts 2014 Tax Rates

Taxable Income	
Tax Rate	
15%	\$0 to \$2,500
25%	\$2,500 – \$5,800
28%	\$5,800 – \$8,900
33%	\$8,900 – \$12,150
39.6%	Over \$12,150

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

(2013 and 2012 Tax Years)

Below are the 2013 and 2012 income tax rate brackets.

2013 Tax Rates

Tax Rate	Single	Married Filing Jointly	Married Filing Separate	Head of Household	Estates and Trusts
10%	\$0 – \$8,925	\$0 – \$17,850	\$0 – \$8,925	\$0 – \$12,750	N/A
15%	\$8,925 – \$36,250	\$17,850 – \$72,500	\$8,925 – \$36,250	\$12,750 – \$48,600	\$0 – \$2,450
25%	\$36,250 – \$87,850	\$72,500 – \$146,400	\$36,250 – \$73,200	\$48,600 – \$125,450	\$2,450 – \$5,700
28%	\$87,850 – \$183,250	\$146,400 – \$223,050	\$73,200 – \$111,525	\$125,450 – \$203,150	\$5,750 – \$8,750
33%	\$183,250 – \$398,350	\$223,050 – \$398,350	\$111,525 – \$199,175	\$203,150 – \$388,350	\$8,750 – \$11,950
35%	\$398,350 – \$400,000	\$398,350 – \$450,000	\$199,175 – \$225,000	\$398,350 – \$425,000	N/A
39.6%	\$400,000 and up	\$450,000 and up	\$225,000 and up	\$425,000 and up	\$11,950 and up

2012 Tax Rates

Tax Rate	Single	Married Filing Jointly	Married Filing Separate	Head of Household	Estates and Trusts
10%	\$0 – \$8,700	\$0 – \$17,400	\$0 – \$8,700	\$0 – \$12,400	NA
15%	\$8,700 – \$35,350	\$17,400 – \$70,700	\$8,700 – \$35,350	\$12,400 – \$47,350	\$0 – \$2,400
25%	\$35,350 – \$85,650	\$70,700 – \$142,700	\$35,350 – \$71,350	\$47,350 – \$122,300	\$2,400 – \$5,600
28%	\$85,650 – \$178,650	\$142,700 – \$217,450	\$71,350 – \$108,725	\$122,300 – \$198,050	\$5,600 – \$8,500
33%	\$178,650 – \$388,350	\$217,450 – \$388,350	\$108,725 – \$194,175	\$198,050 – \$388,350	\$8,500 – \$11,650
35%	\$388,350 and up	\$388,350 and up	\$194,175 and up	\$388,350 and up	Over \$11,650

APPENDIX A: INCOME TAX TABLES

Corporations[†] (Tax Years Beginning in 2013¹)

Taxable Income			
From	To	The tax is:	Of the amount over:
\$0	\$50,000	15%	N/A
\$50,001	\$75,000	\$7,500 + 25%	\$50,000
\$75,001	\$100,000	\$13,750 + 34%	\$75,000
\$100,001	\$335,000	\$22,250 + 39%	\$100,000
\$335,001	\$10,000,000	\$113,900 + 34%	\$335,000
\$10,000,001	\$15,000,000	\$3,400,000 + 35%	\$10,000,000
\$15,000,001	\$18,333,333	\$5,150,000 + 38%	\$15,000,000
Over	\$18,333,333	35%	

[†] Personal Service Corporations are taxed at a flat rate of 35%.

2015 Inflation Indexed Amounts

In April 2014, the IRS announced, in Revenue Procedure 2013-25, these ~~2014~~ inflation indexed amounts:

Health Savings Accounts. An HDHP has annual deductible of not less than \$1,300 for self-only coverage, \$2,600 for family coverage, annual out-of-pocket expenses not exceeding \$6,450 for self-only coverage, or \$12,900 for family coverage. The maximum annual HSA contribution will increase to \$3,300 for self-only coverage and \$6,550 for family coverage.

Please refer to Tax Facts Online and Tax Facts Update (www.TaxFactsUpdates.com) for further developments.

1. IRS Publication 542.

APPENDIX B

Transfer Tax Tables

Though the American Taxpayer Relief Act of 2012 made transfer tax rates permanent for tax years beginning after 2012, in an effort to keep you informed, we have inserted material throughout the text to explain the status of the information and changes that have occurred. In the future, when legislative action is taken we will post the critical information at www.TaxFactsUpdates.com.

2007-2009 Gift and Estate Tax Table

Taxable Gift/Estate		Tax on Col. 1	Rate on Excess
From	To		
\$0	\$10,000	\$0	18%
10,001	20,000	1,800	20%
20,001	40,000	3,800	22%
40,001	60,000	8,200	24%
60,001	80,000	13,000	26%
80,001	100,000	18,200	28%
100,001	150,000	23,800	30%
150,001	250,000	38,800	32%
250,001	500,000	70,800	34%
500,001	750,000	155,800	37%
750,001	1,000,000	248,300	39%
1,000,001	1,250,000	345,800	41%
1,250,001	1,500,000	448,300	43%
1,500,001	555,800	45%

2010 Estate and Gift Tax Table

Taxable Gift/Estate		Tax on Col. 1	Rate on Excess
From	To		
\$0	\$10,000	\$0	18%
10,001	20,000	1,800	20%
20,001	40,000	3,800	22%
40,001	60,000	8,200	24%
60,001	80,000	13,000	26%
80,001	100,000	18,200	28%
100,001	150,000	23,800	30%
150,001	250,000	38,800	32%
250,001	500,000	70,800	34%
500,001	155,800	35%

2011-2012 Gift and Estate Tax Table

Taxable Gift/Estate		Tax on Col. 1	Rate on Excess
From	To		
\$0	\$10,000	\$0	18%
10,001	20,000	1,800	20%
20,001	40,000	3,800	22%
40,001	60,000	8,200	24%
60,001	80,000	13,000	26%
80,001	100,000	18,200	28%
100,001	150,000	23,800	30%
150,001	250,000	38,800	32%
250,001	500,000	70,800	34%
500,001	750,000	155,800	35%
IRC Secs. 2001(c), 2502(a), 2210, as amended by EGTRRA 2001.			

2013 Gift and Estate Tax Table

Taxable Gift/Estate		Tax on Col. 1	Rate on Excess
From	To		
\$0	\$10,000	\$0	18%
10,001	20,000	1,800	20%
20,001	40,000	3,800	22%
40,001	60,000	8,200	24%
60,001	80,000	13,000	26%
80,001	100,000	18,200	28%
100,001	150,000	23,800	30%
150,001	250,000	38,800	32%
250,001	500,000	70,800	34%
500,001	750,000	155,800	37%
750,001	1,000,000	248,300	39%
1,000,001		345,800	40%
IRC Secs. 2001(c), 2502(a), 2210, as amended by EGTRRA 2001 and ATRA.			

2014 Gift and Estate Tax Table

Taxable Gift/Estate		Tax on Col. 1	Rate on Excess
From	To		
\$0	\$2,500	\$0	15%
2,500	5,800	375	25%
5,800	8,900	1,200	28%
8,900	12,150	2,068	33%
Over 12,150	N/A	\$3,140.50	39.6
IRC Secs. 2001(c), 2502(a), 2210, as amended by EGTRRA 2001 and ATRA. Rev. Proc. 2013-35			

APPENDIX B: TRANSFER TAX TABLES

Estate Tax Unified Credit

Year	Exclusion Equivalent	Unified Credit
2000-2001	\$675,000	\$220,550
2002-2003	\$1,000,000	\$345,800
2004-2005	\$1,500,000	\$555,800
2006-2008	\$2,000,000	\$780,800
2009	\$3,500,000	\$1,455,800
2010	\$5,000,000	\$1,730,800
2011	\$5,000,000	\$1,730,800
2012	\$5,120,000	\$1,772,800
2013	\$5,250,000	\$2,045,800
2014	\$5,340,000	\$2,081,800
IRC Sec. 2010(c), as amended by EGTRRA 2001 and ATRA. Rev. Proc. 2013-35		



Gift Tax Unified Credit

Year	Exclusion Equivalent	Unified Credit
1977 (1-1 to 6-30)	\$30,000	\$6,000
1977 (7-1 to 12-31)	120,667	30,000
1978	134,000	34,000
1979	147,333	38,000
1980	161,563	42,500
1981	175,625	47,000
1982	225,000	62,800
1983	275,000	79,300
1984	325,000	96,300
1985	400,000	121,800
1986	500,000	155,800
1987-1997	600,000	192,800
1998	625,000	202,050
1999	650,000	211,300
2000-2001	675,000	220,550
2002-2009	1,000,000	345,800
2010	\$5,000,000	\$1,730,800
2011	\$5,000,000	\$1,730,800
2012	\$5,120,000	\$1,772,800
2013	\$5,250,000	\$2,045,800
2014	\$5,340,000	\$2,081,800
IRC Secs. 2505(a), 2010(c), as amended by EGTRRA 2001 and ATRA. Rev. Proc. 2013-35		



2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

Maximum State Death Tax Credit (SDTC)

Adjusted Taxable Estate		Credit on Col. 1	Rate on Excess
From	To		
\$40,000	\$90,000	\$0	0.8%
90,001	140,000	400	1.6%
140,001	240,000	1,200	2.4%
240,001	440,000	3,600	3.2%
440,001	640,000	10,000	4.0%
640,001	840,000	18,000	4.8%
840,001	1,040,000	27,600	5.6%
1,040,001	1,540,000	38,800	6.4%
1,540,001	2,040,000	70,800	7.2%
2,040,001	2,540,000	106,800	8.0%
2,540,001	3,040,000	146,800	8.8%
3,040,001	3,540,000	190,800	9.6%
3,540,001	4,040,000	238,800	10.4%
4,040,001	5,040,000	290,800	11.2%
5,040,001	6,040,000	402,800	12.0%
6,040,001	7,040,000	522,800	12.8%
7,040,001	8,040,000	650,800	13.6%
8,040,001	9,040,000	786,800	14.4%
9,040,001	10,040,000	930,800	15.2%
10,040,001	1,082,800	16.0%

For this purpose, the term "adjusted taxable estate" means the taxable estate reduced by \$60,000.

Reduction in Maximum SDTC

Year	Multiply Maximum SDTC Above By
2002	75%
2003	50%
2004	25%
2005-2009	NA*
2010	NA*
2011-2014	NA*

*deduction for state death taxes paid replaces credit
IRC Secs. 2011(b), 2011(g), 2058, as amended by EGTRRA 2001 and
ATRA.

APPENDIX B: TRANSFER TAX TABLES

Qualified Family-Owned Business Deduction

Year	Deduction Limitation
1998-2003	\$675,000
2004-2014	NA
IRC Secs. 2057(a)(2), 2057(j), as amended by EGTRRA 2001 and ATRA.	

Estate Tax Deferral: Closely Held Business

Year	2% Interest Limitation
1998	\$410,000
1999	\$416,500
2000	\$427,500
2001	\$441,000
2002	\$484,000
2003	\$493,800
2004	\$532,200
2005	\$539,900
2006	\$552,000
2007	\$562,500
2008	\$576,000
2009	\$598,500
2010	(\$603,000)
2011	\$601,600
2012	\$486,500
2013	\$572,000
2014	\$580,000

Special Use Valuation Limitation

Year	Limitation
1997-1998	\$750,000
1999	\$760,000
2000	\$770,000
2001	\$800,000
2002	\$820,000
2003	\$840,000
2004	\$850,000
2005	\$870,000
2006	\$900,000
2007	\$940,000
2008	\$960,000
2009	\$1,000,000
2010	\$1,000,000
2011	\$1,020,000
2012	\$1,040,000
2013	\$1,070,000
2014	\$1,090,000

IRC Sec. 2032A(a). As updated by Rev. Proc. 2013-35.



Qualified Conservation Easement Exclusion

Year	Exclusion Limitation
1998	\$100,000
1999	\$200,000
2000	\$300,000
2001	\$400,000
2002 and thereafter	\$500,000

IRC Sec. 2031(c)(3).

APPENDIX B: TRANSFER TAX TABLES

Gift (and GST) Tax Annual Exclusion

	Annual
Year	Exclusion
1997-2001	\$10,000
2002-2005	\$11,000
2006-2008	\$12,000
2009-2010	\$13,000
2011-2012	\$13,000
2013	\$14,000
2014	\$14,000
IRC Sec. 2503(b). As updated by Rev. Proc. 2013-35.	



Gift Tax Annual Exclusion (Donee Spouse not U.S. Citizen)

Year	Annual Exclusion
1997-1998	\$100,000
1999	\$101,000
2000	\$103,000
2001	\$106,000
2002	\$110,000
2003	\$112,000
2004	\$114,000
2005	\$117,000
2006	\$120,000
2007	\$125,000
2008	\$128,000
2009	\$133,000
2010	\$134,000
2011	\$136,000
2012	\$139,000
2013	\$143,000
2014	\$145,000
IRC Sec. 2523(i). As updated by 2013-35	



Generation-Skipping Transfer Tax Table

Year	Tax Rate
2001	55%
2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007-2009	45%
2010	0%
2011--2012	35%
2013	40%
2014	40%
IRC Secs. 2641, 2001(c), 2664, as amended by EGTRRA 2001 and ATRA.	



Generation-Skipping Transfer Tax Exemption

Year	GST Exemption
1997-1998	\$1,000,000
1999	\$1,010,000
2000	\$1,030,000
2001	\$1,060,000
2002	\$1,100,000
2003	\$1,120,000
2004-2005	\$1,500,000
2006-2008	\$2,000,000
2009	\$3,500,000
2010--2011	\$5,000,000
2012	\$5,120,000
2013	\$5,250,000
2014	\$5,340,000
*Plus increases for indexing for inflation after 2012. IRC Secs. 2631, 2010(c), as amended by EGTRRA 2001 and ATRA.	



APPENDIX B: TRANSFER TAX TABLES

Indexed Amounts Source

Year	Rev. Proc.
1999	98-61, 1998-2 CB 811
2000	99-42, 1999-46 IRB 568
2001	2001-13, 2001-3 IRB 337
2002	2001-59, 2001-52 IRB 623
2003	2002-70, 2002-46 IRB 845
2004	2003-85, 2003-49 IRB 1184
2005	2004-71, 2004-50 IRB 970
2006	2005-70, 2005-47 IRB 979
2007	2006-53, 2006-48 IRB 996
2008	2007-66, 2007-45 IRB 970
2009	2008-66, 2008-45 IRB 1107
2010	2009-50, 2009-45 IRB 617
2011	2010-40, 2010-46 IRB 663
2012	2011-52, 2011-45 IRB 701
2013	2013-15, 2013-5 IRB 444
2014	2013-35, 2013-47 IRB 537

TABLE OF CASES

(All references are to question numbers.)

212 Corp. v. Comm.	8903	BOSP Invs, RS & P/WC Fields Ltd.	
303 West 42nd St. Enterprises, Inc. v. IRS	8669	Partnership v.	8863
Aero Indus. Co., Inc. v. Comm.	8833	Bowers, Wilson v.	8886
Ahmanson Found. v. U.S.	8864	Bright, Est. of v. U.S.	8864
Akers v. Comm.	8890	Brock v. Comm.	8708
Allen v. Comm.	8656	Brodie v. Comm.	8903
Allison Engine Co., Grande v.	8792	Brodrick v. Gore	8886
Al-Murshidi v. Comm.	8540	Bronk v. Mountain States Telephone & Telegraph	8668
Alsobrook v. U.S.	8694	Bronstein, Spivak v.	8875
American Bar Endowment, U.S. v.	8916	Brown v. U.S.	8917
American Family Mut. Ins. Co. v. U.S.	8736	Bruce v. Cole	8863
American Foundry v. Comm.	8740	Buffalo Tool & Die Manufacturing Co., Inc. v. Comm.	8885
American Institute of Family Relations v. U.S.	8670	Bullard v. U.S.	8699
American Savings Bank v. Comm.	8674	Burr v. Comm.	8732
American Taxpayer Relief Act of 2012	8854	Burrey v. Pacific Gas and Electric Co.	8668
Anderson v. Comm.	8695, 8862	Butts v. Comm.	8671
Andress v. U.S.	8732	Byers v. Comm.	8689
Andrews, Est. of v. Comm.	8864	Byrd, Est. of v. Comm.	8861
Anselmo v. Comm.	8917	Caligiuri v. Comm.	8698
Arbini v. Comm.	8917	Canaday v. Guitteau	8708
Atlantic Coast Realty Co. v. Comm.	8915	Caplan, Est. of v. Comm.	8886
Atlas Heating & Ventilating Co. v. Comm.	8705, 8856	Carroll, Est. of v. Comm.	8929
Austin v. Comm.	8649	Carter Trust v. Comm.	8638
Bailey v. Comm.	8672	Casale v. Comm.	8703, 8706, 8903
Baker v. Comm.	8540	Castner Garage, Ltd. v. Comm.	8739
Barret, U.S. v.	8649	Centre v. Comm.	8903
Barringer v. Comm.	8917	Cerone v. Comm.	8860
Beane v. Comm.	8668	Champion Trophy Mfg. Corp. v. Comm.	8705, 8708, 8856
Beaudry v. Comm.	8699	Charlie Sturgill Motor Co. v. Comm.	8740
Beisler v. Comm.	8730	Child's Est., Comm. v.	8886
Bell Est. v. Comm.	8903	Chism, Est. of v. Comm.	8732
Bennett, Est. of v. Comm.	8864	Citizens Bank & Trust Co. v. Comm.	8864
Bensel, Comm. v.	8886	City Bank Farmers Trust Co. v. Comm. .	8886
Berg, Est. of v. Comm.	8864	Clark v. Comm.	8673
Bernard v. U.S.	8681	Coca-Cola Co., Wolf v.	8668
Billman v. Comm.	8649	Cole v. Comm.	8698
Bingham v. Comm.	8568, 8697	Cole, Bruce v.	8863
Blake v. Comm.	8916	Colton v. Comm.	8730
Boecking v. Comm.	8705, 8856	Community Research and Dev. Corp. v. Comm.	8695
Bogene, Inc. v. Comm.	8740	Connelly v. Comm.	8690
Bohn v. Comm.	8697	Corwin, Rosing v.	8699
Bond v. Comm.	8919		

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

Costanza, Est. of v. Comm.	8873	Foglesong v. Comm.	8845
Cotlov v. Comm.	8673	Ford, Est. of v. Comm.	8892
Courier Journal Job Printing Co. v Glenn	8695	Fox, Sanders v.	8707
Cox v. Comm.	8672	Frane vs. Comm.	8873
Coyle v. Comm.	8699	Frank Aragona Trust et. al. v. Comm.	8597
Crane v. Comm.	8927, 8930	Frazier v. Comm.	8732
Cravens v. Comm.	8689	Freeman-Dent-Sullivan Co. v U.S.	8695
Critical Care Support Services, Inc., In re	8670	Fries v. Fries	8858
Crocker v. Comm.	8917	Fry Est. v. Comm.	8865
Curry, Est. of v. U.S.	8864	Fryer v. Comm.	8695
D'Alonzo v. Comm.	8697	Gallo, Est. of v. Comm.	8885
Darrell Harris, Inc. v. U.S.	8670	Gannon, Est. of v. Comm.	8886
Data Mgmt. Resources, Inc., Hunt v.	8866	General Dynamics Corp., U.S. v.	8725
David Metzger Trust v. Comm.	8860	General Inv. Corp. v. U.S.	8670
Davidson v. Comm.	8673, 8674	Geometric Stamping Co. v. Comm.	8915
Davis v. Comm.	8649, 8919	George Blood Enterprises, Inc. v. Comm.	8672
Davis v. U.S.	8922	Giberson v. Comm.	8740
De Loss v. Comm.	8699	Gillet, Est. of v. Comm.	8885
Deamer v. Comm.	8679	Glacier State Electric Supply Co. v. Comm.	8859
DeBie, Est. of v. Comm.	8917	Gliptis v U.S.	8694
Deming v. Comm.	8739	Godley v. Comm.	8894
Denison v. Comm.	8690	Goldman v. Comm.	8917
Dennis v. Comm.	8672	Goldsmith v. U.S.	8706
Desmond, Est. of v. Comm.	8864	Goodman v. U.S.	8930
Dodge v. Comm.	8739	Gore, Brodrick v.	8886
Doherty v. Comm.	8917	Gorkes v. Comm.	8645
Dolese v. Comm.	8811	GPD, Inc. v. Comm.	8829
Donruss Co, U.S. v.	8854	Grande v. Allison Engine Co.	8792
Drever, Stephenson v.	8852	Greco v. U.S.	8670
Drew/Core Dev., LLC, Maxx Private Invs., LLC v.	8858	Green v. Comm.	8546, 8699
Durden v. Comm.	8649	Greene v. U.S.	8924
Edgar v. Comm.	8695, 8794	Grider v Comm.	8906
Elkins	8675	Gross v. Comm.	8864
Epmeier v. U.S.	8732	Guest v. Comm.	8927
Epstein v. Comm.	8740	Guinan v. U.S.	8618
Ernest Holdeman & Collet, Inc. v. Comm.	8725	Guitteau, Canaday v.	8708
Essenfeld v. Comm.	8794	Gustafson v Comm.	8906
Express Oil Change, Inc. v. U.S.	8728	Haar v. Comm.	8546
Eyefull Inc. v. Comm.	8829	Hackett v. Comm.	8903
Fay v. Helvering	8649	Hamlen v Welch	8695
Ferguson v. Comm.	8924	Hansen, Comm. v.	8904
Finkbohner v. U.S.	8649	Harris v. U.S.	8732
Finzer v. U.S.	8540	Haskel v. Comm.	8697
Fiorito v. Comm.	8886	Hassen v. Comm.	8569
First National Bank v. U.S.	8689	Haverty Realty & Investment Co. v. Comm.	8718
Flowers, Comm. v.	8677	Hecksher, Est. of v. Comm.	8864
		Helvering v. Horst	8674

TABLE OF CASES

Helvering, Fay v.	8649	Leuthold v. Comm.	8694
Helvering, Shuster v.	8903	Levine v. Comm.	8732, 8740
Henderson v. Comm.	8540	Littick, Est. of.	8886
Hendon, Raymond B. Yates Profit Sharing Plan v.	8666	Lomb v. Sugden	8886
Hendrix v. Comm.	8862	Lucas v. Comm.	8693
Herman v. U.S.	8917	Lutz v. Comm.	8695
Hewitt v. Comm.	8919	Maddock, Est. of.	8886
Hill, Farrer & Burrill v. Comm.	8665	Mandel v. Sturr	8886
Hoffman v. Comm.	8886	Mandelbaum v. Comm.	8864
Holman v. Comm.	8695	Markey v. Comm.	8677
Horst, Helvering v.	8674	Martin Ice Cream Co. v. Comm.	8891
Hunt v. Data Mgmt. Resources, Inc.	8866	Martin v. Comm.	8887, 8894
Hynard v. IRS	8695	Maryland Ship- building & Drydock Co. v. U.S.	8904
In the Matter of Appeal of M and L Tofig	8671	Massachusetts Mutual Life Ins. Co. v. U.S.	8903
Industrial Rayon Corporation v. Comm.	8699	Matheson v. Comm.	8649
J & J Cab Service, Inc. v. U.S.	8670	Mathews, Est. of v. Comm.	8886
Jacobs v. Comm.	8852	Mathias v. Comm.	8917
Jacuzzi v. Comm.	8903	Maxx Private Invs., LLC v. Drew/Core Dev., LLC	8858
James F. Waters, Inc. v. Comm.	8718	May v. McGowan	8886
James v. U.S.	8679, 8865	McAdams v. Comm.	8546
James, Est. of v. Comm.	8886	McAvoy v. Comm.	8680
Jameson v. Comm.	8708	McCann, Comm. v.	8886
Jankowsky v. Comm.	8699	McCormick Estate v. Comm.	8864
John H. Watson, Jr.	8699	McGill, Est. of v. Comm.	8885
Johnson v. Comm.	8715, 8856	McGowan v. Comm.	8738
Kaufman, Est. of.	8732	McGowan, May v.	8886
Kavanaugh v. U.S.	8695	McGowan, Williams v.	8805
Kerner v. Comm.	8917	McGuire v. Comm.	8917
Kimbell v. U.S.	8894	McNeill v. Comm.	8679
King v. Comm.	8518	McWilliams v. Comm.	8569
Kline v. Comm.	8886	Medical Emergency Care Associates v. Comm.	8669
Knott v. Comm.	8864	Meisels, Winthrop v.	8916
Krasnow v. U.S.	8694	Mellen v. Comm.	8698
Krauss v. U.S.	8886	Mensik v. Comm.	8672
Labombarde v., Est. of.	8873	Mercil v. Comm.	8698
Lacey v. Comm.	8703, 8706	Michigan Trust Co. v. Comm.	8886
Lafavre v. Comm.	8654	Microsoft Corp., Vizcaino v.	8668
Lambert's Nursery and Landscaping, Inc. v. U.S.	8670	Miller Development Co. v. Comm.	8915
Lambeth v. Comm.	8718	Miller v. Comm.	8801
Land v. U.S.	8886	Millette and Associates, Inc. v. Comm.	8674
Lane v. U.S.	8694	Minton v. Comm.	8866
Lang v. Comm.	8732	Minzer, Comm. v.	8672
Larkin v. Comm.	8727, 8740	Monroe v. Patterson.	8718
Latendresse v. Comm.	8673	Moore v. Comm.	8864
Lavery v. Comm.	8730	Moss v. Comm.	8873
Leidy, Est. of v. Comm.	8740		
Leuschner, U.S. v.	8706		

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

Mountain States Telephone & Telegraph, Bronk v.	8668	Rockefeller v. Comm.	8922
Moyer v. Comm.	8699	Rodeo Family Enters., LLC v Matte	8859
Murray v. U.S.	8908	Rohlin, Oldcastle Materials, Inc. v.	8865
Musgrave v. Comm.	8926	Rose v Comm.	8694
National Federation of Independent Business v. Sebelius.	8763	Rosen v. U.S.	8730
National Indus. Investors, Inc. v. Comm.	8705	Rosing v. Corwin	8699
Newman v. Comm.	8691	Roubik v. Comm.	8845
Nicholson v Comm.	8694	RS & P/WC Fields Ltd. Partnership v. BOSP Invs.	8863
Niekamp v. U.S.	8732	Rubinkam v Comm.	8696
Northwestern Ind. Tel. Co. v. Comm.	8829	Rubish, Est. of v. Comm.	8885
Norwalk v. Comm.	8890	Rushing v Comm.	8867
Nu-Look Design v. Comm.	8670	Russon v. Comm.	8648
Oak Rd. Family Dentistry, P.C. v. Provident Life & Accident Ins. Co.	8855	Salt, Est. of	8886
Oatman v. Comm.	8698	Sanders v. Comm.	8680
Oden v. Comm.	8814	Sanders v. Fox	8707
Oldcastle Materials, Inc. v. Rohlin.	8865	Schapiro v. Comm.	8917
Oleander Co., Inc. v. U.S.	8740	Schneider v. Comm.	8695
Oppenheim v. Comm.	8701	Schwartz v. Comm.	8708
Ostheimer v. U.S.	8672	Sebelius, National Federation of Independent Business v.	8763
Pacific Gas and Electric Co., Burrey v.	8668	Security Associates Agency Insurance Corp. v. Comm.	8672
Patterson, Monroe v.	8718	Seidel v. Comm.	8740
Peurifoy v. Comm.	8678	Seismic Support Services v. Comm.	8675
Peyser v. U.S.	8699	Shah v. U.S.	8685
Pickle v. Comm.	8732	Sharp v. U.S.	8646
Poyda v. Comm.	8741	Shaw v. Comm.	8674
Pritchett v. Comm.	8633	Sheppard v. U.S.	8916
Providence Mill Supply Co. v. Comm.	8890, 8893	Sherman v. Comm.	8681
Provident Life & Accident Ins. Co, Oak Rd. Family Dentistry, P.C. v.	8855	Shuster v. Helvering.	8903
Prunier v. Comm.	8707	Sierracin Corp. v. Comm.	8912
Putnam v Comm.	8694	Silk, U.S. v.	8662
Raffold Process Corp. v. Comm.	8697	Simplot v. Comm.	8864
Rakow v. Comm.	8864	Simplot, Est. of v. Comm.	8864
Rath v. Comm.	8701	Simpson v. U.S.	8794
Rath, Est. of v. U.S.	8720	Six v. U.S.	8678
Rauenhorst v. Comm.	8924	Sklar v. Comm.	8916
Raymond B. Yates Profit Sharing Plan v. Hendon.	8666	Slocum v. U.S.	8881, 8886
Reimels v. Comm.	8546	Smith Elec. Co. v. U.S.	8696
Remington v. Comm.	8673	Smith v. Comm.	8694, 8740
Robert Dallas	8873	Smithback v. Comm.	8740
Robertson v. Comm.	8677	Smoky Mountain Secrets v. U.S.	8670
Robertson vs. Comm.	8903	Snedeker v. Comm.	8701
Robin Haft Trust v. Comm.	8860	Snyder v. Comm.	8870
Robinson v. Comm.	8794	Spitzer v. Comm.	8886
Robinson-Davis Lumber Co. v Crooks ...	8695	Spivak v. Bronstein	8875
		Spoul v. Comm.	8903
		Sproull, and Jacuzzi v. Comm.	8903
		St. Louis County Bank v. U.S.	8886

TABLE OF CASES

Stephenson v. Drever	8852	Webster v. Comm.	8730
Stovall v. Comm.	8895	Weeks v. Comm.	8708
Strangi, Est. of v. Comm.	8894	Weil v. Comm.	8917
Stubbs v. U.S.	8916	Weil, Est. of	8886
Sturgis v. Comm.	8708	Wells v. Comm.	8689
Sturr, Mandel v.	8886	Wesley H. Morgan	8701
Styles, Wilcox v.	8863	Wessels v. Whetstone	8858
Styron v. Comm.	8926	West v. Comm.	8730
Sugden, Lomb v.	8886	Western Products Co. v. Comm.	8653
Superior Coal Co. v. Comm.	8699	Whetstone, Wessels v.	8858
Sutton v. Comm.	8571	Whitaker v. Comm.	8714
Swanson v. Comm.	8719	Wickersham v. Comm.	8618
Tauferner, U.S. v.	8680	Wigutow v. Comm.	8740
Thomas by & Through Schmidt v. Thomas	8858	Wilcox v. Styles	8863
Thomas v. U.S.	8903	Williams v. Comm.	8837
Thomas, Thomas by & Through Schmidt v.	8858	Williams v. McGowan	8805
Titus, Est. of	8864	Williford v. Comm.	8917
Tompkins, Est. of v. Comm.	8886	Willis v. Comm.	8614
Torre v. Comm.	8649	Wilson v. Bowers	8886
Trammell, Est. of v. Comm.	8886	Wilson v. Comm.	8678
Tripp v. Comm.	8917	Windsor	8502
True v. Comm. 8853, 8858, 8862, 8865		Winkler v, Est. of	8864
True, Est. of v. Comm.	8886	Winokur v. Comm.	8928
Trujillo v. Comm.	8738	Winthrop v. Meisels	8916
Tucker v. Comm.	8680	Wolf v. Coca-Cola Co.	8668
Tufts, Comm. v.	8540	Wollenburg v. U.S.	8736
Turner v. Comm.	8673	Wood v. Comm.	8570
Two Percent Safe Harbor”	8820	Woodbury v. Comm. 8537, 8924, 8925	
Van Anda Est. v. Comm.	8698	Worcester County Trust Co. v. Comm.	8886
VIP Industries Inc. v. Comm.	8606	Worden v. Comm.	8672
Vizcaino v. Microsoft Corp.	8668	Worster, Est. of v. Comm. 8705, 8856	
Vogel Fertilizer Co., U.S. v.	8833	Wortham Mach. v. U.S.	8695
Wachovia Bank & Trust Co. v U.S.	8696	Wortmann v. Comm.	8919
Walmart v. Comm.	8915	Wright, Est. of v. Comm.	8794
Wandry vs. Comm.	8870	Wyoming Inv. Co. v. Comm.	8699
Ware v. U.S.	8671	Yuengling v. Comm.	8708
Watts, Est. of v. Comm.	8885	Zipkin v. U.S.	8540
		Zorniger v. Comm.	8890

TABLE OF IRC SECTIONS CITED

(All references are to question numbers.)

1	8899	24(f)	8544
1(e)	8840	25A	8542
1(f)(1)	8511	25B	8542
1(f)(2)	8511	25C	8542
1(f)(3)	8511	25D	8542
1(f)(4)	8511	26(a)(2)	8552
1(g)(2)	8557	27	8593
1(g)(4)	8557	30	8542
1(g)(4)(A)(i)	8557	30B(g)(1)	8542
1(g)(7)	8558	30C(d)(1)	8542
1(h)	8561, 8563, 8564	30D	8542
1(h)(1)	8564, 8573	31(a)	8541
1(h)(2)	8562, 8564	32	8541
1(h)(5)	8563	35	8541
1(h)(7)	8623	36B	8767
1(h)(9)	8564	36B(d)(1)	8768
1(h)(11)(D)(i)	8527	36B(d)(2)	8768
1(i)	8564	36B(d)(2)(B)	8768
2	8502	36B(d)(5)	8767
2(b)	8503	38	8593, 8909
2(b)(1)	8503	38(b)	8542
2(d)	8503	38(c)(4)(B)	8726
11	8822	38B(c)(2)(C)(i)	8775
11(b)	8825	38B(c)(2)(C)(ii)	8776
21	8542, 8785	40(a)	8542
21(b)(2)	8782	40A(a)	8542
21(c)	8785	41(a)	8542
22	8542, 8543	42(a)	8542
22(b)	8543	43(a)	8542
22(c)	8543	44(a)	8542
22(c)(2)(B)(i)	8543	45(a)	8542
22(c)(2)(B)(ii)	8543	45(b)	8726
22(c)(3)	8543	45A(a)	8542
22(d)	8543	45B(a)	8542
22(e)(1)	8543	45C(a)	8542
22(e)(3)	8543	45D(a)	8542
23	8542	45E(a)	8542
24	8542	45E(c)	8542
24(a)	8544	45F(a)	8542
24(b)(2)	8544	45G(a)	8542
24(b)(3)	8544	45H(a)	8542
24(c)(1)	8544	45I(a)	8542
24(c)(2)	8544	45J(a)	8542
24(d)	8544	45K(a)	8542
24(d)(1)	8544	45L(a)	8542
24(e)	8544	45M(a)	8542

TABLE OF IRC SECTIONS CITED

45R	8726, 8760	63(c)(5)	8521
45R(c)	8726	63(c)(6)	8520
45R(d)	8726	63(c)(6)(D)	8810
45R(d)(4)	8726	63(f)	8519
45R(g)(2)(A)	8726	67	8661, 8671, 8693
45R(g)(2)(B)	8726	67(a)	8524
45R(g)(2)(C)	8726	67(b)	8524, 8688
45R(g)(3)	8726	67(c)(1)	8524
46	8542	68(a)	8525
49(a)(1)	8629	68(b)	8525
49(a)(1)(D)(iv)	8634	68(c)	8525, 8738
49(a)(2)	8629	68(d)	8525
51(a)	8542	68(e)	8525
53	8542	72(a)	8583
53(b)	8554, 8831	72(b)	8583
53(c)	8831	72(m)(3)	8723
53(d)	8554	72(m)(7)	8756
55	8831	72(p)	8581
55(a)	8551	72(r)(1)	8546
55(b)(1)(A)	8551	79	8721, 8722, 8788
55(b)(1)(B)	8831	79(a)	8721
55(b)(2)	8553, 8831	79(a)(1)	8721
55(d)(1)	8551	79(b)	8723
55(d)(2)	8831	79(b)(3)	8723
55(d)(3)	8555, 8831	79(d)	8724
55(e)	8832	79(d)(3)(A)	8724
55(e)(1)	8832	79(d)(3)(B)	8724
55(e)(2)	8832	79(d)(4)	8724
55(e)(5)	8832	79(d)(5)	8724
56	8553	79(d)(6)	8724
56(a)	8831	79(d)(7)	8724
56(b)(1)(F)	8525	82	8686
56(c)	8831	83	8882
56(d)	8831	83(a)	8882
56(g)	8831	83(h)	8882
57(a)(7)	8623	86	8546
58	8553	86(a)(1)	8545
59(j)	8556	86(b)(2)	8545
61	8727, 8741, 8742	86(c)(1)	8545
61(a)	8512	86(c)(1)(C)(ii)	8546
61(a)(1)	8672, 8795	86(c)(2)	8545
61(a)(12)	8514	86(e)	8546
62	8661, 8671, 8676	101(a)	8512, 8715, 8731, 8739, 8794
62(a)(1)	8671, 8676	101(a)(2)	8717
62(a)(2)	8693	101(a)(2)(A)	8717, 8719
62(a)(15)	8685	101(a)(2)(B)	8717, 8719
62(c)	8664, 8693	101(d)	8512
63	8519	101(i)	8794
63(c)	8501, 8519	101(j)	8716
63(c)(4)	8519, 8521	101(j)(2)	8710

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

101(j)(2)(A)	8716	125	8743, 8744, 8749,
101(j)(2)(B)	8716		8791, 8792, 8793
101(j)(3)(A)	8716	125(b)(1)	8789
101(j)(4)	8716	125(b)(2)	8789
102	8512	125(d)	8787
104	8739	125(d)(1)(B)	8788
104(a)(1)	8512, 8546	125(d)(2)	8788
104(a)(3)	8739	125(d)(2)(C)	8788
104(a)(4)	8512, 8546	125(d)(2)(D)	8744, 8748, 8788
105	8736, 8740	125(e)	8789
105(b)	8729, 8730, 8743, 8788	125(f)	8788
105(c)	8730	125(g)(1)	8789
105(e)	8732, 8740	125(g)(2)	8789
105(e)(2)	8740	125(g)(3)	8789
105(g)	8732, 8850	125(g)(4)	8789
105(h)	8716, 8733, 8736, 8762	125(i)	8788, 8791, 8792
105(h)(1)	8737	125(j)(1)	8790
105(h)(2)	8733	125(j)(2)	8790
105(h)(3)	8733	125(j)(3)(A)	8790
105(h)(3)(A)	8736	125(j)(3)(B)	8790
105(h)(3)(B)	8736	125(j)(3)(D)	8790
105(h)(4)	8736	125(j)(4)(A)	8790
105(h)(5)	8733, 8736	125(j)(4)(B)	8790
105(h)(6)	8734	125(j)(5)(A)	8790
105(h)(7)	8737	125(j)(5)(C)	8790
106	8727, 8741, 8742,	127	8780, 8781
	8743, 8788	127(a)(1)	8778
106(a)	8727	127(a)(2)	8778
106(b)	8754	127(b)(1)	8779
106(b)(2)	8748	127(b)(2)	8779
106(b)(5)	8744	127(b)(3)	8779
106(c)(1)	8792	127(b)(4)	8779
106(d)	8512, 8748	127(b)(5)	8779
106(d)(1)	8744, 8748	127(b)(6)	8779
106(d)(2)	8744, 8748	127(c)(1)	8780
106(e)	8743	127(c)(3)	8779
106(e)(5)	8753	127(c)(5)	8779
106(f)	8743, 8756, 8792	129	8785
108(a)(1)(E)	8514	129(a)	8785
108(c)(3)	8514	129(a)(2)(A)	8793
108(d)(7)(A)	8838	129(b)	8785
108(g)(2)	8514	129(c)	8785
121	8587, 8605, 8615, 8616,	129(d)	8783, 8788
	8618, 8619, 8620, 8621	129(d)(1)	8782, 8783
121(a)	8587, 8615	129(d)(5)	8782
121(b)	8615, 8617	129(d)(8)(B)	8783
121(b)(3)	8615	129(d)(9)	8783
121(c)(1)	8616	129(e)(1)	8782
121(c)(2)	8616	129(e)(8)	8785
121(d)(7)	8616	129(e)(9)	8786

TABLE OF IRC SECTIONS CITED

132	8795, 8800	163(d)	8525, 8527, 8645, 8648
132(a)(6)	8686	163(d)(1)	8645
132(c)	8797	163(d)(2)	8646
132(d)	8798	163(d)(3)	8527
132(e)(1)	8799	163(d)(3)(A)	8645
132(e)(2)	8799	163(d)(4)	8647
132(f)(1)	8796	163(d)(4)(A)	8645
132(f)(2)	8796	163(d)(4)(B)	8645
132(f)(3)	8796	163(d)(4)(B)(i)	8645
132(f)(5)(A)	8796	163(d)(4)(B)(ii)	8645
132(f)(5)(B)	8796	163(d)(4)(B)(iii)	8562
132(f)(5)(C)	8796	163(d)(4)(C)	8645
132(f)(5)(E)	8796	163(d)(5)	8873
132(f)(6)	8796	163(d)(5)(A)(i)	8645
132(g)	8686	163(h)(2)	8531
132(h)	8795	163(h)(2)(F)	8532
132(j)(1)	8795, 8797	164(a)	8522
132(j)(2)	8797	164(b)(5)(A)	8523
132(j)(3)	8798	164(b)(5)(I)	8523
132(j)(6)	8795	164(f)	8550, 8663
135	8512	164(h)(3)	8529
137	8512	164(h)(4)(A)	8529
138	8512	165	8573, 8585, 8649,
139A	8512		8654, 8659, 8699
151	8501, 8515, 8517, 8748	165(a)	8659, 8715
151(c)	8782, 8785	165(c)(3)	8649
151(d)(2)	8515	165(e)	8652
151(d)(3)	8516	165(g)(2)	8699
151(d)(4)	8516	165(g)(2)(C)	8699
151(e)	8515, 8517	165(g)(3)	8700
152	8517, 8743	165(h)(1)	8654
152(a)	8517	165(h)(2)	8654
152(c)	8517, 8544	165(h)(2)(A)	8658
152(c)(4)(B)	8518	165(h)(2)(B)	8658
152(d)	8517	165(h)(4)(A)	8658
152(e)(1)(B)	8518	165(h)(5)(D)	8655
152(f)	8517	165(h)(5)(E)	8522, 8655
152(f)(1)	8544	165(i)	8656, 8659
152(f)(1)(B)	8544	165(k)	8659
152(f)(1)(C)	8544	165(l)(1)	8660
152(f)(3)	8517	165(l)(2)	8660
162	8664, 8686, 8695,	165(l)(3)	8660
	8741, 8742, 8784	165(l)(4)	8660
162(a)	8676, 8678, 8704,	165(l)(5)	8660
	8705, 8856, 8882	165(l)(6)	8660
162(a)(2)	8677	165(l)(7)	8660
162(l)	8667, 8741, 8742, 8850	165(m)(1)	8700
162(l)(1)(B)	8667	166	8698, 8699
162(l)(2)(A)	8667	166(a)	8694
163(a)	8854	166(a)(2)	8697

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

166(b)	8695, 8697	170(f)(11)(A)(ii)	8918
166(d)(1)	8694, 8697	170(f)(11)(B)	8918
166(d)(2)	8694	170(f)(11)(C)	8918, 8919
166(d)(2)(A)	8694	170(f)(11)(D)	8918, 8919
166(d)(2)(B)	8694	170(f)(11)(E)	8919
166(e)	8699	170(f)(11)(F)	8918
168(b)(3)(A)	8563	170(f)(11)(G)	8918
168(c)	8566	170(f)(12)	8539
168(e)(2)(A)(ii)(I)	8914	170(f)(16)	8539, 8917
170	8916, 8917, 8920, 8923	170(f)(17)	8539, 8918
170(a)	8916	170(j)	8922
170(a)(1)	8918, 8923	170(l)	8916
170(a)(3)	8923	170(m)	8539, 8917
170(b)(1)(A)	8535, 8922	170(o)	8928
170(b)(1)(A)(ii)	8788	170(o)(3)(B)	8928
170(b)(1)(A)(vii)	8538	199	8825
170(b)(1)(B)	8922	212	8637
170(b)(1)(B)(i)	8536	213	8525, 8540, 8738, 8741, 8743
170(b)(1)(C)	8537, 8922, 8924, 8925	213(a)	8738
170(b)(1)(C)(ii)	8537	213(c)	8540
170(b)(1)(C)(iii)	8537, 8924, 8925	213(d)	8540, 8756, 8792
170(b)(1)(D)	8922	213(d)(1)	8540, 8738, 8761
170(b)(1)(D)(ii)	8922	213(d)(1)(D)	8738
170(b)(1)(E)	8535, 8538, 8922	213(d)(2)	8540
170(b)(2)	8825	213(d)(5)	8540
170(c)(2)(B)	8596	213(d)(6)	8738
170(d)	8535	213(d)(7)	8738
170(d)(1)	8922	213(d)(9)	8540
170(d)(2)	8825	213(d)(9)(A)	8540
170(e)(1)	8537, 8924, 8925, 8926	213(d)(10)	8667
170(e)(1)(A)	8537, 8924, 8925, 8926	217	8513, 8686
170(e)(1)(B)	8537, 8539, 8917, 8925, 8926	217(a)	8685
		217(b)(1)	8685
170(e)(2)	8926	217(b)(2)	8685
170(e)(5)	8538	217(c)(1)	8685
170(e)(5)(C)	8538	217(c)(2)	8685
170(e)(7)	8925	219	8665
170(f)(3)(A)	8928, 8929	220(i)	8513
170(f)(3)(B)(i)	8928	221	8532
170(f)(3)(B)(ii)	8928	223	8754
170(f)(3)(B)(iii)	8928	223(a)	8744, 8748
170(f)(5)	8927	223(b)	8748
170(f)(5)(B)	8927	223(b)(1)	8748, 8754
170(f)(8)	8539	223(b)(2)	8748
170(f)(8)(A)	8918	223(b)(3)	8748
170(f)(8)(B)	8918	223(b)(4)	8748
170(f)(8)(C)	8918	223(b)(5)	8748
170(f)(8)(D)	8918	223(b)(6)	8748
170(f)(11)	8539	223(b)(7)	8745
170(f)(11)(A)(i)	8918	223(b)(8)	8748

TABLE OF IRC SECTIONS CITED

223(c)(1)(A)	8745	274(n)(2)(A)	8688
223(c)(1)(B)	8745	274(n)(3)	8688
223(c)(2)(A)	8747	280A	8619
223(c)(2)(C)	8747	280A(c)(1)	8692
223(c)(3)	8745	280A(c)(1)(C)	8692
223(c)(5)	8747	280A(f)(1)(A)	8619
223(d)(1)	8744	301(a)	8859
223(d)(2)	8756	301(c)	8708
223(d)(2)(A)	8761	302	8839, 8859, 8860
223(e)(1)	8744, 8755	302(b)(3)	8860
223(e)(2)	8755	302(c)(2)	8860
223(f)	8744	303	8839, 8851, 8859, 8861
223(f)(1)	8512, 8756	303(a)	8861
223(f)(2)	8754, 8756	303(b)	8861
223(f)(3)(A)	8754	303(b)(1)	8861
223(f)(4)(A)	8756	303(b)(2)(A)	8861
223(f)(4)(B)	8756	303(b)(2)(B)	8861
223(f)(4)(C)	8756	303(b)(3)	8861
223(g)	8747	303(b)(4)	8861
243	8825	303(d)	8861
243(a)(1)	8826	304(a)(1)	8859
243(a)(3)	8826	311(b)	8839
243(c)	8826	312(a)	8859
245	8826	312(n)(7)	8859
246(a)	8826	316(a)	8859
248	8824, 8849	318	8724, 8860, 8879
262(a)	8713, 8714	318(a)	8860, 8861, 8910
263	8741	318(a)(1)	8860
263A	8905	331(a)	8868
264(a)(1)	8704, 8705, 8711, 8712	336(a)	8868
264(a)(4)	8717	351	8844
265	8526	368(a)(1)(F)	8844
265(a)(1)	8714	381	8839
267	8698	401(a)	8581, 8665, 8802
267(a)	8569	401(a)(22)	8804
267(a)(1)	8569	401(a)(23)	8802
267(b)	8569, 8609, 8633, 8683, 8818, 8820, 8910	401(a)(28)	8804
267(c)	8569	401(c)	8665
267(c)(4)	8569, 8820	401(c)(3)	8665
267(d)	8569	401(c)(4)	8665
267(f)	8569, 8834	401(m)	8788
274	8683	403(a)	8581
274(a)	8688	403(b)	8581
274(a)(1)(A)	8688	408	8581
274(c)	8683	408(e)(2)	8755
274(e)	8691	408(e)(4)	8755
274(k)	8688	408(m)(2)	8563
274(n)	8688	408A	8581, 8665
274(n)(1)	8688	409(c)(2)	8804
		409(c)(3)	8804

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

409(e)(5)	8804	453(d)	8911
409(h)	8802	453(e)	8867, 8910
409(h)(2)(B)	8802	453(e)(1)	8910
409(h)(3)	8802	453(e)(2)	8910
409(h)(4)	8802	453(e)(6)	8910
409(h)(5)	8802	453(e)(6)(C)	8910
409(h)(6)	8802	453(e)(7)	8910
409(o)(1)(A)	8803	453(f)	8910
409(o)(1)(C)	8803	453(f)(3)	8873
414(b)	8833	453(g)(2)	8867
414(c)	8833	453(l)	8908
414(q)	8716, 8783	453(l)(2)	8908
414(q)(1)(B)	8789	453B(a)	8868
414(q)(4)	8783	457(b)	8581
414(r)	8783	460	8913
414(t)	8724	460(b)(1)	8913
416(i)	8724	460(b)(5)	8913
441	8507, 8896	460(e)	8914
441(a)	8507	460(e)(1)(B)	8914
441(b)	8507	460(e)(1)(B)(ii)	8914
441(b)(3)	8507	460(e)(4)	8914
441(c)	8896	460(e)(6)(A)	8914
441(d)	8507, 8896	460(f)(1)	8912
441(e)	8507, 8896	460(f)(2)	8912
441(f)	8896	460(f)(2)(B)	8912
441(f)(1)	8507	461(h)	8904
441(g)	8507	465	8627
441(i)	8507	465(a)	8631
442	8507, 8902	465(b)	8632
443(a)	8507, 8901	465(b)(2)	8633
443(a)(1)	8901	465(b)(3)	8633
443(a)(2)	8901	465(b)(3)(C)	8633
443(b)	8507	465(b)(4)	8632
443(b)(1)	8901	465(b)(6)	8634
443(c)	8507, 8901	465(b)(6)(C)	8634
444	8866, 8897	465(b)(6)(D)(i)	8634
444(b)	8899	465(c)	8630
444(e)	8899	465(d)	8629
446(b)	8907	469	8530, 8589, 8597, 8635,
446(c)	8906		8636, 8648
446(c)(1)	8903	469(a)	8637, 8641
446(e)	8907	469(a)(2)	8636
448(a)	8905	469(b)	8639
448(b)	8905	469(b)(7)(B)	8597
448(c)	8832	469(c)	8589
448(h)(4)	8904	469(c)(2)	8597, 8640
453	8854	469(c)(3)	8637
453(b)(1)	8867, 8908	469(c)(7)(B)	8597
453(b)(2)	8908	469(e)(1)	8648
453(c)	8908	469(e)(2)	8635

TABLE OF IRC SECTIONS CITED

469(e)(4)	8637	704(c)(1)(A)	8811
469(f)	8639	704(c)(1)(B)	8811
469(g)(1)	8644	704(c)(1)(C)	8811
469(g)(1)(B)	8644	704(c)(2)	8811
469(g)(2)	8644	704(d)	8627, 8813
469(g)(3)	8644	704(e)	8808
469(h)(1)	8597, 8638	704(e)(1)	8817
469(h)(4)	8638	704(e)(2)	8627, 8817
469(h)(5)	8638	704(e)(3)	8817
469(j)(1)	8635	705	8814
469(j)(2)	8635	705(a)	8814, 8815
469(j)(6)	8644	705(a)(1)	8814
469(j)(8)	8640	705(a)(2)	8814
469(j)(9)	8644	705(a)(3)	8814
469(j)(10)	8640	706	8896, 8897
469(j)(12)	8644	706(a)	8813
469(k)	8641	706(b)	8507, 8897
469(k)(1)	8639, 8641	706(b)(1)(C)	8899
469(k)(3)	8644	706(b)(2)	8507
471	8915	706(b)(3)	8897
472(b)(2)	8915	706(b)(4)	8897
481(a)	8907	706(d)	8627, 8810
482	8811, 8834, 8845	707(b)	8569
483	8909	707(b)(1)	8633, 8818, 8820
483(e)(3)	8909	707(c)	8675, 8741
501	8569, 8596, 8900	708(b)	8844
501(c)(3)	8724, 8925	709(b)	8809
509(a)(1)	8538	721	8844
531	8829	722	8814
532(c)	8829	732	8820
533(c)(1)	8854	741	8930
535	8829	751	8537, 8816
535(c)(2)	8829	752	8815
537(a)(2)	8854	752(a)	8814
541	8830	752(b)	8814
542(a)(1)	8830	754	8816
542(a)(2)	8631, 8830	761(f)	8806
543(a)	8830	851(a)	8819
544	8830	901	8542, 8593
641(c)	8840	911	8774
664	8596	911(d)	8774
671	8719	911(d)(2)	8557
677(b)	8559	936	8835
701	8807, 8810	1001	8827
702	8813	1001(a)	8565
703(a)	8810	1011(b)	8926, 8930
704(a)	8627, 8810, 8811	1012	8565, 8882
704(b)	8810, 8811	1014	8565, 8828
704(b)(2)	8627	1015(a)	8565, 8882
704(c)	8815	1016(a)(1)	8566

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

1016(a)(2)	8563, 8566	1222(11)	8562
1022	8560	1223	8567, 8827
1031	8606, 8608, 8610, 8612	1223(15)	8625
1031(a)	8606, 8622, 8827	1231	8639, 8819, 8837
1031(a)(1)	8606	1233	8568
1031(a)(2)	8606	1233(b)(1)	8568
1031(a)(2)(D)	8606	1233(b)(2)	8568
1031(d)	8608	1233(d)	8568
1031(f)	8609	1233(f)	8568
1031(f)(1)	8609	1234	8571
1031(f)(2)	8609	1234(a)(1)	8571
1031(f)(4)	8609	1234(a)(2)	8571
1031(h)	8606	1234(b)	8571
1033	8611, 8612, 8613, 8614, 8621, 8651, 8910	1234(b)(2)	8571
1033(a)	8611, 8612	1235	8572
1033(a)(2)	8611, 8612	1235(a)	8572
1033(a)(2)(A)	8612	1235(b)	8572
1033(a)(2)(B)	8613	1244	8701
1033(h)	8613	1244(b)	8701
1036	8622, 8827	1245	8630
1041	8720	1250	8562, 8563, 8564, 8573, 8619
1044	8626	1256(a)(2)	8924
1044(a)	8626	1259	8624
1044(b)(1)	8626	1271	8570
1044(b)(2)	8626	1271(a)(1)	8570
1044(c)(3)	8626	1271(a)(2)	8570
1044(c)(4)	8626	1271(a)(2)(A)	8570
1044(d)	8626	1271(a)(2)(B)	8570
1045	8625	1274(d)(2)(B)	8909
1045(a)	8625	1274(e)	8909
1045(b)(3)	8625	1361	8835, 8841, 8844
1045(b)(4)	8625	1361(b)	8866
1045(b)(5)	8625	1361(b)(1)(B)	8840
1201	8825	1361(b)(1)(D)	8878
1202	8563, 8564, 8573, 8623, 8624, 8625	1361(b)(3)	8842
1202(b)	8623	1361(c)(1)	8840
1202(b)(3)(B)	8623	1361(c)(2)	8840
1202(g)	8623	1361(c)(2)(B)(v)	8840
1202(j)	8624	1361(c)(4)	8835, 8841
1202(j)(1)	8624	1361(d)	8840
1202(j)(2)	8624	1361(e)	8840
1211(a)	8575	1362	8835, 8841
1211(b)	8573, 8575, 8585	1362(d)	8866
1212(a)	8575	1362(d)(3)	8836
1221	8560, 8827	1363	8710, 8835
1221(a)	8571	1363(a)	8836
1222	8567, 8825, 8827	1363(b)	8837
1222(3)	8537	1363(d)	8836
		1366	8710
		1366(a)	8837

TABLE OF IRC SECTIONS CITED

1366(a)(1)	8837	1411(c)(6)	8589
1366(a)(1)(A)	8869	1411(d)	8578
1366(b)	8837	1411(e)	8580
1366(d)(1)	8838	1561(a)(1)	8834
1366(d)(2)	8838	1561(a)(2)	8834
1366(f)(3)	8837	1563	8783, 8833
1367(a)	8869	1563(d)	8833
1367(a)(1)	8838	2031	8853
1367(a)(2)	8838	2031(b)	8887
1367(a)(2)(A)	8839	2032	8828
1367(a)(2)(D)	8710	2032A	8895
1368	8710	2032A(a)(1)	8895
1368(b)	8839	2032A(b)	8895
1368(c)	8839	2032A(b)(1)(A)	8895
1368(c)(3)	8839	2032A(b)(1)(C)	8895
1371	8869	2032A(c)	8895
1371(a)	8839	2032A(c)(7)(C)	8895
1371(c)	8839	2032A(d)(2)	8895
1371(d)	8836	2032A(e)(6)	8895
1372	8742, 8850	2035	8861, 8883
1374	8836	2035(c)(1)(A)	8861
1374(b)(1)	8869	2036	8879, 8894
1374(d)(7)	8869	2036(a)	8879
1375(a)	8836	2036(b)	8879
1375(b)(3)	8836	2036(b)(2)	8879
1375(b)(4)	8836	2053	8861
1377(a)	8837	2054	8861
1378	8507, 8866	2056(b)(5)	8881
1378(b)	8898, 8899	2056(b)(7)	8880
1396(a)	8542	2512	8894
1400S(b)	8659	2701	8878
1401	8550	2701(a)(2)	8878
1401(b)(2)	8550	2701(a)(3)	8878
1402(a)	8675	2701(a)(3)(B)	8878
1402(a)(1)	8895	2701(a)(3)(C)	8878
1402(a)(13)	8675	2701(b)	8878
1402(g)(1)	8765	2701(b)(2)	8878
1411	8564	2701(b)(2)(C)	8878
1411(a)	8580	2701(c)(3)	8878
1411(a)(1)	8577	2701(e)(1)	8878
1411(c)	8589	2701(e)(2)	8878
1411(c)(1)	8579	2701(e)(3)	8878
1411(c)(1)(A)	8579	2702	8883
1411(c)(1)(A)(i)	8583, 8586, 8588	2703	8862, 8881, 8886
1411(c)(1)(A)(ii)	8588	2703(b)	8862
1411(c)(1)(A)(iii)	8583, 8584, 8585, 8586, 8587, 8588	3101	8548
1411(c)(2)	8588	3101(a)	8548
1411(c)(3)	8588	3101(b)	8548
1411(c)(5)	8581	3101(b)(2)	8598
		3102(a)	8599

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

3111(a)	8548	6039I	8716
3121(d)	8661	6050L	8917, 8920, 8925
3121(d)(3)	8661	6093I	8716
3121(d)(3)(B)	8676	6166	8861, 8874
3401(a)(20)	8734	6166(a)(1)	8874
3405(c)	8803	6166(a)(3)	8874
3405(e)(8)	8803	6331	8744
3508	8727	6511(d)(1)	8696
4973(a)	8754	6654(a)	8549
4973(g)	8754	6654(c)	8549
4975(e)(7)	8802, 8804	6654(d)(1)(A)	8549
4980(D)(d)(1)	8762	6655(g)(4)	8836
4980D	8762	6662(a)	8921
4980D(c)(3)	8762	6662(b)(3)	8921
4980D(d)(1)	8762	6662(d)	8921
4980E	8749	6662(e)(1)(A)	8921
4980E(a)	8752	6662(h)(2)(A)(i)	8921
4980E(b)	8752	6707A(c)(2)	8628
4980E(d)(2)	8749	6720B	8925
4980E(d)(3)	8749, 8750	6721	8920
4980G	8749, 8753	7519	8836, 8866
4980G(b)	8752	7519(b)	8899
4980G(d)	8749, 8751	7701(a)(20)	8727, 8787
5000A(c)	8764	7701(a)(23)	8896
5000A(d)	8764	7701(a)(24)	8896
5000A(d)(2)	8765	7702	8731
5000A(d)(3)	8765	7702B(b)	8667, 8756
5000A(d)(4)	8765	7704	8810
5000A(e)(1)	8765	7704(b)	8818
5000A(e)(2)	8765	7704(c)(1)	8819
5000A(e)(3)	8765	7704(c)(3)	8819
5000A(e)(4)	8765, 8773	7704(d)(1)	8819
5000A(e)(5)	8765	7704(e)	8819
5011(a)	8542	7704(f)	8819
6012(a)	8501, 8813	7805(b)	8860
6017	8550, 8663	7872	8645
6039D	8781, 8786		

INDEX

References to question numbers.

A

Above the line deduction	8676
ACA. <i>See</i> Patient Protection and Affordable Care Act (PPACA)	
Accidental death benefit	8725
Accounting	
accounting method	8907
accrual method	8904, 8905, 8906
accrual basis.....	8904, 8905
all event test	8904
cash basis method.....	8903, 8906
installment method	8908, 8909, 8911
applicable federal rate (AFR)	8909
interest	8909
inventory accounting method	8915
first-in, first-out (FIFO)	8915
last-in, first-out (LIFO).....	8915
specific identification methods.....	8915
material items	8907
percentage of completion method.....	8913, 8914
accounting period.....	8896, 8897, 8898, 8900, 8901, 8902
alternate.....	8902
grandfathered	8899
short period	8900
accrual basis	8904, 8905
accrual method	8904, 8905, 8906
accrual basis	8904, 8905
all event test.....	8904
AFR	8909
all event test	8904
alternate accounting period	8902
annual business cycle test.....	8900
applicable federal rate (AFR)	8909
C corporation.....	8905
calendar year.....	8896
cash basis method	8903, 8906
cash equivalence.....	8903
constructive receipt	8903
de minimis rule.....	8913
dealer disposition	8908
economic benefit.....	8903
FIFO	8915
first-in, first-out (FIFO)	8915
fiscal year	8896
grandfathered accounting period.....	8899
home construction contract.....	8914
exemption	8914

Accounting (cont'd)

installment method	8908, 8909, 8911
applicable federal rate (AFR).....	8909
interest	8909
installment sale rules	8910, 8911
involuntary conversion	8910
second sale.....	8910
inventory accounting	8915
first-in, first-out (FIFO).....	8915
last-in, first-out (LIFO)	8915
specific identification methods	8915
involuntary conversion.....	8910
last-in, first-out (LIFO)	8915
LIFO	8915
long-term contract.....	8912, 8913, 8914
material items	8907
partnership	8897, 8899, 8900, 8902
percentage of completion method	8913, 8914
personal service corporations.....	8905
principal partner	8897
related party	8910
S corporation	8898, 8899, 8900, 8902
safe harbor	8912
customized item	8912
inventoried item	8912
short production period.....	8912
seasonal business test	8900
short period.....	8901
specific identification methods.....	8915
25 percent gross receipts test.....	8900
valid business purpose.....	8899, 8900
annual business cycle test	8900
seasonal business test	8900
25 percent gross receipts test	8900

Accounting for bad debts..... 8696

Accounting method

accrual method	8904–8906
accrual basis	8904, 8905
all event test	8904
cash basis method	8903, 8906
installment method	8908, 8909, 8911
applicable federal rate (AFR).....	8909
interest	8909
inventory accounting method.....	8915
first-in, first-out (FIFO).....	8915
last-in, first-out (LIFO)	8915
specific identification methods	8915
material items	8907
percentage of completion method	8913, 8914

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Accounting period	8896, 8897, 8898, 8900, 8901, 8902
alternate	8902
grandfathered	8899
short period	8900
Accrual basis	8904, 8905
Accrual method	8904–8906
accrual basis	8904, 8905
all event test	8904
Adjusted basis	8653, 8654
Adjusted gross income	
dependency exemption	8517
defined	8513
discharge of indebtedness	8514
exemptions, personal	8515
Adjusted tax basis	8566
capital improvement	8566
depreciation	8566
AFR	8909
Affiliated corporation	
defined	8700
Affordable Care Act (ACA). <i>See</i> Patient Protection and Affordable Care Act (PPACA)	
All event test	8904
Alternate accounting period	8902
Alternative minimum tax (AMT)	
generally	8551
calculation of	8551
credit for prior year tax liability	8553
exemption	8555
kiddie tax	8557
personal tax credits	8552
adoption tax credit	8552
child and dependent care credit	8552
child tax credit	8552
earned income credit	8552
energy saving credits	8552
learning credits	8552
phase out	8555
prior year tax liability, credit for	8553
Alternative minimum taxable income (AMTI)	
adjustments	8553
exemption amounts	8553
preference items added to	8553
AMT. <i>See</i> Alternative minimum tax (AMT)	
AMTI. <i>See</i> Alternative minimum taxable income (AMTI)	
Annual business cycle test	8900
Applicable federal rate (AFR)	8909
Assignments	
transfer for value rule	8718
“At risk” limitation on losses	
adjustments to “amount at risk”	8632
“amount at risk,” defined	8632

“At risk” limitation on losses (cont’d)	
borrowed amounts	8632
cash contributions to covered activity	8632
nonrecourse financing	8632
Away from home	8677, 8678
defined	8678
temporarily	8678

B

B corporation	
defined	8846
tax treatment	8847
Bad debt	
accounting for	8696
bona fide debt	8695
creditor-debtor relationship	8695
business	8697
capital loss treatment	8694
charge-off method in accounting for	8696
creditor-debtor relationship	8695
deduction	8694, 8698
business	8694, 8695
nonbusiness	8694
from ordinary income	8694
permitted	8699
deduction from ordinary income	8694
deduction permitted	8699
identifiable event	8699
loan made between related parties	8698
nonbusiness debts,	
partially worthless	8697
partially worthless	8697
business bad debt	8694
nonbusiness bad debt	8697
partially worthless business	8694
partially worthless nonbusiness debt	8697
reserve method	8696
S corporation	8694
security, defined	8699
significantly modified	8696
valid and enforceable agreement	8695
worthless	8695
worthless loan	8698
worthless securities	8699
deduction permitted	8699
identifiable event	8699
Bad debt deduction	8698
Basis	
generally	8565
defined	8565
exchange	
property acquired by	8565
stock	8566

INDEX

References are to question numbers.

Basis (cont'd)

purchased property 8565

Benefit corporation. *See* B corporation

Blind individuals

standard deduction, increase in 8519

Bona fide business purpose 8682

Bona fide debt 8695

creditor-debtor relationship 8695

Business bad debt 8694, 8697

deduction from ordinary income 8694

Business expense deduction

above the line deduction 8676

away from home 8677, 8678

defined 8678

temporarily 8678

bona fide business purpose 8682

business-related education expenses 8687

requirements 8687

business-related entertainment

expenses and meals 8688–8691

deductibility of 8688

directly related to or associated with trade or

business 8688

50 percent limitation 8688

lavish or extravagant 8688

ordinary and necessary 8689

substantiation requirements 8691

business travel expenses 8677–8684

away from home 8677

bona fide business purpose 8682

commuting between principal residence and place

of business 8680

cost of commuting 8684

in the pursuit of business 8677

multiple places of business 8681

no tax home 8679

primary purpose behind trip 8682

“principal” place of business 8681

reasonable and necessary travel expense 8677

related travel outside the United States 8683

transportation days 8683

transportation expenses when not travelling away

from home 8684

trip has both business and personal elements 8682

commuting between principal residence and place of

business 8680

cost of commuting 8684

deductibility of reimbursed moving expenses 8686

employer 8686

education expenses 8687

requirements 8687

employer’s reimbursement 8693

reporting requirements 8693

unreimbursed expenses 8693

Business expense deduction (cont'd)

entertainment 8688–8691

deductibility of 8688

directly related to or associated with trade or

business 8688

50 percent limitation 8688

lavish or extravagant 8688

ordinary and necessary 8689

substantiation requirements 8691

50 percent limitation 8688

lavish or extravagant 8688

defined 8690

home office,

deductibility of 8692

part of residence as office 8692

principal place of business 8692

place of business used for meeting with

patients, clients, or customers 8692

separate structure 8692

included in gross income of employee 8686

nonqualified 8686

qualified 8686

lavish or extravagant 8688

defined 8690

meals 8688–8691

deductibility of 8688

directly related to or associated with trade

or business 8688

50 percent limitation 8688

lavish or extravagant 8688

ordinary and necessary 8689

substantiation requirements 8691

moving expenses 8685–8686

deductibility of reimbursed expenses 8686

included in gross income of employee 8686

nonqualified 8686

qualified 8686

multiple places of business 8681

necessary expense 8676

no tax home 8679

ordinary expense 8676

outside the United States 8683

transportation days 8683

primary place of business 8678

primary purpose behind trip 8682

“principal” place of business 8681

reasonable and necessary travel expense 8677

related travel outside the United States 8683

transportation days 8683

reporting requirements 8693

temporarily “away from home” 8678

transportation expenses when not travelling

away from home 8684

trip has both business and personal elements 8682

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Business expense deduction (cont'd)

unreimbursed expenses. *See also* Self-employed person 8693

Business expenses

business life insurance 8713, 8714

Business health insurance

accidental death benefit 8725
benefits

disability 8725

discrimination 8733

sight loss and dismemberment 8725

credit for expenses of small employers 8726

deduction by employer 8725

discrimination rules, plans

subject to 8733

employee contributions 8733

employer deductions 8725

highly compensated employees,

special rules for 8733

nondiscrimination 8733

part-time workers 8733

premiums

deductibility of 8725

seasonal workers 8733

self-insured plans 8733

small employers, credit for expenses of 8726

withholding 8733

Business life insurance. *See also* Life insurance

corporations

premiums, deduction of 8705

death proceeds 8715

generally 8715

contracts after August 17, 2006 8715

exemption from income tax 8715

family member, sale of policy to 8720

insured himself, sale of policy to 8719

partners and partnerships 8717

receipt of, generally 8715

sale of policy, effect on exemption 8717

spouse, sale of policy to 8720

transfer for value rule 8717

defined 8702

distributions 8710

employer

premiums paid by, effect of 8708, 8709

employer-owned life insurance (EOLI)

death proceeds 8716

defined 8716

notice and consent requirements 8716

reporting requirements 8716

Form 8925 8716

key person

partners 8711, 8712

premium. *See* premiums, key person, *this entry*

Business life insurance. (cont'd)

loans, policy

transfer subject to 8717, 8718

nondeductible expenses

S corporations, premiums paid by 8710

officer, on life of

deduction of premiums paid 8705

income, premiums paid, as 8703, 8706

premiums paid by business 8705, 8706

partners and partnerships

death proceeds 8715

deduction of premiums 8711, 8712

premiums

corporations and stockholders 8705

deduction of. *See* premiums, deduction of, *this entry*

dividend, as 8705

employee, policy insuring life of 8705

employer, payment by 8708, 8709

income, as 8703, 8706, 8707

insured employee,

tax liability 8703, 8706

key person, policy insuring life of 8706

partnerships and partners 8711–8712

reasonable compensation, as 8705

S corporation, payment by 8710

sole proprietorships 8713–8714

stock redemption agreements, funding for 8707

stockholder, policy insuring life of 8705

taxability to insured 8703

premiums, C corporation

deduction of 8705, 8710

dividend, as 8705, 8710

income, as 8703, 8706, 8710

reasonable compensation, as 8705

premiums, deduction of

generally 8704, 8705, 8710

corporation, by 8705

employee, by 8704, 8714

partners, by 8711, 8712

partnership, by 8711

rules 8704

sole proprietor, by 8713

premiums, key person

deduction of 8705, 8711, 8712

income, as 8703

insured employee, tax liability 8703, 8706

proceeds

death. *See* death proceeds, *this entry*

living. *See* Life insurance

S corporation

premiums paid by, effect of 8710

sale of life policy

grantor trust, to 8718, 8719

loan, subject to 8718

transfer for value rule. *See* Transfer for value rule

INDEX

References are to question numbers.

Business life insurance. (cont'd)

Section 79 plan	
cost of coverage	8722
in excess of \$50,000	8722
cost of excess coverage	8722
defined	8721
exceptions	8723
supplemental insurance premiums	8723
excludable limit	8721, 8722
nondiscrimination requirements	8724
exemption for church plans	8724
key employee defined	8724
sole proprietor	8713, 8714
stock redemptions. <i>See also</i> Buy-sell agreement	
generally	8707
insurance funded plan	8707
stockholder, on life of	
premium paid by C corporation. <i>See</i> premiums, C corporation, <i>this entry</i>	
transfer of life policy	
value, for	8718
Business purchase agreement. <i>See</i> Buy-sell agreement	
Business-related education expenses	8687
requirements	8687
Business-related entertainment expenses and meals	
deductibility of	8688
directly related to or associated with	
trade or business	8688
50 percent limitation	8688
lavish or extravagant	8688
ordinary and necessary	8689
substantiation requirements	8691
Business succession planning	
asset sale	8868
buy-sell agreement	
constructive dividends	8856
cross-purchase	8852, 8856, 8859
defined	8852
how funded	
debt instrument	8854
installment sale	8867
insurance	8854
involuntary transfer	8854
self-funding	8854
triggering events	8854
installment sale	8867
installment method	8867
insurance funded	
cash value life insurance	8855
consequences	8857
disability insurance	8854, 8855
term life insurance	8855
triggering events	8854

Business succession planning (cont'd)

buy-sell agreement (cont'd)	
interests valued, how are	
purchase price	8862
price term control test	8862
minority or majority interest	8864
control premiums	8864
swing vote	8864
redemption	8852, 8859
section 302	8860
right of first refusal	8865
triggering event	8865
S corporations	8866
Section 302 stock redemption	8860
attribution rules	8860
constructively owned	8860
Section 303 stock redemption	
defined	8861
showdown clause	8863
triggering event	8863
triggering events	
call-type option	8858
mandatory purchase requirements	8858
put-type option	8858
right of first refusal	8865
showdown clause	8863
used in business succession planning	8853
C corporation	
asset sale	8868
liquidation	8868
controlled corporation	8879
voting stock	8879
family business	8870
gift tax	8870
grantor retained annuity trust (GRAT)	8871
grantor retained income trust (GRIT)	8883
intentionally defective grantor	
trust (IDGT)	8872
qualified terminable interest	
property (QTIP)	8881
self-cancelling installment note (SCIN)	8873
transfer of stock, treatment of	8882
trust entities	8871
family-owned business	
applicable retained interest	8878
member of the transferor's family	8878
preferred stock complications	8878
qualified payment	8878
qualified terminable interest property (QTIP)	8880
qualifying income interest for life	8880
family partnership	
issues	8875
special considerations	8877
transitioning	8876
gift tax	8870
grantor retained annuity trust (GRAT)	8871

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Business succession planning (cont'd)

intentionally defective grantor trust (IDGT).....	8871
liquidation	
C corporation	8868
S corporation.....	8869
built-in gains	8869
self-cancelling installment note (SCIN)	8873

Business travel expenses

away from home	8677
bona fide business purpose	8682
commuting between principal residence	
and place of business	8680
cost of commuting	8684
in the pursuit of business	8677
multiple places of business	8681
no tax home.....	8679
primary purpose behind trip	8682
“principal” place of business	8681
reasonable and necessary travel expense	8677
related travel outside the United States	8683
transportation days.....	8683
transportation expenses when not travelling	
away from home.....	8684
trip has both business and	
personal elements	8682

Buy-sell agreement

business succession planning. <i>See</i>	
Business succession planning	
cross-purchase agreement. <i>See</i> Cross-purchase	
agreement, corporation; Cross-purchase	
agreement, partnership	
liquidation of partnership interest	
transfer for value, as	8718
stock redemption agreement. <i>See</i> Stock redemption	
agreement	
transfer for value rule	8717

C

C corporation

accumulated earnings tax	8829
accumulated taxable income	8829
minimum accumulated	
earnings credit.....	8829
alternative minimum tax (AMT)	8831
adjusted current earnings (ACE)	8831
alternative minimum taxable	
income (AMTI)	8831
minimum tax credit.....	8831
capital gains and losses	8825
closely held corporation	8822
how it is formed.....	8823
certificate of incorporation	8823
corporate charter.....	8823
corporation’s bylaws.....	8823

C corporation (cont'd)

personal holding company (PHC) tax	8830
“PHC income” requirement	8830
“stock ownership” test	8830
publicly held corporation.....	8822
taxable income	8825
deductions	
in general.....	8825
production activities.....	8825
sale of shareholder’s stock in	8827
tax treatment	8825
separate entity	8822

Cafeteria plan

defined	8787
employee benefits offered by employers	
cash benefit	8788
group term life insurance coverage	8788
health flexible spending arrangement (FSA)	8788
qualified benefit.....	8788
tax benefits	8791
nondiscrimination requirements	
highly compensated individuals	8789
key employee	8789
pre-tax	8787
salary reduction contributions	8787
simple cafeteria plan for small businesses	
defined	8790
qualified employee	8790
safe harbor	8790

Calendar year

defined	8896
---------------	------

Capital asset, defined

defined	8560
---------------	------

Capital gains

adjusted net capital gain	8562
collectibles gain	8561, 8563
holding period	
calculation of	8567
tacking of periods	8567
long-term	8561, 8567, 8568
net capital gain	8561, 8562
netting of	8561, 8573
redemption of a debt obligation	8570
reduction in rates for individuals	8564
reporting requirements	8576
sale or exchange	
redemption of a debt	8570
option	8571
patent.....	8572
short-term.....	8567, 8568, 8574
taxation of.....	8561, 8562, 8573

Capital losses

carry forward	8575
collectibles loss	8563
holding period	
calculation of	8567
tacking of periods	8567

INDEX

References are to question numbers.

Capital losses (cont'd)

limitation	8575
long-term	8567, 8568
net long-term capital loss	8563
net short-term capital loss	8563
netting of	8561, 8573
reporting requirements	8576
sale or exchange	
redemption of a debt	8570
option	8571
patent	8572
short-term	8567, 8568, 8574
taxation of	8561, 8562, 8573

Capital loss treatment

Cash basis method

Cash equivalence

Casualty loss

adjusted basis	8653, 8654
amount of deduction	8653
appraisal	8653
fair market value	8653
appraisal	8653
as a business deduction	8657
blasting operations	8649
business-related	8657
as a business deduction	8657
claim limitations	8654
criteria	8649
defined	8649
disallowed	8655
fair market value	8653, 8654
federally declared disaster area	8656, 8659
special rules	8659
taxpayer's residence located in	8659
insurance claim	8655
investment purposes	8654
involuntary conversions	8651
miscellaneous itemized deduction	8657
net operating loss	8654
qualified insolvent financial institution loss	8660
as a casualty loss	8660
defined	8660
qualified individual defined	8660
personal use	8654
reasonable prospect of recovery doctrine	8656
termite infestation	8649
trade or business	8653, 8654
adjusted basis	8653
worthlessness of currency	8649

Charge-off method in

accounting for

Charitable contributions deduction

generally	8916
amount of	8916

Charitable contributions deduction (cont'd)

appreciated property	
intangible	8924
real estate	8924
tangible	8925
bargain sales	8926
ceiling limits	8535
clothing, gift of	8534
debt, property donated subject to	8927
fair market value	8917
household item, gift of	8534
income percentage limits	8535, 8922
income tax deduction	8537, 8916
intellectual property	8917
less than entire interest, gift of	8534, 8916, 8928
liability, property subject to	8927
limits on deduction	8916
long-term capital gain property, gift of	8534, 8537
maintenance and repair costs	8929
maximum annual limit	8534
misstatement of value of property	8919
monetary gifts, recordkeeping for	8918
mortgage or debt, donation subject to	8927
overvaluation, penalty for	8919
partial interests	8534, 8537, 8916, 8929
partnership interest	
contribution of	8930
liability, treatment of	8930
patents	8917
penalty for overvaluation	8919
percentage limits	8922
private foundations	8534, 8538, 8922
real estate, contribution of	8924
recordkeeping for monetary gifts	8918
reduced price, sale to charity at	8926
right to use property	8929
S corporation stock, gift of	8534, 8537
sale at reduced price	8926
special rules for certain types of gifts	8534
split-dollar arrangements	8916
stock, gifts of	8534, 8924
substantiation requirement	8534, 8539
tangible personal property	8534, 8537, 8925
time of deduction	8923
"to" or "for the use of," distinguished	8922
use of property, gift of right to	8929
valuation	
fair market value, determination of	8917, 8924
misstatement, effect of	8919
verification	
charitable contributions	8918
monetary contributions	8918

Charitable gifts

appreciated real estate	8924
-------------------------------	------

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Charitable gifts (cont'd)

deduction for. <i>See</i> Charitable contributions deduction	
fair market value of gift	8917, 8924
future interests	
intangible personal property	8923
real property	8923
tangible personal property	8923
overvaluation, penalty for	8919
partnership interest, of	8930
real estate, appreciated	8924
trusts	
generally	8534
deduction limitations	8534
undivided present interests, of	8923
valuation of	8917, 8919

Charitable trusts

deduction for contribution to stock options, grant of	8923
--	------

Child tax credit

adopted child	8544
child, defined	8544
foster child	8544
nonrefundable	8544
qualifying child, defined	8544
refundable portion	8544
restrictions on	8544
supplemental, repeal of	8544
who qualifies	8544

Children

custodial gifts and property to. <i>See</i> Uniform Gifts/Transfers to Minors Acts	
gifts to minors	8559
kiddie tax	8557
unearned income of	8557, 8558
net unearned income, defined	8557
election to include on parents' return	8558

Choice of entity. *See also specific entity*

employment benefits treatment	8850
estate planning considerations	8851
losses during operation of a business	8848
transferability of interests	8849

Constructive receipt

Commuting between principal residence and

place of business	8680
-------------------------	------

Consumer price index (CPI)

Corporation

alternative minimum tax (AMT)	
exceptions to the rule	8832
\$5 million gross receipts test	8832
small corporation provision	8832
basis in securities, special considerations	8828
methods	
average basis	8828
first-in, first-out (FIFO)	8828

Corporation (cont'd)

controlled group	8833
brother-sister	8833
combined	8833
parent-subsidiary	8833
tax treatment	8834
treatment of transactions	8834
corporate dividend exclusion	
debt-financed portfolio stock	8826
domestic corporations, dividends from	8826
foreign corporations, dividends from	8826
deductibility of expenses incurred in organizing ...	8824
Cost of commuting	8684
Cost-of-living adjustments	App. B
Creditor-debtor relationship	8695
Credits against tax	8541
generally	8541
alternative minimum tax	8554
alternative motor vehicle	8542
child tax credit	8544
disabled, permanently and totally	8543
elderly, for	8543
first-time homebuyer	8541
general business credit	8542
income tax, generally	8541
nonrefundable	8542
refundable	8541
retirement savings credit	8541
work opportunity credit	8547

Cross-purchase agreement, corporation.

life insurance funding of transfer for value, as	8718
---	------

Cross-purchase agreement, partnership.

deduction by partners	8711, 8712
transfer for value, as	8718

Custodial gifts and property. *See* Uniform Gifts/ Transfers to Minors Acts

Customized item

D

Dealer disposition

Death benefits

Income in respect of a decedent	8794
taxation to surviving spouse	8794

Deductibility of reimbursed

moving expenses	8686
employer	8686

Deductions

below the line	8522
business	8694, 8695
charitable contributions	8916–8930
maximum annual limit for	8534
depreciation. <i>See</i> Depreciation	
interest, deductibility of	8526

INDEX

References are to question numbers.

Deductions (cont'd)

itemized	
generally	8522
miscellaneous	8525
medical expenses. <i>See also</i> Medical	
expense deduction	8540
miscellaneous itemized	8525
nonbusiness	8694
ordinary income, from	8694
permitted	8699
sales tax	8523
standard deduction. <i>See also</i> Standard deduction ..	8519
theft loss	8522
Deduction from ordinary income	8694
Deduction permitted	8699
De minimis fringe benefit	8799
De minimis rule	8913
Demutualization	8567
Dependency exemption	8516, 8517
adopted children	8517
child, defined	8517
conditions that must be met	8517
divorced parents, special rule for	8517
eligible foster child	8517
qualifying child	
defined	8517
determination	8518
release of claim	8518
qualifying relative	8517
Dependent care assistance program	
deduction for employer	8784
defined	8782
employment-related expenses	8782
reporting requirements	8786
due diligence	8786
Form W-10	8786
taxable income	
exclusion limit	8785
highly compensated employee	8783
non-highly compensated employee	8783
Dependent care flexible spending arrangement (FSA)	
debit and credit cards	8793
defined	8793
reimbursement	8793
Depreciation	
alternative minimum tax	8551
unrecaptured section 1250 gain	8563
Disability	
disability income	8725
disability provisions in life policy.	
<i>See</i> Life insurance	
Disabled individuals, credit for	8543
Discharge of indebtedness	8514

E

Economic benefit	8903
Education expenses	8687
requirements	8687
Educational assistance program (EAP)	
educational assistance	
tax-preferred basis	8780
types of	8780
employee education-related expenses	8778
excluded from income	8778
provision of funds	8778
reporting requirements	8781
requirements for tax-preferred treatment	8779
Elderly individuals	
credit for	8543
standard deduction, increase in	8519
Elections	
capital gain, net	
investment income, treated as	8562
child's income, inclusion on parent's return	8558
investment income	
net capital gain treated as	8562
Electric vehicles, credit for	8542
Employee vs. independent contractor	
common law rules	8662
defined, for employment tax purposes	8661
statutory employees	8661
substantial facilities	8661
substantial investment	8661
employment expenses, treatment of	8664
business-related expenses	8664
general partner	8675
income received by a limited partner	8675
life insurance agent	
advance commissions	8672
assigned commissions	8674
assigning income	8674
assignment of future income	8674
classification	8671
common law employee	8671
constructive receipt of commissions	8672
credit life and health insurance sales	8674
credit life insurance commissions	8672
deductibility of commissions	8674
deduction of expenses directly related	
to status	8671
renewal commissions, how taxed	8672, 8673
drawing account	8672
federal income tax liability	8673
ordinary income	8672
statutory employee	8671
20 factor test	8671
limited partner	8675

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Employee vs. independent contractor (cont'd)

limited liability company (LLC)	
member	8675
taxed as partnership	8675
misclassification of workers by employer,	
consequences of	8668
Form SS-8	8668, 8670
“leased” employees and the 20-factor test	8668
refund of self-employment taxes	8668
rights to benefits under employer’s employee	
benefit plans	8668
safe harbor provisions	8669
social security taxes	8668
right to control and direct work	8662
safe harbor provisions	8669
reasonable basis requirement	8669, 8670
any other reasonable basis	8670
judicial precedent	8670
longstanding recognized practice	8670
past IRS audit	8670
significant section of the industry	8670
reporting consistency requirement	8669
significant section of the industry	8670
substantive consistency requirement	8669
Section 530 safe harbor	8669, 8670
reasonable basis requirement	8669, 8670
any other reasonable basis	8670
judicial precedent	8670
longstanding recognized practice	8670
past IRS audit	8670
significant section of the industry	8670
reporting consistency requirement	8669
significant section of the industry	8670
substantive consistency requirement	8669
self-employment tax	
defined	8663
who is liable for paying	8663
schedule SE	8663
social security taxes	8663
statutory employees	8661
20 factor test	8662

Employee fringe benefits. *See specific entry*

de minimis fringe benefit	8799
employer-provided stock bonus plan	8801
distribution rules	8803
special requirements	8802
voting rights	8804
fair market value of	8800
no-additional-cost-service	8795
qualified employee discount exclusion	8797
qualified transportation	8796
exclusion limit	8796
employer-provided stock bonus plan	8801
distribution rules	8803

Employee fringe benefits. (cont'd)

employer-provided stock bonus plan (cont'd)	
special requirements	8802
voting rights	8804
value of	8800
working condition	8798

Employer

life insurance	
premiums paid by employer	8708, 8709

Employer deduction

business health insurance	8725
---------------------------------	------

Employer-owned life insurance (EOLI)

death proceeds	8716
defined	8716
notice and consent requirements	8716
reporting requirements	8716
Form 8925	8716

Employer-provided stock

bonus plan	8801
distribution rules	8803
special requirements	8802
voting rights	8804

Employer-sponsored accident & health insurance benefits

Affordable Care Act (ACA). <i>See</i> Patient Protection and	
Affordable Care Act (PPACA)	
employer deduction	8725
closely-held C corporation	8740
credit for small employers	8726
flexible spending accounts (FSAs)	8746
health reimbursement arrangement (HRA)	
COBRA continuation coverage	8743
defined	8743
reimbursements	8743
taxation of	8743
health savings account (HSA)	
accumulated funds, taxation of	
prior to distribution	8755
cafeteria plan	8748
catch-up contributions	8748
comparable contributions	8749
comparability requirements for employers	
exceptions	8751
penalty for failure to meet	8752
contribution rules for employers	8750
maximum annual contribution	8750
contributions	
catch-up	8748
comparable	8749
employer	8749
excess contributions, penalty for	8754
in general	8744
limit on	8748
defined	8744

INDEX

References are to question numbers.

Employer-sponsored accident

& health insurance benefits (cont'd)

health savings account (HSA) (cont'd)	
distributions in general	8744
nonqualified	8756
penalty tax	8756
taxation of	8756
eligible individual	8745
employer contributions	8749
exceptions to comparability rules	8751
excess contributions, penalty	8754
high deductible health plan (HDHP)	8745, 8746, 8747, 8750, 8751
ineligible to contribute	8746
limits on contributions	8748
Patient Protection and Affordable Care Act impact	8761
penalty	
excess contributions	8754
failure to meet comparability requirements	8752
qualified HSA distribution defined	8753
rollovers	
from FSAs	8753
from HRAs	8753
qualified HSA distribution	8753
high deductible health plan (HDHP) defined	8747
nondiscrimination requirements	8733
HIPAA rules	8733
Patient Protection and Affordable Care Act	8733
penalties to employers who violate	8762
Patient Protection and Affordable Care Act. See Patient Protection and Affordable Care Act (PPACA)	
PHS Act	8758
self-insured plan	
defined	8734
discriminatory	8737
nondiscrimination requirements	8736
taxation of reimbursements	8735
tax credit for small employers	8726
taxable to employee	
accidental death benefits	8731
survivors' benefits	8731
choice to receive coverage or higher salary	8728
coverage for spouse, children or dependents ...	8729
critical illness benefits	8730
disability income	8730
in general	8727
noninsured accident and health plan benefits ...	8732
reimbursement from prior year	8730
salary reduction contributions	8730
wage continuation	8730
taxation of	8744

Employer-sponsored accident

& health insurance benefits (cont'd)

taxation of (cont'd)	
health reimbursement arrangements	8742
partners and sole proprietors, for	8741
provided by closely-held C corporation, for ...	8740
S corporation shareholders, for	8742
Employer's reimbursement of expenses	8693
reporting requirements	8693
Energy credits	8542
alternative motor vehicle credit	8542
hybrid vehicles	8542
plug-in electric vehicle credit	8542
solar water heating property expenditure	8542
unreimbursed expenses	8693
Entertainment expenses	8688–8691
deductibility of	8688
directly related to or associated with trade or business	8688
50 percent limitation	8688
lavish or extravagant	8688
ordinary and necessary	8689
substantiation requirements	8691
ERISA	
self-employed owner-employee	8666
Estate tax, federal	
indexed amounts	App. B
tables	App. B
tax rates schedule	App. A
valuation of property. <i>See</i> Valuation, estate and gift tax	
Estimated tax	
who is required to pay tax	8549
Exemptions	
dependency. <i>See also</i> Dependency	
exemption	8515, 8516, 8517
personal, amount of	8515

F

Fair market value

burden of proof	8917
defined	8917

Family partnership

defined	8817
kiddie tax	8817
special considerations	8817

Federal gift tax. *See* Gift tax, federal

Federal income tax, generally. *See* Income taxation

FICA

rate, on employer and employee	8547, 8548
--------------------------------------	------------

FIFO

50 percent limitation

lavish or extravagant	8688
defined	8690

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

First-in, first-out (FIFO)	8915
Fiscal year	8896
Flexible benefit plan. <i>See</i> Cafeteria plan	

G

Gain on sale	
capital gain. <i>See also</i> Capital gains	8561
Generation-skipping transfer tax	
tables	App. B
tax rates	App. B
tax rates schedule	App. B
Gift tax, federal	
indexed amounts	App. B
tables	App. B
tax rates	App. B
Gross income	
adjusted gross income, defined	8513
capital asset, defined	8560
capital gains. <i>See</i> Capital gains	
capital losses. <i>See</i> Capital losses	
deductions from	8522
defined	8512
discharge of indebtedness	
generally	8514
mortgage forgiveness	8514
principal residence debt exclusion	8514
qualified principal residence indebtedness	8514
qualified real property business	
indebtedness	8514
indebtedness, discharge of	8514
railroad retirement benefits	8545, 8546
related persons, loss on sale between	8569
Social Security benefits	8545, 8546
tax basis, defined	8565
unearned income of certain children	8557
Uniform Gifts/Transfers to Minors Acts	
income from property transferred to minor	8559
Group term life insurance. <i>See</i> Section 79 plan	
Guarantor	8694
Grandfathered accounting period	8899

H

Head of household	8506
Health flexible spending arrangement (FSA)	
debit and credit cards	8792
defined	8792
period of coverage	8792
Health insurance	
taxation of	
partners and sole proprietors, for	8741
provided by closely-held C corporation, for ...	8740
S corporation shareholders, for	8742

Health reimbursement arrangement (HRA)	
COBRA continuation coverage	8743
deduction of expense	8725
defined	8743
highly compensated employees, for	8733
nondiscrimination requirements	8733
reimbursements	8743
taxation of	8743
withholding on benefits	8733

Health savings account (HSA)	
accumulated funds, taxation of	
prior to distribution	8755
cafeteria plan	8748
catch-up contributions	8748
comparable contributions	8749
comparability requirements for employers	
exceptions	8751
penalty for failure to meet	8752
contribution rules for employers	8750
maximum annual contribution	8750
contributions	
catch-up	8748
comparable	8749
employer	8749
excess contributions, penalty for	8754
in general	8744
limit on	8748
defined	8744
distributions	
in general	8744
penalty tax	8756
taxation of	8756
nonqualified	8756
eligible individual	8745
employer contributions	8749
exceptions to comparability rules	8751
excess contributions, penalty	8754
high deductible health plan (HDHP)	8745, 8746, 8747, 8750, 8751
limits on contributions	8748
Patient Protection and Affordable Care	
Act impact	8761
penalty	
excess contributions	8754
failure to meet comparability	
requirements	8752
qualified HSA distribution defined	8753
rollovers	
from FSAs	8753
from HRAs	8753
qualified HSA distribution	8753
High-income taxpayers	8516
Highly compensated employee	
medical expense reimbursement for	8733

INDEX

References are to question numbers.

Holding period

- calculation of 8567
- capital gains and losses 8567, 8568
- demutualization transaction, stock received in 8567
- tacking of holding periods 8567

Home construction contract 8914

- exemption 8914

Home office expenses,

- deductibility of 8692
- part of residence as office 8692
- principal place of business 8692
- place of business used for meeting
with patients, clients, or customers 8692
- separate structure 8692

Hybrid vehicles, credit for 8542

I

Identifiable event 8699

Included in gross income of employee 8686

- nonqualified 8686
- qualified 8686

Income

- gross. *See* Gross income
- unearned 8557

Income taxation

- adjusted gross income. *See* Adjusted gross income
- alternative minimum tax. *See* Alternative
minimum tax (AMT)
- basis. *See* Basis
- cancellation of debt 8514
- capital assets, defined 8560
- capital gains and losses
 - holding period 8567
 - limitations 8575
 - reporting requirements 8576
 - taxation of 8561, 8562, 8573
- charitable contributions deduction. *See*
Charitable contributions deduction
- child, unearned income 8557
- computing tax liability, steps in 8508
- consumer price index (CPI) 8511
- credits. *See* Credits against tax
- current income tax rates 8509
- custodial property 8559
- deductions. *See also* Deductions 8519, 8522
 - charitable, maximum annual limit on 8534
 - interest, deductibility of 8526
 - itemized 8522–8525
 - medical expense 8540
 - “miscellaneous itemized” 8524
 - standard 8519
- dependency exemption 8515, 8516, 8517
- discharge of indebtedness 8514

Income taxation (cont'd)

- estimated tax 8549
- exemptions
 - amount of personal and dependency 8515
 - dependency, requirements for 8517
 - filing requirements 8501
 - general rules 8501–8508
 - gross income. *See* Gross income
 - head of household 8506
 - head of household rates 8503
 - holding period 8567
 - indexed annually for inflation 8510
 - indexing 8510
 - indexing factor 8511
- individuals
 - current income tax rates 8509
 - deductions, itemized
 - charitable contributions 8534
 - interest 8526
 - interest deduction 8526
 - joint returns, who may file 8502
 - kiddie tax 8557
 - losses on related-party sales 8569
 - medical expense deduction 8540
 - miscellaneous itemized deductions 8525
 - penalties for underpayment of estimated tax 8549
 - qualifying child 8504
 - qualifying person 8504
 - qualifying relative 8504
 - qualifying widow(er) 8502
 - railroad retirement benefits,
 - taxation of 8545, 8546
 - rates 8509
 - related-party sales 8569
 - returns, who must file 8501
 - same-sex spouses 8502
 - self-employment tax 8550
 - short period 8507
 - short-term vs. long-term 8567, 8568
- Social Security
 - benefits, taxation of 8545, 8546
 - rates 8547
- standard deduction. *See also* Standard
deduction 8519
- tables App. A
- tax, calculation of 8508
- tax preference items 8551
- taxable year 8507
- trusts. *See* Trusts
- underpayment of estimated tax 8549
- Uniform Gifts/Transfers to Minors Acts,
 - income from custodial property 8559
- who must file 8501
- withholding. *See* Withholding, income tax

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Indebtedness, discharge of	8514	Investment interest	
Independent contractor. <i>See also</i>		deductibility of	8526
Employee vs. independent contractor		Installment method	8908, 8909, 8911
employment expenses, treatment of	8664	applicable federal rate (AFR)	8909
business-related expenses	8664	interest.....	8909
ERISA protection	8666	Installment sale rules	8910, 8911
health insurance		involuntary conversion.....	8910
deductibility of.....	8667	second sale	8910
partners, eligibility of.....	8667	Interest	8909
sole proprietors, eligibility of	8667	Inventoried item	8912
IRAs	8665	Inventory accounting	8915
long-term care insurance	8667	first-in, first-out (FIFO)	8915
individual	8667	last-in, first-out (LIFO)	8915
spouse	8667	specific identification methods.....	8915
sole proprietors	8667	Investment income tax	
partners	8667	additional Medicare tax	8598
S corporation shareholders	8667	additional withholding.....	8601
retirement savings plan participation	8665	earned income	8598
partnership	8665	employer's failure to withhold.....	8600
proprietor	8665	estimated tax payments	8602
self-employed individual as employee	8665	interest or penalties	8600
sole practitioner	8665	noncash fringe benefits	8604
Roth IRAs	8665	threshold level	8598
self-employment tax		married taxpayers, for	8599
defined	8663	self-employment income.....	8603
who is liable for paying	8663	amounts received under an annuity contract.....	8584
schedule SE	8663	capital gains and dividends tax	8597
social security taxes	8663	defined	8577
Indexed amounts		disposition of property	8585
estate taxes	App. B	distributions from retirement accounts	
gift taxes	App. B	and qualified plans.....	8581, 8583
how taxes are indexed	8510	estate or trust.....	8595
Indexed annually for inflation	8510	exception for income realized in ordinary course of	
Indexing factor	8511	trade or business	8588
Intangible drilling costs (IDCs)		pass-through entity.....	8588
tax preference item.....	8553	exclusion	8590
Interest		form(s).....	8594
deduction, limitations on, generally.....	8526	gain on sale of taxpayer's primary	
estate tax extended payments.....	8531	residence	8587
Interest expense deduction	8526	group activities	8591
allocation of interest expense	8526	liability	8580
education loans, interest on	8532	losses	8586
estate tax, interest on extended payments of	8531	modified adjusted gross income	8578
passive activity, computation of income		net gain	8584, 8585
or loss from	8530	net investment income.....	8577, 8592
personal interest	8533	deductibility of.....	8527
qualified education loan interest.....	8532	defined	8579
qualified residence interest. <i>See</i> Qualified residence		disposition of property	8585
interest		modified adjusted gross income.....	8578
residence, interest on debt secured by. <i>See</i> Qualified		net gain.....	8584, 8585
residence interest		net losses.....	8586
trade or business interest	8528	pass-through entity	8588, 8592
Investment income		passive activity.....	8589
tax on	8547	principal residence.....	8587

INDEX

References are to question numbers.

Investment income tax (cont'd)

recognized gain on sale or exchange of property ...	8595
regroup activities.....	8591
Roth IRA	8582
tax credits	8593
threshold amount	8577
trade or business activity	8597
traditional IRA	8582
trusts not subject to	8596

Investor losses

abusive tax shelter, defined	8628
allowable investment interest deduction.....	8647
applicability rules.....	8648
calculating	8647
Form 4952.....	8647
tax consequences	8647
“at risk” rules	
C corporation	8631
defined	8629
determining amount “at risk”.....	8632, 8633
nonrecourse	8633
qualified nonrecourse financing	8634
recourse liabilities	8633
pass-through entities	8631
types of investment activities.....	8630
interest expense	
deduction	8645
exceed net investment income.....	8646
materially participates.....	8637, 8638
five tests.....	8638
passive activity.....	8637
materially participates	8637, 8638
publicly traded partnerships	8641
special rules for rental real estate investors	8640
passive loss rules	
applies to.....	8636
casualtiy losses.....	8642
carried over	8639
defined	8635
disallowed	8639
dispose of interests in.....	8644
ordinary loss treatment	8644
interact with at-risk rules	8643
passive activity	8637
tax shelter	
abusive	8628
common features	8627
defined	8627
Involuntary conversion	8609, 8611–8614, 8616, 8621, 8651, 8910

Itemized deductions

generally.....	8522
limit, adjustments to	8522
miscellaneous.....	8524

Itemized deductions (cont'd)

phase-out rules	8525
sales tax deduction.....	8523
state and local taxes	8523

J

Joint returns, who may file.....	8502
---	------

K

Kiddie tax	8557
-------------------------	------

L

Last-in, first-out (LIFO).....	8915
---------------------------------------	------

Lavish or extravagant expense.....	8688
defined	8690

Life insurance

business insurance. <i>See</i> Business life insurance	
business owner, on life of. <i>See</i> Business life insurance	
cross-purchase agreement, funding of premiums	
transfer for value, as	8718
death benefit. <i>See</i> death proceeds, <i>this entry</i>	
death proceeds	
business life insurance	8715
loans, policy	
gift of policy subject to	8718
sale of policy subject to.....	8718
sole proprietor, on life of.....	8713, 8714
stock redemption agreement. <i>See also</i>	
Buy-sell agreement	
generally	8707
transfer for value rule	8718

Life insurance agent

advance commissions	8672
assigned commissions	8674
assigning income	8674
assignment of future income	8674
classification.....	8671
common law employee	8671
constructive receipt of commissions.....	8672
credit life and health insurance sales	8674
credit life insurance commissions	8672
deductibility of commsions	8674
deduction of expenses directly related	
to status	8671
renewal commissions, how taxed.....	8672, 8673
drawing account	8672
federal income tax liability	8673
ordinary income	8672
statutory employee	8671
20 factor test.....	8671
LIFO	8915

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Limited liability company (LLC)	
defined	8843
how is it formed	8843
articles of organization	8843
operating agreement	8843
tax treatment	8844
Limited liability limited partnership (LLP)	8821
Limited liability partnership (LLP)	
defined	8821
limited liability limited partnership (LLP)	8821
tax treatment	8821
Limited partnerships. <i>See also</i> Partners and partnerships	
charitable gift of interest	8930
gift of partnership interest	8930
Loan made between related parties	8698
Long-term contract	8912, 8913, 8914
Losses	
capital	8563
long-term	8568
related parties, sales between	8569
short-term	8567

M

Material items	8907
Meal expenses	8688–8691
deductibility of	8688
directly related to or associated with trade or business	8688
50 percent limitation	8688
lavish or extravagant	8688
ordinary and necessary	8689
substantiation requirements	8691
Medical expense deduction	
breast reconstruction surgery following mastectomy	8540
cosmetic surgery	8540
health insurance premiums	8725
limits on	8540
medical care, defined	8540
lodging expenses	8540
medicines and drugs without prescription	8540
prescription drugs	8540
vision correction surgery	8540
vitamins and nutritional supplements	8540
weight-loss programs	8540
Medical expense reimbursement plan.	
<i>See</i> Health reimbursement arrangements	
Medical insurance. <i>See</i> Business health insurance	
Mid-term gain	8561
Minimum tax, alternative. <i>See</i> Alternative minimum tax (AMT)	

Minors. <i>See</i> Children; Uniform Gifts/Transfers to Minors Acts	
Miscellaneous itemized deductions	8525
Misclassification of workers by employer, consequences of	8668
Form SS-8	8668, 8670
“leased” employees and the 20-factor test	8668
refund of self-employment taxes	8668
rights to benefits under employer’s employee benefit plans	8668
safe harbor provisions	8669
social security taxes	8668
Mortgage Forgiveness Debt Relief Act	8514
basis reduction	8514
discharges not related to financial condition of taxpayer	8514
ordering rule	8514
principal residence	8514
qualified principal residence indebtedness	8514
Mortgages	
debt forgiveness	8514
relief from	8514
Moving expenses	8685–8686
deductibility of reimbursed expenses	8686
included in gross income of employee	8686
nonqualified	8686
qualified	8686
Multiple places of business expense	8681
Municipal bonds	
alternative minimum tax preference	8553

N

Necessary expense	8676
Net investment income	8527, 8577, 8646
Net income investment exclusion	8590
No-additional-cost-service	8795
No tax home, defined	8679
Nonbusiness bad debt	8694
capital loss treatment	8694
guarantor	8694
Nonbusiness debts,	
partially worthless	8697
Nondiscrimination requirements	
business health insurance	8733
health reimbursement arrangements	8733
Nontaxable exchanges	
boot	8608
carryover basis	8607, 8608
corporate stock, sale of	8622–8623
exclusion of gain on	8623
five-year holding period	8623
like-kind exchange	8622

INDEX

References are to question numbers.

Nontaxable exchanges (cont'd)

corporate stock, sale of (cont'd)	
nonrecognition treatment.....	8622
net short-term and long-term capital	
gains and losses.....	8623
Section 1202 stock, special rules	8623
death of the taxpayer	8609
defined	8605
determining principal residence.....	8618
traditional facts and circumstances analysis	8618
dwelling unit defined.....	8619
exchange of personal property	8606
exchange of property.....	8606
exclusion of gain on sale of corporate stock	8623
five-year holding period	8623
exclusion of gain on sale of principal residence	
change in employment	8616
health reasons	8616
how is it calculated.....	8617
how much	8617
ownership and use requirements	8616
primary residence	8616
reduced exclusion	8616
safe harbor	8616
selling a primary residence	8616
unforeseen circumstances	8616
change in employment.....	8616
death	8616
divorce or legal separation	8616
involuntary conversion	8616
loss of employment.....	8616
multiple births.....	8616
natural or man-made disaster	8616
exclusion of gain on sale of vacant land	8620
involuntary conversion	8621
nonrecognition treatment	8621
principal residence destroyed.....	8621
Section 1033.....	8621
qualify as sale of principal residence	8620
Section 121 requirements.....	8620
involuntary conversion.....	8609, 8611–8614, 8616, 8621
defined	8611
nonrecognition treatment.....	8609, 8612, 8613, 8614
IRC Section 1031	8608
like-kind exchange.....	8606–8610
multiple residences	8618
determining principal residence	8618
traditional facts and circumstances	
analysis	8618
sale of a principal residence.....	8618
traditional facts and circumstances analysis	8618
nature or character of property	8606

Nontaxable exchanges (cont'd)

non-like-kind property. <i>See</i> boot, this entry	
nonrecognition treatment	8605–8609, 8612–8615
avoidance of	8610
death of the taxpayer	8609
involuntary conversion	8609, 8611–8614
sale of corporate stock.....	8622
sale of principal residence.....	8615
Section 1033 “destruction”	8614
Section 121 exclusion	8615
two-year rollover provision	8615
principal residence	
exclusion of gain on sale of	8616, 8617
sale of.....	8615, 8617, 8618, 8619
real property located outside the U.S.	8606
related parties	8609
sale of corporate stock	8622–8623
exclusion of gain on.....	8623
five-year holding period	8623
like-kind exchange	8622
nonrecognition treatment.....	8622
net short-term and long-term capital	
gains and losses.....	8623
Section 1202 stock, special rules	8623
sale of principal residence	8615, 8617, 8618, 8619
exclusion of gain on.....	8616, 8617
multiple residences	8618
determining principal residence.....	8618
traditional facts and circumstances	
analysis	8618
used partially for business.....	8619
allocating gain and basis.....	8619
dwelling unit	8619
sale of small business stock	8624–8625
offsetting short position	8624
postpone recognition of gain	8624
rollover provisions	8625
holding period.....	8625
partnership	8625
S corporation	8625
Section 1045 election	8625
Section 121 exclusion	8615–8620
change in employment	8616
health reasons	8616
safe harbor	8616
Section 1031 nonrecognition provision.....	8606
Section 1033 “destruction”	8614
small business stock, sale of.....	8624–8625
offsetting short position	8624
postpone recognition of gain	8624
rollover provisions	8625
holding period.....	8625
partnership	8625
S corporation	8625
Section 1045 election	8625

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Nontaxable exchanges (cont'd)

specialized small business investment	
company (SSBIC).....	8626
postpone recognition of gain	8626
tax-free transaction	8605
two-year rollover provision	8615
unrelated qualified intermediary	8609
unused net capital loss carryover	8610
vacant land	8620–8621
exclusion of gain on sale of	8620
qualify as sale of principal residence	8620
Section 121 requirements	8620
involuntary conversion	8621
nonrecognition treatment	8621
principal residence destroyed.....	8621
Section 1033.....	8621

O

Ordinary expense	8676
Ordinary loss	8700
affiliated corporation	8700
Outside the United States, travel	8683
transportation days	8683

P

Partially worthless

business bad debt.....	8694
nonbusiness debt	8697

Partners and partnerships

buy-sell agreements	
life insurance funding	8711, 8712
charitable contribution of partnership interest.....	8930
life insurance premiums	8711, 8712

Partnerships

accounting.....	8897, 8899, 8900, 8902
acquiring interest in	8808
allocation of income and loss	8811
contributions of property made after 10/22/	
2004.....	8811
nonrecourse obligations	8812
basis	
calculation of	8814
defined	8814
liabilities	8814, 8815
constructive liquidation.....	8815
date partnership begins	8809
deductions.....	8809
organizational expenses	8809
defined	8807
economic risk of loss	8815
limited partner	8815

Partnerships (cont'd)

family partnership	
defined	8817
kiddie tax	8817
special considerations.....	8817
how is interest acquired by partner.....	8808
how is it formed.....	8807
income and loss	
allocation of	8811
reporting of.....	8813
liabilities	8814, 8815
constructive liquidation	8815
nonrecourse	8815
economic risk of loss	8815
minimum gain	8815
limited liability limited partnership (LLP).....	8821
limited liability partnership (LLP)	
defined	8821
limited liability limited partnership (LLP)	8821
tax treatment.....	8821
limited partner	8815
amount of gain recognized on sale.....	8816
minimum gain	8815
nonrecourse obligations	8812
allocation of losses and deductions	
attributable to	8812
nonrecourse debt	8812
nonrecourse deductions requirements.....	8812
nonrecourse liability	8812, 8815
organizational expenses	8809
date partnership begins	8809
deductions	8809
partnership agreement	8807
partnership minimum gain	8812
pass-through approach	8807
publicly traded	
block transfers	8818
defined	8818
established securities market	8818
readily tradable on secondary market.....	8818
tax treatment.....	8819
“at risk” rules	8819
“passive loss” rules	8819
passive-type income	8819
safe harbor provisions	8820
safe harbor provisions	
private placement	8820
private transfers	8820
redemption and repurchase agreements.....	8820
two percent	8820
sale of partnership interest.....	8816
limited interest	8816
separately taxable entity	8807
substantial economic effect test.....	8810, 8811
defined	8811

INDEX

References are to question numbers.

Partnerships (cont'd)

tax allocation	8810
substantial economic effect	8810
taxable income	8810
allocation provisions	8810
capital gain or loss	8810
double-taxation	8807
ordinary income or loss	8810
partner's distributive share	8813
pass-through approach	8807
sale of partnership interest	8816
separately taxable entity	8807

Patient Protection and Affordable

Care Act (PPACA) (cont'd)

affordable, defined	8775
defined	8757
effective date	8757
employer-sponsored health coverage	8776
failure to provide required health insurance under	8763
exemptions	
affordability	8765
foreign persons	8765
how to obtain	8766
incarcerated individuals	8765
individuals not required to file a tax return	8765
membership in an Indian tribe	8765
religious	8765
short coverage gaps	8765
health insurance exchanges	8769
health insurance nondiscrimination rules	
penalties to employers who violate	8762
health insurance tax credit for employers	8759
availability	8759
eligibility	8760
health savings accounts, impact of	8761
minimum essential health coverage	8773
minimum value	8776
nondiscrimination requirements	8733
penalties to employers who violate	8762
penalty to employer	
failure to provide required health insurance under	8763
violation of nondiscrimination rules	8762
penalty to individual	
exemptions	8764, 8765
failure to obtain required health insurance under	8764
plans cover under	8758
health insurance tax credit for employers	8759
availability	8759
eligibility	8760
premium assistance tax credit	
affordable coverage	8767

Patient Protection and Affordable

Care Act (PPACA) (cont'd)

premium assistance tax credit (cont'd)	
dependency exemption	8767
eligibility	8771
family size	8769
federal poverty line	8767
foreign earned income exclusion	8774
health insurance exchanges	8769
how to obtain	8772
household income	8767, 8768
minimum value	8767
modified adjusted gross income (MAGI)	8768
shared responsibility penalty	8770
shared responsibility penalty	8770, 8773, 8774
foreign earned income exclusion	8774
minimum essential health coverage	8773, 8774
transition relief	8777

Pension, profit sharing, and stock bonus plans

nondiscrimination	
health reimbursement arrangements	8733

Percentage of completion method

8913, 8914

Personal casualty or theft gains and losses

8658

Personal exemption

8515

amount of	8517
-----------------	------

high-income taxpayer rules	8516
----------------------------------	------

phase out	8516
-----------------	------

Personal health insurance

deductibility of premiums	8738
critical illness insurance policy	8738
Medicare	8738
state disability benefits fund	8738
partners and sole proprietors, taxation for	8741
taxable income	8739

Personal service corporations

8905

Personal tax credits

adoption tax credit	8552
child and dependent care credit	8552
child tax credit	8552
earned income credit	8552
energy saving credits	8552
learning credits	8552

PHS Act

8758

Policy loans

interest, deductibility of	8526
----------------------------------	------

limitations	8526
-------------------	------

PPACA. See Patient Protection and

Affordable Care Act

Primary place of business, expense

8678

Primary purpose behind trip

8682

Principal partner

8897

Principal place of business

8681

Private foundation

charitable gift to	8534
--------------------------	------

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Professional service corporation (PSC)

defined	8845
tax treatment	8845

Publicly traded

block transfers	8818
defined	8818
established securities market	8818
readily tradable on secondary market	8818
tax treatment	8819
“at risk” rules	8819
“passive loss” rules	8819
passive-type income	8819
safe harbor provisions	8820

Q

Qualified dividend income

reporting requirements	8576
------------------------------	------

Qualified employee discount exclusion

Qualified insolvent financial institution loss

as a casualty loss	8660
defined	8660
qualified individual defined	8660

Qualified residence interest

acquisition indebtedness	8529
date of loan	8529
deductibility of	8529
defined	8529
home equity indebtedness	8529
qualified residence, defined	8529

Qualified real property business

indebtedness	8514
--------------------	------

Qualified transportation fringe benefit

exclusion limit	8796
-----------------------	------

Qualifying child

Qualifying person

Qualifying relative

Qualifying widow(er)

R

Railroad retirement benefits

Rates

estate tax	App. B
generation-skipping transfer	App. B
gift tax	App. B
income tax	
individuals	App. A
trusts and estates	App. A
Social Security	8547, 8548

Real estate

related persons	8569
sale of property to	8569

Reasonable and necessary travel expense

Reasonable prospect of recovery

doctrine	8652, 8656
----------------	------------

Related party

defined	8569
sale to related party	
loss on	8569

Related travel outside the United States

transportation days	8683
---------------------------	------

Reporting requirements

Reserve method

Retirement income credit

S

S corporation

S corporation	8694, 8835–8840, 8898, 8899, 8900, 8902
---------------------	---

basis in, special considerations	8838
--	------

defined	8835
---------------	------

distributions, treatment of	8839
-----------------------------------	------

how is it formed	8835
------------------------	------

ineligible corporation	8835
------------------------------	------

life insurance	
----------------	--

premiums paid by S corporation	8710
--------------------------------------	------

pass-through entity	8835
---------------------------	------

qualified subchapter S subsidiary (QSSS)	8842
--	------

restrictions for issuance of stock	8841
--	------

shareholders	8837
--------------------	------

basis in, special considerations	8838
--	------

eligibility	8840
-------------------	------

members of a family	8840
---------------------------	------

restrictions for 2 percent shareholders	8840
---	------

trusts as shareholders	8840
------------------------------	------

taxation	8837
----------------	------

tax treatment	8836
---------------------	------

excess “net passive income”	8836
-----------------------------------	------

of shareholder	8837
----------------------	------

basis in, special considerations	8838
--	------

passive investment income	8836
---------------------------------	------

pre-election appreciation	8836
---------------------------------	------

Safe harbor

customized item	8912
-----------------------	------

inventoried item	8912
------------------------	------

short production period	8912
-------------------------------	------

Safe harbor provisions. *See also*

Section 530 safe harbor	
private placement	8820
private transfers	8820
redemption and repurchase agreements	8820
two percent	8820

Sales tax deduction

Same-sex spouses

Seasonal business test

Second sale

INDEX

References are to question numbers.

Section 79 plan		
cost of coverage	8722	
in excess of \$50,000	8722	
cost of excess coverage	8722	
defined	8721	
exceptions	8723	
supplemental insurance premiums	8723	
excludable limit	8721, 8722	
nondiscrimination requirements	8724	
exemption for church plans	8724	
key employee defined	8724	
Section 530 safe harbor	8669, 8670	
reasonable basis requirement	8669, 8670	
any other reasonable basis	8670	
judicial precedent	8670	
longstanding recognized practice	8670	
past IRS audit	8670	
significant section of the industry	8670	
reporting consistency requirement	8669	
significant section of the industry	8670	
substantive consistency requirement	8669	
Section 1202 gain	8561, 8563, 8573	
Section 1231 gain	8563, 8573	
Section 1244 stock	8701	
Section 1250 gain	8561, 8563, 8573	
Securities		
abandoned	8522	
Security, defined	8699	
Self-employed		
health insurance		
deductibility of	8667	
partners, eligibility of	8667	
sole proprietors, eligibility of	8667	
long-term care insurance	8667	
individual	8667	
spouse	8667	
sole proprietors	8667	
partners	8667	
S corporation shareholders	8667	
tax		
defined	8663	
who is liable for paying	8663	
schedule SE	8663	
social security taxes	8663	
Self-employed individuals		
self-employment tax	8550	
Self-employment tax	8547, 8550	
Self-insured plan		
defined	8734	
discriminatory	8737	
excess reimbursement	8737	
highly compensated employee	8737	
tax consequences	8737	
Self-insured plan (cont'd)		
nondiscrimination requirements	8736	
benefits	8736	
eligibility	8736	
highly compensated individual	8736	
part-time and seasonal workers	8736	
taxation of reimbursements	8735	
Short period	8507, 8901	
Short production period	8912	
Short sale	8568	
holding period	8568	
substantially identical property	8568	
Short-term gain	8568	
Significantly modified	8696	
Small business corporation	8701	
Small business stock	8701	
Small business valuation		
asset valuation approach	8884	
buy-sell agreement	8886	
closely held corporation	8887, 8888	
income valuation approach	8889	
market valuation approach	8888	
determining	8884	
estate tax valuation	8884	
special use valuation provision	8895	
external risks	8892	
fair market value	8885	
“goodwill” value	8885, 8890	
determining	8891	
valuing goodwill	8891	
income valuation approach	8889	
intangible business value	8890	
determining	8891	
valuing goodwill	8891	
majority interest	8894	
management structure	8893	
market valuation approach	8888	
marketability discount	8888	
minority interest	8894	
valuation	8884	
winner take all approach	8885	
Social Security		
benefits, taxation of	8545, 8546	
payroll tax forgiveness	8548	
rates	8547, 8548	
Sole proprietorship		
defined	8805	
estate of	8806	
life insurance premiums	8713, 8714	
tax treatment	8806	
self-employment tax	8806	
qualified joint venture	8806	
Specific identification methods	8915	

2015 TAX FACTS ON INDIVIDUALS & SMALL BUSINESS

References are to question numbers.

Spouses

joint return.....	8501
losses on sales between	8569

Standard deduction.....

blind individuals.....	8519
defined.....	8519
claimed as a dependent by another taxpayer	8521
elderly individuals	8519
ineligible taxpayers	8520
“marriage penalty” relief.....	8519

Stock

losses	8522
redemption. <i>See</i> Stock redemption agreement	

Stock losses

Stock purchase agreement. *See* Buy-sell agreement

Stock redemption agreement. *See also*

Buy-sell agreement	
premiums	
deduction of.....	8705
income to insured, as	8707

T

Tables

income tax	App. A
indexed estate, gift, generation-skipping	
amounts	App. B
tax rates	App. A
transfer tax	App. B

Tax basis. *See* Basis

Tax preference items

Tax rates

estate tax	App. B
generation-skipping transfer	App. B
gift tax	App. B
income tax, trusts and estates.....	App. A
Social Security	8547, 8548

Taxable year

Taxes

income, on. <i>See</i> Income taxation	
rates. <i>See</i> Tax rates	

Temporarily “away from home”

Theft loss

accounting fraud	8650
adjusted basis	8654
amount of deduction	8652
claim limitations	8654
deduction.....	8522
defined	8650
embezzlement	8650
fair market value	8654
false pretenses	8650
investment purposes.....	8654
involuntary conversion.....	8650, 8651

Theft loss (cont’d)

larceny	8650
by false pretenses	8650
miscellaneous itemized deduction	8657
net operating loss	8654
personal use.....	8654
reasonable prospect of recovery doctrine ...	8652, 8656
robbery	8650
trade or business	8654
when entitled to take deduction for	8652

Trade or business interest

Transfer for value rule

generally	
business life insurance	8717, 8718
defined	8718
exceptions.....	8717, 8719
sale or transfer	
generally	8717
family member, to	8720
grantor trust, to	8718, 8719
insured, to	8719
spouse of insured, to.....	8720
trust, to	8719
transfer for value, defined	8718

Transfer tax tables.....

Transfers

business life insurance contract. <i>See</i> Business life	
insurance	
minors, to. <i>See</i> Uniform Gifts/Transfers	
to Minors Acts	

Transportation expenses when not travelling away from home

Trip has both business and personal

elements	8682
----------------	------

Trusts

grantor	
transfer for value to	8718, 8719
income taxation of	
tax rates	App. A

25 percent gross receipts test.....

1202 gain

1231 gain

1250 gain

U

Unearned income

child, of.....	8557
----------------	------

Unified credit

amount of	App. A, App. B
-----------------	----------------

Uniform Gifts/Transfers to Minors Acts

custodial property, income from.....	8557
income on property transferred to minor	8559
income taxation of custodial property.....	8557

INDEX

References are to question numbers.

Unincorporated business entity. *See also*
Sole proprietorship 8805
Unrecaptured Section 1250 gain 8561, 8563
Unreimbursed expenses. *See also*
Self-employed person 8693

V

Valid and enforceable agreement 8695
Valid business purpose 8899, 8900
annual business cycle test 8900
seasonal business test 8900
25 percent gross receipts test 8900
Valuation, estate and gift taxation
charitable gift
fair market value of 8917, 8924
overvaluation of, penalty for 8919

Valuation, income taxation
charitable contributions
generally 8917
overvaluation, penalty for 8919

W

Withholding, income tax
medical expense reimbursement 8733
Work opportunity credit 8548
Working condition fringe benefit 8798
Worthless loan 8698
Worthless securities 8699
capital loss 8700
deduction permitted 8699
identifiable event 8699
ordinary loss 8700
affiliated corporation 8700

