PART VII: FEDERAL INCOME TAXATION

General Rules

566. Who must file a return?

A return must be filed for taxable year 2014 by every individual whose gross income equals or exceeds the following limits:[1]

(1) Married persons filing jointly–$20,300 (if one spouse is 65 or older–$21,500; if both spouses are 65 or older–$22,700).

(2) Surviving spouse (see Q 641)–$16,350 (if 65 or older–$17,550).

(3) Head-of-household (see Q 642)–$13,050 (if 65 or older–$14,600).

(4) Single persons–$10,150 (if 65 or older–$11,700).

(5) Married filing separately–if neither spouse itemizes, a return must be filed if gross income equals or exceeds $3,950 in 2014 regardless of age.

(6) Dependents–every individual who may be claimed as a dependent of another must file a return for 2014 if he has unearned income in excess of $1,000 (plus any additional standard deduction if the individual is blind or elderly) or total gross income that exceeds the sum of any additional standard deduction if the individual is blind or elderly plus the greater of (a) $1,000 or (b) the lesser of (i) $350 plus earned income, or (ii) $6,200.

(7) If you are blind, you may need to attach supporting documentation to a tax return to support your claim for the additional standard deduction. The additional standard deduction for taxpayers who are blind at the end of the tax year is not considered when determining a taxpayer's filing threshold amount.

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 591.

A taxpayer with self-employment income must file a return if *net* self-employment income is $400 or more. See Q 655.

Planning Point: A taxpayer must file a return if any of the following special taxes are due:

1. Alternative minimum tax.

2. Additional tax on a qualified plan, including an individual retirement arrangement (IRA), or other tax-favored account. If you are filing a return only because you owe this tax, you can file Form 5329 by itself.

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

3. Household employment taxes. You can file Schedule H by itself if you are filing a return only because you owe this tax.

4. Social security and Medicare tax on tips you did not report to your employer or on wages you received from an employer who did not withhold these taxes.

5. Recapture of first-time homebuyer credit.

6. Write-in taxes, including uncollected social security and Medicare or RRTA tax on tips you reported to your employer or on group-term life insurance and additional taxes on health savings accounts.

7. Recapture taxes.

8. Additional tax on a health savings account (HSA), Archer MSA, or Medicare Advantage MSA distributions. If you are filing a return only because you owe this tax, you can file Form 5329 by itself.

9. Wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and medicare taxes.

Even if you are not required to file a federal tax return, you may want to file one if withholdings of tax have occurred, or you are eligible for a refundable credit, such as the Earned Income Credit.

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

Taxpayers are generally required to pay estimated tax if failure to pay would result in an underpayment (see below) of federal income tax.[1] Taxpayers must include the alternative minimum tax, additional Medicare tax, net investment income tax, and estimated self-employment tax in their calculation of estimated tax (see Q 653 and Q 655, respectively).[2] An underpayment is the amount by which a required installment exceeds the amount, if any, paid on or before the due date of that installment (due dates are April 15, June 15, September 15 and January 15 of the following year).[3] The required amount for each installment is 25 percent of the *required annual payment*.[4]

Generally, the "required annual payment" is the lower of (a) 90 percent of the tax shown on the return for the taxable year (or, if no return is filed, 90 percent of the tax for the year), or (b) 100 percent of the tax shown on the return for the preceding year (but only if the preceding taxable year consisted of 12 months and a return was filed for that year).[5] However, for an individual whose adjusted gross income for the previous tax year exceeded $150,000 ($75,000 in the case of married individuals filing separately), the required annual payment is the lesser of (a) 90 percent of the current year's tax, as described above, or (b) the *applicable percentage*

1. IRC Sec. 6654.
2. IRC Sec. 6654(d)(2)(B)(i).
3. IRC Secs. 6654(b), 6654(c).
4. IRC Sec. 6654(d)(1)(A).
5. IRC Sec. 6654(d)(1)(B).

of the tax shown on the return for the preceding year. The applicable percentage for tax years beginning 2002 or later is 110 percent.[1]

As an alternative to the required annual payment methods in the preceding paragraph, taxpayers can pay estimated tax by paying a specified percentage of the current year's tax, computed by annualizing the taxable income for the months in the taxable year ending before the month in which the installment falls due. The percentages that apply under the annualization method are: 22.5 percent (1st quarter), 45 percent (2nd quarter), 67.5 percent (3rd quarter), and 90 percent (4th quarter).[2]

However, regardless of the method used to calculate estimated taxes, there is no interest penalty imposed if: (1) the tax shown on the return for the taxable year (or, if no return is filed, the tax) after reduction for withholdings is less than $1,000; or (2) the taxpayer owed no tax for the preceding year (a taxable year consisting of 12 months) and the taxpayer was a U.S. citizen or resident for the entire taxable year.[3] Otherwise, underpayment results in imposition of an interest penalty, compounded daily, at an annual rate that is adjusted quarterly so as to be three percentage points over the short-term applicable federal rate.[4] (See Q 589).

If the taxpayer elects to apply an overpayment to the succeeding year's estimated taxes, the overpayment is applied to unpaid installments of estimated tax due on or after the date(s) the overpayment arose in the order in which they are required to be paid to avoid an interest penalty for failure to pay estimated income tax with respect to such tax year.[5] For application of the estimated tax to trusts and estates, see Q 663.

568. What is an individual's "taxable year"?

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.[6]

Generally, a taxpayer may decide whether he wishes to use the calendar year or fiscal year in reporting his tax liability. Most individuals report on a calendar year basis. The year used for reporting tax liability must generally correspond to the taxpayer's accounting period.[7] Thus, if the taxpayer keeps books on a fiscal year basis he cannot determine his tax liability on a calendar year basis. But if the taxpayer keeps no books, he must report on a calendar year basis.[8] Once the taxpayer has chosen his tax year, he cannot change without the permission of the Internal Revenue Service.[9] A principal partner cannot change to a taxable year other

1. IRC Sec. 6654(d)(1)(C).
2. IRC Sec. 6654(d)(2).
3. IRC Sec. 6654(e).
4. IRC Sec. 6621(a)(2).
5. Rev. Rul. 99-40, 1999-2 CB 441.
6. IRC Secs. 441(a), 441(b), 441(d), 441(e).
7. IRC Sec. 441(f)(1).
8. IRC Sec. 441(g).
9. IRC Sec. 442.

than that of the partnership unless he establishes, to the satisfaction of the IRS, a business purpose for doing so.[1]

Under certain circumstances, partnerships, S corporations, and personal service corporations are required to use the calendar year for computing income tax liability.[2]

A short period return is required (1) where the taxpayer changes his annual accounting period, and (2) where a taxpayer has been in existence for only part of a taxable year.[3] A short period is treated in the law as a "taxable year."[4]

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.[5] But income for the short period is not required to be annualized if the taxpayer is not in existence for the entire taxable year.[6]

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 Treas. Regs. §§1.441-0, 1.441-1, 1.441-2, 1.441-3, 1.441-4; TD 8996.[7]

For the general procedures for establishing a business purpose and obtaining approval to adopt, change, or retain an annual accounting period, see Rev. Proc. 2002-39.[8]

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 is set forth in Revenue Procedure 2003-62.[9]

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.[10]

569. What are the basic steps in computing an individual's tax liability?

The computation is made up of these basic steps:

...Gross income for the taxable year is determined (see Q 570 to Q 614).

1. IRC Sec. 706(b)(2).
2. See IRC Secs. 441(i), 706(b), 1378.
3. IRC Sec. 443(a).
4. IRC Sec. 441(b)(3).
5. IRC Secs. 443(b), 443(c).
6. Treas. Reg. §1.443-1(a)(2).
7. 67 Fed. Reg. 35009 (5-17-2002).
8. 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.
9. 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.
10. 2006-45 IRB 859.

...Certain deductions are subtracted from gross income to arrive at adjusted gross income (see Q 619, Q 620).

...The deduction for personal and dependency exemptions is determined (see Q 626, Q 627).

...Itemized deductions (taking into consideration any limitations thereon) are totaled (see Q 629 to Q 635), compared to the *standard deduction* (see Q 638), and (generally) the greater amount, along with the deduction for exemptions, is deducted from adjusted gross income to arrive at taxable income.

...The proper tax rate is applied to taxable income to determine the tax (see Appendix A).

...The following amounts are subtracted from the tax to determine the net tax payable or overpayment refundable: (1) credits (see Q 643), and (2) prepayments toward the tax (e.g., tax withheld by an employer or payments made on an estimated tax return).

The steps in calculating the alternative minimum tax are explained in Q 653.

Gross Income

570. What items are included in gross income? What items are excluded from gross income?

Gross income includes all income (whether derived from labor or capital) *less* those items that are excludable by law. Thus, 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.[1]

Some of the items that can be *excluded* from gross income and received tax-free by an individual taxpayer are: gifts and inheritances;[2] gain (within limits) from the sale of a personal residence (see Q 7781); at least 50 percent of gain (within limits) from the sale of certain qualified small business stock held for more than five years (see Q 7521 and Q 7522); interest on many bonds of a state, city or other political subdivision (see Q 7642); Social Security and railroad retirement benefits (within limits–see Q 590); veterans' benefits (but retirement pay is taxable);[3] Workers' Compensation Act payments (within limits);[4] 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] 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] contributions to a "Medicare Advantage MSA" by the Department of Health and Human Services;[7] exempt-interest dividends from mutual funds

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.

(see Q 7851); interest on certain U.S. savings bonds purchased after 1989 and used to pay higher education expenses (within limits–see Q 7666);[1] contributions paid by an employer to Health Savings Accounts;[2] distributions from Health Savings Accounts used to pay qualified medical expenses;[3] and federal subsidies for prescription drug plans.[4]

571. How are the commissions, including insurance commissions, of a sales representative taxed?

Commissions are generally taxable as ordinary income in the year received, regardless of whether the taxpayer is on a cash or accrual method of accounting, and regardless of whether the taxpayer has a contingent obligation to repay them. Commissions on insurance premiums, however, are a special situation. (See Q 3515 regarding the limitation on certain employers' deductions).

General rule for insurance commissions. First year and renewal commissions are taxable to the agent as ordinary income in the year received. If the agent works on commission with a drawing account, the amount he reports depends upon his contract with the company. If the drawing account is a loan that must be repaid (or upon which he remains personally liable) if he leaves, he 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.[5] The procedure by which an insurance company may obtain automatic consent to change its method of accounting for cash advances on commissions paid to its agents is set forth in Revenue Procedure 2001-24.[6]

The Tax Court held that an agent's advance commissions were not compensation where they were repayable on demand, bore interest, and were secured by earned commissions as well as by the personal liability of the agent. Thus, even though the amounts were reported to the taxpayer as income on Form 1099-MISC, they were not income.[7] The IRS determined that cash advances made to an agent by an insurance company *were* income in the year of receipt where the agent was not unconditionally obligated to repay the advances, and any excess in advances over commissions earned would be recovered by the insurance company only by crediting earned commissions and renewals against such advances.[8] These positions are consistent with other IRS rulings and prior case law.[9] A salesman who was discharged from the obligation to repay advance commissions received in previous years was required to recognize income in the year of discharge.[10] The Tax Court determined that an agent had cancellation of indebtedness income where earned commissions had been used to offset advanced commissions (which were

1. See IRC Sec. 135.
2. IRC Sec. 106(d).
3. IRC Sec. 223(f)(1).
4. IRC Sec. 139A.
5. See Rev. Rul. 75-541, 1975-2 CB 195; *Security Assoc. Agency Ins. Corp. v. Comm.*, TC Memo 1987-317; *Dennis v. Comm.*, TC Memo 1997-275.
6. 2001-10 IRB 788.
7. *Gales v. Comm.*, TC Memo 1999-27; acq. in result, 1999-2 CB 3.
8. TAM 9519002.
9. See Rev. Rul. 83-12, 1983-1 CB 99 (also released as IR 82-150); *Geo. Blood Enter., Inc. v. Comm.*, TC Memo 1976-102. (See Rev. Proc. 83-4, 1983-1 CB 577 for guidance in complying with these rules.)
10. *McIsaac v. Comm.*, TC Memo 1989-307. See also *Cox v. Comm.*, TC Memo 1996-241; *Diers v. Comm.*, TC Memo 2003-229.

actually loans). Accordingly, the agent was held to have received gross income at the time any pre-existing deficiency in her commission account was offset, irrespective of the fact that she never received an actual check.[1]

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.[2]

The Tax Court also held that where a retired insurance agent did not actually own any company assets he returned to the insurance company upon his retirement, termination payments received by the agent were not proceeds from a sale of capital assets subject to capital gain treatment, but instead were ordinary income.[3]

572. How are the commissions on an insurance agent's own policies taxed?

Commissions on policies purchased by the agent for himself, on his own life or on the life of another, are taxable to him as ordinary income. Such commissions are considered compensation, not a reduction in the cost of the policies.[4] This rule applies to brokers as well as to other life insurance salesmen.[5]

573. How are an insurance agent's commissions taxed if they are received pursuant to a deferred income plan?

If, before he retires, an insurance agent enters into an irrevocable agreement with the insurance company to receive his renewal commissions in level installments over a period of years, only the amount of the annual installment will be taxable to him each year–instead of the full amount of commissions as they accrue.[6] Although the *Oates* case and Rev. Rul. 60-31 concern deferred compensation arrangements during retirement years, the same principle should apply if the agent during his lifetime elects a level commission arrangement for payments after his death. The IRS determined that an insurance agent's contributions of commissions to his company's nonqualified deferred compensation plan will not be includable in the agent's gross income or subject to self-employment tax until actually distributed.[7] In *Olmsted*, the insurance company, by agreement with the agent, substituted an annuity contract for its obligation to pay future renewal commissions. The Tax Court and the U.S. Court of Appeals for the Eighth Circuit held that the agreement was effective to defer tax until payments were received under the annuity.[8] However, the IRS did not acquiesce to the *Olmsted* decision.[9]

1. *Harper v. Comm.*, TC Summary Op. 2007-133.
2. *Clark v. Comm.*, TC Memo 1994-278. See also *Farnsworth v. Comm.*, TC Memo 2002-29, *Parker v. Comm.*, TC Memo 2002-305.
3. *Baker v. Comm.*, 118 TC 452 (2002), *aff'd*, 2003 U.S. App. LEXIS 15509 (7th Cir. 2003). See also *Trantina. v. United States*, 512 F. 3d 567, 2008-1 USTC ¶50,138 (9th Cir. 2008).
4. *Ostheimer v. U.S.*, 264 F.2d 789 (3rd Cir. 1959); Rev. Rul. 55-273, 1955-1 CB 221.
5. *Comm. v. Minzer*, 279 F.2d 338 (5th Cir. 1960); *Bailey v. Comm.*, 41 TC 663 (1964); *Mensik v. Comm.*, 37 TC 703 (1962), *aff'd*, 328 F.2d 147 (7th Cir. 1964).
6. *Comm. v. Oates*, 207 F.2d 711 (7th Cir. 1953); Rev. Rul. 60-31, 1960-1 CB 174; Let. Ruls. 9540033, 9245015.
7. Let. Rul. 9609011.
8. *Comm. v. Olmsted Inc. Life Agency*, 35 TC 429 (1960), *aff'd*, 304 F.2d 16 (8th Cir. 1962).
9. Non-acq., 1961-2 CB 6.

574. What are the tax consequences if an insurance agent sells or assigns the agent's right to receive renewal commissions?

Assignment of renewal commissions. If the agent assigns the agent's right to renewal commissions as a gift, he still must pay income tax on them as they are received by the donee.[1] The Tax Court determined that an insurance agent had to pay income tax on his commission income despite the assignment of that income to his S corporation. The court noted that the agent was the true earner of the income and that he made no valid assignment of his employment agreement with the insurance company.[2] In *Zaal*, a 1998 memorandum decision, the Tax Court held that an agent's transfer to a corporation of his right to receive renewal commissions was ineffective for tax purposes, since it constituted an anticipatory assignment of income rather than a sale of property. Citing *Helvering v. Eubank*, the court held that the commission income continued to be taxable to the agent, not to the corporation to which he transferred the rights.[3]

Sale of renewal commissions. It appears likely that a bona fide, arm's length *sale* of a right to receive renewal commissions can successfully transfer the federal income taxation of renewal commissions to the purchaser. The Court of Appeals for the Second Circuit has held that in the event of a sale of the right to receive renewal commissions, the sale price would constitute ordinary income to the agent in the year received.[4] The court in *Cotlow* added that the purchaser receives the renewals tax free until he recovers his cost; then the excess is taxable to him as ordinary income as it is received. Other cases have held that the purchaser must amortize his cost. In other words, he can exclude from gross income each year only that portion of the purchase price that the renewals received in that year bear to the total anticipated renewals.[5]

575. How are commissions received after the death of the insurance agent taxed?

Commissions owed to an agent before he died, but paid after his death, are includable in his gross income on his final return. Renewal commissions payable after his death are "income in respect of a decedent"; consequently, the value of the right to the commissions is includable in the agent's gross estate. The renewal commissions are taxable income to whoever receives them (e.g., his estate, beneficiaries, or a trust).[6] However, the person who receives the commissions is entitled to take an income tax deduction against them for any portion of federal estate taxes and generation-skipping transfer taxes attributable to their value. If the decedent has purchased renewal commissions from another agent, the recipient will be allowed to amortize any portion of the decedent's cost unrecovered at his death.[7] If the recipient of the right to commissions sells or otherwise disposes of his right to receive them, he is taxed on the fair market value of the right in the year of sale or other disposition (e.g., gift). But if the recipient dies, the fair market value of the right to commissions will not be included in his final return; the person

1. *Helvering v. Eubank*, 311 U.S. 122 (1940); *Hall v. U.S.*, 242 F.2d 412 (7th Cir. 1957).
2. *Isom v. Comm.*, TC Memo 1995-383.
3. *Zaal v. Comm.*, TC Memo 1998-222. See also *McManus v. Comm.*, TC Summ. Op. 2006-68.
4. *Cotlow v. Comm.*, 228 F.2d 186 (2nd Cir. 1955); see also, *Turner v. Comm.*, 38 TC 304 (1962).
5. *Latendresse v. Comm.*, 243 F.2d 577 (7th Cir. 1957); *Hill v. Comm.*, 3 BTA 761 (1926).
6. *Latendresse v. Comm.*, above; *Est. of Goldstein v. Comm.*, 33 TC 1032 (1960), *aff'd*, 340 F.2d 24 (2nd Cir. 1965); *Est. of Remington v. Comm.*, 9 TC 99 (1947).
7. *Latendresse v. Comm.*, above.

who receives the income right from the second decedent by will or inheritance pays tax on the commissions as they are received by him.[1]

576. How are an insurance agent's commissions treated for self-employment tax purposes?

Termination payments received by former insurance salesmen are not included in self-employment income if: (1) the amount is received after the termination of the agent's agreement to perform for the company; (2) the agent does not perform services for the company after the date of the termination of the service agreement and before the end of the taxable year; (3) the agent enters into a covenant not to compete with the company for at least a 1-year period beginning on the date of the termination; and (4) the amount of the payment (a) depends primarily on policies sold by or credited to the agent's account during the last year of the service agreement or to the extent such policies remain in effect for some period after termination of service, or both, and (b) does not depend to any extent on the length of service or overall earnings from services performed for such company (without regard to whether eligibility for payment depends on length of service).[2] For termination payments that do not fall within the above description, earlier case law and rulings may apply.

The Tax Court held that because an independent insurance agent's renewal commissions were tied to the quantity and quality of the taxpayer's prior labor, and those payments derived from the carrying on of the taxpayer's business as an independent insurance agent, the taxpayer's renewal commissions were not exempt from self-employment tax.[3] The Tax Court also held that an insurance agent was liable for self-employment tax because he was not a statutory employee, but instead was engaged in a self-employed trade or business activity.[4]

The Eleventh Circuit Court of Appeals held that the FICA statute does not impliedly provide a private cause of action to purported "employees" – in this case, insurance agents claiming they had been improperly classified as independent contractors – to sue their purported "employer" for nonpayment of the employer's portion of FICA taxes.[5]

577. What is an insurance premium rebate? What are the income tax consequences of rebating premiums?

Generally

Insurance premium rebates are unlawful in most states. A premium rebate is a transaction in which a life insurance agent returns all or a portion of his commission to the purchaser of a life insurance policy, or simply pays the policy's first-year premium without contribution from the purchaser. The amount of the commission, allowance and/or bonus paid by the insurance company to the agent for the sale of the policy often exceeds the policy premium. The purchaser of the policy receives free or less expensive life insurance coverage.

1. IRC Sec. 691(a); Treas. Reg. §1.691(a)-1.
2. IRC Sec. 1402(k).
3. *Gilbert v. Comm.*, TC Summary Op. 2005-176.
4. *Byer v. Comm.*, TC Summary Op. 2006-125.
5. See *McDonald v. Southern Farm Bureau Life Ins. Co.*, 291 F. 3d 718, 2002 U.S. App. LEXIS 9110 (11th Cir. 2002).

Income Tax to the Agent

As mentioned above, almost all states have anti-rebating statutes that prohibit the sharing of insurance commissions with unlicensed persons. The tax consequences to the agent may vary, depending on the laws of the state in which the agent resides, as well as the position of the respective circuit court. In one state where such an anti-rebating statute was in force, the Ninth Circuit Court of Appeals found that an agent who rebated a premium was considered to have received taxable income in the amount of the total commission earned on the sale of the policy, including any portion used by the agent to rebate the premium to the insured.[1] The agent in that case argued that the portion of the premium rebated should be excluded from income since the rebate was in the nature of a price adjustment. The court did not agree with this characterization.[2]

Furthermore, the agent in the *Alex* case was not permitted to offset commission income earned on the sale of the policy with a business expense deduction for the payment of premiums because the Code disallows deductions for any payment that is illegal under a generally enforced state law that subjects the payor to a criminal penalty or to the loss of a license or privilege to engage in a trade or business.[3] However, in the *Custis* case, an agent who rebated premiums was allowed to deduct the amount of the rebates under IRC Section 162 as business expenses since he was able to show that the state anti-rebating statute was not generally enforced.

The Court of Appeals for the Tenth Circuit decided that an insurance agent who expressly agreed with his clients to waive his right to collect basic commissions on policies sold by him was not in receipt of taxable income. The agent was required to collect and remit only the net premiums due on the policies he sold, which he did. The court found that since he was never in receipt of the basic commissions, taxable income could not be imputed to him. The court did not address the issue of whether the transactions violated state anti-rebating laws.[4]

Income Tax to the Purchaser

A federal district court and the Tax Court have determined that the purchasers of universal and whole life policies are subject to tax on the full amount of any premiums illegally rebated to them by the agents who sold the policies.[5] The courts rejected the purchasers' argument that the agents' reimbursements were really price adjustments. The court in *Woodbury* stated that the reimbursements were analogous to kickbacks and, as such, were includable in the purchasers' gross income. The court also rejected the purchasers' argument that their tax liability should be limited to the term element of the universal life policies. The fact that the purchasers did not intend to renew the policies did not convert the universal policies into term life insurance for tax purposes. The Tax Court has expressed its agreement with the district court's conclusions set forth in the *Woodbury* decision. In *Wentz*, it noted that the insurance agent was, in effect,

1. *Alex v. Comm.*, 628 F.2d 1222 (9th Cir. 1980), *aff'g* 70 TC 322 (1978).
2. See also *Custis v. Comm.*, TC Memo 1982-296; *Kreisberg v. Comm.*, TC Memo 1979-420.
3. IRC Sec. 162(c)(2). See *Kreisberg*, above.
4. *Worden v. Comm.*, 2 F.3d 359 (10th Cir. 1993).
5. *Woodbury v. U.S.*, 93-2 USTC ¶50,528 (D. N.D. 1993), *aff'd per curium*, 27 F.3d 572 (8th Cir. 1994); *Wentz v. Comm.*, 105 TC 1 (1995); *Haderlie v. Comm.*, TC Memo 1997-525.

a purchaser of the policies, and that he realized income in the amount of the kickbacks. Both the Tax Court and the *Woodbury* district court stated that the taxation of both the seller and the purchaser engaged in such an illegal scheme was permissible.

The Service has concluded that the purchaser of a life insurance policy is subject to income tax on the value of the free insurance coverage obtained as a result of receiving a premium rebate.[1] However, the Service stated that the valuation process itself was outside the scope of the memoranda; thus, it is unclear how the Service will calculate the actual value of the free coverage. (See Q 3899 and Q 3843 for an explanation of how employer-provided life insurance coverage is valued under split dollar arrangements and qualified retirement plans, respectively).

578. 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, in the case of *unearned* income of most children under age 19 (age 24, if the child is a full-time student), the unearned income taxable to the child generally will be taxed at the parents' marginal rate when it exceeds $2,000 (in 2013 and 2014, as adjusted for inflation). 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.[2] 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.[3]

579. When does a cash basis taxpayer "receive" income? What is the doctrine of constructive receipt?

As a general rule, taxable income must be computed under the method of accounting regularly used by the taxpayer.[4] There are two commonly accepted methods for recognizing income and expense: (1) the cash basis and (2) the accrual basis.[5]

Under the cash basis method, the general rule is that all items that constitute gross income (whether in the form of cash, property or services) are includable for the taxable year in which they are actually or constructively received.[6] Salary checks received in one year but not cashed until a later year are income when received unless substantial restrictions are placed on current negotiation or the issuer is insolvent.[7] A taxpayer who refused to cash a check in which his entire qualified plan balance was erroneously distributed was unsuccessful in deferring the date on which it was deemed received.[8]

1. TAMs 9214008, 9214007, 9214006.
2. Rev. Rul. 56-484, 1956-2 CB 23; Rev. Rul. 59-357, 1959-2 CB 212.
3. IRC Sec. 677(b).
4. IRC Sec. 446(a).
5. IRC Sec. 446(c).
6. IRC Sec. 451(a); Treas. Reg. §1.451-2(a).
7. *Chapman v. Comm.*, TC Memo 1982-307; *Baxter v. Comm.*, 816 F.2d 493 (9th Cir. 1987), *rev'g in part* TC Memo 1985-378.
8. See Let. Rul. 9826036.

As a general rule, expenses are deductible by a cash basis taxpayer for the taxable year in which they are paid.[1]

The doctrine of constructive receipt of income affects only cash basis taxpayers. Under this doctrine, a cash basis taxpayer is required to report income that has been credited to his account or set apart for him in such a way that he may draw on it freely at any time – even though he has not actually received it.[2] Thus, a cash basis taxpayer must report the interest credited to his bank savings account in the year it is credited regardless of whether he withdraws the interest or leaves it on deposit (see Q 7844).

However, the doctrine applies only where the taxpayer's control of the income is unrestricted. Thus, a sum is not constructively received if it is only conditionally credited, or if it is indefinite in amount, or if the payor has no funds, or if it is subject to any other substantial limitation. However, the courts say, generally, that there can be no constructive receipt of an amount that is available only through surrender of a valuable right.[3]

Under the accrual method, income is includable for the taxable year in which the right to receive the income becomes fixed and the amounts receivable become determinable with reasonable accuracy.[4] Expenses are deductible for the taxable year in which the liability for payment becomes definite and the amounts payable become reasonably certain, but only to the extent that economic performance with respect to the item has occurred.[5]

For the revised comprehensive procedures by which taxpayers may obtain *automatic* consent to change their method of accounting, see Rev. Proc. 2011-14.[6]

The Tax Court held that a contract for a deed resulted in a completed sale of real property for tax purposes in the year that the contract was executed; therefore, income attributable to that disposition was required to be recognized and reported in the taxable year in which the contract was executed.[7] Controlling shareholders of a privately held company that sold derivative instruments through flow-through entities were required to recognize their pro rata share of the gain in the year that the shares were sold.[8] An investor who experienced losses on foreign currency contracts that required repayment on a future maturity date, but who was unable to post adequate collateral in the year the losses were sustained, was entitled to deduct the losses in the year in which the debt was repaid.[9] Under the constructive receipt doctrine, the mere right of an employee to make an election to cash out future vacation leave under the employer's plan would not result in taxable income for the employee under the cash method of accounting if the employee chose not to make such an election.[10]

1. IRC Sec. 461(a).
2. Treas. Reg. §1.451-2. See, e.g., *Visco v. Comm*, 281 F.3d 101 (3rd Cir. 2002), *aff'g*, TC Memo 2000-77 (employment-related dispute).
3. See *Cohen v. Comm.*, 39 TC 1055 (1963).
4. Treas. Reg. §1.451-1(a).
5. IRC Sec. 461(h).
6. Rev. Proc. 2011-14, IRB 2011-4, as modified by Rev. Proc. 2014-16, 2014 IRB LEXIS 59.
7. *Keith v. Comm.*, 115 TC 605 (2000).
8. FSA 200111011.
9. FSA 200106005.
10. Let. Rul. 200130015.

580. What are the tax consequences of a discharge of indebtedness?

General

Gross income generally includes income from discharge of indebtedness.[1] However, debt discharge is excluded from gross income if the discharge: (1) occurs in a Title 11 bankruptcy case; (2) occurs when the taxpayer is insolvent; (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," Q 581) that is discharged before January 1, 2014.[3]

The Treasury regulations reiterate that the discharge of indebtedness, in whole or in part, generally results in the realization of income. For example, if an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than face value. In general, if a shareholder in a corporation that is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.[4]

581. What is the Mortgage Forgiveness Debt Relief Act of 2007 (MFDRA 2007) and how does it impact the tax consequences of a discharge of indebtedness?

As discussed in Q 580, qualified principal residence indebtedness discharged before January 1, 2014 is excludable from gross income under MFDRA 2007,[5] the American Taxpayer Relief Act of 2012 ("ATRA") extended the applicable time period through 2013. The principal residence debt exclusion (under IRC Section 108(a)(1)(E)) takes precedence over the insolvency exclusion (under IRC Section 108(a)(1)(B)) unless the taxpayer *elects* to apply the insolvency exclusion in lieu of the principal residence debt exclusion.[6] The principal residence debt exclusion applies to discharges of indebtedness on or after January 1, 2007.[7]

Basis reduction. The amount excluded from gross income by reason of the exclusion for qualified principal residence indebtedness must be applied to reduce (but not below zero) the basis of the principal residence of the taxpayer.[8]

Qualified principal residence indebtedness. For purposes of this exclusion, "qualified principal residence indebtedness" means "acquisition indebtedness" (within the meaning of IRC Section 163(h)(3)(B)—see Q 7934), with respect to the principal residence of the

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).
4. Treas. Reg. §1.61-12(a).
5. IRC Sec. 108(a)(1)(E), as amended by EESA 2008.
6. IRC Sec. 108(a)(2)(C).
7. Act Sec. 2(d), MFDRA 2007.
8. IRC Sec. 108(h)(1).

taxpayer, *except* that the amount of excludable indebtedness is limited to $2,000,000 (i.e., instead of $1,000,000).[1]

Exception for certain discharges not related to the taxpayer's financial condition. The principal residence debt exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.[2]

Ordering rule. If any loan is discharged, in whole or in part, and only a portion of that loan is qualified principal residence indebtedness, the exclusion will apply only to so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) that is not qualified principal residence indebtedness.[3]

Principal residence. For purposes of this exclusion, the term "principal residence" has the same meaning as when used in IRC Section 121.[4] See Q 7781.

582. What is a below-market loan?

Editor's Note: The Sarbanes-Oxley Act of 2002 (P.L. 107-204) adopted new securities law provisions intended to deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and shareholders of publicly-traded corporations. However, it would appear that one provision of the Act indirectly impacts below-market loans made to executives of publicly-traded corporations. See Q 585.

Generally, a below-market loan is any demand loan with an interest rate that is below the applicable federal rate (see below) *or* any term loan in which the amount received by the borrower exceeds the present value of all payments due under the loan. A demand loan is any loan that is payable in full at any time on the demand of the lender, or that has an indefinite maturity. All other loans are generally term loans.[5] The IRC essentially recharacterizes a below-market loan as two transactions: (1) an arm's-length loan requiring payment of interest at the applicable federal rate, and (2) a transfer of funds by the lender to the borrower ("imputed transfer").[6]

Below-market loans include gift loans (Q 583), and compensation-related loans and corporation-shareholder loans (Q 584). In addition to these types of loans, below-market loans in which one of the principal purposes is tax avoidance or, to the extent provided for in regulations, in which the interest arrangements have a significant effect on the federal tax liability of either party, will also be subject to the rules governing below-market loans. (See Q 583, Q 584 and Q 585)[7] The Service has determined that the interest arrangements of certain loans *will not* be considered as having a significant effect on the federal tax liability of either party–tax-

1. IRC Sec. 108(h)(2).
2. IRC Sec. 108(h)(3).
3. IRC Sec. 108(h)(4).
4. IRC Sec. 108(h)(5).
5. IRC Secs. 7872(e), 7872(f).
6. Prop. Treas. Reg. §1.7872-1(a).
7. IRC Sec. 7872(c)(1).

exempt obligations, obligations of the U.S. government, life insurance policy loans, etc.–and, unless one of the principal purposes is tax avoidance, such transactions will not be subject to the below-market loan rules.[1]

Applicable Federal Rate

The applicable federal rate (see Q 589) for demand loans is the short-term rate in effect during the period for which the forgone interest is being determined, compounded semiannually.[2] In the case of a below-market loan of a fixed principal amount that remains outstanding for the entire calendar year, forgone interest is equal to the *excess of* the "blended annual rate" for that calendar year multiplied by the outstanding principal *over* any interest payable on the loan properly allocable to the calendar year. The blended annual rate is published annually with the AFRs for the month of July.[3] The blended annual rate for the calendar year 2011 was 0.40 percent, the blended annual rate for calendar year 2012 was 0.22 percent, and the blended annual rate for calendar year 2013 was 0.22 percent.[4]

For term loans, the applicable federal rate is the corresponding federal rate (i.e., short-, mid-, or long-term) in effect on the day the loan was made, compounded semiannually.[5]

The applicable federal rates are determined by the Secretary on a monthly basis.[6] The Secretary may by regulation permit a rate that is lower than the applicable federal rate to be used under certain circumstances.[7]

Reporting Requirements

In any taxable year in which the lender or the borrower either has imputed income or claims a deduction for an amount imputed under IRC Section 7872, he must: (1) attach a statement to his income tax return explaining that it relates to the amount includable in income or deductible by reason of the below-market loan rules; (2) provide the name, address and taxpayer identification number of the other party; and (3) specify the amount includable or deductible and the mathematical assumptions and method used in computing the amounts imputed.[8]

583. What are the income tax consequences of a below-market loan that is categorized as a gift loan?

A below-market demand or term loan is a gift loan if the foregoing of interest is in the nature of a gift.[9] The lender is deemed to have transferred to the borrower and the borrower is deemed to have transferred to the lender an amount equal to the forgone interest.[10] "Forgone

1. Temp. Treas. Reg. §1.7872-5T.
2. IRC Sec. 7872(f)(2)(B).
3. Rev. Rul. 86-17, 1986-1 CB 377.
4. Rev. Rul. 2010-18, Rev. Rul. 2012-20, 2012-27 IRB 1, Rev. Rul. 2013-15.
5. IRC Sec. 7872(f)(2)(A).
6. IRC Sec. 1274(d).
7. See IRC Sec. 1274(d)(1)(D).
8. Prop. Treas. Reg. §1.7872-11(g).
9. IRC Sec. 7872(f)(3).
10. IRC Sec. 7872(a)(1).

interest" is the *excess of* the amount of interest that would have been payable if it accrued at the applicable federal rate and was payable on the last day of the calendar year *over* any interest actually payable on the loan during such period.[1] In the case of below-market gift loans between natural persons, the transfer is treated, for both the borrower and the lender, as occurring on the last day of the borrower's taxable year.[2] The amount of forgone interest is included in the gross income of the lender; deductibility by the borrower depends on how the interest is classified for tax purposes (i.e., personal, passive, etc.–see Q 7932).

These rules do not apply to any below-market gift loan between individuals on any day the aggregate outstanding amount of *all* loans made directly between them (husband and wife are treated as one person) does not exceed $10,000; however, this de minimis exception will not apply to any gift loan directly attributable to the purchase or carrying of income-producing assets.[3] In addition, a special rule limits the amount of income included in the lender's gross income to the borrower's net investment income for the year if: (1) the aggregate outstanding amount of all loans made directly between *individuals* does not exceed $100,000; (2) the lender has a signed statement from the borrower, stating the amount of borrower's net investment income properly allocable to the loan; (3) the time or amount of investment income cannot be manipulated by the borrower, and (4) tax avoidance is not one of the principal purposes of the interest arrangements.[4] Net investment income equals the excess of investment income over investment expenses, *plus* any amount that would be includable as interest on all deferred payment obligations were the original issue discount rules to apply. Deferred payment obligations include annuities, U.S. savings bonds and short-term obligations. Net investment income will be treated as zero in any year it does not exceed $1,000.[5]

For the gift tax consequences of below-market gift loans, see Q 740.

584. What are the income tax consequences of a below-market loan that is categorized as a compensation-related loan or a corporation-shareholder loan?

In the case of demand loans that are compensation-related (e.g., employer to employee, between an independent contractor and the individual for whom the services are provided and, under proposed regulations, between a partnership and a partner in certain circumstances) or corporation-shareholder loans, the same transfer and retransfer of forgone interest is deemed to have occurred as explained in gift loans, Q 583.[6] The lender in a compensation-related loan will have interest income to the extent of the forgone interest and a corresponding deduction for compensation paid (if reasonable). The borrower will have compensation income, but a deduction for the forgone interest will be subject to the limitations on interest deductions (see Q 7932). The same consequences result in corporation-shareholder loans except that the forgone interest is treated as a dividend; therefore, there is no deduction available to the lender-corporation.

1. IRC Sec. 7872(e)(2).
2. IRC Sec. 7872(a)(2); Prop. Treas. Reg. §1.7872-6(b)(3).
3. IRC Sec. 7872(c)(2); Prop. Treas. Reg. §1.7872-8(b)(3).
4. IRC Sec. 7872(d)(1); Prop. Treas. Regs. §§1.7872-8(c), 1.7872-11(g)(3).
5. IRC Sec. 7872(d)(1)(E).
6. IRC Secs. 7872(c)(1)(B), 7872(c)(1)(C); Prop. Treas. Reg. §1.7872-4(c).

In the case of below-market term loans that are compensation-related or corporation-shareholder loans, the lender is deemed to have transferred to the borrower and the borrower is deemed to have received a cash payment equal to the *excess of* the amount loaned *over* the present value (determined as of the date of the loan, using a discount rate equal to the applicable federal rate) of all payments required to be made under the terms of the loan.[1] The excess is treated as original issue discount and, generally, treated as transferred on the day the loan was made. The lender can deduct the amount treated as original issue discount as compensation in compensation-related loans and will include such amount as interest income as it accrues over the term of the loan. The borrower will have includable compensation on the day the loan is made, but deductions (if allowed–see Q 7932) for the "imputed" interest can be taken only as such interest accrues over the loan period. With regard to corporation-shareholder loans, the same results occur except that the amount treated as original issue discount is considered a dividend, and there is no deduction available to the lender-corporation.

Compensation-related loans and corporation-shareholder loans, whether demand or term, are not subject to either of the above rules on any day the aggregate outstanding amount of all loans between the parties does not exceed $10,000 and tax avoidance is not one of the principal purposes of the interest arrangements.[2] With respect to term loans that are not gift loans, once the aggregate outstanding amount exceeds $10,000, this de minimis exception no longer applies, even if the outstanding balance is later reduced below $10,000.[3]

In a case of first impression involving below-market loans made to noncontrolling shareholders, the Tax Court held that the below-market loan rules may apply to a loan to a majority *or* a minority shareholder. The court also held that direct *and* indirect loans are subject to these rules.[4]

585. What securities law restrictions apply to a below-market loan?

Section 402 of the Sarbanes-Oxley Act of 2002 (P.L. 107-204) amended Section 13 of the Securities and Exchange Act of 1934 (15 USC 78m) to prohibit "issuers" (i.e., publicly-traded companies) from directly or indirectly (1) extending or maintaining credit, or (2) arranging for the extension of credit, or renewing an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent) of that issuer.

The narrow exceptions to this rule are loans made for the following purposes: home improvement; consumer credit; any extension of credit under an open-end credit plan; a charge card; or any extension of credit by a broker or dealer to buy, trade, or carry securities. To fall within the exception, the loan must also be (1) made or provided in the ordinary course of business of the company, (2) of a type that is generally made available by the company to the public, and (3) made on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit.

1. IRC Sec. 7872(b)(1).
2. IRC Sec. 7872(c)(3).
3. IRC Sec. 7872(f)(10).
4. *Rountree Cotton, Inc. v. Comm.*, 113 TC 422 (1999), *aff'd per curiam*, 87 AFTR 2d ¶2001-718 (10th Cir. 2001).

Thus, it would appear that a below-market loan made by a publicly-traded company to a director or executive officer for a purpose other than those outlined in the exceptions would be prohibited under the securities laws. Extensions of credit maintained by a company on July 30, 2002 are not subject to the prohibition so long as no material modification is made to any term of the loan and the loan is not renewed on or after that date.

586. What is an installment sale? How is it taxed?

Editor's Note: JGTRRA 2003 reduced capital gain rates for sales or exchanges occurring *on or after* May 6, 2003 and *before* January 1, 2013.[1] For tax years beginning after 2012, the American Taxpayer Relief Act of 2012 ("ATRA") permanently set capital gain rates at 0 percent for taxpayers in the 10 and 15 percent income tax brackets, 15 percent for taxpayers in the 25, 28, 33 and 35 percent income tax brackets and 20 percent for taxpayers in the 39.6 percent income tax bracket. For the tax treatment of installment payments, see Q 608.

An installment sale is a disposition of property (other than marketable securities, certain real property, and "inventory") where at least one payment is to be received by the seller after the close of the taxable year in which the disposition occurs.[2] It is not necessary that there be more than one payment.

Unless the taxpayer *elects out* on or before the due date, including extensions, for filing his federal income tax return for the taxable year in which the disposition occurred, any gain must be reported under this method.[3] An election out is made by reporting all of the gain on the transaction in the year of the sale. A decision by the taxpayer not to elect out is generally irrevocable unless the IRS finds that the taxpayer had good cause for failure to make a timely election.[4] Good cause will not be found if the purpose of a late election out is tax avoidance.[5] However, where a taxpayer intended to use the installment method but failed to do so through his accountant's error, the IRS permitted the taxpayer to revoke his election out of the installment method.[6] Similarly, the IRS has granted permission to revoke an election out where the election was not the result of a conscious choice by the taxpayer.[7] But see *Krause v. Comm.*[8] (holding that an election out will not be revoked when one of the purposes for the revocation is the avoidance of federal income taxes).

Loss cannot be reported on the installment method.[9] Dealers generally are not permitted to use the installment method (with exceptions for farm property and certain timeshares and residential lots).[10] See Q 7517 for the treatment of gain from the sale of publicly traded stock.

1. IRC Sec. 1(h), as amended by JGTRRA 2003 and ATRA; see also TIPRA 2005, Sec. 102.
2. IRC Sec. 453(b).
3. IRC Secs. 453(a), 453(d); Bolton v. Comm., 92 TC 303 (1989).
4. Treas. Reg. §15A.453-1(d); Rev. Rul. 90-46, 1990-1 CB 107.
5. Let. Rul. 9230003.
6. Let. Rul. 9218012. See also Let. Rul. 200226039.
7. Let. Ruls. 9419012, 9345027.
8. TC Memo 2000-343.
9. See IRC Sec. 453.
10. IRC Secs. 453(b)(2)(A), 453(l)(2).

Under the installment method, the total payment is divided into (a) return of the seller's investment, (b) profit, and (c) interest income. Generally, where the sale price is over $3,000 and any payment is deferred more than one year, interest must be charged on payments due more than six months after the sale at least at 100 percent of the "applicable federal rate," compounded semiannually, or it will be imputed at that rate.[1] However, the following are exceptions to this general rule:

(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 $5,339,300 in 2012, $5,468,200 in 2013 or $5,557,200 in 2014.[2]

(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 his family (i.e., brothers, sisters, spouse, 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);[3] 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).[4]

The applicable federal rate (see Q 589) 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.[5]

All interest received by the taxpayer is ordinary income.[6] 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.

Once interest is segregated, any depreciation is recaptured and recognized as ordinary income in the year of sale to the extent of gain on the sale.[7] In the case of an installment sale of IRC Section 1250 property (i.e., generally, most real estate subject to the allowance for depreciation under IRC Section 167),[8] regulations state that unrecaptured IRC Section 1250 gain

1. IRC Sec. 483.
2. IRC Sec, 1274A, Rev. Rul. 2012-33, 2012-51 IRB 710, Rev. Rul. 2013-23, 2013-48 IRB 590.
3. IRC Sec. 483(e)(3).
4. IRC Sec. 1274(e).
5. IRC Sec. 1274(d)(2)(B).
6. Treas. Reg. §1.483-1.
7. IRC Sec. 453(i).
8. See IRC Sec. 1250(c).

(which is generally taxed at a maximum marginal rate of 25 percent–see Q 608) must be taken into account *before* any adjusted net capital gain (taxed at a maximum of 20%/15%/0%–see Q 608).[1] This means that the allocation of unrecaptured IRC Section 1250 gain is front-loaded, *not* prorated over the life of the installment transaction.

For installment sales of IRC Section 1250 property occurring before May 7, 1997, the amount of unrecaptured IRC Section 1250 gain that is taken into account on payments received after May 6, 1997 under the regulations is determined as follows: amounts received after the sale date but before May 7, 1997 are treated as if unrecaptured IRC Section 1250 gain on payments received before May 7, 1997 had been taken into account before adjusted net capital gain.[2] In other words, the taxpayer is permitted to treat payments after May 6, 1997 as though the regulations had already been applied to earlier payments. Also, if the amount of unrecaptured IRC Section 1250 gain on payments received after May 6, 1997 and before August 23, 1999 would have been less under the Internal Revenue Code than the amount as determined under the regulations, the lesser amount may be used to determine the amount of unrecaptured IRC Section 1250 gain that remains to be taken into account.[3]

Once depreciation has been recaptured, any adjusted net capital gain (see Q 608) is allocated to each payment by determining a profit percentage (ratio of total profit to be realized to total selling price, exclusive of interest and any recaptured depreciation) that is applied to the noninterest portion of each installment.[4] Thus, if the selling price (the principal amount or imputed principal amount) was $10,000 and the total profit to be realized after depreciation has been recaptured is $2,000, 20 percent ($2,000/$10,000) of each dollar collected (after segregating interest) is gain that must be reported as income for that taxable year. Whether the gain is adjusted net capital gain or ordinary income is determined by the type of asset sold and the length of the holding period.

In determining the ratio, contract price may have to be adjusted for outstanding indebtedness on the property.[5]

587. How are sales between related parties taxed?

There are strict rules governing installment reporting of sales between "related" parties. Except as noted below, "related" persons include the following: (1) members of the same family (i.e., brothers, sisters, spouses, ancestors and lineal descendants); (2) an individual and a corporation of which the individual actually or constructively owns more than 50 percent of the stock; (3) a grantor and a fiduciary of a trust; (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 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

1. Treas. Reg. §1.453-12(a).
2. Treas. Reg. §1.453-12(b).
3. Treas. Reg. §1.453-12(c).
4. See IRC Sec. 453(c).
5. Treas. Reg. §15A.453-1. See, however, *Professional Equities, Inc. v. Comm.*, 89 TC 165 (1987).

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; or (12) generally, an executor and a beneficiary of an estate.[1]

For purposes of determining the ownership of stock, an individual is considered to own stock owned by family members (brothers and sisters, spouse, ancestors and lineal descendants), and stock owned by a corporation, partnership, estate, or trust in proportion to the interest in the entity owned by the individual or a family member, or a partner owning stock in the same corporation in which the individual owns stock.[2] A different definition of "related" generally applies to sales made before October 24, 1986. A different definition of "related" also applies in the case of sales of depreciable property, as explained below.[3]

If a related purchaser disposes of the property before the related seller has received the entire selling price, a special "second disposition" rule applies. This rule provides that the amount realized on the second disposition, (to the extent it exceeds payments already received by the related seller) will be treated as though it had been received by the related seller *on the date of the second disposition*. However, this rule generally does not apply if:

(1) the second disposition occurs more than two years after the first disposition;

(2) the second disposition is an involuntary conversion, the threat of which did not exist at the time of the first disposition;

(3) the second disposition occurs after the death of either of the related parties; or

(4) neither disposition had as one of its principal purposes the avoidance of income tax.[4]

If an installment sale between related parties is canceled or payment is forgiven, the *seller* must recognize gain in an amount equal to the difference between the fair market value of the obligation on the date of cancellation (but in no event less than the face amount of the obligation) and the seller's basis in the obligation.[5] The Service ruled that no disposition occurred on the substitution of new installment notes, without any other changes, because there was no evidence that the rights accruing to the sellers under the installment sale had either disappeared or been materially altered.[6]

A sale of depreciable property between related parties may *not* be reported on the installment method, unless it is shown that avoidance of income tax was not a principal purpose. For

1. IRC Secs. 453(f)(1), 318(a), 267(b).
2. IRC Secs. 453(f)(1), 318(a), 267(c).
3. See IRC Sec. 453(g).
4. IRC Sec. 453(e).
5. IRC Sec. 453B(f).
6. FSA 200125073.

purposes of this rule only, "related persons" refers generally to controlled business entities, not natural persons related by family.[1]

588. What is an interest surcharge?

Generally, an interest surcharge is applied to installment obligations in which deferred payments for sales during the taxable year exceed $5,000,000. Exceptions to this rule are provided for: (1) property used or produced in the trade or business of farming, (2) timeshares and residential lots, and (3) personal use property.[2]

The amount of the interest surcharge is determined by multiplying the "applicable percentage" of the deferred tax liability by the underpayment rate in effect at the end of the taxable year. The "applicable percentage" is determined by dividing the portion of the aggregate obligations for the year that exceeds $5,000,000 by the aggregate face amount of such obligations that are outstanding at the end of the taxable year. If an obligation remains outstanding in subsequent taxable years, interest must be paid using the same percentage rate as in the year of the sale.[3] In addition, if the installment obligation is pledged as security for a loan, the net proceeds of the loan will be treated as a payment received on the installment obligation (up to the total contract price); however, no additional gain is recognized on subsequent payments of such amounts already treated as received. The date of such constructive payment will be (a) the date the proceeds are received *or* (b) the date the indebtedness is secured, whichever is later.[4]

Planning Point: This interest surcharge on installment sales with deferred payments can be minimized in some cases by splitting the sale between a husband and wife, and between two taxable years. For example, a $20 million business owned by a couple could be split into two $10 million sales, and the transaction could be completed in two stages: $5 million per spouse in December, followed by $5 million per spouse in January. Structured this way, the sale would not trigger the interest surcharge. *Robert S. Keebler, CPA, MST.*

589. What is the applicable federal rate?

The applicable federal rate (AFR) is used in determining the amount of interest in the case of certain below-market loans for both income and gift tax purposes (see Q 582, Q 740), in imputing interest on debt instruments given on the sale or exchange of property (see Q 586, Q 7775), and for determining interest and present values in connection with deferred payments for the use of property or services (see Q 7769).

The applicable federal rates are determined by the Secretary on a monthly basis (and published in a revenue ruling). The rates–short-term, mid-term and long-term–are based on the average market yield on the outstanding marketable obligations of the United States with maturity periods of three years or less, more than three but not more than nine years, and over nine years.[5] The AFRs can be found at: www.taxfactsonline.com.

1. IRC Sec. 453(g).
2. IRC Sec. 453A(b).
3. IRC Sec. 453A(c).
4. IRC Sec. 453A(d)(1). See Revenue Act of 1987 Conf. Rept., at pages 22-23.
5. IRC Sec. 1274(d)(1).

In the case of any sale or exchange, the applicable federal rate will be the lowest 3-month rate. The lowest 3-month rate is 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]

The Secretary may by regulation permit a rate that is lower than the applicable federal rate to be used under certain circumstances.[2]

To determine the appropriate AFR to apply in the case of below-market loans, see Q 582 and Q 740. To determine the appropriate AFR in the case of deferred rent, see Q 7769.

590. Are Social Security and railroad retirement benefits taxable?

If a taxpayer's modified 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, then a portion of the benefits received must be included in gross income and taxed as ordinary income. "Modified adjusted gross income" is a taxpayer's adjusted gross income (disregarding foreign income, savings bonds, adoption assistance program exclusions, the deductions for education loan interest and for qualified tuition and related expenses) *plus* any tax-exempt interest income received or accrued during the taxable year.[3]

A taxpayer whose modified adjusted gross income plus one-half of his Social Security benefits exceed a base amount is required to include in gross income the *lesser* of (a) 50 percent of the excess of such combined income over the base amount, *or* (b) 50 percent of the Social Security benefits received during the taxable year.[4] The "base amount" is $32,000 for married taxpayers filing jointly, $25,000 for unmarried taxpayers, and zero ($0) for married taxpayers filing separately who have not lived apart for the entire taxable year.[5]

In a case of first impression, the Tax Court held that for purposes of IRC Section 86(c)(1)(C)(ii), the term "live apart" means living in separate residences. 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 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.[6]

In addition to the initial tier of taxation discussed above, a percentage of Social Security benefits that exceed an adjusted base amount will be includable in a taxpayer's gross income. The "adjusted base amount" is $44,000 for married taxpayers filing jointly, $34,000 for unmarried taxpayers, and zero ($0) for married individuals filing separately who did not live apart for the entire taxable year.[7] If a taxpayer's modified adjusted gross income plus one-half of his or her Social Security benefits exceed the adjusted base amount, his gross income will include the *lesser* of (a) 85 percent of the Social Security benefits received during the year, *or* (b) the sum

1. IRC Sec. 1274(d)(2).
2. See IRC Sec. 1274(d)(1)(D).
3. IRC Sec. 86(b)(2).
4. IRC Sec. 86(a)(1).
5. IRC Sec. 86(c)(1).
6. *McAdams v. Comm.*, 118 TC 373 (2002).
7. IRC Sec. 86(c)(2).

of – (i) 85 percent of the excess over the adjusted base amount, plus (ii) the smaller of – (A) the amount that is includable under the initial tier of taxation (see above), or (B) $4,500 (single taxpayers) or $6,000 (married taxpayers filing jointly).[1]

> *Example 1*: A married couple files a joint return. During the taxable year, they received $12,000 in Social Security benefits and had a modified adjusted gross income of $35,000 ($28,000 plus $7,000 of tax-exempt interest income). Their modified adjusted gross income plus one-half of their Social Security benefits [$35,000 + (½ of $12,000) = $41,000] is greater than the applicable *base amount* of $32,000 but less than the applicable *adjusted base amount* of $44,000; therefore, $4,500 [the lesser of one-half of their benefits ($6,000) or one-half of the excess of $41,000 over the base amount (½ × ($41,000 – $32,000), or $4,500)] is included in gross income.

> *Example 2*: 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 + (½ of $8,000) = $37,000] is greater than the applicable *adjusted base amount* of $34,000. Thus, $6,550 [the lesser of 85 percent of his benefits ($6,800), or 85 percent of the excess of $37,000 over the adjusted base amount (85 percent × ($37,000 – $34,000), or $2,550) plus the lesser of $4,000 (the amount includable under the initial tier of taxation) or $4,500] is included in gross income.

An election is available that permits a taxpayer to treat a lump sum payment of benefits as received in the year to 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] In *Green v. Comm.*,[4] the taxpayer argued that his Social Security disability benefits were excludable from gross income[5] 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* in the nature of workers' compensation. 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 his 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

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

within the meaning of IRC Section 104(a)(4), the benefits were not eligible for exclusion under IRC Section 104(a)(4).[1]

Tax-exempt interest is included in the calculation made to determine whether Social Security payments are includable in gross income.[2] It has been determined that although this provision may result in indirect taxation of tax-exempt interest, it is not unconstitutional.[3]

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.[4] Legislation enacted in 2001 provides increased benefits for surviving spouses and adjustments to the Tier II tax rates.[5]

591. How is unearned income of certain children treated for federal income tax purposes?

Property Given Under the Uniform Gifts to Minors Act or the Uniform Transfers to Minors Act

Taxable income derived from custodial property is, ordinarily, taxed to the minor donee. To the extent that the custodian uses custodial income to discharge the legal obligation of any person to support or maintain the minor, such income is taxable to that person.[6] For this purpose, it makes no difference who is the custodian or who is the donor. State laws differ as to what constitutes a parent's obligation to support. A person who may be claimed as a dependent by another may use a standard deduction of $1,000 in 2013 and 2014 ($950 in 2011 and 2012) to offset unearned income (or, if higher, the dependent may take a standard deduction in the amount of the sum of $350 (in 2013 and 2014) and his *earned* income, as indexed for inflation– see Q 638). Dependents for which another taxpayer is allowed a personal exemption cannot take a personal exemption for themselves (see Q 626).[7] For the treatment of unearned income for children, see below.

Unearned Income of Certain Children

Under certain circumstances, children under the age of 19 (age 24 for students) must pay tax on their unearned income above a certain amount at their parents' marginal rate. (See Q 639 for the current tax rates). The tax applies to *all* unearned income, regardless of when the assets producing the income were transferred to the child.

1. *Reimels v. Comm.*, 123 TC 245 (2004), *affi'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.
2. IRC Sec. 86(b)(2)(B).
3. *Goldin v. Baker*, 809 F.2d 187 (2nd Cir. 1987), cert. denied, 484 U.S. 816 (1988).
4. See IRC Sec. 72(r)(1).
5. See Secs. 101 and 204, The Railroad Retirement and Survivors' Improvement Act of 2001.
6. IRC Sec. 61; Rev. Rul. 56-484, 1956-2 CB 23; Rev. Rul. 59-357, 1959-2 CB 212.
7. Rev. Proc. 2013-35, 2013-47 IRB 537.

The so-called "kiddie tax" applies to children who have not attained certain ages before the close of the taxable year, who have at least one parent alive at the close of the taxable year, and who have over $2,000 (in 2013 and 2014 and $1,900 for 2011 and 2012) of unearned income.

The kiddie tax applies to:

(1) a child under age 18; *or*

(2) a child who has attained the age of 18 if: (a) the child has not attained the age of 19 (24 in the case of a full-time student) before the close of the taxable year; and (b) the earned income of the child does not exceed one-half of the amount of the child's support for the year.[1]

The 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 2013 and 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.[2]

"Earned income," essentially, means all compensation for personal services actually rendered.[3] A child is therefore taxed at his own rate on reasonable compensation for services.

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.[4] In the case of a trust, distributable net income that is includable in the child's net income can trigger the tax; however, most accumulation distributions received by a child from a trust will not be included in the child's gross income because of the minority exception under IRC Section 665(b).[5] Generally, the tax on accumulation distributions does not apply to domestic trusts (see Q 663). The source of the assets that produce unearned income need not be the child's parents.[6] The application of the "kiddie tax" to funds provided to a child by sources other than the child's parents was held constitutional.[7]

Example: Cole is a child who is 17 years of age at the end of the taxable year beginning on January 1, 2014. Both of Cole's parents are alive at the end of the taxable year. During 2014, Cole receives $2,400 in interest from his bank account and $1,700 from a paper route. Some of the interest earned by Cole from the bank account is attributable to Cole's paper route earnings that were deposited in the account. The balance of the account is attributable to cash gifts from Cole's parents and grandparents and interest earned prior to 2014. Some cash gifts were received by Cole prior to 2014. Cole has no itemized deductions and is eligible to be claimed as a dependent on his parent's return. Therefore, for the taxable year 2014, Cole's standard

1. IRC Sec. 1(g)(2).
2. IRC Sec. 1(g)(4); Rev. Proc. 2013-15, 2013-5 IRB 444, Rev. Proc. 2013-35, 2013-47 IRB 537.
3. IRC Secs. 911(d)(2), 1(g)(4)(A)(i).
4. Temp. Treas. Reg. §1.1(i)-1T, A-8, A-9, A-15.
5. Temp. Treas. Reg. §1.1(i)-1T, A-16.
6. Temp. Treas. Reg. §1.1(i)-1T, A-8.
7. See *Butler v. U.S.*, 798 F. Supp. 574 (E.D. Mo. 1992).

deduction is $2,050, the amount of Cole's earned income, plus $350. Of this standard deduction amount, $1,000 is allocated against unearned income, and $1,050 is allocated against earned income. Cole's taxable unearned income is $1,400, of which $1,000 is taxed without regard to section 1(g). The remaining taxable unearned income of $400 is net unearned income and is taxed under section 1(g). The fact that some of Cole's unearned income is attributable to interest on principal created by earned income and gifts from persons other than Cole's parents or that some of the unearned income is attributable to property transferred to Cole prior to 2014will not affect the tax treatment of this income under section 1(g).

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. "Child," for purposes of the kiddie tax, includes children who are adopted, related by half-blood, or from a prior marriage of either spouse.[2]

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.[3]

In the event that a child does not have access to needed information contained in the tax return of a parent, he (or his legal representative) may, by written request to the IRS, obtain such information from the parent's tax return as is needed to file an accurate return.[4] The IRS has stated that where the necessary parental information cannot be obtained before the due date of the child's return, no penalties will be assessed with respect to any reasonable estimate of the parent's taxable income or filing status, or of the net investment income of the siblings.[5]

Certain parents may elect to include their child's unearned income over $2,000 (in 2014) on their own 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.[6]

The election will not be available 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. If the election is made, any gross income of the child in excess of $2,000 in 2014 is included in the parent's gross income for the taxable year. (However, the inclusion of the child's income will increase the parent's adjusted gross income for purposes of certain other calculations, such as the 2 percent floor on miscellaneous itemized deductions and the limitation on medical expenses). Any interest that is an item of tax preference of the child (e.g., private activity bonds) will be treated as a tax preference of the parent. For each child to

1. Temp. Treas. Reg. §1.1(i)-1T, A-11, A-12.
2. Temp. Treas. Reg. §1.1(i)-1T, A-13, A-14.
3. Temp. Treas. Reg. §1.1(i)-1T, A-17, A-19.
4. Temp. Treas. Reg. §1.1(i)-1T, A-22.
5. Ann. 88-70, 1988-16 IRB 37.
6. IRC Sec. 1(g)(7); Rev. Proc. 2008-66, above.

whom the election applies, there is also a tax of 10 percent of the lesser of $1,000 or the excess of the gross income of such child over $1,000. If the election is made, the child will be treated as having no gross income for the year.[1] The threshold and ceiling amounts for the availability of this election, the amount used in computing the child's alternative minimum tax, and a threshold amount used in computing the amount of tax are indexed for inflation.

For treatment of the unearned income of minor children under the alternative minimum tax, see Q 653.

592. What is an Education Savings Account (also known as a Coverdell Education Savings Account)?

Education IRAs were renamed Coverdell Education Savings Accounts (ESAs) in 2001.[2] An ESA means a trust or custodial account created exclusively for the purpose of paying the "qualified education expenses" of the designated beneficiary of the trust, and that is designated as an ESA at the time it is created.[3] The designated beneficiary of an ESA must be a life-in-being as of the time the account is established.[4] ESAs are exempt from taxation (except for unrelated business income tax, if applicable).[5] Distributions from ESAs for "qualified education expenses" (Q 594) are not includable in income and contributions to ESAs are not deductible.[6]

For guidance regarding certain reporting requirements and transition rules applicable to Coverdell ESAs, see Notice 2003-53.[7] See Q 695 for the estate tax treatment and Q 749 for the gift tax treatment of ESAs.

593. What are the rules governing contributions to an Education Savings Account?

Annual contributions may be made up until the due date (excluding extensions) for filing the tax return for the calendar year for which such contributions were intended.[8]

Contributions must be made in cash and must be made on or before the date on which the beneficiary attains age 18 unless the beneficiary is a special needs beneficiary. According to the Conference Report, a special needs beneficiary will include an individual who because of a physical, mental, or emotional condition (including learning disabilities) requires additional time to complete his or her education.[9]

In general, aggregate contributions to an ESA on behalf of a beneficiary (except in the case of rollover contributions) cannot exceed $2,000.[10] The maximum contribution amount is

1. IRC Sec. 1(g)(7)(B).
2. P.L. 107-22 (7-26-2001).
3. IRC Secs. 530(b), 530(g).
4. IRC Sec. 530(b)(1).
5. IRC Sec. 530(a).
6. IRC Sec. 530(d).
7. 2003-33 IRB 362.
8. IRC Sec. 530(b)(5).
9. IRC Sec. 530(b)(1).
10. IRC Sec. 530(b)(1)(A)(iii).

phased-out for certain high-income contributors. The maximum contribution for single filers is reduced by the amount that bears the same ratio to such maximum amount as the contributor's *modified adjusted gross income* (MAGI) in excess of $95,000 bears to $15,000.[1] For joint filers, the maximum contribution is reduced by the amount that bears the same ratio to such maximum amount as the contributor's MAGI in excess of $190,000 bears to $30,000.[2] For this purpose, MAGI is adjusted gross income without regard to the exclusions for income derived from certain foreign sources or sources within United States possessions.[3] For taxable years beginning after 2001, contributions to an ESA are not limited due to contributions made to a qualified state tuition program in the same year.

Contributions in excess of the maximum annual contribution (as reduced for high-income contributors) that are not returned before the first day of the sixth month of the taxable year following the taxable year in which the contribution was made are subject to the 6 percent excess contribution excise tax under Code section 4973(a).[4] Note that any excess contributions from previous taxable years, to the extent not corrected, will continue to be taxed as excess contributions in subsequent taxable years.[5]

594. How are distributions from an Education Savings Account treated? What are "qualified education expenses"?

A distribution from an ESA is subject to income tax using the IRC Section 72(b) exclusion ratio for investment in the contract.[6] However, distributions from an ESA are excludable from income tax if the distributions received during the year are used solely for the "qualified education expenses" of the designated beneficiary.[7]

Qualified education expenses include both "qualified *higher* education expenses" and "qualified *elementary* and *secondary* education expenses."[8] Qualified higher education expenses include tuition, fees, costs for books, supplies, and equipment required for the enrollment or attendance of the student at any "eligible educational institution," and amounts contributed to a qualified tuition program.[9] Room and board (up to a certain amount) is also included if the student is enrolled at least half-time.[10] An "eligible educational institution" is any college, university, vocational school, or other postsecondary educational institution described in section 481 of the Higher Education Act of 1965.[11] Thus, virtually all accredited public, nonprofit, and proprietary postsecondary institutions are considered eligible educational institutions.[12]

1. IRC Sec. 530(c)(1).
2. IRC Sec. 530(c)(1).
3. IRC Sec. 530(c)(2).
4. IRC Sec. 4973(e)(2).
5. IRC Sec. 4973(e).
6. IRC Sec. 530(d)(1).
7. IRC Sec. 530(d)(2)(A).
8. IRC Sec. 530(b)(2).
9. IRC Secs. 529(e)(3), 530(b)(2).
10. IRC Sec. 530(b)(2).
11. See IRC Sec. 529(e)(5).
12. Notice 97-60, 1997-2 CB 310, at 16 (Sec. 3, A16).

Qualified education expenses must be reduced by any scholarships received by the individual, any educational assistance provided to the individual, or any payment for such expenses (other than a gift, devise, bequest, or inheritance) that is excludable from gross income. These expenses must also be reduced by the amount of any such expenses that were taken into account in determining the Hope Scholarship Credit or the Lifetime Learning Credit.[1] (Note that for taxable years beginning before 2002, these education credits could not be claimed in a taxable year in which distributions from an ESA were excluded from income).[2]

Qualified elementary and secondary education expenses include tuition, fees, and costs for academic tutoring, special needs services, books, supplies, and other equipment that are incurred in connection with the enrollment or attendance of the designated beneficiary at any public, private, or religious school that provides elementary or secondary education (K through 12) as determined under state law. Also included are expenses for room and board, uniforms, transportation, supplementary items and services (including extended day programs) that are required or provided by such schools, and any computer technology or certain related equipment used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school.[3]

If a designated beneficiary receives distributions from both an ESA and a qualified tuition program and the aggregate distributions exceed the "qualified education expenses" of the designated beneficiary, then the expenses must be allocated among such distributions for purposes of determining the amount excludable under each.[4] Any "qualified education expenses" taken into account for purposes of this exclusion may not be taken into account for purposes of any other deductions, credits, or exclusions.[5]

Where distributions from the ESA exceed the "qualified education expenses" of the designated beneficiary for the year, the amount includable is determined by: (1) calculating the amount subject to tax under IRC Section 72(b) (without regard to the following proration); (2) multiplying the amount in (1) by the ratio of "qualified education expenses" to total distributions; and (3) subtracting the amount in (2) from the amount in (1).[6]

If a distribution from an ESA is includable in the income of the recipient, the amount includable in income will be subject to an additional 10 percent penalty tax unless the distribution is (1) made after the death of the beneficiary of the ESA, (2) attributable to the disability of such beneficiary (within the meaning of IRC Section 72(m)(7)), (3) made in an amount equal to a scholarship, allowance, or other payment under IRC Section 25A(g)(2), or (4) includable in income because expenses were reduced by the amount claimed as a Hope Scholarship Credit, Lifetime Learning Credit, or American Opportunity Credit.[7] The penalty tax also does not apply to any distribution of an excess contribution and the earnings thereon if such contribution and

1. IRC Sec. 530(d)(2)(C).
2. IRC Sec. 25A(e)(2), prior to amendment by EGTRRA 2001.
3. IRC Sec. 530(b)(4).
4. IRC Sec. 530(d)(2)(C)(ii).
5. IRC Sec. 530(d)(2)(D).
6. IRC Sec. 530(d)(2)(B).
7. IRC Sec. 530(d)(4).

earnings are distributed before the first day of the sixth month of the taxable year following the taxable year in which the contribution was made.[1] However, the earnings are includable in the contributor's income for the taxable year in which such excess contribution was made.

No part of the assets of the ESA can be used to purchase life insurance.[2] Nor can the assets of the ESA be commingled with other property except in a common trust fund or common investment fund.[3] If the beneficiary engages in a prohibited transaction, the account loses its status as an ESA and will be treated as distributing all of its assets. If the beneficiary pledges the account as security for a loan, the amount so pledged will be treated as a distribution from the account.[4]

An amount may be rolled over from one ESA to another ESA without being treated as a distribution (and without being subject to taxation) *only* if the beneficiary of the recipient ESA is the same as the beneficiary of the original ESA, or a member of such beneficiary's family. The new beneficiary must be under age 30 as of the date of such distribution or change, except in the case of a special needs beneficiary.[5] The rollover contribution must be made no later than 60 days after the date of the distribution from the original ESA. However, no more than one rollover may be made from an ESA during any 12-month period.[6] Similarly, the beneficiary of an ESA may be changed without taxation or penalty if the new beneficiary is a member of the family of the previous ESA beneficiary and has not attained age 30 or is a special needs beneficiary.[7] Transfer of an individual's interest in an ESA can be made from one spouse to another pursuant to a divorce (or upon the death of a spouse) without changing the character of the ESA.[8] Likewise, non-spouse survivors who acquire an original beneficiary's interest in an ESA upon the death of the beneficiary will be treated as the original beneficiary of the ESA as long as the new beneficiary is a family member of the original beneficiary.[9]

Upon the death of the beneficiary of the ESA, any balance to the credit of the beneficiary must be distributed to his estate within 30 days. The balance remaining in an ESA must also be distributed within 30 days after a beneficiary, other than a special needs beneficiary, reaches age 30.[10] Any balance remaining in the ESA is deemed distributed within 30 days after such events.[11] The earnings on any distribution under this provision are includable in the beneficiary's gross income.[12]

Under Section 225 of BAPCPA 2005, funds placed in an "education individual retirement account" (as defined in IRC Section 530(b)(1)) no later than 365 days before the date of the

1. IRC Sec. 530(d)(4)(C).
2. IRC Sec. 530(b)(1)(C).
3. IRC Sec. 530(b)(1)(D).
4. IRC Sec. 530(e).
5. IRC Sec. 530(b)(1).
6. IRC Sec. 530(d)(5).
7. IRC Secs. 530(b)(1), 530(d)(6).
8. IRC Sec. 530(d)(7).
9. IRC Sec. 530(d)(7).
10. IRC Sec. 530(b)(1)(E).
11. IRC Sec. 530(d)(8).
12. IRC Sec. 530(d)(1).

filing of the bankruptcy petition may be excluded from the bankruptcy estate if certain conditions are met.[1]

595. What is a qualified tuition program (also known as a 529 plan)?

A qualified tuition program is a program established and maintained by a state (or agency or instrumentality thereof) *or* by one or more "eligible educational institutions" (see below) that meet certain requirements (see below) *and* under which a person may buy tuition credits or certificates on behalf of a *designated beneficiary* (see below) that entitle the beneficiary to a waiver or payment of *qualified higher education expenses* (see below) of the beneficiary. These plans are often collectively referred to as "529 plans." In the case of a state-sponsored qualified tuition program, a person may make contributions to an account established to fund the qualified higher education expenses of a designated beneficiary.[2] Qualified tuition programs sponsored by "eligible educational institutions" (i.e., private colleges and universities) are *not* permitted to offer savings plans; these institutions may sponsor only pre-paid tuition programs.[3]

To be treated as a qualified tuition program, a state program or privately sponsored program must:

(1) mandate that contributions and purchases be made in cash only;

(2) maintain a separate accounting for each designated beneficiary;

(3) provide that no designated beneficiary or contributor may directly or indirectly direct the investment of contributions or earnings (but see below);

(4) not allow any interest in the program or portion thereof to be used as security for a loan; *and*

(5) provide *adequate safeguards* (see below) to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the beneficiary's qualified higher education expenses.[4]

(The former requirement that a qualified state tuition program impose a "more than de minimis penalty" on any refund of earnings not used for certain purposes has been repealed.[5] See "Penalties," in Q 597).

With respect to item (3), above, the IRS announced a special rule stating that state-sponsored qualified tuition savings plans may permit parents to change the investment strategy (1) once each calendar year, and (2) whenever the beneficiary designation is changed. According to the IRS, final regulations are expected to provide that in order to qualify under this special rule, the state-sponsored qualified tuition program savings plan must: (1) allow participants

1. 11 USC 541(b), as amended by BAPCPA 2005.
2. IRC Sec. 529(b)(1); Prop. Treas. Reg. §1.529-2(b).
3. IRC Sec. 529(b)(1)(A).
4. IRC Sec. 529(b).
5. IRC Sec. 529(b)(3).

to select among only broad-based investment strategies designed exclusively by the program; and (2) establish procedures and maintain appropriate records to prevent a change in investment options from occurring more frequently than once per calendar year, or upon a change in the designated beneficiary of the account. According to the IRS, qualified tuition programs and their participants may rely on the 2001 guidance pending the issuance of final regulations under IRC Section 529.[1]

A program established and maintained by one or more "eligible educational institutions" must satisfy two requirements to be treated as a qualified tuition program: (1) the program must have received a ruling or determination that it meets the applicable requirements for a qualified tuition program; *and* (2) the program must provide that assets are held in a "qualified trust."[2] "Eligible educational institution" means an accredited *post-secondary* college or university that offers credit towards a bachelor's degree, associate's degree, graduate-level degree, professional degree, or other recognized post-secondary credential *and* that is eligible to participate in federal student financial aid programs.[3] For these purposes, *qualified trust* is defined as a domestic trust for the exclusive benefit of designated beneficiaries that meets the requirements set forth in the IRA rules, (i.e., a trust maintained by a bank, or other person who demonstrates that it will administer the trust in accordance with the requirements, and where the trust assets will not be commingled with other property, except in a common trust fund or common investment fund).[4]

The term *qualified higher education expenses* means (1) tuition, fees, books, supplies, and equipment required for a designated beneficiary's enrollment or attendance at an eligible educational institution (including certain vocational schools), and (2) expenses for special needs services incurred in connection with enrollment or attendance of a special needs beneficiary.[5] Qualified higher education expenses also include reasonable costs for room and board, within limits. Generally, they may not exceed: (1) the allowance for room and board that was included in the cost of attendance in effect on the date that EGTRRA 2001 was enacted as determined by the school for a particular academic period, or *if greater* (2) the actual invoice amount the student residing in housing owned and operated by the private college or university is charged by such institution for room and board costs for a particular academic period.[6]

A safe harbor provides the definition of what constitutes *adequate safeguards* to prevent contributions in excess of those necessary to meet the beneficiary's qualified higher education expenses. The safe harbor is satisfied if all contributions to the account are prohibited once the account balance reaches a specified limit that is applicable to all accounts of beneficiaries with the same expected year of enrollment.[7] The total of all contributions may not exceed the amount established by actuarial estimates as necessary to pay tuition, required fees, and room

1. Notice 2001-55, 2001-39 IRB 299.
2. IRC Secs. 529(b)(1), 529(e)(5).
3. See Prop. Treas. Reg. §1.529-1(c).
4. IRC Sec. 529(b)(1).
5. IRC Sec. 529(e)(3)(A).
6. IRC Sec. 529(e)(3)(B).
7. Prop. Treas. Reg. §1.529-2(i)(2).

and board expenses of the beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program.[1]

Reporting. Each officer or employee having control over a qualified tuition program must report to the IRS and to designated beneficiaries with respect to contributions, distributions, and other matters that the IRS may require. The reports must be filed and furnished to the above individuals in the time and manner determined by the IRS.[2] In 2001, the IRS released guidance regarding certain recordkeeping, reporting, and other requirements applicable to qualified tuition programs in light of the amendments to IRC Section 529 under EGTRRA 2001.[3] Qualified tuition programs and their participants may rely on Notice 2001-81 pending the issuance of final regulations under IRC Section 529. (Note that reporting was not required for calendar years before 1999).[4]

As a general rule, a qualified tuition program is exempt from federal income tax, except the tax on unrelated business income of charitable organizations imposed by IRC Section 511.[5]

Under Section 225 of BAPCPA 2005, funds used to purchase a tuition credit or certificate or contributed to an account under a QTP no later than 365 days before the date of the filing of the bankruptcy petition may be excluded from the bankruptcy estate if certain conditions are met.[6]

IRC Section 529 generally took effect for taxable years ending after August 20, 1996; special transitional rules applied for earlier programs. See Q 597 for the tax treatment of distributions from qualified tuition programs. See Q 696 for the estate tax treatment and Q 750 for the gift tax treatment of qualified tuition programs.

Permanent extension of expiring provisions under PPA 2006: The qualified tuition program provisions that were scheduled to expire by reason of the EGTRRA sunset provision included: (1) the provision that makes qualified withdrawals from qualified tuition accounts fully exempt from income tax; (2) the repeal of a pre-EGTRRA requirement that there be more than a de minimis penalty imposed on amounts not used for educational purposes, and the imposition of the 10 percent additional tax on distributions not used for qualified higher education purposes; (3) the provision permitting certain private educational institutions to establish prepaid tuition programs that qualify under IRC Section 529 if they receive a ruling or determination to that effect from the IRS, and if the assets are held in a trust created or organized for the exclusive benefit of designated beneficiaries; (4) certain provisions permitting rollovers from one account to another account; (5) certain rules regarding the treatment of room and board as qualifying expenses; (6) certain rules regarding coordination with Hope Scholarship and Lifetime Learning Credit provisions; (7) the provision that treats first cousins as members of the family for purposes of the rollover and change in beneficiary rules; and (8) certain provisions regarding the

1. Prop. Treas. Reg. §1.529-2(h)(2).
2. IRC Sec. 529(d); Prop. Treas. Reg. §1.529-4.
3. See Notice 2001-81, 2001-52 IRB 617.
4. Notice 97-52, 1997-2 CB 306.
5. IRC Sec. 529(a).
6. 11 USC 541(b).

education expenses of special needs beneficiaries. All of the above provisions have been made permanent.[1] The Act also provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to prevent abuse of 529 plans.[2]

596. How does contribution to a qualified tuition program (also known as a 529 plan) impact a taxpayer's ability to claim education-related credits? Can a taxpayer contribute both to a qualified tuition plan and an education savings account?

A taxpayer may claim an American Opportunity or Lifetime Learning Credit *and* exclude distributions from a qualified tuition program on behalf of the same student in the same taxable year *if* the distribution is not used to pay the same educational expenses for which the credit was claimed.[3] See Q 646. An individual is required to *reduce* his total qualified higher education expenses by certain scholarships *and* by the amount of expenses taken into account in determining the American Opportunity or Lifetime Learning credit allowable to the taxpayer (or any other person).[4]

A contribution to a qualified tuition program can be made in the same taxable year as a contribution to a Coverdell Education Savings Account for the benefit of the same designated beneficiary without incurring an excise tax. (See Q 592.)[5] If the aggregate distributions from a qualified tuition program exceed the total amount of qualified higher education expenses taken into account *after* reduction for the American Opportunity and Lifetime Learning credits, then the expenses must be allocated between the Coverdell Education Savings Account distributions and the qualified tuition program distributions for purposes of determining the amount of the exclusion.[6]

The total amount of qualified tuition and related expenses for the deduction for qualified tuition and related expenses is *reduced* by the amount of such expenses taken into account in determining the exclusion for distributions from qualified tuition programs. For these purposes, the excludable amount under IRC Section 529 does not include that portion of the distribution that represents a return of contributions to the plan.[7]

597. How are distributions from a qualified tuition program taxed?

Distributions from *state* qualified tuition programs are fully excludable from gross income *if* the distributions are used to pay "qualified higher education expenses" (see Q 595) of the designated beneficiary.[8] (For the general rule governing nonqualified distributions, see below). Beginning in 2004, distributions from pre-paid tuition programs sponsored by *private* colleges

1. Sec. 1304(a), PPA 2006.
2. IRC Sec. 529(f).
3. See IRC Sec. 529(c)(3)(B)(v).
4. IRC Sec. 529(c)(3)(B)(v).
5. IRC Sec. 4973(e).
6. IRC Sec. 529(c)(3)(B)(vi).
7. IRC Sec. 222(c)(2)(B).
8. IRC Sec. 529(c)(3)(B).

and universities are also fully excludable from gross income to the extent those distributions are used to pay qualified higher education expenses of the designated beneficiary.[1]

In the case of excess cash distributions, the amount otherwise includable in gross income must be reduced by a proportion that is equal to the ratio of expenses to distributions.[2] In-kind distributions are not includable in gross income so long as they provide a benefit to the distributee which, if paid for by the distributee himself, would constitute payment of a qualified higher education expense.[3]

Nonqualified distributions (i.e., distributions that are *not* used to pay "qualified higher education expenses") are includable in the gross income of the distributee under the rules of IRC Section 72 to the extent they are not excludable under some other Code provision.[4] Distributions are treated as representing a pro rata share of the principal (i.e., contributions) and accumulated earnings in the account.[5] For purposes of applying IRC Section 72, the Code provides that (1) all qualified tuition programs of which an individual is a designated beneficiary must generally be treated as one program, (2) all distributions during a taxable year must be treated as one distribution, and (3) the value of the contract, income on the contract, and investment in the contract must be computed as of the close of the calendar year in which the taxable year begins.[6]

The IRS announced in 2001 that the final regulations are expected to provide that only those accounts maintained by a qualified tuition program and having the same account owner and the same designated beneficiary must be aggregated for purposes of computing the earnings portion of any distribution.[7] The IRS also stated that the final regulations are expected to revise the time for determining the earnings portion of any distribution from a qualified tuition account. Specifically, for distributions made after 2002 such programs will be required to determine the earnings portion of each distribution *as of the date of the distribution*. A different effective date applies to direct transfers between qualified tuition programs.[8]

Penalties on nonqualified distributions. For taxable years beginning before 2002, a qualified *state* tuition program was required to impose a "more than de minimis penalty" on any refund of earnings not used for qualified higher education expenses of the beneficiary.[9] See Proposed Treasury Regulation Section 1.529-2 for the safe harbor definition of "more than de minimis." For taxable years beginning after 2001, the state-imposed penalty is repealed.[10]

1. IRC Sec. 529(c)(3)(B).
2. IRC Sec. 529(c)(3)(B).
3. IRC Sec. 529(c)(3)(B).
4. IRC Sec. 529(c)(3)(A).
5. IRC Sec. 72(e)(9).
6. IRC Sec. 529(c)(3)(D).
7. Notice 2001-81, 2001-2 CB 617.
8. See Notice 2001-81, 2001-2 CB 617.
9. IRC Sec. 529(b)(3), prior to amendment by EGTRRA 2001.
10. IRC Sec. 529(b)(3).

In place of that penalty, a 10 percent additional tax will be imposed on nonqualified distributions in the same manner as the 10 percent additional tax is imposed on certain distributions from Coverdell Education Savings Accounts (see Q 594).[1] However, the 10 percent additional tax will not apply to any payment or distribution in any taxable year before 2004 that is includable in gross income, but used for qualified higher education expenses of the designated beneficiary.[2] According to the Conference Committee Report, this means that the earnings portion of a distribution from a qualified tuition program of a private institution that is made in 2003, and that is used for qualified higher education expenses, is *not* subject to the additional tax even though the earnings portion is includable in gross income.[3] The 10 percent additional tax also does not apply if the payment or distribution is (1) made to a beneficiary on or after the death of the designated beneficiary, or (2) attributable to the disability of the designated beneficiary.[4]

The IRS has announced that with respect to any distributions made *after* 2001, a qualified tuition program will no longer be required to verify how distributions are used or to collect any penalty, but the program must continue to verify whether the distribution is used for qualified higher education expenses of the beneficiary and to collect a "more than de minimis penalty" on nonqualified distributions made *before* 2002.[5]

Rollovers. Any portion of a distribution that is transferred within 60 days to the credit of a "new designated beneficiary" (see below) who is a "member of the family" (see below) of the designated beneficiary, is not includable in the gross income of the distributee. (In other words, a distribution generally can be "rolled over" within 60 days from one family member to another).[6] A change in designated beneficiaries with respect to an interest in the same qualified tuition program will not be treated as a distribution provided that the new beneficiary is a member of the family of the old beneficiary.[7] A transfer of credits (or other amounts) for the benefit of the *same* designated beneficiary from one qualified tuition program to another is not considered a distribution; however, only one transfer within a 12-month period can receive such rollover treatment.[8] According to the Conference Committee Report, a program-to-program transfer on behalf of the same beneficiary is intended to allow a transfer between a prepaid tuition program and a savings program maintained by the same state, *or* a transfer between a state-sponsored plan and a prepaid private tuition program.[9]

Generally, *member of the family* means an individual's (1) spouse, (2) child or his descendant, (3) stepchild, (4) sibling or step sibling, (5) parents and their ancestors, (6) stepparents, (7) nieces or nephews, (8) aunts and uncles, or (9) in-laws, (10) the spouse of any of the individuals in

1. IRC Secs. 529(c)(6), 530(d)(4).
2. IRC Sec. 529(c)(6).
3. H.R. Conf. Rep. No. 107-84.
4. IRC Sec. 530(d)(4)(B).
5. Notice 2001-81, above.
6. See Prop. Treas. Regs. §§1.529-3(a) and (b); Prop. Treas. Reg. §1.529-1(c).
7. IRC Sec. 529(c)(3)(C).
8. IRC Sec. 529(c)(3)(C)(iii).
9. H.R. Conf. Rep. No. 107-84 (EGTRRA 2001).

(2) through (9), and (11) any first cousin of the designated beneficiary.[1] (However, for any contracts issued before August 20, 1996, IRC Section 529(c)(3)(C) will not require that a distribution be transferred to a member of the family or that a change in beneficiaries may be made only to a member of the family).[2] A *designated beneficiary* is (1) the individual designated at the beginning of participation in the qualified tuition program as the beneficiary of amounts paid (or to be paid) to the program; (2) in the case of a rollover of a distribution or change in beneficiaries within a family (as described above), the new beneficiary; and (3) in the case of an interest in a qualified tuition program that is purchased by a state or local government (or its agency or instrumentality) or certain tax-exempt 501(c)(3) organizations as part of a scholarship program, the individual receiving the interest as a scholarship.[3]

Permanent extension of expiring provisions under PPA 2006: The tax-free treatment for qualified distributions from 529 plans (i.e., withdrawals used to pay qualified higher education expenses) under EGTRRA 2001 has been made permanent. In other words, this tax break did *not* end on December 31, 2010, as originally scheduled under EGTRRA 2001.[4] For the impact of PPA 2006 on other qualified tuition program provisions that were scheduled to expire, see Q 595.

598. What is "tax basis"?

"Tax basis" is the method the Internal Revenue Code employs to keep a continuous total of an individual's "investment" in a particular item of property so that when the property is sold, or otherwise transferred or disposed of, an accurate assessment of the individual's gain or loss can be made for tax purposes.[5]

When an individual acquires an item of property, he is considered to have also acquired an initial tax basis in that property that, depending on the manner of acquisition, may be (1) its cost, (2) its fair market value as of a specified date, or (3) a substituted tax basis. (Basis is a "substituted basis" when it is determined in whole or in part by reference to the property's basis in the hands of a prior individual, or by reference to other property held at some time by the person for whom the basis is determined.[6] See Q 599 to Q 601 as to which of these applies to a given manner of acquisition). However, during the period of time the individual owns the property his tax basis does not necessarily remain fixed at its initial basis. Instead, it is adjusted during the period of ownership to reflect certain real or artificial additions to, and returns of, the initial "investment." (For example, tax basis is increased for such things as improvements; it is reduced for such things as allowable depreciation or depletion). When adjusted in this manner, an individual's tax basis at a particular time is often referred to as his "adjusted tax basis."[7]

1. IRC Sec. 529(e)(2); IRC Sec. 152(d).
2. TRA '97, Sec. 211(f)(6).
3. IRC Sec. 529(e)(1).
4. See Sec. 1304, PPA 2006.
5. IRC Sec. 1011(a).
6. IRC Sec. 7701(a)(42).
7. IRC Sec. 1016.

599. What is the tax basis of property that is acquired by purchase or exchange?

With respect to property purchased or acquired in a taxable exchange on or after March 1, 1913, a taxpayer's basis is cost (the cash he paid for the property or the fair market value of the property he gave for it).[1] If the property was acquired by purchase before March 1, 1913, basis for determining gain is cost, or fair market value as of March 1, 1913, whichever is greater; for determining loss, the basis is cost.

Special rules apply to stock exchanges made pursuant to a plan of corporate reorganization.[2] For the final regulations under IRC Section 358 providing guidance regarding the determination of the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions, see Q 7517. For the rules applicable to stock received in a demutualization, see Q 7517. The Service and the Treasury Department have withdrawn the proposed regulations relating to redemptions of stock in which the redemption proceeds are treated as a dividend distribution.[3]

600. How is the tax basis of property acquired from a decedent determined?

General Rules

Stepped up basis. As a general rule, the basis of property that has been acquired from a decedent is the fair market value of the property at the date of the decedent's death (i.e., the basis is "stepped up" or "stepped down," as the case may be, to the fair market value). This rule applies generally to all property includable in the decedent's gross estate for federal estate tax purposes (whether or not an estate tax return is required to be filed). It applies also to the survivor's one-half of community property where at least one-half of the value of the property was included in the decedent's gross estate. As an exception, however, the rule does not apply to "income in respect of a decedent" (see Q 636); normally the basis of such income is zero.[4] As another exception, the rule does not apply to appreciated property acquired by the decedent by gift within one year of his death where the one receiving the property from the decedent is the donor or the donor's spouse; in such case the basis of the property in the hands of the donor (or spouse) is the adjusted basis of the property in the hands of the decedent immediately before his death.[5] If an estate tax return is filed and the executor elects the alternative valuation (see Q 760), the basis is the fair market value on the alternative valuation date instead of its value on the date of death.[6]

If property in the estate of a decedent is transferred to an heir, legatee, devisee, or beneficiary in a transaction that constitutes a sale or exchange, the basis of the property in the hands of the heir, legatee, devisee, or beneficiary is the fair market value on the date of the transfer (not on the date of decedent's death). Likewise, the executor or administrator of the estate will

1. IRC Sec. 1012.
2. See IRC Sec. 354.
3. See 71 Fed. Reg. 20044 (4-19-2006).
4. IRC Sec. 1014(c).
5. IRC Sec. 1014(e).
6. IRC Sec. 1014(a).

recognize a gain or loss on the transaction. For example, if the executor of the will, to satisfy a bequest of $10,000, transfers to the heir stock worth $10,000, which had a value of $9,000 on the decedent's date of death, the estate recognizes a $1,000 gain, and the basis of the stock to the heir is $10,000.[1]

Jointly held property. Note that the "stepped up" basis rule applies only to property includable in the decedent's gross estate for federal estate tax purposes.[2] Thus, one acquiring property from a decedent who held the property jointly with another (or others) under the general rule of estate tax includability (i.e., the entire value of the property is includable in the estate of the first joint owner to die except to the extent the surviving joint owner(s) can prove contribution to the cost–see Q 679) receives a stepped up basis in the property in accordance with that rule. By contrast, one who acquires property from a decedent spouse who, with the surviving spouse, had a *qualified joint interest* in the property (see Q 679) receives a stepped up basis equal to one-half the value of that interest.

Community property. The stepped up basis rule applies in the case of community property both to the decedent's one-half interest and to the surviving spouse's one-half interest.[3]

Qualified terminable interest property. Upon the death of the donee spouse or surviving spouse, qualified terminable interest property (see Q 700) is considered as "acquired from or to have passed from the decedent" for purposes of receiving a new basis at death.[4]

Decedents Dying in 2010 Who Elected Not To Be Subject to Estate Tax

Modified carryover basis. For decedents dying in 2010 who elected not to be subject to estate tax, a modified carryover basis regime (with limited step-up in basis) replaces the step-up in basis for property acquired from a decedent. That is, the basis of the person acquiring property from a decedent making the election in 2010 will generally be equal to the lesser of (1) the adjusted basis of the decedent (i.e., carried over to the recipient from the decedent), or (2) the fair market value of the property at the date of the decedent's death. However, step-up in basis is retained for up to $1,300,000 of property acquired from a decedent. In the case of certain transfers to a spouse, step-up in basis will be available for an additional $3,000,000 of property acquired from a decedent. In the case of a decedent nonresident who is not a United States citizen, step-up in basis will be available for only $60,000 of property acquired from the decedent.[5]

601. How is the tax basis of property acquired by gift determined?

If the property was acquired by gift after 1920, the basis for determining gain is generally the same as in the hands of the donor. However, in the case of property acquired by gift after September 1, 1958 and before 1977, this basis may be increased by the amount of any gift tax paid, but total basis may not exceed the fair market value of the property at the time of gift.

1. Treas. Reg. §1.1014-4(a)(3).
2. IRC Sec. 1014(b)(9).
3. IRC Sec. 1014(b)(6).
4. IRC Sec. 1014(b)(10).
5. IRC Secs. 1014(f), 1022 (for decedents dying in 2010 only).

In the case of property received by gift after 1976, the donee takes the donor's basis plus a *part* of the gift tax paid. The added fraction is the amount of the gift tax paid that is attributable to appreciation in the value of the gift over the donor's basis. The amount of attributable gift tax bears the same ratio to the amount of gift tax paid as net appreciation bears to the value of the gift.[1]

For the purpose of determining loss, the basis of property acquired by gift after 1920 is the foregoing substituted basis or the fair market value of the property at the time of gift, whichever is lower.[2] As to property acquired by gift before 1921, basis is the fair market value of the property at time of acquisition.[3]

602. How is the tax basis of property acquired in a generation skipping transfer determined?

Generally, in the case of property received in a generation-skipping transfer (see Q 722), the transferee takes the adjusted basis of the property immediately before the transfer plus a *part* of the generation-skipping transfer (GST) tax paid. The added fraction is the amount of the GST tax paid that is attributable to appreciation in the value of the transferred property over its previous adjusted basis. The amount of attributable GST tax bears the same ratio to the amount of GST tax paid as net appreciation bears to the value of the property transferred. Nevertheless, basis is not to be increased above fair market value. When property is acquired by gift in a generation-skipping transfer, the basis of the property is increased by the gift tax basis adjustment (see Q 601) before the generation-skipping transfer tax basis adjustment is made.[4]

However, where property is transferred in a taxable termination (see Q 722) that occurs at the same time and as a result of the death of an individual, the basis of such property is increased (or decreased) to fair market value, except that any increase (or decrease) in basis is limited by multiplying such increase (or decrease) by the inclusion ratio used in allocating the generation-skipping tax exemption (see Q 723).[5]

603. What is the tax basis of property acquired from a spouse or incident to a divorce?

Where property is transferred between spouses, or former spouses incident to a divorce, after July 18, 1984 pursuant to an instrument in effect after that date, the transferee's basis in the property is generally the adjusted basis of the property in the hands of the transferor immediately before the transfer and no gain or loss is recognized at the time of transfer (unless, under certain circumstances, the property is transferred in trust).[6] These rules may apply to transfers made after 1983 if both parties elect.[7] See Q 660 regarding transfers incident to divorce.

1. IRC Sec. 1015.
2. IRC Sec. 1015(a).
3. IRC Sec. 1015(c).
4. IRC Sec. 2654(a)(1).
5. IRC Sec. 2654(a)(2).
6. IRC Secs. 453B(g), 1041; Temp. Treas. Reg. §1.1041-1T, A-1.
7. Temp. Treas. Reg. §1.1041-1T, A-16.

604. What is a "capital asset"?

For tax purposes, a "capital asset" is any property that, in the hands of the taxpayer, is not: (1) property (including inventory and stock in trade) held primarily for sale to customers; (2) real or depreciable property used in his trade or business; (3) copyrights and literary, musical, or artistic compositions (or similar properties) created by the taxpayer, or merely owned by him, if his tax 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 merely owned by him, if his tax basis is determined by reference to the tax basis of such producer or recipient; (5) accounts or notes receivable acquired in his 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 that is clearly identified as such by the required time; and (9) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of his trade or business.[1]

Generally, any property held as an investment is a capital asset, except that rental real estate is generally not a capital asset because it is treated as a trade or business asset (see Q 7744).[2]

605. When is capital gain or loss short-term? When is it long-term? How is an individual's "holding period" calculated?

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*. It is short-term gain or loss if the property was owned for *one year or less*.[3] For an explanation of the tax treatment of capital gains and losses, see Q 608.

To determine how long a taxpayer has owned property (i.e., his "holding period"), begin counting on the day *after* the property is acquired; the same date in each successive month is 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.[4] 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.[5] According to IRS Pub. 544 (Nov. 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. Copeland 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. Copeland 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.

1. IRC Sec. 1221; Treas. Reg. §1.1221-1.
2. See IRS Pub. 544.
3. IRC Sec. 1222.
4. Rev. Rul. 70-598, 1970-2 CB 168.
5. Rev. Rul. 66-7, 1966-1 CB 188.

Example 2: Mrs. Brim bought a capital asset on January 30, 2014. She would begin counting on January 31, 2014. Since February does not have 31 days, Mrs. Brim will start a new month on February 28. In months that have only 30 days, the 30th will begin a new month.

Special rules apply in the case of gains or losses on regulated futures contracts, single stock futures (see Q 7581), nonequity option contracts, and foreign currency contracts (see Q 7586). Furthermore, the short sale rules (see Q 7525) and tax straddle rules (see Q 7587 to Q 7603) may require a tolling or recalculation of an individual's holding period.

Tacking of Holding Periods

In some cases, such as property received as a gift or in a like-kind exchange, the IRC allows a taxpayer to add another individual's holding period in the same property, or the taxpayer's holding period in other property, to the taxpayer's holding period. This is referred to as "tacking" of holding periods.[1]

For an explanation of how the holding period is determined for stock received by a policyholder or annuity holder in a demutualization transaction see SCA 200131028.[2]

Where applicable, tacking of holding periods is discussed in the appropriate question.

606. How are securities that are sold or transferred identified for tax purposes?

When an individual sells or otherwise transfers securities (i.e., stocks, bonds, mutual fund shares, etc.) from holdings that were purchased or acquired on different dates or at different prices (or tax bases), he must generally be able to identify the lot from which the transferred securities originated in order to determine his tax basis and holding period. If he is unable to adequately identify the lot, he will usually be deemed to have transferred the securities in the order in which they were acquired, by a "first-in, first-out" (FIFO) method.[3] However, in cases involving mutual fund shares he may be permitted to use an "average basis" method to determine his tax basis and holding period in the securities transferred (see Q 7860).

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 his broker to sell securities from another lot.[4]

There are several exceptions to the general rule of adequate identification. One occurs when 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

1. IRC Sec. 1223(2).
2. See SCA 200131028.
3. Treas. Reg. §1.1012-1(c)(1).
4. Treas. Reg. §1.1012-1(c)(2).

or other transferee.[1] If the securities held are United States securities (Treasury bonds, notes, etc.) recorded by a book-entry on the books of a Federal Reserve Bank, then identification is made when the taxpayer notifies the Reserve Bank (or the person through whom the taxpayer is selling the securities) of the lot number (assigned by the *taxpayer*) of the securities to be sold or transferred, and when the Reserve Bank (or the person through whom the taxpayer sells the securities) provides the taxpayer with a written advice of transaction, specifying the amount and description of securities sold or transferred.[2]

Another exception arises when 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 himself, then there is adequate identification if he keeps a written record identifying the particular securities he intended to sell.[3]

A third exception occurs when 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 also give the distributee a written document specifying the particular securities distributed). In such a case, the specified securities are the securities sold, transferred or distributed, even though certificates from a different lot are delivered to the purchaser, transferee or distributee.[4]

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

If an individual sells property at a loss to a related person (as defined below), that loss may *not* be deducted or used to offset capital gains for income tax purposes.[5] It makes no difference that the sale was a bona fide, arm's-length transaction.[6] Neither does it matter that the sale was made indirectly through an unrelated middleman.[7] 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.[8] 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.[9]

1. Treas. Reg. §1.1012-1(c)(3)(i).
2. Treas. Reg. §1.1012-1(c)(7); Rev. Rul. 71-21, 1971-1 CB 221.
3. Treas. Reg. §1.1012-1(c)(3)(ii).
4. Treas. Reg. §1.1012-1(c)(4).
5. IRC Sec. 267(a); Treas. Reg. §1.267(a)-1 and Rev. Rul. 2008-5.
6. Treas. Reg. §1.267(a)-1(c).
7. See *Hassen v. Comm.*, 599 F.2d 305 (9th Cir. 1979).
8. *McWilliams v. Comm.*, 331 U.S. 694 (1947).
9. IRC Sec. 267(a)(1).

A loss realized on the exchange of properties between related persons will also be disallowed under these rules.[1] Whether loss is realized in transfers between spouses during marriage or incident to divorce is explained in Q 660.

For this purpose, persons are related if they are: (1) members of the same family (i.e., brothers, sisters, spouses, ancestors, and lineal descendants; but not if they are in-laws);[2] (2) an individual and a corporation of which the individual actually or constructively owns more than 50 percent of the stock; (3) a grantor and a fiduciary of a trust; (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 his or her individual retirement account (IRA).[3] Special rules apply for purposes of determining constructive ownership of stock.[4] 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.[5]

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.[6] 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 (as defined above), a portion of the loss will be disallowed according to the relative interests of the partners.[7] If the transaction is between a partnership and an individual who is related to one of the partners (as defined above), 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.[8] 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.[9]

1. IRC Sec. 267(a)(1).
2. See Let. Rul. 9017008.
3. IRC Sec. 267(b).
4. See IRC Sec. 267(c).
5. Let. Rul. 9017008.
6. IRC Sec. 707(b).
7. Temp. Treas. Reg. §1.267(a)-2T(c), A-2.
8. Treas. Reg. §1.267(b)-1(b).
9. IRC Sec. 267(f).

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.[1]

Special rules apply to installment sales between related parties (see Q 586) and to the deduction of losses (see Q 7911 to Q 7931).

In a case of first impression, the Tax Court held that IRC Section 382(l)(3)(A)(i)—which provides that an "individual" and all members of his family described in IRC Section 318(a)(1) (i.e., his spouse, children, grandchildren, and parents) are treated as one individual for purposes of applying IRC Section 382 (which limits the amount of pre-change losses that a loss corporation may use to offset taxable income in the taxable years or periods following an ownership change)—applies solely from the perspective of individuals who are shareholders (as determined under applicable attribution rules) of the loss corporation. The court further held that siblings are not treated as one individual under IRC Section 382(l)(3)(A)(i).[2] Accordingly, in *Garber*, the sale of shares by one brother to the other brother resulted in an ownership change with respect to the closely held corporation within the meaning of IRC Section 382(g).

608. How is an individual taxed on capital gains and losses?

For tax years beginning in 2013 and beyond, adjusted net capital gain is generally subject to a maximum rate of 0 percent for taxpayers in the 10 and 15 percent tax brackets, a maximum rate of 15 percent for taxpayers in the 25 percent, 28 percent, 33 percent, and 35 percent tax brackets (see "Reduction in Capital Gain Rates," Q 609), and, beginning in 2013, a maximum rate of 20 percent for taxpayers in the 39.6 percent tax bracket. However, detailed rules as to the exact calculation of the capital gains tax result in some exceptions.[3]

"Adjusted net capital gain" is *net capital gain* reduced (but not below zero) by the sum of: (1) *unrecaptured IRC Section 1250 gain*; and (2) *28 percent rate gain* (both defined below); *plus* (3) "qualified dividend income" (as defined in IRC Section 1(h)(11)(B)).[4]

Gain is determined by subtracting the adjusted basis of the asset sold or exchanged from the amount realized. Loss is determined by subtracting the amount realized from the adjusted basis of the asset sold or exchanged. See Q 598. The amount realized includes both money and the fair market value of any property received.[5] Gains and losses from the sale or exchange of capital assets are either short-term or long-term. Generally, in order for gain or loss to be long-term, the asset must have been held for more than one year. See Q 605.

Generally, taxpayers may elect to treat a portion of net capital gain as investment income.[6] If the election is made, any net capital gain included in investment income will be subject to

1. IRC Sec. 267(d); Treas. Reg. §1.267(d)-1.
2. *Garber Industries Holding Co., Inc., v. Comm.*, 124 TC 1 (2005); *aff'd*, 435 F. 3d 555, 2006-1 USTC ¶50,109 (5th Cir. 2006).
3. IRC Sec. 1(h), as amended by ATRA.
4. IRC Sec. 1(h)(3).
5. IRC Sec. 1001.
6. See IRC Secs. 163(d)(4)(B), 1(h)(2).

the taxpayer's marginal income tax rate. The election 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. The election is to be made on Form 4952, "Investment Interest Expense Deduction."[1] See Q 7941.

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] See Q 7941.

The Code provides that for a taxpayer with a net capital gain for any taxable year, 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 (See Appendix B), *or* (II) taxable income reduced by the adjusted net capital gain;

(B) 0 percent of so much of the taxpayer's adjusted net capital gain (or, if less, taxable income) as 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 (see Appendix B) *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)), *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; *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 (E) above.[4]

1. Treas. Reg. §1.163(d)-1.
2. IRC Sec. 1222(11).
3. IRC Secs. 163(d)(4)(B)(iii), 1(h)(2).
4. IRC Secs. 1(h)(1)(D); 1(h)(1)(A), 1(h)(1)(B), IRC Secs. 1(h)(1)(C), 1(h)(1)(E), as amended by ATRA 2012.

It is important to note that as a result of this complex formula, generally, the maximum capital gains rate on *adjusted net capital gain* for 2013 (and beyond) will be 20 percent to the extent an individual is taxed at the 39.6 percent income tax rate, 15 percent to the extent an individual is taxed at the 25, 28, 33 or 35 percent income tax rates (see Q 639), and 0 percent to the extent the individual is taxed at the 15 percent or 10 percent income tax rates.[1]

IRC Section 1250 provides for the recapture of gain on certain property on which accelerated depreciation has been used. "Unrecaptured IRC Section 1250 gain" means the excess, if any, of: (i) that amount of long-term capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if IRC Section 1250(b)(1) included all depreciation and the applicable percentage under IRC Section 1250(a) were 100 percent; over (ii) the excess, if any of (a) the sum of collectibles loss, net short-term capital loss and long-term capital loss carryovers, over (b) the sum of collectibles gain and IRC Section 1202 gain. However, at no time may the amount of unrecaptured IRC Section 1250 gain that is attributable to sales, exchanges and conversions described in IRC Section 1231(a)(3)(A) for any taxable year exceed the net IRC Section 1231 gain, as defined in IRC Section 1231(c)(3) for such year.[2]

"28 percent rate gain" means the excess, if any, of (A) the sum of collectibles gain and IRC Section 1202 gain (i.e., gain on certain small businesses), over (B) the sum of (i) collectibles loss, (ii) net short-term capital loss, and (iii) long-term capital loss carried over under IRC Section 1212(b)(1)(B) (i.e., the excess of net long-term capital loss over net short-term capital gain, carried over to the succeeding taxable year).[3]

"Collectibles gain or loss" is gain or loss on the sale or exchange of a collectible that is a capital asset held for more than one year, but only to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.[4] Examples of collectibles include artwork, gems and coins.[5] For additional details, see Q 7693 and Q 7694.

"IRC Section 1202 gain" means the excess of (A) the gain that would be excluded from gross income under IRC Section 1202 but for the percentage limitation in IRC Section 1202(a) over (B) the gain excluded from gross income under IRC Section 1202 (i.e., 50 percent exclusion for certain qualified small business stock).[6] See Q 7521 and Q 7522 for details. (JGTRRA 2003 provides that for alternative minimum tax purposes, 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.[7] See Q 7522).

1. IRC Sec. 1(h).
2. IRC Sec. 1(h)(6).
3. IRC Sec. 1(h)(4).
4. IRC Sec. 1(h)(5).
5. See IRC Sec. 408(m)(2).
6. IRC Sec. 1(h)(7).
7. IRC Sec. 57(a)(7).

The foregoing rules essentially establish four groups of capital assets (based upon pre-existing tax rates):

(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) 20 percent (in tax years beginning after 2012 for taxpayers in the 39.6 percent income tax bracket)/15 percent (for taxpayers in the 25, 28, 33, or 35 percent income tax brackets) /0 percent capital assets (i.e., 0 percent for taxable years beginning after 2007, and 5 percent for 2003 through 2007) for taxpayers in the 15 and 10 percent tax brackets, consisting of all other long-term capital assets.

Within each group, gains and losses are netted. The effect of this process is generally that if there is a net loss from (1), it is applied to reduce any net gain from (2), (3), or (4), in that order. If there is a net loss from (2) it is applied to reduce any net gain from (3) or (4), in that order. If there is a net loss from (4), it is applied to reduce any net gain from (2) or (3), in that order.[1]

After all of the netting above, if there are net losses, up to $3,000 ($1,500 in the case of married individuals filing separately) of losses can be deducted against ordinary income.[2] Apparently, any deducted loss will be treated as reducing net loss from (1), (2), or (4), in that order. Any remaining net losses can be carried over to other taxable years, retaining its group classifications. If there are net gains, such gains will generally be taxed as described above.

Generally, to the extent a capital loss described above exceeds the $3,000 limit ($1,500 in the case of married individuals filing separately); it may be carried over to other taxable years, but always retaining its character as long-term or short-term. However, special rules apply in determining the carryover amount from years in which a taxpayer has no taxable income.[3]

Collectibles gain and IRC Section 1250 gains under IRC Section 1(h) are subject to special rules when an interest in a pass-through entity (i.e., partnership, S corporation, or trust) is sold or exchanged. Regulations finalized in 2000 provide rules for dividing the holding period of an interest in a partnership.[4]

Special rules apply in the case of wash sales (see Q 7535), short sales (see Q 7525), and IRC Section 1256 contracts (see Q 7586).

NOTE: Beginning in 2013, taxpayers may also have to account for the 3.8 percent tax on investment-type income and gains under Code Section 1411.

1. IRC Sec. 1(h)(1), as amended by ATRA; Notice 97-59, 1997-2 CB 309.
2. IRC Sec. 1211(b).
3. IRC Secs. 1211(b), 1212(b).
4. See TD 8902, 2000-2 CB 323.

609. What is the reduction in capital gain rates for individuals?

Long-term capital gains incurred on or after May 6, 2003 are subject to lower tax rates. For taxpayers in the 25, 28, 33 and 35 percent tax brackets, 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 all the way down to 0 percent in 2008 through 2012. As discussed below, these lower capital gain rates have now been made permanent, and are effective for tax years ending on or after May 6, 2003.[1]

Early in 2013, Congress enacted the American Taxpayer Relief Act of 2012 ("ATRA") under which the reduced capital gain rates were extended for some taxpayers, while increased rates were placed into effect for higher income taxpayers. 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). The applicable threshold amount is 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] The income threshold used for purposes of the 3.8 percent investment income tax is not adjusted for inflation.

Collectibles gain, IRC Section 1202 gain (i.e., qualified small business stock), and unrecaptured IRC Section 1250 gain continue to be taxed at their current tax rates (i.e., 28 percent for collectibles gain and IRC Section 1202 gain, and 25 percent for unrecaptured IRC Section 1250 gain).[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, 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).

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).
3. IRC Sec. 1(h), as amended by ATRA, Sec. 102.
4. IRC Sec. 1411.
5. IRC Sec. 1(h).

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 are repealed. Though this repeal was scheduled to sunset along with the reduced rates, it was made permanent under ATRA.

610. What lower rates apply for qualified dividend income?

Under prior law, dividends were treated as ordinary income and, thus, were subject to ordinary income tax rates. Under JGTRRA 2003, "qualified dividend income" (see Q 611) is treated as "net capital gain" (Q 611) and is, therefore, subject to new lower tax rates.

For taxpayers in the 25, 28, 33 and 35 percent income tax brackets, the maximum rate on qualified dividends paid by corporations to individuals is 15 percent for tax years beginning in 2003 and thereafter. For taxpayers in the 15 percent and 10 percent income tax brackets, the tax rate on qualified dividend income is reduced to 0 percent for tax years beginning in 2008 and thereafter (5 percent in 2003 through 2007).

For taxpayers in the 39.6 percent income tax bracket, the maximum tax rate on qualified dividends is 20 percent for tax years beginning in 2013 and thereafter.

The preferential treatment of qualified dividends as net capital gains was scheduled to "sunset" (expire) on December 31, 2012, after which time the prior treatment of dividends was to become effective.[2] In other words, dividends were once again to be taxed at ordinary income tax rates. The American Taxpayer Relief Act of 2012 prevented this sunset and made the treatment of qualified dividend income as net capital gain permanent.[3]

611. What is qualified dividend income?

Certain dividends are taxed as "net capital gain" for purposes of the reduction in the tax rates on dividends. "Net capital gain" for this purpose means net capital gain *increased* by "qualified dividend income" (without regard to this paragraph).[4] "Qualified dividend income" means dividends received during the taxable year from domestic corporations and "qualified foreign corporations" (defined below).[5]

The term qualified dividend income does *not* include the following:

(1) dividends paid by tax-exempt corporations;

(2) any amount allowed as a deduction under IRC Section 591 (relating to the deduction for dividends paid by mutual savings banks, etc.);

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(e).
2. IRC Sec. 1(h)(1); TIPRA 2005 Sec. 102, *amending* JGTRRA 2003 Sec. 303.
3. ATRA 2012, Pub. Law No. 112-240.
4. IRC Sec. 1(h)(11)(A).
5. IRC Sec. 1(h)(11)(B).

(3) dividends paid on certain employer securities as described in IRC Section 404(k);

(4) any dividend on a share (or shares) of stock that the shareholder has not held for more than 60 days during the *121-day* period beginning 60 days before the ex-dividend date (as measured under IRC Section 246(c)). For preferred stock, the holding period is more than 90 days during the *181-day* period beginning 90 days before the ex-dividend date *if* the dividends are attributable to a period exceeding 366 days (note, however, that if the preferred dividends are attributable to a period totaling less than 367 days, the holding period stated in the preceding sentence applies).[1]

Special rules. Qualified dividend income does *not* include any amount that the taxpayer takes into account as investment income under IRC Section 163(d)(4)(B).[2] If an individual, trust, or estate receives qualified dividend income from one or more dividends that are "extraordinary dividends" (within the meaning of IRC Section 1059(c)), any loss on the sale or exchange of such share(s) of stock will, to the extent of such dividends, be treated as long-term capital loss.[3]

A dividend received from a mutual fund or REIT is subject to the limitations under IRC Sections 854 and 857.[4] For the treatment of mutual fund dividends and REIT dividends under JGTRRA 2003, see Q 7851 and Q 7885, respectively.

Pass-through entities. In the case of partnerships, S corporations, common trust funds, trusts, and estates, the rule that qualified dividends are taxable as capital gains applies to taxable years ending after December 31, 2002, except that dividends received by the entity prior to January 1, 2003 are *not* treated as qualified dividend income.[5]

Qualified foreign corporations. The term "qualified foreign corporation" means a foreign corporation incorporated in a possession of the United States, or a corporation that is eligible for benefits of a comprehensive income tax treaty with the United States. If a foreign corporation does not satisfy either of these requirements, it will nevertheless be treated as such with respect to any dividends paid by that corporation *if* its stock (or ADRs with respect to such stock) is readily tradable on an established securities market in the United States.[6]

Common stock (or an ADR in respect of such stock) is considered "readily tradable on an established securities market in the United States" if it is listed on a national securities exchange that is registered under Section 6 of the Securities Exchange Act of 1934 (15 USC 78(f)), or on the NASDAQ Stock Market. [7] As stated by the Securities and Exchange Commission, registered national exchanges include the following:

- NYSE MKT LLC (formerly NYSE AMEX and the American Stock Exchange)
- BATS Exchange, Inc.

1. IRC Sec. 1(h)(11)(B).
2. IRC Sec. 1(h)(11)(D)(i). See also Temp. Treas. Reg. 1.163(d)-1T.
3. IRC Sec. 1(h)(11)(D).
4. IRC Sec. 1(h)(11)(D)(iii).
5. WFTRA 2004 Sec. 402(a)(6), JGTRRA 2003 Sec. 302(f).
6. IRC Sec. 1(h)(11)(C).
7. Notice 2003-71, 2003-43 IRB 922.

- BATS Y-Exchange, Inc.
- BOX Options Exchange LLC
- NASDAQ OMX BX, Inc. (formerly the Boston Stock Exchange)
- C2 Options Exchange, Incorporated
- Chicago Board Options Exchange, Incorporated
- Chicago Stock Exchange, Inc.
- EDGA Exchange, Inc.
- EDGX Exchange, Inc.
- International Securities Exchange, LLC
- The Nasdaq Stock Market LLC
- National Stock Exchange, Inc.
- New York Stock Exchange LLC
- NYSE Arca, Inc.
- NASDAQ OMX PHLX, Inc. (formerly Philadelphia Stock Exchange)[1]

In order to meet the "treaty test," the foreign corporation must be eligible for benefits of a comprehensive income tax treaty with the United States that the Treasury Secretary determines is satisfactory for these purposes, and the treaty must also provide for the exchange of tax information. For the current list of tax treaties meeting these requirements, see Notice 2011-64.[2]

The term "qualified foreign corporation" does *not* include any foreign corporation *if*, for the taxable year of the corporation in which the dividend was paid (or the preceding taxable year), the corporation is a passive foreign investment company (as defined in section 1297).[3]

Special rules apply in determining a taxpayer's foreign tax credit limitation under IRC Section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of IRC Section 904(b)(2)(B) (concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential) will apply to any qualified dividend income.[4]

1. http://www.sec.gov/divisions/marketreg/mrexchanges.shtml (last accessed February 26, 2014).
2. 2011-37 IRB 231.
3. IRC Sec. 1(h)(11)(C)(iii).
4. See IRC Sec. 1(h)(11)(C)(iv).

For information reporting and other guidance on foreign stock dividends, see Notice 2006-3;[1] Notice 2004-71;[2] and Notice 2003-79.[3]

612. What are the reporting requirements under JGTRRA 2003?

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, 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.[5] For the information reporting requirements for such payments, see Notice 2003-67;[6] Announcement 2003-75;[7] Treasury Regulation Section 1.6045-2(a)(3)(i); TD 9103.[8]

613. How are gains and losses treated for "traders in securities"?

In general, investors' losses are classified as capital losses, may be used to offset capital gains, and can only offset up to $3,000 of ordinary income each year (see Q 608). On the other hand, a "trader in securities" (see below) may elect to recognize gain or loss on any security held in connection with a trade or business at the close of any taxable year as if the security were sold at its fair market value at year-end.[9] Consequently, gains or losses with respect to such securities—whether deemed sold at year-end under the mark-to-market method of accounting (see Q 7585, Q 7586) or actually sold during the taxable year—are treated as ordinary income or loss.[10] Therefore, if a taxpayer is in business as a trader in securities and makes a mark-to-market election (under IRC Section 475(f)(1)) with respect to sales of securities held in connection with his business, the taxpayer's net loss from that business will be an ordinary loss that is fully deductible.[11]

How does an individual investor achieve "trader" status? The Tax Court stated in *Chen* that:

> "In order to qualify as a trader (as opposed to an investor) [the taxpayer's] purchases and sales of securities * * * must have constituted a trade or business. 'In determining whether a taxpayer who manages his own investments is a trader, and thus engaged in a trade or business, relevant considerations are the taxpayer's investment intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the taxpayer's securities transactions.'[12] In general, investors purchase and hold securities 'for capital appreciation and income' whereas traders buy and sell 'with reasonable frequency

1. 2006-3 IRB 306.
2. 2004-45 IRB 793
3. 2003-50 IRB 1206.
4. See Announcement 2003-55, 2003-38 IRB 597.
5. H.R. Rep. No. 108-94, 108th Cong., 1st Sess. 31 n. 36 (2003).
6. 2003-40 IRB 752.
7. 2003-49 IRB 1195.
8. 68 Fed. Reg.74847 (12-29-2003).
9. See IRC Sec. 475(f)(1)(A)(i); *Chen v. Comm.*, TC Memo 2004-132.
10. See IRC Secs. 475(d)(3)(A), 475(f)(1)(D); *Chen v. Comm.*, TC Memo 2004-132.
11. See IRC Section 165(c)(1); *Chen v. Comm.*, TC Memo 2004-132.
12. *Moller v. U.S.*, 721 F.2d 810, 813 (Fed. Cir. 1983).

in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis.'[1] For a taxpayer to be considered a trader, the taxpayer's trading activity must be 'substantial,' and it must be 'frequent, regular, and continuous to be considered part of a trade or business. * * * Sporadic trading does not constitute a trade or business.'[2] ('We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity * * *. A sporadic activity * * * does not qualify.')."[3]

In *Chen*, the taxpayer effected 323 transactions involving the purchase of securities, most of which he held for less than one month. Approximately 94 percent of Chen's transactions occurred during February, March, and April, with no transactions occurring in six of the other nine months. Chen attempted to retroactively elect mark-to-market accounting as a trader so that he could treat his losses as fully deductible ordinary losses incurred in a trade or business. But the Tax Court held that Chen was not a trader in securities eligible to make a mark-to-market election because Chen did not meet the second requirement for trader status—frequent, regular, and continuous trading. In the court's view, Chen's purchases and sales of securities were only frequent, regular, and continuous during the months of February, March, and April. The court also noted that Chen maintained a full-time job as a computer chip engineer. According to the court, in cases in where taxpayers have been held to be "traders in securities," the number and frequency [of trades] indicated that they were engaged in market transactions almost daily for a substantial and continuous period, generally exceeding a single taxable year. Furthermore, those activities constituted the taxpayers' sole or primary income-producing activity." The Tax Court concluded that because Chen's daily trading activities covered only a portion of a single year, and securities trading was not the sole or even primary activity in which Chen engaged for the production of income, Chen was not eligible for trader status.[4]

For the circumstances in which a late Section 475(f) election will be allowed, see *Vines v. Comm*.[5]

Traders are allowed to fully deduct their expenses as business expenses. See Q 7951. Conversely, investors' expenses are classified as miscellaneous itemized deductions and are subject to the 2 percent-of-adjusted gross income (AGI) threshold. See Q 631. The expenses of investors are also subjected to additional limitations. See Q 7941 – investment interest expense; Q 7948 – expenses paid in connection with the production of investment income; and Q 7950 – expenses relating to tax questions.

614. What is a "like-kind" exchange? How is it taxed?

In a like-kind exchange, a taxpayer exchanges property he holds as an investment or for productive use in a trade or business for other property of the same nature or character (but not necessarily of an equivalent grade or quality) that will be held either as an investment or for productive use in a trade or business. The property exchanged must be tangible; stocks,

1. *Liang v. Comm.*, 23 TC 1040, 1043 (1955).
2. *Boatner v. Commissioner*, TC Memo. 1997-379, affd, 164 F.3d 629 (9th Cir. 1998); see also *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).
3. *Chen v. Comm.*, TC Memo 2004-132.
4. *Chen v. Comm.*, TC Memo 2004-132.
5. 126 TC No. 15 (2006).

bonds, notes, other securities or evidences of indebtedness, and partnership interests are *not* eligible for like-kind exchange treatment. An exchange of properties that are of different kinds or classes is not a "like-kind" exchange.[1]

A special rule applies to any partnership that has elected under IRC Section 761(a) to be excluded from the application of subchapter K. An interest in such a partnership generally is treated as an interest in each of the assets of the partnership, not as an interest in the partnership.[2]

In order to qualify as a like-kind exchange, the transaction must also meet the following requirements: (1) the taxpayer must identify the property to be received in the exchange within 45 days after he transfers the property he relinquishes in the exchange, *and* (2) he must receive the like-kind property within 180 days after the date of his transfer or, if earlier, before the due date of his tax return for the tax year (including extensions).[3] The Service has privately ruled that it is not authorized under IRC Section 6503(b) to suspend the 180-day replacement period under IRC Section 1031(a)(3) where a taxpayer's assets are within court custody.[4]

For the final regulations replacing the use of the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAIC) for determining what properties are of a like class for purposes of IRC Section 1031, see Treasury Regulation Section 1.1031(a)-2; TD 9202.[5]

The IRS has provided safe harbors for programs involving ongoing exchanges of tangible personal property using a single intermediary (i.e., "LKE programs" or "like-kind exchange programs").[6]

According to the IRS, the like-kind standard has traditionally been interpreted more narrowly in the case of exchanges of personal property as compared to exchanges of real property.[7]

The Service has ruled that depreciable tangible personal properties were of a like class, even if they did not belong to the same general asset class.[8] The Service has also ruled that transfers of relinquished leased vehicles, followed by the acquisition of replacement leased vehicles through a qualified intermediary, were deferred exchanges qualifying for nonrecognition of gain or loss under IRC Section 1031.[9]

In technical advice, the Service ruled that the exchange of intangible property by a domestic entity for the intangible property of a foreign entity does not qualify as a like-kind exchange to the extent that the exchange is of property used predominantly within the United States for

1. IRC Sec. 1031; Treas. Reg. §1.1031(a)-1.
2. IRC Sec. 1031(a)(2).
3. IRC Sec. 1031(a)(3).
4. Let. Rul. 200211016.
5. 70 Fed. Reg. 28818 (5-19-2005).
6. See Rev. Proc. 2003-39, 2003-22 IRB 971.
7. See, e.g., *California Federal Life Insurance Co. v. Comm.*, 680 F.2d 85, 87 (9th Cir. 1982).
8. Let. Rul. 200327029.
9. Let. Ruls. 200241013, 200240049.

property used predominantly outside the United States. According to the Service—and contrary to the taxpayer's argument—IRC Section 1031(h)(2)(A) clearly provides that personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of like-kind. The statute does not make a distinction between tangible and intangible personal property.[1]

Gain on an exchange of property that fails to qualify for nonrecognition treatment under the like-kind exchange rules may be reportable under the installment method.[2] The Tax Court found that a transaction qualified as an installment sale and not a like-kind exchange where the payment for a transfer of real property was not received until the year after the property's conveyance.[3]

See Q 7777 for an explanation of regulations and safe harbors governing deferred exchanges, and for the procedures governing reverse exchanges.

For the rules coordinating like-kind exchange tax treatment with the exclusion of gain on the sale of a personal residence, see Q 7781.

615. How is the tax treatment of a like-kind exchange altered if, in addition to like-kind property, the taxpayer also receives cash or nonlike-kind property in the exchange?

Receipt of "boot." If the taxpayer receives only like-kind property in the exchange, no taxable gain or loss is reported on his income tax return as a result of the exchange regardless of his tax basis in and value of the respective properties.[4] However, if in addition to like-kind property, the taxpayer receives cash or other property that is different in kind or class from the property he transferred (i.e., nonlike-kind property is often referred to as "boot"), any gain he realizes in the exchange will be taxable to the extent of the sum of the amount of cash and the fair market value of the nonlike-kind property received; any loss realized in such an exchange may *not* be taken into account in calculating the taxpayer's income tax.[5]

If the taxpayer receives only like-kind property, but transfers cash or other nonlike-kind property as part of the exchange, regulations indicate that the nonrecognition rules apply to the like-kind properties, but not to the "boot."[6]

Recapture. In a like-kind exchange where boot is given or received, the recapture provisions applicable to certain depreciable property apply (see Q 620). If property for which an investment credit was taken is exchanged before the investment credit recapture period ends, a percentage will be recaptured (see Q 7824).[7]

1. See TAM 200602034.
2. Treas. Reg. §1.1031(k)-1(j)(2).
3. *Christensen v. Comm.*, TC Memo 1996-254.
4. IRC Sec. 1031(a).
5. IRC Secs. 1031(b), 1031(c); Treas. Reg. §1.1031(b)-1.
6. Treas. Regs. §§1.1031(a)-1(a)(2), 1.1031(d)-1(e). See *Allegheny County Auto Mart*, 12 TCM (CCH) 427, *aff'd per curiam*, 208 F.2d 693 (3rd Cir. 1953); *W.H. Hartman Co. v. Comm.*, 20 BTA 302 (1930).
7. IRC Sec. 50(a)(1).

616. How is the tax treatment of a like-kind exchange altered if one or more parties assumes a liability of the other party or receives property subject to a liability in the exchange?

If, in an exchange, one party assumes a liability of the other party or receives property subject to a liability, he will be deemed to have transferred "boot" in an amount equal to the liability. The party who transfers the property subject to the liability or whose liability is assumed will be deemed to have received the "boot." If each party to an exchange either assumes a liability of the other party or acquires property subject to a liability, the amounts of such liabilities will be offset and only the difference will be treated as "boot" given and received by the applicable parties.[1] Generally, liabilities that qualify to offset or reduce any taxable boot received are those to which the property received was subject to prior to the exchange and that then are assumed as part of the exchange.[2]

The Service ruled that if a partnership enters into an exchange that qualifies as a deferred like-kind exchange, in which property subject to a liability is transferred in one taxable year of the partnership, and property subject to a liability is received in the following taxable year of the partnership, the liabilities must be netted for purpose of IRC Section 752. Any net decrease in a partner's share of partnership liability must be taken into account for purposes of IRC Section 752(b) in the first taxable year of the partnership, and any net increase in a partner's share of partnership liability must be taken into account for purposes of IRC Section 752(a) in the second year of the partnership.[3]

617. What is the tax basis of property received in a tax-free (or partially tax-free) like-kind exchange?

The tax basis of like-kind property received in a tax-free (or partially tax-free) like-kind exchange is generally equal to the adjusted tax basis of the like-kind property given. There are, however, two exceptions. First, if an individual transfers cash or nonlike-kind property or assumes a liability of the other party to the exchange (i.e., the transferee) that exceeds the liabilities (if any) assumed by the transferee, the individual's tax basis in the like-kind property received is equal to his adjusted tax basis in the property given *increased by* the *sum of* (1) the amount of cash and the fair market value of nonlike-kind property given and (2) the net liability assumed.

Second, if liabilities assumed by the transferee exceed the liabilities (if any) assumed by the individual (transferor) and no other cash or boot is transferred by the individual, the individual's tax basis in the like-kind property he receives is equal to his adjusted tax basis in the like-kind property given *decreased by* the net amount of liabilities assumed by the transferee.[4]

1. Treas. Reg. §1.1031(d)-2. See Rev. Rul. 59-229, 1959-2 CB 180.
2. See Treas. Reg. §1.1031(d)-2, Ex. 2.
3. Rev. Rul. 2003-56, 2003-23 IRB 985.
4. IRC Sec. 1031(d), Treas. Reg. §1.1031(d)-2.

The tax basis of any nonlike-kind property received in a like-kind exchange is the fair market value of the nonlike-kind property on the date of the exchange.[1]

618. How is a like-kind exchange between related parties taxed?

If a like-kind exchange that results in nonrecognition of gain or loss occurs between related parties, followed by a disposition of either property within two years of the date of the last transfer that was part of the like-kind exchange, then the original transaction will not qualify for nonrecognition treatment.[2] For purposes of this rule, the term "disposition" does not include dispositions resulting from the death of the taxpayer or (if earlier) the related person. The 2-year disposition rule also will not apply to involuntary conversions, so long as the exchange occurred before the threat or imminence of the conversion. An exception is also provided where it can be established that neither the exchange nor the subsequent disposition had as its principal purpose the avoidance of income tax.[3]

"Related persons," for purposes of this rule, include the following: (1) members of the same family (i.e., brothers, sisters, spouses, ancestors and lineal descendants); (2) an individual and a corporation of which the individual actually or constructively owns more than 50 percent of the stock; (3) a grantor and a fiduciary of a trust; (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 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) a person and a partnership of which the person actually or constructively owns more than 50 percent of the capital interest or profits interest; (13) two partnerships if the same persons actually or constructively own more than 50 percent of the capital interest or profits interest of each; or (14) generally, an executor and a beneficiary of an estate.[4]

Any transaction, or series of transactions, structured to avoid the related party rules for like-kind exchanges will not qualify for nonrecognition treatment.[5] The Service has ruled that a taxpayer who transfers relinquished property to a qualified intermediary for replacement property formerly owned by a related party is *not* entitled to nonrecognition treatment under IRC Section 1031(a) if, as part of the transaction, the related party receives cash or other nonlike-kind property for the replacement property.[6] If the risk of holding any property is

1. Treas. Reg. §1.1031(d)-1(c).
2. IRC Sec. 1031(f)(1).
3. IRC Sec. 1031(f)(2).
4. IRC Secs. 1031(f)(3), 267(b), 707(b)(1).
5. IRC Sec. 1031(f)(4).
6. Rev. Rul. 2002-83, 2002-49 IRB 927.

substantially diminished by a short sale, by the holding of a put option, or by another person holding a right to acquire the property, then the running of the 2-year period will be suspended during the period that the option or other right is held.[1]

Adjusted Gross Income

619. How is adjusted gross income determined?

Adjusted gross income is determined by subtracting the following deductions from gross income: (a) expenses directly incurred in carrying on a trade, business or profession (not as an employee – see Q 7951); (b) 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; (c) certain reimbursed expenses of an employee in connection with his 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); (d) deductions related to property held for the production of rents and royalties (within limits); (e) 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; (f) deductions for losses from the sale or exchange of property (see Q 608); (g) the deduction allowed for amounts paid in cash by an eligible individual to a traditional individual retirement account (IRA), or individual retirement annuity; (h) the deduction allowed for amounts forfeited as penalties because of premature withdrawal of funds from time savings accounts (see Q 7849); (i) alimony payments made to the taxpayer's spouse (see Q 661); (j) certain reforestation expenses; (k) certain jury duty pay remitted to the taxpayer's employer; (l) moving expenses permitted by IRC Section 217; (m) the deduction for Archer Medical Savings Accounts under IRC Section 220(i); (n) the deduction for interest on education loans; (o) the deduction for qualified tuition and related expenses; (p) the deduction for contributions (within limits) to Health Savings Accounts; (q) the deduction for attorneys' fees involving discrimination suits; and (r) and the deduction for certain expenses of elementary and secondary school teachers up to $250 (effective for 2012 and 2013 under ATRA).

620. What is the deduction for depreciation?

Depreciation is a deduction that permits recovery, over a period of time, of capital invested in tangible property used in a trade or business or held for the production of income.[2] It is a deduction taken in arriving at adjusted gross income.[3] Only property that has a limited useful life may be depreciated. Land does not have a limited life and, therefore, cannot be depreciated. However, the improvements on land can be depreciated. Inventory and stock in trade are not depreciable.[4] A taxpayer who purchases a term interest in property cannot amortize or depreciate the cost of the property during any period in which the remainder interest is held by a related person. This rule is effective for interests created or acquired after July 27, 1989, in taxable

1. IRC Sec. 1031(g).
2. IRC Secs. 167(a), 168(a), as amended by ATRA.
3. IRC Secs. 62(a)(1), 62(a)(4).
4. Treas. Reg. §1.167(a)-2.

years ending after such date.[1] However, life tenants and beneficiaries of estates and trusts may be allowed the regular depreciation deduction if the property is depreciable property.[2]

The method used to determine the rate of depreciation depends on when the property was placed into service. Property is "placed into service" when it is first placed in a condition or state of readiness and availability for a specifically assigned function for use in a trade or business, for the production of income, or in a tax-exempt or personal activity.[3]

621. What methods may be used to calculate depreciation on property placed in service after 1986?

Generally, the Accelerated Cost Recovery System (ACRS) was modified for property placed in service after 1986. An election could be made to apply the post-1986 ACRS to property that was placed in service between July 31, 1986 and January 1, 1987 (unless such property would have been subject to the anti-churning rules (See Q 622) if it had been placed in service after 1986).[4] If real property is acquired before 1987 and converted from personal use to a depreciable use after 1986, the post-1986 ACRS is to be used.[5]

The post-1986 ACRS deduction is calculated by applying to the basis of the property either (1) a declining balance method that switches to the straight line method at a time which maximizes the deduction or (2) a straight line method.[6] The initial basis in the property is the basis of the property upon acquisition (usually the cost of the property, see Q 598), reduced by the amount, if any, elected for amortization or an IRC Section 179 deduction (see "Election to Expense," below), and further reduced by any basis reduction required in connection with taking the investment tax credit (see Q 7824).[7] The basis of the property is reduced each year by the amount of the depreciation allowable.[8] Optional depreciation tables set out in Revenue Procedure 87-57 may be used in place of the methods above.[9] Because land cannot be depreciated, the cost basis of improved land must be allocated between the land and improvements.[10] The ACRS deduction is limited in the case of certain automobiles and other "listed property" placed in service after June 18, 1984. See "Limitations," (Q 623).

In general, for certain property acquired after September 11, 2001, and before January 1, 2005, a depreciation "bonus" of 30 percent could be taken in the year the property was placed in service.[11] For certain property acquired after May 5, 2003, and before January 1, 2005, 50 percent bonus depreciation could be taken.[12] The IRS has provided procedures on how to claim the

1. IRC Sec. 167(e).
2. See IRC Sec. 167(d).
3. Prop. Treas. Reg. §1.168-2(l)(2).
4. TRA '86, Sec. 203(a)(1)(B), as amended by TAMRA '88, Sec. 1002(c)(1).
5. TAMRA '88, Sec. 1002(c)(3).
6. IRC Sec. 168(b).
7. IRC Sec. 50(c)(1); Treas. Reg. §1.179-1(f)(1).
8. IRC Sec. 1016(a)(2).
9. Rev. Proc. 87-57, 1987-2 CB 687.
10. See Treas. Reg. §1.167(a)-5.
11. IRC Sec. 168(k)(1), before amendment by ESA 2008.
12. IRC Sec. 168(k)(4), before amendment by ESA 2008.

bonus depreciation.[1] For eligible property, taxpayers may elect 50 percent bonus depreciation, 30 percent bonus depreciation, or no bonus depreciation.

For certain qualified property placed in service in 2008 until 2014, bonus depreciation of 50 percent is allowed.[2]

Bonus first-year depreciation applies only to qualified property. It is claimed in the first year that the property is placed in service. It is the following percentage of the unadjusted depreciable basis of qualified property:

- 100 percent if placed in service after Sept. 8, 2010 and before Jan. 1, 2012; and
- 50 percent, if placed in service after Dec. 31, 2007 and before Sept. 9, 2010; or after Dec. 31, 2011 and before Jan. 1, 2014.

For property used both in an individual's trade or business (or for the production of income) and in a personal or tax-exempt activity during a taxable year, depreciation is allocated to all uses of the property, and only the portion attributable to the trade or business or production of income use is deductible.[3]

The classification of property by recovery period and depreciation method is as follows:[4]

3 years 200% DB*	class life of 4 years or less, certain horses, qualified rent-to-own property
5 years 200% DB*	class life of more than 4 but less than 10 (e.g., heavy trucks, buses, offshore drilling equipment, most computer and data handling equipment, cattle, helicopters and non-commercial aircraft, automobiles and light trucks)
7 years 200% DB*	class life of 10 or more but less than 16 (e.g., most office furnishings, most agricultural machinery and equipment, theme park structures, most railroad machinery, equipment and track, commercial aircraft), motorsports entertainment complexes, Alaska neutral gas pipelines, property without a class life and not otherwise classified under TRA '86
10 years 200% DB*	class life of 16 or more but less than 20 (e.g., vessels, barges and similar water transportation equipment, petroleum refining equipment)
15 years 150% DB*	class life of 20 or more but less than 25 (e.g., industrial steam and electric generation/distribution systems, cement manufacturing equipment, commercial water transportation equipment (freight or passenger), nuclear power production plants)

1. Rev. Proc. 2003-50, 2003-29 IRB 119.
2. IRC Sec. 168(k), as amended by ESA 2008, ARRA 2009 and ATRA.
3. Prop. Treas. Reg. §1.168-2(d)(2)(ii).
4. IRC Secs. 168(c), 168(e), Rev. Proc. 87-57, above.

20 years 150% DB*	class life of 25 or more (e.g., certain farm buildings, railroad structures and improvements, telephone central office buildings, gas utility production plants and distribution facilities), but excluding real property with class life of 27.5 years or more
27.5 years straight line	residential rental property
39 years straight line	nonresidential real property (class life of 27.5 years or more)
50 years straight line	railroad grading or tunnel bore

* Declining balance method switching to the straight line method at a time to maximize the deduction. Substitute 150% DB for 200% DB if 3-, 5-, 7-, or 10-year property is used in a farming business. An election can be made to use the straight line method instead of the declining balance method. Also, with respect to 3-, 5-, 7-, and 10-year property, an election can be made to use 150% DB.

Property is assigned to various *class lives* in Rev. Proc. 87-56.[1] These class lives can also be found in IRS Publication 946. The Tax Reform Act of 1986 assigned certain property to recovery periods without regard to their class life (e.g., automobiles and light trucks). Also, intangible property that is depreciable is subject to special recovery periods. If computer software is depreciable, the deduction is calculated using a straight line method over 36 months.[2] Computer software acquired after August 10, 1993 is generally depreciable if it (a) is a program designed to cause a computer to perform a desired function, (but generally not a database) and (b) either (1) is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified, or (2) is not acquired in a transaction involving the acquisition of assets constituting a trade or business.[3] Certain mortgage servicing rights may be depreciated over 108 months using the straight line method.[4]

Certain rights that are not acquired in a transaction involving the acquisition of a trade or business are subject to special rules for depreciation. Depreciation deductions for (1) rights to receive tangible property or services under a contract or a government grant; (2) interests in patents or copyrights; or (3) certain contracts of fixed duration or amount, are to be defined in the regulations.[5] Regulations generally require the amortization of the right to receive property under a contract or government grant by multiplying the basis of the right by a fraction. The numerator of the fraction is the amount of property or services received during the taxable year and the denominator is the total amount to be received under the contract or government grant. For a patent or copyright, the deduction is generally equal to the amount paid during a taxable year if the purchase price is paid on an annual basis as either a fixed amount per use or a fixed percentage of revenue from the patent or copyright, otherwise it is depreciated either ratably over its useful life or by using the income forecast method. The basis of a right

1. 1987-2 CB 674.
2. IRC Sec. 167(f)(1).
3. IRC Secs. 167(f)(1), 197(e)(3)(B).
4. IRC Sec. 167(f)(3).
5. IRC Sec. 167(f)(2).

to an unspecified amount over a fixed duration of less than 15 years is amortized ratably over the period of the right.[1]

In the years in which property is acquired or disposed of, depreciation is limited to the portion of the year in which the property is considered to be held under the following *conventions*: Residential rental property, nonresidential real property, and railroad grading or tunnel bore are treated as placed in service (or disposed of) on the mid-point of the month in which placed in service (or disposed of). Property, other than such real property, is generally treated as placed in service (or disposed of) on the mid-point of the year in which placed in service.

However, the mid-quarter convention (instead of the mid-year convention) applies to depreciable property placed in service during the taxable year if the aggregate bases of property placed in service during the last three months of the taxable year exceeds 40 percent of the aggregate bases of property placed in service (or disposed of) during the taxable year ("the 40 percent test"). "Aggregate bases" is defined as the sum of the depreciable bases of all items of depreciable property taken into account in applying the 40 percent test.

For taxable years ending after January 30, 1991, property not taken into account in applying the test include the following: (1) real property subject to the mid-month convention (described above), and (2) property placed in service and disposed of in the same taxable year. Conversely, property that would be taken into account in applying the 40 percent test includes: (1) listed property (discussed in Q 623) placed in service during the taxable year, and (2) property placed in service, disposed of, subsequently reacquired, and again placed in service in the same taxable year (but only the basis of the property on the later of the dates that the property is placed in service is considered).[2] The IRS has provided some relief from the mid-quarter convention if a taxpayer's third or fourth quarter included September 11, 2001.[3]

Regardless of whether the mid-year convention or the mid-quarter convention applies, no depreciation deduction is available for property placed in service and disposed of in the same year.[4]

Property subject to the mid-month convention is treated as placed in service (or disposed of) on the mid-point of the month without regard to whether the taxpayer has a short taxable year (i.e., a taxable year that is less than 12 months). The mid-quarter 40 percent test is also made without regard to the length of the taxable year. Thus, if property (with exceptions, as noted in the preceding paragraphs) is placed in service in a taxable year of three months or less, the mid-quarter convention applies regardless of when such property was placed in service (i.e., 100 percent of property has been placed in service in the last three months).[5]

In the case of a short taxable year and with respect to property to which the mid-year or mid-quarter convention applies, the recovery allowance is determined by multiplying the

1. Treas. Reg. §1.167(a)-14(c).
2. IRC Sec. 168(d); Treas. Reg. §1.168(d)-1.
3. Notice 2001-74, 2001-2 CB 551.
4. Treas. Reg. §1.168(d)-1(b)(3)(ii).
5. Rev. Proc. 89-15, 1989-1 CB 816.

deduction that would have been allowable if the recovery year were not a short taxable year by a fraction, the numerator of which equals the number of months in the short taxable year and the denominator of which is 12.[1] Proposed regulations under IRC Section 168(f)(5) (as in effect prior to TRA '86) provided that a taxable year of a person placing property in service did not include any month prior to the month in which the person began engaging in a trade or business or holding recovery property for the production of income.[2] Presumably, this principle would continue to apply after TRA '86.

Alternative Depreciation System

An *alternative depreciation system* is provided for (1) tangible property used predominately outside the United States, (2) tax-exempt use property, (3) tax-exempt bond financed property, (4) certain imported property covered by an executive order regarding countries engaging in unfair trade practices, and (5) property for which an election is made. The election may be made with respect to each property in the case of nonresidential real property and residential rental property. For all other property, the election is made with respect to all property placed in service within a recovery class during a taxable year.[3]

The alternative depreciation is determined using the straight line method and the applicable convention, above, over the following periods:[4]

tax-exempt use property subject to a lease	**longer of 125% of lease term or period below**
residential rental property and nonresidential real property	40 years
personal property with no class life	12 years
railroad grading or tunnel bore	50 years
all other property	the class life

TRA '86 assigns certain property to recovery periods without regard to their class life, e.g., automobiles and light trucks.

General Asset Accounts

Assets that are subject to either the general depreciation system of IRC Section 168(a) or the alternative depreciation system of IRC Section 168(g) may be grouped in one or more general asset accounts. The assets in a particular general asset account are generally depreciable as a single asset. Such an account must include only assets that have the same depreciation method, recovery period, convention, and that are placed in service in the same tax year. An asset may not be included in a general asset account if the asset is used in a personal activity at any time before the end of the tax year in which it was placed in service.[5]

1. Rev. Proc. 89-15, 1989-1 CB 816.
2. Prop. Treas. Reg. §1.168-2(f)(4).
3. IRC Sec. 168(g).
4. IRC Sec. 168(g)(2)(C).
5. Treas. Reg. §1.168(i)-1T(c), as modified by T.D. 9564.

Upon disposition of an asset from a general asset account, the asset is treated as having an adjusted basis of zero, and the total amount realized on the disposition is generally recognized as ordinary income. However, the ordinary income treatment is limited to the unadjusted basis of the account less amounts previously recognized as ordinary income. The character of the amounts in excess of such ordinary income is determined under other applicable provisions of the IRC (other than IRC Sections 1245 and 1250). Because the basis of the property is considered to be zero, no loss is recognized on such a disposition. Generally, the basis in the account is recoverable only through depreciation, unless the taxpayer disposes of all the assets in the account.[1]

Unit of Production Method

Instead of using ACRS, a property owner may elect to use the unit of production method of depreciation (if appropriate) or any other method not expressed in a term of years.[2] For example, under the unit of production method, the depreciation deduction for a machine that, it is estimated, will produce 1,000,000 shoes (units) before wearing out, and that produces 250,000 units in the first year, would be:

$$(250{,}000 \div 1{,}000{,}000) \times \text{basis}$$

Election to Expense

A taxpayer may elect to treat the cost of certain qualifying property as an expense in the year the property is placed in service.[3] To qualify, property must be eligible for depreciation or certain amortization provisions, it must be personal property (or fall within certain other categories described in IRC Section 1245(a)(3), such as property used for manufacturing or as a storage facility), and must have been acquired by purchase (from an unrelated person) for use in the active conduct of a trade or business. This property does not include any air conditioning or heating units or any ineligible property described in IRC Section 50(b) (certain property used outside the U.S., for lodging, by tax-exempt organizations, or by governments or foreign persons or entities). This election is not available to a trust or estate, nor can it be used for property held for the production of income.[4]

Recent legislation has raised the dollar amount that can be expensed for property placed in service in 2008, 2009, 2010, 2011, 2012 and 2013. The aggregate cost deductible for 2008 and 2009 cannot exceed $250,000.[5] The aggregate cost deductible for 2010 through 2013 is $500,000. The aggregate cost deductible in a tax year beginning in 2014 and later is $25,000. The annual dollar limitation is reduced by one dollar for each dollar of such investment above $800,000 for 2008 and 2009, above $2,000,000 for 2010 through 2013, and $200,000 for a tax year beginning in 2014 and later tax years.[6]

1. Treas. Reg. §1.168(i)-1T(e).
2. IRC Sec. 168(f)(1).
3. IRC Sec. 179.
4. IRC Secs. 179(d)(1), 179(d)(4).
5. IRC Sec. 179(b)(7), as amended by ESA 2008, ARRA 2009, HIREA and ATRA.
6. IRC Sec. 179(b)(7), as amended by ESA 2008, ARRA 2009, HIREA and ATRA.

The amount expensed is limited to the aggregate amount of income derived from the active conduct of any trade or business of the taxpayer. An amount that is not deductible because it exceeds the aggregate taxable income from any trade or business may be carried over and taken in a subsequent year. The amount that may be carried over and taken in a subsequent year is the lesser of (1) the amounts disallowed because of the taxable income limitation in all prior taxable years (reduced by any carryover deductions in previous taxable years); or (2) the amount of unused expense allowance for such year. The amount of unused expense allowance is the excess of (1) the maximum cost of property that may be expensed taking into account the dollar and income limitations; over (2) the amount the taxpayer elects to expense.[1] Married individuals filing separately are treated as one taxpayer for purposes of determining the amount that may be expensed and the total amount of investment in such property.[2] No General Business Credit is allowed for any amount expensed under IRC Section 179.[3]

Deductions permitted pursuant to a valid election to expense costs are not prorated if the taxpayer has a short tax year.[4]

622. What are the anti-churning rules? When must pre-1987 depreciation methods be used?

"Anti-churning rules" require the use of the pre-1981 depreciation methods for property placed in service after 1980 (including property placed in service after 1986) if the property or substituted property was used, owned, or leased by certain persons before 1981. In the case of personal property, ACRS may not be used if: the investor or a party related to him owned or used the property in 1980; the property is leased to anyone who owned or used the property in 1980; or the property is acquired from its 1980 owner but the person actually using the property does not change. In the case of real property, ACRS may not be used if a related party owned the property in 1980, the property is leased back to its 1980 owner or to a party related to its 1980 owner, or the property is acquired for property of the individual or related party owned in 1980 in certain like-kind exchanges, rollovers of low-income housing, involuntary conversions or repossessions.[5]

Additional "anti-churning" rules require the use of pre-1987 depreciation methods for property placed in service after 1986 if (1) the property or substituted property was used, owned, or leased by certain individuals before 1987 *and* (2) use of the post-1986 ACRS would result in a larger depreciation deduction than could be taken under preexisting law. Rules similar to those in the previous paragraph are to be applied to determine whether property is considered as property used, owned, or leased before 1987, substituting 1986 for 1980 and 1987 for 1981.[6]

1. IRC Sec. 179(b)(3); Treas. Reg. §1.179-3.
2. IRC Sec. 179(b)(4).
3. IRC Sec. 179(d)(9).
4. Treas. Reg. §1.179-1(c)(1).
5. IRC Secs. 168(f)(5)(A), 168(e)(4) (prior to amendment by TRA '86).
6. IRC Sec. 168(f)(5)(B).

The "anti-churning" rules do not apply with respect to property receiving a new basis under IRC Section 1014(a) when the property is acquired from a decedent (see Q 598).[1] The share of community property received by a surviving spouse at the other spouse's death will not qualify for this exception to the anti-churning rules if the property was placed into service by both spouses prior to the decedent spouse's death (i.e., the general placed in service rules would apply).[2]

623. What special limitations apply to calculating depreciation on automobiles and other property classified as "listed property"?

Limitations

For any *passenger automobile* placed in service during taxable years after June 18, 1984, the amount of the depreciation deduction, including any amount elected as an expense (see above), cannot exceed the monetary limitations as set forth under the applicable heading in the exhibit, below. Note that once the unadjusted basis of an automobile is recovered, depreciation is no longer deductible. For certain automobiles acquired after September 11, 2001, and before January 1, 2005, the first year depreciation limitation was increased by $4,600. For certain automobiles purchased after May 5, 2003 and before January 1, 2005, the first year depreciation limit was increased by $7,650.[3] For certain automobiles purchased after December 31, 2007 and before January 1, 2010, the first year depreciation limit was increased by $8,000.[4]

Property Placed in Service	First Year	Second Year	Third Year	Succeeding Years
6-19-84 through 4-2-85	$4,000	$6,000	$6,000	$6,000
4-3-85 through 1986	$3,200	$4,800	$4,800	$4,800
1987 and 1988	$2,560	$4,100	$2,450	$1,475
1989 and 1990	$2,660	$4,200	$2,550	$1,475
1991	$2,660	$4,300	$2,550	$1,575
1992	$2,760	$4,400	$2,650	$1,575
1993	$2,860	$4,600	$2,750	$1,675
1994	$2,960	$4,700	$2,850	$1,675
1995 and 1996	$3,060	$4,900	$2,950	$1,775
1997	$3,160	$5,000	$3,050	$1,775
1998	$3,160	$5,000	$2,950	$1,775
1999	$3,060	$5,000	$2,950	$1,775
2000, 2001, 2002, and 2003	$3,060	$4,900	$2,950	$1,775

1. IRC Secs. 168(f)(5), 168(e)(4)(H) (prior to amendment by TRA '86).
2. *Est. of Gasser v. Comm.*, 93 TC 236 (1989).
3. See IRC Secs. 168(k)(2)(F), IRC Sec. 168(k)(4)(D), prior to amendment by ESA 2008.
4. IRC Sec. 168(k)(2)(F), as amended by ESA 2008 and ARRA 2009.

Property Placed in Service	First Year	Second Year	Third Year	Succeeding Years
2004	$2,960	$4,800	$2,850	$1,675
2005	$2,960	$4,700	$2,850	$1,675
2006	$2,960	$4,800	$2,850	$1,775
2007	$3,060	$4,900	$2,850	$1,775
2008 and 2009	$2,960	$4,800	$2,850	$1,775
2010	$3,060	$4,900	$2,950	$1,775
2011	$3,060	$4,900	$2,950	$1,775
2012	$3,160	$5,100	$3,050	$1,875
2013	$3,160	$5,100	$3,050	$1,875
2014	$3,160	$5,100	$3,050	$1,875

[Rev. Proc. 2014-21; Rev. Proc.2013-21; Rev. Proc. 2012-23; Rev. Proc. 2011-21; Rev. Proc. 2010-18, 2010-9 IRB 427; Rev. Proc. 2009-24, 2009-17 IRB 885; Rev. Proc. 2008-22, 2008-12 IRB 658; Rev. Proc. 2007-30, 2007-18 IRB 1104; Rev. Proc. 2006-18, 2006-12 IRB 645; Rev. Proc. 2005-13, 2005-12 IRB 759; Rev. Proc. 2004-20, 2004-13 IRB 642; Rev. Proc. 2003-75, 2003-2 CB 1018; Rev. Proc. 2002-14, 2002-1 CB 450; Rev. Proc. 2001-19, 2001-1 CB 732; Rev. Proc. 2000-18, 2000-1 CB 722; Rev. Proc. 99-14, 1999-1 CB 413; Rev. Proc. 98-30, 1998-2 CB 930; Rev. Proc. 97-20, 1997-1 CB 647; Rev. Proc. 96-25, 1996-1 CB 681; Rev. Proc. 95-9, 1995-1 CB 498; Rev. Proc. 94-53, 1994-2 CB 712; Rev. Proc. 93-35, 1993-2 CB 472; Rev. Proc. 92-43, 1992-1 CB 873; Rev. Proc. 91-30, 1991-1 CB 563; Rev. Proc. 90-22, 1990-1 CB 504; Rev. Proc. 89-64, 1989-2 CB 783; IRC Sec. 280F(a).]

The dollar limitations are determined in the year the automobile is placed in service and are subject to an inflation adjustment (rounded to the nearest multiple of $100) for the calendar year in which the automobile is placed in service.[1] Taxpayers who lease passenger automobiles and are allowed a deduction for the lease are required to reduce the deduction if the fair market value of the automobile is greater than a certain amount. For lease terms beginning in 2012, the amount was $18,500 and for lease terms beginning in 2013, the amount was $19,000. In 2014, the amount is reduced to $18,500.[2] This reduction is accomplished by including in gross income an amount determined from tables promulgated by the IRS. The amount to be added to income is dependent on the fair market value of the automobile at the time the lease term begins. The higher the value of the automobile, the more that is added to income.[3] "Passenger automobiles" do not include ambulances, hearses, trucks, vans or other vehicles used by a taxpayer in a trade or business of transporting persons or property for compensation or hire.[4]

The amount of the depreciation deductions is also limited for "listed property" placed in service (or leased) after June 18, 1984 (generally) if the business use of the property does

1. IRC Sec. 280F(d)(7).
2. Rev. Proc. 2014-21, 2014-11 IRB 1.
3. See Treas. Reg. §1.280F-7; Rev. Proc. 2012-23.
4. IRC Sec. 280F(d)(5)(B).

not exceed 50 percent of its total use during the taxable year.[1] "Listed property" includes any passenger automobile or other property used for transportation (generally, unless used in the transportation business); any property of a type used for entertainment, recreation or amusement; any computer (except computers used exclusively at a regular business establishment or at a dwelling unit that meets the home office requirement); any cellular telephone or similar equipment (but only for tax years that begin before January 1, 2010); or other property specified by the regulations.[2] In the case of passenger automobiles, this personal use limitation is applied after the passenger automobile limitation, above.[3]

If the business use of the listed property does not exceed 50 percent, depreciation under the regular pre-1987 ACRS and post-1986 ACRS is not allowed. For such property placed in service after 1986, the amount of the depreciation deduction is limited to that amount determined using the alternative depreciation system (see Q 621).[4] For such property placed in service after June 18, 1984 and before 1987, the amount of the recovery is generally limited to that amount determined using the straight line method over the following earnings and profit lives:[5]

In the case of:	*The applicable recovery period is*:
3-year property	5 years
5-year property	12 years
10-year property	25 years
15-year public utility property	35 years
19-year real prop. and low income housing	40 years

The more-than-50 percent business use requirement must be met solely by use of the listed property in a trade or business, without regard to the percentage of any use in another income producing activity. However, the percentage of use in any other income producing activity is added to the business use when determining the unadjusted basis of the property subject to depreciation (the unadjusted basis is the same as the initial basis, described above). If the listed property meets the more-than-50 percent business use requirement in the year it is placed in service and ceases to do so in a subsequent year, then any "excess depreciation" will be recaptured and included in gross income in the year it ceases to meet the requirement. "Excess depreciation" is the *excess*, if any, of the depreciation allowable while the property met the business use requirement *over* the depreciation that would have been allowable if the property had not met the requirement for the taxable year it was placed in service.[6] This excess depreciation recapture is distinct from the depreciation recapture that occurs on early disposition; see Q 625.

1. IRC Sec. 280F(b).
2. IRC Sec. 280F(d)(4).
3. IRC Sec. 280F(a)(2).
4. IRC Sec. 280F(b)(1).
5. IRC Secs. 280F(b)(2), 312(k), both as in effect prior to amendment by TRA '86).
6. IRC Sec. 280F(b)(2).

624. What depreciation deduction is allowed for intangible assets?

Generally, taxpayers are permitted a depreciation deduction for certain intangible property. The depreciation deduction is allowable for certain computer software, business interests and rights, and mortgage servicing rights.[1] The deduction generally is allowable for depreciable intangible property acquired after August 10, 1993, unless the taxpayer elects to take the deduction for such intangible property acquired after July 25, 1991. If the taxpayer chooses, he may also elect to forgo taking the depreciation deduction and, instead, amortize such intangible property if the property was acquired by the taxpayer pursuant to a written contract in effect on August 10, 1993 and at all times up to the date of acquisition.[2]

Intangible property for which the depreciation deduction is allowable includes (1) any computer program designed to cause a computer to perform a desired function (but it generally does not include any data base), (2) a right under a contract or granted by a government entity that entitles the taxpayer to receive tangible property or services, (3) a right under a contract or granted by a government agency if such right has a fixed duration of less than 15 years, or if such right is fixed as to amount and would otherwise be recoverable under a method similar to a unit-of-production method, (4) any interest in a patent or copyright, and (5) any right to service indebtedness that is secured by residential real property. Generally, if any of the intangible property described above was acquired by the taxpayer upon the acquisition of a trade or business, the depreciation deduction will not be allowable.[3]

625. How does the depreciation deduction impact an individual's basis in the property?

Each year, an individual's basis is reduced by the amount of the depreciation deduction taken so that his adjusted basis in the property reflects accumulated depreciation deductions. If depreciation is not deducted, his basis must nonetheless be reduced by the amount of depreciation allowable, but the deduction may not be taken in a subsequent year.[4]

Recapture

Upon disposition of property, the seller often realizes more than his basis after it has been reduced for depreciation. Legislative policy is that on certain dispositions of depreciated property the seller realizes a gain that is, at least in part, attributable to depreciation. To prevent a double benefit, the IRC requires that some of the gain that would otherwise generally be capital gain must be treated as ordinary income. In effect, it requires the seller to "recapture" some of the ordinary income earlier offset by the depreciation.[5] In addition, if depreciated property ceases to be used predominantly in a trade or business before the end of its recovery period, the owner must recapture in the tax year of cessation any benefit derived from expensing such

1. IRC Sec. 167(f).
2. OBRA '93, Sec. 13261(g).
3. IRC Secs. 167(f), 197(e)(4), 197(e)(6).
4. IRC Sec. 1016(a)(2).
5. IRC Secs. 1245, 1250.

property.[1] This provision is effective for property placed in service in tax years ending after January 25, 1993.[2]

626. What personal exemptions is an individual entitled to deduct in calculating taxable income?

Taxpayers generally are permitted to deduct the following personal exemption amounts: (1) For taxable years beginning in 2014, $3,950 for husband and wife each on a joint return ($7,900 for both); (2) $3,950 for a taxpayer filing a single or separate return; (3) $3,950 for the spouse of a taxpayer filing a separate return, provided the spouse has *no gross* income and is not claimed as the dependent of another taxpayer.[3] The personal exemption amount is adjusted annually for inflation.[4] The basic amount for 2013 was $3,900. Generally, the exemption will not be allowed unless the Social Security number of the individual for whom the personal exemption is being claimed is provided.[5]

There was no phaseout of the personal exemptions based on adjusted gross income (AGI) in 2010-2012. The phaseout, including reductions of the phaseout in 2006 through 2009 and repeal of the phaseout for 2010, as well as its reinstatement in 2013, is discussed below. Under the American Taxpayer Relief Act of 2012 ("ATRA"), the phaseout resumed for tax years beginning in 2013 and thereafter.

The personal exemptions of certain upper income taxpayers are phased out over defined income levels. The dollar amount of personal and dependency exemptions of taxpayers with adjusted gross income above certain levels is reduced by an "applicable percentage" in the amount of two percentage points for every $2,500 (or fraction thereof; $1,250 in the case of a married individual filing separately) by which the taxpayer's adjusted gross income exceeds the following threshold amounts in 2014: Married filing jointly (and surviving spouses): $305,050; Head of household: $279,650; Single: $254,200; Married filing separately: $152,525. These amounts are adjusted annually for inflation.[6]

The phaseout is completed at the following income levels: Married filing jointly (and surviving spouses): $427,550; Head of household: $402,150; Single: $376,700; Married filing separately: $213,775.[7]

In 2006 through 2010, the phaseout was gradually reduced each year until it was completely repealed. During this time, the amended phaseout amount was calculated by multiplying the otherwise applicable phaseout amount by the "applicable fraction." The applicable fraction for each year was as follows: 66.6 percent (⅔) in 2006 and 2007; 33.3 percent (⅓) in 2008 and 2009; and 0 percent in 2010, 2011, and 2012.[8]

1. Treas. Reg. §1.179-1(e)(1).
2. Treas. Reg. §1.179-6.
3. Rev. Proc. 2013-35.
4. IRC Sec. 151.
5. IRC Sec. 151(e).
6. IRC Secs. 151(d)(3), 151(d)(4); Rev. Proc. 2013-35.
7. Rev. Proc. 2013-35, above.
8. IRC Secs. 151(d)(3)(E), 151(d)(3)(F).

A child or other dependent (i.e., an individual who may be claimed as a dependent by another taxpayer) who files his own return cannot claim a personal exemption for himself.[1]

627. What conditions must be met to entitle the taxpayer to a dependency exemption?

A taxpayer may claim the dependency exemption for each dependent with respect to whom the following tests are met.[2] The term "dependent" means a "qualifying child" (see below) or a "qualifying relative" (see below).[3]

Dependents may not claim a personal exemption for themselves in addition to the exemption claimed by the taxpayer who supports them.[4] The dependent, if married, must not file a joint return with his or her spouse.[5] In addition, the term "dependent" does not include an individual who is not a citizen or resident of the United States (*or* a resident of Canada or Mexico). However, a legally adopted child who does not satisfy the residency or citizenship requirements may nevertheless qualify as a dependent if certain requirements are met.[6]

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 his return.[7]

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, half-brother, half-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 attained the age of 19 as of the close of the calendar year in which the taxable year begins, *or* (ii) is a student who has not attained the age of 24 as of the close of the calendar year;

(4) has *not* provided over one-half of the individual's own support for the calendar year in which the taxpayer's taxable year begins; *and*

(5) has not filed a joint tax return (other than for a refund) for the taxable year.[8]

1. IRC Sec. 151(d)(2).
2. IRC Secs. 151, 152.
3. IRC Sec. 152(a).
4. IRC Sec. 152(b)(1).
5. IRC Sec. 152(b)(2).
6. IRC Sec. 152(b)(3).
7. See, e.g., *Miller v. Comm.*, 114 TC 184 (2000).
8. IRC Sec. 152(c), as amended by FCSIAA 2008. See also FS-2205-7 (Jan. 2005).

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.[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] Any adopted children of the taxpayer are treated the same as natural born children.[3]

Qualifying relative. The term "qualifying relative" means an individual:

(1) who is the taxpayer's:

- (i) 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 (see below);

(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.

The Service has provided guidance for determining whether an individual is a qualifying relative for whom the taxpayer may claim a dependency exemption deduction under IRC Section 151(c). The guidance clarifies that an individual is not a qualifying child of "any other taxpayer" if the individual's parent (or other person with respect to whom the individual is defined as a qualifying child) is not required (by IRC Section 6012) to file an income tax return and either (1) does not file an income tax return, or (2) files an income tax return solely to obtain a refund of withheld income taxes.[4]

1. IRC Sec. 152(f)(1).
2. IRC Sec. 152(f)(1)(C).
3. IRC Sec. 152(f)(1)(B).
4. Notice 2008-5, 2008-2 IRB 256.

The amount of the personal exemption ($3,950 in 2014, $3,900 in 2013, $3,800 in 2012 and $3,700 for 2011) is adjusted annually for inflation. The exemption is subject to phaseout for certain upper income taxpayers (but not in 2010-2012). For details, see Q 626.

Life insurance premiums on a child's life are not included in determining the cost of the child's support.[1]

The Tax Court held that a dependent's self-employment loss did not reduce her earned income for purposes of determining her standard deduction under IRC Section 63(c)(5)(B).[2]

628. Who is entitled to claim a dependency exemption for a child in the case of divorced parents?

In the case of divorced parents who between them provide more than one-half of a child's support for the calendar year, and have custody of the child for more than one-half of the calendar year, the custodial parent (i.e., the one having custody for the greater portion of the year) is generally allowed the dependency exemption. However, the noncustodial parent can claim the exemption if the custodial parent signs a written declaration (i.e., Form 8332, or a statement conforming to the substance of Form 8332) agreeing not to claim the child as a dependent, *and* the noncustodial parent attaches the declaration to the tax return for the calendar year. The noncustodial parent can also claim the exemption if a divorce decree or separation agreement executed before 1985 expressly provides such and he provides at least $600 for the support of the child during the calendar year.[3] The Tax Court held that the special support rule under IRC Section 152(e) applies to parents who have never been married as well as divorced parents.[4]

The Service has clarified that a custodial parent may revoke the release of the dependency exemption and, therefore, claim the dependency exemption himself, but only if the noncustodial parent agrees and does not claim the child.[5]

In *Miller v. Comm.*,[6] the Tax Court denied the dependency exemption to the noncustodial parent where the custodial parent had not signed a release of the claim to the exemption. The court order, which gave the noncustodial parent the right to claim the exemption, was held not to be a valid substitute.

In *Boltinghouse v. Comm.*,[7] the Tax Court held that there is no requirement in IRC Section 152(e) or the regulations that a spouse's waiver of his claim to a dependency exemption deduction be incorporated into a divorce decree to be effective. The court stated that such a requirement would make Form 8332 itself ineffective on its own. The court also recognized that under the applicable state law (Delaware), the separation agreement created binding contractual obligations

1. *Kittle v. Comm.*, TC Memo 1975-150; *Vance v. Comm.*, 36 TC 547 (1961).
2. *Briggs v. Comm.*, TC Summary Opinion 2004-22.
3. IRC Secs. 152(e)(1), 152(e)(2); Treas. Reg. §1.152-4.
4. *King v. Comm.*, 121 TC 245 (2003). See also Preamble, REG-149856-03, 72 Fed. Reg. 24192, 24194 (5-2-2007).
5. Legal Memorandum 200007031.
6. 114 TC 184 (2000).
7. TC Memo 2003-134.

that did not cease upon the entry of a divorce decree (regardless of whether the agreement was merged or incorporated into the decree).

In *Omans v. Comm.*,[1] the Tax Court determined that the custodial parent's certified signature on the settlement agreement signified her sworn agreement to the settlement agreement's contents, including her former spouse's entitlement to the dependency exemption.

A state appeals court held that federal law does not preempt a state family law court in its discretion from alternating the dependency exemption between the parents, even though one parent may have custody during the calendar year for less than half the year.[2]

The IRS has provided interim guidance under IRC Section 152(c)(4), which is the rule for determining which taxpayer may claim a qualifying child when two or more taxpayers claim the same child. It clarifies that unless the special rule in IRC Section 152(e) applies (see above), the tie-breaking rule in IRC Section 152(c)(4) applies to the head of household filing status, the child and dependent care credit, the child tax credit, the earned income credit, the exclusion for dependent care assistance, and the dependency deduction as a group, rather than on a section-by-section basis.[3]

Deductions

629. What itemized deductions may be taken by an individual taxpayer?

Itemized deductions are subtracted from adjusted gross income in arriving at taxable income; they may be claimed in addition to deductions for adjusted gross income (see Q 619). Itemized deductions are also referred to as "below-the-line" deductions.

Among the itemized deductions taxpayers may be able to claim are the following:

…Interest, within limits (see Q 7932 to Q 7945).

…Personal expenses for the production or collection of taxable income, within limits (see Q 7948), 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 7950). Deduction of expenses paid in connection with tax-exempt income may be disallowed (see Q 7949). Certain business expenses and expenses for the production of rents and royalties are deductible *in arriving at* adjusted gross income (see Q 619).

…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 (*for the sales tax deduction, see below*). If taxes other than these are incurred in connection with the acquisition or disposition

1. TC Summary Opinion 2005-110.
2. *Rios v. Pulido*, 2002 Cal. App. LEXIS 4412 (2nd App. Dist. 2002).
3. Notice 2006-86, 2006-51 IRB 680.

of property, they must be treated as part of the cost of such property or as a reduction in the amount realized on the disposition.[1]

...Uncompensated personal casualty and theft losses. But 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 $100 amount increased to $500 for 2009 only.[2] 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.[3] Uncompensated casualty and theft losses in connection with a taxpayer's business or in connection with the production of income are deductible in full (see Q 7772).

Stock losses. The IRS has announced that it intends to disallow deductions under IRC Section 165(a) for theft losses relating to declines in value of publicly traded stock when the decline is attributable to corporate misconduct. If the stock is sold or exchanged or becomes wholly worthless, any resulting loss will be treated as a capital loss. Furthermore, the Service may also impose penalties under IRC Section 6662 in such cases.[4] In Field Attorney Advice, the Service concluded that a taxpayer was not entitled to a theft loss deduction for losses related to his exercise of stock options because he had not proven the elements of a theft loss.[5]

Abandoned securities. The Service has issued regulations concerning the availability and character of a loss deduction under IRC Section 165 for losses sustained from abandoned securities. IRC Section 165(g) provides that if any security that is a capital asset becomes worthless during the taxable year, the resulting loss is treated as a loss from the sale or exchange of a capital asset (i.e., a capital loss) on the last day of the taxable year (unless the exception in IRC Section 165(g)(3)—concerning worthless securities of certain affiliated corporations—applies). For purposes of applying the loss characterization rule of IRC Section 165(g), the abandonment of a security establishes its worthlessness. According to the regulations, to abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. All the facts and circumstances determine whether the transaction is properly characterized as abandonment or some other type of transaction (e.g., an actual sale or exchange, contribution to capital, dividend, or gift). The regulations are effective for stock or other securities abandoned after March 12, 2008.[6]

...Contributions to charitable organizations, within certain limitations (see Q 7954, Q 8001).

...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 tax years beginning before 2013) (see Q 635). There is a temporary exemption which

1. IRC Sec. 164(a).
2. IRC Sec. 165(h), as amended by TEAMTRA 2008.
3. IRC Sec. 165(h)(5)(E), as amended by TEAMTRA 2008.
4. Notice 2004-27, 2004-1 CB 782; Treasury Release JS-1263 (3-25-2004).
5. FAA 20073801F (8-1-2007).
6. Treas. Reg. §1.165-5(i).

keeps the threshold at 7.5 percent of AGI for individuals age 65 and older and their spouses until Dec. 31, 2016.

…Expenses of an employee connected with his employment. Generally, such expenses are "miscellaneous itemized deductions" (see Q 631).

…Federal estate taxes and generation-skipping transfer taxes paid on "income in respect of a decedent" (see Q 636).

Generally, certain moving expenses permitted under IRC Section 217 are deductible directly from gross income (see Q 619).

Many of these deductions are disallowed in calculating the alternative minimum tax (see Q 653).

In Chief Counsel Advice, the Service determined that deductions for expenses paid or incurred in connection with the administration of an individual's estate in bankruptcy, which would have not been incurred if the property were not held by the bankrupt estate, are treated as allowable in arriving at adjusted gross income.[1]

Sales tax deduction. 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.

The itemized deduction is based on *actual* sales taxes, or on the optional sales tax *tables* published by the IRS.[4] In general, a taxpayer may deduct actual state and local general sales taxes paid if the tax rate is the same as the general sales tax rate. If the tax rate is more than the general sales tax rate, sales taxes on motor vehicles are deductible as general sales taxes, but the tax is deductible only up to the amount of tax that would have been imposed at the general sales tax rate. Sales taxes on food, clothing, medical supplies, and motor vehicles are deductible as a general sales tax even if the tax rate was less than the general sales tax rate.[5] The Service reminds taxpayers that actual receipts showing general sales taxes paid must be kept to use the actual expense method.[6]

Using the optional state sales tax tables, taxpayers may use their income level and number of exemptions to find the sales tax amount for their state.[7] Taxpayers may add an amount for *local* sales taxes if appropriate. In addition, taxpayers may add to the table amount any sales taxes paid on: (1) a motor vehicle, but only up to the amount of tax paid at the general sales

1. CCA 200630016.
2. IRC Sec. 164(b)(5)(A).
3. IRC Sec. 164(b)(5)(I), as amended by TEAMTRA 2008.
4. See IRC Sec. 164(b)(5)(H).
5. See IRC Secs. 164(b)(5)(C), 164(b)(5)(D), 164(b)(5)(F). See also Pub. 600, State and Local General Sales Taxes (2006); FS-2006-9 (Jan. 2006).
6. Pub. 600.
7. See Publication 600, State and Local General Sales Taxes, pp. 2 – 4 (2006).

tax rate; and (2) an aircraft, boat, home, or home building materials if the tax rate is the same as the general sales tax rate.[1]

The Service has commented that although the sales tax deduction mainly benefits taxpayers with a state or local sales tax but no income tax (i.e., Alaska, Florida, South Dakota, Texas, Washington, and Wyoming), it may also give a larger deduction to any taxpayer who paid more in sales taxes than income taxes. For example, an individual might have bought a new car, thus boosting the sales tax total, or claimed tax credits, and lowering the state income tax paid.[2] Additional guidance on claiming the sales tax deduction is set forth in Notice 2005-31.[3]

630. What is the limitation on certain high income taxpayers' itemized deductions?

There was no phaseout of itemized deductions based on adjusted gross income (AGI) in 2010-2012. Under the American Taxpayer Relief Act of 2012 ("ATRA"), the phaseout resumed for tax years beginning in 2013 and thereafter.

Therefore, in 2014, the aggregate of most itemized deductions is reduced dollar-for-dollar by the lesser of (1) 3 percent (but see *Adjustments to Limit*, below, for tax years beginning before 2010) of the amount of adjusted gross income that exceeds a certain income-based threshold amount (in 2014, the threshold is $254,200 for individual taxpayers, $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.[4] The threshold income levels for determining the phaseout are adjusted annually for inflation.[5]

Adjustments to limit for 2005-2009 tax years. For taxable years beginning after 2005, the limitation on itemized deductions was gradually reduced until it was completely repealed in 2010. The amended limitation amount was calculated by multiplying the otherwise applicable limitation amount by the "applicable fraction." The "applicable fraction" for each year was as follows: 66.6 percent (⅔) in 2006 and 2007; 33.3 percent (⅓) in 2008 and 2009; and 0 percent in 2010-2012.[6]

The limitation on 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.[7] The limitation also is not applicable to estates and trusts.[8] 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

1. See Pub. 600, State and Local General Sales Taxes (2006); see also FS-2006-9 (Jan. 2006).
2. FS-2006-9 (Jan. 2006).
3. 2005-14 IRB 830.
4. IRC Sec. 68(a).
5. IRC Sec. 68(b); as amended by ATRA, Sec. 101(2)(b); Rev. Proc. 2008-66, 2008-45 IRB 1107.
6. IRC Sec. 68(f) (deleted by ATRA, Sec. 101(2)(b)).
7. IRC Sec. 68(c).
8. IRC Sec. 68(e).

deductions are applied *before* the overall ceiling on itemized deductions is applied.[1] The deduction limitation is not taken into account in the calculation of the alternative minimum tax.[2]

631. What are miscellaneous itemized deductions? What limits apply?

"Miscellaneous itemized deductions" are deductions *from* adjusted gross income ("itemized deductions") *other than* the 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 (see Q 7529, Q 7530), (9) certain adjustments under the IRC claim of right provisions, (10) unrecovered investment in an annuity contract, (11) amortizable bond premium (see Q 7639, Q 7646), and (12) certain expenses of cooperative housing corporations.[3]

"Miscellaneous itemized deductions" are allowed only to the extent that the aggregate of all such deductions for the taxable year exceeds 2 percent of adjusted gross income.[4] For tax years other than 2010 through 2012, miscellaneous itemized deductions are also subject to the phaseout for certain upper income taxpayers (see Q 630).

Miscellaneous itemized deductions generally 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.[5]

Expenses that relate to both a trade or business activity and a production of income or tax preparation activity (see Q 7948, Q 7950) must be allocated between the activities on a reasonable basis.[6]

Certain legal expenses from employment-related litigation may be deductible.[7] In *Biehl v. Comm.*,[8] the Ninth Circuit Court of Appeals affirmed the Tax Court's holding that attorneys' fees paid in connection with employment related litigation must be treated as a miscellaneous itemized deduction, and *not* as an above-the-line deduction. The Ninth Circuit stated that simply because a lawsuit arises out of the taxpayer's former employment, that determination is not sufficient to qualify the taxpayer's attorneys' fees for an above-the-line deduction under IRC Section 62(a)(2)(A). Concurring in the Tax Court's analysis, the Ninth Circuit reiterated that the proper inquiry in deciding whether an expense has a "business connection" is what the expenditure was "in connection with" and not simply whether the expenditure arose from, or had its origins in, the taxpayer's trade or business. According to the appeals court, whereas

1. IRC Sec. 68(d).
2. IRC Sec. 56(b)(1)(F).
3. IRC Sec. 67(b).
4. IRC Sec. 67(a).
5. Temp. Treas. Reg. §1.67-1T(a)(1).
6. Temp. Treas. Reg. §1.67-1T(c).
7. See, e.g., *Kenseth v. Comm.*, 88 AFTR 2d 2001-5378, 259 F.3d 881 (7th Circuit 2001); *Brenner v. Comm.*, TC Memo 2001-127; *Reynolds v. Comm.*, 296 F.3d 607 (7th Cir. 2002); *Chaplain v. Comm.*, TC Memo 2007-58.
8. 351 F. 3d 982 (9th Cir. 2003).

IRC Section 62(a)(1) only requires that the expense be attributable to a trade or business, the language in IRC Section 62(a)(2)(A) is much more definite. The court concluded that for a reimbursable expense to qualify for an above-the-line deduction not only must it be attributable to a trade or business, it must also have been incurred during the course of "performance of services as an employee."[1]

The IRC prohibits the indirect deduction, through pass-through entities, of amounts (i.e., miscellaneous itemized deductions) that would not be directly deductible by individuals.[2] However, publicly offered mutual funds are not subject to this rule, and "pass-through entity," for this purpose, does not include estates, trusts (except for grantor trusts and certain common trust funds), cooperatives, or real estate investment trusts.[3] Affected pass-through entities (including partnerships, S corporations, nonpublicly offered mutual funds, and REMICs) must generally allocate to each investor his respective share of such expenses; the investor must then take the items into account for purposes of determining his taxable income and deductible expenses, if any.[4] See Q 7674, Q 7851, Q 7866, Q 7699, and Q 7736 regarding REMICs, mutual funds, exchange-traded funds, publicly traded limited partnerships, and S corporations, respectively.

632. Is interest deductible?

The deductibility of interest depends on its classification, as described below. Furthermore, interest expense that is deductible under the rules below may be subject to the additional limitation on itemized deductions (unless it is investment interest, which is not subject to that provision). Interest must be classified and is deductible within the following limitations:

(1) *Investment interest*. This includes any interest expense on indebtedness properly allocable to property held for investment.[5] Generally, investment interest is deductible only to the extent of investment income; however, investment interest in excess of investment income may be carried over to succeeding tax years. For purposes of this calculation, net long-term capital gain income is included in investment income if the taxpayer foregoes the reduced tax rate (0%/15%/20%) that applies to such income. Under JGTRRA 2003, as extended by ATRA, certain dividends are taxable at the lower capital gains rates rather than at higher ordinary income tax rates. A dividend will be treated as investment income for purposes of determining the amount of deductible investment interest income only if the taxpayer elects to treat the dividend as *not* being eligible for the reduced rates.[6] For the temporary regulations relating to an election that may be made by noncorporate taxpayers to treat qualified dividend income as investment income for purposes of calculating the deduction for investment interest, see Treasury Regulation Section 1.163(d)-1.[7]

1. *Biehl*, above, *aff'g*, 118 TC 467 (2002).
2. IRC Sec. 67(c)(1); Temp. Treas. Reg. §1.67-2T.
3. IRC Sec. 67(c); Temp. Treas. Reg. §1.67-2T(g)(2).
4. Temp. Treas. Reg. §1.67-2T(a).
5. IRC Sec. 163(d)(3).
6. IRC Secs. 1(h)(11)(D)(i), as amended by ATRA, 163(d)(4)(B).
7. 69 Fed. Reg. 47364 (8-5-2004). See also, 70 Fed. Reg. 13100 (3-18-2005).

(2) *Trade or business interest*. This includes any interest incurred in the conduct of a trade or business. Generally, such interest is deductible as a business expense.[1]

(3) *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). There is a limitation of $1,000,000 on the aggregate amount of debt that may be treated as acquisition indebtedness, *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 fair market value of the home less the acquisition indebtedness, or refinancing to borrow against the "equity" in the home) is $100,000.[2] Indebtedness incurred on or before October 13, 1987 (and limited refinancing of it) that is secured by a qualified residence is considered acquisition indebtedness. This pre-October 14, 1987 indebtedness is not subject to the $1,000,000 aggregate limit, but is included in the aggregate limit as it applies to indebtedness incurred after October 13, 1987.[3] (For 2007 through 2013, certain mortgage insurance premiums are treated as qualified residence interest).[4]

A "qualified residence" is the taxpayer's principal residence and one other residence that the taxpayer (a) used during the year for personal purposes more than 14 days or, if greater, more than 10 percent of the number of days it was rented at a fair rental value, or (b) used as a residence but did not rent during the year.[5]

Subject to the above limitations, qualified residence interest is deductible. If indebtedness used to purchase a residence is secured by property other than the residence, the interest incurred on it is not residential interest but is personal interest.[6] The Tax Court denied a deduction for mortgage interest to individuals renting a home under a lease with an option to purchase the property. Although the house was their principal residence, they did not have legal or equitable title to the home and the earnest money did not provide ownership status.[7] An individual member of a homeowner's association was denied a deduction for interest paid by the association on a common building because the member was not the party primarily responsible for repaying the loan and the member's principal residence was not the specific security for the loan.[8] Assuming that the loan was otherwise a

1. IRC Sec. 162.
2. IRC Sec. 163(h)(3).
3. IRC Sec. 163(h)(3)(D).
4. IRC Sec. 163(h)(3)(E), as amended by ATRA.
5. IRC Sec. 163(h)(4)(A). See, e.g., FSA 200137033.
6. Let. Ruls. 8743063 and 8742025.
7. *Blanche v. Comm.*, TC Memo 2001-63, *aff'd without opinion*, 2002 U.S. App. LEXIS 6379 (5th Cir. 2002).
8. Let. Rul 200029018.

bona fide debt, a taxpayer could deduct interest paid on a mortgage loan from his qualified plan, even though the amount by which the loan exceeded the $50,000 limit of IRC Section 72(p) was deemed to be a taxable distribution.[1]

(4) *Interest taken into account in computing income or loss from a passive activity*. A passive activity is generally an activity that involves the conduct of a trade or business but in which the taxpayer does not materially participate, or any rental activity.[2]

(5) *Interest on extended payments of estate tax*. Generally, this interest is deductible.

(6) *Interest on education loans*. An above-the-line deduction is available to certain taxpayers for interest paid on a "qualified education loan."[3] The deduction is subject to a limitation of $2,500 in 2014. The deduction is phased out for 2014, ratably for taxpayers with modified AGI between $65,000 and $80,000 ($130,000 and $160,000 for joint returns).[4] Certain other requirements must be met for the deduction to be available.[5]

(7) *Personal interest*. This is any interest expense not described in (1) through (6) above and is often referred to as "consumer" interest.[6] Personal interest includes interest on indebtedness properly allocable to the purchase of consumer items and interest on tax deficiencies. Personal interest is not deductible.[7]

The proper allocation of interest generally depends on the use to which the loan proceeds are put, except in the case of qualified residence interest. Detailed rules for classifying interest by tracing the use of loan proceeds are contained in temporary regulations.[8] The interest allocation rules apply to interest expense that would otherwise be deductible.[9]

Various provisions in the Code may prohibit or delay the deduction of certain types of interest expense. For example, no deduction is allowed for interest paid on a loan used to buy or carry tax-exempt securities or, under certain conditions, for interest on a loan used to purchase or carry a life insurance or annuity contract (see Q 3).

633. What is the maximum annual limit on the income tax deduction allowable for charitable contributions?

An individual who itemizes may take a deduction for certain contributions "to" or "for the use of" charitable organizations. The amount that may be deducted by an individual in any one year is subject to the income percentage limitations as explained below. The value that may be taken into account for various gifts of property depends on the type of property

1. FSA 200047022.
2. IRC Secs. 163(d), 469(c).
3. IRC Secs. 163(h)(2)(F), 221.
4. IRC Sec. 221(b); Rev. Proc. 2013-35, 2013-47 IRB 537.
5. See IRC Sec. 221; Treas. Reg. §1.221-1.
6. IRC Sec. 163(h)(2).
7. IRC Sec. 163(h)(1).
8. See Temp. Treas. Reg. §1.163-8T.
9. Temp. Treas. Reg. §1.163-8T(m)(2).

and the type of charity to which it is contributed; these rules are explained under separate headings below.

For an explanation of the deduction for charitable gifts of life insurance, see Q 115.

Income Percentage Limits

Fifty percent limit. An individual is allowed a charitable deduction of up to 50 percent of his adjusted gross income for a charitable contribution *to*: 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; 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[1]) that generally direct their support to public charities.[2] The above organizations are often referred to as "50 percent-type charitable organizations."

Thirty percent limit. The deduction for contributions of most long-term capital gain property to the above 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 adjusted gross income, or (b) 50 percent of adjusted gross income minus the amount of charitable contributions allowed for contributions to the 50 percent-type charities.[3]

Twenty percent limit. The deduction for contributions of long-term capital gain property to most private foundations (see below) is limited to the lesser of (a) 20 percent of the taxpayer's adjusted gross income, or (b) 30 percent of adjusted gross income minus the amount of charitable contributions allowed for contributions to the 30 percent-type charities.[4]

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.[5]

Gifts are "to" a charitable organization if made directly to the organization. "For the use of" applies to indirect contributions to a charitable organization (e.g., an income interest in property, but not the property itself).[6] 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.

1. See IRC Sec. 170(b)(1)(E).
2. IRC Sec. 170(b)(1)(A).
3. IRC Secs. 170(b)(1)(B), 170(b)(1)(C).
4. IRC Sec. 170(b)(1)(D).
5. IRC Secs. 170(d)(1), 170(b)(1)(D)(ii).
6. See Treas. Reg. §1.170A-8(a)(2).

Gifts of Long-term Capital Gain Property

If an individual makes a charitable contribution to a 50 percent-type charity of property that, if sold, would have resulted in long-term capital gain (other than certain tangible personal property, see below), he 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.[1]

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."[2]

Any portion of a gift of long-term capital gain property to a 50 percent-type organization that is disallowed as a result of the adjusted gross income limitation may be carried over for five years, retaining its character as a 30 percent type deduction.[3]

A taxpayer may elect in any year to have gifts of long-term capital gain property be subject to a 50 percent of adjusted gross income limit; if he does so, the gift is valued at the donor's adjusted basis. 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) and is generally irrevocable for that year.[4]

Gifts of 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, up to 30 percent of the individual's adjusted gross income; however, if the property is unrelated use property, the deduction is generally limited to the donor's adjusted basis.[5]

Gifts to Private Foundations

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 50 percent-type organizations.[6] 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

1. IRC Sec. 170(b)(1)(C).
2. IRC Sec. 1222(3).
3. IRC Sec. 170(b)(1)(C)(ii).
4. IRC Sec. 170(b)(1)(C)(iii); *Woodbury v. Comm.*, TC Memo 1988-272, *aff'd*, 90-1 USTC ¶50,199 (10th Cir. 1990).
5. IRC Secs. 170(e)(1)(B), 170(b)(1)(C); Treas. Reg. §1.170A-4(b).
6. See IRC Secs. 170(b)(1)(E), 170(b)(1)(A)(vii).

adjusted basis; however, certain gifts of *qualified appreciated stock* made to a private foundation are deductible at their full fair market value.[1]

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.[2] 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.[3] The Service has determined that shares in a mutual fund can constitute qualified appreciated stock.[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 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 determining whether gain on such stock is long-term capital gain for purposes of determining the amount of a charitable contribution.[6]

A contribution of a partial interest in property is deductible only if the donee receives an undivided portion of the donor's entire interest in the property. Such a contribution was upheld even where the donee did not take possession of the property during the tax year.[7] Generally, a deduction is denied for the mere use of property or for any interest which is less than the donor's entire interest in the property, unless the deduction would have been allowable if the transfer had been in trust.

634. What substantiation requirements apply in order for a taxpayer to take an income tax deduction for charitable contributions?

No charitable deduction is allowed 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.[8]

Charitable contributions of $250 or more (whether in cash or property) must be substantiated by a contemporaneous written acknowledgment of the contribution supplied by the charitable organization. Substantiation is not required if certain information is reported on a return filed by the charitable organization.[9] (An organization can provide the acknowledgement

1. IRC Sec. 170(e)(5).
2. IRC Sec. 170(e)(5).
3. IRC Sec. 170(e)(5)(C).
4. Let. Rul. 199925029. See also Let. Rul. 200322005 (ADRs are qualified appreciated stock).
5. IRC Sec. 170(e)(1)(A).
6. IRC Sec. 170(e)(1).
7. *Winokur v. Comm.*, 90 TC 733 (1988), acq. 1989-1 CB 1.
8. IRC Sec. 170(f)(17).
9. IRC Sec. 170(f)(8).

electronically, such as via an e-mail addressed to the donor).[1] Special rules apply to the substantiation and disclosure of quid pro quo contributions and contributions made by payroll deduction.[2] A qualified appraisal is generally required for contributions of nonreadily valued property for which a deduction of more than $5,000 is claimed.[3]

No charitable deduction is allowed for a contribution of clothing or a household item unless the property is in good or used condition. Regulations may deny a deduction for a contribution of clothing or a household item which 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]

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.[5]

635. What are the limits on the medical expense deduction?

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, his spouse and his dependents, to the extent that such expenses exceed 10 percent (7.5 percent before 2013) of his adjusted gross income. (On a joint return, the 10 percent floor amount is based on the combined adjusted gross income of husband and wife.) The taxpayer first determines his net unreimbursed expenses by subtracting all reimbursements received during the year from total expenses for medical care paid during the year. He must then subtract 10 percent of his adjusted gross income from net unreimbursed medical expenses; only the balance, if any, is deductible.[6] The deduction for medical expenses is not subject to the phaseout in itemized deductions for certain upper income taxpayers. (See Q 629.)

Though the 7.5 percent threshold increased to 10 percent in 2013, the 7.5 percent threshold will continue to apply 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.[7]

The Service ruled that amounts paid by individuals for diagnostic and certain similar procedures and devices, not compensated by insurance or otherwise, are deductible medical care

1. IRS Pub. 1771 (March 2008), p. 6.
2. Treas. Regs. §§1.170A-13(f), 1.6115-1.
3. IRC Sec. 170(f)(11).
4. IRC Sec. 170(f)(16).
5. See IRC Secs. 170(e)(1)(B), 170(f)(11), 170(f)(12), 170(m); Notice 2005-44, 2005-25 IRB 1287.
6. IRC Sec. 213.
7. IRC Sec. 213(d)(1).

expenses even though the individuals had no symptoms of illness. According to the Service, this includes an annual physical examination, a full-body electronic scan, and a pregnancy test.[1]

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.[2] But see *Al-Murshidi v. Comm.*[3] (the surgical removal of excess skin from a formerly obese individual was not "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; thus, 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 he pays for a dependent (within the specified limits) even though he is not entitled to a dependency exemption. The fact that the dependent's income exceeds $3,950 (in 2014 and $3,900 in 2013) for the year is immaterial so long as the taxpayer has furnished over one-half of his support. 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.[4] But in the case of a multiple support agreement, only the person designated to take the dependency exemption may deduct the dependent's medical expenses, and then only to the extent that he actually paid the expenses.[5] See Q 627.

Deductible medical expenses include amounts paid for lodging, up to $50 per individual per night, while away from home *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."[6] 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.[7] 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.[8] The Service 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

1. Rev. Rul. 2007-72, 2007-50 IRB 1154.
2. IRC Sec. 213(d)(9); see, e.g., Let. Rul. 200344010.
3. TC Summary Opinion 2001-185.
4. IRC Sec. 213(d)(5).
5. Treas. Reg. §1.213-1(a)(3)(i).
6. IRC Sec. 213(d)(2).
7. Let. Rul. 8516025.
8. Rev. Rul. 2000-24, 2000-19 IRB 963.

education and in those years each child had been diagnosed as having a medical condition that handicapped the child's ability to learn.[1]

Generally, medical expenses are deductible only in the year they are paid, regardless of when the expenses were incurred. (But see *Zipkin v. U.S.*,[2] holding that 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). 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.[3] However, medical expenses of a decedent paid out of his estate within one year from date of death are considered paid by the decedent at the time the expenses were incurred.[4] 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 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.[5]

The Social Security hospital tax that an individual pays as an employee or self-employed person cannot be deducted as a medical expense.[6] But a 65-year-old who has signed up for the supplementary medical plan under Medicare can treat his monthly premiums as amounts paid for insurance covering medical care.[7] A new voluntary prescription drug insurance program, Medicare Part D, went into effect on January 1, 2006. According to the Service, an individual taxpayer can include in medical expenses the premiums paid for Medicare Part D insurance.[8]

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).[9] 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.[10] But, a federal district court held that none of an 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 (citing *Comm. v. Tufts*[11]).[12]

1. See Let. Rul. 200521003. See also Let. Rul. 200729019.
2. 86 AFTR 2d 2000-7052, 2000-2 USTC ¶50,863 (D. Minn. 2000).
3. *Henderson v. Comm.*, TC Memo 2000-321.
4. IRC Sec. 213(c).
5. Rev. Rul. 77-357, 1977-2 CB 328.
6. See IRC Sec. 213(d).
7. Rev. Rul. 66-216, 1966-2 CB 100.
8. See IRS Pub. 502, Medical and Dental Expenses.
9. Rev. Rul. 76-481, 1976-2 CB 82, *as clarified by* Rev. Rul. 93-72, 1993-2 CB 77; Let. Rul. 8641037.
10. *Baker v. Comm.*, 122 TC 143 (2004).
11. 461 U.S. 300, 307 (1983).
12. *Finzer v. United States*, 496 F. Supp. 2d 954 (N.D. Ill. 2007).

Amounts paid by an individual for medicines and drugs, which can be purchased without a doctor's prescription, are not deductible.[1] 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. (In this ruling, the IRS determined that the crutches were used to mitigate the effect of the taxpayer's injured leg and the blood sugar test kits were used to monitor and assist in treating the taxpayer's diabetes; accordingly, the costs were amounts paid for medical care and were deductible).[2]

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.[3] Certain expenses for smoking cessation programs and products are deductible as a medical expense.[4]

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. But amounts paid by individuals to whiten teeth discolored as a result of age are not medical care expenses and are not deductible.[5]

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 are deductible as medical expenses; however, costs of diet food are not deductible.[6] According to 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.[7]

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.[8] Egg donor fees and expenses relating to obtaining a willing egg donor count as medical care expenses that are deductible.[9]

1. Rev. Rul. 2003-58, 2003-22 IRB 959.
2. Rev. Rul. 2003-58, above; see also IRS Information Letter INFO-2003-169 (6-13-2003).
3. IRS Pub. 502, Medical and Dental Expenses.
4. See Rev. Rul. 99-28, 1999-25 IRB 6.
5. Rev. Rul. 2003-57, 2003-22 IRB 959.
6. Rev. Rul. 2002-19, 2002-16 IRB 778.
7. Information Letter INFO 2003-0202.
8. Let. Rul. 8919009.
9. Let. Rul. 200318017; see also Information Letter INFO 2005-0102 (3-29-2005).

The Service has clarified that no deduction is allowed for the cost of drugs imported from Canada.[1]

636. What is income in respect of a decedent and how is it taxed? Is the recipient entitled to an income tax deduction for estate and generation-skipping transfer taxes paid on this income?

"Income in respect of a decedent" (IRD) refers to those amounts to which a decedent was entitled as gross income, but that were not includable in his taxable income for the year of his death.[2] It can include, for example: renewal commissions of a sales representative; payment for services rendered before death or under a deferred compensation agreement; and proceeds from sales on the installment method (see Q 586). Generally, if stock is acquired in an S corporation from a decedent, the pro rata share of any income of the corporation that would have been IRD if that item had been acquired directly from the decedent is IRD.[3]

The IRS has determined that a distribution from a qualified plan of the balance as of the employee's death is IRD.[4] The Service has also privately ruled that a distribution from a 403(b) tax sheltered annuity is IRD.[5] The Service has also concluded that a death benefit paid to beneficiaries from a deferred variable annuity would be IRD to the extent that the death benefit exceeded the owner's investment in the contract.[6] In addition, the Service has determined that distributions from a decedent's individual retirement account were IRD, including those parts of the distributions used to satisfy the decedent's estate tax obligation, since the individual retirement account was found to have automatically vested in the beneficiaries.[7]

However, a rollover of funds from a decedent's IRA to a marital trust and then to the surviving spouse's IRA was not IRD, according to the Service, where the surviving spouse was the sole trustee and sole beneficiary of the trust.[8] The Service also ruled that designation of a QTIP trust as the beneficiary of a decedent's account balance in a qualified profit sharing plan would not result in the acceleration of IRD at the time the assets from the plan passed into the trust. Consequently, the taxpayer would include the amounts of IRD in the plan in the taxpayer's gross income only when the taxpayer received a distribution (or distributions) from the trust.[9]

Gain realized upon the cancellation at death of a note payable to a decedent has been held to be IRD to the decedent's estate.[10]

The unreported increase in value reflected in the redemption value of savings bonds as of the date of a decedent's death constitutes income in respect of a decedent.[11] See Q 7668. If savings

1. See Information Letter INFO 2005-0011 (3-14-2005); see also Pub. 502.
2. IRC Sec. 691(a).
3. IRC Sec. 1367(b).
4. Rev. Rul. 69-297, 1969-1 CB 131; Rev. Rul. 75-125, 1975-1 CB 254.
5. Let. Rul. 9031046.
6. Let. Rul. 200041018.
7. Let. Rul. 9132021. See Rev. Rul. 92-47, 1992-1 CB 198. See also Let. Rul. 200336020.
8. Let. Rul. 200023030.
9. Let. Rul. 200702007.
10. *Est. of Frane v. Comm.*, 998 F.2d 567 (8th Cir. 1993).
11. See Rev. Rul. 64-104, 1964-1 CB 223.

bonds on which the increases in value have not been reported are inherited, or the subject of a bequest, the reporting of such amounts may be delayed until the bonds are redeemed or disposed of by the legatee, or reach maturity, whichever is first.[1] However, to the extent savings bonds are distributed by an estate or trust to satisfy *pecuniary* obligations or legacies, the estate or trust is required to recognize the unreported incremental increase in the redemption price of Series E bonds as income in respect of a decedent.[2]

The Service determined that in the case of a taxpayer who dies before a short sale of stock is closed, any income that may result from the closing of the short sale is not IRD, and the basis of any stock held on the date of the taxpayer's death will be stepped up.[3] The Service also privately ruled that in the case of a sales contract entered into before the decedent's death, where an economically material contingency existed at the time of the decedent's death that might have disrupted the sale of the real property, any gain realized from the sale of the real property after the decedent's death did not constitute IRD.[4]

The Court of Appeals for the Tenth Circuit has held that an alimony arrearage paid to the estate of a former spouse was IRD and thus, taxable to the recipient beneficiaries as ordinary income.[5]

Generally IRD must be included in the gross income of the recipient; however, a deduction is normally permitted for estate and generation-skipping transfer taxes paid on the income. The amount of the total deduction is determined by computing the federal estate tax (or generation-skipping transfer tax) with the net IRD included and then recomputing the tax with the net IRD excluded. The difference in the two results is the amount of the income tax deduction. However, if two or more persons receive IRD of the same decedent, each recipient is entitled to only a proportional share of the income tax deduction. Similarly, if the IRD is received over more than one taxable year, only a proportional part of the deduction is allowable each year. Where the income would have been ordinary income in the hands of the decedent, the deduction is an itemized deduction.[6] The recipient does not receive a stepped up basis (see Q 598).[7] A beneficiary was allowed to claim a deduction for IRD attributable to annuity payments that had been received even though the estate tax had not yet been paid.[8]

In technical advice, the IRS stated that the value of a decedent's IRA should not be discounted for estate tax purposes to reflect income taxes that will be payable by the beneficiaries upon receipt of distributions from the IRAs or for lack of marketability. The Service reasoned that the deduction is a statutory remedy for the adverse income tax impact and makes any valuation discount inappropriate if the deduction applies.[9] Courts have likewise

1. See Let. Ruls. 9845026, 9507008, 9024016.
2. Let. Rul. 9507008.
3. Let. Rul. 9436017. See IRC Sec. 1014.
4. Let. Rul. 200744001.
5. *Kitch v. Comm.*, 103 F. 3d 104, 97-1 USTC ¶50,124 (10th Cir. 1996).
6. IRC Sec. 691(c); Rev. Rul. 78-203, 1978-1 CB 199.
7. IRC Sec. 1014(c).
8. FSA 200011023.
9. TAM 200247001; see also TAM 200303010.

denied discounts for lack of marketability.[1] The Service also determined that a deduction claimed on a decedent's estate tax return – which represented income taxes paid by the estate on the estate's income tax return, which in turn were triggered by the amount distributed to the estate from the decedent's IRAs – was not allowable as a deduction under IRC Section 2053. According to the Service, even if the estate had not claimed the IRD deduction, the income taxes paid on the distributions from the IRAs would still not be deductible under IRC Section 2053 because any additional benefit beyond what Congress had intended would be unwarranted.[2]

The Service has ruled that if the owner-annuitant of a deferred annuity contract dies *before* the annuity starting date, and the beneficiary receives a death benefit under the annuity contract, the amount received by the beneficiary in a lump sum in excess of the owner-annuitant's investment in the contract is includible in the beneficiary's gross income as IRD. If the death benefit is instead received in the form of a series of periodic payments, the amounts received are likewise includible in the beneficiary's gross income in an amount determined under IRC Section 72 as IRD.[3] See, e.g., Let. Rul. 200537019 (where the Service ruled that the amount equal to the excess of the contract's value over the decedent's basis, which would be received by the estate as the named beneficiary of the contract upon surrender of the contract, would constitute IRD includible by the estate in its gross income; however, the estate would be entitled to a deduction for the amounts of IRD paid to charities in the taxable year, or for the remaining amounts of IRD that would be set aside for charitable purposes).

The Tax Court determined that because a signed withdrawal request from the decedent constituted an effective exercise of the decedent's right to a lump-sum distribution during his lifetime, the lump-sum distribution from TIAA-CREF was therefore income to the decedent and properly includable in the decedent's income. Accordingly, the court held, the lump sum payment received by the decedent's son was not a death benefits payment and, thus, was not includable in the son's gross income as IRD.[4]

In *Estate of Kahn*,[5] the Tax Court held that in computing the gross estate value, the value of the assets held in the IRAs is not reduced by the anticipated income tax liability following the distribution of IRAs, in part because IRC Section 691(c) addresses the potential double tax issue. The Tax Court further held that a discount for lack of marketability is not warranted because the assets in the IRAs are publicly traded securities. Payment of the tax upon distribution is not a prerequisite to making the assets in the IRA marketable; consequently there is no basis for the discount. In technical advice the Service has also determined that a discount for lack of marketability is not available to an estate where the deduction for IRD is available to mitigate the potential income tax liability triggered by the IRD assets.[6]

1. See *Est. of Smith v. U.S.*, 300 F.Supp.2d 474 (S.D. TX 2004), *appeal docketed*, No. 04-20194 (5th Cir. 2004); *Est. of Robinson v. Comm.*, 69 TC 227 (1977).
2. Let. Rul. 200444021.
3. Rev. Rul. 2005-30, 2005-20 IRB 1015.
4. *Eberly v. Comm.*, TC Summary Op. 2006-45.
5. 125 TC 227 (2005).
6. TAM 200247001; see also TAM 200303010.

637. How are business expenses reported for income tax purposes?

A deduction is permitted for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Examples of deductible business expenses include: (1) expenditures for reasonable salaries, (2) traveling expenses (within limits), and (3) certain rental expenses incurred for purposes of a trade or business.[1] Illegal payments made in the course of business, such as bribes to government officials or illegal rebates (see Q 577), are not deductible.[2] In 2014, the business standard mileage rate is 56 cents per mile. In 2013, the business standard mileage rate was 56.5 cents per mile[3] and in 2012 the business standard mileage rate was 55.5 cents per mile.[4]

The amount of the deduction for expenses incurred in carrying on a trade or business depends upon whether the individual is 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; however, where an employer has the right to control the manner and the means by which services are performed, an employer-employee relationship will generally be found to exist.[5] 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.[6] See Q 3829. Furthermore, according to decisions from the Sixth and Eleventh Circuit Courts of Appeals, 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.[7] The IRS has determined, however, that a district manager of an insurance company was an employee of the company, and not an independent contractor.[8] On the other hand, the IRS has determined that individuals who were 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.[9]

Independent contractors may deduct all allowable business expenses from gross income (i.e., "above-the-line") to arrive at adjusted gross income.[10] The business expenses of an employee are deductible from adjusted gross income (i.e., "below-the-line) if he itemizes instead of taking the standard deduction, but only to the extent that they exceed 2 percent of adjusted gross income when aggregated with other "miscellaneous itemized deductions".

Industrial agents (or "debit agents") are treated as employees for tax purposes.[11] Thus, as in the case of any employee, a debit agent can deduct transportation and away-from-home

1. IRC Sec. 162(a).
2. IRC Sec. 162(c).
3. IR 2012-95.
4. IR 2011-69; Ann. 2011-40, 2011-29 IRB; IR 2011-116, IR 2013-95.
5. See *Butts v. Comm.*, TC Memo 1993-478, *aff'd*, 49 F.3d 713 (11th Cir. 1995); Let. Rul. 9306029.
6. Rev. Rul. 90-93, 1990-2 CB 33.
7. See *Ware v. U.S.*, 67 F.3d 574 (6th Cir. 1995); *Butts v. Comm.*, above.
8. TAM 9342001.
9. TAM 9736002.
10. IRC Sec. 62(a)(1).
11. Rev. Rul. 58-175, 1958-1 CB 28.

traveling expenses *from* adjusted gross income if he itemizes, only to the extent that the aggregate of these and other miscellaneous itemized deductions exceeds 2 percent of adjusted gross income.[1]

Self-employed taxpayers are permitted a deduction equal to one-half of their self-employment (i.e., Social Security) taxes for the taxable year. This deduction is treated as attributable to a trade or business that does not consist of the performance of services by the taxpayer as an employee; thus it is taken "above-the line."[2]

In a legal memorandum concerning the deductibility of medical insurance costs, the Service ruled as follows: (1) A sole proprietor who purchases health insurance in his individual name has established a plan providing medical care coverage with respect to his trade or business, and therefore may deduct the medical care insurance costs for himself, his spouse, and dependents under IRC Section 162(l), but only to the extent the cost of the insurance does not exceed the earned income derived by the sole proprietor from the specific trade or business with respect to which the insurance was purchased. (2) 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, but a self-employed individual may not add the net profits from all his trades and businesses for purposes of determining the deduction limit under IRC Section 162(l)(2)(A). However, if a self-employed individual has more than one trade or business, he 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.[3] In a legal memorandum, the Service ruled that 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.[4]

In *Allemeier v. Commissioner*,[5] the Tax Court held that the taxpayer could deduct his expenses ($15,745) incurred in earning a master's degree in business administration to the extent those expenses were substantiated and education-related. The court based its decision on the fact that the taxpayer's MBA did not satisfy a minimum education requirement of his employer, nor did the MBA qualify the taxpayer to perform a new trade or business.

Expenses for business meals and entertainment must meet one of two tests, as defined in regulations, in order to be deductible. The meal must be: (1) "directly related to" the active conduct of the trade or business, or (2) "associated with" the trade or business. Generally, the deduction for business meals and entertainment expenses is limited to 50 percent of allowable expenses.[6] The 50 percent otherwise allowed as a deduction is *then* subject to the 2 percent floor

1. IRC Sec. 67.
2. IRC Sec. 164(f).
3. CCA 200524001.
4. CCA 200623001.
5. TC Memo 2005-207.
6. IRC Sec. 274(n)(1).

that applies to miscellaneous itemized deductions.[1] The taxpayer or his employee generally must be present for meal expenses to be deductible, and expenses that are lavish or extravagant may be disallowed. Substantiation is required for lodging expenses and, in the case of expenditures incurred on or after October 1, 1995, for most items of $75.00 or more.[2] An employee must generally provide an "adequate accounting" of reimbursed expenses to his employer.[3]

Standard Deduction

638. What is the standard deduction?

There are two ways that taxable income may be calculated: taxpayers may subtract from adjusted gross income (see Q 619) the sum of their personal exemptions and the standard deduction. Alternatively, taxpayers can deduct from adjusted gross income their allowable personal exemptions (see Q 626, Q 627) and the total of their itemized deductions (see Q 629).[4]

In the case of individuals, the standard deduction for taxable years beginning in 2014 is $12,400 for married individuals filing jointly and surviving spouses; $9,100 for heads of households, $6,200 for single individuals and married individuals filing separately.[5] The standard deduction is adjusted annually for inflation.[6]

Individuals who do not itemize and who are elderly (age 65 or older) or blind are entitled to increase their standard deduction. For taxable years beginning in 2010, individuals who are married or are surviving spouses are each entitled to an additional deduction of $1,200 (in 2014) if they are elderly and an additional $1,200 (in 2014) deduction if they are blind. The extra standard deduction is $1,550 (in 2014) for unmarried elderly taxpayers and $1,550 (in 2014) for unmarried blind taxpayers.[7] The additional amounts for elderly and blind individuals are indexed for inflation.[8]

The following taxpayers are ineligible for the standard deduction and thus must itemize their deductions or take a standard deduction of zero dollars: (1) married taxpayers filing separately, if either spouse itemizes[9], (2) non-resident aliens, (3) taxpayers filing a short year return because of a change in their annual accounting period, and (4) estates or trusts, common trust funds, or partnerships.[10]

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

1. Temp. Treas. Reg. §1.67-1T(a)(2).
2. Treas. Reg. §1.274-5(c)(2)(iii).
3. Treas. Reg. §1.274-5(f)(4).
4. IRC Sec. 63.
5. IRC Sec. 63(c); Rev. Proc. 2013-35.
6. IRC Sec. 63(c)(4).
7. IRC Sec. 63(f); Rev. Proc. 2013-35, above.
8. IRC Sec. 63(c)(4).
9. See, e.g., Legal Memorandum 200030023.
10. IRC Sec. 63(c)(6).

dependent's earned income (but the standard deduction so calculated cannot exceed the regular standard deduction amount above).[1] These dollar amounts are adjusted for inflation.[2]

"Marriage penalty" relief. EGTRRA 2001 increased the basic standard deduction for a married couple filing a joint return, providing for a phase-in of the increase until the basic standard deduction for a married couple filing jointly equaled twice the basic standard deduction for an unmarried individual filing a single return by 2009. JGTRRA 2003 accelerated the phase-in, providing that the basic standard deduction for a married couple filing a joint return equaled twice the standard deduction for an unmarried individual filing a single return for 2003 and 2004, then reverting to the lower, gradually increasing standard deduction amounts provided for under EGTRRA for 2005 through 2009. However, under WFTRA 2004 the standard deduction for married individuals filing jointly (and surviving spouses) is twice the amount (200 percent) of the standard deduction for unmarried individuals filing single returns for tax years beginning *after December 31, 2003*.[3] The larger standard deduction for married individuals filing jointly was scheduled to "sunset" (expire) for taxable years beginning after December 31, 2012, at which time the standard deduction in effect prior to the enactment of EGTRRA 2001 was to become effective (i.e., the standard deduction for married individuals filing jointly would, once again, be 167 percent of the standard deduction for single individuals).[4] The American Taxpayer Relief Act of 2012 prevented this sunset, so that the standard deduction for married individuals filing jointly (and surviving spouses) continues to be equal to 200 percent of the standard deduction for individual filers for tax years beginning after 2012.[5]

639. What are the federal income tax rates for individuals?

EGTRRA 2001 added a new 10 percent income tax rate and reduced income tax rates above 15 percent for individuals, trusts and estates. EGTRRA 2001 also provided for subsequent rate reductions to occur in 2004 and 2006.[6] JGTRRA 2003 accelerated the reductions that were scheduled to occur in 2004 and 2006. Thus, for 2003 to 2012, the income tax rates above 15 percent were lowered to 25 percent, 28 percent, 33 percent and 35 percent (down from 27 percent, 30 percent, 35 percent, and 38.6 percent).[7] The American Taxpayer Relief Act of 2012 ("ATRA") made the 10 percent, 15 percent, 25 percent, 28 percent, 33 percent and 35 percent income tax rates permanent, preventing their increase to pre-2001 levels for tax years beginning after 2012.[8]

As discussed above, the income tax brackets effective in 2012 will continue in effect permanently under ATRA, but certain high-income taxpayers will be subject to a new 39.6 percent tax rate. These high-income taxpayers include individual taxpayers with taxable income that is above the "applicable threshold" amount (for 2014, the applicable threshold

1. IRC Sec. 63(c)(5); Rev. Proc. 2013-35, above.
2. IRC Sec. 63(c)(4).
3. IRC Sec. 63(c).
4. JGTRRA 2003 Sec. 107.
5. See Rev. Proc. 2013-35, above.
6. IRC Secs. 1(i)(1), 1(i)(2), prior to amendment by JGTRRA 2003.
7. IRC Sec. 1(i)(2), as amended by JGTRRA 2003.
8. American Taxpayer Relief Act of 2012, Pub. Law No. 112-240.

is $406,750 per year for single taxpayers, $457,600 for married taxpayers filing jointly, $432,200 for taxpayers filing as heads of household, and $228,800 for married taxpayers filing separately).[1] These dollar limits are subject to annual inflation adjustment. For all other taxpayers, the tax rates put into place under the EGTRRA 2001 and JGTRRA 2003 are permanent for tax years beginning after 2012. Thus, for 2014, there are seven income tax brackets (10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent and 39.6 percent).

The income brackets to which each rate applies depend upon whether a separate return, joint return, head-of-household return, or single return is filed. (For an explanation of which taxpayers may file jointly or as a head-of-household, see Q 641 and Q 642). The income brackets are indexed annually for inflation.[2]

Further, separate tax rates apply to capital gains (see Q 608). For the taxation of children on their unearned income, see Q 591. See the income tax tables, in Appendix B.

10 percent tax bracket made permanent after 2012. EGTRRA created a new 10 percent bracket and provided for a scheduled increase in the brackets beginning in 2008. JGTRRA 2003 accelerated the scheduled increases to 2003 and 2004. WFTRA 2004 extended the expanded 10 percent brackets through 2012 at the 2003 levels. See the income tax tables, in Appendix B.

The 10 percent tax bracket was scheduled to "sunset" (expire) for tax years beginning after December 31, 2012, at which time the 10 percent tax bracket was to be eliminated and the portion of the income that was taxed in the 10 percent bracket was once again to be subject to taxation in the 15 percent bracket.[3]

ATRA eliminated this sunset provision and made the 10 percent tax bracket permanent.[4]

"Marriage penalty" relief. EGTRRA 2001 increased the size of the 15 percent bracket for married couples filing joint returns to twice the size of the corresponding bracket for unmarried individuals filing single returns, phasing in the increase over four years, beginning in 2005. JGTRRA 2003 accelerated those increases, making the size of the 15 percent bracket for married individuals filing jointly equal to twice the size of the corresponding bracket for unmarried individuals filing single returns for taxable years beginning in 2003 and 2004. For taxable years beginning after 2004, the applicable percentages were scheduled to revert to those provided under EGTRRA 2001.

WFTRA 2004 prevented this reversion, and maintained the 15 percent bracket for married individuals filing jointly as twice the size (200 percent) of the corresponding bracket for unmarried individuals filing single returns for tax years beginning *after December 31, 2003*.[5]

1. See ATRA, Sec. 101; Rev. Proc. 2013-35.
2. IRC Sec. 1(f).
3. IRC Sec. 1(i)(1); WFTRA 2004 Sec. 105; JGTRRA 2003 Sec. 107.
4. See ATRA, Sec. 101.
5. IRC Sec. 1(f)(8).

The larger 15 percent bracket for married individuals filing jointly was again scheduled to "sunset" (expire) for taxable years beginning after December 31, 2012, at which time the tax bracket that was in effect prior to the enactment of EGTRRA 2001 was to become effective (i.e., the 15 percent bracket for single individuals would have, once again, been 160 percent of the 15 percent bracket for married individuals filing jointly). However, under ATRA, all marriage penalty relief was made permanent (including the expanded 15 percent income tax bracket and increased standard deduction).[1]

640. How are taxes indexed?

The individual rate brackets, basic standard deduction, and personal exemption amounts are adjusted annually for inflation.[2] Indexing also applies to the additional standard deduction for the blind and elderly, the adoption credit, the exclusion for employer-provided adoption assistance, the exemption amount for the alternative minimum tax, and the threshold income levels for: phaseout of personal exemptions; phaseout of the savings bond interest exclusion; phaseout of the deduction for interest on a qualified education loan; phaseout of the adoption credit; phaseout of the exclusion for employer-provided adoption assistance; and the ceiling on itemized deductions.[3] The American Opportunity and Lifetime Learning Credits are also indexed for inflation, as are the threshold income levels for their phaseout.[4]

Indexing provides the benefit of preventing tax rate increases that result purely from inflation, as taxpayers' escalating income levels push them into higher tax brackets. It also ensures that the income levels at which certain tax benefits are eliminated remain at inflation-adjusted levels so that the provisions continue to benefit those taxpayers for whom they were intended.

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.[5] 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. This method of increase explained above, however, does not apply to the phaseout of the marriage penalty in the 15 percent bracket (see Q 639).[6]

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.[7] See Q 639 and the tax tables in Appendix B of this book.

1. WFTRA 2004 Sec. 105; JGTRRA 2003 Sec. 107, ATRA, Sec. 101.
2. IRC Secs. 1(f), 63(c)(4), 151(d)(4).
3. IRC Secs. 63(c)(4), 23(h), 137(f), 151(d)(4)(B), 135(b)(2)(B), 221(g), and 68(b)(2).
4. IRC Sec. 25A(h).
5. IRC Secs. 1(f)(3), 1(f)(4).
6. IRC Sec. 1(f)(2).
7. IRC Sec. 1(f)(1).

641. Who may file a joint return?

A husband and wife may file a joint return. Same-sex couples who currently are married under state law must now file either jointly or married filing separately for 2013 and beyond because of the Supreme Court's *Windsor* decision.[1] Gross income and deductions of both spouses are included; however, a joint return may be filed even though one spouse has no income. A widow or widower *who has a dependent child* may file as a "surviving spouse" and calculate tax using joint return tax rates for two years after the taxable year in which the spouse died. However, no personal exemption is allowed for the deceased spouse except in the year of death.[2]

642. Who may use head-of-household rates?

An individual who meets the four requirements below may use the applicable head-of-household rates:

1. He must be (a) unmarried, or (b) legally separated from his spouse under a decree of divorce or of separate maintenance, or (c) married, living apart from his spouse during the last six months of the taxable year, and maintain as his home a household that constitutes the principal place of abode for a "qualifying child".[3] See Q 627 with respect to whom the individual is entitled to claim a deduction, and with respect to whom the taxpayer furnishes over one-half the cost of maintaining such household during the taxable year.[4]

2. He must maintain as his home a household in which one or more of the following persons lives: (a) a qualifying child (if that individual is unmarried, it is not necessary that he have less than $3,950 in 2014 ($3,900 in 2013) of income or that the head-of-household furnish more than one-half his support; if the qualifying child is married, he must qualify as a dependent of the taxpayer claiming head-of-household status or would qualify except for the waiver of the exemption by the custodial parent (see Q 627)), *or* (b) any other person for whom the taxpayer can claim a dependency exemption except a cousin or unrelated person living in the household.[5] An exception to this rule is made with respect to a taxpayer's dependent mother or father: so long as he maintains the household in which the dependent parent lives, it need not be his home.[6]

3. He must contribute over one-half the cost of maintaining the home.[7]

4. He must not be a nonresident alien.[8]

1. *Windsor v. U.S.* 133 S. Ct. 2675 (2013).
2. IRC Secs. 1(a), 2(a), 6013(a). See IRC Sec. 151(b).
3. As defined in IRC Sec. 152(c).
4. IRC Secs. 2(b)(1), 2(c), 7703(b).
5. IRC Sec. 2(b)(1); Treas. Reg. §1.2-2(b).
6. IRC Sec. 2(b)(1).
7. IRC Sec. 2(b)(1).
8. IRC Secs. 2(b), 2(d).

Credits

643. What credits may be taken against the tax?

Editor's Note: Many of the credits listed below contain sunset provisions so that they apply only so long as Congress chooses to renew them from year to year. As of the date of this publication, Congress has not yet acted to renew many of the provisions that expired at the end of 2013. However, taxpayers should note that Congress has a history of retroactively restoring the applicability of many of these tax credits.

After rates have been applied to compute the tax, certain payments and credits may be subtracted from the tax to arrive at the amount of tax payable. *Refundable credits* are recoverable regardless of the amount of the taxpayer's tax liability for the taxable year. The refundable credits include:

...Taxes withheld from salaries and wages.[1]

...Overpayments of tax.[2]

...The excess of Social Security withheld (two or more employers).[3]

...The earned income credit.[4]

... A portion of the child tax credit.

... A portion of the American Opportunity credit.

...The 72.5 percent health care tax credit for uninsured workers displaced by trade competition.[5]

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

For 2009 and 2010, a making work pay credit was available equal to the lesser of (1) 6.2 percent of earned income or (2) $800 for a joint return and $400 for all others. The credit was reduced by 2 percent of the taxpayer's modified adjusted gross income in excess of $150,000 for a joint return and $75,000 for all others. The credit was also reduced by certain other benefits provided by ARRA 2009. The credit was not available for nonresident aliens, for persons for whom a personal exemption was claimed on another person's return, or an estate or trust.[6]

There was a first-time homebuyer credit available for a home purchased after April 8, 2008 and through April 2010.[7] The credit was available for 10 percent of the purchase price, up to

1. IRC Sec. 31(a).
2. IRC Sec. 35.
3. Treas. Reg. §1.31-2.
4. IRC Sec. 32.
5. IRC Sec. 35.
6. IRC Sec. 36A, as amended by ARRA 2009.
7. IRC Sec. 36, as added by HERA 2008 and amended by ARRA 2009 and WHBAA 2009.

certain limits. For homes purchased in 2009 and 2010, the dollar limits were $8,000 ($4,000 for a married individual filing separately). However, for a home purchased after November 6, 2009 by a long-time resident treated as a first-time homebuyer, the dollar limit was only $6,500 ($3,250 for a married individual filing separate). For a home purchased before November 7, 2009, the credit was phased out based on AGI of $75,000 to $95,000 ($150,000 to $170,000 for a joint return). For a home purchased after November 6, 2009, the credit was phased out based on AGI of $125,000 to $145,000 ($225,000 to $245,000 for a joint return). For a home purchased after November 6, 2009, the credit was not available to a person for whom a personal exemption was allowable to another person. The credit was not available for a home purchased after November 6, 2009 if the purchase price exceeded $800,000. For a home purchased in 2008, the credit must generally be recaptured over a 15-year period beginning with the second year after the home is purchased. The recapture is accelerated if the home is sold or is no longer the taxpayer's principal residence. Credit recapture does not apply to a home purchased in 2009 or 2010 unless the home was disposed of, or ceases to be used as a primary residence, within three years of purchase. For a first-time homebuyer's credit that can be properly claimed in a year after 2008, the taxpayer can elect to claim the credit as of December 31 of the previous year.

The *nonrefundable credits* are as follows:

...The personal credits—which consist of the child and dependent care credit;[1] the credit for the elderly and the permanently and totally disabled;[2] the qualified adoption credit;[3] the non-refundable portion of the child tax credit;[4] the American Opportunity (extended under ATRA through 2017), Hope Scholarship, and Lifetime Learning credits[5] (see Q 646); the credit for elective deferrals and IRA contributions (the "saver's credit," which became permanent under PPA 2006)[6];

...The nonbusiness energy property credit (retroactively extended under ATRA for 2012 and 2013)[7]; and the residential energy efficient property credit[8].

...Other nonbusiness credits.[9]

...The general business credit (see Q 7817) is the sum of the following credits determined for the taxable year: (1) the investment credit determined under IRC Section 46 (see Q 7824) (including the rehabilitation credit; see Q 7761); (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);

1. IRC Sec. 21.
2. IRC Sec. 22.
3. IRC Sec. 23.
4. See IRC Sec. 24.
5. IRC Sec. 25A, as amended by ATRA, Sec. 103.
6. IRC Sec. 25B.
7. IRC Sec. 25C, as amended by ATRA, Sec. 401.
8. IRC Sec. 25D.
9. See e.g., IRC Secs. 53, 901.

(5) the low-income housing credit (see Q 7754) determined under IRC Section 42(a); (6) the enhanced oil recovery credit (see Q 7817) 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]

ETIA 2005 provides an alternative motor vehicle credit for qualified fuel cell vehicles, advanced lean-burn technology vehicles, qualified hybrid vehicles, and qualified alternative fuel vehicles.[2] (This credit replaced the prior deduction for qualified clean-fuel vehicle property, which expired on December 31, 2005.)[3] The portion of the credit attributable to vehicles of a character subject to an allowance for depreciation is treated as a portion of the general business credit; the remainder of the credit is a personal credit allowable to the extent of the excess of the regular tax (reduced by certain other credits) over the alternative minimum tax for the taxable year.[4]

For new qualified plug-in electric drive motor vehicles acquired and placed in service after 2009, a credit is available. The credit can vary from $2,500 to $7,500 depending on battery capacity (and subject to phaseout based on number of vehicles sold by the manufacturer). The

1. IRC Sec. 38(b).
2. IRC Sec. 30B.
3. See Sec. 1348, ETIA 2005; IRC Sec. 179A.
4. See IRC Sec. 30B(g).

portion of the credit attributable to property of a character subject to 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]

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

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]

This base figure is limited for individuals under age 65 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 he is absent from work on account of permanent and total disability) received during the taxable year.[7] (Proof of continuing permanent and total disability may be required.)[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 or if only one is under age 65, the sum of $5,000 plus the disability income of the spouse who is under 65.[9]

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).[10] A reduction

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(e)(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).
10. IRC Sec. 22(d).

is also made for Social Security and railroad retirement benefits that are excluded from gross income, and certain other tax-exempt income.[1]

645. Who qualifies for the child tax credit?

A child tax credit is available for each "qualifying child" (defined below) of eligible taxpayers who meet certain income requirements. The child tax credit is $1,000.[2]

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.[3]

"Qualifying child" means, with respect to any taxpayer for any taxable year, an individual:

(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 such individual's own support for the calendar year in which the taxpayer's taxable year begins.[4]

Additionally, a qualifying child must be either a citizen or a resident of the United States.[5]

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.[6] 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.[7] Any adopted children of the taxpayer are treated the same as natural born children.[8]

The amount of the credit is reduced for taxpayers whose modified adjusted gross income (MAGI) exceeds certain levels. A taxpayer's MAGI is his 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 $1000, or fraction 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.[9]

1. IRC Sec. 22(c)(3).
2. IRC Sec. 24(a).
3. IRC Sec. 24(c)(1).
4. IRC Sec. 152(c).
5. IRC Sec. 24(c)(2).
6. IRC Sec. 152(f)(1).
7. IRC Sec. 152(f)(1)(C).
8. IRC Sec. 152(f)(1)(B).
9. IRC Sec. 24(b)(2).

The child tax credit is refundable to the extent of 15 percent of the taxpayer's earned income in excess of $10,000 (as indexed–see below).[1] For example, if the taxpayer's earned income is $16,000, the excess amount would be $6,000 ($16,000 – $10,000 = $6,000), and the taxpayer's refundable credit for one qualifying child would be $900 ($6,000 × 15 percent = $900). For families with three or more qualifying children, the credit is refundable to the extent that the taxpayer's Social Security taxes exceed the taxpayer's earned income credit *if* that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,000.[2] The $10,000 amount is indexed for inflation. But ARRA 2009 reduced the dollar amount to $3,000 for 2009 through 2012.[3] ATRA extended the $3,000 floor amount through 2017.[4] (Prior to 2001, the child tax credit was refundable only for individuals with three or more qualifying children).[5]

The nonrefundable child tax credit can be claimed against the individual's regular income tax *and* alternative minimum tax (see Q 643). The nonrefundable child 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.[6] For tax years beginning after 2001, the refundable child tax credit is not required to be reduced by the amount of the taxpayer's alternative minimum tax.[7] The nonrefundable credit must be reduced by the amount of the refundable credit.[8]

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.[9] For purposes of applying a uniform method of determining when a child attains a specific age, the Service 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).[10] The IRS stated that it would apply Revenue Ruling 2003-72 retroactively and would notify those taxpayers entitled to a refund for 2002 as a result of Revenue Ruling 2003-72.[11]

646. What is the Hope Scholarship (American Opportunity) Credit?

The Hope Scholarship (American Opportunity) Credit is available to certain eligible taxpayers who pay qualified tuition and related expenses.[12]

1. IRC Sec. 24(d)(1)(B)(i).
2. IRC Sec. 24(d)(1).
3. IRC Sec. 24(d)(3).
4. ATRA, Sec. 103.
5. IRC Sec. 24(d), prior to amendment by EGTRRA 2001.
6. IRC Sec. 24(b)(3).
7. IRC Sec. 24(d).
8. IRC Sec. 24(d)(1).
9. IRC Secs. 24(e), 24(f).
10. Rev. Rul. 2003-72, 2003-2 CB 346.
11. IRS Information Letter INFO-2003-0215 (8-29-2003).
12. IRC Sec. 25A.

Hope Scholarship (American Opportunity) Credit

The Hope Scholarship (American Opportunity) Credit provides a credit for each *eligible student* equal to the sum of: (1) 100 percent of qualified tuition and related expenses up to $2,000 (in 2009 through 2017); plus (2) 25 percent of qualified tuition and related expenses in excess of $2,000, up to the applicable limit. The applicable limit ($4,000 in 2009 through 2017) is two times the $2,000 amount.[1] AARA 2009 increased the credit amounts for 2009 and 2010 (later extended through 2012 and again early in 2013 by the American Taxpayer Relief Act of 2012 ("ATRA"), through 2017).[2] In other years, the amounts used to calculate the credit are adjusted for inflation and rounded to the next lowest multiple of $100.[3] The maximum credit for 2010-2017 is $2,500 ($2,000 + (25% × $2,000).

The credit is available only for the first two years (AARA 2009 expanded to four years for 2009 through 2012 and this was extended through 2017 by ATRA) of postsecondary education, and can be used in only two (four) taxable years.[4] To qualify for the credit, the student must carry at least half of a full-time academic workload for an academic period during the taxable year.[5]

An *eligible student* generally means a student who: (1) for at least one academic period beginning in the calendar year, is enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential and is enrolled in one of the first two (four years for 2009 through 2017) years of postsecondary education, and (2) is free of any conviction for federal or state felony offenses consisting of the possession of a controlled substance.[6]

Qualified tuition and related expenses are tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer (for whom he is allowed a dependency exemption) at an "eligible education institution."[7] Qualified tuition and related expenses do not include nonacademic fees such as room and board, medical expenses (including required student health fees), transportation, student activity fees, athletic fees, insurance expenses, and similar personal, living or family expenses unrelated to a student's academic course of instruction.[8] Additionally, qualified tuition and related expenses do not include expenses for a course involving sports, games or hobbies, unless it is part of the student's degree program.[9] AARA 2009 expanded qualified tuition and related expenses to include required course materials for 2009 through 2012 and ATRA continues this expansion through 2017.

An *eligible educational institution* generally means a postsecondary educational institution that: (a) provides an educational program for which it awards a bachelor's degree, or a 2-year

1. IRC Secs. 25A(b)(1), 25A(b)(4); Treas. Reg. §1.25A-3(a).
2. ATRA, Sec. 103.
3. IRC Sec. 25A(h)(1).
4. Treas. Reg. §1.25A-3(c).
5. IRC Sec. 25A(b)(2); Treas. Reg. §1.25A-3(d)(ii).
6. IRC Sec. 25A(b)(3); Notice 97-60, 1997-2 CB 310 (Sec. 1, A3); Treas. Reg. §1.25A-3(d)(1).
7. Treas. Reg. §1.25A-2(d)(1).
8. Treas. Reg. §1.25A-2(d)(3).
9. IRC Sec. 25A(f)(1); Treas. Reg. §1.25A-2(d)(5).

program that would be accepted for credit towards a bachelor's degree; (b) has at least a one year program that trains students for gainful employment in a recognized profession; (c) participates in a federal financial aid program under Title IV of the Higher Education Act of 1965 or is certified by the Department of Education as eligible to participate in such a program; or (d) meets requirements for certain postsecondary vocational, proprietary institutions of higher learning and certain institutions outside the United States. In any event, the institution must also be accredited or have been granted pre-accreditation status.[1]

An *academic period* means a quarter, semester, trimester or other period of study (such as summer school session) as reasonably determined by an eligible educational institution.[2]

647. What is the Lifetime Learning Credit?

The Lifetime Learning Credit is available to certain eligible taxpayers who pay qualified tuition and related expenses.[3]

The Lifetime Learning Credit is available in an amount equal to 20 percent of "qualified tuition and related expenses" (defined above) paid by the taxpayer during the taxable year for any course of instruction at an "eligible educational institution" (defined above) taken to acquire or improve the job skills of the taxpayer, his spouse or dependents. The Lifetime Learning Credit is a per taxpayer credit and the maximum credit available does not vary with the number of students in the family. The maximum amount of the credit in 2014 is $2,000 (20 percent of up to $10,000 of qualified tuition and related expenses).[4]

Qualified tuition and related expenses, for the purposes of the Lifetime Learning Credit, include expenses for graduate as well as undergraduate courses. The Lifetime Learning Credit applies regardless of whether the individual is enrolled on a full-time, half-time, or less than half-time basis. Additionally, the Lifetime Learning Credit is available for an unlimited number of taxable years.[5]

Where taxpayers had pre-paid their child's tuition in November 2001 for the academic period that began during the first three months of the following taxable year (i.e., the spring semester of 2002), the prepayment amount was properly includable in the calculation of the taxpayers' Lifetime Learning Credit for the 2001 taxable year, not the 2002 taxable year.[6]

648. What limitations and phaseouts apply to the Hope Scholarship (American Opportunity) and Lifetime Learning Credits?~~?~~

The Code sets forth special rules coordinating the interaction of these credits. The Lifetime Learning Credit is not available with respect to a student for whom an election is made to take

1. See IRC Sec. 25A(f)(2); HEA 1965 Sec. 481; Treas. Reg. §1.25A-2(b).
2. Treas. Reg. §1.25A-2(c).
3. IRC Sec. 25A.
4. IRC Sec. 25A(c); Treas. Reg. §1.25A-4(a).
5. Treas. Regs. §§1.25A-4(b), 1.25A-4(c).
6. *Patel v. Comm.*, TC Sum. Op. 2006-40.

the Hope Scholarship Credit during the same taxable year.[1] However, the taxpayer may use the American Opportunity Credit for one student and the Lifetime Learning Credit for other students in the same taxable year.

Both credits are subject to the same phaseout rules based on the taxpayer's modified adjusted gross income (MAGI). MAGI is the taxpayer's adjusted gross income without regard to the exclusions for income derived from certain foreign sources or sources within United States possessions. The maximum credit in each case is reduced by the credit multiplied by a ratio. For single taxpayers, the ratio equals the excess of (i) the taxpayers' MAGI over $40,000 to (ii) $10,000. For married taxpayers filing jointly, the ratio equals (a) the excess of the taxpayer's MAGI over $80,000 to (b) $20,000.[2] The $40,000 and $80,000 amounts are adjusted for inflation and rounded to the next lowest multiple of $1,000.[3] For 2014, the threshold amounts are $54,000 (up from $53,000 for 2013) for single taxpayers and $108,000 (up from $107,000 for 2013) for married taxpayers filing jointly for the Lifetime Learning Credit.[4] The threshold amounts for the American Opportunity Credit are $160,000 for married taxpayers filing jointly and $80,000 for single taxpayers for 2012-2014.

The amount of qualified tuition and related expenses for both credits is limited by the sum of the amounts paid for the benefit of the student, such as scholarships, education assistance advances, and payments (other than a gift, bequest, devise, or inheritance) received by an individual for educational expenses attributable to enrollment.[5] The IRS has determined that qualified tuition and related expenses paid with distributions of educational benefits from a trust could be used to compute American Opportunity and Lifetime Learning Credits if the distributions were included in the taxable income of the beneficiaries.[6]

Neither credit is allowed unless a taxpayer elects to claim it on a timely filed (including extensions) federal income tax return for the taxable year in which the credit is claimed. The election is made by completing and attaching Form 8863, Education Credits (American Opportunity and Lifetime Learning Credits), to the return.[7] Neither credit is allowed unless the taxpayer provides the name and the taxpayer identification (i.e., Social Security) number of the student for whom the credit is claimed.[8]

If the student is claimed as a dependent on another individual's tax return (e.g., parents) he cannot claim either credit for himself, even if he paid the expenses himself.[9] (The Service has privately ruled that a student was entitled to claim a Hope Scholarship Credit on his own return even though his parents were eligible to claim him as a dependent, but chose not to do so.[10]) However, if another individual is eligible to claim the student as a dependent, but does not

1. IRC Sec. 25A(c)(2)(A); Treas. Reg. §1.25A-1(b).
2. IRC Sec. 25A(d); Treas. Reg. §1.25A-1(c).
3. IRC Sec. 25A(h)(2); Treas. Reg. §1.25A-1(c)(3).
4. Rev. Proc. 2013-35.
5. IRC Sec. 25A(g)(2); Treas. Reg. §1.25A-5(c).
6. Let. Rul. 9839037.
7. Treas. Reg. §1.25A-1(d).
8. Treas. Reg. §1.25A-1(e).
9. IRC Sec. 25A(g)(3); Treas. Reg. §1.25A-1(f)(1).
10. Let. Rul. 200236001.

do so, only the student may claim the Hope or Lifetime Learning Credit for his own qualified tuition and related expenses.[1] Both credits are unavailable to married taxpayers filing separately.[2] Neither of these credits is allowed for any expenses for which there is a deduction available.[3] Taxpayers are not eligible to claim an American Opportunity or Lifetime Learning Credit and the deduction for qualified higher education expenses in the same year with respect to the same student.[4]

A taxpayer may claim an American Opportunity or Lifetime Learning Credit *and* exclude distributions from a qualified tuition program on behalf of the same student in the same taxable year *if* the distribution is not used to pay the same educational expenses for which the credit was claimed.[5] See Q 595.

A taxpayer can claim an American Opportunity or Lifetime Learning Credit *and* exclude distributions from a Coverdell Education Savings Account (ESA – see Q 592) on behalf of the same student in the same taxable year *if* the distribution is *not* used to pay the same educational expenses for which the credit was claimed.[6] A taxpayer may elect *not* to have the American Opportunity or Lifetime Learning Credit apply with respect to the qualified higher education expenses of an individual for any taxable year.[7]

For 2009 through 2012, AARA 2009 (as amended) made the American Opportunity Credit allowable against the alternative minimum tax and a portion of the tax is made refundable. ATRA did not extend the provision that allowed the American Opportunity Credit to be taken against the alternative minimum tax.

Reporting. For the reporting requirements for higher education tuition and related expenses, see IRC Section 6050S.[8] For the reporting requirements for qualified tuition and related expenses, see Treasury Regulation Section 1.6050S-1; TD 9029.[9]

649. What is the credit for nonbusiness energy property that may be taken against the tax?

Editor's Note: The credit for nonbusiness energy property expired on December 31, 2007. Congress later revived it through 2013. As of the date of this publication, Congress has not yet acted to renew the credit for 2014. However, taxpayers should note that Congress has a history of retroactively restoring the applicability of many tax credits.[10]

An individual taxpayer may claim as a credit an amount equal to *the sum of*: (1) 10 percent of the amount paid or incurred by the taxpayer for "qualified energy efficiency

1. Treas. Reg. §1.25A-1(f)(1).
2. IRC Sec. 25A(g)(6); Treas. Reg. §1.25A-1(g).
3. IRC Sec. 25A(g)(5); Treas. Reg. §1.25A-5(d).
4. IRC Sec. 222(c)(2)(A).
5. See IRC Sec. 529(c)(3)(B)(v).
6. See IRC Sec. 530(d)(2)(C).
7. IRC Sec. 25A(e).
8. As amended by P.L. 107-131 (1-16-2002).
9. 67 Fed. Reg. 77678 (12-19-02). See also Notice 2006-72, 2006-36 IRB 363.
10. IRC Sec. 25C(g), as amended by EIEA 2008, ARRA, and ATRA.

improvements" (see below) installed during the taxable year; *and* (2) the amount of the "residential energy property expenditures" (see below) paid or incurred by the taxpayer during the taxable year.[1]

Qualified energy efficiency improvements means any energy efficient "building envelope component" (see below) that meets certain energy conservation criteria, if: (1) the component is installed in or on a dwelling located in the United States that is owned and used by the taxpayer as his principal residence; (2) original use of the component commences with the taxpayer; *and* (3) the component reasonably can be expected to remain in use for at least five years.[2] The term "building envelope component" means: (1) any insulation material or system specifically and primarily designed to reduce the heat loss or gain of a dwelling when installed in or on the dwelling; (2) exterior windows, including skylights; (3) exterior doors; and (4) metal roofs if the roof has appropriate coatings specifically and primarily designed to reduce the heat gain of the dwelling.[3]

In guidance, the Service clarified that a component will be treated as reasonably expected to remain in use for at least five years if the manufacturer offers, at no extra charge, at least a two-year warranty providing for repair or replacement of the component in the event of a defect in materials or workmanship. However, if the manufacturer does not offer such a warranty, all relevant facts and circumstances are taken into account in determining whether the component reasonably can be expected to remain in use for at least five years. The Service also confirmed that a taxpayer may rely on a manufacturer's certification that a building envelope component is an "eligible building envelope component." A taxpayer is not required to attach the certification to the tax return on which the credit is claimed, but should retain the certification statement as part of his records. In addition, the Service stated that a credit is allowed *only* for amounts paid or incurred to purchase the components, *not* for the onsite preparation, assembly, or original installation of the components.[4]

Residential energy property expenditures means expenditures made by the taxpayer for "qualified energy property" that is: (1) installed on or in connection with a dwelling unit located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; *and* (2) originally placed in service by the taxpayer.[5] The term "qualified energy property" means: (1) "energy-efficient building property" (see below); (2) a qualified natural gas, propane, oil furnace or hot water boiler; or (3) an advanced main air circulating fan. All of the types of property listed in the preceding sentence must meet certain performance and quality standards.[6] "Energy efficient building property" means: (1) electric heat pump water heaters; (2) electric heat pumps; (3) geothermal heat pumps; (4) central air conditioners; and (5) natural gas, propane, or oil water heaters.[7]

1. IRC Sec. 25C(a).
2. IRC Sec. 25C(c)(1).
3. IRC Sec. 25C(c)(2).
4. Notice 2006-26, 2006-11 IRB 622.
5. IRC Sec. 25C(d)(1).
6. IRC Sec. 25C(d)(2).
7. IRC Sec. 25C(d)(3).

The Service has confirmed that a taxpayer may rely on a manufacturer's certification that a product is "qualified energy property." A taxpayer is not required to attach the certification to the tax return on which the credit is claimed, but should retain the certification statement as part of his records. In addition, the Service stated that a credit is allowed for amounts paid or incurred to purchase qualified energy property *and* for expenditures for labor costs allocable to the onsite preparation, assembly, or original installation of the property.[1] The Service has issued additional guidance regarding the credit.[2]

The lifetime limitation with respect to any taxpayer for any taxable year is $500.[3] An additional limit of $200 applies to windows.[4] Other limits are as follows: advanced main air circulating fans – $50; qualified natural gas, propane, oil furnace or hot water boilers – $150; and energy-efficient building property – $300.[5]

The credit is available for property placed in service after December 31, 2005, and before January 1, 2008, and in 2009 through 2013. (See Editor's Note above).[6]

650. What is the residential energy efficient property credit that may be taken against the tax?

An individual taxpayer may claim as a credit an amount equal to *the sum of* 30 percent of the following expenditures made by the taxpayer during the taxable year: (1) "qualified solar electric property" (see below); (2) "qualified solar water heating property" (see below); (3) "qualified fuel cell property" (see below); (4) qualified small wind energy property (see below); and (5) qualified geothermal heat pump property (see below).[7] Solar water heating property must be certified in order for the credit to be claimed.[8]

"Qualified solar water heating property expenditure" means an expenditure for property to heat water for use in a dwelling unit located in the United States and used as a residence by the taxpayer if at least half of the energy used by such property for such purpose is derived from the sun. The term "qualified solar electric property expenditure" means an expenditure for property which uses solar energy to generate electricity for use in a dwelling unit located in the United States and used as a residence by the taxpayer. "Qualified fuel cell property expenditure" means an expenditure for qualified fuel cell property (as defined in IRC Section 48(c)(1)) installed on or in connection with a dwelling unit located in the United States and used as a principal residence by the taxpayer. "Qualified small wind energy property expenditure" means an expenditure for property which uses a wind turbine to generate electricity for use in connection with a dwelling unit located in the United States and used as a residence by the taxpayer. "Qualified geothermal heat pump property expenditure" means an expenditure for qualified geothermal heat pump

1. Notice 2006-26, 2006-11 IRB 622.
2. See Notice 2006-71, 2006-34 IRB 316 (clarifying the effective dates); Notice 2006-53, 2006-25 IRB 1180 (clarifying that exterior siding does not qualify as an eligible building envelope component).
3. IRC Sec. 25C(b)(1).
4. IRC Sec. 25C(b)(2).
5. IRC Sec. 25C(b)(3).
6. IRC Sec. 25C(g), as amended by ATRA, Sec. 401.
7. IRC Sec. 25D(a).
8. IRC Sec. 25D(b)(2).

property installed on or in connection with a dwelling unit located in the United States and used as a residence by the taxpayer.[1]

A special rule provides that expenditures allocable to a swimming pool, hot tub, or any other energy storage medium that has a function other than the function of storage cannot be taken into account for these purposes.[2]

The maximum credit allowed for any taxable years before 2009 cannot exceed $2,000 with respect to qualified solar water heating property expenditures, $500 with respect to each half kilowatt of capacity of qualified fuel cell property (as defined in section 48(c)(1)) for which qualified fuel cell property expenditures are made, $500 with respect to each half kilowatt of capacity (not to exceed $4,000) of wind turbines for which qualified small wind energy property expenditures are made, and $2,000 with respect to any qualified geothermal heat pump property expenditures.[3] For tax years starting in 2009, the only remaining limit is the $500 limit for each half-kilowatt of capacity of fuel cell plants. The unused portion of the credit can be carried forward to the succeeding taxable year.[4]

The credit is available for property placed in service after December 31, 2005 and before January 1, 2017.[5]

651. What is the alternative motor vehicle credit that may be taken against the tax?

The alternative motor vehicle credit is equal to the *sum* of: (A) the new qualified fuel cell motor vehicle credit; (B) the new advanced lean burn technology motor vehicle credit; (C) the new qualified hybrid vehicle credit; (D) the new qualified alternative motor vehicle credit; and (E) the plug-in conversion credit.[6] (This credit replaces the prior deduction for qualified clean-fuel vehicle property, which sunset on December 31, 2005.)[7]

(A) The new qualified fuel cell motor vehicle credit is based on the weight of the vehicle, and ranges from $8,000 (8,500 pounds maximum) to $40,000 (over 26,000 pounds).[8] The amount determined above with respect to a passenger automobile or light truck is *increased* if the vehicle achieves certain fuel efficiencies, ranging from $1,000 to $4,000.[9] The credit for passenger automobiles and light trucks can be as much as $12,000.

The term "new qualified fuel cell motor vehicle" means a motor vehicle: (1) propelled by power derived from one or more fuel cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel that is stored on board the vehicle in any

1. IRC Sec. 25D(d).
2. IRC Sec. 25D(e)(3).
3. IRC Sec. 25D(b).
4. See IRC Sec. 25D(c).
5. See Sec. 1333, Energy Policy Act of 2005; IRC Sec. 25D(g).
6. IRC Sec. 30B(a).
7. See Sec. 1348, ETIA 2005; IRC Sec. 179A.
8. IRC Sec. 30B(b)(1).
9. IRC Sec. 30B(b)(2).

form and may or may not require reformation prior to use; (2) that, in the case of a passenger vehicle or light truck, has received a certificate that the vehicle meets certain emission levels; (3) the original use of which begins with the taxpayer; (4) that is acquired for use or lease by the taxpayer and not for resale; and (5) that is made by a manufacturer.[1]

(B) The amount of the new advanced lean burn technology motor vehicle credit is based on fuel economy, and ranges from $400 to $2,400. The amount of the credit is *increased* by the conservation credit (based on lifetime fuel savings), and ranges from $250 to $1,000.[2] The credit for passenger automobiles and light trucks can be as much as $3,400.

The term "advanced lean burn technology motor vehicle" means a passenger automobile or light truck: (1) with an internal combustion engine that (i) is designed to operate primarily using more air than is necessary for complete combustion of the fuel, (ii) incorporates direct injection, (iii) achieves at least 125 percent of the 2002 model year city fuel economy, and (iv) for 2004 and later model vehicles, has received a certificate that the vehicle meets or exceeds certain emission standards; (2) the original use of which begins with the taxpayer; (3) is acquired for use or lease by the taxpayer and not for resale; and (4) is made by a manufacturer.[3]

(C) The new qualified hybrid motor vehicle credit amount is determined as follows: (1) If the new qualified hybrid motor vehicle is a passenger automobile or light truck weighing no more than 8,500 pounds, the credit amount is the sum of the fuel economy amount and the conservation credit (see (B), above).[4] (2) For other motor vehicles, the credit amount is equal to the applicable percentage of the "qualified incremental hybrid cost" (i.e., the excess of the manufacturer's suggested retail price for such vehicle over the price for a comparable gas or diesel powered vehicle) of the vehicle as certified.[5] The credit for passenger automobiles and light trucks can be as much as $3,400.

A "new qualified hybrid motor vehicle" means a motor vehicle that: (1) draws propulsion energy from onboard sources of stored energy that are both (i) an internal combustion or heat engine using consumable fuel, and (ii) a rechargeable energy storage system; (2) has been certified as meeting specified emission standards; (3) has maximum available power meeting certain percentages based on weight; (4) the original use of which begins with the taxpayer; (5) is acquired for use or lease by the taxpayer; and (6) is made by a manufacturer.[6]

(D) The new qualified alternative fuel motor vehicle credit is an amount equal to the applicable percentage of the incremental cost of any new qualified alternative fuel motor vehicle.[7] The "applicable percentage" is 50 percent, plus 30 percent if the vehicle has been certified as meeting certain emission standards.[8] The "incremental cost" (i.e., the excess of the manufacturer's sug-

1. IRC Sec. 30B(b)(3).
2. IRC Sec. 30B(c)(2).
3. IRC Sec. 30B(c)(3).
4. IRC Sec. 30B(d)(2)(A).
5. IRC Sec. 30B(d)(2)(B).
6. IRC Sec. 30B(d)(3).
7. IRC Sec. 30B(e)(1).
8. IRC Sec. 30B(e)(2).

gested retail price for the vehicle over the price for a gas or diesel powered vehicle of the same model) cannot exceed $5,000 to $40,000 based on the weight of the vehicle.[1]

"New qualified alternative fuel motor vehicle" means any motor vehicle: (1) that is only capable of operating on an alternative fuel; (2) the original use begins with the taxpayer; (3) is acquired by the taxpayer for use or lease but not for resale; and (4) is made by a manufacturer.[2] "Alternative fuel" means compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid at least 85 percent of the volume of which consists of methanol.[3]

Certifications and Limitations for Hybrid Vehicles

Certifications. The tax credit for hybrid vehicles may be as much as $3,400 for those who purchase the most fuel-efficient vehicles. (For the guidance used by manufacturers in certifying credit amounts, see Notice 2006-9).[4] The Service cautions that even though a manufacturer has certified a vehicle, taxpayers must meet the following requirements to qualify for the credit:

(1) The vehicle must be placed in service after December 31, 2005, and purchased on or before December 31, 2009.[5]

(2) The original use of the vehicle must begin with the taxpayer claiming the credit.

  (a) The credit may only be claimed by the original owner of a new, qualifying, hybrid vehicle and does not apply to a used hybrid vehicle.

(3) The vehicle must be acquired for use or lease by the taxpayer claiming the credit.

  (a) The credit is only available to the original purchaser of a qualifying hybrid vehicle. If a qualifying vehicle is leased to a consumer, the leasing company may claim the credit.

  (b) For qualifying vehicles used by a tax-exempt entity, the person who sold the qualifying vehicle to the person or entity using the vehicle is eligible to claim the credit, but only if the seller clearly discloses in a document to the tax-exempt entity the amount of credit.

(4) The vehicle must be used predominantly within the United States.

Limitations. There is a limit on the number of new qualified hybrid and advanced lean burn technology vehicles eligible for the credit. The phaseout period begins with the second calendar quarter following the calendar quarter that includes the first date on which the number of

1. IRC Sec. 30B(e)(3).
2. IRC Sec. 30B(e)(4)(A).
3. IRC Sec. 30B(e)(4)(B).
4. 2006-6 IRB 413.
5. IRC Sec. 30B(k)(3).

qualified vehicles manufactured by the manufacturer is at least 60,000.[1] The Service publishes notices providing the adjusted credit amount based on the actual number of vehicles sold for the applicable quarter.

Effective dates. The credits are in effect as follows: new qualified fuel cell motor vehicle credit (2006 – 2014); (B) new advanced lean burn technology motor vehicle credit (2006 – 2010); (C) new qualified hybrid vehicle credit (2006 – 2009); and (D) new qualified alternative fuel motor vehicle credit (2006 – 2010).

652. What tax credits are available for plug-in electric vehicles?

The ARRA modified the credit for qualified plug-in electric drive vehicles purchased after December 31, 2009. To qualify, vehicles must be newly purchased, have four or more wheels, have a gross vehicle weight rating of less than 14,000 pounds, and draw propulsion using a battery with at least four kilowatt hours that can be recharged from an external source of electricity. The minimum amount of the credit for qualified plug-in electric drive vehicles is $2,500 and the credit tops out at $7,500, depending on the battery capacity. The full amount of the credit will be reduced with respect to a manufacturer's vehicles after the manufacturer has sold at least 200,000 vehicles.[2]

ARRA also creates a special tax credit for two types of plug-in vehicles — certain low-speed electric vehicles and two- or three-wheeled vehicles. The amount of the credit is 10 percent of the cost of the vehicle, up to a maximum credit of $2,500 for purchases made after Feb. 17, 2009, and before Jan. 1, 2014. To qualify, a vehicle must be either a low speed vehicle propelled by an electric motor that draws electricity from a battery with a capacity of 4 kilowatt hours or more or be a two- or three-wheeled vehicle propelled by an electric motor that draws electricity from a battery with the capacity of 2.5 kilowatt hours. A taxpayer may not claim this credit if the plug-in electric drive vehicle credit is allowable.

Alternative Minimum Tax

653. How is the alternative minimum tax calculated?

Generally

In addition to the tax calculated under the normal rates, it is sometimes necessary for a taxpayer to pay the *alternative minimum tax (AMT)*. The AMT is calculated by first determining the alternative minimum taxable income (AMTI), reducing this amount by the allowable exemption to determine taxable excess, and then applying a two-tier tax rate schedule to the amount of the taxable excess. The two-tier rate schedule applies a 26 percent rate to taxable excess that does not exceed $182,500 ($91,250 for married taxpayers filing separately), and a 28 percent rate to taxable excess over that amount. The resulting amount is the taxpayer's tentative minimum tax. The preferential tax rates on certain capital gains held for more than twelve months and certain dividends are also used when determining the taxpayer's tentative minimum tax (see Q 608).[3]

1. IRC Sec. 30B(f).
2. IRC Sec. 30D.
3. IRC Secs. 55(a), 55(b).

If the tentative minimum tax reduced by the AMT foreign tax credit exceeds the regularly calculated tax (with adjustments) for the tax year, the excess is the AMT. Regularly calculated tax for AMT purposes excludes certain taxes including: (1) the alternative minimum tax; (2) the tax on benefits paid from a qualified retirement plan in excess of the plan formula to a 5 percent owner; (3) the 10 percent penalty tax for certain premature distributions from annuity contracts; (4) the 10 percent additional tax on certain early distributions from qualified retirement plans; (5) the 10 percent additional tax for certain taxable distributions from modified endowment contracts; (6) taxes relating to the recapture of the federal subsidy from use of qualified mortgage bonds and mortgage credit certificates; (7) the additional tax on certain distributions from education IRAs; and (8) the 15 percent additional tax on medical savings account distributions not used for qualified medical expenses. Regularly calculated tax is reduced by the foreign tax credit, the Puerto Rico and possession tax credit, and the Puerto Rico economic activity credit.[1]

For tax years from 2000 through 2011, certain nonrefundable personal credits (see Q 643) could be used to reduce the sum of a taxpayer's regular tax liability and AMT liability. The American Taxpayer Relief Act of 2012 ("ATRA") made the use of nonrefundable personal credits against the AMT permanent.[2]

Alternative Minimum Taxable Income

Alternative minimum taxable income is taxable income, with adjustments made in the way certain items are treated for AMT purposes, and increased by any items of tax preference.[3]

Except as otherwise provided below, the provisions that apply in determining the regular taxable income of a taxpayer also generally apply in determining the AMTI of the taxpayer.[4] In addition, references to a noncorporate 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.[5]

Exemption

ATRA permanently "patches" the AMT exemption amount, and applies retroactively to 2012 and all tax years thereafter. Because the AMT was originally intended to apply only to higher income taxpayers who are able to avoid taxation through the use of tax preferences, only taxpayers with income levels above a certain threshold amount are required to calculate their AMT tax liability. Prior to enactment of ATRA, Congress passed legislation each year to retroactively "patch" the AMT exemption amount for the prior tax year so that millions of lower income taxpayers would not become subject to the AMT. ATRA includes an inflation adjustment provision so that the exemption amount will be increased annually for inflation for all tax

1. IRC Secs. 55(c)(1), 26(b).
2. IRC Sec. 26(a), as amended by TEAMTRA 2008 and ARRA 2009.
3. IRC Sec. 55(b)(2).
4. Treas. Reg. §1.55-1(a).
5. Treas. Reg. §1.55-1(b).

years beginning after 2012. Under ATRA, the exemption amount for 2012 is $78,750 for joint filers, $39,375 for married taxpayers filing separately, and $50,600 for single filers.[1] In 2013, the exemption amounts increase to $80,800 for joint filers and surviving spouses, $51,900 for individual filers, $40,400 for married taxpayers filing separately and $23,100 for trusts and estates.[2] For 2014, the exemption amounts are $82,100 for joint filers and surviving spouses, $52,800 for individual filers, $41,050 for married taxpayers filing separately and $23,500 for trusts and estates.

Without this patch, exemption rates for 2012 would have been $45,000 for joint filers, $22,500 for marrieds filing separately, and $33,750 for single filers.

Exemption amounts were $72,450 in 2010 and $74,450 for 2011 on joint returns (or returns filed by surviving spouses); $47,450 in 2010 and $48,450 in 2011 on single returns; $36,225 in 2010 and $37,225 in 2011 for married taxpayers filing separately; and $22,500 returns filed by an estate or trust.

These exemption amounts are reduced by 25 percent of the amount by which the AMTI exceeds $156,500 on a joint return, $117,300 on a single return and $78,250 on a separate return or in the case of an estate or trust.[3] In 2008, a married individual filing a separate return was required to increase AMTI by the lesser of (a) 25 percent of the excess of the AMTI over $214,900, or (b) $34,975. After 2008, a married individual filing a separate return is required to increase AMTI by the lesser of (a) 25 percent of the excess of the AMTI over $165,000, or (b) $22,500.[4] For children subject to the "kiddie tax" (Q 591) the exemption is the lesser of the above amounts or the child's earned income plus $7,250 (as indexed for 2014, up from $7,150 in 2013).[5]

Adjustments

In general, the following adjustments are made to taxable income in computing alternative minimum taxable income: (1) generally, property must be depreciated using a less accelerated method or the straight line method over a period which is longer than that used for regular tax purposes, except that a longer period is not required for property placed in service after 1998; (2) the AMT net operating loss is deductible only up to 90 percent of AMTI determined without regard to such net operating loss; (3) no deduction is allowed for miscellaneous itemized deductions; (4) generally, no deduction is allowed for state and local taxes unless attributable to a trade or business, or property held for the production of income (recovery of state tax disallowed for AMT purposes in a previous year is not added to AMTI in the year recovered); (5) medical expenses are allowed as a deduction only to the extent such expenses exceed 10 percent of adjusted gross income; (6) interest on indebtedness secured by a primary or second residence is generally deductible (within dollar limitations) if incurred in acquiring, constructing, or substantially improving the residence; however, the amount of refinanced indebtedness

1. ATRA, Sec. 104.
2. Rev. Proc. 2013-15, 2013-5 IRB 444, Rev. Proc. 2013-35, 2013-47 IRB 537.
3. IRC Sec. 55(d), as amended by TEAMTRA 2008, ARRA 2009, and ATRA.
4. See IRC Sec. 55(d), as amended by TEAMTRA 2008 and ATRA.
5. IRC Sec. 59(j); Rev. Proc. 2009-50, 2009-45 IRB 617, Rev. Proc. 2012-41, 2012-45 IRB 539, Rev. Proc. 2013-35, above.

with regard to which interest is deductible is limited to the amount of indebtedness immediately prior to refinancing; (7) no standard deduction is allowed; (8) no deduction for personal exemptions is allowed; (9) the limitation on itemized deductions for upper-income taxpayers does not apply; (10) the taxpayer will include any amount realized due to a transfer of stock pursuant to the exercise of an incentive stock option; (11) AMTI is determined using losses from any tax shelter farm activity (determined by taking into account the AMTI adjustments and tax preferences) only to the extent that the taxpayer is insolvent or when the tax shelter farm activity is disposed of; and (12) passive activity losses (determined by taking into account the adjustments to AMTI and tax preferences) are not allowed in determining AMTI except to the extent that the taxpayer is insolvent.[1]

Preference Items

Items of tax preference which must be added to AMTI include: (1) the excess of depletion over the adjusted basis of property (except in the case of certain independent producers and royalty owners); (2) the excess of intangible drilling costs expensed (other than drilling costs of a nonproductive well) over the amount allowable for the year if the intangible drilling costs had been amortized over a 10 year period to the extent the excess is greater than 65 percent of the net income from oil, gas, and geothermal properties (with an exception for certain independent producers); (3) tax-exempt interest on specified private activity bonds (but reduced by any deduction not allowed in computing the regular tax if the deduction would have been allowable if the tax-exempt interest were includable in gross income) (ARRA 2009 provides that tax-exempt interest from private activity bonds issued during 2009 and 2010 is not a tax preference); (4) accelerated depreciation or amortization on certain property placed in service before 1987; and (5) seven percent of the amount excluded under IRC Section 1202 (gain on sales of certain small business stock).[2]

Credit for Prior Year Minimum Tax Liability

A taxpayer 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 total of the adjusted minimum taxes imposed in prior years reduced by the amount of minimum tax credits allowable in prior years. However, the amount of the credit cannot be greater than the excess of the taxpayer's regular tax liability (reduced by certain credits such as certain business related credits and certain investment credits) over the tentative minimum tax. The adjusted net minimum tax for any year is the AMT for that year reduced by the amount that would be the AMT if: (1) the only adjustments were those concerning the limitations on certain deductions (such as state taxes, certain itemized deductions, the standard deduction and personal exemptions); (2) the only preferences were those dealing with depletion, tax exempt interest, and small business stock; and (3) the limit on the foreign minimum tax credit did not apply. The adjusted net minimum tax is increased by the amount of any nonconventional fuel source credit and qualified electric vehicles credit that was not allowed for that year due to the AMT. For tax years after 2006 and

1. IRC Secs. 56, 58.
2. IRC Sec. 57(a).

before 2013, if an individual has minimum tax credits that have not been usable for three years, those long-term unused credits may be treated as a refundable credit.[1]

Social Security Taxes

654. What are the Social Security tax rates?

Although an automatic cost-of-living increase applies, the earnings base remained the same in 2009, 2010, and 2011. It was increased for inflation for 2012 to $110,100, for 2013 to $113,700, and for 2014 to $117,000. For 2011 and 2012, the OASDI rate was reduced by 2 percent for employees and self-employed individuals.

Self-employment tax: 15.30 percent (13.30 percent in 2011 and 2012) (12.40 percent OASDI and 2.90 percent hospital insurance). In 2014, the OASDI tax is imposed on up to $117,000 of self-employment income for a maximum tax of $14,508. In 2013, the OASDI tax is imposed on up to $113,700 of self-employment income for a maximum tax of $14,098.80. For 2012, the reduced OASDI tax was imposed on up to $110,100 of self-employment income, for a maximum tax of $11,450.40. The hospital insurance tax is imposed on all of a taxpayer's self-employment income. However, an above-the-line deduction is permitted for one-half of self-employment taxes paid by an individual and attributable to a trade or business carried on by the individual (not as an employee) (see Q 7951).[2] For compensation received in taxable years beginning after 2012, the hospital insurance tax is increased by 0.9 percent for wages above $250,000 for married taxpayers filing jointly and surviving spouses, $125,000 for married taxpayers filing separate, and $200,000 for single taxpayers and heads of households. The dollar thresholds for the 0.9 percent tax on the self-employment income of high wage earners are reduced (but not below zero) by wages subject to the FICA tax. The deduction for one-half of self-employment tax is not available for the additional 0.9 percent tax.

FICA: 7.65 percent (6.20 percent OASDI and 1.45 percent hospital insurance) for the employer and 7.65 percent (5.65 percent for 2011 and 2012) (6.20 percent OASDI and 1.45 percent hospital insurance) for the employee for 2011 and 2012. In 2014, the OASDI tax is imposed on up to $117,000 of wages for a maximum tax of $7,254.00 for the employer and $7,254.00 for the employee or $14,508 for employer and employee together. In 2013, the OASDI tax was imposed on up to $113,700 of wages for a maximum tax of $7,049.40 for the employer and $7,049.40 for the employee or $14,098.80 for employer and employee together. In 2012, the OASDI tax was imposed on up to $110,100 of wages, for a maximum tax of $6,826.20 for employers and $4,624.20 for employees, or $11,450.40 for employer and employee. The hospital insurance tax is imposed on all of a taxpayer's wages.[3] For compensation received in taxable years beginning after 2012, the employee's portion of the hospital insurance tax is increased to 2.35 percent for wages above $250,000 for married taxpayers filing jointly (tax applies to combined wages of taxpayer and taxpayer's spouse) and surviving spouses, $125,000 for married taxpayers filing separate, and $200,000 for single taxpayers and heads of households.

1. IRC Sec. 53.
2. IRC Sec. 164(f).
3. IRC Secs. 3101(b), 3121(u).

Back wages paid as the result of a settlement agreement are subject to FICA and FUTA taxes in the year the wages are actually paid, not in the year the wages were earned or should have been paid.[1]

Payroll tax forgiveness for new hires in 2010. An employer who hired certain persons in 2010 did not have to pay the 6.2 percent OASDI tax on such person for employment after March 18, 2010 and before 2011.[2]

In general, the new employee had to be hired after February 3, 2010 and before 2011, must not have been employed for more than 40 hours during the 60-day period ending on the day the person began the employment, must not have been hired to replace another employee unless the employee separated from service voluntarily or for cause, and must not have been related to the employer. The payroll tax relief is not available for federal, state, or local governments and their instrumentalities, except for institutions of higher learning.

The employer could elect to have the payroll tax forgiveness provision not apply. The Work Opportunity Credit was not available for wages of an employee for which the payroll tax forgiveness provision applied for the one-year period beginning on the date such person was hired.[3]

Business Credit for New Hires in 2010. In the case of taxable years beginning after March 18, 2010, the business credit under IRC Section 38 was increased by the lesser of $1,000 or 6.2 percent of wages paid during a 52 week period for certain new hires. The employee must have been employed on any date during the year, the employee must have been hired for a period of not less than 52 consecutive weeks, and the employee's wages during the last 26 weeks of such period must have equalled at least 80 percent of the employee's wages during the first 26 weeks of such period.

Tax on Investment Income. For investment income (excludes distributions from qualified plans and IRAs) received in taxable years beginning after 2012, an additional tax is imposed at 3.8 percent on the lesser of (1) net investment income, or (2) the excess of modified adjusted gross income over $250,000 for married taxpayers filing jointly and surviving spouses, $125,000 for married taxpayers filing separately, and $200,000 for single taxpayers and heads of households. For trusts and estates, the 3.8 percent additional tax is imposed on the lesser of (1) undistributed net investment income, or (2) the excess of adjusted gross income over the dollar amount for which the highest income tax bracket begins.[4]

655. Who must pay the self-employment tax?

An individual whose net earnings from self-employment are $400 or more for the taxable year must pay the self-employment tax.[5] In 2014, such an individual must file

1. *U.S. v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001). See also *The Phillies v. U.S.* 153 F. Supp. 2d 612 (E.D. PA. 2001).
2. IRC Sec. 3111(d), as added by HIREA.
3. IRC Sec. 51(c), as added by HIREA.
4. IRC Sec. 1411.
5. IRC Sec. 6017.

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). However, 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 (not as an employee).[1] 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.

Community Property

656. How can community property law affect the federal income tax treatment of investment income?

Community property law applies in determining whether property and the income it produces is community property or separate property if (1) in the case of income from personal property, the spouses or either of them is domiciled in a community property state; or (2) in the case of income from real property, the property is located in a community property state, regardless of the spouses' domicile(s).[2]

In the states of Arizona, California, Nevada, New Mexico, and Washington, income from separate property is separate property of the spouse who owns the property. In the states of Idaho, Louisiana, and Texas, income from separate property is community property. (In Wisconsin, under the Marital Property Act, income from individual (separate) property is marital (community) property. For federal income tax purposes, the IRS has recognized that spouses' rights under the Wisconsin Marital Property Act are community property rights).[3] In May 1998 Alaska adopted a wholly consensual community property statute, which allows married couples to select which assets are community property and which assets are to be held in some other form of ownership. Both resident and non-resident married couples may classify property as community property by transferring it to a community property trust which has been established under the provisions of the statute.

In all community property states, the income from community property is, of course, community property. And in all states, spouses can have community property converted to separate property by partitioning or by making gifts or sales of their community interests in property. For federal income tax purposes, the distinctions between separate property and community property are important when the spouses file separate returns.

The rules in all community property states for determining whether property is separate or community are quite similar. In general, separate property is (1) property owned by a spouse before marriage and brought into the marriage as such, (2) property acquired by a spouse by gift, will or inheritance during marriage, and (3) property exchanged for separate property or

1. IRC Sec. 164(f).
2. *Poe v. Seaborn*, 282 US 101 (1930); Boris I. Bittker, *Federal Taxation of Income, Estates and Gifts* (Boston: Warren, Gorham & Lamont, Inc., 2nd Ed., 1991) vol. 3, ¶76.2.
3. Rev. Rul. 87-13, 1987-1 CB 20.

bought with separate funds during marriage. Once property is identified as separate property, it remains separate property as long as it can be traced. All other property is community property (i.e., property owned one-half by each spouse). Earnings of the spouses while domiciled in a community property state are community property. Property acquired during marriage with community funds is presumed to be community property even if title to the property is taken in the name of one spouse only. The presumption can be rebutted only by clear and convincing evidence that the spouses intended the property to be the separate property of the spouse who has title.

The Tax Court held that a married couple's marriage contract had the effect of stopping the application of Louisiana's community property laws for federal income tax purposes, noting that, shortly before marrying, the couple "filed for registry" (in the parish where both of them resided) a marriage contract stating that "the intended husband and wife shall be separate in property."[1]

In general, if property is bought partly with community funds and partly with separate funds, the property is partly community and partly separate in proportion to the source of the funds. If the property is bought with separate and community funds that have been so commingled that it is not known what part is separate and what part is community, the whole will probably be considered community, and consequently the property purchased will likewise be community. But see Q 659 for a different effect of commingling when spouses move to a noncommunity property state.

The IRS may disallow the benefits of any community property law to any taxpayer who acts as if he or she were solely entitled to certain income and failed to notify his or her spouse before the due date (including extensions) for filing the return for the taxable year in which the income was derived of the nature and amount of such income.[2] In Service Center Advice, the Service stated that taxpayers domiciled in community property states have an undivided one-half interest in the entire community so that their filing status must be married filing jointly or, if married filing separately, their returns must each reflect one-half of the total community income and expenses. The Service must establish facts and evidence to demonstrate that IRC Section 66(b) applies (i.e., it may disregard community property laws where the spouse is not notified of community income).[3]

A California appeals court held that a spouse's early retirement benefit must be characterized as community property where (1) the benefit is payable pursuant to a contract entered into during the marriage, and (2) the years of qualifying employment occurred before the parties' separation.[4]

The Tax Court held that in a community property jurisdiction, the spouse of a distributee who did not receive a distribution from an IRA should not be treated as a distributee (under

1. *Downing v. Comm.*, TC Memo 2003-347.
2. IRC Sec. 66(b).
3. SCA 200030022.
4. *Drapeau v. Drapeau*, 93 Cal. App. 4th 1086 (2001).

IRC Section 408(d)) despite whatever his or her community property interest in the IRA may have been under state law. Thus, under these circumstances, distributions are taxable to the distributee and the penalty tax (under IRC Section 72(t)) applies to the distributee spouse, only.[1]

The Tax Court also held that a taxpayer's gross income from his continued employment—which he received in lieu of retirement benefits—did *not* include the amount of payments to which his former spouse was entitled under California community property law on the basis of the pension earned by the taxpayer. But the appeals court reversed the Tax Court's decision, holding the fact that the taxpayer owed money to a creditor—in this case his former spouse—did not justify excluding any amount of his wages from income.[2]

For guidance on the classification for federal tax purposes of a qualified entity that is owned by a husband and wife as community property under the laws of a state, foreign country, or possession of the United States, see Revenue Ruling 2002-69.[3]

For more information, see IRS Publication 555, "Federal Tax Information on Community Property."

657. How is community income reported if spouses live apart?

Special rules apply when reporting certain community income of two individuals who are married to one another at any time during the calendar year, if all the following conditions exist:

(1) The spouses live apart all year;

(2) The spouses do not file a joint return with each other for a tax year beginning or ending within the calendar year;

(3) Either or both spouses have earned income for the calendar year that is community income; and

(4) The spouses have not transferred, directly or indirectly, any of their earned income between themselves before the end of the year.

If all these conditions exist, the spouses must report their community income as explained below.[4]

Earned income. Earned income that is not trade or business or partnership income is treated as the income of the spouse who performed the personal services.

Trade or business income. Trade or business income and deductions attributable to such trade or business are treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which

1. See *Morris v. Comm.*, TC Memo 2002-17, *Bunney v. Comm.*, 114 TC 259 (2000).
2. *Comm. v. Dunkin*, 500 F.3d 1065 (9th Cir. 2007), *reversing*, 124 TC 180 (2005).
3. 2002-2 CB 760.
4. IRC Secs. 66(a), 879(a).

case all of such gross income and deductions are treated as the gross income and deductions of the wife.

Partnership income or loss. A partner's distributive share of partnership income or loss from a trade or business carried on by a partnership is the income or loss of the partner, and no part of it is his spouse's.

Income from separate property. Community income derived from a spouse's separate property (see Q 656) is treated as that spouse's income.

All other community income. All other community income, such as dividends, interest, rents, royalties, or gains, is treated as provided in the applicable community property law.[1]

If an individual subject to the foregoing special rules (1) does not include in gross income an item of community income properly includable under the above rules in the other spouse's gross income, and (2) establishes that he or she did not know of, and had no reason to know of, such item of community income, and the IRS determines that under the facts and circumstances it would be inequitable to include such item of community income in that individual's income, then the income item will be includable in the other spouse's gross income (rather than in the individual's gross income).[2] The Service has released guidance for taxpayers seeking equitable innocent spouse relief under IRC Section 66(c).[3]

The Tax Court held that it has authority to review the Service's determination that a spouse is not entitled to equitable relief under IRC Section 66(c).[4] The Tax Court also held that unlike IRC Section 6015(e) (which provides for equitable relief from liability for the understatement of tax), IRC Section 66 does not provide for jurisdiction permitting a taxpayer to file a "stand alone" petition in response to a denial of a request for relief made pursuant to IRC Section 66(c).[5]

For the treatment of community income in general, see Treasury Regulation Section 1.66-1. For the treatment of community income where spouses live apart, see Treasury Regulation Section 1.66-2. With respect to the denial of benefits of community property law where the spouse is not notified, see Treasury Regulation Section 1.66-3. For the rules governing the request for relief from the operation of community property law, see Treasury Regulation Section 1.66-4.

658. How does community property law affect the federal income tax treatment of dividends received from corporate stock?

If state law characterizes the income as community income (see Q 656); the dividends are treated as having been received one-half by each spouse. This rule has been held to apply to dividend income received by a spouse as marital property under the Wisconsin Marital Property

1. IRC Sec. 66(a).
2. IRC Sec. 66(c).
3. See Rev. Proc. 2003-61, 2003-2 CB 296, *superseding*, Rev. Proc. 2000-15, 2000-1 CB 447.
4. *Beck v. Comm.*, TC Memo 2001-198; *revised acq.*, AOD CC-2002-05 (12-9-2002).
5. *Bernal v. Comm.*, 120 TC 102 (2003).

Act.[1] If the dividends are characterized as separate property and the spouses file separate returns, each spouse reports his or her own separate income.[2]

659. If spouses move from a community property state to a common law state, will their community property rights in the property they take with them be recognized and protected by the law of their new domicile?

Yes.[3] Thus, if the spouses report their incomes separately, the income from the community property or from property into which the community property is traceable is reported by the spouses as belonging one-half to each.[4] If income is community income, the deductions applicable to it must be taken one-half from each spouse's portion if they file separately.[5] But if community property is commingled with one spouse's separate property so that the original community property cannot be traced, the income from the property must be reported as that spouse's separate income, if the spouses file separately.[6]

Divorce

660. Do transfers of property between spouses, or between former spouses incident to a divorce, result in taxable gains and losses?

Property transferred between spouses or former spouses incident to a divorce generally will not result in recognition of gain or loss (unless the transfer is by trust, under certain circumstances, or pursuant to an instrument in effect on or before July 18, 1984, and the spouses or former spouses have not elected otherwise).[7] The property transferred will be treated as if it were acquired by gift, and the transferor's basis in the property will be carried over to the transferee, whether the fair market value of the property is more or less than the transferor's basis.[8] Ordinarily, if the fair market value of property transferred as a gift is less than the donor's basis, the fair market value is the donee's basis for determining loss (see Q 598).

This nonrecognition rule means that the transfer of property between divorcing spouses in exchange for the release of marital claims generally will not result in a gain or loss to the transferor spouse. A transfer is considered made "incident to a divorce" if it is made within one year after the date the marriage ceases, or if the transfer is related to the cessation of the marriage.[9] A transfer is related to the cessation of a marriage if: (1) the transfer is pursuant to a divorce or separation instrument; and (2) the transfer occurs not more than six years after the date on which the marriage ceases.

Transfers not meeting the above two requirements are presumed *not* to be related to the cessation of a marriage, but taxpayers may overcome this presumption by showing that the

1. Rev. Rul. 87-13, 1987-1 CB 20.
2. IRS Pub. 555.
3. *Johnson v. Comm.*, 7 BTA 820 (1927).
4. *Phillips v. Comm.*, 9 BTA 153 (1927).
5. *Stewart v. Comm.*, 95 F.2d 821 (5th Cir. 1938).
6. *Johnson v. Comm.*, 1 TC 1041 (1943), appeal dismissed, 139 F.2d 491 (8th Cir. 1943).
7. IRC Sec. 1041. See IRS Pub. 504, Tax Information for Divorced or Separated Individuals.
8. IRC Sec. 1041(b).
9. IRC Sec. 1041(c).

transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. Taxpayers may show this by establishing that certain factors, such as legal impediments, hampered an earlier transfer of the property, provided that the transfer occurs promptly after any cause for the delay is resolved.[1] For example, a transfer of a business interest between former spouses that did not occur within six years of their divorce was considered incident to divorce since there existed a legal dispute between the former spouses concerning the value of the property and the terms of payment.[2] See also *Young v. Commissioner*,[3] in which a transfer within four years of the divorce was considered to have been made "incident to divorce," thus making all gain on the transaction taxable to the transferee spouse.[4]

While the nonrecognition rule shields from recognition gain that would ordinarily be recognized on a sale or exchange of property, it does not shield from recognition interest income that is ordinarily recognized upon the assignment of that property to another taxpayer. Where a husband transferred Series E and EE bonds to his wife pursuant to a divorce settlement, the IRS determined that he must include as income the unrecognized interest accrued from the date of original issuance to the date of transfer. This income does not constitute gain, for purposes of the nonrecognition rule, but rather is interest income subject to the general rule that deferred, accrued interest on United States savings bonds be included as income in the year of transfer. The wife's basis in the bonds became the amount of the husband's basis *plus* the amount of deferred, accrued interest recognized by him upon transfer.[5]

The Tax Court held that the nonrecognition provided in IRC Section 1041 does not apply to interest income received by a spouse through monthly installment payments made on a promissory note executed to effect a division of marital property. The court reasoned that the principal and interest portions of an installment payment constitute two distinct items that give rise to separate federal income tax consequences. Thus, the portions of the monthly installment payments that were allocated to principal under the terms of the separation agreement were not taxable to the payee spouse, but the portions allocated to interest were taxable to her.[6]

Where property is transferred by trust, either between spouses, or between former spouses incident to divorce, gain will be recognized by the transferor to the extent that the sum of the liabilities assumed by the transferee plus the amount of liabilities to which the property is subject exceeds the total of the adjusted basis of all the property transferred. The transferee's basis will be adjusted to reflect the amount of gain recognized by the transferor.[7]

In addition, the transfer of an installment obligation generally will not trigger gain, and transfer of investment credit property will not result in recapture if the property continues to be used in a trade or business.[8] However, where installment obligations are transferred in trust,

1. Temp. Treas. Reg. §1.1041-1T(b).
2. Let. Rul. 9235026.
3. 113 TC 152 (1999), *aff'd*, 240 F.3d 369 (4th Cir. 2001).
4. Let. Rul. 200233022.
5. Rev. Rul. 87-112, 1987-2 CB 207 clarified by Rev. Rul. 2002-22, 2002-1 CB 849.
6. *Yankwich v. Comm.*, TC Memo 2002-37.
7. IRC Sec. 1041(e).
8. IRC Secs. 50(a)(5)(B), 453(h); Temp. Treas. Reg. §1.1041-1T(d), A-13. See IRS Pub. 537.

gain will be recognized by the transferor to the extent that the obligation's fair market value at the time of transfer exceeds its basis.[1]

The transfer of an interest in an individual retirement account or an individual retirement annuity to a spouse pursuant to a divorce or separation instrument will not be considered a taxable event. The individual retirement account will be treated as owned by the transferee at the time of transfer, and the transfer does not result in taxable gain or loss.[2] However, the statutory requirements for this nonrecognition treatment must be strictly observed.[3] The Service privately ruled that a husband's payment of a lump-sum in exchange for his ex-wife's community property interest in a nonqualified deferred compensation plan payable to the husband by his employer constituted nontaxable transfers between former spouses related to the cessation of their marriage. Furthermore, the assignment of income doctrine did not cause the wife to be taxed when her former husband received payment of that deferred compensation from his employer.[4]

The IRS has determined that the division of one charitable remainder unitrust (CRUT – see Q 7980) into two CRUTs to effectuate a property settlement in a divorce proceeding does not cause the original or resultant trusts to fail to qualify under IRC Section 664.[5]

The Service has ruled that when nonstatutory stock options and nonqualified deferred compensation are transferred incident to divorce, the nonstatutory stock options will be taxed at the time that the receiving spouse exercises the options, and the deferred compensation will be taxed when paid (or made available) to the receiving spouse.[6] In addition, the Service has ruled that the transfer of interests in nonstatutory stock options and nonqualified deferred compensation from the employee spouse to the nonemployee spouse incident to divorce does not result in a payment of wages for FICA and FUTA tax purposes. The nonstatutory stock options are subject to FICA and FUTA taxes at the time of exercise by the nonemployee spouse to the same extent as if the options had been retained and exercised by the employee spouse. The nonqualified deferred compensation also remains subject to FICA and FUTA taxes to the same extent as if the rights to the compensation had been retained by the employee spouse. To the extent FICA and FUTA taxation apply, the wages are those of the employee spouse. The employee portion of the FICA taxes is deducted from the wages as, and when, the wages are taken into account for FICA tax purposes. The employee portion of the FICA taxes is deducted from the payment to the nonemployee spouse. The revenue ruling also contains reporting requirements with respect to such transferred interests.[7]

Stock redemptions. If a corporation redeems stock owned by a wife, and the wife's receipt of property with respect to the stock is treated, under applicable tax law, as a constructive distribution to the husband (i.e., where the non-redeeming shareholder has a primary and unconditional obligation to purchase the redeeming shareholder's stock), the final regulations

1. IRC Secs. 50(a)(5)(B), 453B(g).
2. IRC Sec. 408(d)(6).
3. See, e.g., *Jones v. Comm.*, TC Memo 2000-219.
4. Let. Rul. 200442003.
5. See, e.g., Let. Ruls. 200301020, 200221042, 200143028, 200120016, 200109006, 200045038, 200035014, 9851007, 9851006, 9403030.
6. Rev. Rul. 2002-22, 2002-1 CB 849.
7. Rev. Rul. 2004-60, 2004-24 IRB 1051, modifying, Notice 2002-31, 2002-1 CB 908. See also Let. Rul. 200646003.

treat the redemption as (1) a transfer of the stock by the wife to the husband, followed by (2) a transfer of the stock by the husband to the redeeming corporation.[1] Nonrecognition treatment would apply to the deemed transfer of stock by the wife to the husband (assuming IRC Section 1041 requirements are otherwise satisfied), so that no gain or loss would be included on account of that portion of the transaction. However, nonrecognition treatment would *not* apply to the deemed transfer of stock from the husband to the redeeming corporation.[2]

The receipt of any property by the wife from the redeeming corporation with respect to the stock would be recharacterized as (1) a transfer of such property to the husband by the redeeming corporation in exchange for the stock, in a transaction to which nonrecognition treatment would not apply, followed by (2) a transfer by the husband to the wife in a transaction, to which nonrecognition treatment would apply (assuming the requirements of IRC Section 1041 are otherwise satisfied).[3] For details of the rules applicable to constructive transfers between spouses and former spouses, see Treasury Regulation Section 1.1041-2.[4]

A divided Tax Court held that a stock redemption incident to divorce qualified for nonrecognition treatment where the ex-wife was considered to have transferred property to a third party on behalf of her ex-husband. The court further held that the primary and unconditional obligation standard is not an appropriate standard to apply in a case involving a corporate redemption in a divorce setting.[5] See also *Craven v. U.S.*[6] (stock redemption incident to divorce qualified for nonrecognition treatment). But see FSA 200222008 (where the Service ruled that based on the language in the settlement agreement, the redemption should be treated as a complete termination of the wife's interest; thus, the wife was taxable on the stock redemption. The Service reasoned that the intent of IRC Section 1041 and the parties involved was best served by respecting the form of the redemption transaction). For the tax treatment of stock options transferred incident to a divorce, generally, see FSA 200005006.

Where a husband transferred his 25 percent interest in real property to his former wife, in consideration for a settlement agreement that provided to her a credit against the $500,000 equalizing money judgment that he owed to her, and the former wife then sold her undivided 50 percent interest in the same property to an unrelated third party, the Tax Court held as follows: (1) the first transaction, which occurred within one year after the date of the divorce, took place incident to divorce and, therefore, qualified for nonrecognition treatment under IRC Section 1041(a)(2); and (2) the second transaction did *not* fall within IRC Section 1041(a)(2) because it was not a transfer to, or on behalf of, the taxpayer's former husband and incident to divorce. The Tax Court reasoned that the wife's sale of the property to the unrelated third party did not satisfy any legal obligation or liability that the taxpayer's former husband owed to her (or anyone else). Accordingly, the Tax Court concluded that the wife would have to recognize gain resulting from the sale in her interest in the property.[7]

1. Treas. Reg. §1.1041-2(a)(2).
2. Treas. Reg. §1.1041-2(b)(2).
3. Treas. Regs. §§1.1041-2(a)(2), 1.1041-2(b)(2).
4. TD 903567 Fed. Reg. §1534 (1-13-2003).
5. *Read v. Comm.*, 114 TC 14 (2000), *aff'd* per curiam, *Mulberry Motor Parts, Inc. v. Comm.*, 273 F.3d 1120 (11th Cir. 2001).
6. 215 F.3d 1201 (11th Cir. 2000).
7. *Walker v. Comm.*, TC Memo 2003-335; compare Read, Craven, above.

Transfers occurring before July 19, 1984 were subject to substantially different rules, which sometimes resulted in a taxable gain to the transferor spouse. For application of the gift tax to property settlements, see Q 740.

661. Are alimony payments included in the gross income of the recipient? May the payor spouse take a deduction for these payments?

Alimony and separate maintenance payments generally are taxable to the recipient and deductible from gross income by the payor (even if the payor does not itemize).[1] Payments of arrearages from prior years are taxed to a cash basis taxpayer in the year of receipt.[2] Furthermore, the Tenth Circuit Court of Appeals has held that an alimony arrearage paid to the estate of a former spouse was taxable as income in respect of a decedent (see Q 636).[3]

A payment received by (or on behalf of) a recipient spouse pursuant to a divorce or separation instrument executed after 1984 is an alimony or separate maintenance payment if: (1) the payment is made in cash; (2) the divorce or separation instrument does not designate the payment as *not* includable or deductible as alimony;[4] (3) there is no liability to make the payments after the death of the recipient,[5] where the Tax Court held that "substitute" payments – i.e., post-death payments that would begin as a result of the death of the taxpayer's ex-wife, and would substitute for a continuation of the payments that terminated on her death, and that otherwise qualified as alimony – were not deductible alimony payments); and (4) if the individuals are legally separated under a decree of divorce or separate maintenance, the spouses are not members of the same household at the time the payment is made.[6]

A divorce or separation instrument includes any decree of divorce or separate maintenance or a written instrument incident to such, a written separation agreement, or other decree requiring spousal support or maintenance payments.[7] The failure of the divorce or separation instrument to provide for termination of payments at the death of the recipient will not disqualify payments from alimony treatment.[8] However, if both the divorce or separation instrument and state law fail to unambiguously provide for the termination of payments upon death, such payments may be disqualified from receiving alimony treatment.[9]

It has been held that an attorney's letter detailing a settlement agreement constituted a separation instrument for purposes of determining whether payments made thereunder were alimony.[10] However, a list of expenses by the former wife, negotiation letters between attorneys,

1. IRC Secs. 71(a), 215(a).
2. *Coleman v. Comm.*, TC Memo 1988-442.
3. *Kitch v. Comm.*, 103 F. 3d 104, 97-1 USTC ¶50,124 (10th Cir. 1996).
4. See *Richardson v. Comm.*, 125 F.3d 551 (7th Cir. 1997), *aff'g* T.C. Memo 1995-554; see also Let. Rul. 200141036.
5. See, e.g., *Okerson v. Comm.*, 123 TC 258 (2004).
6. IRC Sec. 71(b).
7. IRC Sec. 71(b)(2).
8. See IRC Sec. 71(b)(1)(D); TRA '86 Conf. Rept. at page 849.
9. *Hoover v. Comm.*, 102 F. 3d 842, 97-1 USTC ¶50,111 (6th Cir. 1996); *Ribera v. Comm.*, TC Memo 1997-38. See *Mukherjee v. Comm.*, TC Memo 2004-98; *Lovejoy v. Comm*, 293 F.3d 1208 (10th Cir. 2002), *aff'g*, *Miller v. Comm.*, TC Memo 1999-273; *Thomas D. Berry v. Comm*, 36 Fed. Appx. 400, 2002 U.S. App. LEXIS 10785 (10th Cir. 2002), *aff'g*, TC Memo 2000-373; *Fithian v. United States*, 45 Fed. Appx. 700, 2002-2 USTC ¶50,629 (9th Cir. 2002). But see *Kean v. Comm.*, 407 F. 3d 186, 2005-1 USTC ¶50,397 (3rd Cir. 2005), *aff'g*, TC Memo 2003-163; *Michael K. Berry v. Comm.*, TC Memo 2005-91.
10. *Azenaro v. Comm.*, TC Memo 1989-224.

notations on the husband's check to his former wife indicating support, and the fact that the husband actually provided support did not constitute a written separation agreement for purposes of IRC Sections 71(b)(2) and 215.[1] A husband's payments to his wife during the couple's separation under a later invalidated separation agreement and subsequent payments made pursuant to a circuit court's orders were held to be alimony or separate maintenance payments.[2]

The deduction for alimony paid is limited to the amount required under the divorce or separation instrument.[3] Payments made voluntarily by a husband to his spouse, which were not mandated by a qualifying divorce decree or separation instrument, were not deductible to the husband.[4] Where the husband made his initial payment too early because he wanted to "get it over with," and because it was convenient for him to schedule his alimony payments on or immediately after his paydays, the Tax Court concluded that the husband's premature payment was voluntary because it fell outside the scope of the qualified divorce instrument. Accordingly, the payment was not deductible by the husband as alimony.[5]

According to the General Explanation of TRA '84, where a beneficial interest in a trust is transferred or created incident to a divorce or separation, the payments by the trust will be treated the same as payments to a trust beneficiary under IRC Section 682, disregarding that the payments may qualify as alimony. Thus, instead of including payments entirely as ordinary income, the transferee, as beneficiary, may be entitled to the flow-through of tax-exempt income.

The Tax Court held that interest income, which arose from annual payments made to the taxpayer by her former husband under their divorce settlement, was taxable to the wife. The court further held that because the wife was not able to differentiate between the costs incurred in connection with the divorce, and the amounts paid to obtain the interest income, the taxpayer was therefore not entitled to deduct the interest income under IRC Section 212 (i.e., as an ordinary and necessary expense paid or incurred for the production or collection of income).[6]

The Tax Court held that a contract for deed is a third-party debt instrument; consequently, the taxpayer could not deduct the value of the contract for deed transferred to his former spouse as alimony because it did not constitute a cash payment.[7]

In deciding whether the transfer of ownership of an annuity contract itself constituted alimony, the Service determined that, because IRC Section 71 and the treasury regulations make it clear that in order to constitute alimony a payment must be in cash, the transfer of ownership

1. *Ewell v. Comm.*, TC Memo 1996-253.
2. *Richardson v. Comm.*, 125 F.3d 551 (7th Cir. 1997), *aff'g*, TC Memo 1995-554.
3. *Ritchie v. Comm.*, TC Memo 1989-426.
4. *Meyer v. Comm.* TC Memo 2003-12. See also *Ali v. Comm.*, TC Memo 2004-284.
5. See *Ray v. Comm.*, TC Summary Opinion 2006-110.
6. *Cipriano v. Comm.*, 55 Fed. Appx. 104, 2003-1 USTC ¶50,203 (3rd Cir. 2003), *aff'g*, TC Memo 2001-157.
7. *Lofstrom v. Comm.*, 125 TC 271 (2005).

of the annuity contract to the taxpayer in this instance did not constitute alimony includable in the taxpayer's gross income.[1]

For the types of payments that can constitute alimony payments, see *Mozley v. Commissioner*,[2] (military retirement payments); *Zinsmeister v. Commissioner*,[3] (payments on first mortgage, real estate taxes, and miscellaneous expenses); *Marten v. Commissioner*,[4] (life insurance premiums paid on former wife's life insurance policy insuring the couple's paraplegic child); but cf. *Berry v. Commissioner*,[5] (former wife's attorney's fees not deductible). Alimony can include rental payments paid to a former spouse. See *Israel v. Commissioner*.[6] However, lump sum payments made by a husband to his former wife under a consent judgment were not deductible under IRC Section 215(a) except to the extent the lump sum constituted past due alimony.[7]

Recapture. Alimony recapture rules generally require recapture in the third post-separation year of "excess" payments (i.e., disproportionately large payments made in either the first or second years–or both–that are deemed to represent nondeductible property settlements previously deducted as alimony). The first post-separation year is the first calendar year in which alimony or separate maintenance payments are made; the second and third years are the next two calendar years thereafter.

The amount recaptured is included in the income of the payor spouse and deducted from the gross income of the recipient. The amount recaptured is determined by first comparing the alimony payments made for the second and third post-separation years. If payments during the second year exceed the payments during the third year by more than $15,000, the excess is "recaptured." Next, the payments during the first year are compared with the average of the payments made during the second year (as reduced by any recaptured excess) and the payments made during the third year. If the payments made during the first year exceed the average of the amounts paid during the second (as reduced) and third years by more than $15,000, the excess is also recaptured.[8]

There are limited exceptions to the recapture rule: if payments cease because of the marriage of the recipient or the death of either spouse before the close of the third separation year, or to the extent payments required over at least a 3-year period are tied to a fixed portion of income from a business or property or compensation, the payments will not come within these rules. Furthermore, payments under temporary support orders do not come within the recapture rules.[9]

Payments made under instruments executed before 1985 are taxed under different rules (i.e., IRC Section 71 prior to TRA '84, unless the instrument is modified after 1984).

1. Let. Rul. 200536014.
2. TC Memo 2001-125.
3. TC Memo 2000-364, *aff'd per curiam*, 21 Fed. Appx. 529 (8th Cir. 2001).
4. TC Memo 1999-340, *on motion for reconsideration, holding reaffirmed in* TC Memo 2000-185; *aff'd per curiam*, *Comm. v. Lane*, 2002 U.S. App. LEXIS 8367 (9th Cir. 2002).
5. 36 Fed. Appx. 400, 2002 U.S. App. LEXIS 10785 (10th Cir. 2002), *aff'g*, TC Memo 2000-373.
6. TC Memo 1995-500. See Temp. Treas. Reg. §1.71-1T(b), A-6.
7. *Barrett v. U.S.*, 74 F. 3d 661, 96-1 USTC ¶50,084 (5th Cir. 1996).
8. IRC Sec. 71(f).
9. IRC Sec. 71(f)(5); Temp. Treas. Reg. §1.71-1T(d), A-25.

Depending on the date of modification after 1984, either the TRA '84 rules or a 3-year recapture period will apply, or the recapture rules for instruments executed after 1986 (described above) will apply.

When a payor spouse claims alimony payments as a deduction, he is required to furnish the recipient spouse's Social Security number on his tax return for each taxable year the payments are made.[1] Alimony paid by a U.S. citizen spouse to a foreign spouse is deductible by the payor spouse even though the recipient is not taxable on the income under a treaty; however, the penalty for failing to include the recipient's Taxpayer Identification Number (TIN) on the payor's tax return may still apply. [2]

662. Is child support taxed in the same manner as alimony payments?

Child support. Any portion of an alimony payment specified in the divorce or separation instrument as payable for child support is not treated as alimony (Q 661).[3] In *Freyre v. U.S.*,[4] the appeals court held that because the divorce court order did not specifically designate or fix the disputed monthly payments as child support, as required in the statute[5] and the treasury regulations,[6] the payments had to be considered as alimony and, thus, were deductible by the taxpayer.[7]

Even portions not specified as child support may be treated as child support to the extent that the amount of the alimony payment provided for in the divorce or separation instrument is to be reduced on the occurrence of a contingency relating to a child or at a time clearly associated with such a contingency (e.g., the year a child would turn 18 years old).[8] If the divorce or separation instrument provides for alimony and child support payments, any payment of less than the amount specified in the instrument will be applied first as child support, to the extent of the amount specified in the instrument.[9] The Tax Court determined that an agreement between former spouses, absent a court modification of their divorce decree, would not alter the tax consequences of this provision.[10] A parent was required to include in his gross income the portion of a distribution from his pension plan that was used to satisfy a back child support obligation.[11]

The Service has privately ruled that interest paid on past due child support is taxable income to the recipient parent. According to the Service, interest income is not excludable income in the same manner as amounts designated for child support are excludible. The Service reasoned that for child support to be excludable from gross income, the decree, instrument or agreement must specifically designate the sum as child support; interest that is assessed later does not come under an amount specifically designated as child support.[12]

1. Temp. Treas. Reg. §1.215-1T, A-1.
2. CCA 200251004.
3. IRC Sec. 71(c)(1).
4. 135 Fed. Appx. 863 (6th Cir. 2005).
5. IRC Sec. 71(c)(1).
6. Treas. Reg. §1.71-1(e).
7. See also *Preston v. Comm.*, 209 F.3d 1281 (11th Cir. 2000).
8. IRC Sec. 71(c)(2). See Let. Rul. 9251033.
9. IRC Sec. 71(c)(3).
10. *Blair v. Comm.*, TC Memo 1988-581.
11. *Stahl v. Comm.*, TC Memo 2001-22.
12. Let. Rul. 200444026.

Trusts and Estates

663. How is the federal income tax computed for trusts and estates?

Taxable income is computed by subtracting the following from gross income: allowable deductions; amounts distributable to beneficiaries; and the exemption. Estates are allowed a $600 exemption. For trusts that are required to distribute all their income currently, the exemption is $300; for all other trusts, $100. Certain trusts that benefit disabled persons may use the personal exemptions available to individuals.[1] A standard deduction is not available.[2] Rates are determined from a table for estates and trusts (see Appendix B).

For estates of decedents dying after August 5, 1997, an election may be made to treat a *qualified revocable trust* as part of the decedent's estate for income tax purposes. The election must be made by both the executor of the estate and the trustee of the qualified revocable trust. A qualified revocable trust is a trust that was treated as a grantor trust during the life of the decedent due to his power to revoke the trust (see Q 664). If such an election is made, the trust will be treated as part of the decedent's estate for tax years ending after the date of the decedent's death and before the date that is two years after his death (if no estate tax return is required) or the date that is six months after the final determination of estate tax liability (if an estate tax return is required).[3]

Generally, income that is accumulated by a trust is taxable to the trust, and income that is distributable to beneficiaries is taxable to the beneficiaries.[4] A beneficiary who may be claimed as a dependent by another taxpayer may not use a personal exemption, and his standard deduction may not exceed the greater of (1) $500 as indexed ($1,000 in 2013 and 2014, up from $950 for 2011 and 2012); or (2) $250 as indexed ($350 in 2013 and 2014, up from $300 for 2010 through 2012) plus earned income.[5] The amount of trust income which can be offset by the basic standard deduction will be reduced if the beneficiary has other income (see Q 626, Q 638). Also, trust income taxable to a beneficiary under 19 years of age (24 for certain students) may be taxed at the parents' marginal tax rate (see Q 591).[6]

A charitable remainder trust is generally not subject to income tax (see Q 7994). However, beneficiaries of a charitable remainder trust are taxable on distributions (see Q 7991). A charitable lead trust is generally taxable as a grantor trust (see Q 664) if an upfront charitable deduction is claimed (see Q 7997). Otherwise, a charitable lead trust is generally taxed as described here. Proposed regulations would treat annuity distributions from charitable lead annuity trusts (CLATs) and unitrust distributions from charitable lead unitrusts (CLUTs) as made proportionately from all categories of trust income. State law or trust provisions providing otherwise would be ignored. The regulations would prevent such

1. IRC Sec. 642(b).
2. IRC Sec. 63(c)(6).
3. IRC Sec. 645.
4. IRC Secs. 641(a), 652(a).
5. IRC Secs. 151(d)(2), 63(c)(5); Rev. Proc. 2009-50, 2009-45 IRB 617, Rev. Proc. 2013-15, 2013-5 IRB 444, Rev. Proc. 2013-35, 2013-47 IRB 537.
6. IRC Secs. 651-652, 661-663.

a provision from being used, for example, to allocate all taxable income to the charitable distribution with capital gain and tax-exempt income retained by the trust.[1]

Deductions available to an estate or trust are generally subject to the 2 percent floor on miscellaneous itemized deductions.[2] However, deductions for costs incurred in connection with the administration of an estate or trust that would not have been incurred if the property were not held by the estate or trust are fully deductible from gross income.[3]

Deductions excepted from the 2 percent floor include only those costs that would not have been incurred if held by an individual (those costs that would be uncommon for a hypothetical investor). Investment advisory fees incurred by a trust were subject to the 2 percent floor.[4] Final regulations have been issued on the proper treatment of costs incurred by trusts and estates. The regulations provide that if a cost is unique to a trust or estate, it is *not* subject to the 2 percent floor, but if the cost is not unique to a trust or estate, it is subject to the 2 percent floor.[5] For taxable years beginning before 2009, taxpayers can deduct the full amount of bundled fiduciary fees without regard to the 2 percent floor.[6] For taxable years beginning on or after May 9, 2014, bundled fiduciary fees must be allocated between fully deductible expenses and those subject to the 2 percent floor.[7] Any reasonable method may be used to allocate a bundled fee.

For distributions in taxable years beginning after August 5, 1997, the throwback rule for accumulation distributions from trusts in IRC Sections 665-667 has been eliminated for domestic trusts, except for domestic trusts that were once foreign trusts, and except in the case of trusts created before March 1, 1984, which would be aggregated with other trusts under the multiple trust rules.[8] Generally, for those trusts subject to the throwback rule, if a trust distributes income which it has accumulated after 1968, all of the income is taxed to the beneficiary upon distribution. The amounts distributed are treated as if they had been distributed in the preceding years in which the income was accumulated, but are includable in the income of the beneficiary for the current year. The "throwback" method of computing the tax in effect averages the tax attributable to the distribution over three of the five preceding taxable years of the beneficiary, excluding the year with the highest and the year with the lowest taxable income.[9]

Excess taxes paid by the trust may not be refunded, but the beneficiary may take a credit to offset any taxes (other than the alternative minimum tax) paid by the trust. However, a beneficiary who receives accumulation distributions from more than two trusts may not take such an offset for taxes paid by the third and any additional trusts. But if distributions to a beneficiary from a trust total less than $1,000 for the year, this penalty will not apply to distributions from that trust.[10]

1. Prop. Treas. Regs. §§1.642(c)-3(b), 1.643(a)-5(b).
2. IRC Sec. 67(a).
3. IRC Sec. 67(e).
4. *Knight v. Comm.*, 128 S. Ct. 782 (2008), 2008-1 USTC ¶50,132 (U.S. 2008).
5. Treas. Reg. §1.67-4.
6. Notice 2008-32, 2008-11 IRB 593; Notice 2008-116, 2008-52 IRB 1372.
7. Treas. Reg. §1.67-4(c)
8. IRC Sec. 665(c).
9. IRC Secs. 666-667.
10. IRC Secs. 666-667.

Distributions of income accumulated by a trust before the beneficiary is born or before he attains age 21 are not considered accumulation distributions and thus are not generally subject to the throwback rules.[1]

Estates are required to file estimated tax for taxable years ending two years or more after the date of the decedent's death.[2] Trusts are generally also required to pay estimated tax (see Q 567). However, there are two exceptions to this rule: (1) with respect to any taxable year ending before the date that is two years after the decedent's death, trusts owned by the decedent (under the grantor trust rules) and to which the residue of the decedent's estate will pass under his will need not file estimated tax (if no will is admitted to probate, this rule will apply to a trust which is primarily responsible for paying taxes, debts and administration expenses); and (2) charitable trusts (as defined in IRC Section 511) and private foundations are not required to file estimated tax.[3] A trustee may elect to treat any portion of a payment of estimated tax made by the trust for any taxable year as a payment made by a beneficiary of the trust. Any amount so treated is treated as paid or credited to the beneficiary on the last day of the taxable year.[4]

664. What is a grantor trust? How is a grantor trust taxed?

A grantor who retains certain interests in a trust he creates may be treated as the "owner" of all or part of the trust and thus taxed on the income of the trust in proportion to his ownership. There are five categories of interests for which the IRC gives detailed limits as to the amount of control the grantor may have without being taxed on the trust income. These categories are: reversionary interests, power to control beneficial enjoyment, administrative powers, power to revoke, and income for benefit of grantor.[5] With respect to any taxable year ending within two years after a grantor/decedent's death, any trust, all of which was treated under these grantor trust rules as owned by the decedent, is not required to file an estimated tax return (see Q 663).[6]

Reversionary Interests

Generally, a grantor will be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income, if, as of the date of inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of the trust.[7] There is an exception to this rule where the reversionary interest will take effect at the death before age 21 of a beneficiary who is a lineal descendant of the grantor.[8] For transfers in trust made prior to March 2, 1986, the reversionary interest was not limited to a certain percentage, and so long as it took effect *after* 10 years it did not result in taxation of the grantor.[9] Using a 6 percent

1. IRC Sec. 665(b).
2. IRC Sec. 6654(l).
3. IRC Sec. 6654(l).
4. IRC Sec. 643(g).
5. IRC Secs. 673-677.
6. IRC Sec. 6654(l)(2)(B).
7. IRC Sec. 673(a).
8. IRC Sec. 673(b).
9. IRC Sec. 673(a), prior to amendment by TRA '86.

valuation table, the value of the reversionary interest of a term trust falls below 5 percent if the trust runs more than about 51 years. The value of a reversion will depend on the interest rate and the valuation tables required to be used (see Appendix C).

Power to Control Beneficial Enjoyment

If the grantor has any power of disposition over the beneficial enjoyment of any portion of the trust, and such power is exercisable without the approval of an adverse party, he will be treated (i.e., taxed) as the owner of that portion.[1] A grantor may do any of the following without such action resulting in his being treated as the owner of that portion of the trust: (1) reserve the power to dispose of the trust corpus by will, (2) allocate corpus or income among charitable beneficiaries (so long as it is irrevocably payable to the charities), (3) withhold income temporarily (provided the accumulated income must ultimately be paid to or for the benefit of the beneficiary), (4) allocate receipts and disbursements between corpus and income, and (5) distribute corpus by a "reasonably definite standard."[2] An example of a "reasonably definite standard" is found in Treasury Regulation Section 1.674(b)-1(b)(5): "for the education, support, maintenance and health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency." A grantor also may retain the power to withhold income during the disability or minority of a beneficiary.[3] However, if *any person* has the power to add or change beneficiaries, other than providing for the addition of after-born or after-adopted children, the grantor will be treated as the owner.[4]

IRC Section 674(c) allows powers, solely exercisable by a trustee or trustees (none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor), to distribute, apportion, or accumulate income to or for beneficiaries or pay out trust corpus to or for a beneficiary without the grantor being considered the owner of the trust. A related or subordinate party is a person who is not an adverse party and who is the grantor's spouse if living with the grantor; the grantor's father, mother, issue, brother or sister; an employee of the grantor; or a corporation or employee of a corporation if the grantor and the trust have significant voting control of the corporation.[5] An adverse party is any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or non-exercise of the power the person possesses respecting the trust.[6]

The grantor will also not be considered the owner of the trust due to a power solely exercisable by a trustee or trustees, none of whom are the grantor or the grantor's spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary as long as the power is limited to a reasonably definite external standard set forth in the trust instrument.[7]

1. IRC Sec. 674(a).
2. IRC Sec. 674(b).
3. IRC Sec. 674(b)(7).
4. IRC Sec. 674(c).
5. IRC Sec. 672(c).
6. IRC Sec. 672(a).
7. IRC Sec. 674(d).

Regulations treat a reasonably definite external standard as synonymous with a reasonably definite standard, described above.[1]

Income for Benefit of Grantor

If the trust income is (or, in the discretion of the grantor or a nonadverse party, or both, may be) distributed or held for the benefit of the grantor or his spouse, he will be treated as the owner of it.[2] This provision applies to the use of trust income for the payment of premiums for insurance on the life of the grantor or his spouse, although taxation does not result from the mere power of the trustee to purchase life insurance. This provision is also invoked any time trust income is used *for the benefit of the grantor*, to discharge a legal obligation. Thus, when trust income is used to discharge the grantor's legal support obligations, it is taxable income to the grantor.[3] State laws vary as to what constitutes a parent's obligation to support; however, such a determination may be based in part on the background, values and goals of the parents, as well as the children.[4]

The mere power of the trustee to use trust income to discharge a legal obligation of the grantor will not result in taxable income to the grantor. Under IRC Section 677(b), there must be an actual distribution of trust income for the grantor's benefit in order for the grantor to be taxable on the amounts expended.

Other Grantor Powers

A grantor's power to revoke the trust will result in his being treated as owner of it. This may happen by operation of law in states requiring that the trust instrument explicitly state that the trust is irrevocable. Such a power will also be inferred where the grantor's powers are so extensive as to be substantially equivalent to a power of revocation, such as a power to invade the corpus.[5]

Certain administrative powers retained by the grantor will result in his being treated as owner of the trust; these include the power to deal with trust funds for less than full and adequate consideration, the power to borrow without adequate interest or security, or borrowing from the trust without completely repaying principal and interest before the beginning of the taxable year.[6]

Corporations and Other Business Entities

665. How is a corporation taxed?

Any corporation, including a professional corporation or association, is considered a C corporation, taxable under the following rules, unless an election is made to be treated as an S corporation.

1. Treas. Reg. §1.674(d)-1.
2. IRC Sec. 677(a).
3. IRC Sec. 677(b).
4. *Stone v. Comm.*, TC Memo 1987-454; *Braun v. Comm.*, TC Memo 1984-285.
5. IRC Sec. 676.
6. IRC Sec. 675.

Graduated Tax Rates

A corporation pays tax according to a graduated rate schedule. The rates range from 15 percent to 35 percent.[1] See Appendix B for the rates. A "personal service corporation" is subject to a different income tax rate. See Q 672.

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 nature (e.g., deductions for medical expenses and the personal exemptions). A corporation also does not receive a standard deduction. There are a few special deductions 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.[2] A corporation may deduct contributions to charitable organizations to the extent of 10 percent of taxable income (with certain adjustments).[3] Generally, charitable contributions in excess of the 10 percent limit may be carried over for five years.[4]

A corporation is also allowed a deduction for production activities. This deduction was fully phased in (in 2010), and 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.[5]

666. How is a corporation taxed on capital gains?

Capital gains and losses are netted in the same manner as for an individual 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" (i.e., 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.[6]

1. IRC Sec. 11(b).
2. IRC Sec. 243.
3. IRC Sec. 170(b)(2).
4. IRC Sec. 170(d)(2).
5. IRC Sec. 199.
6. IRC Secs. 1201, 1222.

667. How is a corporation's alternative minimum tax calculated?

A corporate taxpayer must calculate its liability under the regular tax and a tentative minimum tax, then add to its regular tax so much of the tentative minimum tax as exceeds its regular tax. The amount added is the alternative minimum tax.[1]

To calculate its alternative minimum tax (AMT), a corporation first calculates its "alternative minimum taxable income" (AMTI).[2] Also, the corporation calculates its "adjusted current earnings" (ACE), increasing its AMTI by 75 percent of the amount by which ACE exceeds AMTI (or possibly reducing its AMTI by 75 percent of the amount by which AMTI exceeds ACE).[3] The tax itself is a flat 20 percent of AMTI.[4] Each corporation receives a $40,000 exemption; however, the exemption amount is reduced by 25 percent of the amount by which AMTI exceeds $150,000 (thus phasing out completely at $310,000).[5]

AMTI is regular taxable income determined with certain adjustments and increased by tax preferences.[6] *Tax preferences* for corporate taxpayers 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 adjusted current earnings (ACE).[7]

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. However, certain dividends received by a corporation are allowed to be deducted. 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

1. IRC Secs. 55-59.
2. IRC Sec. 55(b)(2).
3. IRC Sec. 56(g).
4. IRC Sec. 55(b)(1)(B).
5. IRC Secs. 55(d)(2), 55(d)(3).
6. IRC Sec. 55(b)(2).
7. IRC Secs. 56(a), 56(c), 56(d).

as the treatment of intangible drilling costs, amortization of certain expenses, installment sales, and depletion.[1]

Application of the adjustments for ACE with respect to life insurance is explained at Q 300.

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.[2] However, the amount of the credit cannot be greater than the excess of the corporation's regular tax liability (reduced by certain credits such as certain business related credits and certain investment credits) over its tentative minimum tax.[3]

Certain small corporations are deemed to have a tentative minimum tax of zero and thus are exempt from the AMT. To qualify for the exemption, the corporation must meet a gross receipts test for the three previous taxable years. To meet the test, a corporation's average annual gross receipts for the three years must not exceed $7.5 million. For purposes of the gross receipts test, only tax years beginning after 1993 are taken into account. For a corporation not in existence for three full years, those years the corporation was in existence are substituted for the three years (with annualization of any short taxable year). To initially qualify for the exemption, the corporation must meet the three-year gross receipts test but with $5 million substituted for $7.5 million. Generally, a corporation will be exempt from the AMT in its first year of existence.[4]

If a corporation fails to maintain its small corporation status, it loses the exemption from the AMT. If that happens, 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 exemption 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]

668. What is the accumulated earnings tax?

A corporation is subject to a penalty tax, in addition to the graduated tax, if, for the purpose of preventing the imposition of income tax upon its shareholders, it accumulates earnings instead of distributing them.[7] The tax is 20 percent of the corporation's *accumulated taxable income*

1. IRC. Sec. 56(g).
2. IRC Sec. 53(b).
3. IRC Sec. 53(c).
4. IRC Secs. 55(e), 448(c)(3).
5. IRC Sec. 55(e)(2).
6. IRC Sec. 55(e)(5).
7. IRC Secs. 531-537; *GPD, Inc. v. Comm.*, 508 F. 2d 1076, 75-1 USTC ¶9142 (6th Cir. 1974).

(15 percent for tax years beginning prior to 2013).[1] Accumulated taxable income is taxable income for the year (after certain adjustments) less 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."[2]

The tax can be imposed only upon amounts accumulated beyond those required to meet the reasonable needs of the business since an accumulated earnings credit, generally equal to this amount, 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.[3] The use of accumulated funds for the personal use of a shareholder and his family is evidence that the accumulation was to prevent the imposition of income tax upon its shareholders.[4] 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.[5] 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 preceding taxable year.[6] Consequently, an aggregate of $250,000 ($150,000 in the case of the above listed service corporations) 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.[7] 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 in computing accumulated taxable income (see Q 285, Q 288).[8]

The accumulated earnings tax applies to all C corporations, without regard to the number of shareholders in taxable years beginning after July 18, 1984.[9]

669. What is the personal holding company tax?

The personal holding company (PHC) tax is a second penalty tax designed to keep 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 it meets both the "stock ownership" and "PHC income" tests.[10]

1. IRC Sec. 531, as amended by ATRA.
2. IRC Sec. 535.
3. *Eyefull Inc. v. Comm.*, TC Memo 1996-238.
4. *Northwestern Ind. Tel. Co. v. Comm.*, 127 F. 3d 643, 97-2 USTC ¶50,859 (7th Cir. 1997).
5. TAM 9822009.
6. IRC Sec. 535(c)(2).
7. Rev. Rul. 70-497, 1970-2 CB 128.
8. Rev. Rul. 70-642, 1970-2 CB 131.
9. IRC Sec. 532(c).
10. IRC Secs. 541, as amended by ATRA, 542, 545.

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.[1] Certain stock owned by families, trusts, estates, partners, partnerships, and corporations may be attributed to individuals for purposes of this rule.[2]

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.[3]

670. How are corporations that are classified as professional corporations and associations taxed?

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 the same as regular C corporations. See Q 672. Note that if a professional corporation has elected S corporation status, the shareholders will be treated as S corporation shareholders.

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] However, note that the IRS has stated that it will not follow the *Foglesong* decision to the extent that it held that the two business requirement of IRC Section 482 is not satisfied where a controlling shareholder works exclusively for the controlled corporation.[7] A professional corporation may also be subject to the special rules applicable to "personal service corporations," see Q 672.

671. How is an S corporation taxed?

An S corporation is one that elects to be treated, in general, as a passthrough entity, thus avoiding most tax at the corporate level.[8] To be eligible to make the election, a corporation

1. IRC Sec. 542(a)(2).
2. IRC Sec. 544.
3. IRC Secs. 542(a)(1), 543(a).
4. Rev. Rul. 77-31, 1977-1 CB 409.
5. *Roubik v. Comm.*, 53 TC 365 (1969).
6. *Foglesong v. Comm.*, 691 F. 2d 848, 82-2 USTC ¶9650 (7th Cir. 1982).
7. Rev. Rul. 88-38, 1988-1 CB 246.
8. See IRC Secs. 1361, 1362, 1363.

must meet certain requirements as to the kind and number of shareholders, classes of stock, and sources of income. 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.[1]

Members of a family are treated as one shareholder. "Members of the family" are defined as "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.[2]

Trusts that may be S corporation shareholders include the following: (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 (see Q 664); (2) a trust that was described in (1) above immediately prior to the deemed owner's death and 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); (6) an electing small business trust (ESBT); and (7) in the case of an S corporation that is a bank, an IRA or Roth IRA.[3]

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 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, and 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.[4]

An ESBT is a trust in which all of the beneficiaries are individuals, estates, or charitable organizations.[5] Each potential current beneficiary of an ESBT is treated as a shareholder for purposes of the shareholder limitation.[6] 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 (see Q 664) is a potential current beneficiary.[7] If for

1. IRC Sec. 1361.
2. IRC Sec. 1361(c)(1).
3. IRC Secs. 1361(c)(2), 1361(d).
4. IRC Sec. 1361(d).
5. IRC Sec. 1361(e).
6. IRC Sec. 1361(c)(2)(B)(v).
7. Treas. Reg. §1.1361-1(m)(4).

any period there is no potential current beneficiary of an ESBT, the ESBT itself is treated as an S corporation shareholder.[1] 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.[2] If any portion of a beneficiary's basis in the beneficiary's interest is determined under the cost basis rules, the interest was acquired by purchase.[3] An ESBT is taxed at the highest income tax rate under IRC Section 1(e) (39.6 percent in 2014).[4]

An S corporation may own a qualified subchapter S subsidiary (QSSS). A QSSS is a domestic corporation that is not an ineligible corporation, 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. Except as provided in regulations, a QSSS is 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.[5] Regulations provide special rules regarding the recognition of a QSSS as a separate entity for tax purposes if an S corporation or its QSSS is a bank.[6] A QSSS will also be treated as a separate corporation for purposes of employment taxes and certain excise taxes.[7]

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.[8] Regulations provide that 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. Examples where this rule would apply include an S corporation selling all of its QSSS stock to another S corporation, or an S corporation distributing all of its QSSS stock to its shareholders and the former QSSS making an S election.[9]

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.[10] However, "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

1. Treas. Reg. §1.1361-1(h)(3)(i)(F).
2. IRC Sec. 1361(e).
3. Treas. Reg. §1.1361-1(m)(1)(iii).
4. IRC Sec. 641(c).
5. IRC Sec. 1361(b)(3).
6. Treas. Reg. §1.1361-4(a)(3).
7. Treas. Reg. §1.1361-4(a)(7) and §1.1361-4(a)(8).
8. IRC Sec. 1361(b)(3).
9. Treas. Reg. §1.1361-5(c).
10. Treas. Reg. §1.1361-1(l)(1).

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.[1] Regulations provide that agreements triggered by divorce and forfeiture provisions that cause a share of stock to be substantially nonvested will be disregarded in determining whether a corporation's shares confer identical rights to distribution and liquidation proceeds.[2]

An S corporation is generally not subject to tax at the corporate level.[3] However, a tax is imposed at the corporate level under certain circumstances described below. When an S corporation disposes of property within 10 years after an election has been 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.[4] ARRA 2009 provided 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.[5]

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 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), and if passive investment income exceeds 25 percent of gross receipts. The rate is the highest corporate rate (currently 35 percent).[6] "Passive investment income" for this purpose is rents, royalties, dividends, interest, and annuities.[7] However, passive investment income does not include rents for the use of corporate property if the corporation also provides substantial services or incurs substantial cost in the rental business,[8] or 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. Also, passive investment income does not include 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.[9] Regulations provide that if an S corporation owns 80 percent or more of a C corporation, passive investment income does not include 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

1. Treas. Reg. §1.1361-1(l)(2)(iii). See IRC Secs. 1361, 1362.
2. Treas. Reg. §1.1361-1(l)(2)(iii)(B).
3. IRC Sec. 1363(a).
4. IRC Sec. 1374.
5. IRC Sec. 1363(d).
6. IRC Sec. 1375(a).
7. IRC Secs. 1362(d)(3), 1375(b)(3).
8. See Let. Ruls. 9837003, 9611009, 9610016, 9548012, 9534024, 9514005.
9. Treas. Reg. §1.1362-2(c)(5).

business.[1] 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.[2]

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.[3]

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.[4] 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.[5]

Like a partnership, an S corporation computes its taxable income similarly to an individual, except that certain personal and other deductions are allowed to a shareholder but not to the S corporation, and the corporation may elect to amortize organizational expenses.[6] Each shareholder then reports on his individual return his proportionate share of the corporation's items of income, loss, deductions and credits. These items retain their character on passthrough.[7] 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). 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.[8] Before passthrough, 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.[9] 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 his individual return.[10] 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 7918 through Q 7929) if the activity is passive with respect to the shareholder (see Q 7919). Apparently, 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 (see Q 7918).

1. Treas. Reg. §1.1362-8(a).
2. IRC Sec. 1375(b)(4).
3. IRC Sec. 1371(d).
4. IRC Sec. 7519.
5. IRC Sec. 6655(g)(4).
6. IRC Sec. 1363(b).
7. IRC Secs. 1366(a), 1366(b).
8. IRC Sec. 1366(a)(1).
9. IRC Sec. 1366(f)(3).
10. IRC Sec. 1366(a).

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.[1] The S corporation income must also be included on a current basis by shareholders for purposes of the estimated tax provisions (see Q 567).[2]

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.[3]

The basis of each shareholder's stock is *increased* by his share of items of separately stated income (including tax-exempt income), by his share of any nonseparately computed income, and by any excess of deductions for depletion over basis in property subject to depletion.[4] An S corporation shareholder may *not* increase his basis due to excluded discharge of indebtedness income.[5] The basis of each shareholder's stock is *decreased* (not below zero) by (1) items of distributions from the corporation that are not includable in the income of the shareholder, (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 makes a charitable contribution of property, each shareholder's basis is reduced by the pro rata share of their basis in the property.[6] If the aggregate of these amounts exceeds his basis in his stock, the excess reduces the shareholder's basis in any indebtedness of the corporation to him.[7] A shareholder may not take deductions and losses of the S corporation that, when aggregated, exceed his basis in his S corporation stock plus his basis in any indebtedness of the corporation to him.[8] Such disallowed deductions and losses may be carried over.[9] In other words, he may not deduct in any tax year more than he has "at risk" in the corporation. As of the date of this publication, Congress has not yet acted to extend this provision. Taxpayers should note, however, that Congress has a history of retroactively extending provisions that have already expired.

Generally, earnings of an S corporation are not treated as earnings and profits. A 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 carryover of earnings and profits under IRC Section 381.[10] Corporations that were S corporations before 1983 but were

1. IRC Sec. 1377(a).
2. Let. Rul. 8542034.
3. *Williams v. Comm.*, 123 TC 144 (2004).
4. IRC Sec. 1367(a)(1).
5. IRC Sec. 108(d)(7)(A).
6. IRC Sec. 1367(a)(2), as amended by TEAMTRA 2008 and ATRA.
7. IRC. Sec. 1367(b)(2)(A).
8. IRC Sec. 1366(d)(1).
9. IRC Sec. 1366(d)(2).
10. IRC Sec. 1371(c).

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.[1]

A distribution from an S corporation that does not have accumulated earnings and profits lowers the shareholder's basis in the corporation's stock.[2] Any excess is generally treated as gain.[3]

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, it is 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.[4] However, 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.[5] If the IRC Section 1368(e)(3) election is made, it will apply to all distributions made in the tax year.[6]

Certain distributions from an S corporation in redemption of stock receive sale/exchange treatment. (Generally, only gain or loss, if any, is recognized in a sale.) In general, redemptions that qualify for "exchange" treatment include redemptions 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.[7]

If the S corporation distributes appreciated property to a shareholder, gain will be recognized to the corporation as if the property was sold at fair market value, and the gain will pass through to shareholders like any other gain.[8]

The rules discussed above generally apply in tax years beginning after 1982. Nonetheless, certain casualty insurance companies and certain corporations with oil and gas production will continue to be taxed under the rules applicable to Subchapter S corporations prior to these rules.[9]

672. How is a "personal service corporation" taxed?

Certain personal service corporations are taxed at a flat rate of 35 percent.[10] In effect, this means that the benefit of the graduated corporate income tax rates is not available. (See Appendix B). A personal service corporation for this purpose is a corporation in which sub-

1. SBWOTA 2007 Sec. 8235.
2. IRC Sec. 1367(a)(2)(A).
3. IRC Sec. 1368(b).
4. IRC Sec. 1368(c).
5. IRC Sec. 1368(e)(3).
6. Let. Rul. 8935013.
7. See IRC Secs. 302, 303.
8. IRC Secs. 1371(a), 311(b).
9. Subchapter S Revision Act of 1982, Sec. 6.
10. IRC Sec. 11(b)(2).

stantially all corporate activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. In addition, substantially all of the stock must be owned (1) directly by employees, retired employees, or their estates or (2) indirectly through partnerships, S corporations, or qualified personal service corporations.[1]

IRC Section 269A permits the IRS to reallocate income, deductions, credits, exclusions, and other allowances (to the extent necessary to prevent avoidance or evasion of federal income tax) between a personal service corporation (PSC) and its employee-owners if the corporation is formed for the principal purpose of securing tax benefits for its employee-owners (i.e., more than 10 percent shareholder-employees after application of attribution rules) and substantially all of its services are performed for a single other entity. For purposes of IRC Section 269A, a personal service corporation is a corporation the principal activity of which is the performance of personal services and such services are substantially performed by the employee-owners.[2] A professional basketball player was considered to be an employee of an NBA team, not his personal service corporation, and all compensation from the team was taxable to him individually, even though his PSC had entered into a contract with the team for his personal services.[3]

In addition, special rules apply to the tax year that may be used by a personal service corporation (as defined for purposes of IRC Section 269A, except that all owner-employees are included and broader attribution rules apply).[4]

673. What is a limited liability company and how is it taxed?

A limited liability company (LLC) is a statutory business entity that may be formed by at least two members (although one-member LLCs are permitted in some states) by drafting articles of organization and filing them with the appropriate state agency. There are no provisions for LLCs in the Code, but regulations provide rules to determine how a *business entity* is classified for tax purposes. A business entity is any entity recognized for federal tax purposes that is not a trust. Unlike an S corporation, an LLC has no restrictions on the number or types of owners and multiple classes of ownership are generally permitted. If the LLC is treated as a partnership, it combines the liability shield of a corporation with the tax advantages of a partnership.

An LLC may be treated as either a corporation (see Q 665), partnership (see Q 674), or sole proprietorship for federal income tax purposes. A sole proprietor and his business are one and the same for tax purposes. An *eligible entity* (a business entity not subject to automatic classification as a corporation) 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.

1. IRC Sec. 448(d)(2).
2. IRC Sec. 269A(b)(1).
3. *Leavell v. Comm.*, 104 TC 140 (1995).
4. IRC Secs. 441(i), 444.

A separate entity must exist for tax purposes, in that its participants must engage in a business for profit. Trusts are not considered business entities.[1] 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 for federal tax purposes. A business entity 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.[2] 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. 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.[3]

If a business entity elects to change its classification, rules are provided for how the change is treated for tax purposes.[4]

Revenue Ruling 95-37[5] 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.[6]

An LLC formed by two S corporations was classified as a partnership for federal tax purposes.[7] 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.[8] 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.[9]

1. Treas. Reg. §301.7701-1.
2. Treas. Reg. §301.7701-2.
3. Treas. Reg. §301.7701-3.
4. Treas. Reg. §301.7701-3(g).
5. 1995-1 CB 130.
6. Let. Rul. 9607006.
7. Let. Rul. 9529015.
8. Let. Rul. 9543017.
9. Let. Rul. 9636007.

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.[1]

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 the gains from it; (3) limited liability; (4) free transferability of interests; (5) continuity of life; and (6) centralized management.[2] 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.[3] 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.[4]

674. How is the income from a partnership taxed?

With the exception of certain publicly traded partnerships, a partnership, as such, is not taxed.[5] However, the partnership must file an information return on Form 1065, showing taxable ordinary income or loss and capital gain or loss. The partnership is regarded as an entity for the purpose of computing taxable income, and business expenses of the partnership may be deducted. In general, taxable income is computed in the same manner as for individuals; but the standard deduction, personal exemptions, and expenses of a purely personal nature are not allowed.[6] The deduction for production activities may also be allowed (see Q 665). Each partner must report his share of partnership profits, whether distributed or not, on his individual return. A partner's distributive share is determined either on the basis of the partner's interest or by allocation under the partnership agreement. Allocation by agreement must have a "substantial economic effect." Special allocation rules apply where the partner's interest changes during the year.[7]

A person is a partner if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether he acquired his interest by purchase or gift. Generally, such a person will be taxable on his share of partnership profits. If capital is not an income-producing factor, 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. Where an interest is acquired by gift (an interest purchased

1. Treas. Reg. §301.7701-3(h)(2).
2. Treas. Reg. §301.7701-2(a)(1), as in effect prior to January 1, 1997.
3. Treas. Reg. §301.7701-2(a)(2), as in effect prior to January 1, 1997.
4. Treas. Reg. §301.7701-2(a)(3), as in effect prior to January 1, 1997.
5. IRC Sec. 701.
6. IRC Secs. 703(a), 63(c)(6)(D).
7. IRC Secs. 706(d), 704(b).

by one family member from another is considered to have been acquired by gift), allocation of income among the partners according to 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 he is not old enough to serve in the capacity of partner, his interest must be controlled by a fiduciary for his benefit.

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. A qualified joint venture is any joint venture conducting a trade or business where the only owners are the husband and wife, 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.[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.[3]

1. IRC Sec. 704(e).
2. IRC Sec. 761(f).
3. IRC Sec. 7704.