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THE BIG BOOK™ of Taxes 2019

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This text is designed to provide the experienced tax professional with theory and practical knowledge for a variety of problems encountered in preparing individual income tax returns. The topics covered are those that often raise questions, or those in which the IRS has shown an interest. Special emphasis is given to the latest tax law changes, court cases, IRS rulings and related 1040 subjects. The text incorporates examples and problems to illustrate points that have a practical application of law.

This text is used for both seminars and correspondence courses. Not all of the material in the text is covered in the seminar, but is included in the text to provide the user with a practical year-round reference source.

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TCJA

Head of Household Due Diligence – Effective with 2018 returns, a paid preparer is subject to due diligence requirements in determining a client's eligibility for the head of household filing status. (IRC Sec 695(g), as amended by Sec 11001(b) of the TCJA) For returns filed in 2020, the penalty for failing to exercise due diligence with respect to the head of household status is $530 ($520 for filings in 2019). The IRS has revised Form 8867, Paid Preparer's Due Diligence Checklist, to add a section for this new requirement.

Pubs Forms

Related IRS Publications and Forms
- **Form 1040 –** Instructions
- **Pub 17 –** Your Federal Income tax
- **Pub 501 –** Exemptions, Standard Deduction and Filing Information

The Details

Filing status depends on marital status at the end of the tax year, with two major exceptions:

1. ***Surviving spouses may*** file a joint return in the year of their spouse's death, and
2. Certain ***married persons living apart*** may file as unmarried (see below).

Taxpayers are considered married if:
- They are married and living together as a married couple. However, individuals who have entered into a registered domestic partnership, civil union, or other similar relationship that is not considered a marriage under state law are not considered married for federal tax purposes.
- They are living together in a ***common law marriage*** that is recognized in the state where they now live or in the state where the common law marriage began.
- They are married and living apart, but not legally separated under a decree of divorce or separate maintenance.
- They are separated under an interlocutory (not final) decree of divorce. For purposes of filing a joint return, they are not considered divorced.

TERMINATION OF MARITAL STATUS: The marital status of husband and wife is terminated when the couple is legally separated under a decree of divorce or of separate maintenance *(Code Sec. 2(b)(2), Code Sec. 7703(a)(2), Code Sec. 6013(d)(2))*. This termination of the marital status for tax purposes is constitutional (Hamilton, Raleigh, (1977) 68 TC 603). An interlocutory (temporary) decree of divorce doesn't end a marriage until the decree becomes final *(Reg § 1.6013-4(a), Rev Rul 57-368, 1957-2 CB 896).* A couple living under a legal separation agreement but without any court decree isn't legally separated for tax purposes, because such an agreement could be abrogated by the parties upon reconciliation and resumption of cohabitation.

UNMARRIED TAXPAYERS:

If single (widowed, divorced or never married) as of the last day of the tax year, the filing status possibilities are:

- **Single**
- **Head of Household:** For a ***single*** individual to claim ***head of household***, the taxpayer must be a U.S. citizen or resident AND must either:
  - (a) Pay more than one-half of the cost of maintaining as his or her home a household, which is the principal place of abode for more than one-half the year for a qualified person. A qualified person generally includes a qualified child (the child's exemption does not have to be claimed – it can be released to the other parent), or a relative for whom the taxpayer may claim a dependency exemption, **OR**
  - (b) Pay more than half the cost of maintaining a separate household that was the main home for a dependent parent for the entire year.

  Relative **–** *The following individuals are treated as related persons (if filing a joint return, the person can be related to either spouse):*
  - Taxpayer's child, stepchild, foster child, or a descendant of any of them (for example, a grandchild). A legally adopted child is considered the taxpayer's child.
  - Taxpayer's brother, sister, half-brother, half-sister, stepbrother, or stepsister.
  - Taxpayer's father, mother, grandparent, or other direct ancestor, but not foster parent.
  - Taxpayer's stepfather or stepmother.
  - The son or daughter of the taxpayer's brother or sister.
  - The son or daughter of the taxpayer's half-brother or half-sister.
  - The brother or sister of the taxpayer's father or mother.
  - Taxpayer's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

  Relationship Established by Marriage – In determining qualifications for dependency, a relationship established by marriage is not ended by death or divorce (Reg § 1.152-2(d)).

  One House – One Household Rule - IRS has ruled that a single house cannot contain more than one household. However, the Tax Court overruled the IRS's view in *Fleming, Jean Foster Estate, TC Memo 1974-137* where a family occupied a single house but with a certain amount of divisibility of quarters--one for mother and unmarried daughter, another for married daughter and family.

  Temporary Absences - For head of household purposes, "temporary absences" for school, vacations, illness, military service, etc., do not change place of abode.

  Cost of Maintaining the Household - To figure the cost of maintaining a household, include food consumed at home, rent paid, home mortgage interest and taxes, home insurance, repairs and utilities. Do not include costs of clothes, education, vacations, medical care, life insurance, and transportation. In addition, qualifying costs paid with funds received from a government agency (e.g., Temporary Assistance for Needy Families), don't count toward qualifying a taxpayer for head of household.

  Married Child - A married child (including grandchild, stepchild, or adopted child) who is a dependent will qualify a taxpayer for this filing status. But to be a "qualifying child" the child cannot file a joint return, unless the return was filed only as a claim for refund. Such a child would also qualify if not claimed as a dependent because of the special dependency rules of *Code Section 152(e)(2) or 152(e)(4)* (i.e., children of divorced parents).

  Multiple Support Agreement - A person claimed as a dependent under a multiple support agreement does not qualify a taxpayer for the head of household filing status.

  Foster Child - Revenue Ruling 84-89, 1984-1 CB 5 states that a dependent foster child who lives with a taxpayer all year can qualify that taxpayer for head of household because a foster child is treated as the taxpayer's own child.

- **Qualifying Widow(er)** - If a taxpayer's spouse dies during the tax year, the surviving spouse can use MFJ as their filing status for that year if they otherwise qualify to use that status. Then if the surviving taxpayer has not remarried, the taxpayer may be able to file as qualifying widow(er) for the subsequent two years if the taxpayer has a dependent child in those years. The benefit being the taxpayer can use the MFJ tax rates, and if not itemizing, the MFJ standard deduction.

  For a taxpayer to be eligible to file as a qualifying widow(er) the taxpayer must meet **all** of following tests:

  1. The taxpayer was entitled to file a joint return with his or her spouse for the year the spouse died. It doesn't matter whether the taxpayer actually filed a joint return.
  2. The spouse died in one of the two prior years and the taxpayer didn't remarry by the end of the year. For example, to use the qualifying widow(er) status for 2019, the taxpayer's spouse must have died in either 2018 or 2017 and the taxpayer hasn't remarried as of December 31, 2019.

3. Taxpayer has a son, daughter, stepson, or stepdaughter (no age limits), but not a foster child and not a grandchild, that can be claimed as a dependent either as a qualified child or dependent relative except
    a. The child's gross income is disregarded ((Sec 2(a)(1)(B)), (Sec 152(d)(1)(B)).
    b. The child cannot have filed a joint return ((Sec 2(a)(1)(B)), (Sec 152(b)(2)).
    c. The taxpayer cannot be claimed as a dependent of another ((Sec 2(a)(1)(B)), (Sec 152(b)(1)).

4. The child lived in the taxpayer's home all year, except for temporary absences or in the cases where a child was born or died during the year and for a kidnapped child.

5. The taxpayer paid more than half the cost of keeping up a home for the year.

Example: *John's wife died in 2018. John hasn't remarried. He has continued during 2019 and 2020 to keep up a home for himself and his child, who lives with him and who he can claim as a dependent. For 2018 he was entitled to file a joint return with his deceased wife. For 2019 and 2020, he can file as a qualifying widower. After 2020, he can file as head of household if he so qualifies.*

MARRIED TAXPAYERS: If married at the end of the year (including those taxpayers in the process of divorce and legally married same sex individuals), the filing status alternatives are:

- **Joint** (Even if only one spouse had income):

    Changing joint filing status to married separate: Once a joint return has been filed, the joint filers may not change to filing separate returns after the unextended due date of the tax return.

    Changing married separate status to joint: A taxpayer may file a joint return after filing married separate if the change is made within THREE YEARS from the unextended due date of the original return (Sec 6013(b)).

    Annulment: If a marriage is annulled, joint returns filed prior to annulment and still open by the statute of limitations should be amended.

    Common law marriages: File married joint for common law marriages, but only if they are recognized under the law in the taxpayer's locality.

    Same-sex marriages: Couples legally married in jurisdictions that recognize their marriages, will be treated as married for federal tax purposes (*Windsor, (Sup Ct 6/26/2013*); Rev Ruling 2013-14) even if the state (or foreign country) where they now live does not recognize same-sex marriages.

    Death of a spouse: In the year a spouse dies, and if the executor agrees, the surviving spouse can claim joint status if not remarried by the end of the year. If the survivor does remarry before year-end, the deceased spouse's status is married separate.

- **Head of Household:** A married individual may use this status if he or she:
    (a) ***Lived apart from their spouse*** at least the last six months of the year,
    (b) ***Pays more than one-half of the cost*** of maintaining as his or her home a household which is the principal place of abode for more than one-half the year of a child, stepchild or eligible foster child for whom the taxpayer may claim a dependency exemption. (A nondependent child qualifies only if the taxpayer gave written consent to allow the dependency to the non-custodial parent, or the non-custodial parent has the right to claim the dependency under a pre-'85 divorce agreement).
- **Married Separate**

ELECTION TO TREAT NONRESIDENT ALIEN SPOUSE AS A U.S. RESIDENT: Generally, a U.S. citizen or a U.S. resident who is married to a nonresident alien must file as Married Separate. However, a person who is a nonresident alien at the end of his taxable year, and who is married to a U.S. citizen or a U.S. resident can be treated as a U.S. resident for income tax purposes if the spouses so elect *(Code Sec. 6013(g)(1))*.

In so doing, both spouses must agree to subject their worldwide income for the taxable year to U.S. taxation. *(Code Sec. 6013(g); Code Sec. 6013(h))*

Both parties must make the election. One party must have been, at the close of the taxable year for which the election was made, a nonresident alien individual married to a citizen or resident of the United States *(Code Sec. 6013(g)(2)).* To qualify for the election, the U.S. resident or U.S. citizen spouse needs to be a U.S. resident or U.S. citizen only at the close of the taxable year *(Reg § 1.6013-6(a)(1)).*

How To Make the Choice - Attach a statement, signed by both spouses, to the joint return for the first tax year for which the choice applies. It should contain the following information:

- A declaration that one spouse was a non-resident alien and the other spouse a U.S. citizen or resident alien on the last day of the tax year, and
- That the non-resident alien spouse chooses to be treated as a U.S. resident for the entire tax year.

Provide the name, address, and identification number of each spouse. (If one spouse is deceased, include the name and address of the person making the choice for the deceased spouse.) Generally this will require obtaining an ITIN for the non-resident spouse. (Reference Pub 519)

Once made, and as long as one of the spouses is a U.S. citizen or resident, the election applies not just for the year for which it is made but for all future years until it is terminated. If the election is terminated, neither spouse is eligible to make the election for any subsequent tax year. *(Code Sec 6013(g)(6))*

Terminating the Election – The election terminates at the earliest of any of the following events:

- ***Revocation by taxpayer or spouse*** - Either spouse may revoke the election by filing a statement of revocation by the due date for filing the tax return for the tax year.
- ***Death*** – Death of either spouse terminates the election beginning with the first tax year following the year the spouse died. However, if the U.S. citizen or resident spouse is the surviving spouse and meets the requirements for the qualified widow(er) status, the election continues for two years following the death of the non-resident spouse.
- ***Legal separation*** - If the couple legally separates under a decree of divorce or of separate maintenance, the election terminates as of the beginning of the taxable year in which the legal separation occurs.
- ***IRS action*** – The IRS may terminate the election for any tax year for which it determines that either spouse has failed to keep or provide sufficient books, records, and other information with which to determine tax liability. *(Reg. §1.6013-6(b)(4))*
- ***Other Issues:***

  NIIT **-** Higher income taxpayers with investment income are subject to a 3.8% surtax on net investment income (see Chapter 12.05 for details). However, this tax does not apply to nonresident aliens. Therefore, when weighing the pros and cons of making the election to treat a nonresident alien spouse as a U.S. resident, the effect of the 3.8% tax on the couple's total tax picture must be considered.

  ITIN – The non-resident spouse will need an ITIN if the election to file a joint return is made. An ITIN for the non-resident spouse is not needed if the resident spouse files MFS. Page 15 of the Form 1040 instructions indicates that where a spouse is not otherwise required to have an ITIN or SSN, enter "NRA" in the space on the 1040 for the SSN/ITIN.

  FBAR – There may also be an FBAR filing requirement. For additional details related to FBAR filings see page 01.14.03.

FEDERAL FILING STATUS DETERMINATION CHART – See last page of chapter

CALIFORNIA DIFFERENCES

Filing status for California must generally be the same as the filing status used on the federal income tax return.

Exceptions: Married taxpayers who file a joint federal income tax return may file either a joint return or separate returns if either spouse was:

- An active member of the United States armed forces or any auxiliary military branch during the tax year; or
- A nonresident for the entire year and had no income from California sources during the tax year. However, if the taxpayers file a joint return and if either spouse was a nonresident during the tax year, the taxpayer must file Form 540NR, California Nonresident or Part-Year Resident Income Tax Return.

Registered Domestic Partners (RDP)– See Chapter 1.12 RDP.

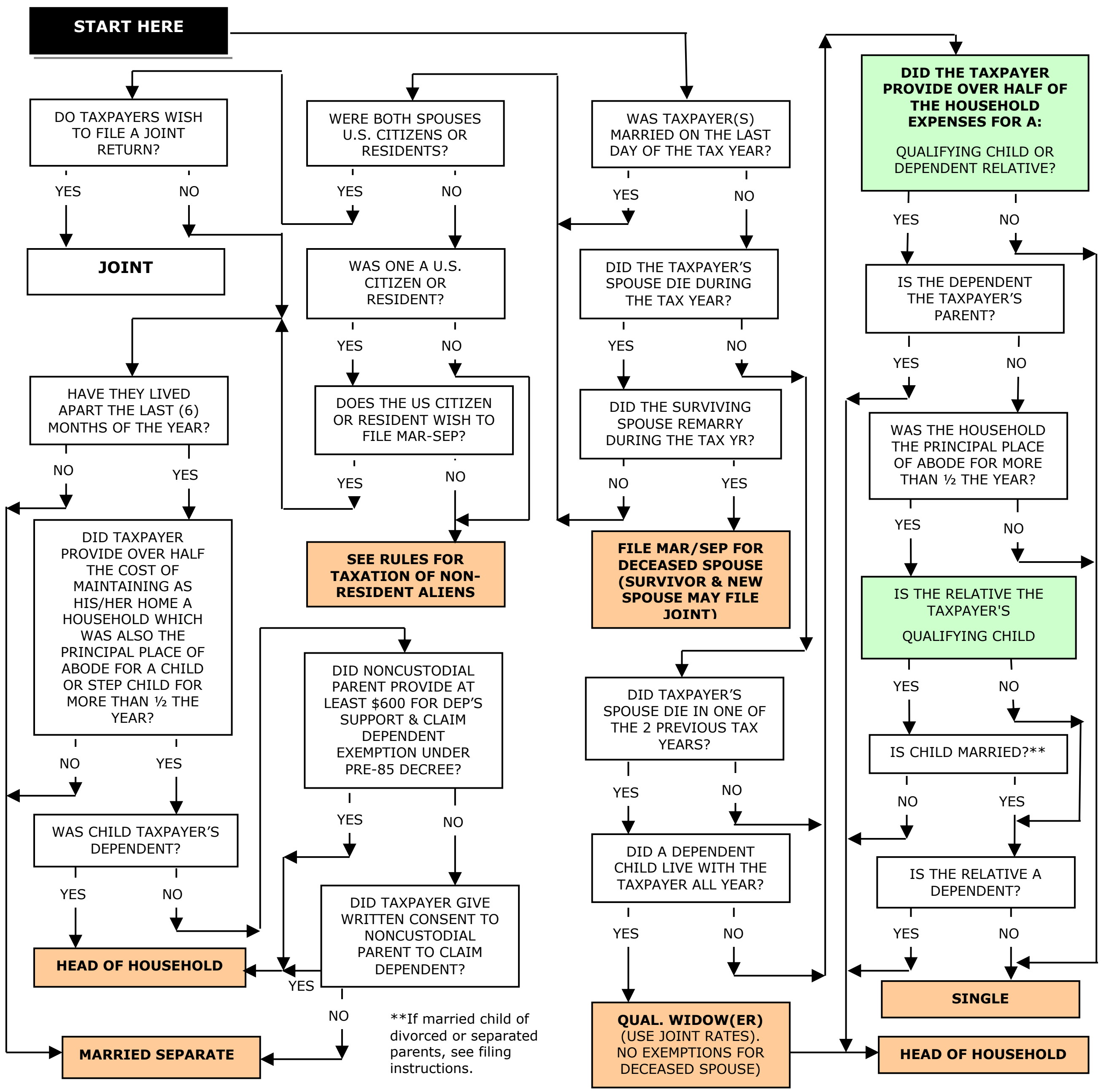
Qualifying for Head of Household While Still Married - California follows the federal rule that allows a married individual to use the head of household status if he or she (a) lived apart from their spouse at least the last six months of the year, and (b) paid more than one-half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one-half the year of a child, stepchild or eligible foster child for whom the taxpayer may claim a dependency exemption. The "lived apart" requirement is unchanged by an amendment to the California Family Code (SB 1255, Stats. 2016, ch. 114, 7/25/16) regarding the definition of "date of separation." Under that revision, date of separation is the date that a complete and final break in the marital relationship has occurred as evidenced by the spouse's expression of his or her intent to end the marriage and conduct that is consistent with that intent. In other words, for purposes of the Family Code, the spouses don't have to live in separate residences to establish a date of separation, but for Head of Household qualification purposes, they must still meet requirement (a) above. (FTB News, Sept. 2017)

FTB Form 3532 - For taxable years beginning on or after January 1, 2015, California requires taxpayers who use the head of household filing status to file form FTB 3532, Head of Household Filing Status Schedule, with their Form 540, 540NR or 540 2EZ to report how the head of household filing status was determined.

Common Law Marriages - California abolished common law marriages by statute in 1895. However, CA has recognized common law marriages originating in states that recognize common law marriages. Reference: ***Appeal of Estate of Lawrence Foley, Deceased,* 77-SBE-100, 7-26-77**

NOTES

FEDERAL FILING STATUS DETERMINATION CHART



DEPENDENTS

To be claimed as a taxpayer's dependent an individual must be either:

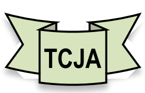
- A **QUALIFIED CHILD** – as determined under the uniform definition of a child (Details start on page 1.01.02):
  - Residency Test (Principal place of abode)
  - Relationship test
  - Age test
  - Joint return test
  - Cannot be self-supporting
- A **QUALIFYING RELATIVE** – who meets the following tests (Details start on page 1.01.09):
  - Relationship or member of the household test
  - Gross income test
  - Joint return test
  - Citizenship/residence test
  - Support test

RAPID FINDER

Related IRC and IRS Publications and Forms

- **Dependency Worksheet** (ClientWhys) – at end of chapter
- **Dependency Flow Charts** (ClientWhys) – at end of chapter
- **Qualified Child Worksheet** (ClientWhys) – at end of chapter

- **IRC Sec 152; IRC Sec 151**
- **Pub 17 –** Your Federal Income Tax
- **Pub 501 –** Exemptions, Standard Deduction and Filing Information
- **Pub 504 –** Divorced or Separated Individuals
- **Pub 929 –** Tax Rules for Children & Dependents
- **Form 1040 –** Instructions
- **Form 2120** – Multiple Support Agreement
- **Form 8332 –** Exemption Release by Custodial Parent – Divorced or Separated Parents Note: Under TCJA the exemption deduction is suspended for years 2018 through 2025 but Form 8332 will still be needed to release the dependency so that the noncustodial parent can claim the child tax credit (Sec. 151(d)(5)(B). ***Sec. 151(d)(5)(B) —*** *For purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph Section 151(d)(5)(A) shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.*



NOTE – for divorce decrees after 2008, only Form 8332 or a similar statement will be accepted – pages from the divorce decree or separation agreement cannot be substituted for Form 8332.

TESTS TO BE A DEPENDENT: As explained below, to be claimed as a taxpayer's dependent, an individual must be:

- A **qualified child** – as determined under the uniform definition of a child, **or**
- A **qualifying relative.**

TESTS FOR MEETING UNIFORM DEFINITION (QUALIFIED CHILD)

In general, a child is a qualifying child of a taxpayer if the child satisfies each of these tests: a **residency test**, a **relationship test**, a **joint return test**, and an **age test**. In addition, with one exception (see "self-supporting children" below), the child may not have provided over one-half of his or her own support for the year. The support and gross income tests for determining whether an individual is a "qualifying relative" generally do not apply to a child who meets the requirements of the uniform definition.

- **Residency test -** To satisfy the residency test, the child must have the ***same principal place of abode as the taxpayer for more than one half of the tax year.*** Exceptions apply for temporary absences, when the child is born or dies during the tax year, for children of divorced or separated parents, and for certain missing children. Temporary absences due to special circumstances, including absences due to illness, education, business, vacation, or military service, are not intended by Congress to be treated as absences. Further, the child must be a U.S. citizen, resident or national, or a resident of Mexico or Canada.

  Adopted nonresident alien exception - There are exceptions to this test for the dependency of certain adopted children who are nonresident aliens. For such a child to qualify as a taxpayer's dependent, the *taxpayer* must be a U.S. citizen or national, and the child must live with the taxpayer all year. The child need not have been adopted for the entire year, as long as he/she lived with the taxpayer for the whole year (except for temporary absences).

  Residency test for kidnapped children **-** A child who has been kidnapped is treated as meeting the residency test if both of the following requirements are met:
    - The child is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the child's or taxpayer's family, and
    - In the year of the kidnapping, the child lived with the taxpayer for more than half of the part of the year prior to the date of the kidnapping.

  If both requirements are met, the child is treated as meeting the residency test for the following tax benefits:
    - The child's dependency exemption deduction (TCJA suspended 2018 through 2025 by treating the amount of the deduction as $0).
    - The child tax credit.
    - Earned income tax credit.
    - Head of household or qualifying widow(er) with dependent child filing status.

  This treatment applies for all tax years ending during the period that the child is kidnapped. However, it ceases to apply as of the first tax year beginning after the calendar year in which the child is determined to be dead, or, if earlier, the year in which the child would have reached age 18 (age 17 for purposes of the child tax credit).

- **Relationship test -** To meet the relationship test, the child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual. An individual who is legally adopted by the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer, is treated as a child of the taxpayer by blood. A foster child is treated as a child of the taxpayer only if the child qualifies as an "eligible foster child," meaning that the individual was placed with the taxpayer by an authorized placement agency or by judgment, decree or other court order.

- **Joint return test –** An individual who is married and files a joint return for the tax year beginning in the calendar year in which the tax year of the taxpayer claiming the individual begins can't be a qualifying child, unless the return is filed only as a refund claim. (Code Sec. 152(c)(1)(E))

- **Age test -** The age test varies depending upon the tax benefit involved. The child is treated as reaching a given age on the anniversary of the date the child was born (e.g., a child born January 1, 2000 attains age 19 on January 1, 2019). In general, to be a qualifying child, an individual must be:
    - Under age 19* or
    - Under age 24 in the case of a full-time student*;
    - Under age 13 (if he or she is not disabled) for purposes of the dependent care credit;
    - Under age 17 (whether or not disabled) for purposes of the child credit.

    **These age requirements are as of the end of the tax year, and they don't apply if the individual is permanently and totally disabled at any time during the calendar year.*

  Regardless of the individual's age: to be a qualifying child, the **individual (child) must be younger than the taxpayer** who claims him or her. (Code Sec. 152(c)(3)(A)) This rule does not apply if the individual is totally and permanently disabled. (Code Sec. 152(c)(3)(B))

  This provision addresses the problem where a taxpayer caring for a younger sibling in a home with no parents would be ineligible to claim the earned income credit based solely on the fact that the taxpayer is a qualifying child of the younger sibling if the taxpayer meets the age, relationship, and residency tests. Accordingly, the taxpayer would not be a qualifying child of the younger sibling and thus would not be barred from claiming the earned income credit with respect to the younger sibling.

OLDER CHILD MAY QUALIFY AS DEPENDENT (Qualified Relative)

The qualified relative rules may apply for someone other than a qualifying child of the taxpayer(s). Whether an older child can be claimed as a dependent is determined under the rules for qualifying dependents. As a result, they will need to meet five dependent qualification tests to be claimed as a dependent.

Full-Time Student - A full-time student is one enrolled for some part of five calendar months (whether or not consecutive) for the number of hours or courses considered full-time attendance by the school. (Reg Sec 1.151-3(b)).

The enrollment in school needn't be for full months—or for five consecutive months. So, if the student is enrolled from mid-February to mid-June, the five months' qualification is met. On the other hand, if the student is enrolled from September to December or February to May, the student has been enrolled for only four months and there must be full-time enrollment during at least one other month during the calendar year. Any part of a month counts as a full month.

Enrolled means registered. That is, an individual will qualify as a student if the individual is registered for a semester in a full-time course of study at an educational organization. (IRS Letter Ruling 9838027).

Self-supporting children - A child who provides over one half of his or her own support generally is not considered a qualifying child of another taxpayer. However, a child who provides over one half of his or her own support may constitute a qualifying child of another taxpayer for purposes of the earned income tax credit.

The term "support" and "income" have entirely different meanings. The question is, does a child **provide** over half of his or her own support? A child may have income, save it and not contribute to their own support, in which case the child may very well be the qualifying child of his or her parents, who would be entitled to claim the child as a dependent and claim a higher education tax credit for the tuition they paid. It may present an odd looking dependent of another return, but it is what it is. Also remember there is no gross income test for a "qualified child."

For a "qualifying child," the support requirement will be that the dependent had not provided over one-half of his or her own support for the calendar year in which the taxpayer's tax year begins. In determining whether a child provided more than one-half of his or her own support (for a qualifying child), or whether a taxpayer provided more than one-half of a relative's support (for a qualifying relative), the amount of support provided by the child, or by the taxpayer, will be compared to the total amount of support from all sources. The term "support" will include amounts incurred for support and/or the fair market value (FMV) of an item of support, if the item is property or lodging. The amount of total support will include support provided for the dependent's own support, and income that's excludable from gross income. Support will include amounts spent (and FMV of goods or property used) to provide: food and clothing; lodging (shelter); medical and dental care; education (but not certain scholarships); and similar items. Worksheet 2 in IRS Pub 501 is useful for determining support.

From Pub 929 – Page 18 – Support - All amounts spent to provide the child with food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. To figure your child's support, count support provided by you, your child, and others. However, a scholarship received by your child isn't considered support if your child is a full-time student.

Qualifying child tax benefits generally limited to child's parents - If an individual's parents may claim the individual as a qualifying child but no parent does so, no other taxpayer may claim the individual as a qualifying child unless that taxpayer's adjusted gross income (AGI) is higher than the highest AGI of any parent of the individual. (Code Sec. 152(c)(4)(C))

Tie-breaker rules – The tie-breaker rules apply if an individual **may be claimed** as a qualifying child by two or more taxpayers and the taxpayers cannot agree between themselves who will claim the child, or if the child is actually claimed by more than one taxpayer and the IRS has to step in and determine who can claim the child. The tie-breaking rules are as follows:

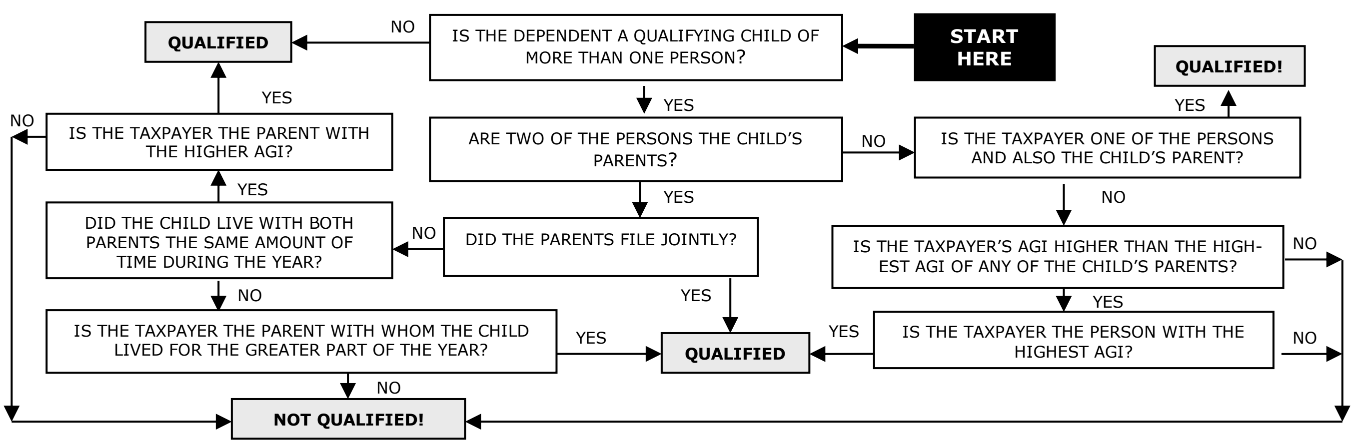
- **Parent and Other Relative** - If only one of the taxpayers who may claim the individual as a qualifying child is the individual's parent (e.g., where a child lives with his or her mother and grandmother in the same residence), the individual is treated as the qualifying child of his or her parent. (Code Sec. 152(c)(4)(A)(i))
- **Parents Not Filing Jointly** - If more than one parent may claim the child as a qualifying child and the parents don't file a joint return together, the child is treated as the qualifying child of: (a) the parent with whom the child resided for the longer period of time during the tax year, or (b) if the child resides with both parents for the same amount of time during the tax year, the parent with the higher adjusted gross income. (Code Sec. 152(c)(4)(B)(ii)) However, a child is treated as the qualifying child of the noncustodial parent if the custodial parent releases a claim to the dependency as discussed below.
- **Parents Not Claiming** – If an individual may be but isn't claimed by either parent, the individual may be claimed as the qualifying child of another taxpayer only if that taxpayer's adjusted gross income is higher than the highest AGI of any parent of the individual. (Code Sec. 152(c)(4)(C))

TIE-BREAKER RULES	
IF more than one person may claim the same qualifying child and . . .	**THEN the child will be treated as the qualifying child of the. . .**
Only one of the persons is the child's parent.	Parent.
Two of the persons are parents of the child and they do not file a joint return together.	Parent with whom the child resided for the longer period of time during the year.
Two of the persons are parents of the child, they do not file a joint return together, and the child lived with each parent the same amount of time during the year.	Parent with the higher adjusted gross income (AGI).
No parent claims the child	Person with the highest AGI, but only if that person's AGI is higher than the AGI of any parent of the child.

In **Notice 2006-86** the IRS has indicated that the rule that goes into effect when two or more taxpayers claim a child as a qualifying child must be applied uniformly to all tax provisions that rely on the same definition of a qualifying child. The only exception is where the Code Sec. 152(e) rule for non-custodial parents applies, in which case a child may be the non-custodial parent's qualifying child for child tax credit and dependency deduction purposes and may be the custodial parent's qualifying child for other provisions. (The dependency deduction is suspended for years 2018-2025.)

In other words, except to the extent that the special rule for non-custodial parents applies, when more than one taxpayer may claim a child as a qualifying child, the child is treated as the qualifying child of only one taxpayer for **ALL** the provisions that employ the uniform definition of a qualifying child: head of household, child and dependent care credit, child tax credit, EITC, and the exclusion for dependent care assistance. The notice says the **tiebreaker rules are applied** to these provisions **as a group**, rather than on an IRC section-by-section basis.

QUALIFIED CHILD TIE-BREAKER CHART*



*Applies when a child can be claimed as the qualifying child of more than one person.

Special rule for non-custodial parents – A special rule allows a non-custodial parent to claim the child as a qualifying child for purposes of the Code Sec. 24 child tax credit and the Code Sec. 151 dependency deduction, the latter being suspended for years 2018 through 2025. The non-custodial parent may claim the child as a qualifying child under Code Sec. 152(e) (notwithstanding the rule of Code Sec. 152(c)(4)(B)), if:

(1) The child is in the custody of one or both parents for more than one-half of the calendar year;
(2) The child receives over one-half of the child's support during the calendar year from the child's parents;
(3) The parents:

- Are divorced or separated under a decree of divorce or separate maintenance,
- Are separated under a written separation agreement, or
- Live apart at all times during the last 6 months of the calendar year; and

(4) The custodial parent releases the claim to the dependency of the child to the non-custodial parent in a written declaration that the non-custodial parent attaches to the non-custodial parent's tax return.

Final regulations §1.152-4 includes the following definitions and clarifications relating to the special rule for non-custodial parents:

Custody – A child is in the custody of one or both parents for over one-half the calendar year if one or both parents have the **right under state law to physical custody** of the child for more than one-half the calendar year. Thus, for purposes of Sec. 152(e), a child is not in the custody of either parent once the child reaches the age of majority under state law. Whether a child who is not in one or both parents' custody over half the year is the qualifying child or qualifying relative of either parent is determined under the rules of code sections 152(c) or (d).

> ***Example 1:*** *Duane and Ellie are the divorced parents of Carol. Under a custody decree, Grandmother has the right under state law to physical custody of Carol from January 1 to July 31, 2019. Because Duane and Ellie do not have the right under state law to physical custody of Carol for over one-half of the 2019 calendar year, Carol is not in the custody of one or both parents for over one-half of the calendar year. Therefore, section 152(e) does not apply. Whether Carol is the qualifying child or qualifying relative of Duane, Ellie, or Grandmother is determined under section 152(c) ("qualifying child") or (d) ("qualifying relative").*

> ***Example 2:*** *Frank and Ginnie are the divorced parents of Chris. In May of 2019, Chris turns age 18 and is emancipated under the law of the state where Chris resides. Therefore, in 2019 and later years, Frank and Ginnie do not have the right under state law to physical custody of Chris for over one-half of the calendar year, and Chris is not in the custody of Frank and Ginnie for over one-half of the calendar year. Section 152(e) does not apply, and whether Chris is the qualifying child or qualifying relative of Frank and Ginnie is determined under section 152(c) or (d).*

> ***Example 3:*** *The facts are as in Example 2, except Chris turns age 18 on August 1, 2019. In 2019, Chris resides with Frank from January 1 through May 31 and with Ginnie from June 1 through December 31. Frank executes a Form 8332 releasing his right to claim Chris as a dependent for 2019. Chris is considered to be in the custody of Frank and Ginnie for over one-half the year, but he is treated as not residing with either parent after his emancipation on August 1. Therefore, Chris resides for 151 nights with Frank and 61 nights with Ginnie. As long as Ginnie attaches a copy of the Form 8332 that Frank executed to her return, she may claim Chris as a dependent for 2019.*

Custodial Parent – The IRS defines "custodial parent" to be the parent with whom the child resides for the **greater number of nights** during the year. A child resides with a parent for a night if the child sleeps at the residence of that parent (whether or not the parent is present) or in the company of the parent when the child doesn't sleep at the parent's residence, such as when the parent and child are on vacation together. The time that the child goes to sleep is irrelevant. Provisions for special circumstances include:

- Absences of Child - If a child is temporarily absent from a parent's home for a night, the child is treated as residing with the parent with whom the child would have resided for the night. A night is not counted for either parent if the child would not have resided with either parent for the night (for example, because a court awarded custody of the child to a third party for the period of absence) or it cannot be determined with which parent the child would have resided for the night.

- Equal Number of Nights - If a child resides with each parent for the same number of nights, then the parent with the higher AGI for the year is treated as the custodial parent.

- Night Spans Two Years – A night that extends over two tax years is allocated to the tax year in which the night begins. Thus, the night that begins on December 31, 2019, is counted for taxable year 2019.

- Parent Works at Night – If, due to a parent's nighttime work schedule, a child resides for a greater number of days but not nights with the parent who works at night, that parent is treated as the custodial parent. On a school day, the child is treated as residing at the primary residence registered with the school.

> ***Example 4:*** *Hector and Jana are the divorced parents of Claudia. Claudia generally resides with Hector during the week and with Jana every other weekend. Claudia resides with Jana in Hector's residence for 10 consecutive nights while Hector is hospitalized. Under Regs Sec 1.152-4(d)(1)(i) Claudia resides with Hector for the 10 nights.*
>
> ***Example 5:*** *Karl and Lisa, who are separated under a written separation agreement, are the parents of Charles. In August 2019, Karl and Charles spend 10 nights together in a hotel while on vacation. Under the regulations Charles resides with Karl for the 10 nights that Karl and Charles are on vacation.*

Example 6: *Oscar and Pam, who never married, are the parents of Cora. In 2019, Cora spends alternate weeks residing with Oscar and Pam. During a week that Cora is residing with Oscar, he gives Cora permission to spend a night at the home of a friend. The night Cora spends at the friend's home is treated as a night that Cora resides with Oscar.*

Example 7: *Same facts as in Example 6, except Cora also spends 6 weeks away at summer camp. Because she resides with each parent for alternate weeks, Cora would have resided with Oscar for 3 weeks and with Pam for 3 weeks of the period that she is at camp. Cora is treated as residing with Oscar for 3 weeks and with Pam for 3 weeks.*

Example 8: *Same facts as in Example 7, except that Cora does not spend alternate weeks residing with each parent, and it cannot be determined whether Cora would have resided with Oscar or Pam for the period she was at camp. Therefore, she is treated as residing with neither parent for the 6 weeks.*

Written Declaration Releasing Claim to Noncustodial Parent – The final regs state that if the custodial parent releases to the noncustodial parent the claim to the child as a dependent, the release must be a **written declaration** and it must be **unconditional** (no strings attached such as requiring the noncustodial parent to meet support payment obligations). It must name the noncustodial parent and specify the year or years for which it is effective. If it specifies "all future years," it is treated as specifying the first taxable year after the year in which it is executed and all subsequent years. The written declaration may be made on Form 8332, or successor form designated by the IRS. If the release is not made on the official IRS form, it must conform to the substance of that form, and it must be executed for the sole purpose of serving as a written declaration under this section. **A court order or decree or separation agreement may not serve as a written declaration*** (because it has other purposes than releasing the dependency to the non-custodial parent). The IRS also will not accept a state court's allocation of dependents because IRC Sections 151 and 152, not state law, determine who may claim a child as a dependent for federal income tax purposes. The noncustodial parent **must attach a copy** of the written declaration to his or her return for each year in which the child is claimed as a dependent. * Swint, (2014) 142 TC No. 6

Effect on Prior Multi-Year Releases **-** Although the final regs apply prospectively, they clarify that a multi-year written declaration will be treated as satisfying the release format requirements under the final regs, if it satisfied the requirements for the form of a written declaration at the time it was executed. The regulations also provide that a release executed on or before July 2, 2008 may be revoked.

In Ltr Rul 200925041, a Chief Counsel Advice that may not be used or cited as precedent, the IRS said that a noncustodial parent may continue to attach pages of a divorce decree or separation instrument **executed on or before July 2, 2008,** that unconditionally allows the noncustodial parent to claim an exemption for a child, if the pages constitute a statement substantially similar to Form 8332 under the requirements in effect at the time the decree or agreement was executed.

Revoking the Release - The declaration releasing the claim to the child's dependency may be revoked if:

- A written notice of revocation is provided to the other parent.
- The parent revoking the declaration makes reasonable efforts to provide actual notice to the other parent. Facts and circumstances will determine what attempts are "reasonable," but mailing a copy of the written revocation to the noncustodial parent at the last known address or "at an address reasonably calculated to ensure receipt" will satisfy the requirement.
- The revocation is effective no earlier than the taxable year that begins in the first calendar year after the year in which the parent revoking the written declaration provides, or makes reasonable efforts to provide, the written notice.
- The revocation may be made on Form 8332 or its successor. If not made on the IRS form, the revocation must conform to the substance of the 8332; it must be a document executed solely for the purpose of making the revocation and must specify the year or years the revocation is effective. A copy of the revocation must be attached to the parent's return for each taxable year for which the parent claims a child as a dependent as a result of the revocation. The parent revoking the written declaration must keep a copy of the revocation as well as evidence of delivery of the notice to the other parent, or of the reasonable efforts to provide actual notice.

CAUTION:

The custodial parent's release of the claim is a condition of the non-custodial parent claiming the child as a dependent. Absent the written release, the non-custodial parent may not claim the child for the dependency exemption (years before 2018 and after 2025) or the child tax credit. Further, under Reg. 1.152-4, if the custodial parent does not release the claim to the dependency, only the taxpayer who is entitled to claim the child as a dependent under the qualifying child or qualifying relative rules (Sec. 152 (c) or 152 (d)) may treat the child as a dependent for purposes of claiming the child's medical expenses (Sec. 213 (d) (5)) and treating the child as a dependent with respect to fringe benefits (Sec. 132 (h) (2) (B)) and amounts received from employer health plans (Sec. 105 (b)).

Never Married Parents – The Tax Court held in *King, (2003) 121 T.C. No. 12*, that a never-married non-custodial parent is entitled to a dependency exemption because the custodial parent signed Form 8332 waiving the dependency. Regs § 1.152-4 follow the holding in *King*.

When a Child Is a Dependent of Both Parents - In Revenue Procedure 2008-48, 2008-36 IRB, IRS has described the circumstances under which it will treat a child of parents who are divorced, separated, or living apart as the dependent of both parents for purposes of the:

- Exclusion from gross income of certain employer-provided reimbursements of expenses incurred for the medical care of the employee's dependent child under Code Sec. 105(b);
- Exclusion from gross income of employer contributions to an accident or health plan on behalf of the employee's children under Code Sec. 106(a) and Reg. §1.106-1;
- Exclusion from gross income of fringe benefits qualifying as no-additional-cost services or qualified employee discounts under Code Sec. 132(a) that are treated as used by the employee due to use by an employee's child under Code Sec. 132(h)(2);
- Deduction of medical expenses of the taxpayer's child under Code Sec. 213(a); and
- Exclusions under Code Secs. 220(f)(1) and 223(f)(1) for distributions from Archer Medical Savings Accounts and Health Savings Accounts, respectively, if the distributions are used to pay qualified medical expenses of the account beneficiary's child.

IRS says that it will treat a child as the dependent of both parents for purposes of the above whether or not the custodial parent releases the claim to the dependency under Code Sec. 152(e)(2) if the taxpayers are:

- Divorced, legally separated under a decree of divorce or separate maintenance, legally separated under a written separation agreement, or live apart at all times for the last 6 months of the calendar year; and
- The parents of a child who: (1) receives over one-half of the child's support during the calendar year from the child's parents; (2) is in the custody of one or both parents for more than one-half of the calendar year; and (3) qualifies as a qualifying child or qualifying relative of one of the child's parents.

<u>SPECIFIC AREAS OF IMPACT</u>

Several tax attributes are affected by the "Uniform Definition of a Child." The table below highlights the special requirements associated with each attribute followed by a discussion of each.

	QUALIFIED CHILD – ADDITIONAL ATTRIBUTE REQUIREMENTS			
	Dependency Exemption **	**Child Tax Credit (CTC)**	**Dependent Care Credit**	**EITC**
Lived with Taxpayer Requirement	More than half the year (except 8332 release)	More than half the year (except 8332 release)	More than half the year	More than half the year
Age Requirements*	**Under age 19,** full-time **Student under 24** or **Totally disabled**	**Under age 17** at end of year	**Under age 13,** or incapable of **self-care,** when care provided	**Under age 19,** full-time **Student under 24** or **Totally disabled**
Self-Supporting Restriction	Must not be self-supporting	Must not be self-supporting	Must not be self-supporting	Not considered
Citizenship Requirement	U.S. Citizen, national, resident alien or resident of Canada or Mexico	U.S. Citizen, national, or resident alien	U.S. Citizen, national, resident alien or resident of Canada or Mexico	U.S. Citizen, national, or resident alien
ID Number	SSN or ITIN***	SSN only 2018-2025 Or ITIN other years	SSN or ITIN	SSN Only
Other Issues	Parents together must furnish more than 50% support for custodial releasey	Qualifying child must be taxpayer's dependent	Custodial parent eligible, if dependency released	Custodial parent eligible, if dependency released

*Child must be younger than taxpayer who is claiming the child

**Dependency exemption deduction has been suspended for years 2018 through 2025.

***While a qualified child *could* have an ITIN, a timely obtained SSN is needed to qualify for the CTC or EITC.

Multiple support agreements - The rules relating to multiple support agreements do not apply with respect to qualifying children because the support test does not apply to them.

Taxpayers can apply dependency rules to claim a dependency for a qualifying relative who does not satisfy the qualifying child definition. In such cases, gross income and support tests, including the special rules for multiple support agreements, the special rules relating to income of handicapped dependents, and the special support test in case of students, apply for purposes of the dependency.

Earned income tax credit (EITC) - A qualifying child must be a qualifying child under the dependency rules (except for the requirement that the child not provide more than one-half of his or her own support). If a taxpayer claims the earned income tax credit on the basis of a qualifying child, the child must have a Social Security number. The same tie-breaker rules apply for the EITC as for dependency.

Child credit –A qualifying child for the child tax credit is defined the same as for determining dependency, except the child must be under age 17, regardless of whether the child is disabled, and a taxpayer cannot claim a child for the child tax credit unless the taxpayer is entitled to the child's dependency. For years 2018 through 2025 the ID number of the child must be a Social Security number and the SSN must be obtained before the due date of the return.

If the child doesn't meet the requirements to be a qualified child but is eligible to be a qualifying relative (i.e., "other dependent"), the taxpayer may claim the $500 nonrefundable dependent credit instead of the child tax credit.

Dependent care credit - If other applicable requirements are satisfied, a taxpayer may claim the dependent care credit for a child who lives with the taxpayer for more than one half of the year, even if the taxpayer does not provide more than one half of the cost of maintaining the household.

Head of household filing status - A taxpayer is eligible for head of household filing status only with respect to a qualifying child or an individual who qualifies as the taxpayer's dependent (qualifying relative). Thus, a taxpayer may claim head of household filing status if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one half the year of:

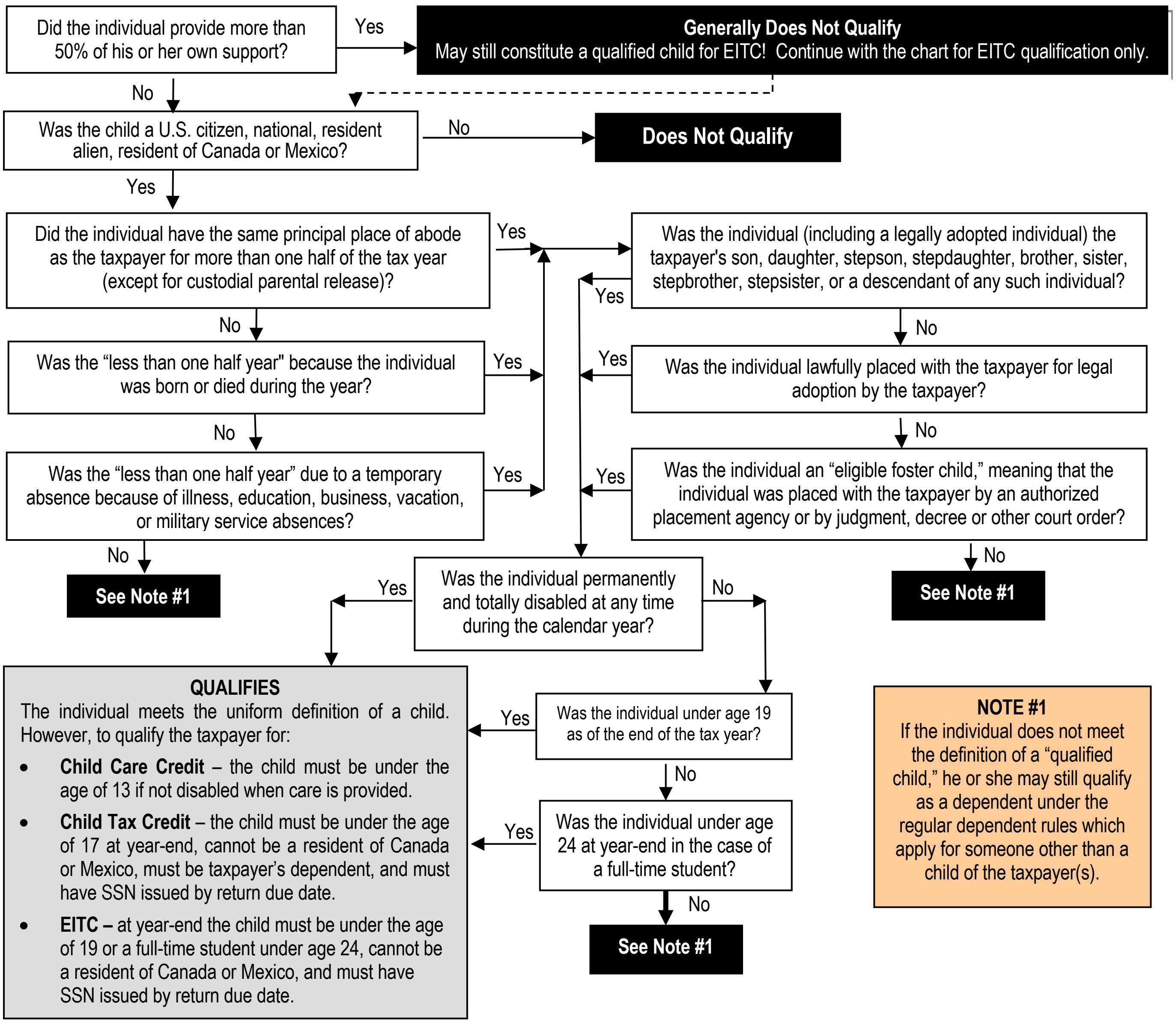
- A qualifying child, or
- An individual who is a relative the taxpayer may claim as a dependent.

A taxpayer cannot claim head of household status using as a qualifier an individual who is the taxpayer's dependent only because the individual is part of the taxpayer's household. Thus, the taxpayer and qualifying individual must be related. A taxpayer may claim head of household status with respect to a parent who qualifies as the taxpayer's dependent even if the parent does not live with the taxpayer if certain requirements are satisfied.

Continue to next page for flow chart

FLOW CHART
QUALIFICATION UNDER THE UNIFORM DEFINITION OF A CHILD

(For a taxpayer (or spouse, if joint) who is not claimed as a dependent by someone else)



TESTS TO BE A QUALIFYING RELATIVE:

1. The person **cannot be a qualifying child** of the taxpayer or anyone else. Notice 2008-5 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 section 6012 to file an income tax return and (i) does not file an income tax return, or (ii) files an income tax return solely to obtain a refund of withheld income taxes.

   Example 1 *- Joe supports as members of his household for the taxable year an unrelated friend, Susan, and her 3-year-old child, Marty. Susan has no gross income, is not required to file an income tax return, and does not file an income tax return for the taxable year. Accordingly, because Susan does not have a filing requirement and did not file an income tax return, Marty is not treated as a qualifying child of Susan or any other taxpayer, and Joe may claim both Susan and Marty as his qualifying relatives, based upon the fact that Susan and Marty meet the relationship or* ***member of the household*** *test, provided all other requirements to qualify for the deduction are met.*

Example 2 *- Same facts as Example 1, except that Susan has earned income of $1,500 during the taxable year, had income tax withheld from her wages, and is not required by section 6012 to file an income tax return. With one qualifying child, Susan may claim the earned income tax credit (EITC) for the taxable year. Susan files an income tax return solely to obtain a refund of withheld income taxes and <u>does not claim the EITC.</u> She forgoes the EITC because the tax benefit to Joe by claiming both her and Marty as dependents is greater than what the EITC would be to her. Accordingly, because Susan does not have a filing requirement and filed only to obtain a refund of withheld income taxes, Marty is not a qualifying child of Susan or any other taxpayer, and Joe may claim both Susan and Marty as his qualifying relatives, provided all other requirements to qualify for the deduction are met. Note, however, that Joe does not qualify to use the Head of Household filing status since neither Susan nor Marty are related to him.*

Caution: *If in example #2 Susan had filed an income tax return to obtain the EITC, and not solely to obtain a refund of withheld income taxes, Marty would be the qualifying child of another taxpayer, Susan, and Joe may not claim Marty as a qualifying relative.*

2. The person must either:
   (a) Be related to the taxpayer in one of the ways listed below under *relatives who do not have to live with the taxpayer*, or
   (b) Live with the taxpayer all year as a member of the taxpayer's household.[1]
3. The person's gross income for the year must be less than $4,200 for 2019 ($4,150 for 2018).[2]
4. The taxpayer must provide more than half of the person's total support for the year.[3]

[1] There are exceptions for temporary absences, children who were born or died during the year, children of divorced or separated parents, and kidnapped children.
[2] There is an exception if the person is disabled and has income from a sheltered workshop.
[3] There is an exception for multiple support agreements.

AGE TEST DOES NOT APPLY FOR QUALIFYING RELATIVE!
Unlike a qualifying child, who (unless permanently and totally disabled) must be younger than the person claiming the child, a qualifying relative can be any age because there is no age test for a qualifying relative.

<u>RELATIONSHIP OR MEMBER OF HOUSEHOLD TEST</u>: To meet this test, an individual must live with the taxpayer all year or be related to the taxpayer.

- ***Relative –*** *The following are treated as related persons (Note* - a relationship established by marriage is not ended by death or divorce (Reg § 1.152-2(d)))*:*
  - Taxpayer's child, stepchild, foster child, or a descendant of any of them (for example, a grandchild). A legally adopted child is considered the taxpayer's child.
  - Taxpayer's brother, sister, half brother, half sister, stepbrother, or stepsister.
  - Taxpayer's father, mother, grandparent, or other direct ancestor, but not foster parent.
  - Taxpayer's stepfather or stepmother.
  - Son or daughter of taxpayer's brother or sister.
  - Son or daughter of taxpayer's half brother or half sister.
  - Brother or sister of taxpayer's father or mother.
  - Taxpayer's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

- **Unrelated individuals** must live with the taxpayer all year in order to qualify as dependents under this test. But keep the following special rules in mind:
  - ***Temporary absences from home***, such as for school or for care in a nursing home don't count as time living out of the home.
  - An ***unrelated person*** can also qualify under this test in the year of birth or death provided the person lived with the taxpayer at all times (prior to death or after birth).
  - Those ***"foster" relationships*** excluded under the qualifying relative test can qualify under this test.
  - A person will not be counted as a member of the taxpayer's household if the relationship of that person to the taxpayer is in ***violation of local law***.
  - Although cousins, great-nieces/nephews, and wife or husband of uncles or aunts do not qualify under the relationship test, they could all qualify if ***they lived with a taxpayer all year***.
  - Even if eligible to be the taxpayer's dependent, an unrelated person ***cannot qualify*** the taxpayer for the ***Head of Household*** filing status.

Domestic partner as member of taxpayer's household - Unless the domestic partner meets one of the relationship tests, he or she must be a member of the taxpayer's household as defined for "unrelated person" above (***Code Sec. 152(d)(2)(H))*** to qualify as the taxpayer's dependent. The same rule applies with respect to the domestic partner's children. Thus, an unmarried taxpayer couldn't claim as his dependents the children of a woman he lived with, where the woman and her children (who weren't his adopted or foster children) left in the latter part of the year and weren't members of his household for the entire year.

Relationship in violation of local law - Under the member-of-household requirement, an individual qualifies as a dependent if the individual is a member of the taxpayer's household for the entire tax year. However, if at any time during the taxpayer's tax year, the relationship between that individual and the taxpayer "is in violation of local law", the individual won't be considered to be a member of the taxpayer's household. ***Code Sec. 152(f)(3); Reg § 1.152-1(b)*** This day and age it would be extremely rare to encounter such laws.

GROSS INCOME TEST: The ***"dependent's" gross income must generally be less than the personal exemption amount*** in order for an individual to qualify as a dependent. As part of tax reform, the federal deduction for exemptions has been suspended for tax years 2018 through 2025. However, the exemption amount ($4,200 for 2019, $4,150 for 2018) continues to be used elsewhere in the tax code for other purposes, including for the definition of a qualified relative. The amount is subject to inflation adjustment annually.

All ***gross income which is taxed counts towards this test*** (e.g., gross rents before expenses), but exempt amounts such as worker's compensation or gifts are not counted. Social Security benefits are only counted to the extent they are taxable.

Gross income under this test does not include certain income from ***sheltered workshops for permanently and totally disabled individuals***. To be excludable, the income must come from activities that are incidental to medical care during special training and it must be paid by an exempt organization or government agency.

JOINT RETURN TEST: An individual does not qualify as a dependent of another if the individual filed a joint return. However, this rule will not apply if:

a) Neither the "dependent" nor his/her spouse was required to file;
b) Neither the "dependent" nor spouse would have a tax liability if they filed separate returns; and
c) The couple filed only to claim a refund of withholding.

EXAMPLE – Joint Return No EITC – John is 25 years old. He and his 21-year-old wife live with John's parents and had $1,500 of wages from part-time jobs and no other income. Neither John nor his wife is required to file a tax return. They do not have a child. Taxes were taken out of John's pay, so John files a joint return only to get a refund of the withheld income taxes. John's parents are not disqualified from claiming John as a dependent just because he filed a joint return. They can claim John and his wife as dependents if all the other tests to do so are met. If they can claim John as a dependent, John cannot claim the EITC.

EXAMPLE – Joint Return Claiming EITC – The facts are the same as in the previous example except no taxes were taken out of John's pay. Also, John and his wife are not required to file a tax return, but they file a joint return to claim an EITC of $117 and get a refund of that amount. Since they filed a return to get the EITC, they are not filing only to claim a refund of withholding tax. Thus John's parents cannot claim either John or his wife as a dependent.

CITIZENSHIP/RESIDENCE TEST: Under this fourth dependency test, a person must be:

- A ***citizen or resident of the U.S***., ***or***
- A U.S. "national" (e.g., an American Samoan), ***or***
- A resident of Canada or Mexico at some time during the calendar year in which the taxpayer's tax year begins.

Non-resident child & Multiple Support Agreements - A resident alien taxpayer may not claim a dependency for his or her child who is a citizen-resident of a country contiguous to the U.S. where the basis for such a claim is a multiple support agreement between the taxpayer and nonresident aliens not engaged in a trade or business within the U.S. (Rev Rul 82-183, 1982-2 CB 54).

Resident aliens - A person who is not a citizen and is living in the U.S. must have "resident" status, i.e., must not be a visitor. A foreign student participating in an educational exchange program who is placed by the program's organizer in the home of a U.S. taxpayer generally would not be a U.S. resident and would not be eligible to be the taxpayer's dependent. To determine resident status, use the same tests that are used to determine whether an alien is a resident for the purpose of filing his/her own tax return.

Citizen – Generally taxpayers and dependents become U.S. citizens either at birth or after birth by the naturalization process. To become a citizen at birth, the person must:

- Have been born in the United States or certain territories or outlying possessions of the United States, and be subject to the jurisdiction of the United States; OR
- Have had a parent or parents who were citizens at the time of his/her birth (if born abroad) and meet other requirements.

SUPPORT TEST: A taxpayer must provide ***more than half of the cost of a qualified relative's support***. Exceptions to the test include multiple support agreements and children of divorced parents (see more below).

What is "support"? Consider support from all sources, including the "qualified relative's" own funds; compare the total with amounts the taxpayer contributed. Amounts an individual receives for support aren't considered support unless they are actually spent for support. To determine support, consider items like food, lodging, clothing, education, entertainment and travel, childcare, medical care, etc. Worksheet 2 in IRS Publication 501 is useful in determining the support test for dependency.

Support is not limited to necessities, nor does the amount paid for support have to be reasonable or depend on what different parents would spend to support a child. However, one case ruled differently. In ***Flowers, Harriet v. U.S., 52 AFTR 1383,*** the District Court ruled that a boat, rifle and lawn mower were not necessities and could not be included in the support provided by the taxpayer.

Lodging as support - For a qualified relative who lives with the taxpayer, the amount to include for lodging is the "fair rental value" (FRV) of the qualified relative's share of the home, not the actual mortgage payment, repairs, etc. "Fair rental value" generally covers maintenance (so do not add it to support); it might or might not include utilities (include utilities if rent for houses in the local vicinity usually includes the cost of utilities). For a qualified relative that lives in his/her own home, the taxpayer's actual contributions to lodging are support, and the balance of the FRV is considered support provided by the "qualified relative."

> ***EXAMPLE - Qualified Relative's Home Ownership Affects Support*** *- Blair provides $2,500 to support his father, Mr. Doats. Doats lives in his own home, which has a fair rental value (FRV) of $4,200 a year, including an allowance for utilities, furnishings, etc. Mr. Doats actually uses $1,500 from his savings to provide for taxes and upkeep items on his home. His total support is $6,700 ($2,500 provided by Blair and the FRV of the home, $4,200). Since Blair does not provide more than half of his father's support, he is unable to claim his father as his dependent. Note that the $1,500, which Mr. Doats paid for taxes, etc., is not used in the calculation of support because it is taken into account in the FRV of the house.*

The following items are included in support:

a) Certain ***capital expenditures***, e.g., cars and home furnishings. Be careful in determining whether capital items should be included in support. Two examples in ***Rev Rul 77-282, 1977-2 CB 52*** came to different results: (1) a car gifted by a parent to a child was regarded as support provided by the parent versus (2) the cost of a car owned by a parent and used equally by the parent and child, was not considered support provided by the parent (only the operational costs of the child's use and paid by the parent were parental support);

b) ***Incarceration*** - For a person in a state facility due to antisocial behavior, the ***cost of state or agency care*** is support provided by the government;

c) ***Welfare*** is support provided by the government;

d) Support ***does not include Medicare benefits***;

e) ***Tax-exempt income*** such as social security, life insurance proceeds, nontaxable pensions, child support, and interest must be considered if used to provide support.

Timing and calculations - Items are included in the support calculation in the year provided. It does not matter if they are actually paid for later (or earlier). Determine the total amount used for support during the year, and how much was provided by each person (e.g., taxpayer, "qualified relative" himself, other parties, government agencies). If the taxpayer provided more than one half of the total, then he/she can claim the dependency.

Designate support - Where a single taxpayer is helping to support both parents and is having difficulty showing over half of the support for both, it may be appropriate for the taxpayer to designate the support to only one of the parents. This will overcome the 50% dependency support requirement for one of them and possibly allow the taxpayer to qualify as head of household.

To qualify for this break, the taxpayer must maintain a household that constitutes one or both of his parents' principal abode, and at least one of the parents must be the taxpayer's dependent, i.e., must individually have gross taxable income for the year of less than the personal exemption amount (or for years 2018-2025 what that amount would be if the exemption deduction wasn't suspended by the TCJA, e.g., $4,200 for 2019) and receive over half of his or her support from the taxpayer. The taxpayer himself need not reside in the household he or she maintains for the parents. The home could even be a retirement home or facility.

To accomplish this, the taxpayer must be able to provide proof that the support is for one of the parents only. Otherwise, the support will be designated as a "fund" equally allocated to both. The IRS suggests a notation on a check as an acceptable designation procedure. It says, "Notations by the maker on support checks purporting to allocate funds to particular household members made payable to an individual having custody of a claimed dependent, will be regarded as evidence of actual support." ***(Rev Rul 72-591, 1972-2 CB 84)***

Multiple support agreements - When several people together provide over 50% of support, all that provide ***MORE THAN 10%*** of the support can agree about which of them will claim the dependent. Of course, the agreeing parties must also otherwise qualify to claim the dependent. The taxpayer claiming the qualifying relative's dependency under this provision needs to attach a completed IRS Form 2120 to his/her return listing each other eligible person who paid over 10% of the support and obtain from each one a signed statement waiving their right to claim the dependency. The statement must include the calendar year the waiver applies to, the name of the qualifying relative for whom the support was provided, and the name, address and Social Security number of the person waiving the dependency. The person claiming the dependency is to retain the signed statement(s) in case the IRS later requests them; they are not to be attached to the tax return.

EXAMPLE - Meeting the Support Test - *Hal and Betty Norman and their young child lived in a rented home near Phoenix, AZ. Their monthly rent was $1,000, which included the cost of gas and electricity. Hal's parents, Woody and Cyd, were retired and also lived with the Normans. Woody received social security income of $8,400 ($4,000 was spent on Woody's support, $3,500 on Cyd's, and the remainder was deposited in savings). Woody and Cyd received no other income for the tax year.*

Hal and Betty paid $7,500 for food. They also paid $1,500 to Dr. Akida for Cyd's dental expenses. In addition, Hal and Betty paid the total cost ($1,200) of a week's vacation in New Mexico for the whole family (including Woody and Cyd). Computation of Woody and Cyd's total support:

Support Item	***Woody***	***H&B***	***Cyd***	***H&B***
Lodging ($12,000/5)……………………………	*$2,400 **	*$2,400*	*$2,400 **	*$2,400*
Social security………………………………………	*4,000*		*3,500*	
Food ($7,500/5)…………………………………..	*1,500 **	*1,500*	*1,500 **	*1,500*
Dental…………………………………………………			*1,500 **	*1,500*
Vacations ($1,200/5)……………………………..	*240 **	*240*	*240 **	*240*
Total	*$8,140*	*$4,140*	*$9,140*	*$5,640*
** Amounts provided by Hal and Betty.*		*>50%*		*>50%*

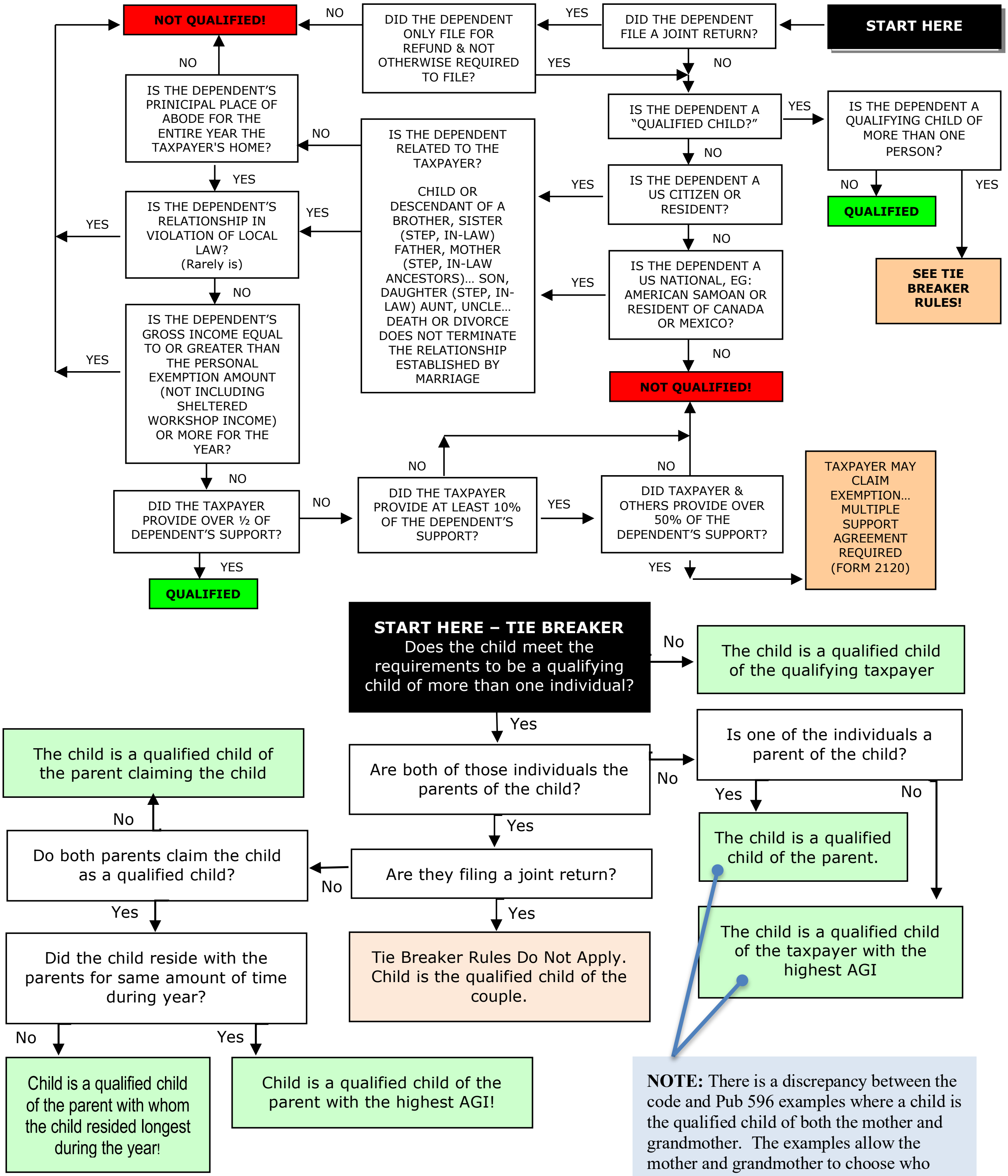
Hal and Betty may claim Cyd as their dependent because they contributed over half of her support ($5,640 of $9,140). They may also claim Woody as their dependent because they contributed $4,140 (over half of Woody's total support of $8,140).

California conforms to Federal law for the determination of dependency. California allows a nonrefundable credit for the taxpayer, spouse and each dependent. See Chapter 1.03 for the amounts.

Dependent determination chart on next page

NOTES

DEPENDENT DETERMINATION CHART



NOTE: There is a discrepancy between the code and Pub 596 examples where a child is the qualified child of both the mother and grandmother. The examples allow the mother and grandmother to choose who claims the child where the mother's AGI is less than the grandmother's AGI. The decision tree follows the specific wording of the code.

DEPENDENCY WORKSHEET – TAX YEAR 2019

Taxpayer's Name:____________________________

Complete a separate worksheet for each person the taxpayer (T/P) is trying to establish as a dependent. The person must be either a "Qualifying Child" or a "Qualifying Relative" to be a dependent. Refer to Notes *for definitions and exceptions and additional instructions.*

PART I – **QUALIFYING CHILD** - Answer the following questions to determine if the T/P has a ***qualifying child*** who is a dependent:

1. If any of the following individuals **lived with the T/P for more than half of 2019**[(1), (6)], check the applicable box:
   a. ☐ Son, daughter, or stepchild
   b. ☐ Foster child placed with the T/P by an authorized placement agency or by judgment, decree or other court order.
   c. ☐ Brother, sister, stepbrother, or stepsister.
   d. ☐ Descendant of any of those listed in a, b or c above.
   e. If 1a, 1b, 1c, or 1d is checked, enter the individual's name and continue:____

2. Is the individual named on 1e, younger than the taxpayer? ☐ Yes *(continue to item 3)* ☐ No – *not a qualifying child, but complete Part II to see if the individual is a "qualifying relative"*

3. The individual named on line 1e was:
   a. ☐ Under age 19 at the end of 2019, **or**
   b. ☐ Under age 24 at the end of 2019 and a student [(2)], **or**
   c. ☐ Any age and permanently and totally disabled [(3)].

If box 3a, 3b or 3c was marked, the individual is a "qualifying child" – continue. If none of the item 3 boxes were checked, the individual cannot be a "qualifying child" – do not complete the rest of Part I (but complete PART II to see if the individual can be a "qualifying relative").

4. Did the individual named on line 1e provide over half of his or her own support in 2019?
   ☐Yes - *this person cannot be the T/P's dependent*
   ☐No - *this individual is a qualifying child [(4)]; continue to item 5 (to determine if the T/P can claim the qualifying child as a dependent).*

5. Was the child a U.S. citizen, U.S. National or a resident of the U.S., Canada or Mexico? (Or if the T/P is a U.S. citizen or U.S. National and the child is adopted, did the adopted child live with the T/P all year as a member of the T/P's household?)
   ☐Yes – *continue* ☐No – *does not qualify as a dependent*

6. Was the child married [(5)]? ☐Yes – *does not qualify as a dependent (but see Notes before answering)* ☐No – *continue*

7. Can T/P (or spouse if filing married joint) be claimed as a dependent on someone else's 2019 return?
   ☐Yes – *child does not qualify as a dependent* ☐No – *child qualifies as a dependent*

PART II – QUALIFYING RELATIVE - Answer the following questions to determine if the T/P has a qualifying relative who is a dependent (someone other than the qualifying child from PART I).

8. The individual is the T/P's:
   a. ☐ Son, daughter, stepchild, foster child (defined the same as at 1b) or descendant of any of these.
   b. ☐ Brother, sister, son or daughter of either (i.e., T/P's nephew or niece).
   c. ☐ Father, mother, ancestor or sibling of either (i.e., grandparent, aunt or uncle).
   d. ☐ Step -brother, -sister, -father, -mother; son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law.
   e. ☐ Any other person (non-spouse) who lived *all year* as a member of T/P's household, if the relationship doesn't violate local law.
   f. If 8a, 8b, 8c, 8d or 8e is checked, enter individual's name and continue: ____

9. Did the person named on 8f have gross income less than $4,200 in 2019? ☐ No – *stop – not qualified* ☐ Yes – *continue*

10. Did the T/P provide over half of the support in 2019 for the individual named on line 8f?
    ☐ No – *stop – not qualified* ☐ Yes – *continue*

11. Was the person named in line 8f a U.S. citizen, U.S. National or a resident of the U.S., Canada or Mexico?
    ☐ No – *stop – not qualified* ☐ Yes – *continue*

12. Was the person named on line 8f married[5]? ☐ Yes *(but see Notes before answering)* ☐ No – *continue*

13. Can the T/P (or spouse if filing married joint) be claimed as a dependent on someone else's 2019 return?
    ☐ Yes – *individual on line 8f is not qualified as a dependent* ☐No – *qualifies as a dependent*

Notes – Dependency Worksheet – Tax Year 2019

(1) **Exception to time lived with T/P**: If a person was born or died in 2019 and the T/P's home was this person's home for the entire time alive, he or she is considered to have lived all year with the T/P. Temporary absences for school, vacation, medical care, military service or detention in a juvenile facility count as time lived with the T/P.

(2) **Student** is defined as someone enrolled full-time during any part of 5 calendar months in 2019 at a school, including a technical, trade or mechanical school, but not an on-the-job training course, correspondence or Internet school. A full-time on-farm training course given by a school or government agency qualifies.

(3) **Permanently and totally disabled**: In 2019, the person couldn't engage in any substantial gainful activity due to a mental or physical condition that a doctor has determined (a) lasted or can be expected to last continuously for at least a year, or (b) can be expected to lead to death.

(4) **Tie-breaker rules:** (If the child is the **qualifying child of more than 1 person**, only 1 person may claim the child for dependency, child tax credit, Head of Household filing status, credit for child and dependent care and earned income credit.) These rules apply if 2 or more taxpayers may claim an individual. Tie-breaking rules are as follows:

- If only one of the persons is the child's parent, the child will be treated as the qualifying child of the parent.
- If two of the persons are the child's parents, the child will be treated as the qualifying child of the parent with whom the child lived for the longer period of time in 2019. If the child lived with each parent for the same amount of time, the child will be treated as the qualifying child of the parent who had the higher adjusted gross income (AGI) for 2019.
- If the child could be, but is not, claimed by either parent, the child will be treated as the qualifying child of another person only if that person's AGI is higher than the highest AGI of any parent of the child.

(5) If the person is **married** and does not file a joint return, answer "NO." If the person is married and files a joint return only as a claim for refund and no tax liability would exist for either spouse if they had filed separate returns, answer "NO." If neither exception applies, the dependency is not allowed.

(6) **Rules for Children of Divorced or Separated Parents**: A child will be treated as a qualifying child or qualifying relative of his or her noncustodial parent (the parent with whom the child lived for the lesser part of 2019) if all of the following apply.

1. The parents are divorced, legally separated, separated under a written separation agreement, or lived apart at all times during the last 6 months of 2019.
2. The child received over half of his or her support for 2019 from the parents (without regard to the rules on Multiple Support Agreements).
3. The child is in the custody of one or both of the parents for more than half of 2019.
4. The custodial parent signs Form 8332 (or a substantially similar statement) that he or she will not claim the child as a dependent for 2019. Pertinent pages from divorce decree or separation agreement may not be substituted for Form 8332 (or similar statement).

If the rules above apply and this child would otherwise be the qualifying child of more than one person:

- Only the non-custodial parent can claim the child for purposes of the child tax credits.
- For head of household filing status, the credit for child and dependent care expenses, and the earned income tax credit (EITC), only one person can claim these three benefits. No other person can claim any of these three benefits unless he or she has a different qualifying child.

If more than one person can claim the child as a qualifying child, see Note 4 above.

FILING STATUS & DEPENDENT CASE STUDIES

Overview

Some of the most complicated issues in tax preparation revolve around filing status and dependency issues. This lesson combines the issues of some uncommon filing circumstances with those of claiming dependency in a series of case studies that apply to both the filing status qualifications and dependency qualifications. In addition, the case studies occasionally mention the impact on other tax issues such as child tax credit and EITC. Use the Rapid Finder below to locate case studies of interest.

RAPID FINDER

CASE STUDY #1: Unmarried Couple, One With No Income - Al and Janice, both U.S. Citizens lived together for the entire year but are not married to each other. Janice has no income for the year, and Al provided her entire support for the year.

Dependency Janice – For Al to claim Janice as a dependent she would have to meet the five qualifying relative tests. The first test is the **relationship or member of the household test**. She is not related to him, but she was a member of the household for the entire year, so she meets that test. The next test is the **gross income test**, which she passes since she has no income. Since he provides over half of her **support** and she is an **unmarried U.S. Citizen**, he can claim her as his dependent.

Filing Status Al – Al cannot file as head of household (HH) because the individual qualifying him for HH must be related to him. So even though Janice qualifies as his dependent, she is not a qualifying person for purposes of the HH filing status. Thus he must file as single.

CASE STUDY #2: Unmarried Couple, Both Employed - Al and Janice, both U.S. Citizens lived together for the entire year (2019), but are not married to each other. Al provided over half her support. Janice was employed and had earnings in excess of the personal exemption amount for the year.

Exemption Janice – Because Janice's earnings were in excess of the personal exemption amount, she fails the **gross income test**, and therefore cannot be claimed as a dependent of Al.

Filing Status Janice – If Janice's earnings exceed the standard deduction for a single person, she is required to file her own return and would file as single. Even if Janice had no filing requirement, she may want to file to recover withholding. (For years prior to 2018, the personal exemption allowance amount is added to the standard deduction when determining if there's a filing requirement based on gross income. With the exemption deduction suspended starting in 2018, only the standard deduction amount is used for the filing requirement test.)

Filing Status Al – Al cannot file as head of household (HH) because Janice is not a qualified individual (qualifying child or dependent relative) for purposes of HH. Thus he must file as **single**.

CASE STUDY #3: Unmarried Couple, With Minor Child - Al and Janice, both U.S. Citizens, have lived together for the entire year. They are not married to each other. They have a minor child, Susan, who lived with them the entire year. Al is employed, but Janice is not and she has no income.

Dependency Janice – Janice meets the **member of the household** and the **other four dependency tests**, so Al can claim her as a dependent.

Dependency Susan – Susan, Al's daughter meets all of the tests for a **qualified child** (principal place of abode, relationship and age). Thus Susan qualifies as Al's dependent.

Filing Status Al – Although Janice is not a qualifying individual for purposes of the head of household (HH) filing status, Susan is, since she is Al's qualifying child, and Al's filing status for the year will be **Head of Household**.

CASE STUDY #4: Unmarried Couple, Each with Minor Child - Al and Janice, both U.S. Citizens, have lived together for the entire year but are not married to each other. They each have a minor child by a previous relationship: Bob is Al's son and Susan is Janice's daughter. Both of the children have lived with Al and Janice the entire year. Both Al and Janice are employed and share the household expenses.

Dependency Bob – Since Bob meets the age, residency and relationship tests with Al, he is a qualifying child of Al's and thus a dependent of Al.

Dependency Susan – Since Susan meets the age, residency and relationship tests with Janice, she is a qualifying child and thus a dependent of Janice.

Filing Status Al & Janice – Since Al and Janice are not married they cannot file a joint return. Both Al and Janice have a qualified person (their respective children) for purposes of filing as head of household. However, there are two issues that come into play regarding HH:

(1) The HH rules specify that a taxpayer must pay over half the costs of maintaining as his or her home a household which is the principal place of abode for more than one-half the year for a qualified person. With Al and Janice sharing the household expenses, the issue is who paid over half of the costs?

(2) The IRS also contends that there can only be one HH in a single home, unless there is a certain amount of divisibility of quarters (TC Memo 1974-137)

Thus, either Al or Janice will file HH and the other will file as single.

Other Issues: Each, if they otherwise meet the requirements would qualify for child credit, EITC and child care credit. They would each be a separate tax family for purposes of the ACA.

CASE STUDY #5: Married Couple, Separated With Minor Child - Married Couple, Al and Janice, have a minor daughter Susan. They separate and Al moves out on May 5th. Susan continues to live with her mother Janice who pays more than one-half of the cost of maintaining the household, which is the principal place of abode for more than one-half the year for Susan.

Dependency Susan – Susan is the qualified child of the couple and continues to reside with Janice, making Janice the custodial parent and entitled to claim Susan as her dependent unless she releases Susan's dependency to Al using Form 8332.

Filing Status Janice – When married individuals file they must file using the married joint or married separate status. An exception to that rule applies for an individual who lived apart from his or her spouse for the last six months of the year and pays more than one-half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one-half the year of a child, stepchild or eligible foster child for whom the taxpayer may claim the dependency. An individual meeting this exception may use the HH status. (A nondependent child may be the HH qualifier only if the custodial parent gave written consent to allow the dependency to the non-custodial parent.) Thus, Janice qualifies for the Head of Household filing status.

Filing Status Al – Since Al is married he must file as married filing separately.

> **Variation: Each Has Minor Child** - However, if Al had another qualifying child who lived with him after the separation, and Al pays more than one-half of the cost of maintaining as his home a household which is the principal place of abode for more than one-half the year for that child, Al would also qualify for the Head of Household filing status.

Other Issues: If Janice otherwise meets the requirements, Janice would qualify for the child credit, EITC and child care credit. The same would apply to Al in the variation.

CASE STUDY #6: Non-Resident Alien Spouse - Married Couple, Al and Janice, with no children. Al is a U.S. Citizen (or a resident alien) and Janice is a non-resident alien spouse residing abroad.

Filing Status Janice – Since Janice is a non-resident alien she does not have a U.S. filing requirement, unless she elects to file a joint return with Al as discussed under Al's filing options below.

Filing Status Al – Since Al is married, he must either file jointly with Janice or file as married separate. Al has the following filing options:

- **Married separate**, or
- **Married Joint**. However to file married joint he and Janice must make a joint election to treat Janice as a resident alien (Code Sec. 6013(g)(1)). In so doing, both spouses must agree to subject their worldwide income for the taxable year to U.S. taxation (Code Sec. 6013(g); Code Sec. 6013(h)). One party must have been, at the close of the taxable year for which the election was made, a nonresident alien individual married to a citizen or resident of the United States (Code Sec. 6013(g)(2)). An ITIN will be required for Janice (Form W-7).

Variation: U.S. Citizen Passes Away – Al is a U.S. Citizen married to a non-resident alien. Al passes away during the year. The filing options for Al in his year of death are the same as if he were alive. However, the executor for Al's estate is the one that acts on Al's behalf, and if the executor and Janice both agree, she and Al can file married filing jointly and include their worldwide income. The other option is married filing separately.

CASE STUDY #7: Non-Resident Alien Spouse & Alien Child - Married Couple, Al and Janice. Al is a resident alien and Janice is a non-resident alien spouse residing in Italy with their non-U.S. citizen daughter, Susan.

Filing Status Janice – Since Janice is a non-resident alien she does not have a U.S. Filing requirement, unless she elects to file a joint return with Al as discussed under Al's filing options below.

Filing Status Al – A resident alien has the same filing requirements as a U.S. citizen. Since Al is married, he must either file jointly with Janice or file as married separate. Al has the following filing options:

- **Married separate**, or
- **Married Joint**. However to file married joint he and Janice must make a joint election to treat Janice as a resident alien (Code Sec. 6013(g)(1)). In so doing, both spouses must agree to subject their worldwide income for the taxable year to U.S. taxation (Code Sec. 6013(g); Code Sec. 6013(h)). One party must have been, at the close of the taxable year for which the election was made, a nonresident alien individual married to a citizen or resident of the United States (Code Sec. 6013(g)(2)). An ITIN will be required for Janice (Form W-7).

Dependency Susan – In order for Al to claim Susan as a dependent, she would need to be a qualifying relative or a qualified child. To be a **qualified child**, Susan must meet the residency test. To satisfy the residency test, the child must have the same principal place of abode as the taxpayer for more than one half of the tax year (Sec 152(c)(1)(B)). Therefore Susan is not a qualified child of Al.

To be a **qualifying relative** she must meet the five qualifying relative tests and not be a qualifying child. Assuming Susan meets the relationship, the gross income test, the support test and the joint return test, she would still fail the citizenship or resident of the U.S test since she is not a U.S. Citizen, U.S. resident or a resident of Canada or Mexico. Thus Susan is not a qualifying relative, and Al cannot claim her as a dependent.

Variation: Child is U.S. Citizen - Even if Susan were a U.S. Citizen, she would still not be a qualified child of Al's, since she does not meet the residency test. However, she could be Al's dependent if she meets the qualifying relative test. The qualifying relative test requires Susan to be related or a member of the household. She meets the related test. She also needs to meet the citizenship or residence test, which she passes since she is a citizen. If she also satisfies the gross income test, joint return test and Al provides over half of her support, she would qualify as Al's dependent.

CASE STUDY #8: Self-Supporting Qualified Child - Susan is the 21 year-old daughter of Al and Janice. Her sources of funds for support include distributions from a Sec 529 plan funded by her parents (Al & Janice), a part-time job and student loans.

Generally, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: a residency test, a relationship test, and an age test (Code Sec. 152(c)). However, a self-supporting child (one that provides over one half of his or her own support) is not a qualifying child of another taxpayer (Code Sec. 152(c)(1)(D)).

In determining whether Susan is self-supporting, in addition to the usual accounting of support, a major question is whether the Sec 529 plan counts as support provided by Susan or her parents. Contributions to Sec 529 plans are completed gifts (Sec. 529(c)(2)) and any non-qualified distributions from the 529 plan would be taxable to Susan, supporting the premise the distributions from the Sec 529 plan are support Susan provided. The argument could also be made that because the account owner controls whether a distribution is made and the amount of the distribution, and can even withdraw funds for him or herself, the distribution from a QTP should be considered provided by the account owner for purposes of the support test. The IRS has provided no guidance on this issue.

At stake here, in addition to Susan's dependency, is who gets the education credits. If Susan were self-supporting, then she would get the education credits on her return. This would be desirable where her parents' income phases out the credit, and especially in the case of the American Opportunity Credit, where a portion is refundable.

CASE STUDY #9: Single Parent With Child Away At College - Janice is a single parent with her 21-year-old daughter, Susan, a full-time student attending a university out of state. Janice provides over half of Susan's support in the form of tuition, room and board and expenses.

Dependency Susan – Susan meets the requirements of a qualified child since she is under the age of 24, a full time student and is not self-supporting. Thus Janice will claim Susan as a dependent.

Filing Status Janice – For Janice to claim Head of Household, she must pay over half the cost of maintaining her home, which is the principal place of abode for more than one-half the year for Susan. Susan being away at college is considered a temporary absence and does not change Susan's place of abode for tax purposes; thus Janice can claim the Head of Household filing status.

Other Issues - Since Janice is claiming the dependency she would also be the taxpayer claiming the education tax credits.

CASE STUDY #10: Daughter and Daughter's Child living with Daughter's Mother - Susan, Janice's daughter, and her minor child Whitney, age 4, have lived with Janice the entire year. Susan is age 22, unmarried, not a full-time student and has no income.

Dependency Susan –As a 22-year-old who is not a student, Susan does not meet the requirements of a qualified child. She would have to be under the age of 19 to be a qualified child. However, Susan does meet the requirements of a qualifying relative since she meets the relationship test, gross income test, joint return test, citizenship test and support test and therefore is a dependent of Janice.

Variation: Child's Income in Excess of Exemption Amount - However, if Susan had income in excess of the personal exemption amount for the year she would not be a qualified relative.

Dependency Whitney – Whitney meets the principal place of abode test, age test, and gross income test and therefore is a qualifying child of both her mother, Susan, and her grandmother, Janice. Thus, either Susan or Janice can claim the dependency for Whitney and they can decide between themselves who will claim Whitney. In this circumstance since Susan is not filing, Janice will claim Whitney's dependency.

Variation: Mother & Grandmother Claim Child - If Susan had to file a return and Whitney was the qualifying child of both Susan and Janice, they could still decide who would claim Whitney's dependency. If they could not agree, or if both actually claimed Whitney as a dependent, the tie-breaking rules would apply. The tie-breaker rules specify that in the case where a parent and another relative claim or could claim a qualified child, the dependency defaults to the parent. Therefore, Susan would be entitled to claim Whitney's dependency.

Filing Status Janice– For Janice to claim Head of Household, she must pay over half the cost of maintaining her home, which is the principal place of abode for more than one-half the year for a qualified child or a dependent relative. Janice can claim Head of Household since she has a qualifying individual, either Susan or Whitney.

Other Issues – Since Janice is claiming Whitney, who is under age 17, and meets the relationship test, member of the household test, is not self supporting and is claimed as Janice's dependent, Janice can claim the child tax credit for Whitney subject to the AGI phase-out. Janice can also claim EITC subject to disqualifying income limits and AGI phase-out provided she has earned income. Since Janice is claiming both Susan and Whitney she is also subject to the ACA penalty for not being insured if Susan and Whitney do not have qualified insurance. (This penalty does not apply to years after 2018.)

CASE STUDY #11: Divorced Parents, Court Awards Dependency - Al and Janice are divorced and have a minor child, Susan. Janice is the custodial parent, but the family court judge specified in the divorce decree that Al should be able to claim Susan as a dependent.

Dependency Susan – Tax law specifies that the custodial parent is the one that can claim the dependency for the child. A divorce court judge cannot override federal tax law. The IRS also will not accept a state court's allocation of dependency because IRC Sections 151 and 152, not state law, determine who may claim a child's dependency for federal income tax purposes. Unless Janice completes a Form 8332 (or other form conforming to TCJA), releasing Susan's dependency to Al, Janice is the one entitled to claim Susan as a dependent.

Other Issues:

Child Credit – To claim the child credit, the child must have lived with the taxpayer over half the year and be claimed as the taxpayer's dependent. However, when the custodial parent releases the dependency to the non-custodial parent they also release the right to claim the child credit to the non-custodial parent. (Code Sec. 152(e)) Thus, if Janice releases the dependency to Al, if otherwise qualified, he would be the one to claim the child credit.

Earned Income Tax Credit (EITC) – Unlike the child credit, the EITC does not include the requirement for the child to be the taxpayer's dependent. However, it does include the requirement that the qualifying child, except for temporary absences, reside with the taxpayer over half the year. Thus in this case even if Janice releases the dependency to Al, she is the one that can claim EITC if she otherwise qualifies.

Child Care Credit – Like the EITC, there is no requirement for the child to be the taxpayer's dependent. In the case of a child of divorced or separated parents, only the custodial parent may claim the credit, even if the non-custodial parent may claim the dependency for that child under Code Sec. 152(e). Regulations define a custodial parent as the parent with whom a child shares the same principal place of abode for the greater portion of the calendar year. *(Reg. Sec. 1.21-1(b)(5)(ii))* Thus in this case Janice would be the only one able to claim the childcare credit even if Al incurred some work related childcare expenses during the periods he had custody.

CASE STUDY #12: Divorced Parents, Joint Custody - Al and Janice are divorced and have a child, Susan, age 12. The divorce decree specifies that Al and Janice have **joint custody** of Susan.

Dependency Susan – The qualified child rules specify that the child must have the same principal residence as the taxpayer for more than one half of the year. It may be difficult and argumentative to determine which parent had custody the longer period during the year. However, for a practical matter, either parent can claim Susan, but not both. So a problem arises if they both attempt to claim Susan, in which case the qualified child rules specify **if more than one parent claims the child** as a qualifying child and the parents don't file a joint return together, the child is treated as the qualifying child of:

(a) the parent with whom the child resided for the longer period of time during the tax year, or

(b) if the child resides with both parents for the same amount of time during the tax year, the parent with the higher adjusted gross income. (Code Sec. 152(c)(4)(B)(ii)).

For purposes of determining who had custody for the greater portion of the year, custody for a specific day is determined by where a child slept that night (there are some elaborate rules relating to determining where a child slept that are included in Chapter 1.02). Any rational individual understands it is virtually impossible for a child to reside with both parents equally. But try telling that to some divorced parents. Remember that someone else is preparing the other parent's return and making the same decisions as you.

Filing Status Parents – For either of the parents to qualify for head of household (HH) filing status they would have to pay for more than one-half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one-half the year for a qualified person. A qualified person generally includes a qualified child (in this case Susan). So the HH goes to the one that actually did have physical custody for over half the year. Here again, in joint custody cases, where both parents believe they had the child over half the year, they both may attempt to file as HH.

Other Issues – Child credit, EITC, and childcare credit can only be claimed by the parent who had custody for the greater portion of the year.

CASE STUDY #13: Permanently and Totally Disabled Older Child - Janice is unmarried and her permanently and totally disabled unmarried child Susan, age 33, lives with her; Janice takes care of Susan.

Dependency Susan – To meet the qualified child tests, the child must meet four tests: principal place of abode, joint return, relationship and age test. Susan clearly meets all but the age test, which she would normally fail because she is older than 18, and not a full time student under the age of 24. However, the age requirement is waived when a child is permanently and totally disabled. Thus, Susan is Janice's qualified child and Janice can take her as a dependent.

Other Issues:

Child Credit: Even though the qualified child age requirements are waived for a permanently disabled child, the child credit age 17 requirements continue to apply, so Janice does not qualify for a child credit.

Earned Income Tax Credit (EITC): For purposes of the EITC, a qualifying child is the same definition as under the rules that apply to the dependency. Thus Susan is a qualified child for EITC, and therefore, if Janice otherwise qualifies she can claim EITC based on one child.

Child & Dependent Care: Generally this credit is thought of as allowed only for children under the age of 13. However, if otherwise qualified, a taxpayer can claim it for the care of a spouse or dependent who is physically or mentally unable to care for themselves if they live with the taxpayer more than half of the year.

Variation: Older Child Only Temporarily Disabled - Suppose Susan was only temporally disabled (not permanently) as a result of an accident or medical condition and had W-2 income of $10,000. Thus she would not be a qualified child because of her age and neither would she be Janice's qualifying relative because her income exceeds the personal exemption amount. However, if Susan would have been Janice's dependent except for failing the gross income test, Susan would have been what is referred to as a medical dependent, and although Janice cannot claim Susan as a dependent, she can deduct any medical expenses she pays for Susan's care, and if she otherwise qualifies, except for the gross income, she can also claim the child and dependent care credit.

CASE STUDY #14: Parent Living with Adult Child - Susan is a single adult taxpayer. Her mother, Janice, lives with her in Susan's home. Janice is a single, U.S. citizen, age 70, and receives $15,000 per year in Social Security benefits (SS).

Dependency Janice: In order for Janice to be claimed as Susan's dependent the five dependency tests must be met. Since she lives with Susan, she meets the relationship-member of the household test. She also meets the gross income test, since that only applies to taxable income and her SS is not taxable. She also meets the citizenship and joint return tests. So the issue here is whether or not Janice provides over half of her mother's support.

Consider support from all sources, including the "dependent's" own funds; compare the total with amounts the taxpayer contributed. Amounts an individual receives for support aren't considered support unless they are actually spent for support, so if Janice saved part of her SS benefits, the amount saved would not be counted towards her own support.

For a dependent who lives with the taxpayer, the amount to include for lodging is the "fair rental value" (FRV) of the dependent's share of the home, not the actual mortgage payment, repairs, etc. FRV generally covers maintenance (so do not add it to support); it might or might not include utilities (include utilities if rent for houses in the local vicinity usually includes the cost of utilities).

Filing Status Susan: The next question is whether Susan files as single or head of household (HH). To file as HH Susan must pay more than one-half of the cost of maintaining as her home a household, which is the principal place of abode for more than one-half the year for a qualified person. A qualified person generally includes a qualified child or a relative the taxpayer may claim as a dependent. So, if Susan is able to claim her mother (meet the support test) then she is also qualified to file as head of household.

CASE STUDY #15: Parent Supported by Adult Child – Susan helps to support her elderly, U.S. citizen (or resident alien), married parents, Al and Janice, who do not reside with Susan. Al and Janice have a combined Social Security (SS) income of $20,000, which is their only income.

Dependency Al and Janice: To claim either or both of her parents as dependents, they must meet the five qualified relative tests. Since they meet the relationship test they don't need to live with Susan. Their only income is the SS income (all nontaxable), so they are not required to file a return and thus meet the joint return test. They also meet the gross income test because the gross income test only counts taxable income, and if their income was just the $20,000 of SS, it would not be taxable. Since they also meet the citizenship test the only issue is, does Susan pay over 50% of her parents' support?

Consider support from all sources, including the "dependent's" own funds; compare the total with amounts the taxpayer contributed. Amounts an individual receives for support aren't considered support unless they are actually spent for support, so if Al and Janice saved part of their SS benefits, the amount saved would not be counted towards their own support.

Variation: Designate Support - If Susan's support for dependency purposes is insufficient to meet the 50% requirements for both parents, she can designate her support payments to only one of her parents. To accomplish this, she must be able to provide proof that the support is for one of the parents only. Otherwise, the support will be designated as a "fund" equally allocated to both. The IRS suggests a notation on a check as an acceptable designation procedure.

Variation: Care Facility - Suppose one or both of Susan's parents are in a rest home. Where they reside makes no difference in the support calculation, so they could be living in their own home, a rental or a care facility. Note also, that if Susan made support payments directly to the care facility and her parents qualify as her dependent, she would be able to deduct the care facility payments, if they qualify, as a medical expense.

Variation: Multiple Support - If Susan and others, such as siblings, all chip in to support Al and Janice, and the combined support exceeds 50% of the total support, all the individuals who provide over 10% can agree upon which one of them claims the dependents by filing the Form 2120 multiple support agreement. Where the group is supporting both parents, two Forms 2120 can be filed permitting two of the contributors to an exemption. Careful consideration should be given to who claims the dependent(s). The two issues to consider are high-income exemption phase-out (for years before 2018) and the current medical deduction floor.

Filing Status Susan: Does Susan file single or head of household? To file as head of household, Susan would have to pay more than half the cost of maintaining a separate household that was the main home for her dependent parent for the entire year. The fact that Susan can claim one or both of her parents as dependents does not necessarily mean she paid more than half the cost of maintaining a separate household for a dependent parent. An accounting will need to be done to determine if Susan provided more than half the cost of maintaining her parents' home.

CASE STUDY #16: Qualified Widow with Dependent Child – Al and Janice were married but Al passed away in 2019. For 2020 and 2021 Janice continues to maintain a home for herself and her minor dependent daughter, Susan.

Filing Status Janice: If Janice does not remarry after Al's passing, Janice files married joint with Al in 2019 and files as qualified widow with dependent child in both 2020 and 2021. After 2021, if Susan is still a dependent, Janice would file as head of household.

Variation: Dependent Not Taxpayer's Child - Al and Janice were caring for a minor grandchild that they claimed as a dependent when Al passed away. If Janice does not remarry after Al's passing, she would file married joint with Al in 2019. However, she would not be eligible for the qualified widow filing status in 2020 and 2021 because the dependent must be her child. Grandchildren and foster children do not qualify the surviving spouse for the qualified widow(er) filing status. However, Janice would qualify as head of household.

Variation: Spouse Remarries - Janice remarries in the same year as Al passes away. In this case, Al's return would be filed using the married filing separate status and Janice would file married filing jointly (or separately) with her new spouse.

CASE STUDY #17: Military Spouse Missing In Action – Al and Janice are married but Al is in the Marines and deployed to Afghanistan. Al went missing in action in 2017 and remains on missing status. What is Janice's filing status in 2019?

Filing Status Janice: The date of death for a member of the Armed Forces who was in a missing status (missing in action or prisoner of war) is the date his or her name is removed from missing status for military pay purposes. This is true even if death actually occurred earlier. Thus Janice would still be considered married until Al's name is removed from missing status, and she would file using the status married filing joint. Of course she could file as married filing separately, but that makes no sense since there is no tax advantage for doing so.

CASE STUDY #18: Resident Alien Parents Living In Foreign Country – Phil's parents lived in a foreign country the entire tax year. Here are the facts about the parents:

Parents as dependents

- They are green card holders and thus resident aliens.
- They meet the relationship or member of the household test – they are his parents.
- They meet the gross income test – their income is less than the personal exemption amounts.
- They are married, but the joint return test does not apply because they are not required to file.
- They meet the U.S. citizen or resident test since they are green card holders (resident aliens).
- They meet the support test since Phil provides over half their support.

Thus the parents qualify as Phil's dependents.

Phil's Filing Status

- Phil's parents qualify as his dependents.
- Phil provided over half the cost of maintaining a separate household that was the main home for a dependent parent for the entire year.

Thus Phil qualifies to use the head of household status.

NOTES

EXEMPTIONS

As part of tax reform, the federal deduction for exemptions has been suspended for tax years 2018 through 2025. However, the exemption amount ($4,200 for 2019) is used elsewhere in the tax code for other purposes. For instance, it is used in the definition of a qualified relative, where the gross income cannot exceed the exemption amount.

- **Personal & Dependent Exemption Allowance**
- 2019: $4,200
- Annually adjusted for inflation

Related IRC and IRS Publications and Forms

- **IRC Sec 151**
- **Form 1040 –** Instructions
- **Form 8332 –** Exemption Release – Custodial Parent
- **Pub 17 –** Your Federal Income tax
- **Pub 501 –** Exemptions, Standard Deductions and Filing Information
- **Pub 929 –** Tax Rules for Children & Dependents

EXEMPTIONS: Prior to 2018, the tax law, via Form 1040, allowed a deduction for personal and dependent exemption allowances. These allowances are permitted for each filer and each dependent claimed on the federal return. For years 2018 through 2025 the exemption deduction has been suspended. However, the dollar value of what would have been the exemption deduction is still used for other purposes in the code, and therefore, an amount is shown for 2018 and 2019 in the table below. This amount is subject to inflation-adjustment in future years.

Year	2014	2015	2016	2017	2018	2019	2020
Exemption	3,950	4,000	4,050	4,050	4,150	4,200	4,300

EXEMPTION PHASE OUT: For years before 2018, the otherwise allowable exemption amounts are reduced by 2% for each $2,500, or part of $2,500 ($1,250 for married filing separately), that the taxpayer's AGI exceeds the threshold amount shown in the table below for the taxpayer's filing status. If the AGI exceeds the amount shown by more than $122,500 ($61,250 if married filing separately), the amount allowed for exemptions is reduced to zero.

FEDERAL EXEMPTION PHASEOUT - AGI THRESHOLDS					
Tax Year	**2014**	**2015**	**2016**	**2017**	**2018-25**
Single	254,200	258,250	259,400	261,500	N/A
Head of Household	279,650	284,050	285,350	287,650	N/A
Joint & Surviving Spouse	305,050	309,900	311,300	313,800	N/A
Married Filing Separate	152,525	154,950	155,650	156,900	N/A

Example: *George and Kate file a married joint return and claim an exemption for their child William. Their 2017 AGI is $334,750, so they have exceeded the threshold for the exemption phase-out. The calculation of their reduced exemption allowance is as follows:*

Federal AGI	*$334,750*
Phase-out threshold	*<313,800>*
Balance (not less than zero)	*20,950*

Increments of $2,500 = 20,950/2,500 = 8.38 – Must round up, so it is 9.
Phase-out percentage: 9 x 2% = 18%

Exemption allowance ($4,050 x 3)	*$12,150*
Phase-out amount (12,150 x 18%)	*<2,187>*
Allowed exemption amount	*9,963*

California allows a nonrefundable exemption tax credit for the filer, spouse (if married filing jointly) and dependents, and additional exemption credits for the filer and spouse if blind and/or a senior. A phase out applies to the credit (see below).

CA Blind Exemptions - The first year claimed requires attachment of a doctor's statement. It must indicate that the filer and/or spouse (not allowed for dependents) cannot see better than 20/200 while wearing glasses or contact lenses, or that their field of vision is not more than 20 degrees.

CA Senior Exemptions - Taxpayer or spouse (not allowed for dependents) must be 65 years of age or older by December 31 of the tax year to qualify for an additional credit. However, if the 65th birthday falls on January 1, the taxpayer (or spouse if applicable) is considered to be age 65 on December 31 of the preceding year.

CA Exemption Credit and Phase-out Threshold Amounts:

Tax Year		2014	2015	2016	2017	2018	2019*
Exemption Credit		108	109	111	114	118	
Dependent		333	337	344	353	367	
Phase-out Threshold	Single & MS	176,413	178,706	182,459	187,203	194,504	
	Joint & SS	352,830	357,417	364,923	374,411	389,013	
	Head of Household	264,623	268,063	273,692	280,808	291,760	

*If any amount is not shown, it is not available at publication date
CA does not release the current year's amount until the Fall of the current year.

Phase out - The California credits are reduced $6 ($12 for Joint and SS) for every $2,500 ($1,250 for MS) or part thereof that the federal AGI exceeds the California threshold amounts.

Example – CA Exemption Phase Out *- Susan is a single taxpayer with one dependent. Her 2018 federal AGI is $202,145. Her exemption credits and phase out for 2018 is computed as follows:*

Federal AGI $ 202,145
Phase-out threshold <194,504>
Balance (not less than zero) 7,641
Increments of $2,500 = 7,641/2,500 3.06 – Must round up, so it is ***4.***
Phase-out amount: 4 x $6 = ***$24***
Susan's personal exemption credit.................................... 118.00
Less phase-out amount..<24.00>
Personal exemption credit allowed.. 94.00
Susan's dependent exemption credit.............................. 367.00
Less phase-out amount...< 24.00>
Dependent exemption credit allowed.. 343.00
Total exemption credits allowed.. 437.00

NOTES

DIVORCE & SEPARATION ISSUES

Taxpayers must resolve many tax-related matters, some listed below, when they separate or divorce. Some of these topics (e.g., filing status) are covered elsewhere in this text. This chapter primarily discusses such issues as joint and several liability, alimony, property transfers between spouses, etc.

(a) *Determining a New Filing Status – See Chapter 1.00;*
(b) *Claiming Dependents – See Chapter 1.01;*
(c) *Joint and Several Liability – This Chapter;*
(d) *Alimony Issues – This Chapter;*
(e) *Community Property Issues – See Chapter 1.10;*
(f) *Property Settlements and Transfers Between Spouses - This Chapter;*
(g) *Family Support – This Chapter;*
(h) *Pension Distributions under Qualified Domestic Relations Orders – See Chapter 4.01.*

RAPID FINDER

Related IRC and IRS Forms & Publications

- **Pub 504** - Divorced or Separated Individuals
- **Pub 1819** - Divorce - An IRS Perspective - Life Cycle Product
- **8332** – Exemption Release – Custodial Parent
- **IRC Sec 71** – Alimony and Separate Maintenance Payments
- **IRC Sec 1041** – Transfers of Property Between Spouses or Incident to Divorce

TCJA CHANGES	**See Page**
Post -2018 Alimony	1.04.04

Strategy - Spousal Buy-Out Debt - When deducting home mortgage interest, for years 2018 through 2025, taxpayers are limited to deducting interest on acquisition debt (up to $1 million of acquisition debt or the grandfathered debt limit, or up to $750,000 for indebtedness incurred after 2017).

Beginning with tax year 2018 equity debt interest is not deductible. What happens in a divorce situation where one spouse refinances to buy out the other spouse?

Notice 88-74, 1988-2 CB 385 states that, in divorce situations, secured debt incurred to buy out a former spouse's interest in a home is acquisition debt. This rule is applied without regard to Code Section 1041, which treats certain transfers of property between spouses incident to divorce as nontaxable events.

Strategy - Alimony and IRA Contributions - In order to contribute to an IRA, an individual must receive "compensation." Compensation includes: Wages, Tips, Bonuses, Professional Fees, Commissions, taxable Alimony received, and Net Income from self-employment.

Thus, for purposes of determining IRA contribution and deduction limits, individuals who receive taxable alimony and separate maintenance payments may treat the alimony as compensation even if it is the only income they have. This allows alimony recipients to save for their retirement by making either Traditional or Roth IRA contributions. *(Code Sec. 219(f)(1))*

Alimony received from divorce agreements entered into after December 31, 2018, or pre-existing agreements that are modified after that date to treat alimony as non-taxable, are non-taxable to the recipient, and therefore cannot be treated as earned income for purposes of an IRA contribution.

JOINT AND SEVERAL LIABILITY

When married taxpayers file joint returns, both spouses are responsible for the tax on that return. What this means is that one spouse may be held liable for all the tax due on a return, even if all the income on that return was earned by the other spouse.

Innocent Spouse Exception - An exception to the joint and several liability rule is allowed for an ***innocent spouse*** (not to be confused with injured spouse relief discussed next)***.***

Payment of Spouse's Debts - If a taxpayer's spouse has not paid child or spousal support payments or certain federal debts (e.g., student loans), the refund on a joint return may be used to pay the past-due amount even though the debt arose prior to marriage to the present spouse. An injured spouse may be able to get his/her share of any refund, however. A person qualifies as an injured spouse under the following circumstances:

- He/she is not required to pay the past-due amount;
- He/she received and reported income on the joint return;
- He/she made and reported tax payments (estimated payments or withholding) on the joint return.

An injured spouse can get his/her portion of a joint return refund by filing Form 8379, Injured Spouse Claim and Allocation. See also Chapter 11.01. **Note:** Taxpayers residing in community property states must divide refunds according to local law. If a taxpayer lives in a community property state in which all community property is subject to the debts of either spouse, the entire joint refund is subject to offset. Claims from California, Idaho, Louisiana and Texas will usually result in no refund for an injured spouse.

Calmes v. U.S., (DC Tex, 05/21/96). This case prevented the IRS from levying on an individual's earnings to satisfy tax debts of her husband that occurred before their marriage. Even though the couple resided in a community property state (see Chapter 1.10), they had entered into a prenuptial agreement where they agreed that the future earnings of each would be his/her own.

TAXABLE ALIMONY ISSUES

Alimony is the term used for payments to a separated or ex-spouse as part of a divorce or separation agreement. Payments cannot be treated as alimony if the spouses file a joint return with each other. If the divorce was prior to 2019, the payments generally are taxable to the recipient and deductible by the payer. Per IRC Sec 71(b)(1)(B), a pre-2019 agreement can designate the payments as non-taxable (and non-deductible). If designated as non-taxable, the alimony isn't considered compensation for IRA contribution purposes.

No deduction for alimony paid before final decree — A taxpayer was denied an alimony deduction for payments he made to his ex-wife, before the final divorce decree was signed. (Milbourn v. Comm., TCM 2015-13)

Since 1985, two ways of defining alimony have been in effect: one for payments under decrees and agreements dated after 1984 and another for payments under decrees and agreements made in 1984 or earlier (and not later changed to incorporate the new rules). TRA '86 made modifications to the post-'84 rules, as indicated below.

POST–2018 - ALIMOMY

Under TCJA the taxability of alimony is modified effective for divorce or separation instruments **entered into after 12/31/2018**. There are also special rules for divorce or separation instruments in existence before 2019 that are modified after 12/31/2018.

- **Pre-2019 divorce agreements** – For divorce or separation instruments entered into before 2019 the old rules continue to apply. Alimony continues to be deductible by the payer and is taxable income to the recipient and qualifies as earned income for an IRA deduction.

- **Post-2018 divorce agreements** - For divorce or separation instruments entered into after 12/31/2018, alimony is no longer deductible by the payer and it is not income to the recipient and no longer qualifies as earned income for an IRA deduction.
- **Modifications after 12/31/18** – Divorce or separation instruments entered into before 2019 and modified after 12/31/18 continue to follow the pre-2019 rules and alimony continues to be deductible by the payer and taxable to the recipient. However, if a pre-2019 divorce or separation instrument is modified after December 31, 2018, the alimony can be subject to the post-2018 rules if the modification expressly provides for post-2018 treatment. (Committee reports, TCJA Section 11051) This gives couples the ability to choose between the pre-2019 rules or the post-2018 rules when they modify their agreement after December 31, 2018. This flexibility allows them to negotiate what is best both financially and tax wise for both parties.

> ***Example***: *An alimony recipient spouse requests a post-2018 increase in alimony of $12,000, from $20,000 to $32,000, and the paying spouse counters with a proposal to keep the alimony at $20,000 but to make the alimony tax free by a "modification" to the original decree.*

"Executed" Date - TCJA specifies that the tax treatment of alimony changes for any divorce or separation agreement "executed" after December 31, 2018. The issue is with the terminology "executed." It is not a question of when the divorce is final or when the paperwork was signed by the judge or recorded – it's when the "divorce or separation instrument… is executed". (TCJA Sec 11051(c))

Note: Although TCJA repealed section 71 it still referred to it for the definition of a divorce or separation agreement.

"Separation Agreement" - **Sec 71(b)(2)** defines a **"Divorce or separation instrument"** - *The term 'divorce or separation instrument' means—*

(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

(B) ***a written separation agreement****, or*

(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse."

The following are quotations from tax court cases.

- *Keegan v Comm TC Memo 1997-511):* "The term 'written separation agreement' (as used in section 71(b)(2)) is not defined by the Code, the legislative history, or applicable regulations".
- *Bogard v. Commissioner 59 TC 97, 100 (1972):* "Logically, it appears Congress was interested in a clear statement in written form of the terms of support where the parties are separated; correspondence between the attorneys representing the husband and wife does not constitute a written separation agreement within the meaning of section 71(a)(2)".
- *Ewell v. Commissioner TC Memo. 1996-253* – "The term "written separation agreement" is not defined by section 71(b)(2), its legislative history, or the Commissioner's regulations. A written separation agreement is a clear, written statement of the terms of support for separated parties. It must be a writing that constitutes an agreement".
- *Other court cases of interest include:* Grant v. Commissioner TC 809, 823 (1985); Kronish v. Commissioner TC 684, 693 (1988; Nemeth v. Commissioner TC Memo 1982-646; and Osterbauer v. Commissioner TC Memo. 1982-266

POST-1984 THROUGH 2018 DECREES AND AGREEMENTS – (*See flow chart page 1.04.04).* Payments:

(1) ***Must be in cash***, paid to the spouse, ex-spouse or a third party on behalf of a spouse or ex-spouse, and the payments must be made after the decree (Reg § 1.71-1(b)(1)(i)). If made under a separation agreement, the payment must be made after execution of that agreement (Reg § 1.71-1(b)(2)).

(2) Must be ***required by a decree or instrument*** incident to divorce, a written separation agreement, or a support decree (IRC § 71(b)(1)(A));

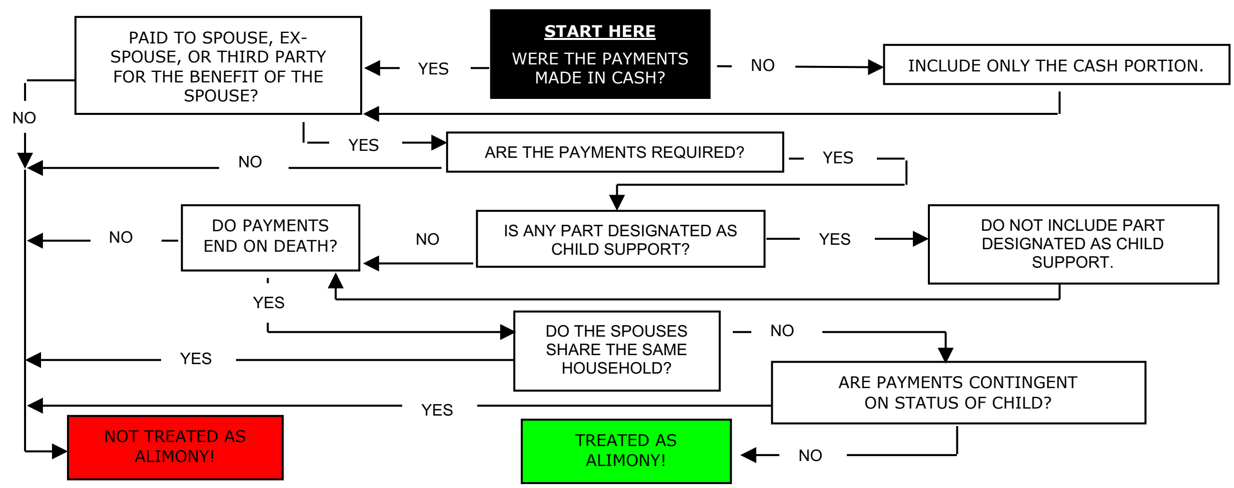
(3) ***Cannot be*** designated as ***child support*** (IRC § 71(c)(1);

(4) Are valid alimony only if the ***taxpayers live apart after the decree***. Spouses who share the same household can't qualify for alimony deductions. This is true even if the spouses live separately within a dwelling unit. (IRC § 71(b)(1)(C))

(5) Must ***end on the death*** of the payee (IRC § 71(b)(1)(D)); ***Linda Hoover, (1995) TC Memo 1995-183*** held that failure to include terminate-at-death language in a final divorce decree converted

(6) payments that would have been deductible as alimony into a nondeductible property settlement. Where the divorce decree is silent, courts will generally consider state law and where state law is vague may make their own decision based on the facts and circumstances of the case.

(7) ***Cannot be contingent on the status of a child*** (IRC § 71(c)(2)) – that is, any amount that is discontinued when a child reaches 18, moves away, etc., is not alimony—contrast the former treatment of the Lester-type agreement described on page 5 of this chapter.



Payments need not be for support of the ex-spouse or based on the marital relationship. They can even be payments for property rights as long as they meet the above requirements. Payments need not be periodic, but there are dollar limits and "recapture" provisions (see below). Even if payments meet all the alimony requirements, the couple may designate in their agreement or decree that the payments are not alimony and that designation will be valid for tax purposes (i.e., not deductible by payer and not taxable to recipient).

Excess front-loading for instruments executed after 1986 and through 2018 – IRC §71(f). The rules affect the first three post-separation years. Recapture may apply to part of the payments made in the first two post-separation years that are more than $15,000. Post-separation years begin the year alimony payments begin. Excess alimony payments are defined as the total of the excess payments in the first and second post-separation years.

These rules apply to divorce instruments executed after Dec 31, 1986 and before January 1, 2019. However, they can also apply to instruments executed before Jan 1, 1987, if the decrees are amended to stipulate that the 1986 law is to apply.

Computing the recapture amount - The following computations cannot be made until the completion of the third post-separation year. The excess amounts from the first and second years are totaled and reported as income (or deducted) in the third year. The following steps are used to compute the recapture:

(1) Add alimony payments made in the third post-separation year to $15,000.

(2) Subtract the result in (1) from alimony payments made in the second post-separation year (not less than zero).

(3) Find the average alimony payments for the second and third post-separation years by adding the alimony paid in the second post-separation year less recapture amount computed in (2) and third post-separation year and dividing the result by 2. Add $15,000 to this average.

(4) Subtract the result in (3) from alimony payments made in the first post-separation year (not less than zero).

(5) Add the results of (2) and (4). This amount must be recaptured at the end of the third post-separation year.

Example - Excess Front-Loading: Agreements Executed After 1986 and before 2019 - *Sammy and Sandra were divorced in Year #1 (which was prior to 2019). He has deducted the alimony he paid her each year; she has reported the alimony as income. The divorce decree stipulated that Sammy must pay alimony as follows: Year #1, $35,000; Year #2, $9,000; Year #3, $5,000. The following worksheet shows Sammy's alimony recapture computation:*
Do NOT enter an amount less than zero on any line.

1. *Alimony paid in 2nd year 9,000*
2. *Alimony paid in 3rd year 5,000*
3. *Floor...15,000*
4. *Add lines 2 and 3 .... 20,000*
5. *Subtract line 4 from line 1 ....0*
6. *Alimony paid in 1st year.. . 35,000*
7. *Adjusted alimony paid in 2nd year (line 1 less line 5)................................ 9,000*
8. *Alimony paid in 3rd year 5,000*
9. *Add lines 7 and 8 ....14,000*
10. *Divide line 9 by 2 .... 7,000*
11. *Floor...15,000*
12. *Add lines 10 and 11 .... 22,000*
13. *Subtract line 12 from line 6...................................... .... 13,000*
14. ***Recaptured alimony**. Add lines 5 and 13 .... 13,000*

Post-1986 recapture rules do not apply if:
(1) either spouse dies;
(2) the alimony recipient remarries within certain time limits;
(3) the payments made are "temporary support payments";
(4) the payments fluctuate due to conditions beyond the payer's control because of a continuing liability to pay, for at least 3 years, a fixed part of business income.

Reporting the recapture amount - The excess amount is reported as income by the alimony PAYER in the year the excess is computed. This is shown as "alimony received" on Form 1040 (Sch 1, line 11 for 2018). Cross out the word "received" and write in "recapture" on the 1040. Also, indicate the social security number of the former spouse. Conversely, the alimony recipient is allowed a deduction in the same year the excess is reported by the payer. The amount is reported on the "alimony paid" line of Form 1040 (Sch 1, line 31(a) for 2018). "Paid" is crossed out and "recapture" is inserted on the form. The recipient must also include the social security number of the payer.

> ***Kitch v. Comm, (CA10, 12/31/96)-*** *The Tenth Circuit Court held that estate beneficiaries were liable for tax on amounts received from their mother's estate that had been received from the estate of her ex-husband under an alimony arrearage settlement. The Court disagreed with the beneficiaries' argument that § 682 (Income of an Estate or Trust in Case of Divorce, Etc.) limited their income to the distributable net income of the ex-husband's estate.*

Pension Substitute Payments to Ex-Spouse - The Court of Appeals for the Ninth Circuit, reversing the Tax Court, has held that a divorced individual who resided in a community property state was taxable on amounts he paid from his wages to his ex-spouse as ordered by a state court. The court had awarded the spouse one-half of the individual's retirement benefits, but because he had not retired, these benefits were not yet payable so the court ordered him to make alternative payments to the spouse until he retired.

Thus, the Ninth Circuit Court of Appeals ruled that even though the pension payments would be made under a qualified domestic relations order (QDRO) agreement and taxable to the spouse, the alternative payments were taxable to the taxpayer and not deductible as alimony under Code Sec. 71(b) since they were required to be made to the ex-spouse or her estate. One of the definitions of alimony is that the payments terminate upon the death of the alimony recipient. ***Comm. v. Dunkin (CA 9 8/31/2007)***

PAYMENTS UNDER PRE-1985 DECREES AND AGREEMENTS - There are three basic requirements for payments to be classified as alimony:

(1) They are required under a written agreement or decree. Gifts or voluntary payments are not considered alimony. Payments made before a divorce was final may be alimony if they are made under court order or written agreement; and

(2) They are for support ("based on the marital relationship"), and are not compensation for PROPERTY RIGHTS, DEBTS, etc. Note that if the agreement says payments are "FOR SUPPORT OF SPOUSE AND CHILDREN" but does not set a specific amount for children, the payments are fully taxable as alimony if other requirements

are met. This is true even if the payments are reduced when the child reaches eighteen, moves away, etc. The latter kind of arrangement is sometimes called a "Lester Agreement;" and

(3) They are "PERIODIC," i.e., not installment payments on a fixed total amount. There is an exception for payments over a period longer than ten years or payments that are "contingent," even if for ten years or less. Contingencies include death of either spouse, remarriage of the alimony-receiving spouse, etc. Payments need not be on any fixed schedule to be "periodic."

TAX ATTRIBUTES

Capital Loss Carryovers – Capital loss carryovers are allocated to the spouse who originally incurred the loss. That can become complicated depending upon whether the carryovers were incurred before or during marriage and whether the loss was incurred as a result of selling community or separate property (2018 Pub 17, Page 117).

Passive Loss Carryovers – For separately owned property, the carryover goes to the spouse that owns the property. Where the property is jointly owned by both or is community property:

- And continues to be owned by both after the divorce, 50% of the carryover would go with each spouse.
- Where one spouse retains the property as part of a property settlement, 50% of the carryover becomes an adjustment to the basis of the property and the other 50% continues to be carryover for the spouse that retained the property.

Net Operating Loss (NOL) Carryovers - If taxpayers haven't been married to each other in all NOL years, the deduction may only be taken by the spouse who incurred the loss and only to offset income generated by that spouse in the carryback or carryforward years. (The TCJA eliminated carrybacks for most NOLs incurred in 2018 or later. See Chapter 3.16 for details.) As example, an NOL sustained by one spouse before her marriage could not, when carried to a year in which she was married, be used to offset the income of her husband (Calvin, Asa E. v. U.S., (1965, CA10)).

> ***Example:*** *George and Joyce, residents of a community property state filed a joint return in 2015. In 2016 George and Joyce divorced and he married Janice in the same year. If George and Janice incur an NOL in 2017, George's share would carry back to 2015, the year he was married to Joyce, and can only offset George's share of the 2015 income. Janice's share of the 2017 loss would be carried back to her 2015 separate or joint return (if she was married in 2015). Any balance of the 2017 loss not used on the 2015 return may be applied against George and Janice's 2016 joint return, and if a balance still remains, it is carried forward to 2018.*

Joint estimated tax payments. If the divorced spouses made joint estimated tax payments but file separate returns, they can divide the payments in any way on which they can both agree. If they cannot agree, the estimated tax each can claim equals the total estimated tax paid times the fraction which is the tax on their individual return divided by the sum of the tax shown on their individual returns for the year (2018 Pub 17, Page 43).

> ***Example:*** *Bill and Jane were divorced during the year. Prior to the divorce they paid $5,000 in joint estimates. They are unable to agree upon how to divide the payments. Bill's tax on his separate return is $10,000 and Jane's tax on her separate return is $7,000. Thus Bill's share of the estimated taxes would be $2,941 ($5,000 x ($10,000/($10,000 + $7,000) and Jane's would be the difference, $2,059.*

When allocating joint estimated tax payments, include the former spouse's SSN in the spouse block on page 1 of the 1040. If the taxpayer has remarried, enter the present spouse's SSN in the spouse block on the 1040 and the former spouse's SSN, followed by "DIV" to the left of line 66 on Form 1040, Schedule 5 (2018).

BASIS OF PROPERTY

When one spouse transfers property to another spouse the basis of the recipient spouse is the same as the transferor-spouse's adjusted basis in the property (Code Sec. 1041(b)).

This rule applies even where the transaction is a sale between the spouses or where the transferee-spouse pays the transferor-spouse (as required under the divorce settlement) for the transfer of title to the property to the transferee- spouse (Reg § 1.1041-1T(a), Q&A-2).

This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer and applies for purposes of determining loss as well as gain, upon later sale by the transferee (Reg § 1.1041-1T(d)). There are exceptions that may apply to certain transfers in trust (Sec 1041(e)) and transfers of installment obligations into a trust (Sec 453B(g)).

> ***Example:*** *George owns land in which his basis is $10,000. He sells it to his wife Allison for $18,000, its fair market value. George does not report any gain on the sale. Allison is the new owner, but her basis is $10,000 (George's basis), even though she actually paid $18,000 for it.*

PROPERTY SETTLEMENTS BETWEEN SPOUSES

No gain or loss is recognized when property is transferred between spouses during marriage. This rule applies also to transfers between former spouses if "incident to a divorce." A transfer is considered incident to divorce if it occurs within one year after a marriage ends or is related to the ending of a marriage (i.e., occurs within 6 years after a marriage ends and the transfer is made under a divorce or separation agreement). A transfer that occurs later than 6 years after a marriage ends can be considered incident to divorce if the taxpayer can show that legal factors prevented earlier transfer of the property.

The Tax Court has held that where a couple provided in their divorce agreement that they would each own 50% of their businesses, but decided over a year later that this arrangement wasn't working, the ex-husband's sale of his 50% interest to the ex-wife was nontaxable because it was incident to the divorce. **Belot, TC Memo 2016-113**

The basis of the property received in a transfer between spouses or former spouses is the adjusted basis the transferring spouse had in the property. In effect, the recipient spouse has received a gift of the transferred property.

> ***Example - Transfers of Property between Spouses –*** *Ed and Elaine were married in 2013. Prior to their marriage, Ed owned some raw land with an adjusted basis of $40,000. In 2019, while still married to each other, Ed sells the property to Elaine for $50,000. Ed realizes no gain on the transaction, but Elaine's basis in the property is $40,000.*

Transfers and Passive Loss Carryovers - Under ***§1041(b)*** and ***469(j)(6),*** if a taxpayer transfers property to a spouse incident to a divorce, the exchange is treated as though it were a gift. Therefore, any suspended losses attributable to the spouse giving up the interest in the passive activity are added to the basis of the property transferred to the other spouse. For the receiving spouse, the basis will be increased by the ex-spouse's suspended losses, but the receiving spouse's suspended losses on the same property will still be considered suspended losses, which are available currently to offset passive income.

Holding Period - For an individual holding property transferred between spouses or transfers incident to divorce, the period the individual owns the property includes the period the transferor owned the property.

Sale After Ex-spouse Retains Property for Some Period of Time - Only for purposes of the Sec 121 home gain exclusion is an individual treated as using property as the individual's principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument. This means that if a husband (or wife) continues to own the home after a divorce, and his/her former wife (husband) is granted use of the property under a divorce instrument, the exclusion could be available when the husband (wife) sells the house if he (she) meets the ownership requirement and his wife (her husband) meets the use requirements. ***(Reg. §1.121-4(b)(2))***

Homebuyer Credit Recapture - Where a home is sold that is subject to a homebuyer or long-term resident credit recapture, and the credit had been claimed on a joint return, each spouse is treated as having received half the credit for recapture purposes. Where one spouse retains the home in a property settlement, recapture or repayment is not triggered as a result of the settlement. However, that spouse takes full responsibility for any subsequent repayment or recapture of the credit. This rule is similar to the Sec 121 home gain rules.

FAMILY SUPPORT

"Family support" payments frequently combine spousal and child support without allocating the payments between deductible alimony and nondeductible child support.

The issue of whether "family support" is deductible as alimony has been to Tax Court on several occasions with conflicting results. However, in the most recent cases, the courts have looked at the termination requirements of alimony. Alimony must terminate on the payee spouse's death. Most family support agreements do not include the provision for the support to terminate on the death of the payee spouse and therefore have failed to qualify as alimony in the recent court cases.

DeLong, TC Memo 2013 – An interesting Tax Court decision in 2013. In this case the Tax Court ruled the entire amount paid towards family support was deductible alimony.

CAUTION – There are unique circumstances with this case. Even though the payments were stipulated by the divorce court as both spousal support and child support, the Court did not fix the amount of either.

Court's conclusion - The Tax Court first examined the issue of whether the family support obligation terminated upon the death of the payee spouse, as required to qualify as alimony. Relying on *Berry, TC Memo 2005-91*, the Tax Court found that Mr. DeLong had no continuing liability for the family support payments past Ms. DeLong's death.

The Tax Court noted that whether a family support obligation terminates upon the death of the payee spouse was not specifically addressed in the California Family Code. Nor had case law conclusively decided the question. In *Berry,* after a careful and comprehensive analysis of California law, the Tax Court found that there was no continuing payment liability past the death of a payee spouse with respect to a family support obligation. The facts of *Berry* were similar to the facts in Mr. DeLong's case, and the Tax Court found no distinguishable facts that would merit a different result in Mr. DeLong's case.

The California Superior Court hearing the Delong case indicated in a temporary and subsequent support order that the family support payments were for both spousal support and child support. It didn't allocate any specific portion of the family support payments as spousal support or child support in either of the support orders. Nor did it provide for a reduction of the family support payment when the children reach maturity.

The Court noted that the statutory directive that child support payments be "fixed" was generally taken literally. Child support cannot be inferred from intent, surrounding circumstances or other subjective criteria. (Comm. v. Lester, (Sup Ct 1961) 7 AFTR 2d 1445, 366 U.S. 299) Mr. DeLong's support orders made an unallocated award of spousal and child support. Consequently, they did not "fix" any portion of the family support payments as a sum that was payable for the support of his children for purposes of Code Sec. 71(c)(1). In addition, there was no amount specified in the support orders that was to be reduced upon the occurrence of a contingency specified in the support orders relating to Mr. DeLong's children or at a time that could clearly be associated with that kind of contingency under Code Sec. 71(c)(2).

COBRA Coverage and Divorce - A group health plan of an employer must provide that each qualified beneficiary who would lose coverage under the plan because of a qualifying event may elect continuation coverage under the plan within a specified at-least-60-day election period (Code Sec. 4980B(f)(1)). Qualified beneficiaries include the covered employee, spouse or dependent child and qualifying events include divorce or legal separation from the covered employee. Coverage for a qualified beneficiary must begin on the date of the qualifying event and end not earlier than 36 months later, the end of the plan, the failure to pay a premium, or the eligibility for group health plan coverage or Medicare.

A WORD OF CAUTION

If you are contemplating preparing both returns of a divorcing couple you must understand that preparing the returns of both can involve inherent conflicts of interest (Cir 230 §10.29) and it may be in your firm's best interest not to represent both parties and in some cases not to represent either individual.

If you reasonably believe that you will be able to provide competent and diligent representation to each affected client, you must inform each affected client of the potential conflict and each so affected client must waive the conflict of interest and provide informed consent, confirmed in writing. For further details consult Cir 230 §10.29.

California follows Federal law. However, California conforms to federal law as it existed on January 1, 2015, with specific significant differences, so most of the TCJA changes, including the treatment of alimony as nondeductible by the payer and nontaxable to the recipient for post-2018 divorce decrees, won't apply for California purposes absent conforming California legislation. For the years California continues to treat alimony from post-2018 decrees as taxable/deductible, adjustment to federal income is made on California Schedule CA

ALIMONY RECAPTURE WORKSHEET

Use only if divorce or separation agreement was entered into before 2019 and has not been modified to adopt the TCJA provision that alimony is not taxable and not deductible.

Recapture only applies to the first three post-separation years. Recapture may apply to part of the payments made in the first two post-separation years that are more than $15,000. Post-separation years begin the year alimony payments begin. Excess alimony payments are defined as the total of the excess payments in the first and second post-separation years. The excess amounts are reported as income (or deducted) in the third post-separation year.

CHECK ANY BOX THAT APPLIES:

- ☐ Either spouse died in the first 3 years of alimony payments.
- ☐ The alimony recipient remarried in the first 3 years of alimony payments.
- ☐ The payments were "temporary support payments."
- ☐ Payments fluctuate due to conditions beyond the payer's control because the payments are based on a fixed part of business income.

IF ANY OF THE ABOVE BOXES IS CHECKED, THE TAXPAYER MAY NOT BE SUBJECT TO THE RECAPTURE PROCESS.

TAXPAYER IDENTIFICATION:

1. Payer:____
2. Payer's taxpayer ID number:.................... ________________________
3. Recipient:____
4. Recipient's taxpayer ID number:.............. ________________________
5. Date of first payment:...____/____/____

ALIMONY PAYMENTS:

6. Payments in first year.. _________
7. Payments in second year... _________
8. Payments in third year.. _________

COMPUTATION OF RECAPTURE:

9. Statutory floor amount... **15,000**
10. Add line 8 plus line 9... _________
11. Line 7 less line 10, but not less than zero... _________
12. Add lines 7 and 8... _________
13. Average payment 2nd and 3rd years - line 12 divided by 2.. _________
14. Line 9 plus line 13.. _________
15. Line 6 less line 14, but not less than zero... _________
16. ***ALIMONY RECAPTURE*** - line 11 plus line 15...................................... _________

REPORTING:

PAYER: Report on alimony "received" line, but cross out word "received" and write in "recapture." Enter social security number of recipient.

RECIPIENT: Report on alimony "paid" line, but cross out word "paid" and write in "recapture." Enter social security number of payer.

NOTES

DEATH OF A TAXPAYER

Overview

- **Filing Status year of death**
  - Joint if married
  - If estate executor agrees
- **Final 1040 Return**
  - ***Medical Expenses***
    - Those up to date of death
    - If estate elects – those within a year of death
  - **Moving Expenses -** 39 or 78 week qualification period waived (2018-2025: moving expense deduction generally not allowed; see detail)
  - **Net Operating Loss Carryovers -** On final return – balance lost*
  - **Investment Interest Carryover -** On final return – balance lost
  - **Charitable Contributions**
    - Carryover useable on final return within normal AGI-based limits – balance lost
    - Post-mortem contributions claimed by beneficiaries
  - **Capital Loss Carryovers -** On final return – balance lost*
  - **Business Credit Carryovers -** On final return – balance lost
  - **Foreign tax credit carryovers -** can be used by the taxpayer's estate or heirs.
  - **Minimum tax credit carryovers -** On final return – balance lost
  - **Passive Loss Carryovers**
    - Accumulated losses deductible
    - Deduction limited to the excess of the property's basis at date of death over the decedent's adjusted basis in the property just before death
  - **Passive activity credits** - Passive activity credits are effectively lost if not used on the final return (See detail).
  - **Exemption -** Full amount allowed (Not allowed 2018-2025)
  - **Unrecovered Basis in Pension Plan**
    - Deductible on final return (Tier 1 Misc. Deduction)
    - If pension is for joint lives, deduction goes to last to die
  - **Inherited Property Basis**
    - Generally FMV at date of death*
    - FMV at alternate valuation date if elected (only applies if value of estate and estate tax would be less)
    - Must equal the value of that property for estate tax purposes, effective for property with respect to which an estate tax return is filed after July 31, 2015 and resulted in increased estate tax.
    - Holding period is automatically long-term
  - **Refund**
    - Surviving Spouse – automatic (note in signature block)
    - All others – file Form 1310

**but see "2010 modified carryover basis" in chapter 11.05*, Form 706-NA, or Form 706-A

RAPID FINDER

Pubs Forms

Related IRS Forms & Publications – See also forms list at end of chapter

Form 706 – Estate Tax Return (Portability feature)
Form 1310 – Refund Deceased Taxpayer
Form 8939 - Allocation of Increase in Basis for Property Acquired From a Decedent (2010 Only)
Form 8971 – Information Regarding Beneficiaries Acquiring Property from a Decedent
Pub 551 – Basis of Assets
Pub 559 – Survivors, Executors and Administrators
Pub 502 – Medical and Dental Expenses
Pub 925 – Passive Activity and At-Risk Rules

VERY IMPORTANT – CAN CREATE A PREPARER FINANCIAL LIABILITY

For spouses dying after 2010 their unused estate tax exclusion can be passed on to the surviving spouse by **electing** the portability feature. However, to make that election, a Form 706 must be timely filed whether or not the estate's value exceeds the statutory filing limit. Typically individuals with small estates will reason they will have no need for the unused amount from their spouse's estate and/or do not want to pay the additional cost of preparing a 706. But that is not a sure thing…there is no guarantee that they might not hit the lotto, receive a sizable inheritance, or Congress might decide to reduce the estate tax exclusion. You as a practitioner must bring this issue to the attention of the executor and surviving spouse, and if they refuse to file a 706, have them sign a statement to that effect. Don't put yourself in jeopardy for the tax on the unused exemption. See suggested statement at the end of the chapter. (Page 01.05.10)

The Details

At the death of a taxpayer, a personal representative (e.g., estate executor/executrix) takes charge of the decedent's property. This person may be named in the decedent's will or trust document, or appointed by the court if there is no will or trust. The duties of the representative include collecting all of the decedent's property, paying creditors, and distributing assets to the heirs. In addition, the representative is responsible for filing various tax returns and seeing that the taxes owed are properly paid. This chapter will primarily be concerned with providing an overview of the various returns and forms, which may have to be filed at a taxpayer's death. A checklist of these forms may be found at the end of the chapter.

FINAL RETURN OF THE DECEDENT

Filing Requirements - Use the same filing requirements for a deceased taxpayer as would otherwise be used if the taxpayer were still living—based on income level, age, and filing status—to determine if an individual income tax return must be filed.

CAUTION!

Do not assume that the filing status will be joint on the final return of a taxpayer who was married at the time of death. If an estate executor (or other representative) has been appointed, the executor must agree to the joint filing, as must the surviving spouse. The executor needs to consider whether a joint filing is the most advantageous status for the overall estate. An executor who is appointed after a joint return has already been filed may revoke the joint return election, provided the revocation is made within one year of the extended due date of the return. ***Reg. 1.6013-1(d)(5)*** A joint return of the decedent and his or her spouse cannot be filed if the surviving spouse remarries during the decedent's year of death.

Refunds – See "Deceased Taxpayer Return Signature"

Income to Include - The decedent's income on the final return includes that income derived up to the date of death. If the decedent was reporting on the ***cash method***, include only items actually or constructively received before death. If the ***accrual method*** was used, report all income that was earned prior to death, whether or not it had actually been received.

Tax Attributes (Exemption, Dependents, Deductions and Carryovers) - The general rules for exemptions (note: the deduction for exemptions is suspended for 2018 through 2025), dependents, deductions and carryovers apply to the final return.

Note - For married couples be sure to separate carryover losses and deductions between the decedent and the surviving spouse according to joint, individual and community property (where applicable) ownership before applying the following rules.

- **Medical Expenses:** Medical expenses paid before death are claimed on the decedent's final return as itemized deductions in the usual manner. Medical expenses not deductible on the final return become liabilities of the estate and are claimed on the estate tax return (Form 706). However, expenses that were paid out of estate funds within one year after death can be treated as if paid by the decedent and claimed on the decedent's final return instead. To make the election, file a statement with the decedent's final return that the expenses are not being claimed on the estate tax return (with the approval of the executor of the estate). Medical expenses cannot be claimed on the estate's income tax return (Form 1041).
- **Moving Expense Deductions:** The 39-week employee or 78-week self-employed qualification periods are waived if the taxpayer fails to meet the qualification period because of the taxpayer's death. ***(Code Sec 217(d)(1)(A)) Note:*** *Per the TCJA of 2017, moving expense deductions are not allowed for tax years 2018 through 2025, except for Armed Forces members on active duty who move pursuant to a military order.*

- **NOLs:** Except for deaths occurring in 2010 and where no estate tax was elected, net operating loss (NOL) carryovers are lost if not used on the individual's final return. However, an NOL resulting from a net business loss on a final return in a year before 2018 may be carried back to earlier years under the normal Code Sec. 172 rules (Note: NOLs incurred in years after 2017 can only be carried forward). ***(Rev Rul 74-175, 1974-1 CB 52).*** Thus the NOL carryover of the decedent (except for those dying in 2010 and using the modified carryover basis) can <u>only</u> be deducted on his/her final return. Death before termination of a bankruptcy estate prevented survivor from using remaining NOL carryovers. An IRS Field Service Advice (FSA) has concluded that where a bankruptcy estate terminated in the same year as but after the debtor died, his surviving spouse lost the unused NOL carryovers that the debtor would have succeeded to had he lived. ***Field Service Advice 200118003.***

- **Investment Interest:** Investment interest carryovers are lost if not used in the deceased taxpayer's final return. ***(Code Sec. 163(d)(2))***

- **Charitable Contributions:** Charitable contribution carryovers are lost if not used on the final return. ***(Reg. § 1.170A-10(d)(4)(iii))*** If a decedent made charitable contributions in his or her final year, or was carrying forward charitable contributions from an earlier year, and total contributions are in excess of the AGI limitation, the excess cannot be claimed as a deduction on the estate tax return. Property of an individual that is donated to charity after the individual's death cannot be claimed as a charitable contribution on the decedent's final return. Instead, the beneficiary who was designated to inherit the property generally claims the deduction on his or her personal return.

- **Capital Losses:** Except for deaths occurring in 2010 and where no estate tax was elected, capital losses do not carry over from the decedent to his or her estate or heirs. ***Rev. Rul. 74-175*** If a joint return was filed in a net capital loss year, and separate returns are filed in the succeeding year, long-term and short-term carryovers must be separately allocated to each spouse. The carryovers are allocated on the basis of their individual net long-term and short-term capital losses for the preceding taxable year, which gave rise to the carryovers. Each spouse carries over from the joint return his separate net long- or short-term loss only to the extent that it wasn't offset, on the joint return, by the other spouse's net long- or short-term gain. ***Reg § 1.1212-1(c)***

- **Domestic production deduction** – Where the decedent performed qualifying section 199 production activities with respect to property transferred to a successor in interest, the successor in interest is treated as having performed the qualifying section 199 production activities. Thus if the successor in interest satisfies other relevant requirements the successor in interest will be entitled to a domestic production activities deduction with respect to the transferred property. *(Reg. § 1.199-8(e)(1)(ii)(B))* ***Caution****: A domestic production deduction is no longer allowed after 2017.*

- **Business credit carryovers** - Business credit carryovers may not be carried over to the decedent's estate or to heirs. However, a deduction is allowed on the individual's final return for any unused "qualified business credits." ***(Code Sec. 196(b))***

- **Foreign tax credit carryovers** - Foreign tax credit carryovers can be used by the taxpayer's estate or heirs. ***(Code Sec. 691(b))***

- **Minimum tax credit carryovers** – The Code Sec. 53 minimum tax credit carryovers are lost if not used on the individual's final return. The Tax Court, in a case involving a widow's attempt to claim the unused minimum tax credit that arose when her deceased husband incurred AMT from an incentive stock option in a year prior to their marriage, noted that neither the statute nor the relevant regulations specified whether the widow was entitled to the carryover of the AMT credit, and held that case law and certain indirectly related regulations dictated that she was not entitled to the credit. **(*Vichich, (2016) 146 TC No. 12)***

- **Passive Losses** – When a passive interest is transferred due to death, the accumulated suspended losses from the activity are deductible on the decedent's final return. The deduction amount is limited to the excess of the basis of the property in the hands of the transferee (heir) over the decedent's adjusted basis in the property just before death. In other words, the amount of the passive activity loss that equals the step-up in basis due to the decedent's death is not allowed as a deduction to anyone in any tax year. ***(Code Sec. 469(g)(2))***

  Example: *Robert was the sole owner of a residence used as a rental, a passive activity, when he died in 2019. In his will he left the property to his brother Tom. At Robert's date of death, the value of the rental was $500,000, his adjusted basis was $494,000, and he had unused passive activity losses of $8,000. Since Tom's basis of the rental is increased by $6,000, the deduction on Robert's final return for the year of death would be limited to $2,000 ($8,000 - $6,000). If the stepped-up basis had been $502,000 or more, none of the suspended passive loss would have been deductible ($502,000 – 494,000 = $8,000; $8,000 - $8,000 = $0).*

- **Passive activity credits -** Passive activity credits are effectively lost if not used on the final return. Although an elective adjustment to pre-death basis is available for the amount of the unused credit ***(Code Sec.***

469(j)(9)), the adjustment has no benefit, since the basis of property after death is equal to the value at death, under current rules.

- **Exemptions:** The exemption deduction is suspended for years 2018 through 2025. For deaths in other years, the full value of the decedent's exemption is claimed on the final return; proration based on the time the taxpayer was alive for the final year is not required.

- **Unrecovered Investment in Pensions:** If a retired person dies before recovering the entire basis in a pension or annuity (that started after 1986), the unrecovered portion is allowed as a tier 1 miscellaneous deduction on the retiree's final return. If the annuity is for the joint lives of a retiree and a designated beneficiary, the deduction would apply to the final return of the last to die. Otherwise, it would be allowed on the final return of the retiree decedent. See Chapter 7.09 for additional information. ***(Code Sec. 67(b)(10); Code Sec. 72(b)(3)(A))***

- **Cancellation of Debt Income:** COD income is reportable on the decedent's return if the cancellation occurred prior to death. If the decedent was married and the surviving spouse was also personally liable, the spouse would report the COD income on his or her 1040.

  If a debt of a taxpayer is cancelled after the death of the taxpayer, the cancellation of debt (COD) income is income to the estate or the non-grantor trust of the decedent and reportable as income on the 1041 return for the estate or non-grantor trust (Reg. 1.108-9(c)(2)) to the extent the estate or non-grantor trust is solvent.

  The Code Sec 108(a)(1)(B) insolvency exclusion applies to estates and non-grantor trusts just as it applies to individuals, so the COD income is only taxable to the extent the estate or non-grantor trust is solvent and would be reportable on the 1041 return. Section 108 does not apply to partnerships or a disregarded entity (Reg. 1.108-9(a)(1)) and thus the COD income is passed through to the partners or a Schedule C owner (i.e., a single member limited liability company not electing to be taxed as a C corporation). With regards to Sub S corporations, the Sec 108(a)(1)(B) insolvency exclusion applies at the corporation level (Sec 108(d)(7)(A)).

  Generally COD income is taxable to the estate under Section 61(a)(12) and reported on Form 1041. The resulting tax liability is payable by the estate. However, if the estate is insolvent, COD income is excludable to the extent section 108 applies, i.e., to the extent the estate's liabilities exceed its assets.

  But watch out; the IRS has the authority to assess the beneficiaries of the insolvent estate for the tax owed by the estate under the transferee provisions of IRC Sec 6901. A transferee for purposes of Sec 6901 includes beneficiaries who have received property from the estate. While the transferee assessment and collection process is the same under Sec 6901, strict statute of limitations periods apply and the burden of proof is on the IRS. (See Section 6902)

  31 U.S.C. 3713 gives priority to claims of the government to be satisfied before other creditors are paid and before distributions are made to beneficiaries. The language of 31 U.S.C. 3713 is "A claim of the United States Government shall be paid first…." Under this provision an executor who distributes estate assets instead of using them to pay the estate's tax obligations can be held personally liable for the unpaid taxes up to the extent of the distributions. (Sec 6901(a)(1)(B))

- **Deceased Taxpayer Return Signature**

  If a taxpayer died before filing a return, the taxpayer's spouse or personal representative can file and sign a return for the taxpayer. In all such cases, enter "Deceased," the deceased taxpayer's name, and the date of death across the top of the return (2018 1040 instructions, Pg. 82). Generally, your software will include a provision for this by entering the date of death.

  Surviving Spouse – Where the surviving spouse is filing a joint return with the deceased spouse in the year of death or any year preceding the year of death in which they qualified to file a joint return, the surviving spouse may sign on behalf of the deceased spouse. In that case, in the signature block include "filing as surviving spouse" (2018 Pub 559, Pg. 4).

  If there is a refund on the return, the surviving spouse is **not** required to file Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer. However, where the IRS issues a refund check in the joint names of the deceased and surviving spouses, the surviving spouse should then complete Form 1310, checking box A, and return the check to the IRS to have a new check issued in only the survivor's name.

  Personal Representative – Other than the taxpayer's spouse discussed earlier, a personal representative can file and sign a return for the deceased taxpayer. A personal representative can be an executor, administrator, or anyone who is in charge of the deceased taxpayer's property (2018 Pub 559 Pg. 3).

  - **Executor or Administrator** – Where the return is filed and signed by a court appointed or certified personal representative, the return is signed by the personal representative followed by "Personal Representative" after the signature. If there is a refund due on an original return, Form 1310 is **not** required, but a copy of the court certificate must be attached to the return (unless previously filed). If filing an amended return (Form 1040X) or a claim for refund (Form 843), complete Form 1310, checking box B, and attach it to the return.

- **Other Than Executor or Administrator** – Sign the return followed by "personal representative" after the signature. If there is a refund due, also complete a Form 1310, checking Box C and completing Part II of the Form 1310. Part II includes a certification that the refund "will be paid out in accordance with the laws of the decedent's resident state," meaning if the estate has any claims against it the refund must be used to pay those.

Due Date - Due date for the decedent's return is the same as for any other taxpayer, regardless of the date of death during the year.

INCOME IN RESPECT OF A DECEDENT (IRD)

What is IRD? Income which the decedent would have received had the death not occurred and which isn't properly included on the decedent's final return is IRD. It retains the same character as it would have had if the decedent had received it. Examples of typical types of IRD include amounts received after the decedent's death as compensation for his or her personal services, retirement plan distributions, investment income, and installment notes collected.

Who Reports IRD? The income must be reported by the decedent's estate, beneficiary, or any other person whom the estate designates as having the right to receive it.

> ***Example 1:*** *James was a cash-basis farmer who grew avocados. Although he sold and delivered 1,000 bushels of avocados for $3,000, he died before receiving payment for them. When the estate was settled, payment had still not been made. The estate transferred the right to receive the $3,000 to James' wife, Shirley. Shirley will include the income on her return for the year she receives it.*
>
> ***Example 2:*** *Assume the same facts as in Example 1 except that James used the accrual instead of the cash method. The $3,000 would be reported on James' final tax return.*

ESTATE TAX DEDUCTION (Not applicable for deaths in 2010 where no estate tax was elected)

IRD Gets Double-Taxed - IRD is included in the decedent's gross estate and is subject to estate tax. The income is also taxed when received by the beneficiary or estate.

How To Deduct Estate Tax - To make up for the double taxation inequity, a deduction for estate tax is allowed to the ultimate recipient of the income. If the recipient is an individual, it is claimed as a tier 1 miscellaneous itemized deduction. If the estate receives the income, the deduction is claimed on Form 1041.

Amount Deductible - The deductible amount of estate tax is the part representing the net value of all items in the estate which are IRD.

> ***Example A:*** *Sergei, a lawyer, was a cash-basis taxpayer. He died this year, and at the time he was entitled to $12,000 from clients in payment for services. He had also accrued $8,000 in bond interest at the time of his death. He owed $5,000 in expenses for which his estate became liable. The income and expenses were reported on Sergei's estate tax return. After credits, the estate owed $9,460 in tax. The net value of items included as IRD is $15,000 ($20,000 income less $5,000 expense). The estate tax determined without including the $15,000 is $4,840. The estate tax that qualifies for the deduction is $4,620 ($9,460 minus $4,840).*

> ***Example B:*** *Assume Diane inherited Sergei's estate (Example A). She collected the $12,000 from the clients in the year he died and will include that amount in her income for the year. She itemizes deductions and will claim a tier 1 miscellaneous deduction of $2,772, figured as follows: $12,000/$20,000 x $4,620 = $2,772*

INSOLVENT ESTATE - Generally, if a decedent's estate is insufficient to pay all the decedent's debts, the debts due the United States government must be paid first. Both the decedent's federal income tax liabilities at the time of death and the estate's income tax liability are debts due the United States. The personal representative of an insolvent estate is personally responsible for any tax liability of the decedent or of the estate if he or she had notice of such tax obligations or had failed to exercise due care in determining if such obligations existed before distribution of the estate's assets and before being discharged from duties.

The extent of such personal responsibility is the amount of any other payments made before paying the debts due the United States, except where such other debt paid has priority over the debts due the United States. The income tax liabilities need not be formally assessed for the personal representative to be liable if he or she was aware or should have been aware of their existence.

For estate tax purposes, if there is no executor or administrator appointed, qualified, and acting within the United States, the term "executor" includes anyone in actual or constructive possession of any property of the decedent. It includes, among others, the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding securities of the decedent as collateral; and the debtors of the decedent who are in this country.

INHERITED PROPERTY

Property Inherited - The property inherited is not included in the heirs' income. However, the income produced on the property is income to the inheritor. An exception to the general rule that the inherited property is not income to the beneficiary is a Traditional IRA, which is taxable to the beneficiary as distributions are received to the extent the income would have been taxable if it had been received by the decedent. See also Chapter 4.17 of this text.

Inherited Basis - Basis of inherited property is generally one of the following (and must be consistent with the value of that property used on the estate tax return, Form 706; see Chapter 11.07 - Basis for additional information):

- FMV at date of death (Step Up – Step Down Basis);
- FMV at an alternate valuation date if eligible and elected by the personal representative; or
- Value under a special-valuation method for real property used in farming or other closely-held business.
- Value determined under the modified carryover basis for decedents dying in 2010 where no estate tax was elected.
- Value as reported to the beneficiary on Schedule A of Form 8971 for certain estate tax returns filed after July 31, 2015.

2010 Modified Carryover Basis - The modified carryover basis is determined as follows:

Begin with the lesser of:

(1) the decedent's adjusted basis, or
(2) the FMV at the date of death

Plus allowable increases to basis allocated to specific assets not to exceed FMV and the total of:

(3) An allowable aggregate basis increase of $1,300,000, plus
(4) the decedent's unused capital loss carryovers and built in losses, plus
(5) the decedent's unused net operating loss carryovers, and,
(6) If applicable, a spousal property basis increase of $3,000,000.

Aggregate Basis Increase & Spousal Increase Worksheet

Aggregate Basis Increase for an Estate	1,300,000[1]	
Decedent's Carryovers[2]:		
Capital Loss		
Net Operating Loss		
Decedent's Built-in Losses[3]		
Total Aggregate Basis Increase[4]		
Spouse Beneficiary additional amount[5]		3,000,000
Total Aggregate Basis Increase plus Spousal Amount		

[1] Substitute $60,000 for a non-resident alien.
[2] Tax loss carryovers that would have carried over to a subsequent tax year but for the death of the decedent.
[3] Losses from the sale of the decedent's property if it had been sold at FMV immediately before the decedent's death. Only losses that would be allowable under Sec 165 are permitted (i.e., losses from personal-use property are not allowed).
[4] Aggregate basis increase that is allocated among all the assets of the decedent.
[5] Additional basis increase that is allocated only to the surviving spouse's "qualified spousal property". Note: If the spouse were the sole beneficiary then the spouse would be entitled to $4,300,000 of basis increase plus allowable carryovers and built-in losses.

Additional Issues – 2010 Modified Carryover Basis:

Form 8939 – If no estate tax is elected for 2010, then the modified carryover basis applies, and Form 8939 is used to establish basis for income tax purposes of property acquired from a person who died in 2010 and the modified carryover basis was used. The 8939 takes the place of Form 706 (Estate Tax Return); the filing due date for this form was January 17, 2012.

Who Made The Allocation? **-** The executor of the estate was generally charged with the responsibility of allocating the allowable FMV step-up to specific assets.

Determining FMV – The process for establishing FMV under Sec 1022 follows the same rules for evaluating assets for an estate tax return. Thus qualified appraisals were required for all assets other than marketable securities or fixed value assets. Since the alternate valuation date under Sec 2032 only applies to estates subject to the estate tax, it was not a factor in determining FMV for the Sec 1022 election.

Informing Beneficiaries of Their Basis – Within 30 days of timely filing Form 8939 the executor was required to provide a statement – generally a copy of Schedule A from Form 8939 – to each recipient acquiring property from the decedent and reported on Form 8939. The statement described the property, the fair market value and the decedent's basis, regardless of whether the executor allocated any basis to the property.

Community Property - Similar to the rule under Code Sec. 1014(b)(6) (which, generally, applies where at least one-half of the whole community interest is included in the decedent's estate), both the decedent's and the surviving spouse's share of community property could be eligible for a basis increase. (H Rept No. 107-37 (PL 107-16) p. 27)

BASIS CONSISTENCY FORM 8971

For estate tax returns filed after July 2015, an estate and others who are required to file Form 706 must complete and file Form 8971 and Schedule A to report the final estate tax value of property distributed or to be distributed from the estate. A copy of Schedule A must be provided to the beneficiary of the property. Due to delays in issuing regulations and the new form, IRS extended the filing deadline of Form 8971 and Schedule A until June 30, 2016 for some estates; normally the due date is 30 days after the earlier of the due date (with extensions) of the 706, or the date filed. The 8971 and Schedule A are filed separately from the 706.

A beneficiary may not use a value higher than the value reported on Schedule A of Form 8971 as their initial basis in the property, and if the beneficiary reports a basis that is inconsistent with the amount reported on Schedule A, the beneficiary may be liable for a 20% accuracy-related penalty. The consistency in reporting applies only to property that was includible in the decedent's gross estate and resulted in increased estate tax liability (reduced by applicable credits) on the estate. If a 706 is not required because the value of the estate is less than the lifetime exclusion amount, but is filed only to preserve the deceased spouse's unused exclusion for the surviving spouse, Form 8971 is not required to be filed. See Chapter 11.07 (Basis) for further information.

FORMS TO BE FILED: Use the chart on page 1.05.10 as a guide to the various forms that must be filed following a taxpayer's death. The following are the basic returns, which may need to be filed (dependent on the filing requirements of each):

Form 1040 - File the decedent's final return as usual on Form 1040 and comparable state return.

Form 1041 - This is the income tax return of the estate--used to report income on the assets in the estate, including sales of property. The estate exists until final distribution of its assets. Tax year can be a calendar year or a fiscal year--the type of year is chosen when the first 1041 is filed for the estate. Once chosen, the tax year can only be changed with IRS permission. If distributions have been made to beneficiaries, the income of the estate generally passes to them via Schedule K-1 for tax reporting purposes. Losses incurred by the estate generally are not passed to the beneficiaries other than on the return and K-1 for the estate's final year.

Form 1041 is also used to file the income tax return of a trust. Many individuals will establish a revocable trust during their lifetime, which will become irrevocable upon the individual's death. If the individual is unmarried, commonly the trust serves merely to administer the assets until they can be distributed to the beneficiaries and then it terminates. Form 1041 is used to report the income during the administrative period, which may include more than one tax year; a 1041 will then be needed for each year. If the individual was married, frequently the revocable trust splits into two or more trusts; the surviving spouse's trust continues to be revocable while the other trust(s) become irrevocable. In most cases Form 1041 need only be filed for the irrevocable trust(s). Refer to the instructions for Form 1041 for more information.

- ***Filing Requirement –*** An income tax return (1041) must be filed if the estate has gross income of $600 or more. However, if one or more beneficiaries is a nonresident alien, Form 1041 must be filed even if the gross income is less than $600.
- **K-1s -** K-1s are filed with the 1041 for each beneficiary showing the income, deductions, etc., allocable to each. A copy of the K-1 must be furnished to each beneficiary.

Form 706 - Used to compute the tax on the <u>value of the assets</u> in the estate. Required if the gross estate exceeds the exclusion amount which is $11.4 Million for deaths in 2019 ($11.18 Million in 2018). See chapter 11.05 for exclusion amounts for other years.

- ***For deaths in 2010 -*** there was a choice to be subject to the estate tax and use FMV basis for beneficiaries or not be taxed and use modified carryover basis (Sec 1022 election). If the option to be not taxed was selected, then no 706 was required and instead the Form 8939 was filed (see previous discussion of Form 8939). Generally, executors of estates valued at no more than $5 million (the 2010 exclusion amount) opted to be subject to the estate tax, but because the estate's value did not meet the filing threshold, the 706 was not required to be filed.
- ***For deaths after 2010 -*** To be eligible for the decedent's unused portion of the exclusion to be transferred to the surviving spouse (the so-called portability election), Form 706 must be timely filed

(including extension), even if the value of the decedent's assets are less than the inflation-adjusted exclusion noted above. See Reg. Sec. 20.2010-2(a) and Form 706 instructions for further details.

- ***NOTE:*** *Relief provided by Rev Proc 2017-34 generally will eliminate the need for a private letter ruling to request an extension of time to file a Form 706 that is being filed only to make the portability election. This revenue procedure provides a permanently available simplified method for estates to obtain an extension of time to make the estate tax portability election. See Chapter 11.05 and Rev Proc 2017-34 for additional information.*

  Prior to Rev Proc 2017-34, the IRS Chief Counsel had indicated that if the gross value of the estate was less than the exclusion amount for the year of death, and a 706 was not timely filed, the "only recourse for obtaining the portability election is to seek relief through the private letter ruling process. The relief will likely be granted. Merely filing a late Form 706 would be ineffective in making this election and the election will not be respected." If the gross estate exceeds the exclusion amount, there is an absolute obligation to file a Form 706 within 9 months of date of death, and if no 706 were filed, the election for portability would be missed. Therefore, no relief would be available to the taxpayer, even if the estate was nontaxable due to the marital deduction. (Chief Counsel Advice 201650017)

Example - Income Reporting at Death of Taxpayer *– Don Drew died on April 9, 2019 at age 62. His daughter, Dana, was named executrix under his will. The will stipulated that Don's wife, Dot, was to receive Don's car and the family home. Don also left $5,000 to Community Church. All other assets in the estate were to be divided between Dot and Don's brother, Dillon. These assets were as follows:*

Checking account	*$ 2,550*
Savings account	*53,650*
(Interest after death was $2,250)	
Family home (FMV at death)	*150,000*
(Home inherited by Don in '87 when FMV was $42,000). Home was debt-free.	
500 shares ABC stock, value $25/share on 04/09/19	*12,500*
(Purchased in 2014 for a total of $5,100)	
500 shares XYZ stock, value $62/share on 04/09/19	*31,000*
(Purchased in 2019 for a total of $10,000, dividends after death were $750)	
Appraised value of car	*6,300*
Appraised value of household property	*18,500*
Don's coin collection	*2,800*
(Face value was $600, sold for $3,000 8/04/19)	
Don's stamp collection	*3,500*
Salary due at Don's death (W-2)	*12,000*
(Check received by estate was for $11,082 net of social security and Medicare tax)	
Good Life Insurance Company check (life insurance paid to Dot as beneficiary)	*$275,000*
Cost of Series EE Bonds (Dot was co-owner)	*2,500*
Accrued interest on Series EE Bonds, 04/09/19	*840*
(Was not reported as income in prior years)	
Original cost of rental home	*89,250*
Appraised value of rental home	*110,000*
Don's income prior to death:	
Wages	*39,000*
FIT Withholding	*2,305*
SIT Withholding	*1,400*
Interest on savings account	*1,900*
Other income:	
Rental property	*$8,400*
(Property in joint tenancy for Don & Dot; will states that Dot is to directly receive all income from the property)	
Deductions:	
Hospital and medical bills for Don's expenses	*$1,311*
(Bills of $1,090 rec'd by Dana as executrix, paid 07/15/19)	
Health insurance premiums	*3,250*
State income tax paid 02/15/19 for prior year return	*791*
Real estate taxes ($4,050 but $2,250 paid by estate)	*4,050*
Charity	*4,800*
Rental expenses	*1,545*
Attorney fee (administration of estate)	*1,325*
Rental depreciation	*$ 2,847 ****

Dana and Dot have agreed that Dot and Don will file a joint return for 2019.

**** Dot's basis in the rental property is $79,000, found by adding the $55,000 value of 1/2 of the property included in Don's estate to $44,625 (Dot's share of cost). The property had been depreciated using a 27.5-year life and $15,000 as land value. Depreciation through date of Don's death was $41,250; Dot's share was $20,625. Her share is subtracted from her share of the cost ($44,625 less $20,625 = $24,000).*

For the period before Don's death, the property is depreciated using the same method and same basis and life used by Don and Dot in previous years. The amount deductible for 1/4 of year is $675.

For the period after Don's death, two computations are necessary to figure depreciation: (1) Dot's basis of $44,625 less half of land value ($7,500) = depreciable basis of $37,125. Dot will continue to use the same life and depreciation method that was originally used on the property. Amount deductible for 3/4 of year is $1,013; (2) The other half of the property must be depreciated using a depreciation method acceptable for property placed in service during the current tax year, which in this case is the same as originally used (MACRS, 27.5 years). Value in the estate is $55,000 less land value of $10,000. Depreciable basis is $45,000. Using the IRS-provided table for 27.5 years, mid-month convention, and starting in April (the month Don died), the depreciation is $1,159 ($45,000 x .02576). Reporting of the above items is as follows

Form 1040, Joint Return

Salary	*$39,000*	
Interest income	*2,740*	
Net rental income	*4,008*	
AGI		*$32,252*
Less: Standard deductions		*-24,400*
Balance		*7,852*
Less: Sec 199A Deduction (20% of 4,008)		*- 802*
Taxable Income		*$7,050*

Don's w/h will also be reported on the 1040.

Form 1041

Unpaid salary	*12,000*	
Interest income	*2,250*	
Dividends (XYZ)	*750*	
LTCG-Coin collection sale (Sch D)	*200*	
Total income		*$15,200*
Taxes (RE)		*-2,250*
Attorney fees		*-1,325*
Adjusted total income		*11,625*

Itemized Deductions: [Medical = ($1,311 + $3,250) – ($32,252 x 10%)] + [taxes = ($1,400 + $791) + ($4,050 – $2,250)] + [charitable contributions = $4,800]. Note: less than the standard, standard used.

EXECUTOR'S CHECKLIST FOR FORMS AND DUE DATES

This is not an exhaustive list and every form doesn't apply to every estate or trust.

Form #	Title	Due Date
FinCEN 114	Report of Foreign Bank & Financial Accts	04/15 of yr after decedent's death/automatic 6-mo. extension
SS-4	Application for EIN	As soon as possible
56	Notice Concerning Fiduciary Relationship	When all necessary info available
706	U.S. Estate (and GST) Tax Return*	9 mos after date of decedent's death
706A	U.S. Add'l Estate Tax Return*	6 mos after cessation or disposition of special-use valuation property
706-CE	Certificate of Pmt of Foreign Death Tax*	9 mos. after death. Filed with 706
706GS(D)	Generation-Skipping Transfer Tax Return*	See form instructions
706GS(D-1)	Notification of Distribution From A GS Trust*	See form instructions
706-NA	U.S. Estate Tax Return, NonRes/NonCitizen*	9 mos. after date of decedent's death
712	Life Insurance Statement*	Pt I to be filed with estate tax return
1040	U.S. Individual Tax Return	Generally, 04/15 of yr after death
1040NR	U.S. Nonresident Alien Income Tax Return	15th day of 6th mo after end of tax yr
1041	U.S. Income Tax Return for Estates	15th day of 4th month after end of the estate's tax year
1041-A	U.S. Information Return--Trust Accumulation	15th day of 4th mo after end of tax year
1041-T	Allocation of Est Tax Pmts to Beneficiaries	65th day after end of estate's tax year
1041-ES	Estimated Income Tax for Estates & Trusts	Generally, 04/15, 06/15, 09/15, and 01/15 for calendar year filers
1042	W/h Tax Rtrn for U.S. Inc of Foreign Persons	March 15
1042S	Foreign Person's U.S. Source Inc. Subj. to w/h	March 15
1310	Refund Due a Deceased Taxpayer	To be filed with 1040 in some cases if refund due
3520	Report Foreign Trust Transactions & Gifts	Generally 04/15 of yr after decedent's death
3520-A	Annual Info. Rtrn of Foreign Trust w/US Owner	15th day of 3rd month after end of trust's year
4768	Appl of Ext of Time To File Rtrn/Pay Estate Tax*	By original due date if filing for automatic 6-month extension
4810	Request for Prompt Assessment IRC 6501(d)	As soon as possible after filing Form 1040 or Form 1041
7004	Application for Automatic Extension (1041)	Unextended due date (generally 4/15 for calendar year)
8300	Report of Cash Payments Over $10,000	15th day after date of the transaction
8822, 8822-B	Change of Address	As soon as the address is changed
8971 & Sch A(s)	Info Re Beneficiaries Acq'ng Prop from Decedent	By 30 days after 706 filed or due date if earlier**

*Or form 8939 if no estate tax was elected for decedents dying in 2010; due date of 8939 was Jan. 17, 2012.
**Supplemental reporting may be required if "final value" of property later revised because of audit, error or omission

Client Portability Notice – The following has had no legal review. Use at your own discretion.

STATEMENT

Regarding Deceased Spouse Unused Estate Tax Exclusion Portability Election

I would like to call your attention to the fact that a surviving spouse can carry over a deceased spouse's unused estate tax exclusion by electing the portability feature. Why is this important? It can save taxes on your estate when you pass away by allowing your estate to add your deceased spouse's unused exclusion to your exclusion amount, thus avoiding inheritance taxes on a larger amount of money (value of your estate).

However, to make that election, a Form 706 (Estate Tax Return) must be filed whether or not the value of your deceased spouse's estate exceeds the statutory filing limit. Typically individuals with small estates will reason they will have no need for the unused exclusion amount from their spouse's estate and/or do not want to pay the additional cost of preparing the Form 706. But that is not a sure thing…there is no guarantee that you might not hit the lotto, or receive a sizable inheritance, or Congress might decide to reduce the amount of the estate tax exclusion, which they have done in the past.

However, the decision to file a 706 solely for the purpose of preserving your spouse's unused estate tax exclusion is up to you. You will need to indicate your decision below, sign and return this statement before your 1040 can be completed

❐ NO, do not prepare a 706

❐ YES, please prepare a 706

_______________________________	________________________________	____________
Print Your Name	Signature	Date

CALIFORNIA DIFFERENCES

Federal Estate Tax – Federal estate tax paid on income in respect of a decedent is not deductible for California. Enter the amount of Federal estate tax shown on Federal Schedule A as a negative adjustment on CA Schedule CA.

Forms to File - If the decedent was a California resident and federal Form 1041 is required, California Form 541 must generally be filed. California does not have an estate or inheritance tax, so there is no state form comparable to federal Form 706.

Inherited Basis of Property of Decedent's Dying in 2010 – California does not conform to the federal modified carryover basis rules for 2010, so for California purposes, the inherited basis of assets of a decedent dying in 2010 is fair market value on the date of death. (R&TC 18031, 18035.6)

NOTES

COMPENSATION OF CLERGY

RAPID FINDER

Overview

- **Parsonage Allowance**
    - Excludable from income
    - Subject to SE tax
    - Fair rental value or rental allowance
    - Cannot exceed fair rental value of home
    - Can still deduct mortgage interest and home taxes

Pubs Forms

Related IRC and IRS Publications and Forms

- **IRC Sec 107** – Rental Value of Parsonages
- **Pub 517** - Clergy
- **Pub 1828** - Tax Guide for Churches and Other Religious Organizations
- **Schedule C** – Self-Employment Income
- **Schedule SE** – Self-Employment Tax

Strategies

Parsonage Allowance – Generally, ministers will receive a certain amount of their compensation as a nontaxable parsonage allowance. This is true even for those who own their homes. Thus, a minister may be paying mortgage interest and taxes on the home and at the same time be receiving a nontaxable housing allowance. Even so, the minister may still deduct the mortgage interest and taxes as an itemized deduction.

New Law & Stuff

Parsonage Allowance Upheld by 7th Circuit - In US District Court for the western district of Wisconsin, Judge Barbara B. Crabb, in Gaylor v. Mnuchin (the Treasury Secretary) concluded that 26 IRC Sec. 107(2), which excludes from the gross income of a "minister of the gospel" a "rental allowance paid to him as part of his compensation," is unconstitutional. Specifically, she concluded that IRC Sec. 107(2) violates the establishment clause of the First Amendment.

On appeal, the Seventh Circuit has overturned the district court, ruling on March 15, 2019, that the Code Sec. 107(2) provision is constitutional on the grounds that it has a secular legislative purpose; its principal effect is neither to endorse nor to inhibit religion; and it does not cause excessive government entanglement.

TCJA EFFECTS	**See Page**
SE Tax for Clergy	1.06.02

The Details

CLERGY COMPENSATION INCLUDES

- Salary paid by the church,
- Fees collected for marriages, funerals, etc.,
- Voluntary contributions made directly to and for support of employee-missionaries of tax-exempt missions.

PARSONAGE/RENTAL ALLOWANCE EXCLUSION - For a "minister of the gospel" to qualify for the rental allowance exclusion from income, the home or rental allowance must be provided as remuneration for services which are ordinarily the duties of a minister of the gospel. A minister's gross income doesn't include the rental value of a home (parsonage) provided, or the rental allowance paid, as part of compensation for ministerial services. Thus, a minister can exclude from income the Fair Rental Value (FRV) of the parsonage, or a rental allowance, for income tax purposes. The allowance is excludable only to the extent **it is used for expenses in providing the minister's home**--e.g. rent, mortgage payments, utilities, repairs, etc. This exclusion from income applies for income tax only; the FRV (or rental allowance) is considered income for the purpose of calculating the minister's self-employment tax. In the case of a minister of the gospel, gross income does not include—

Code § 107(1): The rental value of a home furnished to him as part of his compensation, or

Code § 107(2): The rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home, and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.

"Minister of the gospel" defined for purposes of the rental allowance exclusion - Examples of specific services the performance of which will be considered duties of a minister of the gospel for these purposes include sacerdotal functions, conduct of religious worship, administration and maintenance of religious organizations and their integral agencies, and teaching and administrative duties at theological seminaries (Reg § 1.107-1(a)).

Rental Allowance Cannot Exceed Reasonable Compensation - The rental allowance is not excludable to the extent it exceeds reasonable compensation for the minister's services. ***Rev Rul 78-448, 1978-2 CB 105*** said that where a minister had a full-time outside job and performed only occasional services for a small church, only 1/15 of his church compensation was excludable.

Qualifications - To qualify for income exclusion of a rental allowance by the minister, his/her employing organization must designate the allowance by official action in advance of the payment ***(Reg § 1.107-1(b))***. For a minister employed by a local congregation, the designation must come from the local church instead of the church's national organization. A national church agency may make the allowance designation for ministers it employs. The minister must qualify as a "minister of the gospel," as defined above.

Effect on Expenses - The tax-free parsonage or rental allowances can present a problem for deduction of a minister's expenses. The portion of the expenses attributable to tax-free income is <u>not deductible</u> (this rule does not apply to home mortgage interest or taxes, which are deductible in full, subject to the usual acquisition debt limitation and SALT cap for years 2018-2025, if the minister itemizes deductions).

> ***Example - Allocating a Minister's Expenses:*** *Pastor Smith received a $4,800 parsonage allowance plus $600 of compensation for services as a minister. Her expenses from ministerial activities were $6,000 (no interest or taxes). Since 89% [$4,800/($4,800 + $600)] of Smith's income relates to the tax-exempt parsonage allowance, $5,340 of her expenses ($6,000 x .89) are disallowed. This is true even if the ministerial expenses are paid out of income from other sources.*

No Parsonage Exclusion for Second Residence: - The IRS successfully appealed the Tax Court decision in Driscoll, (2010) 135 TC No. 27 which had ruled that a minister may exclude under Code Sec. 107 the parsonage allowance he received for a second residence as well as his principal residence. In overturning the tax court ruling the Appeals Court concluded that the word "home" in Code Sec. 107 is not plural, especially when the statutory context of the word does not support a plural connotation. The consistent use of the singular in the legislative history of Code Sec. 107 demonstrated that Congress intended for the parsonage allowance exclusion to apply to only one home. (P.A. Driscoll, CA-11, 2012-1)

<u>RETIRED CLERGY</u> - Rev Rul 63-156, 1963-2 CB 79 allows retired clergy to exclude the rental value of a home or a rental allowance furnished as compensation for past services authorized under a convention of their national church organization. However, the exclusion does not extend to the widow(er) of a retired clergyperson (***Rev Rul 72-249, 1972-1 CB 36***).

<u>REIMBURSEMENT OF EXPENSES</u> - Reimbursements of expenses to a minister by a church are treated in the same manner as reimbursements to employees in secular organizations.

<u>W-2 REPORTING SALARY OF CLERGY</u> - According to Publication 1828, Tax Guide for Churches and Other Religious Organizations, salary a church pays ordained clergy is neither subject to mandatory federal income tax withholding nor to the FICA provisions. However, churches are still required to report the minister's earnings on Form W-2 and the minister may request that the church withhold income tax.

<u>SE TAX FOR CLERGY</u> - A minister who hasn't taken a vow of poverty is subject to self-employment tax on income from services as a minister. A clergy member may have the following sources of income from his occupation as a pastor:

- **W-2 from the church** – The income is subject to income tax but the church does not withhold FICA, and if the cleric has not taken the vow of poverty the income is also subject to SE tax.
- **Schedule C** – Typically this income would be for a cleric who does not work for a specific church, or for one that does but also receives income for presiding over weddings, funerals, etc. This income is taxable and also subject to SE tax but based upon the Schedule C net profit after deducting the expenses. These expenses are those specifically associated only with the Schedule C income.
- **Housing allowance from the church** – To the extent allowed by law, this income is not subject to income tax but is subject to SE tax. Prior to tax reform members of the clergy could deduct their business expenses on Schedule A. However, the expenses had to be prorated between taxable income and non-taxable housing allowance with only the proration attributable to taxable income being deductible. In addition, those expenses attributable to taxable income could be used in offsetting the income subject to SE tax.

TCJA

Although TCJA suspended the deduction for employee business expenses as itemized deduction, they are still allowed as a deduction against a member of the clergy's income subject to SE tax.

Reg 1.1402(a)-11(a) says "In general.—For each taxable year ending after 1954 in which a minister or member of a religious order is engaged in a trade or business, within the meaning of Section 1402(c) and § 1.1402(c)-5, with respect to service performed in the exercise of his ministry or in the exercise of duties required by such order, net earnings from self-employment from such trade or business include the gross income derived during the taxable year from any such service, less the deductions attributable to such gross income."

In addition, the instructions for Schedule SE for 2018 say "If you were a duly ordained minister who was an employee of a church and you must pay SE tax, the unreimbursed business expenses that you incurred as a church employee are not deductible as an itemized deduction for income tax purposes. However, when figuring SE tax, subtract on line 2 [of Sch. SE] the allowable expenses from your self-employment earnings and attach an explanation."

> ***Example*** *- Pete receives a salary from the church of $30,000 and a parsonage allowance of $10,000. He has unreimbursed employee business expenses of $6,000 (before excluding nondeductible amounts attributable to his exempt income). Pete's net earnings from self-employment are $34,000 ($30,000 + $10,000 - $6,000). All of Pete's unreimbursed business expenses are deductible for self-employment tax purposes. The requirement of allocating business expenses to exempt income applies to the income tax computation, not the self-employment tax computation.*

CLERGY EXEMPTION FROM SE TAX

An ordained minister may be granted an exemption from SE tax from ministerial services only. To qualify, the church employing the minister must qualify as a religious organization under ***Code Section 501(c)(3)***. Application for exemption is filed in triplicate on Form 4361, Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners.

The application must be filed on or before the extended due date of the return for the second tax year for which the individual has net earnings from self-employment of $400 or more (part of which is from services as a minister). A late application will be rejected. Time for applying starts over when a minister who was not opposed to accepting public insurance (i.e., Social Security benefits) re-enters a new ministry (e.g., adopts a new set of beliefs that include opposition to public insurance with a different church). However, the IRS has said that there is no second chance to apply for exemption by a minister who is ordained in a different church but whose belief regarding public insurance doesn't change (i.e., the minister opposed acceptance of public insurance in both faiths). **(CCM 200404048)**

CALIFORNIA DIFFERENCES

Although California conforms to federal law allowing clergy members to exclude rental allowances received as part of their compensation, California does not conform to the federal provision that limits the exclusion to the fair rental value of the home, including furnishings and appurtenances, plus the cost of utilities. ***(R&TC 17131.6)*** Consequently, clergy members that are required to limit the amount of their exclusion for federal purposes are allowed to exclude an additional amount on their California personal income tax returns.

Itemized Deductions - California conforms to federal law as it existed on January 1, 2015, with specific significant differences, so most of the TCJA changes, including the suspension of Tier 2 miscellaneous itemized deductions for 2018-2025, won't apply for California purposes absent conforming California legislation. If California continues to allow employee business expenses as a miscellaneous itemized deduction, adjustment (increase in this case) to federal itemized deductions would be made on California Schedule CA.

Renter's Credit – If the minister resides in church property that is exempt from real property tax, the minister is not eligible for the CA renter's credit.

NOTES

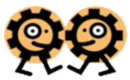
CO-OWNED REAL PROPERTY

A single taxpayer's ownership of real property with another single individual brings up several good tax questions such as:

- What basis does each have in the property?
- Who gets the deductions related to the property?
- What happens when the property is sold?
- What are the consequences if one owner dies?

RAPID FINDER

TYPES OF JOINT OWNERSHIP FOR SINGLE INDIVIDUALS:



Joint Tenancy - In joint tenancy, each tenant gets an undivided interest in the entire property. Title to the property automatically goes to the survivor at the death of an owner.

Tenants in Common- This is a form of joint ownership in which the parties own a specific share of the property. Tenants in common have no rights of survivorship. If one owner dies, his/her interest goes to named beneficiaries, or if no beneficiary is indicated in the decedent's will or trust, to his/her estate, not the remaining co-owners (unless they were designated as the beneficiaries).

BASIS OF CO-OWNED PROPERTY: The usual rules for basis apply, with basis being split according to each owner's investment in the property.

A surviving joint tenant in joint tenancy property applies the FMV at date of death rule to the deceased joint tenant's share of the property. (**Caution**, this rule may not apply to some deaths in 2010.)

Example - Inheriting Property as Joint Tenant - *Ramon and Al owned business property as joint tenants. Ramon had furnished 2/3 of the $30,000 purchase price and Al the remainder. Prior to Ramon's death, depreciation deductions of $12,000 had been claimed on the property. When Ramon died, the property was worth $60,000. Local law mandates that Ramon and Al as joint tenants each have a half interest in the property. Al's basis at Ramon's death is computed as follows:*

Al's interest purchased with his own funds (1/3 of original cost)	*$10,000*	
Interest inherited from Ramon (2/3 of $60,000 FMV)	*40,000*	*$50,000*
Less: 1/2 of depreciation		*<6,000>*
Al's basis at Ramon's death		*$44,000*

If Al hadn't contributed any part of the purchase price, his basis at Ramon's death would be $54,000 ($60,000 FMV less $6,000 depreciation on the half interest he acquired before the date of death).

If local law had determined that Al had no interest in the income from the property and if he contributed no part of the purchase price, his basis at Ramon's death would be $60,000 (the FMV).

Note: *If the surviving joint tenant is a spouse, a more liberal rule than shown in the example above applies.*

INCOME FROM JOINTLY HELD PROPERTY: For co-owners other than married couples, joint ownership of real estate provides a simple way of splitting income from the property. For example, annual rents are divided among co-owners according to their ownership interest and the allocable share is reported on each one's separate return.

Transfer of rented property may shift the tax burden on rental income. In order for the shift to be valid, however, the transferor has to give up control of the property and intend that a transfer occur. In ***Hutcherson, George (1984) TC Memo 1984-165***, a taxpayer was taxed on rent paid to his business associates from rental property he owned. He had transferred the property to the associates in order to get it out of the reach of creditors.

Permission to use property is not conveyance of a property interest that transfers tax burden ***(Helm, Muriel, (1956) 27 TC 270).*** **Note:** A taxpayer who switches ownership of income-producing property to joint ownership with a dependent (e.g., to a son or daughter) may lose the dependency exemption. This must be compared to the income tax savings of switching ownership. The transfer is considered a gift that would most likely require filing a gift tax return (Form 709).

DISPOSITIONS OF JOINTLY OWNED REAL PROPERTY: If jointly owned real estate is sold, gain or loss from the sale is generally divided among the co-owners in proportion to their share of the property. There is an exception to this rule if joint ownership is created during sale negotiations for tax saving purposes. In that case, gain is not divided but is fully taxed to the original owner of the property ***(Lannan, Robert v. Kelm, (1955, CA8) 47 AFTR 741).***

Different Uses By Co-Owners-The way in which one co-owner uses a co-owned property is not necessarily attributed to the other. Where a nonactive co-owner's interest is as an investor, profit from the sale of a property is capital gain to that person even though the other owner holds the property for sale to customers. Two factors should be looked at in determining whether property is held for sale:

- Whether the contemplated purchasers are "customers" of the taxpayer;
- Whether the business activity of others should be imputed to the taxpayer so as to be considered "taxpayer's business".

Case in point: A doctor invested with one of his patients in the purchase of unimproved property. He was allowed capital gain treatment on land subdivided and sold in lots over a six-year period where the subdivision was carried out because the doctor's co-owner needed money and the land couldn't be sold as acreage. The co-owner did all the work of the subdivision and received a 10% commission on the sale. ***(Van Drunen, Jacob, TC Memo 1964-15)***

PROBLEM AREA: A taxpayer was co-owner of both depreciable and nondepreciable property and bought out the other owner's interest in an "exchange" that lacked economic substance. Then the taxpayer exchanged his joint interest in the depreciable property for the co-owner's interest in the nondepreciable property. On the same day, the depreciable assets were purchased from the co-owner. The taxpayer was hoping for a basis for depreciable assets equal to the purchase price. The court allocated the purchase price between both the depreciable and nondepreciable property. ***Harris, Era v. Comm (1971, CA9) 27 AFTR 2d 71-824.***

SALE OF JOINTLY-OWNED HOME: When a jointly-owned home which is the principal residence of two (or more) single owners is sold, each owner applies the rules of Sec. 121 separately. Thus, each is entitled to exclusion of gain privileges under Sec. 121. A former exclusion of gain election by one owner does not affect the other's right to elect the exclusion.

DEDUCTIONS RELATED TO CO-OWNED PROPERTY:

Interest Expense - An interest expense deduction is available only to those who are primarily liable on an underlying debt. However, when two or more persons are jointly and severally liable for a debt, each is primarily liable for the debt; each is entitled to a deduction for the interest on that debt that he/she pays. When co-signers make a gift to another co-signer who paid the interest, this has no effect on the rule.

A father was allowed to deduct the interest he paid on a note that he co-signed with his son as evidence of a student loan to the son for tuition, fees, etc. ***(Rev Rul 71-179, 1971-1 CB 58).***

A father was allowed to deduct mortgage interest paid on property held in common with his daughter. It didn't matter that he had temporarily conveyed legal title to his daughter to avoid creditors' claims ***(Conroy, Thomas, (1958) TC Memo 1958-6).***

Where mortgaged property is owned jointly, and joint owners are jointly liable on the mortgage, each owner is entitled to a deduction for the mortgage interest he/she actually pays out of his own funds.

However, when there isn't joint liability on the mortgage or where there is right to reimbursement, and one joint owner pays all or part of the mortgage interest, the deductibility is the same as under the rules for taxes (see below).

Rev Rul 78-362, 1978-2 CB 248. Are a joint tenant's monthly payments of a mortgage debt on property held jointly regarded as gifts to the other joint tenants?

FACTS: An individual provided funds for the downpayment for a purchase of real property and then conveyed two-thirds of the property to his two children; the property was held in joint tenancy. The individual subsequently made payments on the mortgage without expecting reimbursement from the children.

FINDING: Transfer of the property was termed a gift to each child--after the transfer, the taxpayer and each of the children held a one-third interest in the property. The subsequent mortgage payments were also considered monthly gifts to each child, each equal to one-third of the mortgage payment. ***Amundson, Brent, (1990) TC Memo 1990-337.***

FACTS: A taxpayer's sister bought a home that she financed with a mortgage. She then agreed to sell one-half of the property to the taxpayer in return for the taxpayer paying the mortgage. The taxpayer made the mortgage payments, but didn't disclose his ownership or become directly obligated to the mortgagee (he didn't want to incur the fees required for refinancing). However, an unrecorded quitclaim was made on the property.

FINDING: The taxpayer had an enforceable, interest-bearing debt to his sister. His payments to the mortgagee were, in effect, payments to his sister. Taxpayer gets an interest deduction for his payments.

FORM 1098: Interest payments on a mortgage are reported to the payer on Form 1098. This information is also reported to the IRS for matching purposes. The 1098 will usually be issued to only one co-owner, creating reporting and matching problems for the other(s). To avoid the problem of getting unwanted correspondence from the IRS, the co-owners who didn't receive a 1098 should report the interest they paid on line 8b of Schedule A (2018). They should also attach a statement to their tax return showing the name and address of the person who did receive the 1098. Next to line 8b, write "See Attached" (1040, Sch. A Instructions, Pg. A-9, 2018). Also see Chapter 7.05 for more information on Form 1098.

Does Acquisition Debt Limit Apply to Residence or Individual Co-Owners?

According to a Chief Counsel Advice (CCA 200911077) where two or more individuals own a residence with acquisition debt in excess of $1 Million dollars, the individuals jointly can only deduct the interest on the first $1 Million of acquisition debt.

An appeals court overturned an earlier Tax Court ruling (*C. J. Sophy, 138 TC No. 8, Dec. 58,965)* and took the same position the IRS put forward in the 2009 Chief Counsel Advice cited above.

The Ninth Circuit Court of Appeals reversed the Tax Court's decision and the IRS has announced its acquiescence with the Ninth Circuit's decision. Under this interpretation, the two ***unmarried co-owners are collectively limited to a deduction for interest paid on a maximum of $2.2 million, rather than $1.1 million, of acquisition and home equity indebtedness*** (Voss - IRB 2016-31, p. 193). Applying the *Voss* ruling to the changes made by the TCJA, it would seem that for years 2018 through 2025 the collective limit for acquisition indebtedness incurred after December 15, 2017 for two unmarried co-owners would be $1.5 million (2 x $750,000). No equity debt interest is deductible in 2018 through 2025; therefore, no equity debt is included in determining the collective limitation.

This can have significant implications for unmarried co-owners of a home.

AMENDED OPPORTUNITY: Taxpayers who previously limited their interest deduction in accordance with the IRS' position and Tax Court ruling may be able to amend open-year prior returns for a refund.

TAXES: Where a taxpayer is not 100% owner of property on which a deductible tax is paid, deductibility of the tax that was paid depends on the form of joint ownership. Some forms of joint ownership entail joint and several liability on the part of each owner for taxes on the property. Where there is joint and several liability for a tax, the tax may be deducted by the one who pays it.

In ***Conroy, Thomas, (1958) TC Memo 1958-6,*** a father and daughter owned property as tenants in common. The father's payment of the whole property tax bill was fully deductible since each owner has equal liability for the whole tax bill.

Where a court wasn't able to determine whose funds were used to make the tax payment, each party was entitled to one-half of the deduction ***(Finney, Barbara, (1976) TC Memo 1976-329).***

Where tenants in common don't have joint and several liability for a tax, each tenant is entitled to deduct only his/her proportionate share of the tax.

Where a taxpayer and his mother owned property as equal tenants in common, and local law (PA) obligated the taxpayer to pay only his share of the real estate taxes on the property, he could deduct only his share even though he paid all the taxes ***(James, Joseph J., (1995) TC Memo 1995-562)***.

Other cases indicate that a taxpayer will be allowed to deduct only his proportionate share of taxes on co-owned property, where he paid all of those taxes, but had a right to be reimbursed by the other co-owners for the latter's proportionate shares of the taxes owed (e.g., ***Smith, John (1955, DC NH) 48 AFTR 615).***

When a co-tenant pays all (or a part) of taxes on co-owned property to avoid personal liability or to preserve his/her interest in the property, he/she is entitled to a deduction for the full amount of the payment ***(James, Joseph J., (1995) TC Memo 1995-562).***

In ***Powell, Lulu, (1967) TC Memo 1967-32,*** the court felt that the taxpayer had a beneficial interest in the entire property (right to occupy) and the payment was needed to protect this interest, even without joint and several liability.

Movius, Mary Est, (1954) 22 TC 391 states that a taxpayer who owns a beneficial interest in property and pays taxes on it to protect that interest, may deduct the payment even though legal title is in someone else's name and the tax is assessed against the latter.

Applying "substance over form," the Tax Court in ***Lang, Judith F, (2010) TC Memo 2010-286***, held that real estate tax payments made by a mother to a local government on behalf of her daughter were deductible by the daughter. The payments were considered gifts to the daughter who then transferred them to the tax agency, even though the mother had made the payments directly to the government. Since the mother didn't claim a deduction for them, and wasn't eligible to deduct the taxes because they were not imposed on her, there was no chance of double deduction.

SHARED EQUITY ARRANGEMENTS: Rental of a dwelling to a person having an equity interest in the home won't be considered personal use by the taxpayer if the rental is done under a "shared equity financing agreement". ***Sec. 280A(d)(3)(B)(i).*** These agreements, often entered into between parents and children, enable the latter to purchase a home. A "shared equity financing agreement" is one where two or more people acquire qualified ownership interests in a home and one (or more) of the owners is entitled to occupy the home as a principal residence. That person pays rent to the non-occupant owner(s) at fair rental value (FRV). ***Sec. 280(d)(3)(C).***

Proposed Reg 1.280A-1(e)(3)(v) provides that a shared equity financing arrangement may exist, even if one or more of the owners doesn't charge the occupant fair rent for use of the home. However, the exception to the personal use rules for fair rental to other persons for use as a principal residence, applies only to those owners who do charge FRV.

Fair rental is determined at the time the shared equity financing agreement is entered into and must take into account the occupant's qualified ownership interest. "Qualified ownership interest" is an undivided interest for more than 50 years in the entire dwelling and any appurtenant land acquired in the transaction to which the shared equity financing agreement relates.

CASUALTY LOSSES ON CO-OWNED PROPERTY: Where the same casualty damages co-owned property (other than property owned by spouses), the $100 floor applies separately to each person. In general, one joint owner can't have a theft loss deduction for jointly owned property taken by the other joint owner, since the latter has a right to possession. However, if the other owner can show that he/she has a superior interest in the property, a theft loss between owners may be allowed ***(Dandeneau, Alice, (1971) TC Memo 1971-128).***

Note: *For years 2018-2025, per the TCJA, the only deductible personal casualty losses are those incurred in federally declared disaster areas are deductible.*

TAX LIENS ON CO-OWNED PROPERTY: The Supreme Court held that a district court could enforce a tax lien of a delinquent taxpayer. A forced sale of an entire property was allowed even though a non-delinquent person also had an interest in the property. However, the non-delinquent person was entitled to an appropriate portion of the sales proceeds. Under some circumstances, the district court can use its discretion to disallow a request for the forced sale.

California is a community property state and as such provides married couples with three options for holding title to property: joint tenancy, community property, and community property with right of survivorship

Joint tenancy - guarantees that the surviving spouse will inherit the property with little or no transfer cost. The survivor is also assured of inheriting the decedent's share since a secret will cannot divest a joint tenancy interest. However, the surviving spouse receives a step-up (or step-down) in basis of only 50 percent of the FMV at the time of the decedent's death. The remaining 50 percent retains the surviving spouse's original basis.

Community Property - provides a 100-percent step-up (or step-down) of the property's basis. Both the decedent's and the survivor's halves get a new basis of the FMV upon the death of the first spouse. Unlike joint tenancy, each spouse can will his or her share of the community property to anyone at all. Changing title requires filing a "spousal property petition" and generally will cause the surviving spouse to incur legal costs and can take up to 6 to 8 weeks.

Community Property with Right of Survivorship - combines the tax benefits of holding title as community property with the ease of property transfer available to the survivor of joint tenancy property. Holding title this way results in a double step-up in basis; requires that the surviving spouse inherit the property; and allows the property to pass to the surviving spouse without court action.

General Presumption of Community Property – There is a general presumption that all real property in California and all personal property wherever situated, that is acquired by a spouse during marriage, is community property (Family Code Sec 760). The presumption may be overcome (rebutted) by certain types of evidence to prove that the property is actually separate. Some property acquired during marriage is specifically excluded from the community property presumption (Family Code Sec. 802 and 803). The general community property assumption specifically applies to:

- All real property (including leased) that is located in California and acquired during marriage by a spouse while domiciled in California (Family Code Sec 760).
- All personal property, wherever located that is acquired during marriage by a person while domiciled in California (Family Code Sec 760).
- All community property transferred by husband and wife to a trust pursuant to Family Code Sec 761.

Type of Ownership By Decedent	Date of Death	Beneficiary of Decedent's Share	Basis of Decedent's Share	Basis of Surviving Spouse's Share
Separate Property		Beneficiary	FMV	---
Community Property	After 12/31/86	Spouse or anyone other than spouse	FMV	FMV
Joint Tenancy with Spouse	After 12/31/84	Spouse or anyone other than spouse	FMV	Cost
Community Property with Right of Survivorship		Spouse	FMV	FMV

MILITARY ISSUES

Overview

- **Taxable Pay**
  - Basic Pay
  - Bonus
- **Nontaxable Pay** (normally not included in W-2)
  - Combat Zone Pay
    - Enlisted personnel – 100%
    - Commissioned Officers - limited to the highest rate of enlisted pay.
  - Living (Housing) & Family Allowances
    - Property taxes still deductible within TCJA limit.
    - Mortgage interest still deductible.
  - Death Allowances
  - Moving Allowances
  - Treatment of Combat-Excluded Wages for Other Tax Considerations:
    - Treat as "earned" income for IRA Contributions
    - Elect to treat as Earned Income for EITC purposes
    - Treated as "earned" income for purposes of the refundable portion of the child credit.
- **Home Sale** – 5-yr look back can be suspended up to 10 years while on qualified extended duty.
- **Reservist Travel** – Overnight and more than 100 miles = AGI adjustment
- **Military Base Closure** – Excludable HAP payments: Sales price – 95% of value before closure announcement
- **Missing Status** – Date of death is date removed from missing status
- **State Benefit Payments** – Excludable if in combat zone.
- **Early Withdrawal Penalty** – Reservist Exception.
- **Death Gratuity Payments** – Rollover to Roth or Coverdell accounts.
- **Retired Military Disability Compensation -** VA payments nontaxable, DFAS payments taxable
  - Retroactive Disability – Refund opportunity for previously taxed retirement payments
- **Combat Zone Forgiveness** – Tax liability forgiven for:
  - Year of death, and
  - Any earlier year ending on or after first day in combat zone.
- **Spouse of Military Member** – Can elect military member's state of residence starting 2018

Pubs
Forms

Related IRC and IRS Publications and Forms

- **IRC Sec 112** – Certain Combat Zone Compensation
- **IRC Sec 134** – Certain Military Benefits
- **IRC Sec 692** – Terrorist Attacks
- **IRS Publication 3** – Armed Forces' Tax Guide
- **IRS Publication 525** – Taxable & Non-Taxable Income

New Law & Stuff

NONMILITARY SPOUSE STATE OF RESIDENCE ELECTION

The Veterans Benefits and Transaction Act of 2018, sponsored by Senator Jon Tester of Montana, became public law on 12/31/2018. Sec. 302 of that legislation added the following election:

"**Election**—For any taxable year of the marriage, the spouse of a servicemember may elect to use the same residence for purposes of taxation as the servicemember regardless of the date on which the marriage of the spouse and the servicemember occurred."

The election "shall apply with respect to any return of State or local income tax filed for any taxable year beginning with the taxable year that includes the date of the enactment of this Act." Thus, this provision is effective for 2018 and future years.

RAPID FINDER

Benefit - The benefit of this election is that a spouse of a servicemember stationed in a high-income tax state can elect the state of residency of the servicemember whose resident state has no or low state income tax and not be subject to the state taxes where his or her spouse is stationed. Previously, under the Military Spouses Residency Relief Act of 2009, a military spouse could claim the same resident state as the servicemember only if the spouses had the same domicile and the nonmilitary spouse moved to be with the servicemember.

Example – Jack, a servicemember whose state of residence is Texas, is stationed in California. Sally, Jack's spouse, is employed in California and prior to this law change was required to pay California tax on her wages earned in California. Under this new law, Sally can elect her residency to be the same as Jack's – in this case Texas – which has no state income tax.

The Details

TAXABLE – NONTAXABLE PAY & ALLOWANCES

Taxable Pay - These items are included in gross income, ***unless*** the pay is for service in a combat zone.

- **Basic pay –** including active duty, back wages, reserve training, training duty and drills.
- **Special pay –** including aviation career incentives, diving duty, foreign duty, hazardous duty, hostile fire or imminent danger, medical and dental officers, nuclear-qualified officers and special duty assignment pay.
- **Bonuses –** enlistment and reenlistment, overseas extension, career status and officer.
- **Other payments –** including accrued leave, personal money allowances paid to high-ranking officers, student loan repayment from programs such as the Department of Defense Educational Loan Repayment Program when year's service (requirement) is not attributable to a combat zone.

Nontaxable Pay & Allowances

- **Special pay –** including compensation for active service, while in a combat zone or a qualified hazardous duty area (limited amount for commissioned officers – see "Combat Zone Exclusion" below).
- **Living allowances** - basic allowance for housing (BAH), housing and cost-of-living allowances abroad whether paid by the U.S. Government or by a foreign government and overseas housing allowance.
- **Family allowances -** certain educational expenses for dependents, emergencies, evacuation to a place of safety and separation.
- **Death allowances** - burial services, death gratuity payments to eligible survivors and travel of dependents to burial site.
- **Moving allowances** – including relocation, move-in housing, moving household and personal items, moving trailers or mobile homes, storage, temporary lodging and temporary lodging expenses, and military base realignment and closure benefits (see below).
- **Travel allowances –** including annual roundtrip for dependent students, leave between consecutive overseas tours, and reassignment in a dependent restricted status, transportation for military taxpayer and dependents during ship overhaul or inactivation and per diem.
- **State Benefit Payments** - Any bonus payment made by a state or political subdivision to any member or former member of the U.S. uniformed services, or to his dependent, only by reason of the member's service in a "combat zone" as defined under Code Sec. 112(c)(2) shall be treated as a "qualified military benefit" excludable from gross income. (Code Sec. 134(b)(6))
- **Other payments** - defense counseling, disability (including payments received for injuries incurred as a direct result of a terrorist or military action), group-term life insurance, professional education, ROTC educational and subsistence allowances, survivor and retirement protection plan premiums, uniform allowances and uniforms furnished to enlisted personnel.
- **In-kind military benefits –** including legal assistance benefits, space-available travel on government aircraft, medical/dental care and commissary/exchange discounts.

DEATH GRATUITY MAY BE ROLLED TO ROTH IRA AND COVERDELL ACCOUNTS

A military death gratuity and amounts received under the Service members' Group Life Insurance (SGLI) program may be rolled over to a Roth IRA or Coverdell education savings account without regard to the Roth or Coverdell contribution limits that otherwise apply. (Code Sec. 408A(e) and Code Sec. 530(d)(9))

The rollover must be made no later than one year after the date on which the military death gratuity or SGLI payment is received. The maximum amount that can be contributed to a Roth IRA or Coverdell Savings Account is limited to the sum of the military death gratuity and SGLI payments that the individual receives. (Act § 109(d)(1))

HOME MORTGAGE INTEREST & TAXES

The military taxpayer can deduct mortgage interest and real estate taxes as an itemized deduction, even if they are paid with nontaxable military housing allowance pay. The home mortgage interest is, however, still subject to the general rules for deducting home mortgage interest (see Chapter 7.05). The TCJA limits the real property tax and state/local income or sales tax deductions to $10,000 annually, effective 2018 through 2025. (See Chapter 7.04)

HOME SALE GAIN EXCLUSION

Code Sec. 121 allows taxpayers to exclude gain on a home sale if they have owned and used the home as a principal residence for 2 of the 5 years prior to the sale. A reduced maximum exclusion may apply if the 2-year rule is not met because of an unforeseen circumstance that was not anticipated when the home was purchased, such as a work-related move of over 50 miles. Thus, a military taxpayer who sells his or her primary residence and does not meet the two-out-of-five-years ownership and use tests due to a move to a new permanent duty station may qualify for a reduced maximum exclusion amount.

Exception to Test Period - A military taxpayer may choose to suspend the 5-year test period for ownership and use during any period the taxpayer (or spouse) serves on ***qualified official extended duty*** as a member of the Armed Forces. This means that the 2-year use test may be met even if, because of military service, the taxpayer did not actually live in his or her home for at least the required 2 years during the 5-year period ending on the date of sale.

<u>Suspension Period</u> - The period of suspension cannot last more than 10 years and can be revoked by the taxpayer at any time. The 5-year period cannot be suspended for more than one property at a time.

<u>Qualified Official Extended Duty</u> - A taxpayer is on qualified official extended duty when at a duty station that is at least 50 miles from his or her main home, or while residing under orders in government housing, for more than 90 days or for an indefinite period.

> ***Example*** *– Sarge bought and moved into a home in 2011 that he lived in as his main home for 2½ years. For the next 6 years, he did not live in the home because he was on qualified official extended duty with the Army. He sold the home for a gain in 2019. To meet the use test, Sarge chooses to suspend the 5-year test period for the 6 years he was on qualifying official extended duty – he disregards those 6 years. Sarge's 5-year test period consists of the 5 years before he went on qualifying official extended duty. He meets the ownership and use tests because he owned and lived in the home for 2½ years during this test period.*

> ***Example*** *– Col. Potter owned and lived in his home in Virginia for 3 years until he was stationed overseas in January 2004. He was still overseas in January 2019 when he sold the house. He may disregard just 10 of the 15 years he was overseas, with the result that the 5-year test period covers only years he did not live in the house. Col. Potter will not be eligible for the home sale gain exclusion.*

MOVING EXPENSES

TCJA suspended the moving deduction for all moves except for members of the Armed Forces on active duty and required to move because of a permanent change of station. Moves because of a permanent change of station do not need to meet the normal distance or time tests for conventional moves.

Permanent change of station - A permanent change of station includes:

- A move from home to the first post of duty when appointed, reappointed, reinstated, called to active duty, enlisted or inducted (Reg § 1.217-2(g)(3)(i)),
- A move from one permanent post of duty to another permanent post of duty at a different duty station, even if the member separates from the Armed Forces immediately or shortly after the move (Reg § 1.217-2(g)(3)(iii)), and
- A move from the last post of duty to home or to a nearer point in the U.S. in connection with retirement, discharge, resignation, separation under honorable conditions, transfer, relief from active duty, temporary disability retirement, or transfer to a fleet reserve, if the move occurs within one year or the termination of active duty or within the period prescribed by the Joint Travel Regulations promulgated under the authority in sections 404 through 411 of title 37 of the U.S. Code (Reg § 1.217-2(g)(3)(ii)).

RESERVISTS' TRAVEL EXPENSES

Armed Forces reservists who travel more than 100 miles away from home and stay overnight in connection with service as a member of a reserve component can deduct travel expenses as an adjustment to gross income. This is in lieu of deducting those expenses as a miscellaneous itemized deduction (subject to the 2% of AGI limitation). Thus, this deduction can be taken even if the taxpayer does not itemize their deductions. The TCJA suspended Tier 2 miscellaneous deductions for years 2018 through 2025 but the reservists' above-the-line travel expenses deduction is not affected.

Limit on Travel Expenses – Unreimbursed expenses for the reservist's transportation, meals (subject to the 50% limit) and lodging qualify for the above-the-line deduction, but the deduction is limited to the amount the federal government pays its employees for travel expenses, i.e., the general federal government per diem rate for lodging, meals and incidental expenses applicable to the locale and the standard mileage rate for car expenses plus parking and ferry fees and tolls.

Member of Reserve Component – A member of a reserve component of the Armed Forces is an individual who is in the:

- Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve;
- Army National Guard of the United States;
- Air National Guard of the United States; or
- Reserve Corps of the Public Health Service.

MILITARY BASE REALIGNMENT AND CLOSURE BENEFIT

Under the Dept. of Defense's Homeowners Assistance Program (HAP), payments are made to compensate qualifying uniformed service members and federal employees for the loss in value of a residence at or near a military installation that is partially or totally closed. These HAP payments are generally excluded from income. The excludable amount is limited to:

- 95% of the property's fair market value, determined by the Secretary of Defense, before public announcement of intent to close all or part of the military facility, minus
- The property's fair market value at the time of sale.

Any portion of the payment in excess of the limit is included in income.

MISSING STATUS

The date of death for a member of the Armed Forces who was in a missing status (missing in action or prisoner of war) is the date his or her name is removed from missing status for military pay purposes. This is true even if death actually occurred earlier.

COMBAT ZONE EXCLUSION

A member of the U.S. Armed Forces, who serves in a combat zone, can exclude certain pay from income. Generally, combat pay is not included in the individual's pay reported on Form W-2.

Excludable Pay - The amount excludable generally includes:

- Active duty pay earned in any month served in a combat zone.
- Imminent danger/hostile fire pay.
- A reenlistment bonus, if the voluntary extension or reenlistment occurs in a month served in a combat zone.
- Pay for accrued leave earned in any month served in a combat zone. The Department of Defense must determine that the unused leave was earned during that period.
- Pay received for duties as a member of the Armed Forces in clubs, messes, post and station theaters, and other non-appropriated fund activities. The pay must be earned in a month served in a combat zone.
- Awards for suggestions, inventions, or scientific achievements the service member is entitled to because of a submission made in a month served in a combat zone.
- Student loan repayments that are attributable to the period of service in a combat zone (provided a full year's service is performed to earn the repayment).

Amount of Exclusion

- **Enlisted Military** - Enlisted members, warrant officers, or commissioned warrant officers are allowed to exclude their entire pay while serving in a combat zone. Any part of a month in a combat zone counts as an entire month. Periods hospitalized as the result of wounds, disease and injury in combat zone are also excluded. Hospitalization beginning more than two years after combat activities cannot be excluded. Hospitalization need not be in the combat zone.
- **Commissioned Officers** - Commissioned officers may exclude pay; however, the amount of their exclusion is limited to the highest rate of enlisted pay (plus imminent danger/hostile fire pay received) for each month served in a combat zone or where hospitalized, as a result of service there.

Partial Month of Service - If service in a combat zone is for one or more days during a particular month, the service member is entitled to an exclusion for that entire month.

Combat Zones - A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. An area usually becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order.

- **Afghanistan area.** By Executive Order No. 13239, Afghanistan (and airspace above) is designated as a combat zone beginning September 19, 2001. Since direct support of military operations in Afghanistan is provided in the following locations, service in these areas was designated as eligible for combat zone benefits effective December 14, 2001 (Notice 2002-17):
  - Pakistán, Tajikistan, Jordan, Uzbekistán, Kyrgyzstán
  - Philippines (from January 9, 2002 through September 30, 2015).
  - Djibouti (as of July 1, 2002).
  - Yemen (as of April 10, 2002).
  - Somalia and Syria (as of January 1, 2004).
  - **The Kosovo area.** By Executive Order No. 13119 and Public Law 106–21, the following locations (including air space above) were designated as a combat zone and a qualified hazardous duty area beginning March 24, 1999.
  - Serbia/Montenegro, Albania, Kosovo, The Adriatic Sea, The Ionian Sea—north of the 39th parallel, Airspace in connection with the operation
- **Arabian Peninsula Areas.** By Executive Order No. 12744, the following locations (and airspace above) were designated as a combat zone beginning January 17, 1991.
  - The Persian Gulf, The Red Sea, The Gulf of Oman, Arabian Sea (part of), The Gulf of Aden, Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, United Arab Emirates.
  - Jordan (certified by Dept. of Defense for combat zone tax benefits as of March 19, 2003).
  - Lebanon (certified by Dept. of Defense for combat zone tax benefits as of Feb. 12, 2015).
  - Sinai Peninsula – Retroactive designation – As of June 2015 (IR-2018-95) – see more below

Treatment of Combat-Excluded Wages for Other Tax Considerations:

- **Child Credit** - Excluded combat pay is treated as earned income for purposes of the refundable portion of the child credit.
- **Earned Income Tax Credit (EITC)** - A taxpayer may elect to treat combat pay that is otherwise excluded from gross income as earned income for purposes of the EITC. The amount of the service member's nontaxable combat pay should be shown on Form W-2, in box 12, with code Q.
  Making this election for EITC purposes may or may not be advantageous. If the taxpayer has earned income below the maximum amount of earned income on which the credit is calculated, including the combat pay will increase the credit amount. On the other hand, if the taxpayer's earned income is already in the phase-out range, electing to include combat pay as earned income will decrease the amount of credit that can be claimed.
- **IRA Contributions** – Excluded combat pay is treated as if it were includible compensation for IRA purposes.

RETROACTIVE COMBAT ZONE DESIGNATION – SINAI PENINSULA

U.S. Armed Forces members who served in the Sinai Peninsula of Egypt may qualify for combat zone tax benefits retroactive to June 2015. (IR-2018-95)

Under TCJA, members of the U.S. Army, U.S. Navy, U.S. Marines, U.S. Air Force, and U.S. Coast Guard who performed services in the Sinai Peninsula can now claim combat zone tax benefits. The bill extended the limitation on time for filing a claim for a credit or refund under Code Sec. 6511(a) to one year after the Defense Secretary provides notice to affected service members of the amount of improperly withheld taxes, and instructions for filing amended tax returns to recover the taxes.

Combat pay received on or after Jan. 1, 2018 and through 2025, will be correctly reported on any W-2 forms issued to any service member who serves in the Sinai Peninsula. Service members who served in the Sinai Peninsula in 2015, 2016, or 2017 can provide documentation of their service to their finance officer and ask for a Form W-2c, Corrected Wage and Tax Statement.

COMBAT ZONE FORGIVENESS

If a member of the U.S. Armed Forces dies while in active service in a ***combat zone*** or from wounds, disease, or other injury received in a combat zone, the decedent's income tax liability is forgiven for:

- The tax year in which death occurred, and

- For any earlier tax year ending on or after the first day the member served in a combat zone in active service. If the individual served in more than one combat zone prior to his or her death, no tax is imposed for the years preceding the death starting with the year the individual first served in a combat zone. However, imposition of the statutory time limits for claiming refunds could limit the years for which tax already paid may be refunded. ***(CCM 200447035)***

Any forgiven tax liability for the year of death that has already been paid will be refunded, and any unpaid tax liability for that year at the date of death will be forgiven. In addition, any unpaid taxes for prior years will be forgiven and any prior year taxes paid after the date of death will be refunded (but see "Claims for Tax Forgiveness" below). This provision also applies to a member of the Armed Forces serving outside the combat zone if the service:

- Was in direct support of military operations in the zone, **and**
- Qualified the member for special military pay for duty subject to hostile fire or imminent danger.

TERRORISTIC OR MILITARY ACTION FORGIVENESS (IRC Sec 692)

Tax liability is forgiven for an individual who:

1) Is a military or civilian U.S. employee at death, and
2) Dies from wounds or injury incurred while a U.S. employee in a terroristic or military action regardless of where the terroristic or military action occurred.

Tax is forgiven for the year in which the individual dies and any prior taxable year in the period beginning with the last tax year ending before the decedent's wounds or injury occurred.

Terroristic or Military Action - is any terroristic activity primarily directed against the United States or its allies, or any military action involving the U.S. Armed Forces resulting from violence or aggression against the United States or its allies. Any multinational force in which the United States participates is considered an ally of the United States.

Example - *Army Private John Kane died in 2019 of wounds incurred outside the United States in a terroristic attack in 2018. His income tax liability is forgiven for all tax years from 2017 through 2019. Refunds are allowed for the tax years for which the period for filing a claim for refund has not ended.*

CLAIMS FOR TAX FORGIVENESS

If the tax-forgiveness provisions apply to a prior year's tax that has been paid and the period for filing a refund claim has not ended, the tax will be refunded. If any tax is still due, it will be canceled. Generally, the period for filing a claim for credit or refund of income tax is 3 years from the time the return was filed, or 2 years from the time the tax was paid, whichever is later. If death occurred in a combat zone, or from wounds, disease, or injury incurred in a combat zone, the deadline for filing a claim for credit or refund is extended. See Combat Zone Extension below.

Procedures for claiming forgiveness - All returns and refund claims claiming the tax benefits under Code Sec. 692(c) should be identified by writing the applicable designation provided in IRS Publication 3 (or in other IRS guidance) in bold letters on the top of page one of the return or refund claim and on the total tax line. If the death occurs in the U.S. special procedures apply; See Rev Proc 2004-26.

Attachments - All returns and claims for refund must include the following attachments:

- Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, and
- An attachment that includes a computation of the decedent's tax liability before any amount is forgiven and the amount that is to be forgiven, and
- A certification from the Department of Defense or the Department of State. For military and civilian employees of the Department of Defense, the Department must make certification on Form DOD 1300. The certification must include the deceased individual's name and social security number, the date of injury, the date of death, and a statement that the individual died in a combat zone or from a terroristic or military action.

Where to file - Internal Revenue Service, 333 W. Pershing, Stop 6503, P5, Kansas City, MO 64108 (per 2018 IRS Pub. 3)

Spousal Allocation - Joint returns - Only the decedent's part of the joint income tax liability is eligible for the refund or tax forgiveness. To determine the decedent's part, the person filing the claim must:

1) Figure the income tax for which the decedent would have been liable as if a separate return had been filed,
2) Figure the income tax for which the spouse would have been liable as if a separate return had been filed, and

3) Multiply the joint tax liability by a fraction. The top number of the fraction is the amount in (1) above. The bottom number of the fraction is the total of (1) and (2).

The amount determined in (3) is the decedent's tax liability that is eligible for the refund or tax forgiveness. If you are unable to complete this process, you should attach a statement of all income and deductions, indicating the part that belongs to each spouse. The IRS will make the proper allocation.

Residents of community property states - If the member of the Armed Forces was domiciled in a community property state and the spouse reported half the military pay on a separate return, the spouse can get a refund of taxes paid on his or her share of the pay for the years involved. The forgiveness of unpaid tax on the military pay would also apply to the half owed by the spouse for the years involved.

COMBAT ZONE/QUALIFIED HAZARDOUS DUTY AREA EXTENSION

For military taxpayers in a combat zone/qualified hazardous duty area, the deadlines for taking actions with the IRS are extended. The extension also applies to service members involved in contingency operations, such as Operation Iraqi Freedom or Enduring Freedom. The extension is for 180 consecutive days after the later of:

- The last day a military taxpayer was in a combat zone/qualified hazardous duty area or served in a qualifying contingency operation, or have qualifying service outside of the combat zone/qualified hazardous duty area (or the last day the area qualifies as a combat zone or qualified hazardous duty area), or
- The last day of any continuous qualified hospitalization for injury from service in the combat zone/qualified hazardous duty area or contingency operation, or while performing qualifying service outside of the combat zone/qualified hazardous duty area. The hospitalization must be the result of an injury received while serving in a combat zone or a contingency operation, and includes any hospitalization outside the United States, and up to 5 years of hospitalization in the United States (2018 Pub 3, page 28).

In addition to the 180 days, the deadline is also extended by the number of days that were left for the individual to take an action with the IRS when they entered a combat zone/qualified hazardous duty area or began serving in a contingency operation.

Example - *Captain Margaret Jones entered Saudi Arabia on December 1, 2016. She remained there through March 31, 2018, when she departed for the United States. She was not injured and did not return to the combat zone. The filing deadlines for Captain Jones' 2016, 2017 and 2018 returns are as follows:*

- ***2016 tax return:*** *The deadline is January 13, 2019. This deadline is 288 days (180 plus 108) after Captain Jones' last day in the combat zone (March 31, 2018). The 108 additional days are the number of days in the filing period that were left when she entered the combat zone (January 1 – April 18, 2017).*
- ***2017 tax return:*** *The deadline is January 12, 2019. The deadline is 287 days (180 plus 107) after Capt. Jones' last day in the combat zone (March 31, 2018).* The *107 additional days are the number of days in the 3.5 month filing period that were left when she entered the combat zone (January 1– April 17, 2018).*
- ***2018 tax return:*** *The deadline is not extended because the 180-day extension period after March 31 2018, plus the 105 days left in the filing period when she entered the combat zone, ends on January 10, 2019, which is before the normal due date of her 2018 return, April 15, 2019. Note: The taxpayer could extend the filing date of her 2018 return under the normal automatic 6-month extension rules by filing Form 4868 by April 15, 2019.*

Notifying the IRS About Combat Zone Service - So that the IRS may suspend audit or collection actions until after 180 days after the taxpayer has left the combat zone, the IRS works with the Dept. of Defense to identify taxpayers who are serving in a combat zone. Rather than relying solely on the IRS and Dept. of Defense to communicate, taxpayers qualifying for combat zone relief may also notify the IRS directly of their status by email at combatzone@irs.gov and should include their name, stateside address, date of birth and date of deployment to the combat zone. Social Security number should **not** be included in the email. The taxpayer, spouse or authorized agent or representative may make notification. While the IRS may provide general answers to questions regarding the status of individual combat zone updates, it cannot provide tax account information by email. Instead the IRS will send responses to questions about the taxpayer's account by regular mail to the address on record within 2 business days. ***(IRS Pub 4491, 2018, pg 32-5; IRS website article "Notifying the IRS by E-Mail about Combat Zone Service")***

TAX TREATMENT OF DIFFERENTIAL PAY

Differential pay is compensation that some employers pay to service members during their active duty to make up the difference between the employee's regular salary and his or her military pay. Differential pay is:

- Subject to income tax withholding (not subject to FICA withholding).
- Treated as compensation for retirement plan purposes.
- Qualifies as compensation for purposes of an IRA contribution.
- Taxable and cannot be excluded as combat pay.

Differential pay is pay:

(1) Made by an employer to individuals with respect to any period during which they are performing service in the uniformed services while on active duty for a period of more than 30 days; and

(2) Represents all or part of the wages that they would have received from the employer if they were performing services for the employer. (Code Sec. 3401(h)(2))

An employer must have a written plan providing differential pay.

EXTENSION TO PAY TAX WHEN NOT IN A COMBAT ZONE

A member of the Armed Forces may delay payment of income tax (but not the employee's share of Social Security and Medicare taxes) that becomes due before or during military service. To qualify, the service member must be performing "military service" AND notify the IRS in writing that his or her ability to pay the income tax is materially affected by the military service. The request must include the:

- Service member's name,
- Social Security number,
- Monthly income and source of income before military service,
- Current monthly income,
- Military rank, and
- Date entered military service and date eligible for discharge.

If IRS approves the request, the service member will be allowed up to 180 days after termination or release from military service to pay the tax. If the tax is paid in full by the end of the deferral period, no interest or penalty will be charged for that period.

"Military service" means the period beginning on the date the service is entered and ending on the date released from military service, or date of death while in military service. For National Guard members, this includes service under a call to active service authorized by the President or Secretary of Defense for a period of more than 30 consecutive days for purposes of responding to a national emergency declared by the President and supported by federal funds.

COLLECTION OF OTHER TAXES

Provisions of the Servicemembers Civil Relief Act provide that if a tax or assessment (other than income tax) related to a service member's personal or real property is due and remains unpaid before or during a period of military service, the affected property may not be sold to enforce the collection of the tax or assessment except by court order. To allow the sale, the court must determine that the military service does not materially affect the service member's ability to pay the unpaid tax or assessment. The court may stay a proceeding to enforce collection of the tax or assessment, or sale of the property during the period of the member's military service, plus 180 days.

During the period of military service or within 180 days after being released from military service, a service member has the right to redeem or start an action to redeem personal or real property that was sold or forfeited to enforce the collection of a tax or assessment.

For this provision, real property is that which was occupied for dwelling, professional, business or agricultural purposes by a service member, or his or her dependents or employees:

- Before entry into military service, and
- During the time the tax or assessment remains unpaid.

RESIDENCE OR DOMICILE

The Servicemembers Civil Relief Act of 2003 provides that a service member does not lose or acquire a residence or domicile for tax purposes with respect to his or her person, personal property, or income due to being absent or present in any tax jurisdiction in the U.S. solely to comply with military orders. Further, military compensation is not considered income for services performed or from sources within a tax jurisdiction of the U.S. if the service member is not a resident of or domiciled in the jurisdiction in which he or she is serving.

A state (or other tax jurisdiction) may not use the military compensation of a nonresident service member to increase the tax liability imposed on other income earned by the nonresident service member (or spouse) that is taxed by the state or other jurisdiction.

NONRESIDENT MILITARY SPOUSE EARNED INCOME TAXABLE TO RESIDENT STATE

The Military Spouses Residency Relief Act (MSRRA) (Public Law 111-97) exempts personal service income and wages earned by taxpayers who reside with their military spouses from being taxed by a state other than the spouse's resident state. The couple must have relocated to another state under military orders for the income to be exempt from the nonresident state's taxes. They must also share the same "domicile" or true home outside the duty station state where they intend to return and locate permanently.

The act does not exempt nonmilitary income of military personnel. States were already prohibited from taxing any military pay of nonresident military personnel.

Effective for 2018 and future years – Sec 302 of the Veterans Benefits and Transaction Act of 2018, for any taxable year of the marriage, permits the spouse of a servicemember to elect the same residence for purposes of taxation as the servicemember regardless of the date on which the marriage of the spouse and the servicemember occurred. The election shall apply with respect to any return of State or local income tax filed for any taxable year beginning with 2018.

Benefit - The benefit of this election is that a spouse of a servicemember stationed in a high-income tax state can elect the state of residency of the servicemember whose resident state has no or low state income tax and not be subject to the state taxes where his or her spouse is stationed.

QUALIFIED RESERVIST DISTRIBUTION EARLY WITHDRAWAL EXEMPTION

Qualified reservists are permitted penalty-free withdrawal from IRAs, 401(k)s and other arrangements if ordered or called to active duty. (Code Sec. 72(t)(2)(G)(iv)).

A "qualified reservist distribution" is any distribution to an individual if:

(a) the distribution is from an individual retirement plan, or from amounts attributable to employer contributions made as elective deferrals described in Code Sec. 402(g)(3)(A) , Code Sec. 402(g)(3)(C), or Code Sec. 501(c)(18)(D)(iii);

(b) the individual was, by reason of his being a member of a "reserve component" (as defined in 37 USC 101), ordered or called to active duty for: (i) a period in excess of 179 days, or (ii) an indefinite period;

(c) the distribution is made during the period: (i) beginning on the date of the order or call to active duty, and (ii) ending at the close of the active duty period.

RETIRED MILITARY DISABILITY COMPENSATION

When excludable payments are made to a retired military individual, the payments are made by the Department of Veterans Affairs (VA) and an informational return (i.e., 1099-R) is not issued. The taxable portion of the retirement is paid by the Defense Finance and Accounting Services (DFAS) and included on a 1099-R. In other words the non-taxable portion is not included on the 1099-R.

Example *– Robert is retired from the military with a 30% disability. His annual military retirement is $40,000 of which $12,000 (30% of $40,000) is paid by the Dept. of Veterans Affairs, is not reported on a 1099-R and is not taxable income. His military retirement pay is reduced to $28,000 ($40,000 less the $12,000 amount paid by the VA), reported on a 1099-R and is fully taxable.*

CAUTION – reducing a retired military individual's 1099-R reported income by his or her disability percentage is **INCORRECT**. The disability portion is paid separately by the Dept. of Veteran's Affairs and is not included in the 1099-R from the Defense Finance and Accounting Services (DFAS).

Retroactive Disability Determinations - When the VA determines that a veteran qualifies retroactively for disability compensation, all or part of the taxable retirement pay that was previously received is designated as nontaxable disability compensation, and the veteran is eligible for a refund of taxes previously paid on the retirement income. For initial awards, the retroactive portion is the disability compensation entitlement from the effective date shown on the VA award letter through the day before the reduction of retired pay. For increased awards, the retroactive portion is the difference between the increased award and the amount by which retired pay was reduced, from the effective date of the increased award as shown on the VA award letter through the day before the reduction of retired pay. The excludable amount may not exceed the monthly taxable retired pay for any given month.

When the retired pay is reduced after the effective date of the award, the retroactive portion applicable for the year of the reduction is excludable on that year's return. Enter the retroactive portion as a negative amount on Form 1040, Schedule 1, line 21, and attach an explanation. The DFAS suggests that a copy of the VA award letter and the DFAS-Cleveland Retiree Account Statement (DFAS-CL 7220/148) and, if received, a DFAS-CL waiver notice (DFAS-CL 1800/30) be included with the return. ***(DFAS-CL 1800/36, rev. 6/11)***

To obtain a refund when retroactive disability compensation is awarded for a prior year, that year's return will need to be amended. Until passage of the Heroes Act, veterans' claims for refunds because of retroactive disability classification were subject to the same time period rules for filing claims as for all other reasons.

- **Extended Claims** - The time period for filing a refund claim, which is normally within three years of the filing of the tax return or within two years of the payment of the tax, is extended until one year after the date of the disability determination (if later than the time allowed under the general limitations period for filing a claim for refund or credit). However, the extended time period does not apply with respect to any tax year beginning more than five years before the date of the disability determination. ***(Code Sec. 6511(d)(8), as amended by the Heroes Earnings Assistance and Relief Tax Act of 2008, § 106(a))***

SOME COMBAT INJURED VETERANS ENTITLED TO TAX REFUND

New Law & Stuff

As a result of the 2016 Combat-Injured Veterans Tax Fairness Act, more than 133,000 injured vets may qualify for a federal tax refund. The minimum refunds are estimated to be $1,750, meaning the government will be paying out an estimated minimum of $228 million if all eligible veterans file a claim.

The tax refunds are owed to veterans who received disability severance payments after Jan. 17, 1991, and included that payment as income on their tax returns. According to the IRS, most vets who received a one-time lump-sum disability severance payment when they separated from their military service will receive a letter from the Department of Defense (DOD) explaining the process to follow in order to claim their refund.

For years for which the normal statute for claiming a refund has expired, the vets will have one year from the date of the DOD letter to file a 1040X to claim their refund. Vets have two options in determining the amount of their refund:

- Amend the original return using actual numbers from the original return, or
- Claim a standard refund amount based on the calendar year in which they received the severance payment.

When claiming the standard amount, that amount should be entered on lines 15 and 22 of the 1040-X and "Disability Severance Payment" entered on line 15. The standard amounts are:

- $1,750 for tax years 1991 – 2005
- $2,400 for tax years 2006 – 2010
- $3,200 for tax years 2011 – 2016

Claiming the standard tax refund amount is no doubt the simplest way to claim the refund, because the veteran doesn't need to access the original tax return from the year of their lump-sum disability severance payment.

For returns claiming this refund write either "Veteran Disability Severance" or "St. Clair Claim" across the top of the front page of the Form 1040X. Returns should be mailed to:

Internal Revenue Service
333 W. Pershing Street, Stop 6503, P5
Kansas City, MO 64108

Veterans who are eligible for a refund and don't receive a letter from the Defense Department can still file Form 1040-X to claim a refund but need to include both of the following to verify the disability severance payment:

- A copy of documentation displaying the exact amount of and reason for the disability severance payment, such as a letter from the Defense Finance and Accounting Services explaining the severance payment at the time of the payment or a Form DD-214, and
- A copy of either the VA determination letter confirming the veteran's disability or a determination that the veteran's injury or sickness was either incurred as a direct result of armed conflict, while in extra-hazardous service, or in simulated war exercises, or was caused by an instrumentality of war.

Vets who don't have the necessary documentation indicating the exact amount of their disability severance payment and the reason for it will have to contact the Defense Finance and Accounting Services for the needed documents. See below for California treatment.

CALIFORNIA DIFFERENCES

Exceptions for Married Taxpayers Who File a Joint Federal Income Tax Return – Generally, taxpayers who are required to file a California return and who file a joint federal return must also use the joint status on their California return. However, separate California returns may be filed if either spouse was:

- An active member of the United States Armed Forces or any auxiliary military branch during the tax year; or
- A nonresident for the entire year and had no income from California sources during the year.

California Source Income – California law is compatible with the federal Service Members Civil Relief Act, including treatment of service members' military income. Service members domiciled outside of California and their spouses may exclude the member's military compensation from gross income when computing the tax rate on nonmilitary income. Service members domiciled in California must include their military pay in total income and must include it in California source income when stationed in California.

Permanent Change of Station - A service member stationed outside of CA on Permanent Change of Station orders ceases to be subject to CA income tax. A service member that is attached to a unit whose home is in CA, such as a ship home ported in CA or a unit based in CA is subject to CA income tax – even if the unit is temporarily deployed. File a 540NR, and pro-rate the income: the days in CA are subject to CA taxes, and the days after the transfer are not. Domicile does not change (FTB Pub 1032, Pg 5). For the definition of "permanent change of station" see "Moving Expenses" in the Federal section of this chapter.

Military Spouses' Income – The federal Military Spouses Residency Relief Act (MSRRA) exempts personal service income and wages earned by taxpayers who reside with their military spouses at a duty station outside their state of legal residence from being taxed by the nonresident state or other tax jurisdiction. The couple must have relocated to California under military orders for the income to be exempt from California taxes. They must also share the same "domicile" or true home outside California where they intend to return and locate permanently. But see "Veterans Benefits and Transition Act of 2018," below.

The act does not exempt nonmilitary income of military personnel. States cannot tax any military pay of nonresident military personnel. Both the military member stationed in California and accompanying spouse who are domiciled in another state will now be considered nonresidents of California. As nonresidents, interest, dividends and other intangible income is not taxed by California.

Veterans Benefits and Transition Act of 2018 – This legislation modifies the MSRRA rules to allow the spouse of a servicemember to make the election to use the same residence for purposes of taxation as the servicemember **regardless of the date on which the marriage of the spouse and the servicemember occurred**. This change also applies to California. Income of a servicemember's spouse for services performed in California is not subject to tax if the spouse elects to use the same residence as the servicemember who is a nonresident of California. If the spouse makes the election, write "VBTA" at the top of the tax return in RED INK, or include it according to your software's instructions. (FTB Pub 1032, rev. 02-19)

Domicile and military - The state of domicile for a taxpayer serving in the military is generally the state where he or she was living when the taxpayer first entered military service.

Conformity to Military Family Tax Relief Act – California conforms to the following provisions:

- Suspension for up to 10 years of the 5-year test period for personal residence gain exclusion.
- Above-the-line deduction for overnight travel expenses of reservists traveling over 100 miles away from home to attend Reserve and National Guard meetings.
- Amounts received under HAP.
- Expansion of extension period to include those military members serving in contingency operations as well as those serving in combat zones and hazardous duty areas.

Death Gratuity Exclusion - California permits an exclusion of federal death benefit gratuities and the rollover of military death gratuities to a Roth IRA or a Coverdell Education Savings Account. (R&TC §17160.5)

CA Death Gratuity Payment - CA law provides a $10,000 death gratuity payment to CA National Guard, State Military Reserve or Naval Militia members dying or killed in the line of duty if the legislature appropriates funds for the payments - nontaxable CA, if payment received 1/1/05 or later; taxable federal. (R&TC 17132.4)

DMV Penalty Waiver - The DMV will waive all penalties related to late payment of California vehicle registration renewal fees for members of the armed forces, armed forces reserve, and National Guard who are deployed outside California. "Deployed" means ordered to temporary military duty during a period when a presidential executive order specifies that the United States is engaged in combat or homeland defense. Penalty relief does not apply to:

- People relocated outside California for temporary duty for the sole purpose of training or processing or as a result of a permanent change of station.
- People who apply for registration renewal more than 60 days after termination of their deployment. (AB 1787, Ch. 04-188)

Heroes Act of 2008 –CA conforms to the Heroes Act of 2008 with respect to the following issues:

- Differential compensation is treated as wages for purposes of withholding, retirement plans and IRAs. R&TC §17501(c), IRC §408A(e)(2) and IRC §530(d)(9)
- Differential wages paid for active duty services in excess of 30 days are subject to income tax withholding <u>but are not subject to SDI and UI.</u>
- Tax-Free Rollovers of military death gratuity payments to Roth IRA or Coverdell accounts.

Combat-Injured Veterans Tax Fairness Act 0f 2016 – California does not conform to the special rules extending the statute of limitations for veterans who received disability severance payments after Jan. 17, 1991, that were erroneously included as income on their tax returns, and also does not conform, or have the authority to allow, the use of standard refund amounts. However, Revenue and Taxation Code (R&TC) Section 19311 allows taxpayers to file a claim for refund with FTB within 2 years from the date of a final federal determination, which is defined in R&TC Section 18622 as the date the adjustment or resolution is "assessed" or posted to the taxpayers' IRS account.

Therefore, in those instances where the normal California statute of limitation has closed, taxpayers who file these claims with the IRS may then file claims with FTB within 2 years after the claims are allowed by the IRS. This is true even if the taxpayer used the simplified method and claimed the standard refund amount shown in IR-2018-148, instead of filing an Amended U.S. Individual tax Return (1040X), with the actual excluded amount.

For California purposes though, claims must be based on the actual amount to be excluded and ideally a California Explanation of Amended Return Changes (Schedule X) will be filed with that information. However, under R&TC Section 19322, a taxpayer can file a refund claim in any format, as long as it is in writing, signed by the taxpayer or the taxpayer's representative, and states the grounds of the claim, which in this case, is that they improperly included disability severance pay in income.

Taxpayers claiming a refund as a result of the Combat-Injured Veterans Tax Fairness Act of 2016 should follow FTB's procedures for filing a general claim for refund. Additionally:

1. The taxpayer should include a copy of the letter they received from the Defense Finance and Accounting Service (DFAS) or the Internal Revenue Service, a copy of the IRS Form 1040X, and substantiation indicating the IRS allowed the refund (determination letter, refund issued, etc.).
2. Depending on the taxpayer's situation, the refund may be claimed on either a California Form 540X or through a letter claim.

NONRESIDENT & RESIDENT ALIEN STATUS

Overview

- Generally file as "residents" if they have a green card or meet the "substantial presence test"
- Otherwise file as non-residents
- Require an ITIN (File W-7) with tax return

Pubs Forms

- **Related IRC and IRS Publications and Forms**
  Pub 515 - The Withholding Tax Guide for Nonresident Aliens
  Pub 519 – Tax Guide for Aliens

Form 1040NR – Non-resident tax return
Form 8233 - Claiming Tax Treaty Exemptions from Withholding
Form 8840 – Closer Connection Statement
Form W-4 – Withholding Allowances
Form W-7 – Application for Individual Identification Number
Form W-8BEN – Certificate of Foreign Status of Beneficial Owner of U.S. Withholding
Form W-8ECI – Certificate of Foreign Person's Claim That Income Is Effectively Connected with the Conduct of a Trade or Business in the United States
Form 13551 - Application to Participate in the IRS Acceptance Agent Program
IRC SEC 861 - Gross Income from Sources Within United States
IRC SEC 865 - Source Rules For Personal Property Sales
IRC SEC 7701(b) - Definition of Resident Alien and Nonresident Alien

RAPID FINDER

The Details

RESIDENT & NONRESIDENT ALIEN STATUS

Immigration Status - The immigration laws of the United States refer to aliens as immigrants, nonimmigrants, and undocumented (illegal) aliens. A Foreign person in the U.S. will have one of the following statuses for immigration purposes.

- *Immigrant* - An immigrant has been granted the right by the U.S. Citizenship & Immigration Services (USCIS) to reside permanently within the U.S. and to work without restriction. They may also be referred to as an LPR or Lawful Permanent Resident. They will have a "green card" (form I-551) or for those awaiting issuance of the green card, their foreign passport will bear an I-551 stamp. Immigrants are treated as residents for withholding and tax purposes.
- *Nonimmigrant* - A nonimmigrant may reside temporarily within the U.S. according to the terms corresponding to the visa with which they entered the United States.
- *Undocumented (Illegal) Alien* - An undocumented alien is generally someone who has entered the U.S. without any documentation, or an alien who entered the U.S. legally but has fallen "out of status". An undocumented alien will be treated as a nonresident for tax purposes unless they pass the "substantial presence test" (see definition below). If they pass the substantial presence test then they are treated as a resident for tax purposes.

Tax Status – The tax laws of the United States do not refer to the same three categories as the immigration laws and refer only to the following two controlling principles:

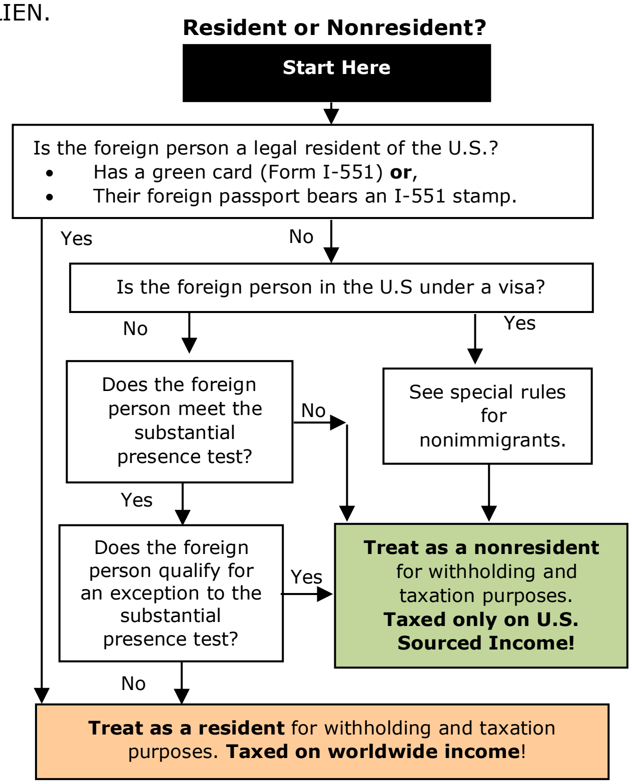
- RESIDENT ALIENS are taxed in the same manner as U.S. citizens on their worldwide income, and
- NONRESIDENT ALIENS are taxed according to special rules contained in certain parts of the IRC.

A major distinguishing feature of this special tax regime concerns the source of income: a nonresident alien (with certain narrowly defined exceptions) is subject to federal income tax only on income which is derived from sources within the United States and/or income that is effectively connected with a U.S. trade or business.

The residency rules for tax purposes are found in IRC § 7701(b). Although the tax residency rules are based on the immigration laws concerning immigrants and nonimmigrants, the rules define residency for tax purposes in a way that is very different from the immigration laws. Under the residency rules of the Code, any alien who is not a RESIDENT ALIEN is a NONRESIDENT ALIEN. An alien will become a RESIDENT ALIEN in one of three ways:

1. By being admitted to the United States as, or changing status to, a Lawful Permanent Resident under the immigration laws (the Green Card test);
2. By passing the Substantial Presence Test (which is a numerical formula which measures days of presence in the United States); or
3. By making what is called the "First-Year Choice" (a numerical formula under which an alien may pass the Substantial Presence Test one year earlier than under the normal rules). Refer to the discussion of "First-Year Choice" in Chapter 1 of Publication 519.

Under these rules, even an undocumented (illegal) alien under the immigration laws who passes the Substantial Presence Test will be treated for tax purposes as a RESIDENT ALIEN.



Alien Residency - Green Card Test – Taxpayers are considered residents, for tax purposes, if they are a Lawful Permanent Resident of the United States at any time during the calendar year. This is known as the "green card" test. They generally have this status if the U.S. Citizenship and Immigration Service (USCIS) has issued them Form I-551, also known as a "green card," or their foreign passport bears an I-551 stamp while awaiting issuance of the actual green card. That status continues unless voluntarily renounced and abandoned or terminated by the USCIS or a U.S. federal court. Their residency starting date is the first day on which they are present in the United States as a Lawful Permanent Resident or they choose to be taxed as a resident alien for the entire calendar year.

Substantial Presence Test – An individual will be considered a U.S. resident for tax purposes if they meet the substantial presence test for the calendar year. To meet this test, they must be physically present in the United States on at least:

1. 31 days during the current year, AND
2. 183 days during the 3-year period that includes the current year and the 2 years immediately before that, counting:
   - All the days present in the current year, and
   - 1/3 of the days present in the first year before the current year, and
   - 1/6 of the days present in the second year before the current year.

Example - Substantial Presence Test *- A foreign individual, Maria, has been visiting the U.S. during the current and past two calendar years. For the current year (2019) Maria spent 112 days in the U.S, 119 days in 2018 and 136 days in 2017. She meets the first half of the test by being in the U.S. for at least 31 days in 2019. However, she does not meet the 183-day test (see below), and therefore must be treated as a non-resident for withholding and taxation purposes.*

Year	*Days*	*Multiplier*	*Test Days*
2019	*112*	*1.0*	*112*
2018	*119*	*0.333*	*39.63*
2017	*136*	*0.167*	*22.71*
Total			*174.34 (required 183, thus failed the test)*

What Constitutes a Day – Generally, any portion of a day is considered a full day for purposes of this test. However, there are exceptions to this rule. Do not count the following as days of presence in the United States for the substantial presence test.

- Days the individual commutes to work in the United States from a residence in Canada or Mexico, if he or she regularly commutes from Canada or Mexico.
- Days in the United States for less than 24 hours, when in transit between two places outside the United States.
- Days in the United States as a crew member of a foreign vessel.
- Days the individual is unable to leave the United States because of a medical condition that develops while he or she is in the United States.
- Days the person is an exempt individual.

For details on days excluded from the substantial presence test for other than exempt individuals, refer to Publication 519, U.S. Tax Guide for Aliens.

Exempt Individual **-** Do not count days for which the individual is an exempt individual. The term "exempt individual" does not refer to someone exempt from U.S. tax, but to anyone in the following categories who is exempt from counting days of presence in the U.S.:

- An individual temporarily present in the United States as a foreign government-related individual.
- A teacher or trainee temporarily present in the United States under a "J" or "Q" visa, who substantially complies with the requirements of the visa.
- A student temporarily present in the United States under an "F", "J", "M", or "Q" visa, who substantially complies with the requirements of the visa.
- A professional athlete temporarily in the United States to compete in a charitable sports event.

If days of presence in the United States are excluded because the individual falls into a special category, a fully-completed Form 8843, Statement for Exempt Individuals and Individuals with a Medical Condition, must be filed.

Closer Connection Exception to the Substantial Presence Test **-** Even if the substantial presence test is met the individual can avoid being treated as a U.S. resident if he or she is:

1. Present in the U.S. on fewer than 183 days during the year, and
2. Establishes that for the year, he has a tax home in a foreign country to which he has a **closer connection** than to the U.S.

To claim the closer connection exception, the taxpayer must include Form 8840, Closer Connection Statement, which must be attached to either the taxpayer's 1040NR or 1040NR-EZ for the year. If the individual is not required to file for the tax year, the 8840 must be filed separately (follow the instructions for the 8840).

First Year of Residency
If an individual is a U.S. resident for the calendar year, but not a U.S. resident at any time during the preceding calendar year, he or she is a U.S. resident only for the part of the calendar year that begins on the residency starting date, and is a nonresident alien for the part of the year before that date (Pub 519).

U.S. SOURCED INCOME

Generally, income is considered U.S. sourced income if it is paid by a domestic corporation, a U.S. citizen, a resident alien or an entity formed under the laws of the United States. *If the property that produces the income is located in the U.S. or if the services for which the income is paid were performed in the U.S. the income is considered U.S. sourced income.* Some examples of income that may be from sources within the U.S. include:

- Compensation for personal services
- Interest and dividends
- Pensions and annuities
- Rental and royalty income
- Taxable scholarship and fellowship grants
- Other taxable grants, prizes and awards

Income sourcing rules are contained at IRC 861 through IRC 865. *Caution:* income tax treaties can modify these rules.

Remember - A nonresident alien is only taxed on U.S. sourced income.

U.S. Sourced Income is broken down into three categories:

- **Effectively Connected Income (ECI)** - if the U.S. source income paid to a foreign person is determined to be from the conduct of a trade or business within the United States it is considered ECI.
  - ECI is subject to the *graduated income tax rates applicable to U.S. persons*, not the 30 percent rate (discussed below).
  - A *foreign person receiving ECI is required to file a U.S. income tax return* because they are conducting a trade or business within the United States.
  - *ECI is subject to reporting requirements by the U.S. payer* or withholding agent.
  - *ECI is not subject to* a withholding obligation.

- **U.S. Source Non-business Income (FDAP)** – Is income that is U.S. source non-business income paid to a foreign person or corporation that is not ECI. FDAP is the acronym for Fixed or Determinable, Annual or Periodic.
  - FDAP is subject to the *30 percent (or lower treaty) tax rate*.
  - A foreign person receiving only FDAP income upon which the 30 percent (or lower treaty) rate has been withheld is not required to file a U.S. income tax return.

- What may seem to fall under the category of FDAP income may in fact be ECI income. See explanation later.
- Examples of FDAP income where the income is U.S. Sourced but not ECI:
  - Portfolio income: interest (excluding OID but see other 30% income below), dividends
  - Annuities, rents,
  - Salaries, wages, premiums and compensation (this applies only to services preformed in the U.S. Those performed by a non-resident alien in a foreign country are not taxable to the U.S.), and other fixed or determinable annual or periodic gains, profits and income.

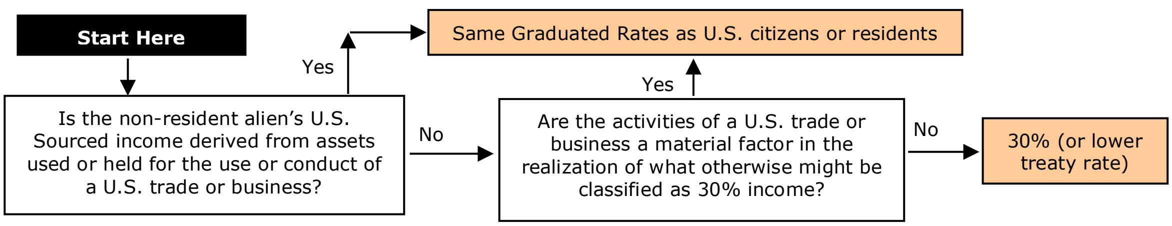
When FDAP income may become ECI – FDAP income can become effectively connected income if:

- The income is derived from assets used in or held for the use in the conduct of that trade or business; or
- The activities of that trade or business in the US are a material factor in the realization of that income.

Example - applying the Asset Use Test *- If the foreign person receives a payment for interest related to an "account receivable" from a U.S. business activity, the interest payment would be treated as ECI and not FDAP income.*

- **Other Income Subject to the 30% Withholding (or other treaty) Tax Rate:**
  - Payments on bonds with OID received at the time of disposition (i.e. does not follow the OID reporting rules for a U.S. resident).
  - 85% of U.S. Social Security benefits paid to non-resident aliens.
  - Gains on sale or exchange of patents, copyrights and the like, where payments are contingent on productivity.
  - Gains from the disposal, with a retained economic interest, of timber, coal, or iron ore.
  - Only in the case of a nonresident alien present in the U.S. for 183 days or more during the tax year, the excess of U.S.-source gains over losses from sales or exchanges of capital assets.

Non-Resident Alien Taxation & Withholding Rates



EMPLOYEE ISSUES – NONRESIDENT ALIENS – Note: These requirements only apply to non-resident aliens working within the U.S. There are no withholding requirements or income tax liabilities for non-resident aliens working outside the U.S.

Withholding Documentation – Nonresident individuals working in the U.S. – Foreign workers must file withholding documents with their U.S. employer or withholding agent. Which form they file will depend upon their circumstances.

Form 8233 - Claiming Tax Treaty Exemptions from Withholding - If a foreign worker claims a tax treaty exemption from Social Security and Medicare, the foreign individual must complete a Form 8233 and provide it to the employer. The employer must review, accept and sign the form, and within 5 days of acceptance forward a copy to the IRS. The employer must wait 10 days to see if the IRS has any objections to the withholding. See the instructions for Form 8233 for more detailed information. **Publication 515** identifies countries that have treaties with the United States.

IRS Recommendation - Even if a nonresident alien employee submits a Form 8233, it is a good business practice to secure a Form W-4 from the employee and withhold accordingly until the submitted Form 8233 is not rejected by the IRS.

- *W-4 – Employee's Withholding Certificate* - All compensation not exempt under the tax treaty will be subject to employment taxes in conjunction with the nonresident alien's Form W-4, which is also subject to special adjustment, for the applicable number of withholding allowances claimed. U.S. employers should advise nonresident aliens to review IRS Notice 1392, Supplemental Form W-4 Instructions for Nonresident Aliens, before completing the Form W-4. U.S. employers should know that nonresident aliens:
  - Cannot write "exempt" on line 7 of the Form W-4 (line 7, 2019 version);
  - Must enter a Social Security number on line 2 of Form W-4 and may not enter an ITIN; and
  - May only claim "single" for their filing status on line 3 of Form W-4, regardless of their actual marital status.

- With limited exceptions, a nonresident alien cannot claim more than one withholding allowance on their W-4.
- They must write "Nonresident Alien" or "NRA" above the dotted line of line 6 (2018).

A nonresident alien who fails to file a valid Form W-4 should have federal income taxes withheld at the rates pertaining to an individual who is single status and zero withholding allowances.

Since the foreign employee is not allowed a standard deduction when filing, the U.S. Employer cannot use the regular withholding table and instead must use a gross up procedure outlined in Publication 15.

Note: Under the tax treaty with India, nonresident alien students and business apprentices from India use the regular withholding tables.

Totalization (International Social Security) Agreements - These agreements are like tax treaties, but are between the Social Security Administration and various foreign countries. The agreement is to address a situation where dual Social Security taxation occurs when a foreign employee is working within the United States and required to pay these taxes to both the U.S. and the NRA's country of residence on the same wages. Totalization agreements must be honored by a U.S. employer.

The foreign worker who claims an exemption under a totalization agreement needs to provide the U.S. employer with a certificate of coverage from the resident country that will be collecting the taxes. The U.S. employer should keep a copy of the certificate in the event the IRS questions why FICA taxes are not being withheld.

More information on totalization agreements is available in Section 7, Page 23 of 2019 IRS Publication 15-A, 2018 Publication 519 (page 45), and at www.socialsecurity.gov/international.

Employer Reporting - Resident alien and nonresident alien employees' wages are reported on the Forms 941 or 944 and W-2 in the same manner as normal payroll reporting. However, when the wages for a nonresident alien are exempt under a tax treaty those payments are reported on Forms 1042 and 1042-S.

State Reporting Obligations - A form W-2 is usually required to report state and local wages and income taxes withheld even in situations in which all of a nonresident alien's wages are exempt from federal income tax under a treaty, and all federal wages would be reported on Form 1042-S. A tax treaty only applies to the Federal tax regime and not state taxes. **There are no tax treaties between a foreign government and a state.**

LIABILITY – FAILURE TO PROPERLY WITHHOLD
Both the foreign person receiving the payment and the U.S. payer are personally responsible for the taxes on U.S. sourced income. If the U.S. payer fails to withhold, and the foreign person does not satisfy its tax obligation, the IRS will approach the U.S. payer for any related tax liability, including interest and penalties.

CAUTION – WAGES TO UNDOCUMENTED (ILLEGAL) ALIENS
A U.S. employer, who hires undocumented (illegal) aliens or aliens who are working in violation of their nonimmigrant status, is expected to correctly report and withhold all required taxes on these wages.

INDEPENDENT CONTRACTOR PAYMENTS

Generally, a U.S. payer must withhold 30 percent of any payment of U.S. sourced income to a foreign person unless they can reliably associate the payment with documentation that:

- Establishes the payee is a US person;
- Claims a reduced rate or exemption with a valid and properly completed series W-8 form; or
- Establishes that the payee is covered under a tax treaty with an accepted Form 8233.

W-8 Series Forms - The W-8 series of forms is the equivalent of a Form W-9, Request for Taxpayer Identification Number and Certification, for a U.S Citizen or Resident. There are a number of W-8 series forms but the following two are the commonly encountered ones when dealing with independent contractors and small businesses:

- W-8BEN - Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding
- W-8ECI- Certificate of Foreign Persons Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States

When should the tax be withheld - Withholding is required at the time that the payment is made. A payment is considered to be made when the beneficial owner of the payment realizes the income. There does not need to be a transfer of cash or other property.

Remember: only U.S. source FDAP income is subject to withholding. Effectively connected income (ECI) is not subject to withholding.

NONIMMIGRANTS TEMPORARILY IN THE U.S.

Individuals such as alien students, teachers, researchers, trainees, etc., are allowed into the U.S. on a temporary (nonimmigrant basis). Their stay is subject to the terms of their visa. For more detailed information than is provided in this overview please refer to Pub 515.

Visa Designations – The following are the more common visas:

F-1 - Generally a foreign student
H-1b - Specialty occupations such as teachers, trainees and researchers;
H-1c - Foreign nurses.
H-2a – Foreign Agricultural Workers (See special treatment this chapter)
J-1 – Generally a foreign student
M-1 – Vocational or technical student
O-1 - Foreign scholars, teachers, researchers or trainees
P - Artists, athletes and entertainers
Q-1 – Cultural exchange visitor
TN - Foreign scholars, teachers, researchers or trainees arriving from Canada or Mexico under a NAFTA treaty.

Students – Generally wages paid to nonresident alien students with F-1, J-1, M-1 and Q-1 nonimmigrant status are not subject to FUTA tax or social security and Medicare taxes on pay for services performed to carry out the purpose for which the alien was admitted to the United States.

> ***Example -*** *A nonresident alien is issued a visa to teach for a university. While in the United States, he takes a part-time job working for a chemical company. The wages earned while teaching at the university are exempt from social security and Medicare taxes. The wages earned at the chemical company are subject to social security and Medicare taxes.*

Wages, salaries, or other compensation paid to a nonresident alien student, trainee, or apprentice for labor or personal services performed in the United States are subject to graduated withholding.

Scholarship or Fellowship Income – A portion or all of a scholarship or fellowship may be taxable. Where there are treaty provisions to exclude the income from withholding the student should file form W-8BEN. There are two types of scholarship or fellowship income:

- **Non-compensatory** – where the student does not provide any personal services. If the student is a degree candidate, the amount of this type of income used for expenses other than tuition and course-related expenses (fees, books, supplies, and equipment) is generally taxable. For example, amounts used for room, board, and travel are generally taxable. Where the individual is not a degree candidate the entire amount is taxable. The withholding rate for the taxable amount is 30% (14% for nonresident aliens temporarily in the U.S on an F, J, M or Q visas).
- **Compensatory -** In general, scholarship or fellowship income is compensatory to the extent it represents payment for past, present, or future services (for example, teaching, research, etc.) performed by a nonresident alien as an employee and the performance of those services is a condition for receiving the scholarship, fellowship or tuition reduction. The withholding rate for this compensation is 30%.

> ***Example -*** *XYZ University awards a scholarship to N, a nonresident alien student. The only condition of the scholarship is that N attends classes and maintains a minimum level of academic performance. The scholarship income is not compensatory because N is not required to perform services as an employee as a condition for receiving the scholarship.*

Artists, Athletes and Entertainers - Because many tax treaties contain a provision for pay to visiting artists, athletes and entertainers, a separate category is assigned these payments for withholding purposes. Withholding rates for this category are:

- 30% for services performed as independent contractors.
- Graduated rates for services performed as employees.
- A central withholding agreement (CWA) allows for lower withholding rates if IRS approved.
- Form 8233 is used to claim special treaty provisions.

However, where the nature of the relationship between the payer of the income and the artist or athlete is not ascertainable, the withhold rate is 30%. See Pub 515 for additional details.

Agricultural Workers – H2-A Visas –IRS issued guidance indicates that a W-2 should be used with the income reported in box 1. Income for these workers should not be reported on Form 1099-MISC. Guidance for reporting the income of H2-A foreign agricultural workers is included in Pub 51, Circular A, and the Agricultural Employer's Tax Guide. Also see the IRS web site for additional information: https://www.irs.gov/individuals/international-taxpayers/foreign-agricultural-workers.

H2-A foreign workers are exempt from Social Security tax, although it seems that those reviewing the returns at the IRS may not be aware of that. If you need proof refer to SERP Alert 12A0537 (SERP is the IRS' abbreviation for Servicewide Electronic Research Program).

The IRS is stepping up filing enforcement on these foreign workers including for prior years. Sec 6012 requires everyone whose income exceeds the exemption amount to file a return. A nonresident alien (NRA) individual engaged or considered to be engaged in a trade or business in the United States during the year is required to file a return. Prior to 2018 if the NRA's only U.S. source income was wages that were less than the personal exemption amount, there was no requirement to file. Effective for 2018 (and presumably later years), exemption from filing only applies if any of the following conditions are met (IRS Pub 519, page 35 and 36 (2018)). The individual:

- Is a nonresident alien student, teacher, or trainee temporarily present in the United States under an F, J, M, or Q visa, and has no income that is subject to tax, such as wages, tips, scholarship and fellowship grants, dividends, etc.
- Is eligible for the benefits of Article 21(2) of the United States–India Income Tax Treaty, is a student or business apprentice, is single or a qualifying widow(er), and gross income is no more than the standard deduction amount for the year.
- Is a partner in a U.S. partnership that was not engaged in a trade or business in the U.S. during the year and Schedule K-1 (Form 1065) includes only income from U.S. sources that is not effectively connected with a U.S. trade or business.
- Has gross income less than $5.

To determine how an H-2A agricultural worked is taxed, apply the substantial presence test on page 01.09.02.

- *Nonresident Alien* – Use Form 1040NR, no standard deduction, report U.S. source income only.
- *Resident Alien* – Use Form 1040, taxed the same as a U.S. Citizen, include worldwide income.
- *Dual-Status Alien* – Use Form 1040 with unsigned 1040NR attached, no standard deduction, only U.S. source income while a nonresident and worldwide income while a resident.

WITHHOLDING AGENT PENALTIES

A U.S. withholding agent must be able to identify all non-U.S. citizens and nonresident payees in order to meet its withholding responsibilities. Who is a withholding agent?

- A withholding agent is a person or entity that has control, receipt, custody, or payment of any item of income belonging to a foreign person that is subject to withholding.
- A withholding agent is often described as the last person in the United States who has control over the money before it is paid to the foreign person.
- The term "withholding agent" includes, but is not limited to individuals, U.S. corporations, foreign intermediaries, and U.S. branches of a foreign entity.

A withholding agent is personally liable for any taxes that were required to be withheld. What is the potential cost of not complying with these withholding regulations? Read on.

Civil Penalties for Failure to Withhold - Aside from owing the amount of tax that should have been withheld and interest, a withholding agent who fails to comply with these withholding requirements can face such civil penalties as:

- The 100 percent penalty equal to the total amount of tax evaded;
- The 20 percent accuracy-related penalty of the amount of the underpayment of withheld tax in the case of negligence;
- A 75 percent penalty for the underpayment of withheld taxes in the case of civil fraud;
- Additional taxes of five percent to a maximum of 25 percent for the negligent failure to file a return; and
- Additional taxes of 15 percent to a maximum of 75 percent for the fraudulent failure to file a return.

Invalid TINS – Normally the IRS will not impose a penalty on a withholding agent for any invalid TINs reported on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, unless the withholding agent knew or should have known that the TIN was incorrect. When penalties are appropriate, they should be assessed under Code Sec. 6721, Failure to File Correct Information Returns. (Chief Counsel Advice 201615012)

Taxpayer ID Problem & ITINS – To file a return a taxpayer must have a taxpayer ID number. Since nonresident aliens do not have and cannot obtain a legal SSN they must use an ITIN. IRS issues ITINs to foreign nationals and others who have federal tax reporting or filing requirements and do not qualify for SSNs. Overall, some 11-million individuals have ITINs.

E-Filing Tip - Undocumented aliens may (illegally) use someone else's SSN to obtain employment. However, they cannot file using that SSN and must obtain an ITIN for filing. This creates a mismatch for e-filing. Practitioners familiar with these type returns indicate using SSN on the W-2 screen but the ITIN on the return will avoid e-filing problems. Of course the individual gets no SS credits for the W-2 wages but they can at least satisfy the filing requirements. According to the instructions to IRS Form W-7, e-filing cannot be done for a return on which an ITIN is used in the calendar year the ITIN is issued. For example, if an ITIN is applied for and received in 2019, no return using that ITIN (including prior year returns) can be e-filed until 2020.

The following individuals qualify for an ITIN:

- U.S. resident alien (based on days present in the United States) filing a U.S. tax return and not eligible for a SSN
- Dependent or spouse of a U.S. citizen/resident alien
- Dependent or spouse of a non-resident alien visa holder

Applying for an ITIN - The IRS provides the following instruction for obtaining an ITIN for the first time.

1. Complete Form W-7.
2. Attach an original, valid federal income tax return behind the Form W-7.
3. Include supporting documents to establish identity and connection to a foreign country (see W-7 instructions) - The IRS will only accept original identification documents or certified copies of these documents from the issuing agency along with a completed Form W-7 and Federal tax return when an individual applies for an ITIN directly to IRS.
4. The package can be filed in one of the following ways:
    a. By submitting it in person, by appointment, at certain IRS Taxpayer Assistance Centers (TACS). Appointments can be scheduled by calling 1-844-545-5640; see https://www.irs.gov/help/tac-locations-where-in-person-document-verification-is-provided for a list of designated TACs that offer ITIN document authentication service;
    b. By mailing the W-7, tax return and required documentation to Internal Revenue Service, ITIN Operation Center, P.O. Box 149342, Austin TX 78714-9342; or
    c. By submitting the W-7 through and signed by an Acceptance Agent or Certified Acceptance agent who verifies the information and signs the W-7 prior to submission and forwards the application to the IRS at the address noted in "b" above.

ITIN Renewal - The IRS announced that approximately 2 million Individual Taxpayer Identification Numbers (ITINs) will be expiring by the end of 2019 and need to be renewed.

All ITINs begin with the digit 9 and are otherwise formatted like an SSN, 9XX-XX-XXXX. The fourth and fifth digit ranges are from 50-65, 70-88, 90-92, and 94-99.

Per a provision in the PATH Act of 2015, ITINs that have not been used on a federal tax return at least once in the last three consecutive years will expire Dec. 31, 2019. In addition, ITINs with middle digits 83, 84, 85, 86 or 87 that have not already been renewed will also expire at the end of the year. ITINs with middle digits of 70 through 82 expired in past years. Taxpayers with these ITIN numbers who haven't already renewed their ITIN can renew at any time. Note: It is important to understand that ITINs with middle digits 83 through 87 will expire whether or not they were used for filing returns in the last three years. Taxpayers whose ITIN is expiring and who need to file a tax return in 2020 must submit a renewal application on Form W-7, along with required documentation (originals or certified copies from the issuing agency). Federal returns that are submitted in 2020 with an expired ITIN will be processed. However, exemptions and/or certain tax credits will be disallowed, and the taxpayers will be notified by mail advising them to renew their ITIN. Once the ITIN is renewed, any applicable exemptions and credits will be reinstated, and any applicable refunds issued. Therefore, renewing early will avoid these last-minute hassles and delays in receiving refunds.

To reduce the paperwork burden on households where several people will need to renew their ITIN, the IRS has created the family option. An individual receiving a renewal letter from the IRS can choose to renew the ITINs of all of their family members at the same time even if family members have an ITIN with middle digits that have not been identified for expiration. Family members include the tax filer, spouse and any dependents claimed on the tax return. However, spouses and dependents residing outside the U.S. do not need to renew their ITINs unless they anticipate being claimed for a tax benefit (for example, after they move to the U.S.) or if they file their own tax return. That's because the deduction for personal exemptions is suspended for tax years 2018 through 2025 by the TCJA. Consequently, spouses or dependents outside the U.S. who would have been claimed for this personal exemption benefit and no other benefit do not need to renew their ITINs this year.

Acceptance Agents or Certifying Acceptance Agents – A practitioner can become an acceptance agent as part of the IRS program by completing Form 13551, Application to Participate in the IRS Acceptance Agent Program, submitting a fingerprint card or proof of professional status and certifying they have completed the on-line training provided on IRS.gov. Forms 13551 are accepted year-round, but the form's instructions caution that it can take up to 4 months for the application to be processed and that renewal requests should be submitted 6 months before an Acceptance Agent's agreement expires. (Form 13551, June 2019) The role of the Acceptance Agent is to verify the documentation being submitted meets the submission requirements.

A Certifying Acceptance Agent (CAA) is an individual who is allowed to submit a W-7 on behalf of an individual without furnishing supporting documentary evidence and who accepts some record keeping responsibilities. CAA applicants must complete forensic training to aid in identifying fraudulent identification documents. This training is at the CAA's own expense.

For more information refer to the instructions for Form 13551, IR-2018-137, and search on "How to become an Acceptance Agent" on the IRS web site. See also on the IRS web site: https://www.irs.gov/individuals/new-itin-acceptance-agent-program-changes.

CALIFORNIA DIFFERENCES

An individual who is a nonresident alien for federal tax purposes is required to file a California resident return reporting worldwide income if he or she meets the state's residency requirements, regardless of the individual's federal immigration status.

The following is an overview of the withholding requirements for non-resident taxpayers; consult FTB Publication 1017 for full details.

Non-resident Income Subject to Withholding

California Revenue and Taxation Code (R&TC) Section 18662 requires withholding of income or franchise tax on payments of California source income made to nonresidents of California. The withholding rate is generally 7%. The following California source income is subject to withholding (FTB Publication 1017):

- Payments to nonresidents for services rendered in California.
- Payments made to nonresident entertainers for services rendered in California.
- Payments received for a covenant not to compete in California.
- Payments releasing a contractual obligation to perform services in California.
- Income from options received because of performing personal services in California.
- Bonuses paid for services performed in California.
- Rents and royalties from assets located in California.
- Prizes and winnings received by nonresidents for contests in California.
- Distributions of California source income.

Withholding is optional and at the discretion of the withholding agent on the first $1,500 of income paid for the calendar year to each payee.

Withholding Exemption Certificate

California Form 590, Withholding Exemption Certificate, is used to certify an exemption from nonresident withholding. It does not apply to payments of wages to employees. It does not apply to sellers of real estate, which must use Form 593-C. Form 590 is certified by the payee.

Reduced Withholding for Foreign Partners

The FTB conforms to Federal Treasury Regulation 1.1446-6 procedures, which allow foreign partners to request reduced or no withholding of California tax on effectively connected taxable income from California sources allocable to a foreign partner. The foreign partner certifies to the partnership, and to the FTB, that no or reduced California tax will be due. If the FTB approves the request, the FTB will notify the foreign partner and the partnership.

Foreign partners can request reduced withholding from the FTB annually before the first installment period using FTB Form 589, Nonresident Reduced Withholding Request. See FTB Form 589 instructions for details.

A foreign partner must submit a completed and signed IRS Form 8804-C, Certificate of Partner-Level Items to Reduce Section 1446 Withholding, with FTB Form 589. On line 10 of the Form 589, enter the total of California amounts from 8a through 8f of Form 8804-C.

How to request and report foreign partner reduced withholding - If a partnership allocates California source income to a foreign partner, **all** of the following must be true for the partnership to withhold a reduced amount for a foreign partner:

- The foreign partner submits to the partnership a completed and signed IRS Form 8804-C, and
- The foreign partner submits to the FTB Form 589 with a signed copy of IRS Form 8804-C attached, allowing the FTB at least 21 business days before the first installment period, and
- The FTB has provided the foreign partner and the partnership a Request for Reduced Withholding - Approved letter.

How to report foreign partner reduced withholding - If the above requirements are met, then the partnership withholds the amount approved by FTB, and:

- Submits the withheld amounts using FTB Form 592-A, Payment Voucher for Foreign Partner or Member Withholding. See Form 592-A for payment due dates.
- At the close of the taxable year, completes and files FTB Form 592-F, Foreign Partner or Member Annual Return. Form 592-F allows reporting of total withholding for the year and allocates to foreign partners the income or gain and related withholding.
- Provides the foreign partner with a statement showing the total income allocated and the total amount withheld. The partnership can use a printed or electronic FTB Form 592-B, Resident and Nonresident Withholding Tax Statement, for this purpose. See FTB Form 592-B instructions for due dates and details.
- Keeps the approved letter, and FTB Forms 592-A, 592-F, and 592-B for a minimum of four years.

In general, the FTB conforms to IRC 1446 and the 10-day notification of withholding for foreign payees. The foreign partner claims credit for the withholding by attaching a copy of the FTB Form 592-B when filing a California tax return. The FTB Form 592-B is proof of California source income and withholding.

On-line requests available The FTB website – www.ftb.ca.gov – has information, forms, and details on how foreign partners can request reduced withholding online. Type in "electronic Form 589" in the search box on the FTB web page.

NOTES

COMMUNITY PROPERTY

Overview

Federal tax law recognizes the principle of community income in community property states (AZ, CA, ID, LA, NV, NM, TX, WA and WI) or countries, which treats half of community income and expenses as belonging to each spouse.

Pubs
Forms

Related IRC and IRS Publications and Forms

- **IRC Sec 66** – Treatment of Community Income
- **Pub 555 –** Community Property
- **Pub 971 –** Innocent Spouse Relief
- **Form 8857** - Request for Innocent Spouse Relief
- **Form 8958** – Allocation of Tax Amounts Between Certain Individuals in Community Property States

The Details

COMMUNITY INCOME

Community income is all the income from community property (including business property) and salaries, etc., for the services of either or both spouses. Income from separate property during marriage is community income only in ID, LA, TX and WI. Community income for Federal purposes is community income as defined by state law.

Community income rules do not apply to income from property that was formerly community property, but in accordance with state law, has ceased to be community property, becoming, e.g., separate property or property held by joint tenancy or tenancy in common.

Community Property States	Community Property	Separate Property
Arizona	Community Income	Separate Income
California	Community Income	Separate Income
Idaho	Community Income	Community Income
Louisiana	Community Income	Community Income
Nevada	Community Income	Separate Income
New Mexico	Community Income	Separate Income
Texas	Community Income	Community Income
Washington	Community Income	Separate Income
Wisconsin	Community Income	Community Income

Note: *Alaska, although not a community property state, does permit a married couple to identify property and income to be classified as community property by agreement or trust.*

Community property laws of foreign countries, related to the taxation of U.S. citizens or residents, are recognized and applied for U.S. tax purposes.

Thus where a determination must be made of whether a property located in a foreign country or income derived from a foreign country is community property or separate property, the community property laws of that country will apply.

In addition to the list at the right, taken from IRM 3.38.147.18.1 (01-01-2016), the Canadian province of Quebec, and most countries of the world with a European law tradition have community property as part of their overall civil law system.

Territories and Foreign Community Property Countries
Belgium
Brazil
Colombia
Dominican Republic
France
Guam
Guatemala
Mexico
Montenegro
Netherlands
Philippines
Portugal
Puerto Rico
Spain
Sweden
Venezuela

DOMICILE

Whether for federal tax purposes taxpayers have community property and community income depends upon their domicile and the laws of the state in which the taxpayers are domiciled (IRS Pub 555 - 2019, Pg 2).

The determination of domicile for income tax purposes is essentially a question of federal law. Hence federal decisions and rulings on questions of domicile relating to one state are generally equally applicable to other states.

A taxpayer has only one domicile even though the taxpayer may have more than one residence. Domicile is a permanent legal home that a taxpayer intends to use for an indefinite or unlimited period, and to which the taxpayer intends to return. Domicile is generally a matter of intent based upon a taxpayer's actions. So there is no bright line definition of domicile and a taxpayer must be able to show factually that he or she intends a given place or state to be his or her permanent home. Time spent in one place doesn't always define the difference between a residence and a domicile. Some of the factors considered in determining domicile are:

- Citizenship,
- Length of residence,
- Voting place,
- State to which income taxes are paid,
- Location of taxpayer's property, and
- Business and social ties (IRS Pub 555 - 2019, Pg 3).

The fact that a taxpayer is living in the U.S. under a visitor's visa doesn't exclude the intent necessary for U.S. domicile (May, (1939) 39 BTA 946, nonacq).

An intention by spouses living in a foreign country to move to a community property state, and their oral agreement that their present income will be community income, isn't sufficient to make the income community income (Hampton, (1962) 38 TC 131).

TREATMENT OF COMMUNITY INCOME

Married Filing Jointly - For a married couple in a community property state who files a joint tax return, separating community income to each spouse is unnecessary.

Married Filing Separate - If the spouses file separate returns, each spouse must report one-half of community income, and if the couple is estranged or uncooperative, determining the correct amount of income that each should report may be difficult. Exceptions to the general rule that community income is to be reported equally by the spouses may apply:

- **§ 66(a)** – **Spouses Live Apart** - provides rules for treating community income when the spouses live apart and don't share income for the entire year.
- **§ 66(b)** – **Traditional Relief** - allows the IRS to disregard community property laws when one spouse is not notified of the type and amount of community income. **CAUTION**: This rule can be used only by IRS in order to disallow the benefits of community property laws to a taxpayer and cannot be used by a taxpayer to avoid his or her liability for tax on community income paid to and/or earned by the taxpayer's spouse. This relief is not considered until after the IRS initiates an audit.
- **§ 66(c) – Equitable Relief** - permits the IRS to grant relief from the operation of community property laws under certain circumstances (this is akin to the "innocent spouse" relief granted certain married joint filers), and further authorizes IRS to grant equitable relief from operation of community property laws if a taxpayer is unable to meet specific requirements of this code section. This relief cannot be requested in advance and is requested only after traditional relief has not been granted.

These three items of relief are discussed in detail later in this chapter.

WHAT IS COMMUNITY AND WHAT IS SEPARATE?

Keep in Mind: the following issues only apply where spouses do not file a joint return for the year and must allocate their income per the community property rules.

Separate Property - Separate property includes property owned by either spouse before marriage or acquired afterward by a gift, bequest, devise, or descent, together with the rent, profits and income derived from this property (Winship, (1947) 8 TC 744). Some states characterize income from separate property as community income. These states include Idaho, Louisiana, Texas, and Wisconsin.

Community Property - Community property is all property (other than separate property) acquired after marriage by either spouse, including all real and personal property within the state, and personal property situated outside the state but acquired while the parties were domiciled within the state. It includes property acquired by purchase. However, a decree of separation or divorce will turn community property into separate property. Earnings from community property assets retain their character as community until such time as the asset is awarded to one spouse.

Personal Property Acquired In a Non-community Property State - If a spouse acquires personal property while domiciled in a non-community property state, it remains the separate property of that spouse even though the couple thereafter moves to CA (Shea v. Com., (1936, CA9)).

Wages – Earned income from personal service received by a husband and wife domiciled in a community property state is generally community income during the period the community is in existence. Thus wages are community income during the period the community is in existence and must be split evenly.

Credit for Tax Withheld on Wages - Reg § 1.31-1(a) - If a husband and wife domiciled in a State recognized as a community property State for Federal tax purposes makes separate returns, each reporting for income tax purposes one-half of the community wages received during the tax year, the credit for tax withheld on the community wages that are reported on separate returns is taken one-half by each spouse.

Wage FICA Withholding – The FICA withholding cannot be allocated. It has already been reported to the Social Security Administration and credited under the SSN of the individual who actually earned it.

Net earnings from self-employment – Where the net self-employed earnings of a taxpayer is community property, then:

- **Self-Employment Tax** – Is assessed on the taxpayer who actually earned the income. If the spouses jointly operate the trade or business, for SE tax purposes, the gross income and related deductions are allocated between the spouses based on their distributive shares of the gross income and deductions.
- **Income Tax** – For purposes of income tax, the SE income that is community income is divided 50-50 between the spouses and the SE income that is separate income is allocated 100% to the spouse who owns it.

> **Example:** Where a married couple lives in a community property state and only one spouse is self-employed, that spouse must pay SE tax on his total gross SE income, less total business deductions, despite the fact that half of that income is attributable to the other spouse for income tax purposes (Code Sec. 1402(a)(5)(A)).

Estimated Tax Payments

- ***Separate Returns – Separate Estimates -*** If the taxpayer and spouse made separate estimated tax payments for the year and file separate returns, they can take credit only for their own payments.
- ***Separate Returns – Joint Estimates -*** If the taxpayers made joint estimated tax payments, they must decide how to divide the payments between the returns. One can claim all of the estimated tax paid and the other none, or they can divide it in any other way they agree on. If they cannot agree, they must divide the payments in proportion to each spouse's individual tax as shown on their separate returns for the year.

> ***Example -*** *James and Evelyn Brown made joint estimated tax payments totaling $3,000. They file separate returns and cannot agree on how to divide estimates. James' tax is $4,000 and Evelyn's is $1,000.*
>
> *James' share = 4,000/5,000 x 3,000 = $2,400*
> *Evelyn's share = 1,000/5000 x 3,000 =$ 600*

- ***Divorced Taxpayers -*** If the taxpayers made joint estimated tax payments for the year and were divorced during the year, either spouse can claim all the payments or they each can claim part of them. If the taxpayers cannot agree on how to divide the payments, they must divide them in proportion to each spouse's individual tax as shown on their separate returns for the year.

Multi-Year Compensation - Where compensation is paid for several years' services, the part attributable to services while the taxpayer was a resident of a non-community property state is separate income (Loew (1946) 7 TC 363, acq.).

Unemployment Income **–** Since unemployment income is a substitute for current earnings it is treated as community income.

Disability Income **–** Since disability income is a substitute for current earnings it is treated as community income.

Dividend & Interest Income **–** Interest and dividend income can be either separate or community income depending whether the underlying investment that produces the income was acquired with joint or separate funds and the domicile at the time of acquisition.

Social Security and Equivalent Railroad Retirement Benefits - Are treated as the income of the spouse who receives the benefits (IRS Pub No. 555, (2019), pg 8).

Pension Income **–** Income from qualified plan distributions can be either community income or separate income based upon the amount of separate and community income used to fund the pension account. One possible proration scenario would be prorating by the respective periods of participation in the pension while married and domiciled in a community property state or in a noncommunity property state during the total period of participation in the pension.

Example – Prorating by Years – Suppose Dave has had a 401(k) plan since January 1 of 2009. He and Shirley are married on Jan 1, 2016. On January 1 of 2019 Dave retires and begins taking distributions from his 401(k) plan. Dave had the 401(k) plan for 10 years, three of which were during the period of marriage to Shirley. Thus prorating by years, Dave's 401(k) distributions would be 70% separate income and 30% community income. If they filed married separate Dave would report 85% of the income (70% plus ½ of 30%) and Shirley would report 15%.

IRA & SEP Accounts **–** Traditional IRAs, Roth IRAs, SIMPLE IRAs, and SEP IRAs are separate property by law, thus:

- **Distributions** - are reported by the individual who owns the IRA.
- **Contributions** - when deductible the deduction is claimed by the individual who owns the IRA.

Lump Sum Distributions – Community property rules are disregarded for qualifying lump sum distributions where the 10-year averaging option is utilized.

Federal Civil Service Retirement – Whether a civil service annuity is separate or community income depends on the employee's marital status and domicile when the services were performed for which the annuity is paid. Even if the taxpayer now lives in a non-community property state and receives a civil service annuity, it may be community income if it is based on services performed during the period married and while domiciled in a community property state.

Partnership Income – Income from a partnership is based upon if:

- **Income Is Attributable to the Personal Services of Either Spouse** – Where the income from the partnership is attributable to the efforts of either spouse, the partnership income is community property.
- **Income Is Not Attributable to Personal Services –** Then income can be either community or separate based upon whether the partnership is community or separate property.

Tax-exempt income **-** Community income exempt from federal tax generally keeps its exempt status for both spouses. For example, under certain circumstances, income earned outside the United States is tax exempt. If either spouse met the conditions that made the income exempt, the income retains its exempt status for both.

Military Compensation

- **Retirement Pay** - Generally, the pay is either separate or community income based on the marital status and domicile of the couple while on active military service.
- **Active Duty** - Active military pay earned while married and domiciled in a community property state is also community income. This income is considered to be received half by the member of the Armed Forces and half by the spouse.

When determining the domicile of a servicemember and the servicemember's spouse keep in mind two laws pertaining to their domicile:

- **The Servicemembers Civil Relief Act of 2003** - provides that a service member does not lose or acquire a residence or domicile for tax purposes with respect to his or her person, personal property, or income due to being absent or present in any tax jurisdiction in the U.S. solely to comply with military orders.
- **The Military Spouses Residency Relief Act (MSRRA) (Public Law 111-97)** - exempts personal service income and wages earned by taxpayers who reside with their military spouses from being taxed by a state other than the spouse's resident state. The couple must have relocated to another state under military orders for the income to be exempt from the nonresident state's taxes. They must also share the same "domicile" or true home outside the duty station state where they intend to return and locate permanently.

Gains & Losses – Gains and losses are classified as separate or community depending on if the gain or loss was from separate or community property.

Income Derived from Capital – Capital can be either separate or community property and income derived from capital follows ownership. Thus community property generates community income and separate property generates separate income.

Coverdell Education Savings Account (ESA) Distributions – ESAs, like IRAs, are by law separate property, and the distributions are reported to the individual who owns the account.

Cancellation of Debt – Treatment generally follows state law. Generally personal debt will be community debt and business debt depends upon whether the debt is secured by community or separate property such as a business or rental.

Alimony - Note: For federal tax purposes, alimony from divorce decrees entered into after 2018 is not taxable to the recipient nor deductible by the payer (a TCJA change). This treatment also applies to pre-2019 agreements that are modified after 2018 and incorporate the TCJA change.

Pre-2019 Agreements (unmodified):

- **Received From Former Spouse** - Alimony arising from a previous marriage is treated as separate income of the spouse who receives the alimony.
- **Paid To A Former Spouse**
  - **Paid From Community Funds** - Where the obligation to pay alimony was paid out of the community property funds of the couple, they each were entitled to deduct ½ of the payment on separate returns. (Newcomb, Dorothy Vs Commissioner, United States Court of Appeals, CA-9, Feb 1953)
  - **Paid From Separate Funds** – If paid by the one obligated to make the alimony payments, the payments would be 100% deductible by that individual.
  - **Current Spouse Before Divorce Is Final** - Alimony or separate maintenance payments received from the current spouse are only taxable to the extent the payments exceed 50% (his or her share) of the reportable community income. Alimony paid deduction under these circumstances is limited to the amount treated as income by the recipient spouse.

Entity Income – Where an entity produces both earned, personal services income and investment income, such as an S-Corporation, the earned income is community income and the investment income can be either community or separate based upon whether the ownership of the corporation is community or separate.

Marriage Voided - Where a taxpayer's marriage is void, his or her income isn't community income (Barr (1948) 10 TC 1288).

Drug Trafficking – Income derived from illegal sources by one spouse, even without the knowledge of the other, is community income (Costa, TC Memo 1990-572).

Stock Options - A stock option for services rendered while a taxpayer was domiciled in a non-community state, and amounts, under a profit-sharing contract, earned by the taxpayer while a resident of a non-community state, are separate property (Veit, (1947) 8 TC 809, acq.).

Dependency – When community funds are used to provide support, the spouses can agree to claim dependencies in any manner they can agree upon. Where the spouses are separated and one spouse has legal custody of a child, then the custodial parent would need to formally waive the dependency to the noncustodial parent for the noncustodial parent to be able to claim the child as a dependent.

Deductions – Generally deductions are allocated by whether they were paid for with community or separate funds. Deductions paid from jointly held accounts are allocated as paid from community funds.

Personal expenses– Expenses that are paid out of separate funds, such as medical expenses, are deductible by the spouse who pays them. If these expenses are paid from community funds, divide the deduction equally between the spouses.

Business and Investment Expenses **-** Expenses incurred to earn or produce community business or investment income are generally divided equally between the spouses. Expenses incurred by a spouse to produce separate business or investment income is deductible by the spouse who earns the corresponding separate business or investment income. Note: prior to 2018, investment expenses were deductible as miscellaneous itemized deductions subject to 2% of AGI reduction; for years 2018-2025 these miscellaneous deductions are suspended for federal tax purposes per the TCJA.

Child Tax Credit - Only one parent can claim the child tax credit with respect to a qualifying child, and that would be the parent who claims the child as a dependent. Where the spouses are separated and one spouse has legal custody of a child, then the custodial parent would need to formally waive the dependency to the noncustodial parent. In either case, if married filing separately the AGI phase-out is half that of married filing jointly.

HEAD OF HOUSEHOLD FILING STATUS

In certain situations, one or both of the spouses may qualify for head of household. Married individuals may use this status if they:

(a) ***Lived apart from their spouse*** at least the last six months of the year,

(b) ***Pay more than one-half of the cost*** of maintaining as his or her home a household, which is the principal place of abode for more than one-half the year of a child, stepchild or eligible foster child for whom the taxpayer may claim a dependency exemption.

YEAR THE COMMUNITY ENDS

Tax liability for a tax year in which community status ends may be in part due from community income and in part due from separate income (earned in that tax year, e.g., after the marital community ended). In all states the marital community ends when there is a final divorce decree or annulment. In other situations, such as when there is a separation agreement or a court issues a decree of legal separation or separate maintenance, the end of the marital community depends on state law. For example, in some states, including California, the community may end when the spouses permanently separate, even if there is no written separation agreement.

Example - Income Allocation in Year Community Ends *- Jim and Jen, California residents, separated on 06/30; their final divorce decree was 10/31. Jim worked as a hospital administrator for the entire tax year. Jen began working in a bank on 08/01. The couple had the following income for the tax year:*

	Wages	***Jan-June***	***July-Oct***	***Nov-Dec***
Jim	*100,000*	*$47,000*	*$40,000*	*$13,000*
Jen	*23,000*		*13,800*	*9,200*
Joint Bank Account Interest		*$100*	*$50*	*$0*
Reportable income*:*		***Jim***	***Jen***	
Wages (Jan-June)		*$23,500*	*$23,500*	
Wages (July-Oct)		*40,000*	*13,800*	
Wages (Nov-Dec)		*13,000*	*9,200*	
Interest (Jan-June)		*$50*	*$50*	
Interest (July-Oct)		*$25*	*$25*	
Total		*$76,575*	*$46,575*	

Note: *Withholding taxes on the income would be allocated in the same manner as the income.*

Filing Status – Filing status is determined as of December 31 of the tax year. If the couple is still legally married as of that date, neither can file using the single status. While they are still legally married they will need to file either a joint return or two married separate status returns, unless either or both qualifies for the head of household status as explained above.

ALLOCATION FORM 8958

IRS requires Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States, to be prepared and included with Form 1040 by married taxpayers (and registered domestic partners) filing separately in community property states. Form 8958 is set up to list all of the income, deductions, credits, etc., being reported by the two taxpayers, and then these amounts are separated into columns to show how much of each item is allocated to each spouse.

SPECIAL RULE REPORTING EARNED INCOME WHEN SPOUSES LIVE APART

A special rule (Sec 879(a)) permits spouses to allocate earned income to the spouse that earned it if they so choose. This rule was created to aid abandoned spouses but can apply in cases where **ALL** the following conditions are met:

- The spouses are married to each other at any time during the calendar year;
- They live apart at **all times** during the calendar year (Regulation Sec 1.66-2(b)).
  - Taxpayers are considered living apart if they maintain separate residences.
  - Spouses who maintain separate residences due to temporary absences aren't considered to be living apart.
- **One or both of the spouses has earned income** (the term earned income includes both profits and losses from self-employment, and pass through business entities) for the calendar year that is community income, and
- No portion of that earned income is transferred directly or indirectly between the spouses during the calendar year.
  - Any amount of earned income transferred for the benefit of the spouses' child won't be treated as an indirect transfer to one spouse (Reg Sec 1.66-2(c)).
  - Husband's payments on the mortgage on the residence where taxpayer and their children lived, and on loans on other properties awarded to taxpayer under the divorce decree were indirect payments for the taxpayer's benefit (Lytle TC Memo 1992-185).
  - Transferred income doesn't include a de minimis amount of earned income that is transferred between spouses (Reg Sec 1.66-2(c)).

CAUTION: This special **rule applies to earned income only**. All other income must be divided according to community property rules. This rule does not apply to partners in registered domestic partnerships, civil unions, or other similar formal relationships that aren't marriages under state law.

Note: This is an exception to the general community property rules where earned income is split 50-50 between the spouses.

TRADITIONAL RELIEF FROM COMMUNITY PROPERTY LAW

When a taxpayer omits (does not include) an item of community income from his or her gross income, relief is not requested until the IRS challenges the omission (Reg Sec.1.66-4). Thus, there is no assurance the taxpayer will prevail.

Qualifications - The requesting spouse does not include an item of community property in his or her gross income if **ALL** of the following apply:

(1) The requesting spouse doesn't file a joint return for the tax year,

(2) The requesting spouse did not include in gross income for the taxable year an item of community income properly includible therein, which, under the rules contained in section 879(a) (treatment of community income when one or both spouses is a nonresident alien), would be treated as the income of the non-requesting spouse, and

(3) The individual establishes that he or she didn't know of, and had no reason to know of, that item of community income. All the facts and circumstances are considered in determining whether a requesting spouse had reason to know of an item of community income. The relevant facts and circumstances include, but aren't limited to:

- The nature of the erroneous item;
- The amount of the erroneous item relative to other income items;
- The couple's financial situation;
- The requesting spouse's educational background and business experience;
- The extent of the requesting spouse's participation in the activity that resulted in the erroneous item; and
- Whether the item of community income was reflected on earlier year's returns (e.g., investment income that was regularly reported on earlier years' returns).

If the requesting spouse is aware of the source of community income or the income-producing activity, but is unaware of the specific amount of the non-requesting spouse's community income, the requesting spouse is considered to have knowledge or reason to know of the item of community income. The requesting spouse's lack of knowledge of the specific amount of community income does not provide a basis for relief under this section.

(4) Taking into account all **facts and circumstances**, it's inequitable to include that item of community income in the individual's gross income. A factor in determining inequitability is whether the requesting spouse benefited, directly or indirectly, from the omitted item of community income.

CAUTION: Traditional relief is on an item-by-item basis.

Requesting Relief – Relief is not requested until the requesting spouse receives notification of an audit or a letter or notice from IRS stating there may be an outstanding liability with regard to that year. File Form 8857 - Innocent Spouse.

The latest time for requesting relief is six months before the expiration of the statute of limitations on assessments, including extensions, against the non-requesting spouse for the tax year that is the subject of the claim for relief, unless the examination of the requesting spouse's return starts during that six-month period. If the examination of the requesting spouse's return starts during that six-month period, the latest time for requesting relief is 30 days after the start of the examination.

A requesting spouse who doesn't meet the above time limitations may be eligible to request equitable relief, since the timing requirements for requesting equitable relief are broader.

EQUITABLE RELIEF FROM COMMUNITY PROPERTY LAWS

When traditional relief is not available, the IRS may relieve a taxpayer of liability for any unpaid tax or any deficiency (or any portion of either) attributable to an item of community income if taking into account all the facts and circumstances, it's inequitable to hold the taxpayer liable. The equitable relief applies to any deficiency, or underpayments of tax, including those arising from disallowed deductions or credits.

This equitable relief provision (under Code Sec. 66(c)) is similar to the equitable relief provision in Code Sec. 6015(f) – relief from joint and several liability – which relieves a spouse from liability for any deficiency or unpaid tax reported on a joint return.

The following threshold conditions must be met before the IRS will consider a request for equitable relief under Code Sec. 66(c):

(1) The spouse requesting relief must apply for relief timely. A claim is timely filed under the following circumstances:

- If applying for relief from a liability or a portion of a liability that remains unpaid, the request for relief must be made on or before the Collection Statute Expiration Date (CSED). Generally, that period expires 10 years after the assessment of tax, but other provisions of the Code may extend it.

- Claims for credit or refund of amounts paid must be made before the expiration of the period of limitation on credit or refund. Generally, that period expires three years from the time the return was filed or two years from the time the tax was paid, whichever is later.

(2) No assets were transferred between the spouses filing the joint return as part of a fraudulent scheme by the spouses;

(3) No disqualified assets were transferred to the requesting spouse by the non-requesting spouse; and

(4) The requesting spouse didn't knowingly participate in the filing of a fraudulent joint return.

(5) The income tax liability from which the requesting spouse seeks relief is attributable (either in full or in part) to an item of the non-requesting spouse with whom the requesting spouse filed the joint return.

WHEN THE IRS CAN DISREGARD COMMUNITY PROPERTY RULES

Sec 66(b) Denial of Community Property Benefits - If a taxpayer acts as if he or she is solely entitled to the community income and fails to timely notify his or her spouse of the nature and amount of the income, IRS may deny any benefit of community property laws to that taxpayer (Reg Sec. 1.66-3(a)).

- *Timely Notification* – Taxpayer fails to notify the other spouse of the nature and amount of the income before the due date (including extensions) for filing the return for the tax year in which the income was derived.
- *Acted as if Solely Entitled to the Item of Income* - Whether a spouse has acted as if solely entitled to the item of income is based upon facts and circumstances. This determination focuses on whether the spouse used, or made available, the item of income for the benefit of the marital community.

Example 1 - *Where a spouse's wages are deposited into a joint bank account from which both spouses pay bills and household expenses, the wage-earning spouse isn't acting as if solely entitled to the wages (Reg Sec. 1.66-3(c), Example 1)).*

Example 2 *– Same as example #1 except the wife had a savings account that was not known to the husband and did not share the 1099-INT from the account with him and used the funds to help support her unemployed brother. In this case the wife is acting as if solely entitled to the interest income (Reg Sec. 1.66-3(c), Example 1)).*

CAUTION: This rule can be used only by IRS in order to disallow the benefits of community property laws to a taxpayer and cannot be used by a taxpayer to avoid his or her liability for tax on community income paid to and/or earned by the taxpayer's spouse.

OTHER ISSUES

Effect of Prenuptial and Postnuptial Agreements - Taxpayers can, with a prenuptial or postnuptial (also termed pre- and post-marital) agreement, opt out of state community property laws and elect to have income treated as if they were domiciled in a non-community property state, in which case IRC § 66 would not apply. (Internal Revenue Manual, 25.15.5.3 (7-24-2017); 25.18.1.3.25 (6-6-2017))

Separate Maintenance – A decree of divorce or separate maintenance ends the community and makes later earnings separate property. However, an interest in a community property may not end where there is no division or settlement of property (Hunt, (1954) 22TC 228). In spite of a separate maintenance agreement, the parties' subsequent actions such as commingling funds could cause income to be community income.

Additional Medicare Tax – Married taxpayers filing separately who reside in a community property state must compute their additional Medicare tax based on each spouse's own wages or self-employment income.

Example *– Jack and Sally are domiciled in a community property state and are married filing separate. Jack has $200,000 in wages and Sally has $100,000 in self-employment income. Jack is liable for additional Medicare tax on $75,000, the amount by which Jack's wages exceed the $125,000 threshold for married filing separate. Sally's self-employment income of $100,000 doesn't exceed the $125,000 threshold, so Sally doesn't owe additional Medicare tax.*

Non-Resident Alien Spouse - The compensation of a U.S. citizen or resident alien, domiciled in a U.S. community property state, married to a nonresident alien retains its character as compensation for personal services derived from sources within the U.S. and taxable to the U.S. (Rev Rul 66-239).

No Relief From Community Property Available - A requesting spouse isn't entitled to relief from the federal income tax liability resulting from the operation of the community property rules under any of the four exceptions provided by Code Sec. 66 for any tax year:

- For which the requesting spouse has entered into a closing agreement with IRS (there are some exceptions not covered here), or
- Has entered into an offer in compromise with IRS.

Gifts of Community Property - Gifts of community property to a third party are generally considered to have been made one half by each spouse.

Entities owned by husband and wife as community property - *Rev Proc 2002-69* - The classification of an unincorporated business entity depends in part on the number of its members or owners. A business entity with only one owner may be classified for tax purposes as a corporation or its entity status may be disregarded. If the entity is disregarded, the activity is treated as a sole proprietorship. A business entity with two or more owners is classified as either a corporation or a partnership.

Rev Proc 2002-69: If a qualified entity and the husband and wife as community property owners treat the entity as a disregarded entity for tax purposes, IRS will accept the position that the entity is a disregarded entity. If a qualified entity and the husband and wife as community property owners treat the entity as a partnership for tax purposes and file the appropriate partnership returns, IRS will accept the position that the entity is a partnership. For this purpose, a business entity is a qualified entity if:

1. It is wholly owned by a husband and wife as community property under the laws of a state, foreign country, or a U.S. possession;
2. No person other than one or both spouses would be considered an owner for tax purposes; and
3. The business entity is not treated as a corporation under Reg. § 301.7701-2.

A change in reporting position will be treated for tax purposes as a conversion of the entity.

Inherited community property - *Code Sec. 1014(b)(6)* - Where a spouse dies owning community property and at least one-half of the entire community interest is includible in the deceased spouse's gross estate (whether or not an estate tax return is required or an estate tax is payable), the surviving spouse's interest is treated as property acquired from a decedent. Accordingly, the basis of the community property inherited by the surviving spouse gets a full step up or step down to fair market value as of the decedent's date of death (or alternate valuation date, if applicable), with some exceptions if the deceased spouse died in 2010.

Military Combat Zone Compensation - *Reg § 1.112-1(d)* - In the case of a husband and wife domiciled in a State recognized for Federal income tax purposes as a community property State, any exclusion for Combat Zone Compensation of a member of the armed services operates before apportionment of the gross income of the spouses under community law. For example, a husband and wife are domiciled in a community State and the member spouse is entitled, as a commissioned officer, to the benefit of the exclusion under section 112(b) of $500 for each month*. The member receives $7,899 as compensation for active service for 3 months in a combat zone. Of that amount, $1,500 is excluded from gross income under section 112(b) and $6,399 is taken into account in determining the gross income of both spouses.

> **The $500 per month exclusion was changed, effective Nov. 21, 1995 (see Chapter 1.08), but the monetary amounts in this example from the regulation have not been revised.*

Married to a Non-resident Alien - *Reg § 1.879-1* - Community income for this purpose includes all gross income, whether derived from sources within or without the United States, which is treated as community income of the spouses under the community property laws of the State, foreign country, or possession of the United States in which the recipient of the income is domiciled. Income from real property also may be community income if so treated under the laws of the jurisdiction in which the real property is located. Generally the following rules apply:

1) ***Earned income***. Wages, salaries, or professional fees, and other amounts received as compensation for personal services actually performed, which are community income for the taxable year, shall be treated as the income of the spouse who actually performed the personal services.

2) ***Trade or business income***. Generally for any income derived from a trade or business carried on by the husband or wife that is community income for the taxable year, all of the gross income, and the deductions attributable to that income, shall be treated as the gross income and deductions of the husband. However, if the wife exercises substantially all of the management and control of the trade or business, all of the gross income and deductions shall be treated as the gross income and deductions of the wife. The term "management and control" means management and control in fact, not the management and control imputed to the husband under the community property laws of a State, foreign country or possession of the United States.

3) ***Partnership income***. If any portion of a spouse's distributive share of the income of a partnership, of which the spouse is a member, is community income for the taxable year, all of that distributive share shall be treated as the income of that spouse and shall not be taken into account in determining the income of the other spouse.

4) ***Income from separate property*** - Income which is derived from the separate property of one of the spouses shall be treated as the income of that spouse. The determination of what property is separate property for this purpose shall be made in accordance with the laws of the State, foreign country, or

possession of the United States in which the recipient of the income is domiciled or, in the case of income from real property, in which the real property is located.

5) ***Other community income*** - Any other income for the taxable year shall be treated as income of that spouse who has a proprietary vested interest in that income under the laws of the state, foreign country, or possession of the United States in which the recipient of the income is domiciled or, in the case of income from real property, in which the real property is located.

Multiple Support Agreements in Community Property States - Compensation earned by one spouse in a community property state is community income. This means for example, that half of the funds earned by the husband and used for support are considered to be support furnished by the wife. (Rev Rul 61-52).

Example: *John and Mary are married, live in a community property state, and file a joint return. They have a 28-year old son, Leo. John and Leo are both employed; Mary does not work outside the home. John and Leo provide all the support for Angie, John's mother (Leo's grandmother). Leo provides 15% of the support. Under community property rules John and Mary would each be providing less than 50% of the support (100% - 15% = 85%/2 = 42.5%). Therefore, no one is providing over 50% of Angie's support, and for either John or Leo to claim Angie as a dependent, they would need to enter into a multiple support agreement.*

CALIFORNIA DIFFERENCES

California is a community property state and follows community property rules. The following are some special issues related to community income for California.

When Does the Community End in California? – To end a community in California does not necessarily require the couple to be legally separated or have filed for separation or divorce. The community ends when the couple separates with no intention of reuniting and is based upon the "facts and circumstances" of the situation.

Living Under the Same Roof - On July 25, 2016, Governor Brown signed SB 1255, which reverses a Supreme Court ruling (*Davis 2/20/15),* and effective January 1, 2017, defines the date of separation so that taxpayers may "separate" while continuing to live under the same roof. **CAUTION**: this law does not change the "lived apart" rule for someone still married to claim head of household filing status.

IRM 25.18.1.3.4.5 - Physical Separation (03-04-2011)- California and Washington hold that the community property estate is terminated when spouses physically separate and both spouses intend to permanently end the marriage. This mutual intent must be established through the actions and conduct of the spouses. This requires an examination of the facts and circumstances of each case, with the burden of proof on the party asserting that the community property estate was terminated. Siezer v. Sessions, 132 Wash. 2d 642, 940 P.2d 261 (1997), citing Wash. Rev. Code § 26.16.140; In re Marriage of Hardin, 38 Cal. App. 4th 448, 45 Cal. Reptr. 2d 308 (Ct. App. 1995), citing Cal. Fam. Code § 771. In these states, the Service should continue to apply community property laws to separated spouses unless both spouses have affirmatively alleged that they do not intend to resume the marriage and community property rules do not apply, and their conduct supports this.

If the clients do not have a written affirmation of separation or a legal state termination of the relationship, then this is where you should suggest the partners consult with an attorney to draw up a written document meeting the IRM's requirements.

Earned Income (Income from personal services) – Income from personal services is governed by the laws of the state of the owner's "domicile". For a California domiciled taxpayer income from personal services is considered community property.

- ***Earned in CA, Domiciled in a Non-Community Property State*** - Earnings in CA by a taxpayer domiciled in a non-community property state would NOT be community income.
- ***Domiciled in a Non-Community Property State, Married to a Spouse Domiciled in CA*** – Where a spouse is a resident and domiciled in another state, the status of that spouse's earnings as either separate or community are determined by the laws of the other state.

  BOE Decision *- Wife was domiciled in WA but a resident of CA and husband was resident of and domiciled in WA – since WA is a community property state, ½ of his wages were reportable to CA.: (Appeal of George F. and Magdalena Herrman, 8/6/1962, 62-SBE-041)*

- *Change of Domicile Before Tax Return's Due* - A spouse's income from separate property in a non-community state remains separate property even though the spouses change their domicile to CA before the tax return's due (Klise (1928) 10 BTA 1234, acq.).

Deductions - Otherwise allowable deductions paid out of community income are generally deductible one-half by each spouse. Liabilities arising against the spouse of the taxpayer while the couple was domiciled in a non-community property state, and settled while they were domiciled in California, were not deductible one half by the taxpayer-spouse (Zukor, Lottie, (1941) 43 BTA 825).

AGE RELATED ISSUES

Age - Birthday or Day Before? Since tax law includes a number of age-related issues, the date on which a taxpayer attains a specified age can have an impact on his or her income tax and the income tax of others. Per common law, a person attains a given age on the day before his/her birthday. This common law rule is why the IRS has held a person whose 65th birthday is Jan. 1 gets the additional standard deduction for the prior year.

However, in other circumstances, the common law rule has a negative impact on the taxpayer. So the IRS in Rev Ruling 2003-72 (IRB 2003-33, 8/18/2003) has ruled for purpose of various provisions included in the list below that a child attains a given age on the anniversary of the date that the child was born. For example, a child born on January 1, 2002 attains the age of 17 on January 1, 2019. The IRS reiterated this provision in Notice 2010-38 with respect to the items on the list related to changes enacted as part of the 2010 health care reform legislation.

Many of these provisions allow a credit, exclusion, or deduction to the taxpayer, provided, among other requirements, an individual has not attained a specific age. For example, under § 24(c), one of the requirements for a qualifying child for the child tax credit is that the child "has not attained the age of 17 as of the close of the calendar year in which the taxable year of the taxpayer begins." So, for example, a child born on January 1, 2002 attains the age of 17 on January 1, 2019, and would be a qualifying child for the credit for 2018 but not 2019 or later.

2019 PERTINENT AGES

BORN	***AGE***	***BORN***	***AGE***
2002	17	1969	50
2000	19	1960	59
1995	24	1954	65
1994	25	1949	70
1992	27		

ISSUE	AGE	CODE SEC.
Dependent Care Credit⬩	Under Age 13*	§ 21
Kiddie Tax	Under Age 18**	§ 1
Child Credit⬩	Under Age 17	§ 24
Adoption Credit ⬩	Under Age 18	§ 23
Adoption Assistance Program⬩	Under Age 18	§ 137
Dependency⬩	Under Age 19	§ 151
Dependent Care Assistance⬩	Under Age 13*	§ 129(e)(1)
Foster Care Payment Exclusion⬩	Under Age 19	§ 131
Full Time Student & Dependent	Under Age 24	§ 151
EITC ⬩	Under Ages 19 and 24	§ 32
Child for Purposes of Health Care Benefits⬩⬩	Under Age 27 (end of year)	Various
Catch Up Contributions	Age 50 and over	§ 414
Early Distribution Penalty	Under Age 59 ½	§ 72
Extra Standard Deduction	Age 65 and over	§ 63
Medical Expense Floor 7.5% through 2016★	Age 65 and over	§ 213(f)
Required Minimum IRA Distributions	Age 70 ½ and over	§ 401
Lump Sum Distributions (Form 4972 tax)	Born Before 1/2/36	§ 402(d)

*At time care is provided. No age limit for a dependent qualifying child or qualifying relative who is physically or mentally incapable of caring for him- or herself

** Also if age 18 with earned income less than half of support or student under age 24 with earned income less than half of support (not including scholarships)

⬩ Addressed in Rev Rul 2003-72

⬩⬩ Includes for purposes of cafeteria plans, FSAs and HRAs (§105(b)), SE health insurance deduction (§162(1)) and retiree health accounts in pension plans (§401(h))

★The percentage of AGI that reduces medical expenses, regardless of taxpayer's age, is 7.5% for 2017 and 2018 and 10% thereafter.

NOTES

REGISTERED DOMESTIC PARTNERS

Filing Status

- California – JT, MS (HH if meeting the normal HH rules)
- Federal – Single (HH if meeting the normal HH rules, though use of non-community property income to pay housing expenses is generally required)

2015 Supreme Court Same Sex Marriage Ruling –The U.S. Supreme Court ruled that the 14th Amendment to the Constitution requires a state to license a marriage between two people of the same sex and to recognize a marriage between two people of the same sex that was lawfully licensed and performed out of state. *(Obergefell v Hodges, SCt, June 26, 2015)* Since the ruling only concerns marriages, the status of registered domestic partners is not affected, and for federal purposes, RDPs still may not file as married.

Related Publications, Forms and Information Sources

- **IRS Publication 555** - Community Property - General rules for determining community and separate income.
- **IRS Q&A** – Search the IRS website under "registered domestic partners" or go to: http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Registered-Domestic-Partners-and-Individuals-in-Civil-Unions
- **Form 8958** - Allocation of Tax Amounts Between Certain Individuals in Community Property States
- **FTB Publication 737** - Tax Information for Registered Domestic Partners - Guidance for how to file joint or separate returns.
- **FTB 1051A** – Guidelines for Married Filing Separate Returns
- **Chapter 1.10** – Community Property
- **RDP Engagement Letter** – End of Chapter
- **RDP Sec 7216 Disclosure Consent** – End of Chapter

Age Requirement Removed - SB 30, signed by the governor on July 30, 2019, removes the requirement that persons be of the same sex, or of the opposite sex and over 62 years of age, in order to enter into a domestic partnership, effective 1/1/2020.

RDP Registration Requirements

To be bound by the rules for RDPs, the taxpayers must be registered with the California Secretary of State or with another state that allows registration of domestic partners. Registration at the city or county level does not count for purposes of the CA filing status rules.

Registration Qualifications – Generally, to qualify to register as a domestic partner in CA, the individuals must meet the following criteria (CA Family Code Sec 297-297.5). At the time of registration:

- Neither person is married to someone else nor is a member of another domestic partnership,
- They share a common residence,
- They are not related in a manner that would prevent them from being married in CA, and
- Both are able to consent to the domestic partnership.

In addition, there are age and gender requirements:

- If the partners are the same sex, then both must be age 18 or older unless there is a court order granting permission to establish the partnership; a certified copy of the order must be filed with the Secretary of State.

RAPID FINDER

- If the partners are of opposite sexes, then one must be age 62 or older.

Other State Status – California recognizes unions originating in another state.

Filing Status

CA State – California enacted SB 1827 as law, beginning January 1, 2007, which **requires** (it is not elective) registered domestic partners (RDPs) to use the same filing status as married couples. Thus, they must use the married joint or married separate filing status for CA. If one **RDP dies, the surviving RDP can file as married filing joint for the year the RDP dies** if he or she does not enter into a new registered domestic partnership or marriage. If the surviving RDP has a dependent child, that RDP may use the **qualifying widow(er)** status in the two years after the death.

Federal – The Federal tax system does not have an RDP status, and therefore, for Federal purposes an RDP cannot file a joint return and instead must file individually (but not married separate status). Chief Counsel Advice 201021050 has concluded that, for tax years beginning with 2007, a California registered domestic partner (RDP) is subject to the community property laws and therefore should report one-half of all community income, including compensation for personal services or income from property, on their Federal tax return.

IRS Does Not Recognize RDPs as Married

Prior to its *Obergefell* ruling, the Supreme Court held in *U.S. v. Windsor*, (Sup Ct 6/26/2013) that limiting marriages to opposite-sex couples only was unconstitutional. After the *Windsor* ruling, the IRS, in **Rev. Rul. 2013-17**, made quite clear that its position is that persons in registered domestic partnerships, civil unions, or other similar formal relationships that aren't marriages under State law aren't considered as married or spouses for federal tax purposes.

This position applies regardless of whether the individuals who've entered such relationships are of the opposite or same sex. Accordingly, they can't file federal tax returns using a married filing jointly or married filing separately status.

Head of Household - To qualify as a head-of-household under Code Sec. 2(b), a taxpayer must provide more than half the cost of maintaining his or her household during the tax year, and that household must be the principal place of abode of the taxpayer's dependent for more than half of the tax year. Where registered domestic partners pay all of the costs of maintaining the household from community funds, each partner is considered to have incurred exactly half the cost, and, therefore, neither can qualify as head of household. Where one of the partners pays more than half by contributing separate funds, that partner cannot file as head of household if the only dependent is his or her RDP because a qualifying person must be a qualified child or related even if the partner is the taxpayer's dependent. (IRS Website FAQ No. 2 & 10)

Dependency

A registered domestic partner can potentially be the dependent of his or her partner for purposes of the federal dependency deduction if (IRS Website - Q&A 11):

(i) that partner has gross income of less than the exemption amount ($4,150 for 2018), taking into account that each partner reports half of the community income of both;
(ii) more than half of that partner's support for the year is provided by the person seeking the dependency deduction from separate funds; and
(iii) other requirements for dependency are satisfied.

To satisfy the support requirement, more than half of an individual's support for the year must be provided by the person seeking to claim the dependency. If a registered domestic partner's (Partner A's) support comes entirely from community funds, that partner is considered to have provided half of his or her own support and cannot be claimed as a dependent by another. However, if the other registered domestic partner (Partner B) pays more than half of the support of Partner A by contributing separate funds, Partner A may be a dependent of Partner B if they otherwise qualify.

Qualifying Child

If a child is a qualifying child of both parents who are registered domestic partners, either parent, but not both, may claim a dependency deduction for the qualifying child. If both parents claim a dependency deduction for the child on their income tax returns, the IRS will treat the child as the qualifying child of the parent with whom the child resides for the longer period of time. If the child resides with each parent for the same amount of time during the taxable year, the IRS will treat the child as the qualifying child of the parent with the higher adjusted gross income. (IRS Website - Q&A 3)

Community or Separate Property?

IRS Publication 555 provides the following guidance for determining what property is community and which is separate property:

Community property is property:

- Acquired during registration while domiciled in a community property state. (Includes the part of property bought with community property funds if part was bought with community funds and part with separate funds.)
- Property that the partners agreed to convert from separate to community property through an agreement valid under state law.
- That cannot be identified as separate property.

Separate property is:

- Property that was owned separately before registration.
- Money earned while domiciled in a non-community property state.
- Property received as a gift or inherited separately during registration.
- Property bought with separate funds, or exchanged for separate property, during registration.
- Property that the partners agreed to convert from community to separate property through an agreement valid under state law.
- The part of property bought with separate funds, if part was bought with community funds and part with separate funds.

However, notwithstanding the guidance above, a partner's premarital separate property can become marital through transmutation or active appreciation.

- *Transmutation (a legal term)* - occurs when RDPs demonstrate an intent, by virtue of their words and actions during the period of registration, to treat one partner's separate property as joint property. (This action will require the filing of a federal gift tax return, if the annual gift tax exemption is exceeded.)
- *Active appreciation* - occurs when both partners' joint funds or joint efforts cause a partner's separate property to increase in value during their period of registration.

Another issue that can affect the separate or community property status is prenuptial and postnuptial agreements. **Caution:** These are legal documents and advice and drafting should be left to those that are licensed to practice law. Generally, five elements are required for a valid prenuptial agreement:

1. The agreement must be in writing;
2. It must be executed voluntarily;
3. There must be full and/or fair disclosure at the time of execution;
4. The agreement cannot be unconscionable;
5. It must be executed by both parties (not their attorneys) in the manner required for a deed to be recorded, known as an acknowledgment, before a notary public.

Ending the Community – To end a community in California does not necessarily require the couple to be legally separated or have filed for separation or divorce. The community ends when the couple separates with no intention of reuniting and is based upon the "facts and circumstances" of the situation.

Living Under the Same Roof - On July 25, 2016, Governor Brown signed SB 1255, which reverses a Supreme Court ruling (Davis 2/20/15), and effective January 1, 2017, defines the date of separation so that taxpayers may "separate" while continuing to live under the same roof. CAUTION: this law does not change the "lived apart" rule for someone still married to claim head of household filing status.

> IRM 25.18.1.3.4.5 - Physical Separation (03-04-2011) - California and Washington hold that the community property estate is terminated when spouses physically separate and both spouses intend to permanently end the marriage. This mutual intent must be established through the actions and conduct of the spouses. This requires an examination of the facts and circumstances of each case, with the burden of proof on the party asserting that the community property estate was terminated. Siezer v. Sessions, 132 Wash. 2d 642, 940 P.2d 261 (1997), citing Wash. Rev. Code § 26.16.140; In re Marriage of Hardin, 38 Cal. App. 4th 448, 45 Cal. Reptr. 2d 308 (Ct. App. 1995), citing Cal. Fam. Code § 771. In these states, the Service should continue to apply community property laws to separated spouses unless both spouses have affirmatively alleged that they do not intend to resume the marriage and community property rules do not apply, and their conduct supports this.

If the clients do not have a written affirmation of separation or a legal state termination of the relationship, then this is where you should suggest the partners consult with an attorney to draw up a written document meeting the IRM's requirements.

Community or Separate Income?

IRS Publication 555 provides the following guidance for determining what income is community and which is separate income:

Community income is generally income from:

- Community property.
- Salaries, wages, or pay for services while registered.
- Real estate that is treated as community property under the laws of the state where the property is located.

Separate income is generally income from:

- Separate property. Separate income belongs to the partner who owns the property.

Income & Deduction Allocations

When preparing RDP returns a preparer must carefully distinguish and allocate community income, separate income and mixed income on each partner's separate return taking into consideration federal law as it applies to treatment of certain types of income. One must also do these allocations and adjustments in such a way to accommodate the IRS informational return matching and the professional software used to prepare the returns.

Thus it becomes an accounting issue. Some practitioners like to refer to this process as "forensic accounting." You may wish to avoid the use of that term since the definition of forensic means "suitable for use in a court of law." There are also professionals that specialize in and have degrees in forensic accounting.

Keep in mind that taxpayers sign returns under penalty of perjury. Allocating separate property income or deductions related to separate property could be interpreted by opposing counsel in a separation or divorce as a transmutation to community property. Therefore care should be taken to properly allocate income and deductions on the separate federal returns. When making the determinations:

- Employ a reasonable basis;
- Document your methodology; and
- Have partners or spouses agree in writing to the allocations.

Allocation Form 8958 – IRS requires Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States, to be prepared and included with Form 1040 by registered domestic partners domiciled in California, Nevada and Washington. Form 8958 is set up to list all of the income, deductions, credits, etc., being reported by the two taxpayers and then these amounts are separated into columns to show how much of each item is allocated to each partner.

In the past we provided a ClientWhys-designed worksheet that developed a plus or minus adjustment for each partner or spouse to be entered on the "other income" line of Form 1040. However, we have withdrawn that worksheet and advocate only using Form 8958 and not making an overall adjustment on just one line (but there still may be specific types of income where using this method to back out income from one RDP and adding it to the other RDP's return is still the better way to accurately reflect the income). Reports from preparers indicate that the use of 8958 draws significantly fewer CP2000s and the form can be e-filed.

Income Issues

Following is a list of various types of income and whether each is community or separate income for Federal filing purposes. In years where a registration began or ended, income shown as community income would be separate income before the registration and after the registration ends, and would need to be prorated accordingly. In addition, federal law sometimes dictates how certain income must be reported.

Gross Income – In determining gross income, AGI, and MAGI registered domestic partners must each report half the combined community income earned by the partners. In addition to half of the community income, a partner who has income that is not community income must report that separate income. (IRS Website - Q&A 9 and 15)

Earned Income – Even though community property laws are taken into account in determining adjusted gross income (AGI) or modified AGI (MAGI) (IRS Website Q&A 9), community property laws are NOT taken into account in determining earned income for purposes of certain credits. (IRS Website Q&A 18) Thus the following credits would be based on the individual partner's earned income without respect to community property rules:

- Earned Income Tax Credit (Sec 32(a))
- Child and Dependent Care Credit (Sec 21(d))
- Additional (Refundable Portion) Child Tax Credit (Sec 24(d))

However, for purposes of the AGI limitations for the above credits, use the return's AGI, i.e., the AGI determined using community property rules. (IRS Website Q&A 19)

Alimony – Alimony arising from a previous heterosexual relationship is treated as separate income of the RDP who receives the alimony and deductible by the payer. (Note: Alimony from a divorce agreement entered into after 2018 is not income to the recipient nor deductible by the payer.) However, if the alimony is the result of an RDP relationship that is not recognized for federal purposes, the treatment of such payments and income is uncertain. IRC Sec 71 allows a deduction for alimony paid to a spouse. For federal purposes the partners are not spouses, so Sec 71 does not apply. Also see "RDP Spousal Support" below.

- <u>Payments prior to divorce or termination of the registered domestic partnership</u> – Pre-divorce or pre-termination payments of alimony or separate maintenance presumably are taxable to the recipient RDP partner only to the extent the payments exceed that individual's share of reportable community income. In this situation in heterosexual or legal same-sex marriages, the payer is allowed an alimony deduction for the amount that exceeds his or her part of community income. Whether an RDP would be entitled to a deduction is not clear but probably no.
- <u>Payments after divorce or termination finalized</u> – The IRS has not issued a ruling on how to treat these payments. If the regular alimony rules do not apply (because the union isn't recognized under federal law), then for federal purposes the recipient most likely would be taxed on the income and the payer would not be eligible to claim a deduction. Could these payments be considered a gift? Probably no, because they are not being made voluntarily but under court order.

Social Security Income – Generally, state law determines whether an item of income constitutes community income. Accordingly, if social security benefits are community income under state law, then they are also community income for federal income tax purposes. If social security benefits are not community income under state law, then they are not community income for federal income tax purposes. (IRS Website Q&A 14)

Social Security benefits are based on the contributions of the individual; in the case of married individuals, a spouse who does not qualify based upon his/her own contributions can qualify for benefits based upon his/her spouse's earnings and attaining retirement age. Here again, the term spouse is used and the RDPs are not spouses for Federal purposes. <u>*Thus for purposes of RDPs, Social Security benefits are separate income.*</u>

Interest Income – Funds (accounts) generating interest income can be either separate or community funds. Thus depending upon the source of the interest income it can be either separate or community income.

Dividends – Funds (accounts) generating dividend income can be either separate or community funds. Thus depending upon the source of the dividend income it can be either separate or community income.

Unemployment Income – Since Unemployment income is a substitute for current earnings it is treated as Community income.

Disability Income – Since disability income is a substitute for current earnings it is treated as Community income.

IRA & SEP Distributions – Traditional IRAs, Roth IRAs, SIMPLE IRAs, and SEP IRAs are separate property by definition and the distributions are reported to the individual who owns the IRA. This is not to say that at separation or dissolution of the registration that a judge might not consider some portion of them to be community property for purposes of dividing up the community assets.

Spousal IRA – There can be no spousal IRA for RDPs and the special provisions that apply to a spouse inheriting an IRA also do not apply.

Coverdell Education Savings Account (ESA) Distributions – ESAs, like IRAs, are deemed to be separate property, and the distributions are reported to the individual who owns the account.

Cancellation of Debt – Treatment generally follows state law. Generally personal debt will be community debt and business debt depends upon whether the debt is secured by community or separate property such as a business or rental.

> ***Example - CA Family Law Section 910(a)*** - Except as otherwise expressly provided by statute, the community estate is liable for a debt incurred by either spouse before or during marriage, regardless of which spouse has the management and control of the property and regardless of whether one or both spouses are parties to the debt or to a judgment for the debt. Sections 911 through 916 include a number of exceptions.

Employment Stock Options – Are stock options community or separate property? Is that decision based upon the grant, vesting or exercise date? Perhaps the decision is based upon whether the stock was purchased with community or separate property funds. Presently there is no official guidance. Without official guidance it is up to the taxpayers to decide on the appropriate methodology. Again this decision can have implication if the partners subsequently separate so it may be appropriate to have them agree in writing to the methodology used.

Generally W-2 income is treated as current income which is community income. However, when an individual exercises a non-qualified option or has an early disposition of a qualified (incentive) option the difference between the option price and FMV at the date of exercise gets added to the individual's W-2 income. Again, no guidance is provided but it would seem that the portion of the W-2 income representing the imputed stock appreciation may need to be allocated between community and separate income.

Sales to Each Other – IRC Sec 267 bars losses derived from sales to related parties. For federal purposes RDPs are not related, and therefore Sec 267 will not apply. This creates some interesting tax planning opportunities as the laws now stand. However, California follows Sec 267, creating a difference in loss allowances and basis from the Federal transaction. One might not be too aggressive here for fear of a retroactive ruling.

Capital Gains and Losses – Here an RDP may have both separate property and community property capital gains and losses. Allocate as appropriate. However keep in mind that on Form 1099-B (or substitute statement) the gross proceeds, and in some cases the basis (under the basis reporting requirements effective as of 2011 returns), will be reported under the SSN of only one RDP. Splitting the gains and losses will necessitate adjustment entries on IRS Form 8949 to avoid a mismatch with the IRS and follow-up correspondence.

Example – Splitting Gains/Losses: *Todd and Ron are registered domestic partners who maintain a joint brokerage account that was funded with community property funds. In 2019, they purchased 100 shares of XYZ Co. on Feb. 13 for $9,500 and sold the shares on May 8 for $10,422, resulting in a short-term profit of $922. The 1099-B from the broker was issued with Todd's Social Security number. For federal purposes, Todd and Ron each include half the profit ($461) on their individual returns. Todd's Form 8949 is completed by including 100% of the sales price and cost in columns (d) and (e), respectively, and showing a negative 461 (the half of the profit that belongs to Ron) in column (g). The code for column (f) is "N" (nominee). Todd's Form 8949 is shown next.*

Form **8949** — Department of the Treasury, Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Information about Form 8949 and its separate instructions is at *www.irs.gov/form8949.*
▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074 — 2019 — Attachment Sequence No. 12A

Name(s) shown on return: TODD EXAMPLE — Social security number or taxpayer identification number: 111-22-3333

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are short term. For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☑ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS
☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
100 SHARES XYZ	2/13/19	5/08/19	10,422	9,500	N	-461	461

Ron's Form 8949, shown below, is completed using half of the sales price and cost amounts, and with box C checked since no 1099-B was issued in Ron's SSN. By entering only 50% of the sales price and cost, no adjustment is needed in column (g) and no code entry is made for column (f). Since the 1099-B was not issued to Ron, box C of the 8949 is checked. When completing Form 8958 (not illustrated), enter 100% of the gain in column 1 on line 6 (identified as "total short-term capital gain/loss") and 50% of the gain in each of columns 2 and 3.

Form **8949** — Department of the Treasury, Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Information about Form 8949 and its separate instructions is at *www.irs.gov/form8949.*
▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074 — 2019 — Attachment Sequence No. 12A

Name(s) shown on return: RON EXAMPLE — Social security number or taxpayer identification number: 222-11-3333

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are short term. For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS
☑ **(C)** Short-term transactions not reported to you on Form 1099-B

1

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
50 SHARES XYZ	2/13/19	5/08/19	5,211	4,790			461

Capital losses - In the case of capital losses, for federal purposes since the RDPs each file individual returns, each would be allowed up to $3,000 of loss, while on their CA joint return they would only be allowed a single $3,000 ($1,500 if filing separate), which will create different carryovers on the federal and state returns.

Wages – IRS Pub 555 indicates that wages should be split on line 7 of the 1040 (versions 2017 and prior; line 1 of 2018 and 2019 versions). However, in doing so the tax software will treat the community property allocation to the other partner as earned income for a number of issues, such as IRA deductions and the dependent care credit, the refundable portion of the child tax credit, and the earned income tax credit, which is not correct. The IRS website (Q&As 18 and 24) clearly states that earned income for these purposes is determined without respect to community property rules.

> ***Recommendation:*** *include the entire W-2 on the return of the individual who earned it and make the appropriate community property adjustments on the 1040, Schedule 1, Line 21 (2018) or line 8 (draft 2019 version), for each partner.*

Wage Withholding – Pub 555 indicates that withholding associated with community income should be split between the partners. The IRS website (Q&A 16) states (emphasis added), "Because each registered domestic partner is taxed on half the combined community income earned by the partners, each is *entitled* to a credit for half of the income tax withheld on the combined wages." However, splitting the withholding is inviting correspondence from the IRS since the entire W-2 is reported to the individual who earned the income. Where the W-2 income can be split using 1040, Schedule 1, line 21 (2018) or line 8 (draft 2019), while matching and thus giving the IRS computer a matching number with regards to W-2 income, there is no similar ability to split the withholding. This essentially leaves two options: leave all the withholding on the return of the partner who earned the W-2 income or split the withholding and deal with the potential post-filing correspondence. (Form 8958 appears to be helping IRS sort out the allocation for matching purposes; practitioners have indicated that there are fewer CP2000s on this issue than before the 8958 was created.) Where a practitioner wishes to split the withholding, most commercial software packages provide an entry for "other withholding" which allows positive and negative entries to accommodate the allocation.

Wage FICA Withholding – The FICA withholding cannot be allocated. It has already been reported to the Social Security Administration and credited under the SSN of the individual who actually earned it.

Employer Reimbursed Medical Care Plans – Employer-paid medical plans are excludable from taxable income (Sec 105(b)) if the care is for the taxpayer, spouse or dependents. Thus, unless the partner qualifies as a dependent (as discussed earlier), any employer-provided care for the non-employee partner would not be excludable for Federal tax purposes. Unlike the requirements for the dependency of a qualifying relative, Sec. 105(b) does not require that the non-employee partner's gross income be less than the exemption amount in order for that partner to qualify as a medical dependent of the employee-partner, provided the dependency support requirement is satisfied (IRS Website Q&A 12). Whether or not the exclusion applies will depend on individual circumstances. However, on the joint California return it would be excludable. When the exclusion does not apply for federal, the employer may or may not have taken the differences into account, and the W-2 should be analyzed to see how the employer dealt with the situation.

If the employer handled it correctly, then the CA taxable W-2 income should be lower by the amount of the non-dependent partner's plan costs that were not excludable for Federal taxable W-2 income. If not handled correctly on the W-2, an adjustment can be made on the California Schedule CA.

Self-Employment Income – Treat self-employment income as community income for income tax purposes. This includes sole proprietorships and distributive income from partnerships. Half of the income, deductions, and net earnings of a business operated by a registered domestic partner must be reported by each registered domestic partner on a Schedule C (or Schedule C-EZ). In addition, each registered domestic partner owes self-employment tax on half of the net earnings of the business. (IRS Website Q&A 15)

Self-Employment Tax – Pub 555 states that RDPs in California report community income for self-employment tax purposes in the same way they do for income tax purposes. Thus Pub 555 dictates that partners that split SE income each also compute the SE tax based upon their share of the split income. Although the employment tax rules prohibit spouses from treating net earnings as community income (section 1402(a)(5)), registered domestic partners are not spouses as defined by federal law and this provision does not apply to them. (IRS Website Q&A 15)

Splitting SE Tax or Not

Although it is clear that the SE income should be split according to community property rules, there are many practitioners who disagree with Pub 555 and the IRS Website Q&A and believe the SE tax should be applied solely to the individual who actually earned the income. IRS pubs and the IRS Website are neither code nor regulation and can be ignored with impunity so long as there is a basis for doing so. Thus many practitioners are applying the SE tax to the individual who actually earned the income.

The following are recommended ways of dealing with splitting the SE income depending upon whether you wish to split the SE tax or not:

Splitting the SE Tax – If you wish to follow Pub 555 and the IRS website guidance, then:

- Enter the entire Schedule C income and deductions on the return of the one who actually earned the income.
- On Schedule SE input for the one who actually earned the income, make a negative adjustment for 50% of the SE income.
- On the actual self-employed person's 1040, Schedule 1, "other income" line (line 21 (2018) or line 8 (2019)) back out 50% of the net SE Income.
- On the return of the other partner add a Schedule C and label it RDP Community Income Split and enter the community property share of net income under gross income. Ensure that this income is reported on Schedule SE for the partner to whom the income was transferred.

Not Splitting the SE tax – If you wish to apply the SE tax entirely to the one that actually earned it:

- Enter the entire Schedule C income and deductions on the return of the one who actually earned the income.
- On 1040, Schedule 1, "other income" line (line 21 (2018) or line 8 (2019)) back out 50% of the net SE Income. Make no adjustment for Schedule SE.
- On the other partner's 1040, Schedule 1, "other income" line (line 21 (2018) or line 8 (2019)) add in 50% of the net SE Income.

Self-Employed Retirement Contributions – Self-employment income is community income for income tax purposes and each partner is required to report 50% of the income and pay the self-employment tax on the income on his or her federal return. (IRS Website Q&A 15) Therefore, based upon the presumption that each partner is subject to SE tax, then it would seem that each partner is able to make contributions to an SE retirement plan based on their 50% of the reported income in the normal manner.

Out Of Whack – The retirement plan contribution issue still seems out of whack! If one of the RDPs is a wage earner contributing to a 401(k), those contributions are presumably based on all of that person's wages, even though the wages have to be split for income tax reporting. So why should the non-self-employed RDP be allowed to contribute to an SE retirement plan based on the other partner's SE income just because the income has to be split for income tax and self-employment tax reporting purposes? Is it OK to use the 50% of net SE income reported by the non-SE RDP to qualify to fund a regular or SEP IRA?

IRA (which include SEP IRAs) rules are applied without regard to community property rules. (Code Sec 408(g)) To compute the amount that can be contributed to a SEP, the net SE income is reduced by a portion of the SE tax deductible on line 27 (2018) or 14 (draft 2019), Schedule 1, of Form 1040, and then the applicable contribution rate is applied.

Neither Pub 555 nor the IRS Website Q&A provides any guidance in this area of how to determine the SE tax to use – probably because there is no rational answer in light of the SE Tax treatment discussed above. However, the IRS Website clearly states the partner is subject to the SE tax on his or her portion of the net SE income.

As an example*, the net from the Schedule C of an RDP before the community property allocation is $40,000. Each RDP includes $20,000 in income and pays SE tax on $20,000 (according to Pub 555). The RDP who actually owns/operates the business wants to contribute to a 25% SEP. Would the contribution amount be 20% x ($40,000 – 50% of SE tax figured on $20,000) or would it be 20% x ($40,000 – 50% of SE tax figured as if this RDP had reported all $40,000)?*

Pension Income – Income from qualified plan distributions can be either community income or separate income based upon the amount of separate and community income used to fund the account. One possible proration scenario would be prorating by the years before and after the registration. Other methods of allocation may be possible; however Pub 555 only talks about "periods of service".

Example – Prorating by Years – Suppose Dave has had a 401(k) plan since January 1 of 2009. He and Don register as domestic partners on Jan 1, 2016. On January 1 of 2019 Dave retires and begins taking distributions from his 401(k) plan. Dave had the 401(k) plan for 10 years, three of which were during the registration period. Thus prorating by years, Dave's 401(k) distributions would be 70% separate income and 30% community income. In this example, Dave would back out 15% (50% of 30%) of his pension on Form 1040, Schedule 1 "other income" line (line 21 (2018) or line 8 (2019)), and Don would add 15% of the pension income to his 1040, Schedule 1 "other income" line (line 21 (2018) or line 8 (2019)).

Lump Sum Distributions – Community property rules are disregarded for qualifying lump sum distributions where the 10-year averaging option is utilized.

Federal Civil Service Retirement – Whether a civil service annuity is separate or community income depends on the employee's status as an RDP and domicile when the services were performed for which the annuity is paid. Even if the taxpayer now lives in a non-community property state and receives a civil service annuity, it may be community income if it is based on services performed during the registered domestic partnership and while domiciled in a community property state.

Example – Mixed Income - Jake retired in January of 2016 after 30 years of civil service. He and his partner have been registered in CA since January of 2012. They have been domiciled in CA for the entire period. Thus 13.33% (4/30) of the pension payments are community income and the balance is separate income. Assuming Jake's 2019 pension income is $40,000, the following is the allocation between Jake and his partner:

		Jake	Partner
Separate Income (86.67%):	$34,668	$34,668	
Community Income (13.33%):	5,332	2,666	$2,666
Total	$40,000	$37,334	$2,666

Sec 199A Deduction – The TCJA added a new deduction used to figure federal taxable income, effective with 2018 returns, that is generally 20% of the "pass-through" income from the taxpayer's trades and businesses (see details in Chapter 3.24). This deduction presents us with the same issues discussed above related to self-employment. Should 100% of the deduction be claimed only on the federal return of the RDP whose business or rental income is the basis for the deduction, or because of the IRS' requirement to treat such income as community property income, should each RDP claim the deduction on their individual federal return based on the split of community income? This is but one of many questions awaiting guidance from the IRS on this new code section.

California has not conformed to this deduction, and isn't likely to do so.

Other Issues

Expenses – The principle of community income in community property states treats **half of community income and expenses as belonging to each spouse.** Thus 50% of the expenses directly associated with community income should be split between the spouses on their Federal returns. The IRS says the same principle applies for the returns of registered domestic partners in California.

The treatment of expenses not related to community income should be based upon the expense and whether it was paid from community or separate funds. Not all expenses paid with community funds can be split 50-50. An example is home mortgage interest where one of the partners does not have an equitable interest in the property. In such a case only the equitable-interest partner would be able to deduct one half of the interest and the other partner could deduct none (see Home Mortgage Interest and Equitable Ownership below).

Similar problems could arise where the education or medical expense of one partner is paid from community income. On their Federal tax returns they are not allowed to deduct education or medical costs for the other partner, and careful planning should be employed when determining if an expense is paid with community or separate funds. Do keep in mind gifts to pay for education and medical expenses are excludable from the gift tax rules when payments are made directly to the educational institution or medical providers. However, in Lang v. Commissioner TC Memo 2010-286 direct donor transfers made to a donee's medical care provider by a third party (in this case the mother) were treated as gifts to the donee and subsequently deductible by the donee.

Transferring Property – Placing a partner on the title of a separate property is a gift and subject to the normal gift rules and gift tax filing requirements. Keep this issue in mind when establishing an equitable interest in a property for purposes of splitting interest and tax deductions (see Home Mortgage Interest and Taxes below). To avoid gift tax issues consider a tenant-in-common ownership that can provide for a specific, less than 50%, ownership for the donee.

Basis Step Up – Step Down – Presumably, for federal purposes, there is no community property basis adjustment on both halves of the property when one of the RDPs dies (because they are not "spouses"). Only the inherited portion will receive a basis adjustment and the inheriting partner will retain his or her basis on their portion. For California, however, the usual full step-up/step-down basis adjustment will apply to the entire community property, creating a difference in basis for federal and state.

Itemized – Standard Deductions - For federal purposes, a registered domestic partner may itemize or claim the standard deduction, regardless of whether his or her partner does the same. (IRS Website Q&A 4) Typically this situation can arise when some of the deductible items are paid with separate property funds. When filing married separate status on California returns, RDPs must use the same deduction method, i.e., both must itemize or both must use the standard deduction. When filing a joint California return, the use of itemized deductions or the standard deduction is not dependent on which method was used on the partners' federal returns.

Estimated Tax Payments – The Federal estimated tax payments must be claimed by the one who pays them. There is no way to allocate them at this time in the Federal processing system. It is therefore necessary that careful consideration be given to preparing estimates based on the community property allocation lest you end up with one partner being underpaid and subject to underpayment penalties while the other has a substantial refund. (IRS Website Q&A 17)

Extensions – Each partner is required to file their own individual federal extension. However, for state purposes they can file a joint extension just like a married couple.

Bank Accounts – It may be appropriate for the RDPs to maintain a joint checking account and for each RDP to also have a separate checking account. Deductions are generally allowed to the taxpayer who is liable for the payment and who actually makes the payment. Having a joint and two separate accounts will allow the partners to selectively pay expenses either jointly or separately to take advantage of certain tax benefits. An example would be where one might qualify for head of household if that partner pays over half the cost of maintaining the household for a qualified individual.

Treatment of Community Income Where Spouses Live Apart – IRC Sec 66 provides that where spouses live apart at all times during the year, community property rules can be disregarded. However, because for federal tax purposes registered domestic partners are not "spouses," Sec 66 does not apply to registered domestic partners. Therefore they are always subject to the community property rules as long as the RDP agreement is in place. (IRS Website – Q7)

Rental Income or Loss - IRC 469 limits the rental real estate passive loss of an individual to a maximum of $25,000 and phases out that maximum loss when federal AGI is between $100,000 and $150,000. Attempting to make the community property rental gain or loss adjustment on Form 1040, Schedule 1 "other income" line (line 21 (2018) or line 8 (2019)) can lead to inaccurate passive loss limitation and carryover calculations. Therefore it is recommended that the adjustments be made on Schedule E where the appropriate apportionment of income and expenses can be made between the two partners.

<u>*Caution:*</u> Since for CA the partners are filing jointly they only have a $25,000 maximum passive loss limit, whereas for federal purposes they each enjoy the $25,000 maximum loss limit. In addition, on a joint return the partners' incomes are combined, which will create a faster phase out than on the individual Federal returns when the phase out floor is exceeded.

Home Mortgage Interest - IRC 163(h) limits the deduction for qualified residence interest to interest on $1 million of acquisition debt ($750,000 for debt incurred after December 15, 2017) and, for years before 2018 and after 2025, $100,000 of equity debt. Chief Counsel Advice CCA200911077 took the position that the $1 Million of acquisition debt limitation applies to the residence not the individual owners. Although not addressed in the Chief Counsel Advice it would seem that the IRS would also say that the $100,000 equity debt would also apply to the residence and be limited to a single $100,000. **Note**: Home equity debt interest is not deductible on Schedule A for years 2018 through 2025. However, it may be traceable to another deductible purpose using the general interest tracing rules; see chapter 2.15.

The Tax Court backed up the IRS by ruling in *C. J. Sophy, 138 TC No. 8, Dec. 58,965* that the unmarried co-owners are collectively limited to deducting interest paid on a maximum of $1.1 million of acquisition and home equity indebtedness. However, the Ninth Circuit Court of Appeals reversed the Tax Court's decision and has held that the mortgage-interest deduction debt limits are applied to the unmarried co-owners on a per-taxpayer, not a per-residence, basis. The IRS has announced its acquiescence with the Ninth Circuit's decision. Under this interpretation, two unmarried co-owners are collectively limited to a deduction for interest paid on a maximum of $2.2 million, rather than $1.1 million, of acquisition and home equity indebtedness (Voss - IRB 2016-31, p. 193). For post-12/15/2017 debt, two unmarried co-owners would be collectively limited to deduct interest paid on $1.5 million of acquisition debt. This can have significant implications for unmarried co-owners of a home. However, because the RDPs are filing married joint or married separate status for California, the $1.1 million (or $550,000 for MFS) indebtedness cap will apply on their California return. (As of early July 2019, California has not conformed to the reduced acquisition debt limit and the no-equity-debt interest deduction changes of the TCJA.)

AMENDED OPPORTUNITY -Taxpayers who previously limited their interest deduction in accordance with the IRS' position and Tax Court ruling may be able to amend open year federal returns for a refund.

Home Mortgage Interest and Equitable Ownership – Individuals are allowed to deduct interest only if they are liable on the loan or have an equitable interest in the property, and they make the mortgage payment. Where an individual makes the mortgage payment but is not liable on the loan, and does not have an equitable interest in the property, that individual cannot deduct the mortgage interest and neither can the individual who is liable on the loan.

Home Gain Exclusion - IRC 121 allows an exclusion of gain on sale of a principal residence up to $250,000 on an individual return where the individual owned and used the home as a principal residence for 2 of the 5 preceding years. It also permits a $500,000 exclusion on a joint return where both filers used the home as their principal residence and **one** of the filers owned the home for 2 of the prior 5 years. Thus it is possible that where only one of the filers owned the home they would qualify for the $500,000 exclusion on the CA joint return but only one of them would qualify for a $250,000 exclusion when filing individual Federal returns.

Tuition Credit – Who Claims the Credit? – This question sometimes arises related to the education credits on the federal returns. By law the credit goes to the individual who claims the student as a dependent, no matter who pays the tuition. So each partner could pay tuition for a particular student but the credit goes to the one who claims the student's dependency. If community funds are used to pay the education expenses, the student partner may determine the credit as if he or she made the entire expenditure. In that case, the student partner has received a gift from his or her partner equal to one-half of the expenditure. (IRS Website – Q23)

Higher Education Interest Deduction – On a joint CA return the interest deduction is limited to $2,500 but on individual Federal returns each RDP would be allowed a deduction of up to $2,500. In addition, the AGI phase-out may impact the joint return differently than the individual returns.

Child & Dependent Care Credit – For individuals the federal credit is limited by the individual's earned income, with community property rules being disregarded for purposes of determining earned income. However, on a joint return for CA purposes the credit is limited to the earned income of the lower earning partner. Thus where only one partner has earned income no credit would be allowed on the CA return even though credit was allowed on the federal individual return of the working partner. Even where both have earned income, because the credit is limited to the earned income of the lower earning partner, the credit may be reduced from the amount allowed for federal purposes.

Investment Interest Expense Deduction & Carryover – The Schedule A deduction for investment interest expense is limited to net investment income. On a joint CA return the investment income, investment expenses and investment interest of the individuals are combined and can produce results that are quite different from that of the individual federal returns of the partners. The currently deductible and carryover investment interest expense deductions can also be affected by pre-registration carryovers, and amounts related to separate and community incomes.

Net Operating Loss Carryback or Carryforward - If taxpayers haven't been married to each other in all net operating loss years, the net operating loss deduction may only be taken by the spouse who incurred the loss and only to offset income generated by that spouse in the carryback or carryforward years (Rev Rul 60-216). Here again the ruling refers to a spouse and the RDPs are not spouses for Federal purposes**. Note**: For federal NOLs incurred after 2017 there is no carryback provision. For CA NOLs occurring in taxable years beginning after December 31, 2018, the 2-year carryback period is repealed. See Chapter 3.16 for details.

California Joint Return – Based on the foregoing, where the NOL occurred in a year prior to becoming RDPs, the NOL loss would retain its character as a separate property deduction and can only offset the income of the partner to whom the carryforward is attributable.

Federal Returns – Since RDPs are filing individual returns the NOL goes on the return of the individual to whom the carryback or carryforward is attributed.

Employer Dependent Care Assistance (Sec 129) - Maximum W-2 exclusion per year is $5,000 ($2,500 for MFS). However on individual federal returns it is possible that each partner may have had dependent care benefits exempted from their pay, thus exceeding the $5,000 limit on the joint CA return. When this occurs, the Federal AGI for CA limitation purposes is increased by the amount that exceeds $5,000.

Adoption Expenses - The question has arisen whether the Federal tax credit can be claimed for the adoption expenses of an RDP adopting their partner's child. The Sec 36C(d) definition of qualified adoption expenses includes the following statement: "*(C) Which are NOT expenses in connection with the adoption by an individual of a child who is the child of such individual's spouse*."

Federal Returns - According to the IRS website, registered domestic partners are not considered spouses and therefore each registered domestic partner may qualify to claim the adoption credit maximum $14,080 per child in 2019; Rev Proc 2018-57) on the amount of the qualified adoption expenses paid or incurred for the adoption. However, the partners may not both claim credit for the same qualified adoption expenses, and the sum of the credit taken by each RDP may not exceed the total amount paid. Thus, if both RDPs paid qualified adoption expenses to adopt the same child, and those expenses total more than $14,080, the maximum credit available for the adoption is $14,080. This maximum may be allocated between them in any way they agree, and the amount of credit claimed by one partner can exceed the adoption expenses paid by that person, as long as the total credit claimed by both partners does not exceed the total amount paid by them. (Q&A 5) Additionally, if a registered domestic partner adopts his or her partner's child, the adopting parent can claim the adoption credit. (IRS Website Q&A 6) Where a registered domestic partner adopts his or her partner's child and the adoption expenses are paid from community property sources, then the adopting partner would only be able to use 50% of the expenses.

California Joint Return – Adoption of a partner's child does not give rise to a CA credit since the CA adoption credit only applies to adoptions of children from a CA public agency or political subdivision.

CA AGI Limitations – Federal AGI is used to determine various limits on CA returns, including: medical expenses, miscellaneous itemized deductions, IRA contributions and certain other phase-outs. The federal AGI of an RDP or former RDP for limitation purposes will be the AGI determined as if the RDP or former RDP filed a federal income tax return using the same filing status as used to file their California income tax return. If no RDP adjustments, simply use the AGI(s) on the federal return(s). If an adjustment is necessary, use the worksheet in FTB Pub.737 or a pro forma federal return. (SB 105-2007)

Exemption Allowances – For years before 2018 and after 2025, each RDP claims his or her own exemption deduction on their individually filed federal returns. The TCJA suspended the filer, spouse and dependent exemption deductions for years 2018 through 2025 but enhanced the child tax credit by doubling the credit amount and making up to 40% refundable, as well as adding a new nonrefundable credit of $500 per dependent who is not a qualified child. If community funds are used to support more than one person who would otherwise qualify as a dependent, but neither RDP qualifies on his or her own to claim the dependency, the RDPs can agree which one of them will claim the dependent(s). They cannot, however, each claim half of the total exemption allowance amount in years when the exemption deduction is allowed.

Form DE-4, Withholding Allowance Certificate– Because of the RDPs' different federal and CA filing statuses careful consideration should be given to the differences in the DE-4 and the W-4. Without careful planning, RDPs may encounter over- or under-withholding. Under-withholding of taxes may result in penalties.

Form 593-B, Real Estate Withholding Tax Statement - RDPs who sell or transfer jointly owned CA real property are treated as spouses for purposes of completing Form 593-B Real Estate Withholding Tax Statement. Therefore, Real Estate Escrow Persons may complete and provide RDP's with a combined Form 593-B listing both partners for the completed real estate transaction

RDP Spousal Support – If a California Family Law Court awards spousal support (alimony), and the payment satisfies the requirements under tax law for alimony, it would be deducted by the payor and included by the payee on their CA returns. (As of early July 2019, California has not conformed to the TCJA change that makes alimony from post-2018 divorce decrees nontaxable to the recipient and nondeductible by the payer.) Since federal tax law does not include an RDP category, the federal treatment of these payments is uncertain. See "Alimony," above.

RDP Property Settlements - If a California Family Law Court orders a division of mutually acquired property (acquired with separate and/or community funds), the treatment is the same as for a property transfer by married individuals in a divorce: no taxable event and each individual would assume the joint basis of the property he or she receives. However, since federal tax law does not recognize RDPs as being married, the treatment of the transactions is uncertain at this time. For federal purposes it could be a gift, sale or part gift and part sale.

California Schedule CA Adjustments (line number references are for 2018 version)

- **Accident and Health Insurance Exclusion of Income –** CA law does, and federal law does **not**, allow exclusion for accident and health insurance paid by the employer for a registered domestic partner and the partner's dependents. (IRC §106(a), California R&TC §17021.7). Enter as an adjustment on Schedule CA (540 or 540NR), line 1, column B the amount included in federal income.
- **Medical Expense Reimbursement as an Exclusion from Income -** CA law does, and Federal law does **not,** allow exclusion for medical expense reimbursement paid by the employer for a registered domestic partner and the partner's dependents. (IRC Code §105(b), California R&TC §17021.7). Enter as an adjustment on Schedule CA (540 or 540NR), line 1, column B the amount included in federal income.

- **Employer Reimbursement of Federal Tax for the Non-Employee RDP's Non-excludable Insurance Premiums** – When the benefits for an RDP are not excludable for federal purposes, some employers choose to reimburse their employees for the additional federal tax they pay on the non-excludable benefits. Effective October 1, 2013, Assembly Bill 362 provides that, if an employer reimburses an employee for the federal tax on the non-dependent RDP partner's health care benefits, the employee may exclude that reimbursement from California tax, with the adjustment made on the FTB Schedule CA. The reimbursement is taxable for federal purposes. This provision ends after 2018.

  Example *– Ted and Harry are RDPs. Ted's employer provides health care benefits for its employees, and the employer's plan also includes benefits for RDPs. Both Ted and Harry utilize Ted's employer's plan and the annual cost of insurance for them is $4,500 each. In addition Ted's employer reimburses Ted $1,125 for the federal tax on Harry's insurance cost, which is not excludable for federal purposes. Thus for Ted's 1040 only the cost of his own insurance is excluded, but the $4,500 value of Harry's insurance and the $1,125 tax reimbursement are taxable. On their joint California return both the $4,500 cost of Harry's insurance and the $1,125 federal tax reimbursement from the employer are excluded.*

- **Medical Expenses -** CA law does, and federal law does **not**, allow a deduction for medical expenses or qualified long term care insurance incurred for a registered domestic partner and the partner's dependents. (IRC Code §213(a), California R&TC §17021.7). Enter as an adjustment on Schedule CA (540 or 540NR), Adjustments to Federal Itemized Deductions, under the line for Other adjustments. Enter the allowed amount as a positive number.

Compliance Issues

- **Conflict of Interest –** Preparing the separate federal returns of both parties involves inherent conflicts of interest. In addition, when representing both taxpayers, conversations or other communications between either party and the preparer is not considered confidential and is available to the other party. The RDPs must consent to the sharing of tax return information needed to complete and file both parties' returns. **A recommended engagement letter dealing with these issues is included at the end of this chapter.**

- **Section 7216 Consent -** Preparing the tax returns of registered domestic partners includes some unique complications. For CA purposes, the partners must file as married individuals but for Federal purposes the partners must file as unmarried individuals. Under Federal law, Registered Domestic Partners are not recognized as being married, and so Registered Domestic Partners would be considered "third parties" with respect to disclosure rules. Sec 7216 of the Internal Revenue Code bars disclosure of tax return information to third parties without informed consent. Thus for Federal tax purposes disclosing the tax information of one partner to the other partner is technically a violation of Sec 7216 even though the IRS asks for the name and social security number of the other partner on allocation Form 8958.

  It is unlikely that the IRS would initiate any Sec 7216 sanctions against a practitioner since IRS instructions say to include the allocation form that includes the name and SSN of the RDP along with the allocated income, etc., items, and disregards the provisions of Section 7216. The potential risk of not having a disclosure consent is a disgruntled client with an aggressive attorney in a civil suit against the practitioner. **A recommended consent form is included at the end of this chapter.**

CAUTION

The Section 7216 consent cannot be combined with an engagement letter. All Section 7216 consents must be included in a separate document that contains the mandatory Sec 7216 language and must be in 12 point font. Thus the RDP partners must sign a separate Sec 7216 disclosure and engagement letter.

Federal Filing Suggestions

E-File versus Paper – Because of the non-standard treatment of income and deductions which causes mismatches with the IRS, most practitioners who specialize in RDP returns recommend they be filed by paper. If the filing recommendations suggested here are followed, the top of the 1040 will be flagged as an RDP return.

Filing Together – The IRS has indicated that the returns should NOT be filed together in the same envelope and should not be attached to each other.

Flag the Return – It is recommended that RDP returns be flagged by including the following statement in the margin at the top of the 1040: ***"This Return Filed in Accordance with CCA201021050"***

Section 7216 Disclosure Consent and Engagement Letter

ClientWhys™ has developed a Section 7216 Consent and Engagement Letter for RDPs. However, the documents have not been reviewed by an attorney, legal authority or sanctioned by any governmental agency. Therefore you use them at your own risk.

The third page following (01.12.15) illustrates a possible Section 7216 Consent for RDPs. Modify as needed for your practice. You may wish to have your legal counsel review the final form.

The fourth page following (01.12.17) illustrates a possible engagement letter for RDPs. Modify as needed for your practice. You may wish to have your legal counsel review the final form.

The Section 7216 Consent and engagement letter were drafted for the sole use of ClientWhys™ students in their personal tax practices. Any other use or reproduction in whole or in part is not authorized.

NOTES

Consent to Disclosure of Tax Return Information between Registered Domestic Partners

Federal law requires this consent form be provided to you. Unless authorized by law, we cannot disclose, without your consent, your tax return information to third parties for purposes other than the preparation and filing of your tax return. If you consent to the disclosure of your tax return information, Federal law may not protect your tax return information from further use or distribution.

Preparing the tax returns of registered domestic partners includes some unique complications. For California purposes, the partners must file as married individuals(1) but for Federal purposes the partners must file as unmarried individuals(2). Sec 7216 of the Internal Revenue Code(3) bars disclosure of tax return information to third parties without informed consent. Thus, for Federal tax purposes, disclosing the tax information of one partner to the other partner is technically a violation of Sec 7216, even though the community and separate property allocation form provided by the IRS asks for the name and SSN of both partners.

Therefore, this firm requires your mutual consent to disclose and share tax return information with your Registered Domestic Partner before your 2019 Federal tax returns can be prepared.

You are not required to complete this form. However, because this firm's ability to disclose tax return information to your registered domestic partner affects this firm's ability to provide tax preparation, we may decline to provide you with service if you do not complete the form. <u>You have the opportunity to have your own legal representative review and advise you on all matters related to the services, including this letter, prior to signing the acknowledgement that this letter contains.</u> If you agree to the disclosure of your 2019 tax return information to your registered domestic partner, your consent is valid for the amount of time that you specify (but not less than one year). We strongly suggest the period of time be 4 years so that it includes the statute of limitations for the 2019 return. If you do not specify the duration of your consent, your consent is valid for one year.

Federal law requires community property rules(4) to be applied in the preparation of Registered Domestic Partner returns. You must also understand and acknowledge that preparing the returns of both parties involves inherent conflicts of interest(5) for the person being asked to prepare the returns. Therefore, before this firm can prepare your return, you must acknowledge that this firm cannot place information on either return that conflicts with information used in preparing your registered domestic partner's return. Additionally, if this firm represents both parties, conversations or other communications between either party with this firm are not considered confidential and are available to the other party. You must consent to the sharing of tax return information needed to complete and file both parties' returns.

We, [insert names of RDPs: __________ and _________], Registered Domestic Partners, consent to the disclosure of our tax return information to [insert preparer's name] for the purposes described above and acknowledge that conflicts of interest may exist in the preparation of our separate federal tax returns.

Duration of our joint consent (defaults to one year if left blank): _____________

This consent is not valid unless signed by both Registered Domestic Partners.

RDP Taxpayer Signature: ______________________________ Date: _________

RDP Taxpayer Signature: ______________________________ Date: _________

If you believe your tax return information has been disclosed or used improperly in a manner unauthorized by law or without your permission, you may contact the Treasury Inspector General for Tax Administration (TIGTA) by telephone at 1-800-366-4484, or by e-mail at complaints@tigta.treas.gov.

(1) *California Law (SB 1827 effective January 1, 2007)* – requires registered domestic partners (RDPs) to use the same filing status as married couples. Thus, they must use the married joint, married separate or surviving spouse (if otherwise qualified) filing status for their California return(s).

(2) *Defense of Marriage Act (DOMA), Public Law 104-199* –The Supreme Court ruled in the *Windsor* case that DOMA §3 violates the Equal Protection Clause of the Fifth Amendment. Following the *Windsor* ruling, the Internal Revenue Service (IRS) in Revenue Ruling 2013-14 provided guidance for same-sex married (SSM) couples that treats SSM couples legally married in jurisdictions that recognize their marriages as married for federal tax purposes. The Supreme Court in 2015 ruled in *Obergefell* that the 14th Amendment requires a state to license a marriage between two people of the same sex and to recognize a same sex marriage that was lawfully licensed and performed out of state. However, the Supreme Court rulings and IRS' revenue ruling do not extend to registered domestic partnerships, civil unions or similar formal relationships that aren't marriages recognized under state law. Therefore, for federal purposes a RDP individual cannot be considered a "spouse," which affects certain issues related to RDP individuals' Federal tax returns.

(3) *IRC §7216* – is a section of the Internal Revenue Code that prohibits preparers of tax returns from knowingly or recklessly disclosing or using tax return information for purposes other than preparing the return.

(4) *Chief Counsel Advice 201021050* – has concluded that California registered domestic partners are subject to the community property laws and therefore should report one-half of all community income, including compensation for personal services or income from community property, on their Federal tax returns.

(5) *Treas. Dept. Circular 230 §10.29, Conflicting Interests* **–** a practitioner may not represent potential conflicting interests in his or her practice before the IRS unless the practitioner reasonably believes that the representation of any party before the Service will not be adversely affected; and all parties represented by the practitioner who have an interest in the matter before the Service expressly consent in writing to the representation after the practitioner has fully disclosed the potential conflict. A practitioner may not represent a party in his or her practice before the IRS if the representation of the party may be materially limited by the practitioner's own interests, unless the practitioner reasonably believes the representation will not be adversely affected and the client consents after the practitioner has fully disclosed the potential conflict, including disclosure of the implications of the potential conflict and the risks involved.

Engagement Letter – Registered Domestic Partners

This firm appreciates the opportunity to prepare your **personal income tax returns for 2019 and 2020 estimated taxes**. This letter sets forth the services this firm provides as part of the tax preparation process, states potential conflicts of interest and outlines your responsibilities as clients.

The returns will be prepared based on information and documentation you provide without independent verification by this firm. This firm will provide you with tax organizers to assist you in gathering and organizing the required tax return data in order to keep the tax preparation fees to a minimum. You will make available information about all of your income and deductions so that substantially correct amounts of income and tax can be properly reported. It is your responsibility to maintain, in your records, the documentation necessary to support the data used in preparing your tax returns. This firm is not responsible for the disallowance of doubtful deductions or inadequately supported documentation, nor for resulting taxes, penalties and interest.

You are expected to promptly provide requested follow-up materials and any missing information. If this firm has not received all of your tax return information in early April, we may not be able to complete the return before the filing due date. If your returns are not filed by midnight on April 15, **2020**, you may be subject to late filing and/or late payment penalties.

This firm is responsible for preparing only the returns listed above. The preparation fee does not include responding to inquiries or examination by taxing authorities. However, the firm is available to represent you and the fees for such services are at the firm's standard rates and would be covered under a separate engagement letter.

It is understood that anything you tell this firm during the interview for the preparation of your tax return is confidential, but not protected from the IRS or state tax authority. In addition, the firm cannot disregard the implications of any information you provide in the process of preparing your return. Any of the work papers used to prepare your returns, as well as the communications between you and this firm, can be summoned by the IRS in a legal action against you. If this is of concern to you, you should discuss this with legal counsel prior to engaging this firm for the preparation of your returns.

This firm will use its best judgment to resolve questions in your favor where a tax law is unclear, if there is a reasonable justification for doing so. Whenever we are aware that a possibly applicable tax law is unclear or that there are conflicting interpretations of the law by authorities (e.g., tax agencies and courts), we will explain the possible positions that may be taken on your return. We will follow whatever position you request, so long as it is consistent with the codes, regulations and interpretations that have been promulgated. If the IRS or a state tax agency should later contest the position taken, there may be an assessment of additional tax plus interest and penalties. We assume no liability for any such additional tax, penalties or assessments.

If you were registered as domestic partners as of 12/31/2019, you are required to file as married individuals for California purposes and unmarried individuals for Federal purposes applying community property rules. For California, you and your partner have the option of filing a joint return or filing married separate returns for **2019**. Where one partner passed away in 2017 or 2018, the surviving partner may qualify to file using the surviving spouse with qualified dependent filing status.

If you file a joint California return, you are accepting joint and/or separate responsibility for any California tax assessed on the return. Be especially concerned if there is an unpaid liability on the final return as submitted; you can be held separately liable for the full amount of the underpayment. If you have any questions about your potential liability, please ask.

- If a jointly filed California return is later challenged by the California Franchise Tax Board (FTB) and any additional tax is assessed, each filer can be held liable for the full additional tax. If you are separated or contemplating termination of the domestic partner registration, you may wish to make sure any dissolution agreement reflects that any additional California tax for the **2019** year will be paid by the individual who generated the additional income. However, this will not prevent the FTB from assessing the tax or attempting to collect it from both parties if the return was filed jointly.
- If a joint CA return is prepared for you that is later challenged by the FTB, this firm will not be allowed to represent either of you separately, and will only be able to represent both of you if the representation can be provided objectively and with written consent from both of you.
- If you are contemplating termination of the domestic partner registration or were previously married or registered to another client of this firm, you must understand that preparing the returns of both can involve inherent conflicts of interest for the person being asked to prepare the returns. Therefore, before this firm can prepare your return, you acknowledge that this firm cannot place information on your return that conflicts with information used in preparing a former registered domestic partner's or former spouse's return. Additionally, if this firm represents both parties, conversations or other communications by either party with this firm are not considered confidential and are available to the other party. In fact, this firm may be required to disclose any oral or written communications between this firm and one party to the other party.

Sec 7216 of the Internal Revenue Code bars disclosure of tax return information to third parties without informed consent. Under Federal law, Registered Domestic Partners are not recognized as being married, and so Registered Domestic Partners would be considered "third parties" with respect to disclosure rules. Thus, for Federal tax purposes, disclosing the tax information of one partner to the other partner is technically a violation of Sec 7216. In addition, community property rules must be applied when preparing individual Federal returns for Registered Domestic Partners. For that reason you will also be required to jointly consent to the disclosure of your tax information and acknowledge the inherent conflicts of interest when preparing your separate Federal returns. A separate document is used for this purpose.

Fees for services will be at the firm's standard rates for preparing returns plus out-of-pocket expenses, plus charges for extra time required to segregate community and separate income and to allocate community income. In some circumstances, a retainer may be required. Payment for service is due when rendered and, in some circumstances, interim billings may be submitted as work progresses and expenses are incurred.

You will be provided with copies of the completed returns. It will be your responsibility to review the documents carefully to verify that the information is correct and accurate before signing and filing the returns or signing the authorization for this firm to electronically file the returns.

Both Registered Domestic Partners Must Sign:

RDP Taxpayer Signature: ______________________________ Date: _________

RDP Taxpayer Signature: ______________________________ Date: _________

FOREIGN RELATED REPORTING ISSUES

FOREIGN REPORTING REQUIREMENTS INCLUDED IN THIS CHAPTER

NOTE: For the tax and withholding treatment of **resident and non-resident aliens** see chapter 1.09.

Related IRS & FinCEN Publications and Forms

- **Form 3520** - Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
- **Form 3520A -** Annual Information Return of Foreign Trust With a U.S. Owner
- **Form 5471 –** Information Return of U.S Persons With Respect to Certain Foreign Corporations
- **Form 8938** - Statement of Specified Foreign Financial Assets
- **FinCEN 114** - Report of Foreign Bank and Financial Accounts (formerly TD F 90-22.1)

FBAR Filing Due Date - The Report of Foreign Bank and Financial Accounts (FBAR - FinCEN Form 114) due date is April 15 (was June 30 for 2015 and prior FBARs) and a maximum 6-month filing extension is available.

The same weekend/holiday rule applies for FBARs as income tax returns. Thus FBARs reporting 2019 account information are due April 15, 2020 (Oct. 15, 2020 if on extension). The 2018 FBAR due date was April 15, 2019 (Oct. 15, 2019 if on extension).

MOST COMMONLY ENCOUNTERED FOREIGN REPORTING REQUIREMENTS

The following table provides an overview of various types of foreign assets and the reporting requirements associated with them – the 8938 or 114 form needs to be filed when the applicable monetary threshold (discussed below) for each form is exceeded. (Source IRS Website)

RAPID FINDER

<table>
<tr><th></th><th>Form 8938</th><th>FinCEN Form 114 (FBAR)</th></tr>
<tr><td>Financial (deposit and custodial) accounts held at foreign financial institutions</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Financial account held at a foreign branch of a U.S. financial institution</td><td>No</td><td>Yes</td></tr>
<tr><td>Financial account held at a U.S. branch of a foreign financial institution</td><td>No</td><td>No</td></tr>
<tr><td>Foreign financial account for which you have signature authority</td><td>No, unless you otherwise have an interest in the account as described above</td><td>Yes, subject to exceptions</td></tr>
<tr><td>Foreign stock or securities held in a financial account at a foreign financial institution</td><td colspan="2">The account itself is subject to reporting, but the contents of the account do not have to be separately reported</td></tr>
<tr><td>Foreign stock or securities not held in a financial account</td><td>Yes</td><td>No</td></tr>
<tr><td>Foreign partnership interests</td><td>Yes</td><td>No</td></tr>
<tr><td>Indirect interests in foreign financial assets through an entity</td><td>No</td><td>Yes, if sufficient ownership or beneficial interest (i.e., a greater than 50 percent interest) in the entity. See instructions for further detail.</td></tr>
<tr><td>Foreign mutual funds</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Domestic mutual fund investing in foreign stocks and securities</td><td>No</td><td>No</td></tr>
<tr><td>Foreign accounts and foreign non-account investment assets held by foreign or domestic grantor trust for which you are the grantor</td><td>Yes, as to both foreign accounts and foreign non-account investment assets</td><td>Yes, as to foreign accounts</td></tr>
<tr><td>Foreign-issued life insurance or annuity contract with a cash-value</td><td>Yes</td><td>Yes</td></tr>
<tr><td>Foreign hedge funds and foreign private equity funds</td><td>Yes</td><td>No</td></tr>
<tr><td>Foreign real estate held directly</td><td>No</td><td>No</td></tr>
<tr><td>Foreign real estate held through a foreign entity</td><td>No, but the foreign entity itself is a specified foreign financial asset and its maximum value includes the value of the real estate</td><td>No</td></tr>
<tr><td>Foreign currency held directly</td><td rowspan="4">No</td><td rowspan="4">No</td></tr>
<tr><td>Precious Metals held directly</td></tr>
<tr><td>Personal property, held directly, such as art, antiques, jewelry, cars and other collectibles</td></tr>
<tr><td>‘Social Security’- type program benefits provided by a foreign government</td></tr>
</table>

FOREIGN ACCOUNT REPORTING REQUIREMENTS (FBAR)

The Tax Return Questions – The IRS includes detailed questions related to foreign account report filing and foreign trusts on the 1040 Schedule B (see wording below). Similar questions appear on Forms 1041 and 1065. These questions and answers are covered by the correctness and completion attestation the taxpayer makes under penalty of perjury when signing the return (also shown below). **Be sure to advise the client of their FBAR filing obligations. It may be appropriate to advise them in writing due to the severe penalties for not filing.**

From Schedule B (1040, 2018), The 2019 version was not available when this chapter was updated:

You must complete this part if you (a) had over $1,500 of taxable interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

Part III Foreign Accounts and Trusts

7a At any time during 2018, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions

If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements

7b If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located ▸ ___________________

8 During 2018, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions

From 1040 signature attestation:
Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Caution: Care should be exercised in answering those questions correctly since they are part of the return and the return is signed under penalty of perjury.

FINCEN FORM 114 - FOREIGN ACCOUNT REPORTING REQUIREMENTS (FBAR)

FBAR Reporting Requirement - Each United States person who has a financial interest in or signature or other authority over any foreign financial accounts, including bank, securities, or other types of financial accounts, in a foreign country, **if the aggregate value of these financial accounts exceeds $10,000** at ***any time*** during the calendar year, must report that relationship to the U.S. government each calendar year. This is done by filing **FinCEN Form 114.**

Due Date **-** Beginning for the 2016 tax year, the annual due date for filing Reports of Foreign Bank and Financial Accounts (FBAR) is April 15 of the subsequent year. As with the 1040, if April 15 falls on a Saturday, Sunday or legal holiday, the FinCEN 114 due date is extended to the next business day. So it will always be the same as the 1040 due date. Reports due in years before 2017 had a due date of June 30.

Extension - To implement the statute with minimal burden to the public and the government, FinCEN will grant filers failing to meet the FBAR annual due date of April 15 an automatic extension to October 15 each year. Accordingly, specific requests for this extension are not required (instructions to FinCEN Form 114, available at https://www.fincen.gov/sites/default/files/shared/FBAR%20Line%20Item%20Filing%20Instructions.pdf).

Purpose of the FBAR Filing Requirement - The Treasury Department's Financial Crimes Enforcement Network (FinCEN) uses the FBAR filings in conjunction with Suspicious Activity Reports, Currency Transaction Reports, and other BSA (Bank Secrecy Act) reports to provide law enforcement and regulatory investigators with valuable information to fight fraud, money laundering, terrorist financing, tax evasion and other financial crime.

Reportable FBAR Accounts – Financial account includes the following types of accounts:

- Bank accounts such as savings accounts, checking accounts, and time deposits,
- Securities accounts such as brokerage accounts and securities derivatives or other financial instruments accounts,
- Commodity futures or options accounts,
- Insurance policies with a cash value (such as a whole life insurance policy),
- Mutual funds or similar pooled funds (i.e., a fund that is available to the general public with a regular net asset value determination and regular redemptions),
- Any other accounts maintained in a foreign financial institution or with a person performing the services of a financial institution.

A financial account is foreign when it is located outside of the United States, defined for this purpose as the 50 states, the District of Columbia, U.S. territories and possessions (Commonwealth Northern Mariana Islands, American Samoa, Guam, Commonwealth of Puerto Rico, U.S. Virgin Islands and Trust Territories of the Pacific Islands), and Indian lands as defined in the Indian Gaming Regulatory Act. Typically, then, a financial account that is maintained with a financial institution located outside of the United States is a foreign financial account.

An account maintained with a U.S. financial institution is generally not considered a foreign account for FBAR purposes, even if the account contains holdings or assets of foreign entities. In general, the FBAR rules also don't apply to certain types of custodial arrangements in which a U.S. bank, acting as a "global custodian," combines the assets of multiple investors and creates pooled cash and securities accounts in non-U.S. markets. U.S. customers with these types of accounts typically have no rights in the foreign accounts and can access their holdings only through the U.S. financial institution. Caution: a U.S. customer is considered to have a foreign financial account if the custodial arrangement allows him to directly access his foreign holdings maintained at the foreign institution.

***Example** – Adam has an account with a branch of a U.S. bank that is physically located in Germany. This is a foreign financial account.*

***Example** - Bonnie maintains an account with a branch of a French bank that is physically located in California. This is not a foreign financial account.*

***Example** - Carl, who is a U.S. citizen, purchased securities of a French company through a securities broker located in New York. Carl is not required to report these securities on a FBAR because he purchased the securities through a financial institution located in the U.S.*

<u>Signature or other authority</u> - FinCEN has ruled that under the definition of "signature or other authority" for FBAR purposes an individual has such authority over an account if the foreign financial institution will act upon a direct communication from the individual regarding the disposition of assets in the account. The signature authority definition applies only to individuals.

Proposed rule change – FinCEN has proposed an amendment to the FBAR regulations to eliminate the requirement for officers, employees, and agents of U.S. entities to report signature authority over entity-owned foreign financial accounts for which they have no financial interest, if those accounts are already required to be reported by their employer or any other entity within the same corporate or other business structure as their employer. (FinCEN Proposed Rule (RIN 1506-AB26, Mar. 2, 2016)) Employers would be required to maintain for 5 years information identifying all officers, employees, or agents with signature authority over, but no financial interest in, those same accounts. However, if the entity that has a financial interest in the foreign financial account over which the officer, employee, or agent has signature authority does not have an obligation to report to FinCEN its financial interest in such accounts, the employee, officer or agent would still be required to file a FBAR.

Filing extension – Until the matters raised in the proposed rule change are settled, certain individuals who have signature authority over one or more foreign financial accounts, but no financial interest in the accounts, have been given an additional extension for filing a FBAR for signature authority they held during calendar year 2018. The extension also applies to reporting deadlines previously extended for years 2011 through 2017. The extended due date is April 15, 2020. (FinCEN Notice 2018-1) This extension applies **only** to the following individuals:

(1) an employee or officer of a covered entity who has signature or other authority over, and no financial interest in, a foreign financial account of another entity that is more than 50-percent owned, directly or indirectly, by the covered entity (a controlled person);

(2) an employee or officer of a controlled person of a covered entity who has signature or other authority over, and no financial interest in, a foreign financial account of the entity or another controlled person of the entity; or

(3) officers and employees of investment advisors registered with the Securities and Exchange Commission with signature or other authority over, and no financial interest in, the foreign financial accounts of persons that are not registered investment companies.

<u>Financial Interest</u> - A United States person has a financial interest in a foreign financial account for which:

(1) The United States person is the owner of record or holder of legal title, regardless of whether the account is maintained for the benefit of the United States person or for the benefit of another person; or

(2) The owner of record or holder of legal title is one of the following:

- (a) An agent, nominee, attorney, or a person acting in some other capacity on behalf of the United States person with respect to the account;
- (b) A corporation in which the United States person owns directly or indirectly:
  - (i) more than 50 percent of the total value of shares of stock or
  - (ii) more than 50 percent of the voting power of all shares of stock;
- (c) A partnership in which the United States person owns directly or indirectly:
  - (i) an interest in more than 50 percent of the partnership's profits (e.g., distributive share of partnership income taking into account any special allocation agreement) or
  - (ii) an interest in more than 50 percent of the partnership capital;
- (d) A trust of which the United States person:
  - (i) is the trust grantor and
  - (ii) has an ownership interest in the trust for United States federal tax purposes. See 26 U.S.C. sections 671-679 to determine if a grantor has an ownership interest in a trust;

(e) A trust in which the United States person has a greater than 50 percent present beneficial interest in the assets or income of the trust for the calendar year; or
(f) Any other entity in which the United States person owns directly or indirectly more than 50 percent of the voting power, total value of equity interest or assets, or interest in profits.

Record Keeping Requirements - Persons required to file an FBAR must retain records that contain the name in which each account is maintained, the number or other designation of the account, the name and address of the foreign financial institution that maintains the account, the type of account, and the maximum account value of each account during the reporting period. The records must be retained for a period of **5 years** from the filing due date.

NOTE: The FBAR generally contains all of the required information and retaining copies of the FBAR returns should satisfy the record keeping requirements.

Individuals who have signature authority over their employer's foreign financial accounts and who are required to file Form 114 are not personally required to maintain the records of that employer for 5 years.

Definition of "U.S. resident" - FinCEN, in rules issued in 2011, clarified that, in determining whether an individual is a U.S. resident, the elections under Code Sec. 6013(g) (under which a nonresident alien married to a U.S. citizen or resident can elect to be treated as a resident for tax purposes) and Code Sec. 6013(h) (where a nonresident alien who becomes a U.S. citizen or resident before the close of the tax year and is married to an individual who is a U.S. citizen or resident on the last day of that tax year is treated as a citizen for the entire year) are disregarded.

Retirement and other financial accounts - Life insurance policies and annuities are accounts for FBAR purposes. The obligation to file an FBAR rests with the policy holder and not the beneficiary.

Proposed rule change – In the rules changes proposed in March 2016, FinCEN clarifies that participants and beneficiaries in retirement plans under IRC sections 401(a), 403(a), or 403(b), as well as owners and beneficiaries of Traditional and Roth IRAs, are not required to file an FBAR with respect to a foreign financial account held by or on behalf of the retirement plan, IRA, or Roth IRA.

Interests in trusts - FinCEN clarified in the 2011 rules that, to avoid confusion for discretionary beneficiaries or remaindermen, only beneficiaries who have a present beneficial interest in excess of 50% of a trust's assets or who are receiving more than 50% of a trust's current income are subject to the FBAR rules. (31 CFR 1010.350(e)(2)(iv))

Proposed rule change – The March 2016 rules change would relieve the beneficiary of a trust described in the paragraph above from having to report the trust's foreign financial accounts if the trust, trustee of the trust, or agent of the trust is a United States person that files a FBAR disclosing the trust's foreign financial accounts.

Person - A person means an individual and legal entities including, but not limited to, a limited liability company, corporation, partnership, trust, and estate.

United States Person - United States (U.S.) person means U.S. citizens; U.S. residents; entities, including but not limited to, corporations, partnerships, or limited liability companies created or organized in the U.S. or under the laws of the U.S.; and trusts or estates formed under the laws of the U.S.

Note: The federal tax treatment of an entity does not determine whether the entity has an FBAR filing requirement. For example, an entity that is disregarded for purposes of the Internal Revenue Code must file an FBAR, if otherwise required to do so. Similarly, a trust for which the trust income, deductions, or credits are taken into account by another person for purposes of the IRC must file an FBAR, if otherwise required to do so.

Filing Exceptions

Certain Accounts Jointly Owned by Spouses. The spouse of an individual who files an FBAR is not required to file a separate FBAR if the following conditions are met:

(1) All the financial accounts that the non-filing spouse is required to report are jointly owned with the filing spouse;

(2) The filing spouse reports the jointly owned accounts on a timely filed FBAR electronically signed; and

(3) The filers have completed and signed Form 114a, Record of Authorization to Electronically File FBARs (maintained with the filer's records).

Otherwise, both spouses are required to file separate FBARs, and each spouse must report the entire value of the jointly owned accounts.

Consolidated FBAR **-** If a United States person that is an entity is named in a consolidated FBAR filed by a greater than 50 percent owner, such entity is not required to file a separate FBAR.

United States Military Banking Facility - A financial account maintained with a financial institution located on a United States military installation is not required to be reported, even if that military installation is outside of the United States.

Watch for Overlooked Accounts - Some taxpayers may not realize that they have accounts that fall under this reporting requirement, such as:

- Family Accounts – Recent immigrants to the U.S. may still have parents or other family members residing in the "old" country, and those relatives may have included them on an account in the foreign country. This is common practice for some ethnic groups. The taxpayer does not really consider the account theirs, but it falls under the reporting requirement if they have signature or other authority over the account.
- Inherited Accounts – Accounts that are in a foreign country and are inherited fall under the FBAR reporting requirement even if the funds are subsequently transferred to the U.S. The FBAR rules state that reporting is required if at any time during the year the foreign account exceeds $10,000. CAUTION: An inheritance may also require the filing of Form 3520 (see Reporting Receipt of Foreign Gifts in this chapter).
- Business Accounts – An officer or board member may have signature authority over a business account held in a foreign country and inadvertently overlook the need to meet the FBAR reporting requirements.
- Foreign Retirement Savings Accounts – For example a U.S. Resident with Canadian RRSPs and RRIFs retirement plans with values exceeding $10,000.
- Clients With On-Line Gambling Accounts – The Tax Court has held that an on-line gambler was required to file an FBAR for on-line gaming accounts with out-of-the-country on-line casinos. He was fined for not making an FBAR reporting of his online account and the tax court sided with the government. Upon appeal, the court ruled that only the account where the taxpayer's financial institution acted as an intermediary between his U.S. bank account and the online poker sites he used was a foreign account that was reportable on the FBAR. (*Hom (DC CA, 6/4/2014); J.C. Hom, CA-9, 2016)*

Determining Maximum Account Value **-** For each foreign account, it is necessary to determine the maximum value in the currency of that account for the calendar year being reported. The maximum value of an account is a reasonable approximation of the greatest value of currency or nonmonetary assets in the account during the calendar year. If periodic account statements fairly reflect the maximum account during the year, they may be relied on to determine the maximum value of the account. Each account must be valued separately.

For accounts in non-U.S. currency, the maximum account value must be converted into U.S. dollars by using the Treasury Department's Bureau of Fiscal Service rate, which can be found at https://www.fiscal.treasury.gov/reports-statements/treasury-reporting-rates-exchange/ from the last day of the calendar year. If the Treasury's rate is not available, another verifiable exchange rate can be used if the source of the rate is identified. If the aggregate of the maximum account values exceeds $10,000, an FBAR must be filed.

> ***Example:*** *A U.S. person has a bank account that is denominated in Euros at a bank in Bucharest, Romania. The highest value of the account during 2019 was on October 4, 2019. To convert the October 4th value to U.S. dollars, use the exchange rate for a Euro as of December 31, 2019 as found on the Treasury Department's web site.*

Filing Information – The Form 114 is not included with an individual's 1040; must be submitted electronically; and is not filed with the IRS. Instead it is filed through the BSA E-filing System.

Tax Preparers - Tax preparers intending to submit their clients' 114 forms to FinCEN will need to enroll with FinCEN to do so. According to FAQs on the FinCEN website:

> "An attorney, CPA or an Enrolled Agent always may assist its clients in the preparation of electronic BSA forms for BSA E-Filing, including the FBAR. Consistent with FinCEN's recent proposal to provide for approved third-party filing of the FBAR, if an attorney, CPA or Enrolled Agent has been provided documented authority [such as a Form 2848 power of attorney or similar form unique to FinCEN] by the legally obligated filers to sign and submit FBARs on their behalf through the BSA E-Filing System, that attorney, CPA or Enrolled Agent can do so through a single BSA E-Filing account established for the attorney, CPA or Enrolled Agent. If such authority is not provided, the filings must be signed and submitted through a BSA E-Filing account unique to each client."

FinCEN has provided Form 114a, Record of Authorization to Electronically File FBARs, on which persons with an obligation to file a FBAR (e.g., your clients) can authorize a third party (you or your firm) who is registered with FinCEN to submit the filing electronically. A copy of the completed Form 114a should be retained for 5 years by both you and your client; a copy is not sent to FinCEN. Check the FinCEN website for additional information and to register to be authorized to file on behalf of your clients: http://bsaefiling.fincen.treas.gov/main.html or contact the BSA E-Filing Help Desk at 1-866-346-9478 with questions.

Amending an FBAR - To amend a previously filed FBAR, check the "Amended" box in the upper right hand corner of the first page of the FBAR and enter the prior report BSA identifier (which was provided in a secure message from BSA when the original FBAR was filed). Complete the form in its entirety and include the amended information.

Statute of Limitations **-** The statutes of limitations on assessment (ASED) and collection (CSED) of FBAR penalties are defined under Title 31, the Bank Secrecy Act. (MSSP Guide 8.11.6.3.1)

- **Failure to file FBAR report** (either willful or negligent): **6 years** from the due date of the FBAR report
- **Failure to maintain required records** (either willful or negligent): **6 years** from the date the IRS first asks for the records.

Note: If both types of violations have occurred, examiners can assert both the failure-to-file an FBAR report penalty and failure to maintain required records penalty on the same account for the same period. However, Compliance policy in IRM 4.26.16.6.7 allows examiners discretion over whether to assert multiple violations against one FBAR report.

FBAR Penalties Mitigation Threshold Conditions (IRM 4.26.16.6.6.1 (11-06-2015)) -

For most FBAR cases, if IRS has determined that a person meets four threshold conditions, then that person may be subject to less than the maximum FBAR penalty depending on the amounts in the accounts. For violations occurring after October 22, 2004, the four threshold conditions are:

- The person has no history of criminal tax or Bank Secrecy Act convictions for the preceding 10 years, as well as no history of past FBAR penalty assessments.
- No money passing through any of the foreign accounts associated with the person was from an illegal source or used to further a criminal purpose.
- The person cooperated during the examination (i.e., IRS did not have to resort to a summons to obtain non-privileged information; the taxpayer responded to reasonable requests for documents, meetings, and interviews; and the taxpayer back-filed correct reports).
- IRS did not sustain a civil fraud penalty against the person for an underpayment for the year in question due to the failure to report income related to any amount in a foreign account.

FBAR Penalties - Examiner Discretion (IRM 4.26.16.6.7 (11-06-2015)) - The examiner may determine that the facts and circumstances of a particular case do not justify asserting a penalty. When a penalty is appropriate, IRS has established penalty mitigation guidelines to aid the examiner in applying penalties in a uniform manner. The examiner may determine that a penalty under these guidelines is not appropriate or that a lesser penalty amount than the guidelines would otherwise provide is appropriate or that the penalty should be increased (up to the statutory maximum). The examiner must make such a determination with the written approval of the examiner's manager and document the decision in the work papers.

1. Factors to consider when applying examiner discretion may include, but are not limited to, the following:
   A. Whether compliance objectives would be achieved by issuance of a warning letter;
   B. Whether the person who committed the violation had been previously issued a warning letter or has been assessed the FBAR penalty;
   C. The nature of the violation and the amounts involved; and,
   D. The cooperation of the taxpayer during the examination.
2. Given the magnitude of the maximum penalties permitted for each violation, the assertion of multiple penalties and the assertion of separate penalties for multiple violations with respect to a single FBAR, should be considered and calculated to ensure the amount of the penalty is commensurate to the harm caused by the FBAR violation.

Penalty Mitigation Guidelines (IRM Exhibit 4.26.16-1). Note this is an overview; for more details consult the IRM.

Non-willful:

BALANCE	PENALTY
LEVEL I: If the maximum aggregate balance for all accounts to which the violations relate **did not exceed $50,000 at any time during the year.**	$500 for each violation, not to exceed an aggregate penalty of $5,000 per year.
LEVEL II: If the maximum aggregate balance of all accounts to which the violations relate **exceeds $50,000 but does not exceed $250,000.**	$5,000 for each violation.
LEVEL III: If the maximum aggregate balance of all accounts to which the violations relate **exceeds $250,000.**	$10,000 for each violation (the statutory maximum for non-willful violations).

Willful:

BALANCE	PENALTY
LEVEL I: If the maximum aggregate balance for all accounts to which the violations relate did not exceed $50,000 during the calendar year, penalty applies to all accounts	The greater of $1,000 per year or 5% of the maximum aggregate balance of the accounts during the year to which the violations relate.
LEVEL II: If the maximum aggregate balance for all accounts to which the violations relate exceeds $50,000 but does not exceed $250,000, Level II penalties are computed on a **per account** basis.	For each account for which there was a violation, the greater of $5,000 or 10% of the maximum account balance during the calendar year at issue.
LEVEL III: If the maximum aggregate balance for all accounts to which the violations relate exceeds $250,000 but does not exceed $1,000,000, Level III penalties are computed on a **per account** basis.	For each account for which there was a violation, the greater of 10% of the maximum account balance during the calendar year at issue or 50% of the account balance on the day of the violation.

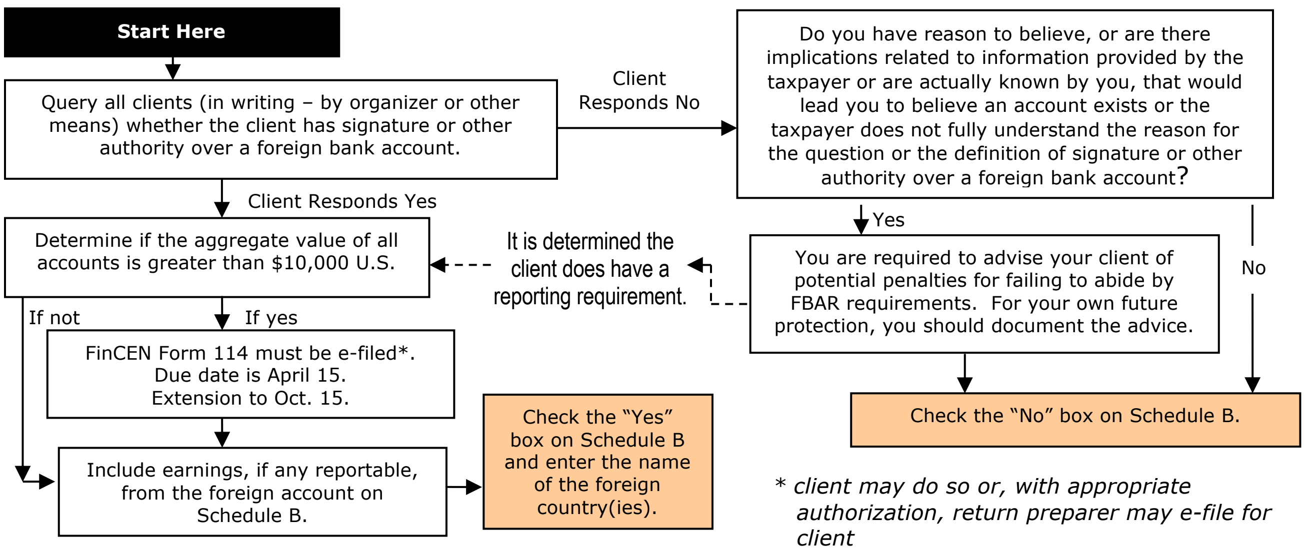
LEVEL IV: If the maximum aggregate balance for all accounts to which the violations relate exceeds $1,000,000, Level IV penalties are computed on a **per account** basis.	For each account for which there was a violation, the greater of 50% of the balance in the account at the time of the violation or $100,000 (i.e., the statutory maximum penalty).

If an account is co-owned with one or more other persons, a penalty determination must be made separately for each co-owner. The penalty against each co-owner will be based on his or her percentage of ownership of the highest balance in the account. If the examiner cannot determine each owner's percentage of ownership, the highest balance will be divided equally among each of the co-owners.

<u>*Practitioner Responsibility*</u> - Some practitioners are taking the position that the FinCEN 114 reporting form is not a tax document and therefore not within their legal responsibility to comply with the reporting requirement.

THIS IS NOT TRUE – The Office of Professional Responsibility (OPR) has made it quite clear that practitioners must comply with the FBAR filing rules and use due diligence in determining if a client has a reporting requirement. The flow chart below is provided as an overview to a practitioner's responsibilities.

FBAR Reporting Flow Chart



<u>*Offshore Voluntary Disclosure Program (OVDP)*</u> **-** The IRS has, for several years, offered "disclosure programs," aimed at getting taxpayers with hidden offshore accounts to voluntarily come forward and comply with FBAR and foreign income reporting. Under these programs participants must file all original and amended tax returns and include payment for back-taxes and interest for up to eight years as well as paying accuracy-related and/or delinquency penalties.

The most current program was the 2014 OVDP, which the IRS shut down as of September 28, 2018 (IR-2018-52). The discontinuance of this program is a reflection of advances in third-party reporting (as a result of FATCA) and increased awareness by U.S. taxpayers of their tax reporting obligations. Only 600 disclosures were made under the program in 2017, down from a peak of 18,000 disclosures under an earlier OVDP. The Streamlined Filing Compliance Procedures program, discussed below, will continue to be available to eligible taxpayers.

<u>*IRS's Streamlined Voluntary Filing Compliance Program*</u> - A U.S. taxpayer who has not reported their foreign financial assets on their tax returns and **can certify that the reporting failure and nonpayment of all tax due related to those assets did not result from willful conduct** on the taxpayer's part, can come into compliance with the IRS by doing the following:

(1) For each of the most recent three years for which the U.S. tax return due date (including extended due dates) has passed, file amended tax returns, together with all required information returns (e.g., Forms 3520, 3520-A, 5471, 5472, 8938, 926, and/or 8621). These three years are referred to as the "covered tax return period";

(2) For each of the most recent six years for which the FBAR (foreign bank account report) due date has passed, file any delinquent FBAR returns (FinCEN Form 114). These six years are referred to as the "covered FBAR period"; and

(3) Pay a 5% miscellaneous offshore penalty plus any tax and interest due on the amended returns. The full amount of the tax, interest, and miscellaneous offshore penalty due in connection with these filings should be remitted with the amended tax returns.

Penalty – The miscellaneous offshore penalty is equal to 5% of the highest aggregate balance/value of the taxpayer's foreign financial assets during the years in the "covered tax return period" and the "covered FBAR period." For this purpose, the highest aggregate balance/value is determined by aggregating the year-end account balances and year-end asset values of all the foreign financial assets and selecting the highest aggregate balance/value from among those years.

Taxpayers who have completed the streamlined filing compliance procedures, will be expected to comply with U.S. law for all future years and file returns according to regular filing procedures.

Returns submitted under the streamlined offshore procedures will not automatically be subject to IRS audit, but they may be selected for audit under the IRS's audit selection processes applicable to any U.S. tax return. If selected, they will be checked for accuracy and completeness, just as with any other audit. If errors or omissions are discovered, the taxpayer could be subject to additional civil penalties, and even criminal liability, if appropriate.

FORM 8938 - REPORTING REQUIREMENT FOR INDIVIDUALS WITH FOREIGN ASSETS – SEC 6038(D)

> **Caution:** This requirement is in addition to the FBAR requirement discussed elsewhere in this chapter. Certain foreign financial accounts are reported on both Form 8938 and the FBAR. However, the information required by the forms is not identical in all cases. Different rules, key definitions (for example, "financial account"), and reporting requirements apply to Form 8938 and FBAR reporting. Because of these differences, certain foreign financial accounts may be reportable on one but not both forms.

Any individual who, during the tax year, holds any interest in a "**specified foreign financial asset**" must attach to his or her income tax return for that tax year the information described below in "Required Information" for each specified foreign financial asset if the aggregate value of all the individual's specified foreign financial assets exceeds $50,000 or a dollar amount higher than $50,000 as IRS may prescribe. (Code Sec. 6038D(a)) Temporary and final regulations (TD 9706, 12/11/14; Reg. Sections 1.6038D-0 through 1.6038D-8) provide for varying thresholds, some of which are more than $50,000, depending on marital status and whether the individual resides in the U.S. or abroad. (Reg. § 1.6038D-2)

The Code Sec. 6038D reporting requirement also applies to any domestic entity formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets, in the same manner as if the entity were an individual. (Code Sec. 6038D(f)) For additional details related to these entities, see proposed regulations NPRM REG-130302-10 and final regulations, TD 9706.

Filing Exception – An individual is not required to file a foreign financial assets report for a tax year in which he or she is not required to file an income tax return, even if the value of the individual's specified foreign financial assets for that year exceeds the filing threshold amount. (Reg. § 1.6038D-2(a)(7)) Caution**:** this filing exception does not apply for FBARs, so even if an individual is not required to file an income tax return, an FBAR still must be filed if the value of the individual's foreign financial accounts exceeds the $10,000 threshold.

Reporting Thresholds - Reporting (on Form 8938) is required if the total value of specified foreign financial assets is **greater than** the amounts shown in the following table, either as of the end of the tax year or at any time during the tax year, based on marital status and residency in the U.S. or abroad.

	Living In The U.S.		**Living Abroad**	
Filing Status	**Year-End Value**	**During Year Value**	**Year-End Value**	**During Year Value**
Married Filing Joint	$100,000	$150,000	$400,000*	$600,000*
Others	$50,000	$75,000	$200,000	$300,000

**Applies even if only one spouse lives abroad*

The ***presence abroad test*** is satisfied if a U.S. citizen has been a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, or if a U.S. citizen or resident was present in a foreign country or countries at least 330 full days during any period of 12 consecutive months that ends in the tax year being reported. (Form 8938 Instructions)

Specified Foreign Financial Asset - For purposes of the reporting requirement for individuals with foreign assets, a "specified foreign financial asset" (Code Sec. 6038D(b)) is:

- Any "**financial account**" maintained by a "**foreign financial institution**", and
- Any of the following assets which are held for investment and are not held in an account maintained by a "**financial institution**":
  - Any stock or security issued by a person other than a U.S. person (Code Sec. 6038D(b)(2)(A)),

- Any financial instrument or contract held for investment that has an issuer or counterparty that is other than a U.S. person (Code Sec. 6038D(b)(2)(B)), and
- Any interest in a "foreign entity" (as defined in Code Sec. 1473). Examples of non-financial account assets that may be considered other specified foreign financial assets include: Stock issued by a foreign corporation; a capital or profits interest in a foreign partnership; a note, bond, debenture, or other form of indebtedness issued by a foreign person; an interest in a foreign trust; an interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement with a foreign counterparty; and any option or other derivative instrument with respect to any of the items listed as examples in this paragraph or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer (Reg. § 1.6038D-3(d)).

An interest in a foreign social security, foreign social insurance or other similar program of a foreign government is **not** a specified foreign financial asset.

Financial Account (Code Sec. 1471(d)(2)) **-** Except as otherwise provided by the Secretary, the term "financial account" means, with respect to any financial institution—

(A) any depository account maintained by such financial institution,

(B) any custodial account maintained by such financial institution, and

(C) any equity or debt interest in such financial institution (other than interests which are regularly traded on an established securities market).

Foreign Financial Institution (Code Sec. 1471(d)(4)) - The term "foreign financial institution" means any financial institution which is a foreign entity. Except as otherwise provided by the Secretary, such term shall not include a financial institution which is organized under the laws of any possession of the United States. A foreign financial institution includes investment vehicles such as foreign mutual funds, foreign private equity funds and foreign hedge funds.

Financial Institution (Code Sec. 1471(d)(5)) **-** Except as otherwise provided by the Secretary, the term "financial institution" means any entity that—

(A) accepts deposits in the ordinary course of a banking or similar business,

(B) as a substantial portion of its business, holds financial assets for the account of others, or

(C) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest including a futures or forward contract or option in such securities, partnership interests, or commodities.

Required Information **–** With respect to any specified foreign financial asset, in addition to the maximum value of the asset during the year, the following information must be provided:

- For ***accounts***: The name and address of the financial institution in which the account is maintained, and the account number.
- For ***stock or securities***: The name and address of the issuer and enough information as is necessary to identify the class or issue of which the stock or security is a part.
- For any other ***instrument, contract or interest***: Such information as is necessary to identify the asset, and the names and addresses of all issuers and counterparties with respect to the asset.

This information will be reported on IRS **Form 8938**, Statement of Specified Foreign Financial Assets. In addition to the information listed above, if a foreign currency exchange rate was used to convert the value of the foreign asset to U.S. dollars, the rate and source of the exchange rate must be disclosed. In most cases, the U.S. Treasury Bureau of the Fiscal Service foreign currency exchange rate for purchasing U.S. dollars must be used. This rate can be found on the following government web site (Form 8938 instructions):

https://www.fiscal.treasury.gov/reports-statements/treasury-reporting-rates-exchange/

One section of the 8938 requires a recap by type of income from the foreign asset(s) that is reported on the return and a description of the form or schedule and line number where it is reported. Refer to the instructions for the 8938 regarding valuing the assets and other useful information.

Failure to Timely Disclose Information - If any individual fails to furnish the information related to foreign assets as described in Code Sec. 6038D(c) for any tax year at the time and in the manner described, he or she must pay a penalty of $10,000. If this failure continues for more than 90 days after the day on which IRS mails notice of the failure to the individual, the individual will be penalized (in addition to the penalties imposed under Code Sec. 6038D(d)(1), discussed above) $10,000 for each 30-day period (or fraction of the 30-day period) during which the failure continues after the expiration of the 90-day period. The penalty imposed for any failure can't exceed $50,000.

Example - *An individual who is notified of his failure to disclose for a single tax year, and who takes remedial action on the 95th day after the notice is mailed, incurs a penalty of $20,000 comprised of the base amount of $10,000, plus $10,000 for the fraction (i.e., the five days) of a 30-day period following the lapse of 90 days after the notice of noncompliance was mailed.*

To the extent IRS determines that the individual has an interest in one or more foreign financial assets but he or she doesn't provide enough information to enable IRS to determine the aggregate value of those assets, the aggregate value of those assets will be presumed to have exceeded $50,000 (or other applicable reporting threshold amount) for purposes of assessing the penalty. (Joint Comm Staff, Tech Expln (JCX-4-10), 2/23/2010, p. 61)

No penalty will be imposed by Code Sec. 6038D on any failure that is shown to be due to reasonable cause and not due to willful neglect. The fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information isn't reasonable cause. (Code Sec. 6038D(g))

Accuracy-Related Penalty for Certain Undisclosed Foreign Assets **-** A 40% accuracy-related penalty is imposed for underpayment of tax that is attributable to an undisclosed foreign financial asset understatement (IRC Sec. 6662(b)(7) and (j)). This is double the normal accuracy-related penalty rate.

Statute of Limitations Extensions **-** If Form 8938 is not filed when it is required, or the taxpayer fails to report a required specified foreign financial asset, the statute of limitations for the tax year may remain open for all or a part of the return until 3 years after the date on which the Form 8938 is filed.

In addition if the taxpayer omits more than $5,000 from gross income attributable to a specified foreign financial asset, the statute of limitations is extended to six years after the return is filed. (IRC Sec. 6501(e)(1)(A))

FOREIGN RENTAL PROPERTY

Generally, except for the following differences, foreign rental property is reported on a tax return in the same manner as a domestic rental.

Depreciation **–** The ADS method of depreciation is applied for tangible property predominantly used outside the U.S. (Code Sec. 168(g)(1)(A)). This would include both residential and nonresidential foreign rental property. Under ADS, the straight line method is used, and the recovery periods for assets commonly found in rentals are:

- 40 years for the real property (building portion) (30 years for residential rental property placed in service in 2018 or later);
- 9 years for appliances, carpets and furniture (Ann 99-82, 1999-32 IRB 244); and
- 20 years for land improvements such as fences and landscaping.
- Personal property for which there is no class life has a recovery period of 12 years.

Passive Loss Rules – The passive loss rules apply to a foreign rental in the same manner as a domestic rental.

Real Estate Professional Issue – Generally it would be difficult to qualify for real estate professional treatment for a rental located in a foreign country unless both the rental and the tax home of the landlord were close to the border of an adjacent country (Canada or Mexico) so the owner can meet the personal services and material participation requirements. However, there is no restriction against including a foreign rental in the aggregation election (Code Sec. 469(c)(7)(A)).

1031 Exchange **-** Real property located in the U.S. and real property located outside the U.S. aren't property of a like-kind for purposes of the like-kind exchange rules under Code Sec. 1031(h).

Sec 199A Deduction – The 20% of qualified business income (QBI) deduction (Sec 199A) does not apply to rental income from real property located outside the U.S. since QBI must be from the conduct of a trade or business within the United States.

Converting Foreign Currency Rental Profits to U.S. Dollars – Rev Ruling 75-90 provides the following method of converting rental profits or losses expressed in a foreign currency to profit or losses expressed in U.S. Dollars. The following worksheet follows that ruling:

1. Profit or loss before depreciation expressed in foreign currency……………………….................. _________
2. Enter the sum of transfers to the U.S during the year computed in foreign currency……………. _________
3. Balance: Subtract Line 2 from Line 1……………………………………….................................. _________
4. Sum up the closing currency exchange rate(1) for each month of the year……………………….. _________
5. Divide Line 4 by 12 (average exchange rate for the year)……………………….…………….. _________
6. Multiply Line 3 by Line 5 (unremitted profit or loss before depreciation in U.S. dollars)…… _________
7. Enter the transfers from Line 2 converted to U.S. Dollars at the time of transfer…..……………… _________
8. Depreciation (expressed in U.S. dollars)(2) …………………………………………………………. <_________>
9. Profit or loss (expressed in U.S. dollars) ……………………………………………………………………………. _________

(1) The rate of exchange for foreign currency to U.S. Dollars
(2) The basis and depreciation would have been established in the year of purchase based upon the exchange rate in effect at the time of purchase, inheritance or gift.

FBAR Reporting – If a foreign bank account is maintained to receive rental income and disperse rental expense payments, and the owner of the property has signature or other authority over the account, that account aggregated with other foreign accounts in which the taxpayer has signature or other authority may require an FBAR filing. On the other hand, if a property management firm handles all the financial transactions, then the rental would not fall under the FBAR reporting requirements.

W-8BEN – If the landlord hires a non-resident alien working in the foreign country to perform services related to foreign rental activity, there are no U.S. reporting or withholding requirements. However, the foreign person providing those services should complete Form W-8BEN and return it to the landlord as proof that the individual is not subject to U.S. taxation.

Form 8938 – Foreign Assets Reporting – The outright ownership of a rental property in a foreign country does not meet the definition of "Specified Foreign Financial Asset" (See Foreign Assets Reporting above). However, if the taxpayer is an owner or partial owner in an entity that owns the rental activity, then it would be included when determining if Form 8938 must be filed.

FOREIGN PENSIONS

A foreign pension or annuity distribution is a payment from a pension plan or retirement annuity received from a source outside the United States such as a:

- foreign employer
- trust established by a foreign employer
- foreign government or one of its agencies (including a foreign social security pension)
- foreign insurance company
- foreign trust or other foreign entity designated to pay the annuity

Taxable Amount - Just as with domestic pensions or annuities, the taxable amount *generally* is the Gross Distribution minus the Cost (investment in the contract) unless there is a tax treaty provision covering the pension.

Tax Treaties

- **General Rule** - As a general rule, the pension/annuity articles of most tax treaties allow the country of residence to tax the pension or annuity under its domestic laws. This is true unless a treaty provision specifically amends that treatment.
- **Special Treaty Rules -** Some treaties, for example, provide that the country of residence may not tax amounts that would not have been taxable by the other country if the taxpayer were a resident of that country. In some cases, government pensions/annuities or social security payments may be taxable by the government making the payments. There also may be special rules for lump-sum distributions. Practitioners need to look at each treaty carefully. The treaties are available on the IRS website at:

https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z

Foreign Residents - If your client lives in a foreign country and receives a pension/annuity paid by a U.S. payer, claim exemption from withholding of U.S. Federal Income Tax (FIT) under a tax treaty by completing Form W-8BEN and delivering it to the U.S. payer. The taxpayer must include their U.S. Taxpayer Identification Number (TIN) on Form W-8BEN for it to be valid for treaty purposes.

U.S. Residents - If the taxpayer resides in the U.S. and receives a pension/annuity paid by a payer from a foreign country and a treaty provision applies, the taxpayer can claim the desired treaty withholding exemption on the form, and in the manner specified by the foreign government. If the foreign government, and/or the foreign withholding agent, refuses to honor the treaty claim, make the treaty claim on the taxpayer's income tax return, or other prescribed form, filed with the foreign country. Note: Don't overlook claiming a Foreign Tax Credit on your client's U.S. federal individual income tax return for any foreign income tax withheld from the foreign pension or annuity which isn't refundable by filing a return or refund claim with the foreign country.

Foreign Social Security Pensions - Most income tax treaties have special rules for social security payments. In many cases, foreign social security payments are taxable by the country making the payments. Unless specified otherwise in an income tax treaty, foreign social security pensions are generally taxed as if they were foreign pensions or foreign annuities. Unless a tax treaty allows it (see, e.g., the USA-Canada treaty), they are not eligible for exclusion from taxable income the way a U.S. social security pension might be.

Selected Treaty Provisions – Caution: these treaty provisions are with the U.S. Federal government and not with the individual states. Consult the state's rules. For example California does not recognize foreign treaties and all pension income is taxable to CA including foreign social security equivalents.

- **Canada Treaty** - Under the treaty, Canadian Old Age Security (OAS) pensions and Canada/Quebec Pension Plan (CPP/QPP) benefits received by U.S. residents are treated for tax purposes as if they were U.S. social security payments. U.S Social Security benefits received by a Canadian resident are taxable to Canada.
- **Canadian IRA Equivalent Plans** - Guidance has been provided by Rev. Proc. 2014-55, which supersedes Rev. Proc. 2002-23, and Notice 2003-75, in regards to the US-Canadian Tax Treaty, and individuals who are citizens or residents of the U.S. and beneficiaries of one of the following Canadian plans which are taxable to the U.S. if the recipient is a U.S. Resident:
  - A registered retirement savings plan (RRSP),
  - A registered retirement income fund (RRIF),
  - A registered pension plan, or
  - A deferred profit-sharing plan.

  Distributions received by any U.S. citizen beneficiary or annuitant from a Canadian retirement plan, including the portion of the distribution that constitutes income that has accrued in the plan and has not previously been taxed in the United States, must be included in gross income by the beneficiary or annuitant in the manner provided under IRC Sec. 72, subject to any applicable provision of the Convention (treaty). (Rev. Proc. 2014-55, Sec. 6) Thus, for example, the gross distribution from an RRSP is reported on line 4a of Form 1040 (2018 version), and the taxable amount (as determined under Sec. 72) is included on line 4b of the 1040.
- **United Kingdom Treaty** - Pensions and other similar remuneration beneficially owned by a resident of one State are taxed only in that State ("state" is used in the treaties in lieu of "country"). Thus UK pensions received by a U.S. Resident are taxable to the U.S. and U.S. pensions received by a resident of the UK are taxable to the UK. Each country can only tax the amount that would have been taxed in the other country. Therefore UK residents would not be taxed on qualified Roth distributions or non-deductible IRA distributions. (U.K. Treaty, Art. 17(1))
- **German Treaty** – German pension benefits, other than equivalent social security benefits, paid to a U.S Resident are taxable to the U.S. just as if they were earned in the U.S. German equivalent social security benefits paid to a U.S. Resident are taxed in the same manner and same exclusion as U.S. Social Security benefits. CAUTION – Germany recently altered its domestic tax policy and the above rules may change in the near future.
- **French Treaty** – According to the French treaty, pensions paid for past employment in France are only taxable to France. However, French pension payments made to a U.S. resident are also taxable by the U.S., and the only relief is through claiming a foreign tax credit.
- **India Treaty** – Under a treaty with India, social security benefits and other public pensions paid by India to a resident of the U.S. are taxable only by India and not included in U.S. income. Social security benefits paid to individuals who are both residents and nationals of India are exempt from U.S. tax if the benefits are for services performed for the United States, its subdivisions, or local government authorities.

CANADIAN REGISTERED RETIREMENT SAVINGS AND INCOME PLANS

With respect to information reporting rules for a U.S. beneficiary of foreign trusts, simplified reporting rules apply to taxpayers who hold interests in Canadian registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs) in lieu of the filing obligations under Code Sec. 6048 that otherwise apply to U.S. citizens and resident aliens who hold interests in Canadian RRSPs and RRIFs. Rev Proc 2002-23 provided a simplified procedure that allowed individuals with these Canadian plans to elect to defer reporting the undistributed income from these plans by filing Form 8891. Rev Proc 2002-23 and Notice 2003-85 were superseded by Rev Proc 2014-55, published in October 2014.

Deemed deferral election – Rev Proc 2014-55, Section 4.02 provides that an "eligible individual" who did not previously make an election under Article XVIII(7) of the U.S.-Canada Income Tax Treaty to defer current U.S. income taxation on the undistributed income of Canadian registered retirement savings plans (RRSPs) or Canadian registered retirement income funds (RRIFs), will be treated as having made the election in the first year in which the individual would have been entitled to make such an election with respect to the plan.

As a result, the eligible individual will not be required to make the election for that first year or for any later years either on Form 8891 or under the procedures in Rev Proc 2002-23. If an eligible individual has an interest in more than one Canadian retirement plan, this provision applies separately to each plan. The relief in Rev Proc 2014-55 applies only to income accrued in a Canadian retirement plan and not to any contributions to the plan. Once an election is made under Rev Proc 2014-55, Sec. 4.02, that election is in effect for all later tax years through the year in which a final distribution is made from the plan, unless the election is revoked with IRS's consent.

Eligible individual - is a beneficiary of a Canadian retirement plan who:

- Is or at any time was a U.S. citizen or resident while a beneficiary of the plan;
- Has satisfied any requirement for filing a U.S. Federal income tax return for each tax year during which the individual was a U.S. citizen or resident;
- Hasn't reported as gross income on a U.S. Federal income tax return the earnings that accrued in, but were not distributed by, the plan during any tax year in which the individual was a U.S. citizen or resident; and
- Has reported any and all distributions received from the plan as if the individual had made an election under Article XVIII(7) for all years during which the individual was a U.S. citizen or resident.

Eligible individuals must report on their U.S. Federal income tax return any income that has accrued in the plan when it is distributed. Distributions received by any beneficiary or annuitant from a Canadian retirement plan, including the part that constitutes income that has accrued in the plan and hasn't previously been taxed in the U.S., must be included in gross income by the beneficiary or annuitant under the usual Code Sec. 72 rules, subject to any applicable treaty provision.

Rules for non-eligible individuals - Beneficiaries who have reported on their U.S. Federal income tax return undistributed income that has accrued in a Canadian retirement plan during a tax year are not eligible individuals able to apply the Rev Proc 2014-55, Sec. 402 relief, and will remain currently taxable on the undistributed income. If such beneficiaries want to make an Article XVIII(7) election with respect to a Canadian retirement plan, they must get IRS's consent.

Form 8891 obsoleted - A taxpayer who previously made an Article XVIII(7) election with respect to a Canadian plan on Form 8891 or under Rev Proc 2002-23, or an eligible individual who is treated as having made the election under Rev Proc 2014-55, Sec. 4.02, isn't required to file Form 8891 or a similar statement for tax years ending after Dec. 31, 2012. Filing of FinCEN 114 (FBAR) is still required if the filing threshold is met.

FORM 3520 - REPORTING RECEIPT OF FOREIGN GIFTS OR BEQUESTS

If the value of the **aggregate** "foreign gifts" (described below) received by a U.S. person (other than an exempt organization) exceeds specified amounts, the U.S. person must report each foreign gift to the IRS. (Code Sec. 6039F) These amounts are:

a. More than $100,000 from a nonresident alien individual or a foreign estate (including foreign persons related to that nonresident alien individual or foreign estate) that are treated as gifts or bequests (Notice 97-34); or

b. More than $16,389 in 2019 ($16,076 in 2018) (Rev Procs 2018-57 and 2018-18) from foreign corporations or foreign partnerships (including foreign persons related to such foreign corporations or foreign partnerships) that are treated as gifts. The threshold amount for gifts from foreign corporations or partnerships is adjusted annually for inflation.

Foreign Gifts - Foreign gifts generally include any amounts received from a person that isn't a U.S. person that the recipient treats as a gift or bequest. The term doesn't include any qualified tuition or medical payments made on behalf of a U.S. person.

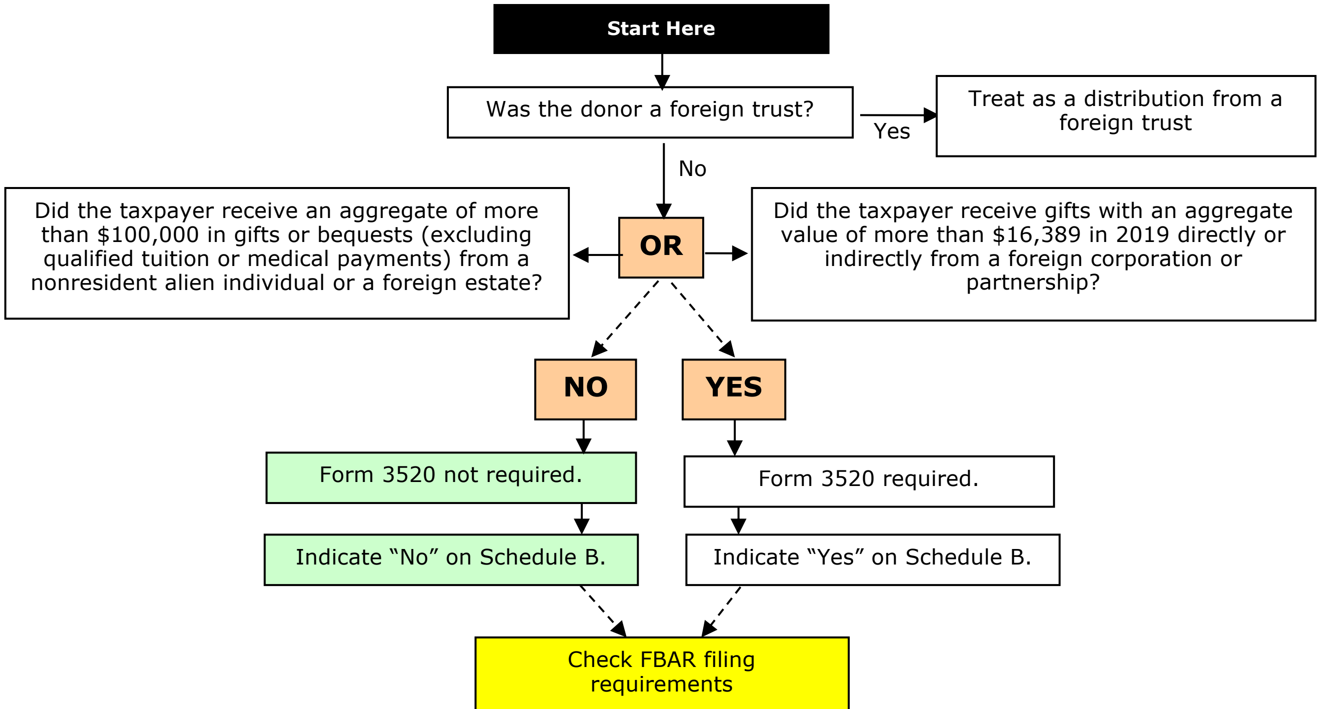
Reporting Forms:

- **1040 Schedule B** – Individuals with foreign gifts need to answer the line 8 question correctly at the bottom of the Schedule B.
- **Form 3520** - Complete the identifying information on page 1 of Form 3520 and Part IV. See the instructions for Part IV.
- **FBAR** - Taxpayers may also be required to file FinCEN Form 114 if the conditions of transfer and account balance require it.

Caution - If the ultimate donor is a foreign trust, then treat the amount as a distribution from a foreign trust and see "reporting ownership of or transactions with foreign trusts" later.

Penalties - The penalty for not reporting a foreign gift that must be reported is 5% of the amount of the gift for each month the failure to report continues, up to a maximum of 25%. The penalty will be excused if reasonable cause for the failure to report can be established. (Code Sec. 6039F(c)(1)(B)).

Foreign Gift & Bequest Reporting Flow Chart



Form 3520 Common Issues

Form 3520 is used for several purposes including:

- Certain Transactions with Foreign Trusts
- Ownership of foreign trusts under the rules of sections 671 through 679
- Receipt of large gifts or bequests from certain foreign persons.

Each of these purposes is addressed separately in this material.

Joint Return Filers: Two transferors or grantors of the same foreign trust, or two U.S. beneficiaries of the same foreign trust, may file a joint Form 3520, but only if they file a joint income tax return.

Due Date – Form 3520's due date is the 15th day of the 4th month (April 15th for calendar year taxpayers). Six-month extension available; use Form 7004 for filing extensions.

Filing - The form is **NOT included with the 1040** and instead is mailed to P.O. Box 409101, Ogden UT, 84409. However double check the current version of the 3520 instructions for possible changes in filing address.

Consistent Treatment - The U.S. beneficiary and U.S. owner's tax return must be consistent with the Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, filed by the foreign trust unless the taxpayer reports the inconsistency to the IRS. If items are being treated on the tax return differently from the way the foreign trust treated them on its return, file Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR). See Form 8082 for more details.

Foreign Trust - A foreign trust is any trust other than a domestic trust. A domestic trust is any trust if:

1. A court within the United States is able to exercise primary supervision over the administration of the trust; and
2. One or more U.S. persons have the authority to control all substantial decisions of the trust.

FORM 3520 - REPORTING OWNERSHIP OR TRANSACTIONS WITH FOREIGN TRUSTS

Form 3520 is also used by a U.S. Person or the executor of the estate of a U.S. Person to report:

- Ownership in a foreign trust under the rules of Section 671 through 679 or
- Transactions carried out with a foreign trust.

Failure to file the 3520, or providing incomplete or incorrect information, will result in a penalty of the greater of $10,000 or (a) 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust, (b) 35% of the gross value of the distributions received from a foreign trust for failure by a U.S. person to report receipt of the distribution, or (c) 5% of the gross value of the portion of the trust's assets treated as owned by a U.S. person for failure by the U.S. person to report the U.S. owner information.

A reportable event includes:

1. The creation of a foreign trust by a U.S. person.
2. The transfer of any money or property, directly or indirectly, to a foreign trust by a U.S. person, including a transfer by reason of death. This includes transfers that are deemed to have occurred under sections 679(a)(4) and (5).
3. The death of a citizen or resident of the United States if:
   - The decedent was treated as the owner of any portion of a foreign trust under the rules of sections 671 through 679, or
   - Any portion of a foreign trust was included in the gross estate of the decedent.

Responsible Party

Responsible party means:

- The grantor in the case of the creation of an inter vivos trust,
- The transferor, in the case of a reportable event other than a transfer by reason of death, or
- The executor of the decedent's estate in any other case (whether or not the executor is a U.S. person).

See the instructions for Form 3520 and Code Sec. 6048 for additional information.

FORM 3520-A - ANNUAL INFORMATION RETURN FOR FOREIGN TRUST WITH A U.S. OWNER

A foreign trust with a U.S. owner must file Form 3520-A in order for the U.S. owner to satisfy its annual information reporting requirements under section 6048(b). Each U.S. person treated as an owner of any portion of a foreign trust under sections 671 through 679 is responsible for ensuring that the foreign trust files Form 3520-A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries. *Exception* **-** Canadian registered retirement savings plans (RRSPs) and Canadian registered retirement income funds (RRIFs) are not required to file Form 3520-A with respect to a U.S. citizen or resident alien who holds an interest in a RRSP or RRIF.

Due Date - 15th day of the 4th month after the close of the trust's tax year. Six-month extension available; use Form 7004 for filing extensions.

Penalties - The U.S. owner is subject to an initial penalty equal to the greater of $10,000 or 5% of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of that tax year, if the foreign trust: (a) fails to file a timely Form 3520-A or (b) does not furnish all of the information required by section 6048(b) or includes incorrect information. See section 6677(b). Additional penalties will be imposed if the noncompliance continues after the IRS mails a notice of failure to comply with the required reporting. For more information, see IRC section 6677.

U.S. Criminal penalties may be imposed under sections 7203, 7206, and 7207 for failure to file on time and for filing a false or fraudulent return. Penalties may also be imposed under section 6662(j) for undisclosed foreign financial asset understatements.

Reasonable Cause - No penalties will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect. Reluctance on the part of a foreign fiduciary or provisions in the trust instrument that prevent the disclosure of required information is not reasonable cause.

Mexican Land Trusts - In Revenue Ruling 2013-14, the IRS has determined that "Mexican Land Trust" arrangements (MLTs) with Mexican banks, which allow non-Mexican persons to hold residential real properties in certain areas of Mexico (within 100 kilometers of its inland borders or 50 kilometers of its coastline ("restricted zones")) that they are legally prohibited from holding directly, don't qualify as trusts under Reg. § 301.7701-4(a).

IRS found that the banks aren't acting in a true trustee capacity where their only function is to hold property. However, IRS noted that if the banks hold title to additional assets or have duties beyond merely holding legal title, then the tax classification of the MLT is determined under the regs.

Therefore simply having an MLT does not trigger the filing of Forms 3520 or 3520-A if the MLT does not hold title to additional assets. It will not trigger the filing of Form 8938 since merely holding title to foreign real estate does not require the filing of the 8938. However, if the MLT holds other assets, it may require the filing of an 8938. When there is ownership of foreign real estate, be sure to ask the client about any foreign bank accounts that may be maintained to pay for taxes and upkeep.

FORM 5471 - INFORMATION RETURN OF U.S. PERSONS WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS

This information is awareness only. The filing requirements for Form 5471 are complicated and if your client has an ownership interest, has substantial voting power, or is an officer or director of a foreign corporation, you should consult the instructions for Form 5471. Generally, a U.S. citizen or resident alien (or one who files a joint return with a U.S. citizen or resident alien) who owns a 10% interest in a foreign corporation or commands control over 50% of the voting power in a foreign corporation must file Form 5471.

FORM 709 - TAX ON NON-RESIDENT ALIEN GIFTS OF PROPERTY SITUATED IN THE U.S

A non-resident alien is subject to gift tax when he makes a gift of real or tangible personal property situated in the U.S. (IRC §2501(a)(1)) A gift of U.S. intangible personal property is generally not subject to gift tax but there are exceptions. (IRC §2501(a)(2).

Unified Credit - Non-resident aliens are not entitled to the unified credit. However, non-resident aliens are entitled to:

1. $15,000 in 2019 and 2018 ($14,000 for 2013 thru 2017) annual exclusion for gifts to any person.
2. Unlimited exclusion for gifts to defray educational or medical expenses.
3. The unlimited exclusion for gifts to citizen spouses.
4. $155,000 for 2019 (see table below for other years) annual exclusion for gifts to noncitizen spouses.

Annual Exclusion for Gifts to Noncitizen Spouses

Year	2015	2016	2017	2018	2019	2020
Exclusion	147,000	148,000	149,000	152,000	155,000	

If value not shown, it was not available at publication date

5. Unlimited amount of property to U.S. charity free of gift tax (IRC §2522(b)).
6. Unlimited amount of property to a trust, or foundation, only if the gift is to be used within the U.S.
7. Basis of property, acquired by gift from a non-resident alien, is determined in the same manner as property basis acquired by gift from a resident alien (IRC §1015, 1015(d)).

Form 709 – Use Form 709 to compute the gift tax for non-resident aliens following the special instructions for Part 2, Line 7 that apply to non-resident aliens.

CALIFORNIA DIFFERENCES

Foreign Information Reporting - Starting with tax years beginning on or after January 1, 2016, California conforms to the federal foreign financial assets reporting requirements by certain individuals. The information required to be reported to the FTB is satisfied by filing a copy of the information filed with the federal return, for example, Form 8938. The requirement applies not just to California residents, but to all individuals required to file a California return. When Form 8938 is required for federal purposes, and a copy is not filed with the California return, without reasonable cause for the failure, the individual is subject to a state penalty of a minimum of $10,000 plus an additional $10,000 for each 30-day period in which the failure continues. (AB 154, Ch. 15-359; R&TC 19141.5(d)).

Foreign Rentals – California conforms to the federal reporting for rentals.

Foreign Pensions – California does not have treaties with foreign countries. Thus pensions from foreign sources, even if not taxable for Federal purpose, will be taxable for California. Even though U.S. Social Security is not taxable in California, foreign Social Security payments to U.S. Citizens or residents are fully taxable in California for California residents.

Taxation of Canadian RRSPs and RRIFs - California does not recognize the U.S.-Canada treaty provision allowing deferral of taxation of the earnings of these plans until distributions are received. Thus, the interest, dividends or capital gains earned by these plans annually are taxed by California and are an adjustment on Schedule CA. The amount taxed becomes the taxpayer's basis in the plan for CA purposes and will not be taxed again when distributions are actually received.

NOTES

GOLD & OTHER PRECIOUS METALS

RAPID FINDER

Overview

Jewelry Sales – Generally not a collectible
Capital Gain (max. 20% capital gains rate) and losses not allowed.

Collectible Sales – Capital Gain or loss (max. 28% capital gains rate). Generally includes any metal, gem or coin

Commodity Futures – Capital Gain or Loss, Long-term is 6 months and a day

IRA – Generally cannot invest in collectibles. Some gold and other precious metals coins and bullion are allowed

Sec 1031 Like Kind – Very narrow definitions

Capital Gains Rates – The capital gains rates vary from 0 to 20%. See chapter 2.04 for income thresholds. Collectibles – 28% max. Recaptured Sec 1250 gains – 25%.

Pubs Forms

Related IRS Publications and Forms

- **Form 8300 –** Report of Cash Payments over $10,000 Received in a Trade or Business
- **Form 1099-B** - Proceeds from Broker and Barter Exchange Transactions
- **Pub 590 –** Individual Retirement Arrangements
- **Pub 550 –** Sales and Trades of Investment Property

The Details

When the values of gold and other precious metals reach record levels, many taxpayers are prompted to:

- Invest in gold and other precious metals and gems.
- Sell their personal jewelry for the gold, silver and precious gem values.
- Sell gold and silver coins they have owned for many years.

This chapter deals with some of the unique tax issues associated with precious metals and gems.

SELLING JEWELRY

Generally personal jewelry is excluded from the definition of a collectible and is taxed as the sale of personal property. This would presumably include silverware and silver service pieces not considered antiques. Excluded from this category would be jewelry that includes gold or silver coins that are classified as collectibles.

Personal use property - Property held for personal use is a capital asset (Code Sec. 1221). Personal use property is treated as follows for tax purposes:

- Gains, if long-term, are taxable at capital gains rates (currently 0%/15%/20% - see Chapter 2.04 for income breakpoints).
- Short-term capital gains are taxed at ordinary rates.
- Losses are not allowed.

Thus clients who sell their jewelry would treat any gain as a capital gain on Form 8949 (Schedule D), and be eligible for the preferential capital gains rate if the jewelry was held for over one year.

Big Problem – Establishing basis for the jewelry sold. Foreseeing an economic climate where jewelry is worth far more than its original purchase price isn't something most individuals think about when they acquire jewelry, so very few people will have kept receipts or other documentation for the purchase, inherited value, or the donor's basis in the case of a gift.

The following table may assist you in determining a basis at least for the value of the gold content of the jewelry. One could take the position that, for example, if the jewelry they sold netted 10 ounces of gold, then the basis generally cannot be less than the cost of ten ounces of gold in the year purchased. Of course, you would have to somehow tie the date to some event such as a special birthday, wedding, anniversary, etc., and convince an auditor to accept this approach. Absent a verifiable basis, cost will be considered zero and the entire proceeds of the sale (minus any applicable selling expenses) will be taxable.

PROBLEM
1099s are not generally (see reporting requirements later in this chapter) issued by the buyers and most taxpayers probably don't realize the sale could be a taxable event. Thus taxpayers will probably not voluntarily fess up to their preparer about selling the family jewels. Tax preparers should make it standard office practice to inquire.

Historical Average Annual Gold Prices

Year	$/oz	Year	$/oz	Year	$/oz	Year	$/oz	Year	$/oz
1970	36.02	1980	615.00	1990	383.51	2000	279.11	2010	1,224.53
1971	40.62	1981	460.00	1991	362.11	2001	271.04	2011	1,571.52
1972	58.42	1982	376.00	1992	343.82	2002	309.73	2012	1,668.98
1973	97.39	1983	424.00	1993	359.77	2003	363.38	2013	1,411.23
1974	154.00	1984	361.00	1994	384.00	2004	409.72	2014	1,266.40
1975	160.86	1985	317.00	1995	383.79	2005	444.74	2015	1,160.06
1976	124.74	1986	368.00	1996	387.81	2006	603.46	2016	1,250.74
1977	147.84	1987	447.00	1997	331.02	2007	695.39	2017	1,226.74
1978	193.40	1988	437.00	1998	294.24	2008	871.96	2018	1,253.00
1979	306.00	1989	381.00	1999	278.98	2009	972.35	2019	1,318.20*

1833-1918 the price range was $18.93 to $18.99
1919-1932 the price range was $20.00 to $20.69
1933–1969 the price range was $26.33 to $41.28

Source: Prices from 1883-1994, World Gold Council. Taken from Timothy Green's *Historical Gold Price Table*, London prices converted to U.S. Dollars. Prices from 1995-2019, Kitco.com, based on the London PM fix.
*thru July 22, '19

Historical Silver Prices (Range within Period) – Per Ounce

1950-60	1961-65	1966-70	1971-78	1979-80	1981-89	1990-99	2000-10	2011-19*
.75-.91	.91-1.27	1.27-2.20	1.60-5.50	5.50-25.00	11.50-3.50	4.80-5.60	5.60-20.92	52.99-15.24

Note: Values shown are approximate – For exact values, Google "Silver Price Historical" *Through July 22, 2019 Price 7/22/19 $16.20

SELLING COLLECTIBLES

Collectibles gains and losses are derived from the sale or exchange of a collectible as defined in Code Sec. 408(m) (without regard to paragraph 3) held for more than one year. "Collectible" gains are taxed at a maximum rate of 28%. A taxpayer in a lower tax bracket, will be taxed at that lower rate. Code Sec 408 lists the following as collectibles:

- Works of art,
- Rugs,
- Antiques,
- **Any metal or gem,**
- Any other tangible personal property specified by IRS for this purpose (Code Sec. 408(m)(2)).
- Stamps
- **Coins**,
- Alcoholic beverages, or

This designation includes all forms of gold (other than jewelry), such as…

- All denominations of gold bullion coins and numismatic/rare coins, gold bars, and gold wafers.
- Any electronic form of gold where the metal is purchased and held in a virtual account. Examples include: GoldMoney.com and BullionVault.com
- Any "paper" or certificate forms of gold, such as Perth Mint Certificates and EverBank accounts.
- All forms of pool gold, rounds, and commemorative coins.

The "collectibles" designation and rules also apply to silver, platinum, and palladium.

Exchange Traded Fund (ETF) – An ETF is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange. According to IRS, ETFs that directly invest in precious metals ("physically backed metal ETFs") generate collectibles gain or loss to their investors (Internal Legal Memorandum PMTA2008-01809). This analysis won't apply if the ETF is not structured as a trust, or if the ETF doesn't directly invest in the metal. Examples of ETFs operating as grantor trusts are SPDR Gold Trust and iShares Silver Trust. Thus, the structure of each "physically backed metal ETF" must be considered to determine the tax consequences of an investment in that ETF.

For ETFs structured as grantor trusts, the preparer will need to carefully review the details included in the 1099 package provided by the taxpayer's broker, or a tax information booklet issued by the trust. The latter may be found online (search by the name of the ETF plus "tax information") if the taxpayer doesn't have a copy. The information in these documents is used to compute the adjusted basis of any metal sold by the trust during the year, and considered a pass-through transaction to the ETF shareholder, so that the proper amount of gain or loss is reported by the taxpayer. Any long-term capital gain is taxable at a maximum rate of 28%. In addition, investment expenses (deductible on Schedule A as a miscellaneous itemized deduction subject to the 2%-of-AGI reduction for years before 2018 and after 2025) must also be separately calculated.

Other Issues related to collectibles:

- Collectibles gain includes gain from the sale of an interest in a partnership, S corporation, or trust due to unrealized appreciation of collectibles.
- Form 1099-DIV – Collectibles gain is reported in box 2d.
- Form 2439 – Undistributed collectibles gain is included in box 1d.

COMMODITY FUTURES

A commodity future is a contract for the sale or purchase of a commodity at a future date for a fixed price. Commodity futures contracts are classified as capital assets, resulting in capital gain or loss. However, when used as part of a hedging transaction, they result in an ordinary gain or loss.

Holding period – The long-term holding period for a commodity future that is subject to the rules of a board of trade or commodity exchange is 6 months and a day.

GOLD STOCKS

Gold mining stocks are not designated as a collectible and therefore, when sold, are subject to the standard capital gains tax rates like all other stocks.

IRAS INVESTED IN COLLECTIBLES

The acquisition by an IRA of any "collectible" is treated as a distribution from the IRA in an amount equal to the cost to the IRA of the "collectible." (Code Sec. 408(m)(1))

Exception - An IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one-ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion. (IRS Pub 590)

An investment in a coin that has been made into a piece of jewelry is considered an investment in a collectible and will be considered a distribution. That is, the exception from treatment as a collectible for gold or silver coins, etc., will not apply. (Notice 87-16)

Exception to the Collectible Rule - The acquisition of shares of a trust invested in gold or silver by either an IRA, or an individually-directed account under a qualified retirement plan, won't be considered the acquisition of a collectible. Thus, the amount invested will not be considered a distribution. However, a redemption of shares that results in a distribution of gold bullion would be treated as an investment in collectibles and as a distribution (IRS Letter Ruling 200732026; IRS Letter Ruling 200732027).

SEC 1031 EXCHANGES

After 2017: Coins and precious metals do not meet the definition of a Sec 1031 exchange. TCJA of 2017 limits Sec 1031 exchanges to real estate transactions only.

Prior To 2018: Certain trades in coins and precious metals meet the definition of a Sec 1031 exchange. When it comes to coins and precious metals the like-kind definition is very narrow. For instance, gold coins are broken down into two categories, those which are numismatic in character (i.e., where the value of the coins is determined by their age, number minted, history, art and aesthetics, condition, and metal content) and those that are bullion-type gold coins. An exchange of numismatic coins for bullion-type coins is not like-kind. Silver exchanged for gold does not qualify for Sec 1031 treatment.

> **Example** - The exchange of U.S. $20 gold coins (numismatic-type coins) for South African Krugerrand gold coins (bullion-type coins) does not qualify as a Sec 1031 exchange. (Rev. Rul. 76-214)
>
> **Example** – The exchange of gold bullion for Canadian Maple Leaf gold coins (bullion-type coins) qualifies as a Sec 1031 exchange. (Rev. Rul. 82-96)
>
> **Example** - The exchange of gold bullion held for investment for silver bullion held for investment does not qualify for Sec 1031 treatment. (Rev. Rul. 82-166)

REPORTING REQUIREMENTS

Form 8300 – Form 8300 is part of the U.S. government's effort to combat money laundering, and whenever a trade or business receives payment of $10,000 or more in cash or cash equivalents in one transaction, or in two or more related transactions, the dealer must file the form. Transactions are considered related even if they occur over a period of more than 24 hours if the recipient knows, or has reason to know, that each transaction is one of a series of connected transactions. ***Precious metal, gem and coin dealers, jewelers, etc., are subject to these rules***.

Cash – For purposes of Form 8300, cash is defined as:

- U.S. and foreign coin and currency received in any transaction; or
- A cashier's check, money order, bank draft, or traveler's check having a face amount of $10,000 or less that is received in a designated reporting transaction, or that is received in any transaction in which the recipient knows that the instrument is being used in an attempt to avoid the reporting of the transaction under either section 6050I or 31 U.S.C. 5331. Note: Cash does not include a check drawn on the payer's own account, such as a personal check, regardless of the amount.

Example: *Don, an individual, buys gold coins from Max, a coin dealer, for $13,200. Don tenders payment to Max in the amount of $6,200 cash and a cashier's check in the face amount of $7,000, which Don had bought. Because the sale is a designated reporting transaction, the cashier's check is treated as cash. Therefore, because Max has received more than $10,000 in cash with respect to the transaction, Max must complete and file the Form 8300 for the transaction.*

Form 8300 requires the name, SSN and contact information of the individual making the payment.

Form 1099-B **-** A sale of a precious metal (gold, silver, platinum, or palladium) in any form for which the Commodity Futures Trading Commission (CFTC) has not approved trading by regulated futures contract (RFC) is not reportable on Form 1099-B. Further, even if the sale is of a precious metal in a form for which the CFTC has approved trading by RFC, the sale is not reportable if the quantity, by weight or by number of items, is less than the minimum required quantity to satisfy a CFTC-approved RFC (2019 1099-B Instructions). For example, at the time this chapter was last updated, sales of fewer than 25 1-ounce Krugerrand or Maple Leaf gold coins or 1,000 US 90% silver dollars, do not fall under the RFC trading rules and thus are exempt from the 1099-B reporting requirements.

Sales of precious metals for a single customer during a 24-hour period must be aggregated and treated as a single sale to determine if this exception applies. This exception does not apply if the broker knows or has reason to know that a customer, either alone or with a related person, is engaging in sales to avoid information reporting.

CALIFORNIA DIFFERENCES

California taxes long- and short-term capital gains as regular income. No special rate for long-term capital gains exists.

The TCJA provision that limits Sec 1031 treatment only to exchanges of real property was adopted by California in AB 91 (signed by the governor 6/27/2019), with two significant differences: the provision only applies to taxpayers with AGI of $500,000 or more ($250,000 for those filing single or married separate) and only applies to exchanges completed after January 10, 2019. Thus gains on exchanges of coins and precious metals that are of like-kind, and that meet the other Sec 1031 requirements and were completed January 10, 2019 or earlier would be eligible for tax deferral on the state return, as would exchanges done by taxpayers with AGI less than $500,000 ($250,000 if filing single or MFS).

California has not conformed to the suspension of tier 2 miscellaneous deductions imposed by the TCJA for 2018 through 2025. Therefore, investment expenses such as those related to ETFs would be deductible on the state return, provided the total miscellaneous deductions exceeds 2% of the federal AGI.

NOTES

CROWDFUNDING

The term "crowdfunding" generally refers to a process of raising money by an individual or business to fund a project or business venture, generally through an online site such as GoFundMe, Kickstarter or Indiegogo, that bypasses traditional lenders such as banks or venture capitalists, and instead appeals directly to the local, or even global, community for financial backing. Originally used by artists, filmmakers and musicians as a way to fund their artistic or musical endeavors, the use of crowdfunding has expanded to include activists, entrepreneurs and even those in need of medical treatment.

RAPID FINDER	
1099-K	1.16.02
Charitable Contribution	1.16.03
Company Raising Capital	1.16.01
Donation Based	1.16.01
Equity Based	1.16.01
Expenses	1.16.03
Gift	1.16.02
Gift Tax	1.16.03
Individuals	1.16.02
Loans	1.16.02
Net Worth	1.16.01
Private Letter Ruling	1.16.02
Quid Pro Quo	1.16.02
Rewards based	1.16.01
SEC	1.16.01

Related IRC and IRS Publications and Forms

- Jumpstart Our Business Startups (JOBS) Act of 2012
- Section 61(a)
- Form 1099-K

How Crowdfunding Works – Crowdfunding is generally done using an online platform that allows the fundraiser to explain the nature of the project or venture, including the amount of money they hope to raise, and the time frame (deadline) for the money-raising campaign. Often, the fundraiser will offer some type of reward to those who contribute (usually termed a backer). The rewards are often really just tokens – a coffee cup or t-shirt with a logo, tickets to an event, a CD – or in some cases an equity interest in the endeavor, or the right to be repaid with interest if the campaign is financially successful. Typically, backers who are interested in participating use their credit card to make a pledge, and if the campaign meets its financial goals within the deadline, the crowdfunding site will process the card-based pledges and fund the campaign.

Types – There three main types of crowdfunding:

- **Equity-Based**: Equity crowdfunding is the process by which an individual is able to invest in an early-stage company in exchange for shares in that company. This type of crowdfunding is best suited for businesses that are established but in need of capital for expansion. However, this type of fundraiser is subject to Securities Exchange Commission (SEC) regulations discussed below.

- **Donation Based**: Donor platforms allow money to be raised without any obligations to investors. Contributions to the stated cause are donations or gifts with no strings attached. Common donation-based causes include philanthropy; medical, funeral or living expenses for individuals; and disaster-relief.

- **Rewards-Based** fundraising is most commonly associated with platforms like Kickstarter and Indiegogo. Through the rewards system, individuals and businesses raise money by offering a product or service in exchange for a campaign contribution.

SEC Issues – Under the Securities Act of 1933, the offer and sale of securities must be registered unless an exemption from registration is available. Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 added Securities Act Section 4(a)(6) that provides an exemption from registration for certain crowdfunding transactions. The Securities and Exchange Commission (SEC) issued final regulations, effective May 16, 2016, implementing these JOBS Act provisions. These regulations permit companies to offer and sell securities through crowdfunding and create a regulatory framework for the broker-dealers and funding portals that facilitate the crowdfunding transactions. These rules, which have a substantial impact on crowdfunding, include the following provisions:

- **Companies Raising Capital:**
  - The maximum amount a company can raise through crowdfunding in a 12-month period is $1.07 Million.
  - Non-U.S. companies, businesses without a business plan, Exchange Act reporting firms, certain investment companies and companies who have failed to meet their reporting responsibilities may not participate.

- **Individuals -** Amounts individuals can invest in any 12-month period is limited. These numbers are inflation adjusted. If the individual's:
  - Annual income or net worth is less than $107,000, an equity investment through crowdfunding is limited to the greater of $2,200 or 5% of their annual net worth.
  - Annual income or net worth are both at least $107,000, investment via crowdfunding is limited to 10% of the lesser of their net worth or annual income up to an aggregate limit of $107,000.

For details on these regulations, see: https://www.sec.gov - enter *crowdfunding* in the search box.

Section 61(a) of the Internal Revenue Code provides the general rule that, except as otherwise provided by law, gross income includes all income from whatever source derived. Gross income includes all accessions to wealth, whether realized in the form of cash, property or other economic benefit. However, some benefits that a taxpayer receives are excludable from income, either because they do not meet the definition of gross income or because the law provides a specific exclusion for certain benefits that Congress chooses not to tax.

In general, money received without an offsetting liability (such as a repayment obligation), that is neither a capital contribution to an entity in exchange for a capital interest in the entity nor a gift, is includible in income. The facts and circumstances of a particular situation must be considered to determine whether the money received in that situation is income.

What that means is that crowdfunding revenues generally are includible in income if they are not

1) Loans that must be repaid,

2) Capital contributed to an entity in exchange for an equity interest in the entity, or

3) Gifts made out of detached generosity and without any "quid pro quo." However, a voluntary transfer without a "quid pro quo" is not necessarily a gift for federal income tax purposes. In addition, crowdfunding revenues must generally be included in income to the extent they are received for services rendered or are gains from the sale of property.

Section 1.451-2 of the Income Tax Regulations sets forth the constructive receipt doctrine and provides that income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. The regulation further provides that income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. However, a self-imposed restriction on the availability of income does not legally defer recognition of that income.

Thus, the income tax consequences to a taxpayer of a crowdfunding effort depend on all the facts and circumstances surrounding that effort.

A taxpayer may request a private letter ruling from the Internal Revenue Service that applies the law to the taxpayer's particular facts and circumstances. The procedure for obtaining a private letter ruling is set forth in Rev. Proc. 2016-1, 2016-1 I.R.B. 1.

Does the IRS track crowdfunding payments? Maybe. It depends on the aggregate number of backers contributing to the campaign and the total amount of the payments. Code Sec. 6050W requires third party transaction companies (credit card, PayPal, etc.) to issue a 1099-K reporting the gross amount of such transactions. There is a de minimis reporting threshold of $20,000 or 200 reportable transactions per year. Question is, will the third party follow the de minimis rule?

Is the income received by the fundraiser taxable or is it a tax-free gift? It depends. Code Sec. 61(a)(1) defines gross income as "all income from whatever source derived." This definition is construed broadly and unless the taxpayer can demonstrate that the income fits into one of the exclusions provided by law it will be taxable. One of those exceptions is provided in Code Sec. 102, where the amount received is a gift if it: comes from a detached and disinterested generosity; is made out of affection, respect, admiration, charity or like impulses; is not made from any moral or legal duty, nor from the incentive of anticipated benefit of an economic nature; and is not in return for services rendered. (*Comm. v. Duberstein, (S Ct, 1960) 5 AFTR 2d 1626*) Recipients may exclude payments that they receive under Code Sec. 102 if they meet the *Duberstein* standard. If there is a quid pro quo in which the donor receives a tangible economic benefit in return for his contribution, then there isn't a gift.

So are the rewards that backers sometimes receive for their crowdfunding participation of significant enough value that the donor receives an economic reward (thus negating a gift) or is it an inconsequential economic incentive that can be ignored? While we do not have the IRS' opinion on the question, the consensus of commentators is that if the crowdfunding is, for example, for the purpose of paying someone's medical bills, it is likely that the funds will be considered a nontaxable gift. On the other hand, if the purpose of the campaign is, for example, to fund the fundraiser's independent film project or start or expand a business, the income is likely taxable.

If the fundraising provides equity in a company, then the one raising the capital must treat each contributor as an investor with equity or stock ownership in whatever business entity the venture is using. The SEC, under the regulations noted above, requires that each investor be included in the normal information reporting requirements, which can be quite extensive. In other words, the entity must be treated as a real business.

If a gift, is the amount subject to gift tax? Maybe. Depending on the amount of the contribution, the relationship between the fundraiser and backer, and the total amount of gifts made during the year by the backer to the fundraiser. For 2019 the annual exclusion of $15,000 is available for gifts to each donee.

Are crowdfunding project expenses deductible? It depends. Sec. 162(a) allows a deduction for all "ordinary and necessary expenses" paid or incurred during the tax year in carrying on any trade or business provided the taxpayer can show that he engaged in the activity with an actual and honest profit objective. So to answer the question, you need to know whether the crowdfunding project is a "trade or business" carried on with an expectation of profit, or whether it is an endeavor with no expectation of profit where the payback is other than monetary (e.g., "vanity" publishing).

If it is a hobby, and not a for-profit activity, deductions are only allowed to the extent of income from the activity (and only as a miscellaneous itemized deduction subject to the 2% of AGI reduction, but these deductions are suspended by the TCJA for years 2018 through 2025).

If a trade or business, the service fees charged by the crowdfunding platform would be deductible by an ongoing business, as would the cost of the rewards (mugs, shirts, etc.) discussed above and the costs related to the actual funded project. Start-up expenses up to $5,000 would be deductible if elected by the taxpayer, with start-up costs in excess of $5,000 amortized over 180 months.

Are charitable contributions allowed to the backer for his/her contribution? Only if the crowdfunding was sponsored by a qualified Sec 501(c)(3) organization and that organization was the recipient of the funds, and the donor meets all other requirements for claiming a charitable contribution (i.e., itemizes, has required receipt and/or acknowledgment, etc.). Contributions to an individual would not be deductible.

CALIFORNIA DIFFERENCES

California conforms to federal treatment

NOTES

IDENTITY THEFT & TAX FRAUD ISSUES


Overview

Identity theft and tax fraud are growing at an alarming rate. These issues see potential tax dollars fraudulently diverted to offshore accounts to be used for who knows what purpose, and we see our clients defrauded out of their hard earned money and their lives turned upside down because of ID theft.

As a tax practitioner you have a fundamental responsibility to do every thing you can to combat ID theft and tax fraud committed against your clients.


Pubs
Forms

Related IRS Publications and Forms

- **Form 14039** – Identity Theft Affidavit
- **Pub 4524** – Security Awareness – Identity Theft
- **Pub 5199** – Tax Preparer Guide To Identity Theft
- **Pub 5027** – Identity Theft Information For Taxpayers
- **Pub 4600 –** Safeguarding Taxpayer Information
- **Pub 4557** – Safeguarding Taxpayer Data
- **Pub 5293** – Data Security Resource Guide for Tax Professionals

A SUGGESTION – MINIMIZE CONNECTION TO THE INTERNET

A great deal of ID theft is accomplished by hacking into computers connected to the Internet via all sorts of schemes developed by ID thieves. Tax practitioners are targets because of the client data contained on their computers. One way to minimize exposure is to have one computer dedicated to only processing tax returns and then only connect to the Internet for the short periods when you are downloading software or e-filing. All other times work off line. Have another computer you use for other purposes.

IRS & TAX INDUSTRY BAND TOGETHER TO COMBAT TAX FRAUD

Starting in 2015 the IRS began working with state tax administrators and tax preparation and software companies on a major effort to combat identity theft tax refund fraud, including several initiatives to improve taxpayer authentication and detect refund fraud, share and assess information about fraudulent activity, and increase public awareness of the need to protect personal information.

Among the results for 2016 are the following *(IR 2016-94, 6/29/16)*:

- New protocols required all individual tax software customers to update their security credentials to a minimum eight-digit password and establish security questions.
- Software providers shared approximately 20 data elements from tax returns with the IRS and states to help identify possible fraud. These elements are confidential but include information to identify returns prepared quickly by automated programs. From January through April 2016, the IRS stopped $1.1 billion in fraudulent refunds claimed by identity thieves on more than 171,000 tax returns. Better data from returns and information about schemes meant better internal processing filters to identify identity theft tax returns.
- Participants from the tax industry performed regular reviews to identify possible identity theft schemes and report them to the IRS and state agencies to help stay on top of emerging schemes. Thanks to leads reported from the tax industry, the IRS suspended for further review 36,000 suspicious returns January through May 8, 2016, and $148 million in claimed refunds. A "Taxes. Security. Together" campaign was launched to increase public awareness about the need for computer security and provide people with tips on how to protect their personal information.

Additional initiatives were put in place for the 2017 filing season, and like the earlier ones, they generally were invisible to taxpayers. A few of the 2017 initiatives were:

- Expanding a W-2 Verification Code test to cover approximately 50 million forms in 2017. The selected forms contain a 16-digit code that taxpayers and tax preparers enter when prompted by software. The code helps validate not only the taxpayer's identity but also the information on the form.
- Identifying additional data elements from tax returns that will help improve authentication of the taxpayer and identify possible ID theft scams and sharing data elements from corporate tax returns.
- Creating an Identity Theft Tax Refund Fraud Information Sharing & Analysis Center (IDTTRF-ISAC) to collect and analyze tax-related ID theft schemes and serve as the early warning system for the IRS, state agencies and the tax industry.

- Expanding the "Taxes. Security. Together." awareness campaign to tax return preparers to ensure they have the information they need to protect themselves from cyberattacks and to safeguard taxpayer data.
- Creating a process for financial institutions to identify questionable state tax refunds and return them to states for validation.
- Continuing enhancement by the software industry of software password requirements for individuals and tax professional users – providing additional safety prior to filing.

The IRS announced results from calendar year 2018 that show major progress in the fight against tax-related identity theft (IR-2019-66 (April 9, 2019), including:

- Between 2015 and 2018, the number of taxpayers reporting they were identity theft victims (i.e., they filed ID theft affidavits) fell 71%. In 2018, the IRS received 199,000 ID theft reports from taxpayers compared to 677,000 in 2015. The number of reports in 2017 was 242,000 compared to 401,000 for 2016.

- Between 2015 and 2018, the number of confirmed identity theft returns that the IRS stopped declined by 54%. For 2018, there 649,000 confirmed ID theft returns, compared to 597,000 in 2017, a 9% increase. But the 2018 count is still significantly less than the 883,000 in 2016 and the 1.4 million in 2015.

- Between 2015 and 2018, the IRS protected a combined $24 billion in fraudulent refunds by stopping the confirmed identity theft returns. In 2018 the 649,000 confirmed fraudulent returns tried to collect $3.1 billion in refunds. In 2015, 2016 and 2017 the IRS stopped fraudulent refunds of $8.7 billion, $6.4 billion and $6 billion, respectively. On top of the fraudulent refunds the IRS protected, the financial industry recovered an additional $1.4 billion in fraudulent refunds from 2015 through 2018.

However, in spite of the progress the IRS and its Security Summit partners have made, the ID thieves are continuously changing their tactics and targets. Most worrisome now are business identity theft and data theft from tax professionals, particularly thieves hacking into practitioners' computer systems, stealing client data and filing fraudulent tax returns, often before a preparer even knows they have been victimized. Thieves are also aiming to steal tax practitioners' Electronic Filing Identification Numbers (EFIN) or Preparer Tax Identification Numbers (PTIN) to use in filing fraudulent returns. Tax professionals who experience a data theft should contact their IRS stakeholder liaison immediately for assistance.

ID THEFT PROTECTION SERVICES

The IRS won't assert that an ID theft victim has to include in gross income the value of free ID theft protection services, etc., provided by the entity that was hacked. (Ann. 2015-22, 6/13/15) In a follow-up announcement, the IRS said that Announcement 2015-22 should be extended to include identity protection services provided to employees or other individuals *before* a data breach occurs. Therefore, the IRS will not assert that an individual must include in gross income the value of identity protection services provided by the individual's employer or by another organization to which the individual provided personal information such as name, SSN, or banking or credit account numbers. Employers providing ID protection services should not include the value of those services in employees' gross income and wages. However, if cash is received in lieu of ID protection services, the cash amount is included in gross income and does need to be reported on Form W-2 or 1099-MISC, as applicable. Proceeds received under an ID theft insurance policy are treated the same as other insurance recoveries under existing law, and are not covered by the announcement. (Ann. 2016-02, 12/30/15)

CLIENT EDUCATION

Scammers – So why is it so easy for criminals, by phone or e-mail, to perpetrate these crimes on your clients? It is most likely attributable to clients' inherent fear of the IRS. The same reason they send the IRS money when they get one of those CP notices without first contacting you and then informing you afterwards. It is the false belief by clients that the IRS never makes any mistakes. They simply want to avoid contact with the IRS at all costs without asking why. That is why it so important that you educate them and let them know:

- Scammers pretending to be IRS agents are calling taxpayers every day trying to dupe them.
- The IRS almost never initiates contact by phone or e-mail.*
- Never to open links on a suspicious e-mail.
- The IRS never asks for credit card, debit card, prepaid card information or account PINs over the telephone.
- The IRS never insists that taxpayers use a specific payment method to pay tax obligations.
- The IRS never requests immediate payment over the telephone.
- The IRS will not take enforcement action immediately following a phone conversation. Taxpayers usually receive prior written notification of IRS enforcement action involving IRS tax liens or levies.

The best practice is for clients to simply hang up on the caller. If they harass a client suggest the client block that phone number if possible.

*Apparently it had been long-standing IRS policy, in some cases, to make initial examination appointments by phone. However, because of the ongoing threat of phishing, phone scams and ID theft, as of May 20, 2016, all initial contacts with taxpayers to commence an examination must be done by mail. (Memo from John Dalrymple, Deputy Commissioner for Services and Enforcement, 5/20/16) Per the IRS web site: "IRS employees conducting audits may call taxpayers, but not without having first attempted to notify them by mail. After mailing an official notification of an audit, an auditor/tax examiner may call to discuss items pertaining to the audit." The IRS "may visit the taxpayer's home or business without notification to the taxpayer if attempts to communicate with the taxpayer in other ways, such as letters or phone calls, are not successful."

ID Theft – Impress on your clients the importance of not divulging key information about themselves or their family members. A combination of name, address, SSN and birth date is a bonanza to ID thieves. It is important to know that not all ID thieves use the data they collect. Some sell the information to others who commit the crimes. Stolen IDs can easily be purchased on line.

E-FILING FACILITATES TAX FRAUD

The IRS promotes e-filing because it eliminates the need (and costs) for thousands of data entry personnel at the IRS service centers around the country (thus eliminating thousands of jobs nationwide). In addition, e-filing provides them with all the data included on a return, not just the crucial information they key in from paper-filed returns, enhancing their abilities to perform computer analysis and matching programs. But it also opened the door for clever crooks who quickly found weaknesses in the system.

One such weakness was that the IRS would begin accepting e-filed returns near the end of January, well over a month before the employer deadline for filing W-2s with the government. So here is what has been happened: the crooks would.

- Buy, steal or appropriate the IDs of two unrelated male and female taxpayers.
- Appropriate the employer identification number (EIN) of any company.
- Make up phony W-2s using the company's EIN.
- Open a bank account using the stolen IDs of the two individuals.
- Make up a phony 1040 with a large refund.
- E-file the return right after e-file season opened.
- Use Direct Deposit to have the refund deposited into the bank account within 2 weeks or less.
- Clean out the bank account as soon as the refund arrived.
- Disappear without a trace.

In the meantime you would try to file your client's return and it would be rejected as already filed. You attempt to get a copy of the return but can't because you don't have the ID of the other unfortunate taxpayer who was used as the other spouse on the return. All the while the scammers were enjoying their ill-gotten gains with impunity.

Earlier W-2 Filing Deadline - To combat this type of fraud, which has cost the government many millions of dollars over the years, Congress, as part of the PATH Act of 2015, standardized the W-2 filing due date. Beginning in 2017, both the employee and government copies of Forms W-2, W-3 and 1099-MISC (when nonemployee compensation is reported) are due by January 31, regardless of whether the forms are filed on paper or electronically. In addition, and also starting in 2017, the IRS eliminated automatic extensions for W-2s, but will allow an employer a 30-day non-automatic extension, likely to be granted only under extraordinary circumstances such as a natural disaster or fire. The request for extension is done on Form 8809, Application for Extension of Time to File Information Returns, and must be requested by the January 31 due date. (*Reg. §1.6081-8T*)

Delayed Refund Payments – Another change that started in tax season 2017 also has helped combat tax fraud. This law prohibits the IRS from issuing refunds from returns claiming the earned income tax credit or the additional (refundable) child tax credit prior to the 15th day of the second month following the close of the year (February 15 for calendar year filers). (PATH Act Sec 201(a)).

QUEEN OF IRS TAX FRAUD

Rashia Wilson, a 27-year old mother of three from Wimauma, FL employed the con described above and over a 3-year period she and her boyfriend defrauded the IRS out of more than $30 million with bogus tax returns. She would have never been caught except for the fact that she taunted authorities on Facebook. She was sentenced to 21 years in prison for tax fraud.

DIRECT DEPOSIT - TAX PREPARER ABUSE & FRAUD

As a way to reduce the cost of issuing refund checks the IRS developed the Direct Deposit method. If the taxpayer wants their refund directly deposited to one bank account, all they need to do is enter the bank routing number and their bank account number on page 2 of Form 1040. By completing and submitting Form 8888, the refund can be routed to multiple accounts, which opens the door to abuse. Here again, the IRS failed to anticipate potential abuses, which resulted in taxpayers' refunds being improperly used or outright stolen.

The first issue, and less concerning, is some practitioners had their fee taken out of the refund and direct deposited to their own account. This is a direct violation of Circular 230, Sec 10.31, which bars the negotiation of a taxpayer's refund by a tax preparer.

The second situation involves dishonest practitioners who prepare an individual's return, give them a copy of their return that shows the refund they are expecting to be direct deposited, and then after the client leaves, alter the return to produce a larger refund before e-filing the return and directing the extra refund amount to their own account.

The IRS was slow to respond to Direct Deposit abuses, but now they will allow only three tax refunds to be deposited electronically into a taxpayer's account or prepaid credit or debit card. Subsequent refunds will be issued by paper check. Further, direct deposits will be made only to accounts bearing the taxpayer's name. As a result, preparer fees cannot be paid by using Form 8888 to split a refund or by preparers opening a joint bank account with taxpayers.

This will put a damper on preparers getting their fee out of the refund, but will not curtail the "Wilson" type fraud.

CONTRIBUTION FRAUD

Another fraud and ID theft scam associated with tax preparation involves charity scams. The fraudsters pop up whenever there are natural disasters such as earthquakes, floods, etc., trying to coax your client into making a donation that will go into the scammer's pockets and not to help the victims of the disaster. These same crooks might also steal your client's identity for other schemes. They use the phone, mail, e-mail, websites and social networking sites to perpetrate their crimes.

When disaster strikes, you can be sure that scam artists will be close behind. It is a natural instinct to want to provide assistance right away but potential donors should exercise caution and make sure their hard-earned dollars go for the purpose intended, not to line the pockets of scam artists. You need to make your clients aware of this type of fraud. The following are some tips to avoid fraudulent fund raisers.

- Donate to known and trusted charities. Be alert for charities that seem to have sprung up overnight in connection with current events.
- Ask if a caller is a paid fundraiser, who they work for, and what percentage of the donation goes to the charity and to the fundraiser. If a clear answer is not provided — consider donating to a different organization.
- Don't give out personal or financial information — including credit card or bank account number — unless the charity is known and reputable.
- Never send cash: The organization may never receive the donation, and there won't be a record for tax purposes.
- Never wire money to a charity. It's like sending cash.
- If a donation request comes from a group claiming to help a local community agency (for example, local police or firefighters), ask the local agency if they have heard of the group and are getting financial support.
- Check out the charity with the Better Business Bureau's (BBB) Wise Giving Alliance, Charity Navigator, Charity Watch, or GuideStar.

PHISHING

Phishing (pronounced fishing) is the attempt to acquire sensitive information such as usernames, passwords, and credit card details (and sometimes, indirectly, money) by masquerading as a trustworthy entity in an electronic communication. Communications purporting to be from popular social web sites, auction sites, banks, online payment processors or IT administrators are commonly used to lure the unsuspecting public. Phishing e-mails may contain links to websites that are infected with malware. Phishing is typically carried out by e-mail spoofing or instant messaging and it often directs users to enter details at a fake website whose look and feel are almost identical to the legitimate one.

There have been a number of phishing scams utilizing look-a-like IRS website pages. These sites use cons such as "get your refund on your Visa and MasterCard" where unsuspecting individuals enter their name, address, date of birth, SSN, mother's maiden name, credit card number, and even the 3 digit code on the back of the card. Another one that has made the rounds claimed there was a problem with an electronic funds tax payment system (EFTPS) payment. Others are just plain malicious and attempt to get individuals to open e-mails and go to websites where malware will download and infect your computer.

Increasingly, tax professionals are being targeted by identity thieves who are looking for real client data to better impersonate the taxpayer when filing fraudulent returns for refunds. One such phishing email emerged in the spring of 2017 purporting to be from a tax software education provider. It was seeking an unusual amount of sensitive preparer data that would enable the thieves to steal client information and file fraudulent tax returns. Tax professionals are reminded that legitimate businesses and organizations never ask for usernames, passwords or sensitive data via email. Nor should a preparer ever provide such sensitive information via email if asked.

Targets of phishing scams can help by forwarding phishing e-mail purportedly from the IRS to phishing@irs.gov For more information visit IRS.gov and search "phishing".

IDENTITY THEFT

To understand just how big a problem identity theft has become for the IRS, they've had more than 3,000 employees working on identity theft cases and have trained more than 35,000 employees who work with taxpayers to recognize and provide assistance when identity theft occurs.

When ID theft happens it becomes a huge problem for the taxpayer and the taxpayer's tax preparer. So, the best way to combat ID theft is to protect against it in the first place and avoid becoming one of those unfortunate individuals that has to deal with it. Here are some tips to protect from becoming a victim:

- Never carry a Social Security card or any documents that include your Social Security number (SSN) or Individual Taxpayer Identification Number (ITIN).
- Don't give anyone your or a family member's SSN or ITIN just because they ask. Give it only when required.
- Protect financial information.
- Check credit report every 12 months.
- Secure personal information at home.
- Protect personal computers by using firewalls and anti-spam/virus software, updating security patches and changing passwords for Internet accounts. Don't use the same password for all accounts.
- Portable computers, tablets and smartphones can be stolen or lost. Limit the amount of personal information they contain that can be used for ID theft. Be extra vigilant against theft.
- Don't give personal information over the phone, through the mail or on the Internet without validating the source.

Indicators of ID Theft:

- More than one tax return for the taxpayer was filed;
- There is a balance due, refund offset or collection actions have been taken for a year the taxpayer did not file a tax return;
- IRS records indicate the taxpayer received more wages than actually earned; or
- State or federal benefits were reduced or cancelled because the agency received information reporting an income change.

IDENTITY THEFT AND THE IRS

IRS Discovery - In some situations, the IRS will discover an ID theft before the taxpayer recognizes it. When this occurs, the IRS will issue one of the two following letters indicating they need to verify certain tax return information with the taxpayer. Although the letters do not say that suspicious or multiple returns have been filed using the taxpayer's information, this is a pretty good indicator that the taxpayer's ID has been compromised. The taxpayer should respond to the IRS immediately at 800-830-5084.

IRS 4883C LETTER

Why are we contacting you?

We received your federal income tax return; however, we need more information to verify your identity in order to process it. The letter you received provides a toll-free IRS Identity Verification telephone number to call.

This contact information is only for taxpayers who received Letter 4883C. The toll-free number is for identity verification only. No other tax-related information, including refund status, is available.

What should you do?

Please call the toll-free IRS Identity Verification telephone number provided in your letter. You will need to have a copy of your prior year tax return and your most recently filed tax return. The toll-free IRS Identity Verification telephone number is available for you to call even if you haven't filed a tax return for this year.

Continue to next page

IRS 5071C LETTER

Why are we contacting you?

We received a federal income tax return with your name and/or social security number. We want to protect you from potential identity theft so we are asking you to verify your identity and tell us if you submitted the return. The letter you received provides two options for responding. Both options enable you to verify your identity with us so we can continue processing your tax return.

This contact information is only for taxpayers who received Letter 5071C. The toll-free number and website are for identity verification only. No other tax-related information, including refund status, is available.

What is involved in this process?

We will continue processing your tax return once we verify your identity. Follow the identity verification described under "What should you do?" below to provide us with the necessary information.

What should you do?

- Use our secure Identity Verification Service website idverify.irs.gov. It's quick and secure. To complete the entries, you will need to have a copy of your prior year tax return and your most recently filed tax return.
- If you cannot use the Idverify website, you can call us using the toll-free Identity Verification telephone number provided in your letter. Again, you will need to have a copy of your prior year tax return and your most recently filed tax return.
- If you did not file the return in question, you can use either option to notify us.

How can I learn more about the IRS's identity protection efforts?

The IRS is continually looking at ways to increase data security and protect taxpayers' identities. To learn more, view these topics [Pub 4535] on IRS.gov.

Information that will be required when responding to the IRS **-** Taxpayer should have a copy of the most recently filed return and the one for the preceding year. The taxpayer will be asked questions about the data included on those two returns. Birth date, SSN or ITIN, and contact information will need to be available.

Client Documents Compromised - If a client believes they are at risk due to a lost or stolen purse or wallet, questionable credit card activity or credit report, they should contact the IRS Identity Protection Specialized Unit at 800-908-4490 (Monday - Friday, 7 a.m. - 7 p.m. local time; Alaska and Hawaii follow Pacific time). The client should also complete and file Form 14039 – IRS Identity Theft Affidavit.

The following actions are recommended:

- Report incidents of identity theft to the Federal Trade Commission at www.consumer.ftc.gov or the FTC Identity Theft hotline at 877-438-4338.
- File a report with the local police.
- Contact the fraud departments of the three major credit bureaus:
  - Equifax – www.equifax.com, 800-525-6285
  - Experian – www.experian.com, 888-397-3742
  - TransUnion – www.transunion.com, 800-680-7289

Close any accounts that have been tampered with or opened fraudulently.

IRS PROCEDURES AFTER ID THEFT IS VALIDATED

- The first step in the process is for the taxpayer to complete and file IRS Form 14039, Identity Theft Affidavit.
- The IRS flags the taxpayer's account to show ID theft documentation has been submitted.
- IRS reconciles the taxpayer's account to reflect the correct tax return information.
- The IRS places an identity protection indicator on the taxpayer's account and notifies the taxpayer with a CP01 notice.
- Prior to the next tax season the IRS will assign the taxpayer a unique IP protection PIN to verify the return.
- If a taxpayer is identified as being deceased, the IRS locks the account to prevent any future filings.
- The IRS assigns a six-digit IP PIN number to a verified ID theft victim that is specific to the tax year, which is used to file their return for that year.

- A new six-digit IP PIN number is issued every year.
- This process is only required if the primary taxpayer is the ID victim.
- E-filed returns requiring IP PINs will be rejected if an IP PIN is missing or incorrect.
- Taxpayers who misplace their IP PINs must contact the IRS for a replacement.

The IRS is requesting the help of tax professionals: Please refer only taxpayers who receive Letter 5071C or Letter 4883C to the Taxpayer Protection Program (TPP) toll-free line. The TPP line is set up for identity verification for letter recipients. TPP assistors do not have information to help your clients with other issues such as refund inquiries.

IP PIN Program Expansion - Within five years of the date of enactment (July 1, 2019) of the Taxpayer First Act, the Treasury Department is required to establish a program to issue an IP PIN to any U.S. resident individual who requests one. And, for each calendar year beginning after the date of enactment, the Treasury Department is required to expand the issuance of IP PINs to individuals residing in such states as IRS deems appropriate, provided that the total number of states served by the program continues to increase. (Act Sec. 2005)

Notification of Suspected Identity Theft – Often identity theft and refund fraud victims may be unaware that their identity has been used fraudulently or, when they are aware, may not be fully informed of the outcome of their case. The Taxpayer First Act addresses this situation by requiring the IRS to notify a taxpayer if it determines there has been any suspected unauthorized use of a taxpayer's identity, or that of the taxpayer's dependents, if an investigation has been initiated and its status, whether the investigation substantiated any unauthorized use of the taxpayer's identity, and whether any action has been taken (such as a referral for prosecution). Furthermore, when an individual is charged with a crime, IRS must notify the victim as soon as possible, giving such victims the ability to pursue civil action against the perpetrators. (Code Sec. 7529(a), as added by Act Sec. 2007(a)) Effective for determinations made after the date that is six months after the date of enactment (July 1, 2019).

Penalty Relief - As part of the Taxpayer First Act, Congress directs the Secretary of the Treasury (or a delegate, i.e., the IRS) to establish procedures to ensure that income reported in connection with the unauthorized use of a taxpayer's identity is not taken into account in determining any penalty for underreporting of income by the victim of identity theft. Applies to determinations made after the date that is 6 months after the date of the Act's enactment (July 1, 2019). (Act Sec. 2007(b))

WHAT YOU SHOULD AND ARE REQUIRED TO DO TO PROTECT YOU CLIENTS' IDENTITIES

Your records would be a bonanza for anyone wanting to steal money from your clients or the IRS, and if they get ahold of your tax return data, that could be the end of your business, because your clients, no matter how understanding, will be put through a lot to straighten out their financial affairs and will not be happy. So it is important that you take every precaution to protect your clients' data from ID thieves. You are also legally required to protect client data and limit disclosures.

IRC §7216 – Disclosure or use of information by preparers of returns - is a criminal provision that prohibits preparers of tax returns from knowingly or recklessly disclosing or using tax return information. It is a misdemeanor offense that is punishable by a fine of not more than $1,000, imprisonment of not more than one year, or both, plus costs of prosecution. [Code § 7216(a) – Regulation § 301.7216-1(a)]

The Taxpayer First Act increases the criminal penalty for knowing or reckless conduct to $100,000 in the case of disclosures or uses made on or after July 1, 2019 in connection with taxpayer identity theft. (Code Sec. 7216(a), as amended by Act Sec. 2009(b))

Neither the Code nor Committee Reports define "knowingly" or "recklessly." The term "recklessly" is not used anywhere in Chapter 75 of the Code (criminal penalties), while "knowingly," which is used in connection with two other criminal penalties, does not appear to be further explained by regs or judicial interpretation. However, in most criminal connotations, "knowingly" means that the action was deliberate as opposed to it being accidental. The effect of adding the "knowingly" or "recklessly" requirement was to decriminalize improper uses and disclosures not "knowingly" or "recklessly" made.

IRS authorization of use or disclosure does not affect legal or ethical rules which prohibit professionals, such as attorneys and accountants, from using or disclosing information to their own advantage or their clients' disadvantage.

IRC §6713 – Disclosure or use of information by preparers of returns - imposes a civil penalty of $250 on any person who…for compensation prepares a return for another person, and discloses any information furnished to him for, or in connection with, the preparation of any such return, or uses any such information for any purpose other than to prepare, or assist in preparing, any such return. <u>Imposition of the penalty under IRC §6713 does not require that the disclosure be knowing or reckless.</u>

New Law & Stuff

Effective with respect to disclosures or uses made on or after July 1, 2019, the Taxpayer First Act increases the civil penalty for the unauthorized disclosure or use of information by tax return preparers from $250 to $1,000 for cases in which the disclosure or use is made in connection with a crime relating to the misappropriation of another person's taxpayer identity ("taxpayer identity theft"). The Act also increases the calendar year limitation from $10,000 to $50,000 in identity theft situations. The calendar year limitation is applied separately with respect to disclosures or uses made in connection with taxpayer identity theft. (Code Sec. 6713(b), as amended by Act Sec. 2009(a)(2))

Who is Subject to Sec. 7216 – Sec. 7216 applies only to tax preparers and then only to those in possession of tax return data of which he or she makes an unauthorized disclosure or use. It does not apply to client data acquired outside of tax return information, as long as the tax preparer can adequately document and prove that it is not tax return information, which might be difficult. It does not apply to the third party who receives the unauthorized disclosure. It also applies to contractors supplying certain ancillary services to which you have given proper notice under the regulations.

Effect of Gramm-Leach-Bliley Act – Generally, tax return preparers are also subject to the privacy provisions of the Gramm-Leach-Bliley Act, PL 106-02, 11/12/99, which imposes requirements on financial institutions to protect personal information. Those provisions do not supersede, alter, or affect pre-existing Code Sec. 7216 requirements restricting preparer disclosure or use of return information. Similarly, Code Sec. 7216 and its associated regulations don't override any requirements or restrictions of the Gramm-Leach-Bliley Act that are in addition to the requirements or restrictions of Code Sec. 7216 and its associated regulations. [Reg § 301.7216-1(c) - Notice 2002-6, 2002-1 CB 326]

FTC "Red Flag" Regulations - The regulations are referred to as "Red Flag Rules" because they require programs to be placed in operation by those affected businesses that will identify, detect, and respond to business practices or specific activities (referred to as "Red Flags") that could result in identity theft. The programs must include procedures to protect against potential identity theft and provide a remedial procedure should identity theft occur. These rules apply to any company that extends credit to clients or accept credit and debit cards as payment for services. Since virtually every preparer extends credit at some time virtually all tax practitioners are affected by the "Red Flag" regulations.

What are Red Flags? - Applicable sections of the Fair and Accurate Credit Transactions Act of 2003 (FACTA), also known as the Red Flags Rule, define a red flag as a pattern, practice or specific activity that indicates the possible existence of identity theft. The regulations provide guidance by listing five specific categories of red flags:

1. Alerts, notifications or other warnings received from consumer reporting agencies or service providers such as fraud detection services.
2. The presentation of suspicious documents.
3. The presentation of suspicious personal identifying information, such as a suspicious address change.
4. The unusual use of, or other suspicious activity related to, a covered account.
5. Notice from customers, victims of identity theft or law enforcement authorities.

Each organization is responsible for coming up with its own list of Red Flags, and the list should be as exhaustive as possible. Unfortunately, there is no specific set of red flags for every business. Even though a business belongs to the same industry as another, it may have different Red Flags because of the manner in which the business is operated. Each business must include every situation that can be envisioned.

CALIFORNIA DIFFERENCES

California conforms to the non-taxable treatment of ID theft protection services provided to potential ID theft victims whose data was compromised. This treatment is the same as announced by the IRS in Ann 2015-22.

As is the case with the IRS, the California Franchise Tax Board (FTB) does not send e-mails asking for personal taxpayer information. If your clients receive this type of request, they should not respond.

To resolve tax-related identity theft issues with the FTB, a taxpayer may complete and submit Form **FTB 3552,** Identity Theft Affidavit.

This form is used if a taxpayer is an actual or potential identity theft victim who thinks their tax account is currently or could potentially be affected and who would like the FTB to update his or her account status to identify questionable activity. The taxpayer should be prepared to send copies of the following documents to the FTB with the 3552:

- Passport
- Driver's license or DMV identification card
- Social Security card
- Police report
- IRS letter of determination

See the 3552 instructions for where to mail or fax the form.

CRYPTOCURRENCY

(Virtual Currency)

Overview

- Use is treated and reported like stock transactions
- Sec 1031 exchanges no longer apply after 2017

Pubs

Forms

- Notice 2014-21 – Taxability of virtual currency transactions
- Currency Converter – https://www1.oanda.com/currency/converter/
- IR-2018-71

TCJA

After 2017, TCJA only allows Sec 1031 tax deferral for domestic real estate exchanges. Thus Sec 1031 cannot be used for virtual currency exchanges.

RAPID FINDER	
Form 8938	1.18.02
Acquisition	1.18.02
Backup Withholding	1.18.03
Bitcoin	1.18.01
Contractors	1.18.03
Convertible	1.18.01
Demographics	1.18.01
Employee Payments	1.18.03
FBAR	1.18.02
Gain or Loss	1.18.02
Goods & Services	1.18.02
Independent Contractor	1.18.03
Information Reporting	1.18.03
Market Value	1.18.01
Mining	1.18.02
Treated as Property	1.18.01

The Details

This is a primer on how cryptocurrencies (virtual currencies) function, along with information on IRS's guidance included in Notice 2014-21 for dealing with taxable transactions involving virtual currency. Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.

"Virtual currency" may be used to pay for goods or services, or held for investment. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction.

Bitcoin, first released as open-source software in 2009, is generally considered the first decentralized cryptocurrency. Since the release of Bitcoin, over 4,000 altcoins (alternative variants of Bitcoin, or other cryptocurrencies) have been created.

Value of One Bitcoin XBT	
September 1, 2016	$575
August 1, 2017	$2,778
April1, 2018	$6,855
June 1, 2018	$5,984
August 1, 2018	$7,835
September 1, 2018	$6,958
July 1, 2019	$10,880

For a more detailed (and complex) understanding of cryptocurrencies, research the Internet. One such informative site is: https://www.genesis-mining.com/how-cryptocurrency-works

Owner Demographics – Individuals who deal in virtual currency are generally tech savvy, might also have an inherent distrust of the government and like the lack of government regulations controlling and tracing virtual currency transactions.

Market Value Determination – The FMV of virtual currency is based on market value, i.e., what a willing buyer will pay a willing seller – much like trading in stocks. That is why the IRS made the decision to treat virtual currency transactions as property transactions.

Treated as property for federal tax purposes - Virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency (IRS Notice 2014-21, Q&A #1).

Example A: *Taxpayer buys Bitcoin (BTC) so he can use it to make on-line purchases without the need for a credit card. He buys one BTC for $2,425 and later uses it to buy goods worth $500 (BTC was trading at $2,500 at the time he made his purchase). He has a $75 ($2,500 - $2,425) reportable capital gain. This is the same result that would have occurred if he had sold the BTC at the time of the purchase and used cash to purchase the goods. This example points up the complicated record-keeping requirement to track BTC basis. Since this transaction was personal in nature no loss would be allowed if the value of BTC had been less than $2,425 at the time the goods were purchased. Of course if the taxpayer in this example only sold a fraction of a Bitcoin, enough to cover the $500 purchase, the gain would only be $15: $500/$2500 = .2 x 2425 = 485; 500 – 485=15*

Example B: *Taxpayer buys Bitcoin (BTC) as an investment. The same rules apply as for stock transactions, including gain/loss rules, $3,000 per year net loss allowed against other income, and the short- and long-term holding period rules.*

Character of the gain or loss - The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is held as a capital asset. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that he or she does not hold as a capital asset. Inventory and other property held mainly for sale to customers in a trade or business are examples of property that is not a capital asset.

Foreign Currency Transactions - Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes (IRS Notice 2014-21, Q&A #2).

Virtual Currency FBAR and Form 8938 Filings - The AICPA recently asked FinCEN if cryptocurrency held in foreign cryptocurrency exchanges requires FBAR and 8938 reporting.

- **FBAR** - FinCEN responded that regulations (31 C.F.R. §1010.350(c)) do not define virtual currency held in an offshore account as a type of reportable account. Therefore, it was FinCEN's opinion that virtual currency is not reportable on the FBAR, at least for now. In addition, the IRS (at the date of this publication) has not officially taken a position on whether a virtual currency account over $10,000 is subject to FBAR reporting.

  However, in a similar situation a few years back FinCEN told tax preparers they didn't need to report on-line gambling accounts with out-of-the country on-line casinos on the FBAR, but a tax court ruled differently and the taxpayer was penalized for failure to report his on-line gambling account where a foreign financial institution was involved (see Hom CA-9, 2016 page 01.13.06). So, to be conservative and on the safe side, we are recommending cryptocurrency held in foreign cryptocurrency exchanges be reported. But of course, that is a decision you and your client will have to make. There is no penalty for over-reporting but there are severe penalties for under-reporting. See page 1.13.02 for FBAR reporting.

- **8938 - Statement of Specified Foreign Financial Assets** – However cryptocurrency held in foreign cryptocurrency exchanges requires reporting on Form 8938 (assuming the taxpayer meets the Form 8938 filing threshold). See page 1.13.09 for Form 8938 reporting.

Payment for Goods & Services - A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received (IRS Notice 2014-21, Q&A #3).

Get Around Money Reporting Laws - There is no bank to report transfers to the government.

How Does One Acquire Bitcoins – One can go to online exchanges and purchase Bitcoins. But care should be taken to make sure the exchange is reputable. There are even Bitcoin ATMs (kiosks) where cash can be exchanged for Bitcoins. Then you have Bitcoins in your on-line wallet and are free to spend them with anyone that accepts Bitcoins.

Bitcoin Mining – Mining is a term used to describe how cryptographic information distributed within a Bitcoin network is secured, authorized, and approved. In essence it is the processing of payments that have taken place once they occur. It takes the place of banks, merchant's accounts, and clearing houses like Visa. It essentially eliminates all the third parties' cuts of income from the transaction. It involves complex mathematical logarithms that need to be solved and the mining process, which requires high-powered computers, completes this task autonomously.

What do miners get for dedicating computer hardware and for the cost of electricity to handle the transactions? After adding a block to the ledger, the miner is given a reward for their efforts, which varies based on the cryptocurrency. For example, Bitcoin originally awarded 50 BTCs, but that award halves at preset times and today has decreased to 12.5 BTCs. It is anticipated that sometime in 2020 it will be halved again to 6.25 BTCs.

If an individual mines virtual currency, it is a trade or business subject to self-employment tax (IRS Q&A #9). The income is the value of the generated income equal to the value of the Bitcoin when mined. Although the IRS has provided no guidance at this time, it would appear that the expenses of producing the mined Bitcoins would have to be capitalized. Luckily there are only a very few individuals or businesses doing mining (estimated to be over 300,000 by btcwires.com in February 2019), so the odds of doing a miner's tax return are slim to none.

Apparently, Bitcoin miners are subject to Form 1099-K filing requirements if certain requirements are met. In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third-party settlement organization (TPSO). A TPSO is required to report payments made to a merchant on a Form 1099-K, *Payment Card and Third Party Network Transactions*, if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200, and (2) the gross amount of payments made to the merchant exceeds $20,000.

Employee Payments - The fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions Act (FICA) tax (Social Security and Medicare A), and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, *Wage and Tax Statement*. (IRS Notice 2014-21, Q&A #11) Of course, these amounts are to be reported in U.S. dollars.

Independent Contractor Payments - The fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax (IRS Q&A #10). Payment may also be subject to informational reporting (IRS Notice 2014-21, Q&A #13).

Informational Reporting **-** A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee (IRS Notice 2014-21, Q&A #12).

Backup Withholding **-** Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payers making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee. The payer must backup withhold from the payment if a TIN is not obtained prior to payment or if the payer receives notification from the IRS that backup withholding is required (IRS Notice 2014-21, Q&A #14).

THE IRS HAS CRYPTOCURRENCY ON ITS RADAR

Back in 2018 Coinbase, a company handling cryptocurrency transactions, released the data of 14,000 of its users to the IRS after the information was subpoenaed, and cryptocurrency traders have been holding their breath as to what comes next. Well, that next is upon us, in the form of a wave of correspondence which most certainly will result in some serious enforcement actions.

IRS Compliance Program – The IRS has begun sending letters to taxpayers about their cryptocurrency activity; by the end of August, more than 10,000 taxpayers will receive one of three varieties of letters. A taxpayer who receives one of these letters, should not ignore it! The IRS compiled this list of taxpayers that it feels has not been reporting their cryptocurrency transactions from various ongoing IRS compliance efforts. The following is a synopsis of the types of letters:

> **Letter 6173** – Requires a response from the taxpayer, either by the taxpayer providing a statement to the IRS that they have already complied with the required reporting or by filing a return that reports their cryptocurrency transactions. For situations where the taxpayer had already filed a return but had left off the cryptocurrency transactions, an amended return (Form 1040X) will need to be filed. Taxpayers who ignore this letter may face a full-blown audit by the IRS and could be subject to penalties.
>
> **Letter 6174** – This is a "soft notice" that does not require a response, and the IRS says it won't be following up on it. However, the notice also warns that if the taxpayer had cryptocurrency gains and fails to amend their return or continues to be noncompliant on future returns despite receiving the letter, the taxpayer will be in hot water.
>
> **Letter 6174-A** – The taxpayer isn't required to respond to the letter but does need to correct their prior returns in which cryptocurrency transactions have been omitted. The IRS warns of future enforcement action if the taxpayer doesn't amend their return(s) or file their delinquent returns. After receiving the letter, the taxpayer can't use an excuse of not knowing the law for failing to report their cryptocurrency gains.

Last year, the IRS announced a virtual cryptocurrency compliance campaign to address tax noncompliance related to virtual currency use through outreach and examinations of taxpayers. The IRS has announced that it will remain actively engaged in addressing non-compliance related to virtual currency transactions through a variety of efforts, ranging from taxpayer education to audits and criminal investigations.

Taxpayers who do not properly report the income tax consequences of virtual currency transactions are liable for the tax, penalties and interest. In some cases, taxpayers could be subject to criminal prosecution.

So, if your clients receive one of the above letters, especially letter 6173, be sure your clients (or you if tasked to do so by your clients) respond timely. For anyone receiving a letter be sure to counsel them on the need to report the transactions and amend any return where reporting was omitted.

As this material was being prepared a second wave of correspondence was launched.

CALIFORNIA DIFFERENCES California follows federal tax treatment

NOTES

Tax Potpourri

(Those things we couldn't find a home for elsewhere)

Potpourri Index

BE AWARE OF PARTNERSHIP AUDIT REGIME

Although this is not a partnership course, we feel it is important to bring this issue to your attention. Under IRC Sec. 6223(a) added by Public Law 114-74, the Bipartisan Budget Act of 2015 and effective as of 2018 and future years, every partnership must select what is now called a Partnership Representative (PR) unless the partnership, under section 6221(b), elects not to be subject to this new "centralized partnership audit regime."

The issue being that a PR will have the power to unilaterally deal with the IRS and any resulting consequences. Under the centralized partnership audit regime, upon an audit of the partnership, any adjustments will be taken into account by the partnership and not the individual partners in the year that the audit or any judicial review is completed (the adjustment year) and any tax owed would be collected from the partnership.

Certain small partnerships (generally 100 or fewer partners) can elect out of the centralized partnership audit regime and not be required to designate a PR.

Here is an overview of the election:

- The partnership must have 100 or fewer partners and if an S-corporation is a partner each shareholder is counted toward the 100 or fewer limit.
- Cannot have any foreign partners.
- The election can be made on any timely filed 1065 partnership return.
- Once made it cannot be revoked without IRS permission.
- The election is made on line 25 of the 1065 and by completing 1065 Schedule B-2 by listing in Part I each eligible partner's name, the partner's U.S. tax ID number (TIN), and one of the following codes:

  I— Individual
  C—Corporation
  S—S corporation
  E— Estate of deceased partner
  F— Foreign partner that would be treated as a C corporation if it were a domestic entity.

  Part II of the Schedule B-2 is used when an S corporation is a partner to list the correct name of each shareholder for the tax year of the S corporation ending with or within the partnership tax year, the correct U.S. TIN for each shareholder, and the type of person code from the following list:

  I— Individual
  T—Trust
  E— Estate of deceased shareholder
  O—Other (such as Employee Stock Ownership Plans (ESOPs); section 501(c)(3) charitable organizations; or eligible disregarded entities).

- Each partnership that elects out of the centralized partnership audit regime must complete Schedule B-2 for every tax year that the election is to be effective. If the form is not completed correctly, the IRS may determine that the election is not valid.

- For any year which the election applies a designated PR is not required.

When a partnership elects out of the centralized audit regime, the IRS will then have to deal with each partner to adjust items associated with the partnership, resolve issues, and assess and collect any tax resulting from the adjustments.

DRAFT 1040-SR RELEASED

The IRS in July released a draft of the new, Congress-mandated and supposedly simplified, 1040 for taxpayers age 65 and older. The draft strangely looks like the old 1040 before tax reform and the ill-advised and politically motivated breakup of the 1040 into 6 postcard-size schedules (repackaged into 3 schedules per the 2019 drafts). The Bipartisan Budget Act of 2018 did what lawmakers have wanted to do for a long time: provide seniors with a simplified tax form rather than having to file a 1040. In the past, seniors could not file a 1040-EZ because of its limitations, especially since it did not include Social Security income and retirement income. Of course, now the 1040-EZ and 1040-A have been discontinued anyway. Use of 1040-SR will be optional.

The draft form can be viewed at: https://www.irs.gov/pub/irs-dft/f1040s--dft.pdf

Form **1040-SR** Department of the Treasury—Internal Revenue Service (99) **U.S. Tax Return for Seniors** **2019** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

DRAFT AS OF July 11, 2019 DO NOT FILE

Filing Status Check only one box.
☐ Single ☐ Married filing jointly ☐ Married filing separately (MFS)
☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)
If you checked the MFS box, enter the name of spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent. ▶

Your first name and middle initial | Last name | **Your social security number**
If joint return, spouse's first name and middle initial | Last name | **Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions. | Apt. no. | **Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).
Foreign country name | Foreign province/state/county | Foreign postal code | If more than four dependents, see inst. and ✓ here ▶ ☐

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1955 ☐ Are blind
Spouse: ☐ Was born before January 2, 1955 ☐ Is blind

Dependents (see instructions): (1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit	Credit for other dependents
				☐	☐
				☐	☐
				☐	☐
				☐	☐

Attach Schedule B if required.

1	Wages, salaries, tips, etc. Attach Form(s) W-2				**1**
2a	Tax-exempt interest	**2a**		**b** Taxable interest	**2b**
3a	Qualified dividends	**3a**		**b** Ordinary dividends	**3b**
4a	IRA distributions	**4a**		**b** Taxable amount	**4b**
c	Pensions and annuities	**4c**		**d** Taxable amount	**4d**
5a	Social security benefits	**5a**		**b** Taxable amount	**5b**
6	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐				**6**
7a	Other income from Schedule 1, line 9				**7a**
b	Add lines 1, 2b, 3b, 4b, 4d, 5b, 6, and 7a. This is your **total income** ▶				**7b**
8a	Adjustments to income from Schedule 1, line 22				**8a**
b	Subtract line 8a from line 7b. This is your **adjusted gross income** ▶				**8b**
9	**Standard deduction or itemized deductions** (from Schedule A)	**9**			
10	Qualified business income deduction. Attach Form 8995 or Form 8995-A	**10**			
11a	Add lines 9 and 10				**11a**
b	**Taxable income.** Subtract line 11a from line 8b				**11b**

Standard Deduction See *Standard Deduction Chart* below.

Standard Deduction Chart

Don't use this chart if someone can claim you (or your spouse if filing jointly) as a dependent, your spouse itemizes on a separate return, or you were a dual-status alien. Instead, see instructions.

Add the number of boxes checked in the "Age/Blindness" section of *Standard Deduction* ▶

IF your filing status is. . .	AND the number of boxes checked is. . .	THEN your standard deduction is. . .	IF your filing status is. . .	AND the number of boxes checked is. . .	THEN your standard deduction is. . .
Single	0	$12,200	Head of household	0	$18,350
	1	13,850		1	20,000
	2	15,500		2	21,650
Married filing jointly or Qualifying widow(er)	0	24,400	Married filing separately	0	12,200
	1	25,700		1	13,500
	2	27,000		2	14,800
	3	28,300		3	16,100
	4	29,600		4	17,400

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 71930F Form **1040-SR** (2019)

Note: Schedules 2 and 3 may still need to be used

Form 1040-SR (2019) Page **2**

12a **Tax** (see instructions). Check if any from: **1** ☐ Form(s) 8814 **2** ☐ Form 4972 **3** ☐ ____ **12a**

b Add Schedule 2, line 3, and line 12a and enter the total ▶ **12b**

13a Child tax credit or credit for other dependents **13a**

b Add Schedule 3, line 7, and line 13a and enter the total ▶ **13b**

14 Subtract line 13b from line 12b. If zero or less, enter -0- **14**

15 Other taxes, including self-employment tax, from Schedule 2, line 10 **15**

16 Add lines 14 and 15. This is your **total tax** ▶ **16**

17 Federal income tax withheld from Forms W-2 and 1099 **17**

18 Other payments and refundable credits:

- If you have a qualifying child, attach Sch. EIC.
- If you have nontaxable combat pay, see instructions.

a Earned income credit (EIC) **18a**

b Additional child tax credit. Attach Schedule 8812 **18b**

c American opportunity credit from Form 8863, line 8 **18c**

d Schedule 3, line 14 **18d**

e Add lines 18a through 18d. These are your **total other payments and refundable credits** ▶ **18e**

19 Add lines 17 and 18e. These are your **total payments** ▶ **19**

Refund

20 If line 19 is more than line 16, subtract line 16 from line 19. This is the amount you **overpaid** **20**

21a Amount of line 20 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐ **21a**

Direct deposit? See instructions.

▶ **b** Routing number ▶ **c** Type: ☐ Checking ☐ Savings

▶ **d** Account number

22 Amount of line 20 you want **applied to your 2020 estimated tax** ▶ **22**

Amount You Owe

23 **Amount you owe.** Subtract line 19 from line 16. For details on how to pay, see instructions ▶ **23**

24 Estimated tax penalty (see instructions) ▶ **24**

Third Party Designee

(Other than paid preparer)

Do you want to allow another person (other than your paid preparer) to discuss this return with the IRS? See instructions. ☐ **Yes.** Complete below. ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature | Date | Your occupation | If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Spouse's signature. If a joint return, **both** must sign. | Date | Spouse's occupation | If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.)

Phone no. | Email address

Paid Preparer Use Only

Preparer's name | Preparer's signature | Date | PTIN | Check if: ☐ 3rd Party Designee ☐ Self-employed

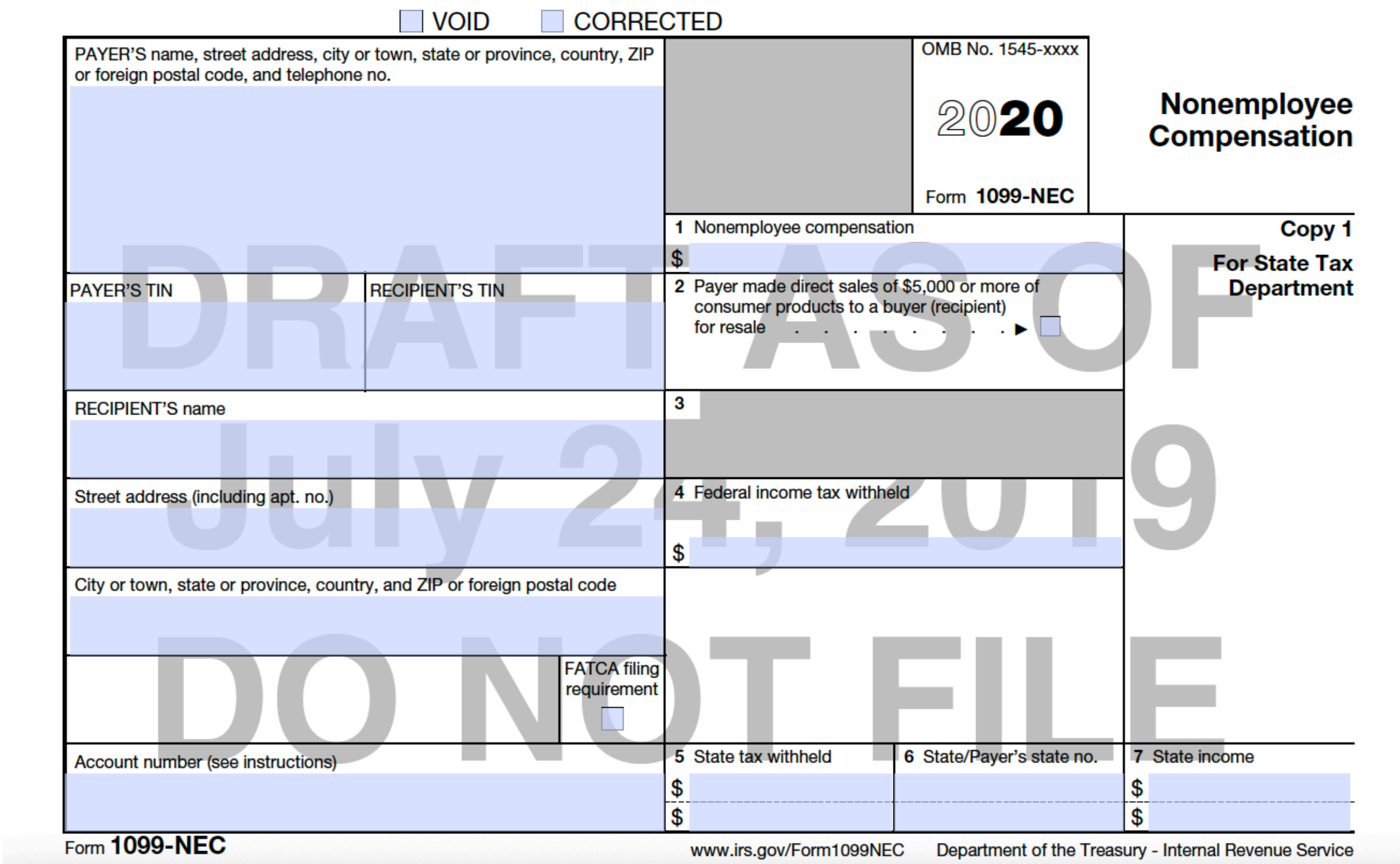
Firm's name ▶ | Phone no.

Firm's address ▶ | Firm's EIN ▶

Go to *www.irs.gov/Form1040SR* for instructions and the latest information. Form **1040-SR** (2019)

FORM 1099-NEC RESURRECTED

The Internal Revenue Service has resurrected a form that hasn't been used since the early 1980s, Form 1099-NEC, Nonemployee Compensation. Draft version is shown below. Since 1983, the IRS has required businesses to instead file Form 1099-MISC for contract workers and freelancers. The revival of Form 1099-NEC is part of an effort mandated by Congress in the PATH Act of 2015 to require businesses to file information returns with any non-employee compensation by Jan. 31 of each year. However, there were problems with the IRS's processing systems because there was still a March 31 due date for any Form 1099-MISC that didn't contain non-employee compensation. The draft form is dated 2020, so it would be used for reporting nonemployee compensation paid in 2020, not for 2019.



VOID CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

OMB No. 1545-xxxx

2020

Form 1099-NEC

Nonemployee Compensation

1 Nonemployee compensation
$

PAYER'S TIN

RECIPIENT'S TIN

2 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶

Copy 1
For State Tax Department

RECIPIENT'S name

3

Street address (including apt. no.)

4 Federal income tax withheld
$

City or town, state or province, country, and ZIP or foreign postal code

FATCA filing requirement

Account number (see instructions)

5 State tax withheld
$
$

6 State/Payer's state no.

7 State income
$
$

DRAFT AS OF July 24, 2019 DO NOT FILE

Form 1099-NEC www.irs.gov/Form1099NEC Department of the Treasury - Internal Revenue Service

IRS HAS POSTED LONG AWAITED 2020 W-4

The IRS has released the second version of the 2020 draft W-4 and indicated there would be no substantial changes going forward. They have previously released a draft of Pub 15-T (it replaces the former Pub 15). The second draft should be released by the time this webinar is presented.

Form **W-4**

Department of the Treasury
Internal Revenue Service

Employee's Withholding Certificate

▶ Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay.
▶ Give Form W-4 to your employer.
▶ Your withholding is subject to review by the IRS.

OMB No. 1545-0074

2020

Step 1: Enter Personal Information

(a) First name and middle initial | Last name | (b) Social security number

Address

City or town, state, and ZIP code

▶ **Does your name match the name on your social security card?** If not, to ensure you get credit for your earnings, contact SSA at 800-772-1213 or go to *www.ssa.gov*.

(c) ☐ **Single or Married filing separately**
☐ **Married filing jointly** (or Qualifying widow(er))
☐ **Head of household** (Check only if you're unmarried and pay more than half the costs of keeping up a home for yourself and a qualifying individual.)

Complete Steps 2 through 4 ONLY if they apply to you. To see if you are exempt from withholding or if you have concerns about your privacy, see page 2. Everyone must complete Step 5. See instructions on page 2.

Step 2: Multiple Jobs or Spouse Works

Complete this step if you (1) hold more than one job at a time, or (2) are married filing jointly and your spouse also works. The correct amount of withholding depends on income earned from all of these jobs.

Do **only one** of the following.

(a) Use the estimator at *www.irs.gov/W4App* for most accurate withholding; **or**

(b) Use the Multiple Jobs Worksheet on page 3 and enter the result in Step 4(c) below for roughly accurate withholding; **or**

(c) If there are only two jobs total, you may check this box. Do the same on Form W-4 for the other job. This option is accurate for jobs with similar pay; otherwise, more tax than necessary may be withheld . . . . . . ▶ ☐

CAUTION: If you have privacy concerns, choose **(a)** or **(b).** If you and/or your spouse have income from self-employment, including as an independent contractor, choose **(a).**

Complete Steps 3 through 4(b) on Form W-4 for only one of these jobs. Leave those steps blank for the other jobs. (Your withholding will be most accurate if you complete Steps 3 through 4(b) on the Form W-4 for the highest paying job.)

Step 3: Claim Dependents

If your income will be $200,000 or less ($400,000 or less if married filing jointly):

Multiply the number of qualifying children under age 17 by $2,000 ▶ $

Multiply the number of other dependents by $500 . . . . ▶ $

Add the amounts above and enter the total here . . . . **3** $

Step 4 (optional): Other Adjustments

(a) Other income. If you want tax withheld for other income you expect this year that won't have withholding, enter the amount of other income here. This may include interest, dividends, and retirement income. You should not include income from any jobs . . **4(a)** $

(b) Deductions. If you expect to claim deductions other than the standard deduction and want to reduce your withholding, use the Deductions Worksheet on page 3 and enter the result here . . . . **4(b)** $

(c) Extra withholding. Enter any additional tax you want withheld each **pay period** . **4(c)** $

Step 5: Sign Here

Under penalties of perjury, I declare that this certificate, to the best of my knowledge and belief, is true, correct, and complete.

▶ **Employee's signature** (This form is not valid unless you sign it.) ▶ **Date**

Employers Only

Employer's name and address | First date of employment | Employer identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 3. Cat. No. 10220Q Form **W-4** (2020)

CODE'S TIMELY MAILING RULE REPLACES COMMON-LAW RULE

The Court of Appeals has reversed a district court decision that the taxpayers timely filed their refund claim because they met the requirements of the common-law mailbox rule.

In 1954, Congress enacted Code Sec. 7502 which provides that if a filing is delivered by U.S. mail to the agency, officer, or office with which it is required to be filed, then the U.S. postmark on the cover in which the document or payment is mailed is considered to be the date of delivery or date of payment. In addition, Sec 7502(c)(1) provides that when a document is sent by registered mail, the registration date will be treated as the postmark date.

However, the courts have been split as to whether Sec. 7502 replaces the common-law mailbox rule or just provides a supplemental safe harbor. Under the common-law mailbox rule, proof of proper mailing - including by testimonial or circumstantial evidence - gives rise to the presumption that a document was physically delivered to the addressee in the time such a mailing would ordinarily take to arrive.

In a timely mailing dispute with the IRS the taxpayer relied on the common-law mailbox rule to establish that the return was timely filed and two of the taxpayer's employees testified they timely deposited the amended return in the mail at the post office.

<u>*District court agreed with taxpayer*</u> - The district court credited the testimony of the taxpayer's employees and found, on the basis of the common-law mailbox rule, that the taxpayer's claim for a refund had been timely filed.

<u>*Circuit Court reverses*</u> - The 9th Circuit Court of Appeals reversed the holding of the district court, finding that Code Sec. 7502 and Reg. § 301.7502-1(e)(2) **replaced** the common-law mailbox rule **rather than supplementing it**, and are the exclusive rules for proving timely delivery of a return to IRS and that the taxpayer did not meet those rules. Baldwin, (CA 9 4/16/2019)

So, make sure you have documentary evidence of mailing!

CALIFORNIA DIFFERENCES

<u>CA AB 91 – CONFORMITY TO TCJA -</u> <u>(Signed by the governor 6/27/2019)</u>

Accounting Methods - Generally brings California into conformity with the accounting method simplifications made by the TCJA, effective for tax years beginning on or after January 1, 2019, with a provision allowing taxpayers to elect to have the new rules apply to tax year 2018.

NOLs – For NOLs occurring in taxable years beginning after December 31, 2018, AB 91 repeals the 2-year carryback period. California continues to allow a 20-year carryover period and has not adopted the federal rule limiting the NOL deduction to 80% of the carryover year's taxable income. Thus, 100% of the unused CA NOL is carried over.

Tax-Deferred Exchanges - The TCJA provision that limits Sec 1031 treatment only to exchanges of real property was adopted by California in AB 91, with two significant differences: the provision only applies to taxpayers with AGI of $500,000 or more ($250,000 for those filing single or married separate) and only applies to exchanges **completed** after January 10, 2019.

Excess Business Loss - California adopts the TCJA change relating to the limitation on excess business losses of noncorporate taxpayers, with the following exceptions:

- California law says that any loss which is disallowed under this provision is to "be treated as a carryover excess business loss for the following taxable year" instead of as a net operating loss carryover as it is for federal. This means the carryover amount is used in determining if there's an excess loss in the carryover year for California.
- The federal provision applies only for years 2018 through 2025, while the California law is effective for taxable years beginning after December 31, 2018 and continues indefinitely.
- California's, rather than the federal's, passive activity loss provisions are used in determining any excess loss.

529 Plans - Generally conforms to the changes relating to Sec 529 plans made by the TCJA and the Consolidated Appropriations Act of 2016, including the following:

- A distribution is not taxable, if, within 60 days of distribution, it is transferred to the credit of another beneficiary who is a "member of the family" as defined in IRC Sec 529(e)(2) or is rolled into an ABLE account for the same beneficiary or a family member.

- Refunded amounts re-contributed to the plan within 60 days will not be taxable.

- Distributions used to purchase computers, computer software, internet access and related services are qualified education expenses and thus not taxable.

- California did not conform to the TCJA provision allowing tax-free distributions from 529 plans for amounts used to pay Kindergarten through grade 12 tuition expenses. Therefore, these distributions are taxable for California and subject to a 2.5% penalty.

ABLE Accounts - AB 91 generally conforms CA law to the changes relating to qualified ABLE accounts made by the TCJA and the Consolidated Appropriations Act of 2016. Thus, California conforms to the TCJA provision allowing ABLE account beneficiaries to contribute their own earnings, up to an amount equal to the federal poverty level amount, to their own account. No effective date included in the legislation.

Higher Education Interest Deduction - AB 91 conforms California law to the TCJA provision that certain student loan debt cancelled upon the death or disability of the student is not taxable, effective for loans cancelled after December 31, 2018.

Earned Income Tax Credit – As of 2020, if a taxpayer's earned income is $30,000 or more, the phaseout will reduce the California EITC to zero. The bill also makes other changes in the phaseout calculation, which will be reflected in the table provided by the FTB in the Form 540 instructions.

Young Child Tax Credit - AB 91 adds new R&TC Sec 17052.1 that, effective for years beginning on or after January 1, 2019, allows a refundable "young child tax credit." The credit is per taxpayer, not per child, and is $1,176 times the EITC adjustment factor, which is 85% for 2019. However, the credit cannot be greater than $1,000 for any year. Thus, the maximum credit for 2019 is $1,000 ($1,176 x .85 = $999.60 = $1,000).

The credit phases out when the taxpayer's earned income exceeds a threshold amount of $25,000. The phaseout rate is $20 per $100 or fraction thereof that the taxpayer's earned income exceeds $25,000. Therefore, the credit is fully phased out once earned income reaches $30,000 ($30,000 – $25,000 = $5,000/$100 = 50 x $20 = $1,000). The threshold amount will be annually adjusted beginning in the year after the year the minimum wage is set at $15 per hour, which is scheduled to be 2022 unless the scheduled increases are suspended by the governor (Labor Code Sec 1182.12).

To be eligible for the young child tax credit, the taxpayer must also be eligible for the CA EITC, have at least one qualifying child as defined for the EITC, and the child must be younger than 6 years old at the end of the tax year.

NOTES

CALIFORNIA RESIDENCY ISSUES

CALIFORNIA DIFFERENCES

Overview

Resident - A California resident includes:

- Anyone who is in California for other than a temporary or transitory purpose, or
- An individual who is domiciled (has his permanent home) in California (CA), but outside CA for a temporary or transitory purpose. ***(Cal. Rev. & Tax. Code Sec. 17041)*** A California resident who is outside the state for a temporary or transitory purpose is still considered to be a California resident.

Related FTB Publications and Forms

Pubs Forms

Pub 1017 – Resident and Nonresident Withholding Guidelines
Pub 1031 – Guidelines for Determining Resident Status
Pub 1100 – Taxation of Nonresident Individuals Who Change Residency
Forms 587, 588, 589 590P – Nonresident withholding adjustment forms
Form 540NR – Nonresident and Part Year Resident Return

The Details

Resident - A resident of California is taxed on income from all sources - both from within and outside of California.

Example - Resident*: Taxpayer is a CA resident and has the following income:*

	Total	***CA Income***
Wages earned in California	*$ 50,000*	*$ 50,000*
Wages earned in Canada	*30,000*	*30,000*
Canadian Equivalent SS	*5,000*	*5,000*
Rental income from Colorado	*1,000*	*1,000*
Sale of land in Nevada	*15,000*	*15,000*
Pension from New York State	*12,000*	*12,000*
Interest from an Arizona bank account	*20,000*	*20,000*
Total	***$ 133,000***	***$ 133,000***

Nonresident - A nonresident of California is any person who is **NOT** a California resident. Nonresidents are taxed only on income from California sources. **(*Cal. Rev. & Tax. Code Sec. 17015)***

Example – Nonresident: *Taxpayer is a CA nonresident and has the following income:*

	Total	***CA Income***
Wages earned in California	*$50,000*	*$50,000*
Interest from a CA bank account	*1,000*	
Rental income from CA property	*1,000*	*1,000*
Sale of land in Nevada	*15,000*	
Wages earned in New York	*30,000*	
Interest from Arizona bank account	*20,000*	
Total	***$117,000***	***$51,000***

Part-Year Resident - A part-year resident means a taxpayer who meets the following conditions:

- Is a resident of California for a period of the taxable year, and
- Is a nonresident of California for a period of the taxable year.

A part-year resident is taxed on:

- All income while received as a resident of California, and
- Income from California sources while a nonresident. ***(Cal. Rev. & Tax. Code Sec. 17015.5)***

RAPID FINDER

Example –Part-year resident - *Taxpayer became a California resident on July 1 of the tax year. He earned the following income during the tax year:*

		Total	***California Income***
NV wages	*Jan 1 to Jun 30*	*$50,000*	*-0-*
NV Rental Income	*Jan 1 to Dec 31*	*8,000*	*4,000*
CA Rental Income	*Jan 1 to Dec 31*	*8,000*	*8,000*
California wages	*Jan 1 to Jun 30*	*15,000*	*15,000*
California wages	*July 1 to Dec 31*	*30,000*	*30,000*
CA PERS Pension	*Jan 1 to Dec 31*	*12,000*	*6,000*
Int. from a CA bank	*Jan 1 to Dec 31*	*2,000*	*1,000*
Arizona wages	*July 1 to Dec 31*	*5,000*	*5,000*
Int. from an AZ bank	*Jan 1 to Jun 30*	*2,400*	*-0-*
Total		*$132,400*	*$69,000*

PRESUMPTION OF RESIDENCE

Nine-month presumption - There is a nine-month California residency presumption. If a taxpayer is in California for more than nine months during the taxable year, that person is said to be a California resident. This nine-month presumption may be overcome with satisfactory evidence that the individual is in California for a temporary or transitory purpose. In addition, if an individual is in California for less than nine months, no presumption of nonresidency exists. ***(Cal. Rev. & Tax. Code Sec. 17016)***

Definition of "temporary" **-** Temporary means that if a person is passing through California, either for a brief rest or for a vacation, or for a short period or to complete a transaction, they are considered to be here temporarily. The Board of Equalization, the CA government entity that, through June 30, 2017, heard audit appeals of the Franchise Tax Board, ruled that the amount of time spent in a location is of substantial importance in determining residency **(*in the Appeal of Louis and Betzi Akerstrom 60 SBE 009).***

Date residence established **-** In general, the date used for determining when a taxpayer's residence changes is the date they enter or leave California. ***(Appeal of George W. and Gertrude Smith Davis 64 SBE 043)***

Foreign citizen performing services in CA **-** A resident of a foreign country performing services in California and/or receiving income from California sources may have a CA filing requirement even if there is no IRS filing requirement.

In a perfect world, all taxpayers would move in to CA and move out of CA only on January 1 or December 31. That would simplify the preparation of a 540 NR. However, the reality is that taxpayers move in and out of California every day of the year. That factor alone creates interesting and complex tax scenarios**.**

DOMICILE – Domicile is defined as the location of your permanent home or the place you intend to return to whenever you leave. Domicile is the location where the taxpayer has the most permanent connections (including home and principal establishment) and intends to remain. Taxpayer intent is important but not enough on its own to determine domicile. An individual can only have one domicile at a time. ***(Cal. Code Regs. Title 18 Sec. 17014, Appeal of Anthony and Ann Eustachio 85 SBE 040)***

In the Noble case, an appeals court ruled in favor of the FTB. This audit focused on the date the taxpayer moved out of California. The taxpayer claimed they had moved from California to Colorado during March 1994. They bought a home in Colorado in February 1994. The facts of the case showed that the taxpayer never moved into that property and eventually made it a rental. The taxpayers ultimately purchased and moved into a principal residence in Colorado during June 1994. The taxpayers were found to be residents of California until July 1994 for these reasons:

1- They did not list their home in California for sale until June 1994.
2- Their cars were registered in California.
3- They had California driver's licenses.
4- Mr. Noble had a business in California.
5- Their business and financial institutions were in California.
6- They did spend more time in California during the period in question.
7- Their doctors and dentists were located in California.
8- They belonged to California clubs.

FTB ruled Noble was a resident of California during the audit period. The Court of Appeals agreed with the lower court that the taxpayers had greater ties to California than Colorado. They also ruled that the date the Noble's residence changed was later than claimed by the taxpayers. ***(Noble v. Franchise Tax Board (2004) 118 Cal. App. 4th 560)***

"Residence" and "Domicile" can be different - Individuals may be residents of California while domiciled outside of the state when here for an indefinite period of time. On the other hand, it may happen that individuals domiciled in California may be treated as a nonresident of California if they are outside California for an indefinite period of time. To illustrate the importance of domicile, in the event of any doubt about domicile, the FTB will presume the domicile has not changed.

Domicile Criteria:

- California has separate definitions for domicile and for residence.
- It is possible to be domiciled in CA but not be a California resident.
- It is possible to be domiciled in another state and still be a California resident.
- For tax purposes, the meaning of the term "domicile" is the place where you establish yourself and your family, not merely for a limited purpose.
- It is your true, fixed and permanent home.
- It is the place where, whenever you are absent, you intend to return.
- You can only have one domicile at a time.

Maintenance of a marital abode in California is an important factor in determining domicile.

NONRESIDENT SAFE HARBOR RULES

California does not have an equivalent to the Federal foreign earned income exclusion provision. Since residents of California are taxed on ALL income, including income from sources outside California, the key is whether or not the taxpayer is a resident.

A safe harbor is available for certain individuals leaving California under employment-related contracts. The safe harbor provides that an individual domiciled in California, who is outside California under an employment-related contract for **at least 546 consecutive days** (18 months), will be considered a nonresident unless:

- The individual has intangible income exceeding $200,000 in any taxable year during which the employment-related contract is in effect; or
- The principal purpose of the absence from California is to avoid personal income tax.

The spouse of the individual covered by this safe harbor rule will also be considered a nonresident while accompanying the individual outside California for at least 546 consecutive days. Return visits to California that in the aggregate do not exceed 45 days during any taxable year covered by the employment contract are considered temporary. Individuals not covered by this safe harbor must determine their residency status based on their facts and circumstances. The determination of residency status cannot be solely based on an individual's occupation, business or vocation. Instead, all activities must be considered in the determination of residency status.

Away-from-home expenses - Taxpayers, who by the facts and circumstances are determined to be California residents, may be able to deduct away-from-home business expenses (for travel, meals and lodging) on their California tax return.

COMMON LAW MARRIAGES

California abolished common law marriages by statute in 1895. California recognizes common law marriages originating in states that recognize common law marriages ***(Appeal of Estate of Lawrence Foley, Deceased 77-SBE-100, 7-26-77)***

SPOUSES RESIDING IN TWO STATES – ONE IN CA AND ONE IN ANOTHER STATE

Today, it is not uncommon for an individual to reside in California and his or her spouse to reside in another state. Therefore, the spouse who remains a California resident may be taxable on ½ of the non-resident spouse's community income. (See FTB Publication 1031).

FEDERAL TAX ELECTIONS

For California tax purposes, taxpayers who move into California are said to have elected, for California tax purposes, the same federal elections they made prior to moving to California. ***(Cal. Rev. & Tax. Code Sec. 17024.5(e)3(B)(i))***

NONRESIDENT AND PART-YEAR RESIDENT TAX CALCULATION

Nonresidents and part-year residents determine their California tax by multiplying California taxable income by an effective tax rate.

Effective Tax Rate - The effective tax rate is the California tax on all income as if taxpayers were California residents for the current tax year and for all prior tax years for any carryover items, deferred income, suspended losses or suspended deductions, divided by that income. ***(Cal. Rev. & Tax. Code Sec. 17041(b), FTB Publication 1100 – Revised 11/2007)***

$$\textbf{Effective Tax Rate} = \frac{\textbf{CA Tax on All Income}}{\textbf{CA Income as if Full-Year Resident}}$$

Prorated Tax = CA Taxable Income (CTI) x Effective Tax Rate

California Taxable Income (CTI) is California adjusted gross income (AGI) less California itemized or standard deductions.

California Deductions - Nonresidents and part-year residents are allowed to claim itemized or standard deductions in computing their California taxable income in the ratio that California adjusted gross income is to total worldwide adjusted gross income ***(Cal. Rev. & Tax. Code Sec. 17304)***

$$\textbf{Prorated Deductions} = \frac{\textbf{California AGI}}{\textbf{Total AGI}} \times \textbf{Total Deductions}$$

California Tax Credits **-** Part-Year and Nonresidents may be able to qualify for California credits on a prorated basis if they meet all credit requirements. They will be allowed all California tax credits in the same proportion as the ratio used to calculate their tax. ***(Cal. Rev. & Tax. Code Sec. 17041)***

$$\textbf{Prorated Credit} = \frac{\textbf{California Taxable Income}}{\textbf{Total Taxable Income}} \times \textbf{Full Credit}$$

Exceptions - The percentage does not apply to the following credits, which are allowed in full for the:

- Renter's credit,
- Other state tax credit, or
- Any credits conditional upon a transaction occurring wholly within California.

OTHER STATE TAX CREDIT

California law allows a taxpayer to take a credit for tax that is paid to another state if the other state and California tax the same income. There are limitations. The credit is taken on California 540, Schedule S if the same income is taxed by Calif. and another state. ***(Cal. Rev. & Tax. Code Sec. 18001(c))***

Residents of California may claim a credit only if the income taxed by the other state has a source within the other state under California law. **No credit is allowed** if the other state allows California residents a credit for net income taxes paid to California.

California Resident - California resident individuals or estates and trusts that derived income from sources within any of the following states or U.S. possessions and paid a net income tax to that state or U.S. possession on income that is also taxed by California may claim the other state tax credit on their California return:

Alabama
American Samoa
Arkansas
Colorado
Connecticut
Delaware
Georgia
Hawaii
Idaho
Illinois
Indiana*
Iowa
Kansas
Kentucky
Louisiana
Maine
Maryland
Massachusetts
Michigan
Minnesota
Mississippi
Missouri
Montana
Nebraska
New Hampshire *(Business Profits Tax)*
New Jersey
New Mexico
New York
North Carolina
North Dakota
Ohio
Oklahoma
Pennsylvania
Puerto Rico
Rhode Island
South Carolina
Tennessee *(excise tax only)*
Utah
Vermont
Virginia *(dual residents)*
Virgin Islands
West Virginia,
Wisconsin
District of Columbia *(Unincorporated business tax and income tax, the latter for dual residents only)*

*Effective for tax years beginning on or after Jan. 1, 2017; for prior years the credit was claimed on the Indiana return

California residents who are included in a group nonresident partnership, S corp, LLC, etc., tax return, filed with the states listed above, as well as Arizona (AZ), Oregon (OR), or Virginia (VA) may also claim a credit for their share of income taxes paid to these states, unless any of these states allow a credit for taxes paid to California on the group nonresident tax return. See more about group nonresident returns starting on page 1.50.18.

Nonresidents - Nonresidents of California may claim a credit only for net income taxes imposed by and paid to their states of residence and only if such states do not allow their residents a credit for net income taxes paid to California. They may claim the out-of-state tax credit on their Form 540 NR return. Only states and territories allowed for nonresidents are:

Arizona
Guam
Oregon
Virginia

California nonresidents who are residents of any state or U.S. possession not listed may not claim this credit.

Part-Year Residents - Part-Year Residents follow the instructions for residents for the part of the year that they were a California resident and follow the instructions for nonresidents for the part of the year that they were a nonresident. Their allowable credit is figured on Form 540, Schedule S. ***(CA Rev. & Tax. Code Sec. 17041)***

The **Other State Tax Credit** is allowed for net income taxes paid to another state (not including any tax comparable to California's alternative minimum tax) on income that is also subject to California tax. The credit is applied against California net tax less other credits. The credit cannot be applied against the California alternative minimum tax.

An **Estate or Trust** may claim a credit if it is treated as a "resident" of California and also as a "resident" of another state. For this purpose, an estate or trust is considered to be a "resident" of any state that taxes all its income, regardless of whether the income is derived from sources within that state.

FORMS TO USE FOR PART-YEAR AND NONRESIDENT RETURNS

- **540 NR – Short Form** - may be used for taxpayers with up to $100,000 of total income and no more than 5 dependents. Adjustments to income are allowed only for unemployment compensation, military pay adjustment and paid family leave insurance (not taxable to CA). Not available if (a) filing married separate, (b) either taxpayer or spouse/RDP is age 65 or over, (c) interest income on the federal return includes U.S. government interest, (d) using itemized deductions, (e) claiming credits other than the personal and dependent exemption credits or renter's credit, (f) CA estimated tax payments were made or the taxpayer has an estimated tax transfer available from the prior year return, or (g) tax is withheld on Forms 592-B or 593.
- **540 NR – Long Form** - may be used for all other nonresident and part-year resident taxpayers.
- **540 NR, Schedule CA** - the 540NR CA form is used to calculate worldwide income, worldwide income using California law, California source income and the ratio of California source income to worldwide income. California tax is computed on the basis of worldwide income. The procedure for computing the California tax when using Form 540NR is summarized in the following steps:
  - Determine worldwide income.
  - Determine California source income.
  - Calculate the ratio.
  - Calculate tax on worldwide income.
  - Apply the ratio of tax on worldwide income to find the California tax due.

> **NOTE -** Since Residency is a question of fact, not law, the FTB will not issue a written opinion on whether an individual is a California resident for a certain period of time.

FTB WRITTEN ADVICE

Requests for written advice must include the name of the taxpayer and an identification number (social security number, corporation number or federal employer identification number). Requests require a complete statement of all the facts regarding the transaction or activity. Taxpayers or their tax representatives requesting written advice on behalf of a client must include a legal analysis and cite the authority for their position. In some cases, tax may be cancelled if the advice is requested and received prior to taking the contemplated action. **(*Rev. & Tax. Code Sec. 21010)***

The FTB will **not issue written advice under certain conditions**:

- Sections of law where state and federal law are the same.
- **Questions of fact (residency, unity)**
- Issues that are currently in audit, protest, appeal, settlement or litigation.

Refer to Franchise Tax Board Notice 2009-8 for more detail on how the Board provides written advice to taxpayers. This document is available on the FTB web site at: https://www.ftb.ca.gov/tax-pros/law/ftb-notices/2009-08.pdf

GUIDELINES FOR DETERMINING RESIDENCY

The following is a list of factors used in determining residency (*FTB Publication 1031 – 2018*):

- Physical Presence - Amount of time spent in CA vs. elsewhere
- Location of spouse/RDP, children and family
- Principal residence – Where is it located (and is it owned or leased)?
- State where professional licenses are maintained
- Voter Registration – What state?
- Location of financial institutions, and point of origin of financial transactions (bank accounts, credit cards)
- Location of professionals, physician, accountant, attorney, insurance agent and broker
- Location of investments and real property
- Location of social, family, religious and business connections
- Permanence of work assignments in California

When the FTB challenges a residency position by a taxpayer, the documentation requested as part of the audit may include the following:

- Real Property
  - Purchase/Sale/Lease Information
  - Escrow Documents
  - Insurance Records
- Personal Property
  - Vehicle/Vessel Registration
- Business Activity Information
  - Travel Logs or Personal Calendars
  - Employment Contracts

- Financial Records
  - Cancelled Checks/Statements
  - Credit Card Receipts/Statements
- Personal Records and/or Information
  - Voter Registration
  - Service Providers (e.g., utility statements)

Voter Registration **-** To illustrate the importance of the above items, just registering to vote in California and/or claiming the California homeowner's property tax exemption can create a presumption that makes a taxpayer a resident. **(See the following BOE cases: Appeal of Pierre and Nicole Salinger 1980 SBE 089 and Appeal of Anthony and Ann D'Eustachio 1985 85 SBE 040)**

Residency Audits – A residency audit – which the FTB aims to complete within 18 months – focuses on:
1. Claimed state of residency
2. Personal records, business activity info and financial records
3. Real property (sale, purchase, lease)
4. Personal property (car, boat, plane)
5. Business activity logs/calendars – possible related business entities
6. Personal records (Voting, Medical Services)

Residency Appeal Board of Equalization Case - A 2003 Residency case that went to Appeal was won by a taxpayer by the name of Stephen D. Bragg. It was an interesting case in which Mr. Bragg had homes and business activities in two states, CA and AZ. He had bank accounts in CA and cars registered in CA. The taxpayer had all of his professional services done in CA. The taxpayer spent substantial time in Arizona. He spent the majority of time during the tax year in his Arizona home. Bragg conducted most of his business in AZ. He also had full-time employment in Arizona. The kicker was the taxpayer had no intention of returning to CA to reside. The Board's findings were made with Bragg's many CA ties.

Appealing FTB Residency Audit Determination - When the audit is complete, FTB will also issue one or more of the following:
- A letter stating FTB accepted the return or the claim for refund as taxpayer filed it.
- A letter stating FTB denied or partially denied taxpayer's claim for refund.
- A Notice of Proposed Assessment indicating the additional tax FTB believes is owed.
- A Notice of Overassessment indicating the refund FTB owes.
- A Notice of Proposed Adjusted Carryover Amount indicating FTB changed a carryover item but taxpayer owes no additional tax.

If FTB issues a Notice of Proposed Assessment and taxpayer does not agree, taxpayer has the right to protest FTB action. Taxpayer must file a written protest by the date shown on the front of the FTB notice. FTB provides specific protest procedures with the notice. If FTB does not grant taxpayer's claim for a refund, taxpayer has the right to appeal the FTB action. Prior to July 1, 2017 such written appeal was filed with the California State Board of Equalization (SBE) within 30 days of the date of the FTB denial letter. A new agency, the Office of Tax Appeals, took over part of the SBE's functions as of July 1, 2017 but didn't begin full operations and hearing appeals until January 1, 2018. For more information regarding taxpayer protest and appeal rights, refer to California Taxpayers' Bill of Rights publications (FTB 4058, 4058B and 4058C – available on the FTB's web site) or visit the Office of Tax Appeals website at ota.ca.gov.

Notice of Proposed Assessment **-** The Notice of Tax Proposed Assessment (NPA) gives the taxpayer a 60-day right of appeal within FTB. After the taxpayer's protest or appeal is ruled on by FTB, a Notice of Action will be issued by FTB. The taxpayer then has 30 days to appeal the FTB determination to the new Office of Tax Appeals, where a 3-member panel of administrative law judges will hear the case. In a residency determination case, the taxpayer is granted a big exception to file an appeal of an FTB notice of action in the California Superior Court with no prepayment of tax required. In general, tax must be paid prior to going to Superior Court.

ALIMONY AND THE NONRESIDENT

Code section 17302 conforms FTB and California law to the U.S. Supreme Court decision **Lunding v. N.Y Appeals Tribunal-1998**, allowing a prorated alimony deduction to nonresidents and part-year residents. Nonresidents or part-year residents are allowed an alimony paid deduction in the same ratio, not to exceed 1.00, as California adjusted gross income for the entire year, computed without regard to the alimony deduction, bears to total adjusted gross income, computed without regard to the alimony deduction. *Note: California has not conformed to the TCJA treatment of alimony (nontaxable by recipient/nondeductible by payer) from decrees entered into after 2018.*

$$\textbf{Prorated Alimony} = \frac{\textbf{California AGI (w/o Alimony Deduction)}}{\textbf{Total AGI (w/o Alimony Deduction)}} \textbf{ X Total Alimony}$$

FOREIGN TAX TREATIES AND FOREIGN TAX CREDITS - California does not conform to the Internal Revenue Code as it relates to treaties that exempt certain income from federal taxation. The result is that, although foreign pensions and social security may be exempt from federal taxation under U.S. treaties, the income is subject to California tax.

Federally Exempt Foreign Pensions - Federally Exempt Foreign Pensions are taxable to California residents. The state's position has been that tax treaties between the U.S. and other countries do not prevent California from taxing persons otherwise covered by such treaties. ***(Appeal of M.T. de Mey van Streefkerk, Cal. St. Bd. Of Equal., Nov. 6, 1985)*** In support of this position, the U.S. Supreme Court has ruled that tax treaties the U.S. enters into generally do not prohibit the taxing activities of sub-national governments.

Foreign Social Security - Only U.S. Social Security Benefits are exempt from CA taxation - There is no provision under either the California statute or the Internal Revenue Code to specifically exempt foreign social security from taxation by California. ***(Cal. Rev. & Tax. Code Sec 17087(a))***

Foreign Tax Treaties and Foreign Tax Credits – Below are three important facts regarding Foreign Tax Treaties and Foreign Tax Credits:

- California does not recognize U.S. Government and foreign country treaties and doesn't allow a tax credit for foreign income taxes paid.
- Federal rules that may exempt certain foreign income from federal tax do not apply to California.
- Any foreign earned income excluded under IRC Sec 911 for federal purposes must be added back to California income on Schedule CA for California tax purposes.

MOVING EXPENSES

Part-Year Residents – Even though the TCJA no longer allows a moving deduction for federal purposes after 2017 (except for Armed Forces members on active duty who move pursuant to a military order), California conforms to the pre-2018 federal treatment of moving expenses as an adjustment to income. California also conforms to the Federal limits (e.g., no meal expenses allowed) regarding moving expenses.

If a part-year resident taxpayer:

- ***Moved Into California*** - in connection with a new job, the moving expenses are deductible.
- ***Moved Out of California*** - in connection with a new job, the moving expenses are not deductible in CA.

Exception: If the taxpayer moved out of California in connection with a new job and received compensation from that job attributable to a California source, the moving expense adjustment will be limited by the ratio of California source compensation from the new job to total compensation from the new job.

NONRESIDENT OR REAL ESTATE WITHHOLDING CREDIT

- If your clients are nonresidents, they may have a nonresident withholding credit. If so, they should have received form FTB 592-B, Resident and Nonresident Withholding Tax Statement, to document their nonresident withholding credit.
- If your clients are individuals (either residents or nonresidents) and sold California real property that was not their principal residence, withholding was probably performed as part of the transaction and they should have received Form 593, Real Estate Withholding Tax Statement, to document how much real estate withholding credit they have.
- To claim these credits on the clients' California income tax return, enter the credit on the Real Estate or Other Withholding line.
- Do not claim it on any other line or the credit will be delayed or denied during processing.

PENSIONS AND ANNUITIES

California generally conforms to Federal treatment of pensions. However, foreign equivalents to Social Security are generally taxable to CA. See Chapter 2.03.

Taxation of Out-of-State Pensions - P.L. 104-95 prevents states from taxing the pensions of **former** residents of any state received after December 31, 1995 (R&TC 17952.5). Benefits received from the following plans are not subject to out-of-state taxation:

- IRC Sec. 401(a) trusts exempt from taxation under IRC Sec. 501(a)
- IRC Sec. 403(a) annuity plans
- IRC Sec. 403(b) annuity contracts
- IRC Sec. 408(k) plans
- IRC Sec. 414(d) government plans
- IRC Sec. 457 deferred compensation plans
- IRC Sec. 501(c)(18) trusts
- IRC Sec. 7701(a)(37) individual retirement plans
- IRC Sec. 401(k) plans)
- IRC Sec. 3121(v)(2)(C) plans (Nonqualified Deferred Compensation Plans) - if payments are made at least annually and spread over the actuarial life expectancy of the beneficiaries or if they are spread over at least a 10-year period; and
- Plans that are trusts under IRC Sec. 401(a) but exceed limits laid down in IRC Sec. 401(a)(17) and IRC Sec. 415.

Taxation of Canadian RRSPs and RRIFs – These Canadian retirement plans do not qualify as IRAs under either federal or California law. California does not recognize the U.S.-Canada treaty provision allowing an election to defer taxation of the earnings of these plans until distributions are received. Thus the interest, dividends or capital gains earned by these plans annually are taxed by California and are an adjustment on Schedule CA. The amount taxed becomes the taxpayer's basis in the plan for CA purposes and will not be taxed again when distributions are actually received.

WAGES AND SALARIES

Wage and Salary Income has a source where the services are performed. When a California resident receives compensation for services, the compensation is taxable by California. Location of the employer, where the payment is issued or the location where the taxpayer received the payment does not affect the source of this income. The most important factor is the place where the services are ultimately performed.

CA Nonresident - A California Nonresident must include the income for services performed in CA. ***(Cal. Rev. & Tax. Code Sec 17954*****)**

Compensation Accrued Before CA Residency - Compensation received by the taxpayer as a California resident that accrued before becoming a resident is taxable by California. Therefore, if a taxpayer is a California resident when compensation is **received**, the compensation is taxable by California.

> ***Example – Accrued before becoming a resident –*** *The taxpayer lived and worked in New York until March 30. He permanently moved to California on April 5. On April 15, he received his last monthly paycheck of $5,000 in the mail from his out-of-state employer. Therefore, the wage income of $5,000 is taxable income to California, because the taxpayer was a California resident when he received the wages. If the taxpayer also paid tax to New York on the $5,000, he may be allowed an other state tax credit on this double-taxed income-Form 540NR, Schedule S.*

INTEREST AND DIVIDENDS – INTANGIBLE INCOME

Intangible income such as interest and dividends has a source where the taxpayer is a resident.

- **CA Resident** – Generally, intangible income from worldwide sources is taxable to CA.
- **CA Nonresident** – Intangible income received from California by a nonresident is not taxed by California. ***Exception*** - interest and dividends have a source in CA if the account or security is used in a trade or business or pledged as security for a loan, the proceeds of which are used in a trade or business in CA.

> ***Example – CA Nonresident -*** *Taxpayer, a California nonresident, owns stock in a California corporation and received $10,000 in dividends. Dividends have a source in the owner's state of residence. Therefore, the dividends the taxpayer received are not California source income and not taxable by California.*
>
> ***Example – CA Part-year resident –*** *The taxpayer moved from New York and became a California resident on June 1. However, he kept his money in a bank account in New York. From January 1 to December 31, the New York bank account earned $5,000. Interest income, which is intangible, has a source in the recipient's state of residence. Because the taxpayer became a California resident on June 1, the interest earned by the taxpayer from June 1 to December 31, is considered California source income. If the $5,000 of interest had been earned ratably through the year, then $2,917 ($5,000 x 7/12) of the interest would be taxable to California.*
>
> ***Example: CA Part-year resident -*** *During the tax year, the taxpayer was a part-year resident. He sold 500 shares of stock at a $20,000 gain after becoming a California resident. Since he was a California resident at the time of sale, the gain on the sale of the stock is taxable by California even though the stock appreciation had taken place over a number of years in a different state.*

BUSINESS INCOME

Nonresident - Nonresidents and resident individuals eligible for the other state tax credit who have income or loss from a trade or business activity conducted within and outside California generally must apportion their income in accordance with the provisions of R&TC Sections 25120 through 25141 (see Cal. Code Regs., tit. 18 section 17951-4). Items of income or loss that would be treated as nonbusiness income under those sections if earned by a corporation should be sourced using the normal sourcing rules that apply to individuals under R&TC Sections 17951 through 17955, and reported on the appropriate line of Schedule CA (540) or Schedule CA (540NR. Individuals complete only Schedule R-1, R-2, and lines 17, 18a, and 18b on Schedule R. Enter on line 17 the total income from the trade or business after any adjustment for federal and state differences. Nonresidents or part-year residents should enter the amount from line 18b on Schedule CA (540NR), Part II line 12 or line 17, column E. Note: In completing these schedules, the term "corporation" should be read as "apportioning business activity."

If an apportioning trade or business is (1) operating as a sole proprietorship owned by a nonresident individual or (2) operating as a single-member disregarded LLC owned by a nonresident individual and therefore treated as a sole proprietorship, for income arising from activities that occur both within and outside California, the single-sales factor formula must be used to determine the California source income of the individual on Schedule R-1. For more information, see Cal. Code Regs., tit. 18 section 17951-4(c)(2).

Nonresident individuals with service or intangible income from a trade or business or profession may have California source income if they have income from California as result of market assignment. See market assignment information in the General Information section of the Schedule R instructions for more information:
https://www.ftb.ca.gov/forms/2018/18-100R-instructions.html

> ***Example*** *- Jill, a nonresident of California, owns a web design business that she holds as a sole proprietorship. She works from her home out of state but has customers in various states including California. For the taxable year, Jill's sales receipts from California customers are $300,000 out of the total sales receipts everywhere of $1,000,000. Since nonresident individuals are taxed on all California source income and Jill's sole proprietorship is carrying on a business in and out of California and will be required to apportion its income to California, she will be required to file a California return. Under market assignment, sales of services are assigned to California if the purchaser of the service received the benefit of the service in California. Accordingly, $300,000 will be assigned to the California sales factor numerator for Jill's sole proprietorship and Jill would apportion 30% ($300,000 CA sales/$1,000,000 total sales) of the business income from her sole proprietorship to California.*

STOCKS AND BONDS

Gains and losses from sales of stocks and or bonds have a source where the taxpayer is a resident at the time of the sale. *(Cal. Rev. & Tax. Code Sec 17952)*

SALE OF A PARTNERSHIP INTEREST

The sale of a partnership interest is considered a sale of an intangible asset. It has a source where the taxpayer is a resident at the time of the sale. *(Appeal of Amyas and Ames SBE 87-042)*

LUMP SUM DISTRIBUTIONS

California Residents - Any lump sum distributions (not rolled over) are taxable by California.

Nonresidents - Lump sum distributions from a qualified plan or annuity are not taxable by California. However, nonqualified plan distributions are still taxable by California.

SALE OF REAL ESTATE

Residents and Nonresidents - Gains or losses from the sale of real estate have a source where the property is located. Thus, both residents and nonresidents are taxed on the gain from the sale of California real estate, and include a loss from sale of California real property on their California return if the loss is otherwise allowed under the usual loss recognition rules. Gains from real estate sales of property located outside of California are only taxable to California if the taxpayer is a resident of California at the time of the sale. Losses from out-of-state real property sales – if the loss is permitted under the normal loss recognition rules – are allowed to California residents the same as if the property were located in California. A California resident selling real property located in another state may be required to file a nonresident return for the other state, depending on the other state's filing requirements.

TAX WITHHOLDING FOR CA FLOW-THROUGH ENTITIES

The withholding applies to Interest, Dividends and Compensation for personal services.

Domestic (non-foreign) Nonresident Partners - Partnerships are required to withhold income taxes when distributing current or prior year income to domestic nonresident partners. Withholding is not required if distributions to a partner are $1,500 or less during the calendar year (*R&TC Sec 18662))* The withholding rate is 7 percent of distributions of California source income to domestic nonresident partners.

Foreign (non-U.S.) Partners - Withholding is required on income from California sources which is allocated to foreign partners. R&TC Section 18666 generally conforms to federal Internal Revenue Code (IRC) Section 1446 to the extent that the income is from California sources. ***(CA R&TC Section 18666)*** The **withholding rate is 12.3 percent** of distributions of California source income to foreign nonresident, noncorporate partners.

- The FTB allows foreign partners to request reduced or no withholding of California tax on effectively connected taxable income from California sources allocable to a foreign partner by certifying to the FTB and the partnership that no or reduced California tax will be due. See FTB Form 589 instructions for details.

Withholding Exceptions - Withholding is not required if one of the following exceptions is met:
- The partner is a California resident.
- The partner is a corporation that is qualified through the California Secretary of State to do business in California or has a permanent place of business in California.
- The partner is a partnership that has a permanent place of business in California.
- The total distributions of California source income to the partner are less than or equal to $1,500 for the calendar year.
- The partner or partnership receives a withholding waiver from the FTB.

- The partner is a tax-exempt entity under either California or federal law.
- The distribution is exempt income.
- The partner has certified that income was previously reported on the partner's California tax return.

Forms – The following are the required withholding forms and instructions:
- 592 - Resident and Nonresident Withholding Statement (submitted to FTB by withholding agent)
- 592B –Resident and Nonresident Withholding Tax Statement (provided to payees by withholding agent)
- FTB Publication 1017

RESIDENCY BY PROFESSION

Airline Employees **-** Wages of nonresident flight personnel are NOT taxable by California unless more than 50% of the individual's scheduled flight times are in California. ***(49 U.S.C. section 40116(f)(2)(B))*** If more than 50% of a nonresident airline employee's pay is earned in California, that California-sourced income can be taxed by the FTB. If more than 50% of flight time is scheduled in California, the wages taxable to CA are determined as follows:

$$\textbf{CA Source Wages} = \frac{\textbf{Scheduled flight time in CA}}{\textbf{Total scheduled flight time}} \times \textbf{Wages}$$

California residents are taxed on all wages received regardless of where flight time is spent.

Railroad or Motor Carrier **-** The wages of these nonresident employees are only taxed by the employee's state of residence. ***(49 U.S.C. sections 11502(a) and 14503(a))***

Merchant Seamen - The following are considered CA nonresidents:
- Any merchant seaman, who is in CA due to the fact that this state is a port of call and who maintains no other contacts or connections with this state, is a nonresident.
- Merchant seamen are normally taxed by state of residence.
- Merchant seamen are normally considered to be domiciled at the location where their family resides. (***Appeal of W.J. Sasser 1963 SBE 126)***

Students **–** Out-of-State students that attend California universities are generally considered to be nonresidents if they are in CA just to attend school and pay out-of-state tuition fees. *(**FTB Legal Ruling 122)*** However, CA source income, such as a CA W-2, would be taxable to California.

Example – Out-of-state Student *- The taxpayer is an out-of-state student attending UCLA. She earned $2,000 from working in the school's library. She also earned $50 of interest from a CA bank and $100 from a bank in her home state of Oregon. She also had a stock sale gain of $24,000 during the year. She would file a 540NR for the year, and her income is allocated as follows:*

	Total Income	***CA Reportable Income***
CA W-2	*2,000*	*2,000*
CA bank interest	*50*	
OR bank interest	*100*	
Capital gain	*24,000*	

Military – Military nonresidents cannot be taxed by California for income from military service earned while on station in California. Only their state of residence can tax military income. ***(Appeal of Cecil L and Bonai G. Sanders 1971 SBE 018)***

The **Service Members Civil Relief Act of 2003** provides that a service member does not lose or acquire a residence or domicile for tax purposes with respect to his or her person, personal property or income due to being absent or present in any tax jurisdiction in the U.S. solely to comply with military orders. Furthermore, military compensation is not considered income for services performed or from sources within a tax jurisdiction of the U.S. if the service member is not a resident of or domiciled in the jurisdiction in which he or she is serving.

A state (or other tax jurisdiction) may not use the military compensation of a nonresident service member to increase the tax liability imposed on other income earned by the nonresident service member (or spouse) that is taxed by the state or other jurisdiction. Military compensation of an armed service member not domiciled in California cannot be used to increase the tax liability imposed on other income earned by that military member or their spouse. Military compensation is therefore excluded from AGI, taxable income and AMT. ***(Revenue & Taxation Code 17140.5)***

- **Military Pay Adjustment For Nonresident Military Service Members ONLY** - If a taxpayer is serving on active duty military and domiciled in AZ, ID, LA, NV, TX, NM, WA, WI or Puerto Rico (community property states) AND the taxpayer's spouse is a California resident, the spouse is entitled to an adjustment of ½ of taxpayer's military pay.

  For tax purposes, income is allocated between spouses based upon whether the person receiving the income is domiciled in a community property or separate property state. The community property states are: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.

> ***Example:*** *Lt. Dan is domiciled in New York, a separate property state, and Mrs. Lt. Dan is domiciled in California, a community property state. Wages earned by Lt. Dan are his separate income for tax purposes. Wages earned by Mrs. Lt. Dan are community property for tax purposes, and each spouse must report his or her community half if they are filing separate returns. Income from joint accounts is assumed to belong equally to each party. Therefore, if the taxpayer and spouse file separate returns, each must report one-half of any taxable income from a joint account.*

- **Nonresident Military Personnel Domiciled Outside California: Military Pay Adjustment (MPA) -** Military pay of a service member domiciled outside of California cannot be used to determine the amount of California tax this taxpayer (or their spouse) must pay. Since the California return starts with federal adjusted gross income, which includes their military pay, they must make an adjustment on their California return.

  If they file:

  - Long Form 540NR, enter their military pay on Schedule CA (540NR), Part II, line 1, column B. Write **"MPA"** to the left of column A or include it according to your software's instructions and enter only the amount of the active duty military pay in column B. Do not include their military pay in column E.
  - Short Form 540NR, enter their military pay on Short Form 540NR, line 14. Write **"MPA"** on the dotted line to the left of line 14. Do not include their military pay on line 32.

  > ***Example*** *- Lt. Dan is a nonresident domiciled outside of California. Mrs. Lt. Dan is a resident of California. They should enter Lt. Dan's military pay on Schedule CA (540NR Long Form), line 7, column B.*

- **Nonresident Military Spouses Residing in California -** The Military Spouses Residency Relief Act (MSRRA) (Public Law 111-97) exempts, as of January 1, 2009, personal service income and wages earned by taxpayers who reside with their military spouses from being taxed by a state other than the spouse's resident state. The couple must have relocated to another state under military orders for the income to be exempt from the nonresident state's taxes. They must also share the same "domicile" or true home outside the duty station state where they intend to return and locate permanently.

  Thus, a servicemember's spouse is considered a nonresident of California for tax purposes if the servicemember and spouse have the same legal residence or domicile outside of California, and the spouse is in California solely to be with the servicemember who is serving in compliance with military orders.

  This means that a qualified spouse's wages or other income received for services performed in California is not considered to be California source income and is not taxed by California. This income is not included in California taxable income, Schedule CA (540NR), column E, but it is included in total taxable income, Schedule CA (540NR), column D, to arrive at the applicable California tax rate.

  A servicemember's spouse who meets the MSRRA qualifications will be subject to California tax on income from real or tangible personal property located in California, as well as income from a trade or business located in California other than income for services performed for the trade or business by the servicemember's spouse.

  The nonmilitary income of military personnel is not exempt. States are prohibited from taxing any military pay of nonresident military personnel.

  <u>*Veterans Benefits and Transition Act of 2018*</u> – This legislation modifies the MSRRA rules to allow the spouse of a servicemember to make the election to use the same residence for purposes of taxation as the servicemember regardless of the date on which the marriage of the spouse and the servicemember occurred. This change also applies to California. Income of a servicemember's spouse for services performed in California is not subject to tax if the spouse elects to use the same residence as the servicemember who is a nonresident of California. If the spouse makes the election, write "VBTA" at the top of the tax return in RED INK, or include it according to your software's instructions. (FTB Pub 1032, rev. 02-19)

<u>*Filing Status CA Military and Nonresidents*</u> **-** Filing status for California must generally be the same as the filing status used on the federal income tax return. Exception: Married taxpayers who file a joint federal tax return may either file a joint return or separate returns if either spouse was:

- An active member of the U.S. Armed Forces or any auxiliary military branch during the tax year; or
- Was a nonresident for the entire year and had no income from California sources during the tax year.

However, if the taxpayers file a joint return and if either spouse was a nonresident during the tax year, the taxpayer must file Form 540NR, California Nonresident or Part-Year Resident Income Tax Return.

Native American Service Members **-** whose legal residence or domicile is a federal Indian reservation are treated as living on the federal Indian reservation. The military compensation is, therefore, treated as income earned from federal Indian reservation sources.

Professors/Teachers on Sabbatical **-** California residents who are professors and teachers remain California residents while on sabbatical. ***(Appeal of Mortimer and Catherine Chambers, 1987 SBE 001)***

Salespeople **-** Sales commissions earned by nonresident taxpayers will be sourced to California based on the ratio of sales in California to total sales everywhere. ***(Rev & Tax Code Sec 17954)***

$$\textbf{Ratio} = \frac{\textbf{Business transacted in CA}}{\textbf{Business transacted everywhere}}$$

Entertainers **-** Income and royalties earned by nonresident entertainers are sourced to California if the performance took place in California. Nonresident entertainers under contract to perform services both within and without California are taxed by California based on the percentage of services performed in California vs. services performed on the entire project. ***(CA Code of Reg 17951)***

The court upheld a nonresident taxpayer to include total time that the actor is "on-call" to be included in "duty days" (for time spent within CA) for actual filming of a project. ***(Newman v. FTB 208 Cal App 3d 972. (1989))***

$$\textbf{Ratio} = \frac{\textbf{Working Days in CA}}{\textbf{Working Days Everywhere}}$$

Withholding on Entertainers **-** California requires withholding at the rate of 7% of gross receipts when payments to an entertainer who is a nonresident of California exceed $1,500 in a calendar year. FTB is authorized to accept a lower rate of withholding if the taxpayer has a history of compliance (both filing and paying the tax due).

Athletes **-** Following special rules for entertainers, compensation paid to professional athletes who are nonresidents of California must be allocated to CA sources based on working days or the duty days formula, which has been upheld by the Board of Equalization. ***(Appeal of Carroll, Joseph 04/07/1987)***

The nonresident athlete's total salary is multiplied by the formula that total number of days the athlete works in CA bears to the total number of working days elsewhere.

In a case involving a nonresident professional football player his California income was based on working days spent in CA from the first practice day and running from the first regular season football game until any post-season playoff games. ***(Appeal of Michael D. and L. Joy Eischeid, SBE 10/6/76)***

Exception: Any signing bonuses that professional athletes receive for signing a contract are not considered to be for services rendered and not subject to the above formula. Nonresident athletes would report signing bonuses to their state of residence. Playing bonuses are considered to be compensation and subject to the working days formula. ***(Appeal of Garrison Hearst, et. Al., 2002 SBE 007)***

Professionals (Doctors, Lawyers and Accountants) - Fees received for services performed in CA are sourced to CA.

COMMUNITY PROPERTY

Separate returns - In California, community income or deductions must generally be split equally between the spouses. When spouses separate with no intention of resuming marital status, the income of each spouse during the period of separation is his or her separate property. Salaries and wages earned during marriage are community income.

Community Income - When a married couple files separate returns, each spouse is required to report all income from his or her separate property and one-half of any community income. Nonresident spouses follow the rules of their state of domicile to determine whether or not income is considered community income. A nonresident spouse that is domiciled in a separate property state would report his or her earnings as separate income.

COVENANT NOT TO COMPETE

There is a State Board of Equalization decision that a payment received in return for an agreement not to compete is taxable by California to the extent income had been earned in California. ***(Appeal of W.W. George, 2/3/1994)***

INSTALLMENT SALES

California taxes installment gains received by a nonresident from the sale of tangible and intangible property on a source basis. ***(FTB Pub 1100)***

- Real property - based upon where the property is located.
- Intangible property - generally sourced to the taxpayer's state of residence at the time of sale.

Nonresident - Installment payments received by a nonresident from the sale of CA property is taxable by California to the extent the income was from a California source. However, the interest earned by a nonresident on the installment sale note is not taxable by California.

> ***Example:*** *The taxpayer has always been a nonresident of California. In a prior year, the taxpayer sold a California rental property in an installment sale. During the tax year, the taxpayer received installment proceeds comprised of capital gain income and interest income. The capital gain income is taxable by California because the property was located in California. The interest income is not taxable by California and has a source in the taxpayer's state of residence.*

Change of Residency to California **-** If the taxpayer is a California resident who sold property located outside of California on an installment basis while a nonresident, the installment proceeds received while a California resident are taxable by California.

> ***Example - Change of Residency to CA:*** *In a prior year, while a nonresident of California, the taxpayer sold a Texas rental property in an installment sale. On May 15 of the current tax year, the taxpayer became a California resident and on August 1, the taxpayer received installment proceeds comprised of capital gain income and interest income. The taxpayer's capital gain income and interest income received on August 1 are taxable by California, because he was a California resident when he received the proceeds.*

Change of Residency from California **-** If the taxpayer is a former California resident, the installment sale proceeds received from the sale of a property located **outside** of California that was sold while a California resident are not taxable by California.

> ***Example – Change from resident to nonresident – sale of CA real property:*** *In March, while a California resident, the taxpayer sold a parcel of real property located in California in an installment sale. On June 1, the taxpayer became a Washington resident, and on August 1, the taxpayer received installment proceeds comprised of capital gain income and interest income. The capital gain income is taxable by California, because the property the taxpayer sold was located in California. The interest income, however, is not taxable by California, because the taxpayer was a nonresident of California when he received the proceeds.*

> ***Example – Change from resident to nonresident – sale of non-CA real property:*** *Same facts as in the prior example, except that the real property that was sold on the installment basis in March was located in Texas. None of the installment payment received on August 1 is taxable to California because the taxpayer is a nonresident when the payment is received and the property was not located in California.*

> ***Example – Change from resident to nonresident – sale of intangible property:*** *In a prior year, while a California resident, the taxpayer sold stock in an installment sale. On Feb 1 of the current year, the taxpayer became a Washington resident, and on May 1, she received installment proceeds consisting of capital gain income and interest income. California will tax the capital gain income, because the taxpayer was a resident when the stock was sold, but will not tax the interest income, because the taxpayer was a nonresident of California when she received the proceeds.*

INDIVIDUAL RETIREMENT ACCOUNTS

Nonresidents **-** California does not tax distributions from IRAs, Qualified Pension, Profit Sharing and Stock Bonus Plans of nonresidents.

Change of Residency to California – Prior to 2002 taxpayers who became residents received a stepped-up basis for annual contributions and earnings on retirement plans due to the fact they were nonresidents when the contributions were made. But since 2002 the law treats taxpayers as though they were residents for all prior years for all items of deferred income, which includes IRAs.

Taxpayers will be allowed a basis for contributions that were actually made, which would not have been allowed under California law had they been a resident.

California did not conform to federal law regarding IRA contributions from 1982 to 1986. During these years, California limited the deduction to 15% of compensation or $1,500, not the federal amounts of 20% or $2,000. For tax years 2007 through 2009, California did not conform to the higher federal phaseout amounts that became effective as of 2007. However, beginning with 2010, California does conform to the federal phaseout amounts.

Historical Limitations: We have provided a table summarizing the various limitations, changes and differences between Federal and California law since the inception of the Traditional IRA. For Federal tax purposes, a basis in an IRA could not be possible until the advent of the nondeductible IRA in 1987. However, because of the delayed conformity to Federal rules and different limitations, a California basis could have been established as early as 1975. **See basis chart in IRA chapter 04.05.**

ROTH IRA

California conforms to the Federal Roth IRA rules, including the phaseout amounts. Thus, for California purposes, taxpayers may use the same elections for state purposes as they use on their Federal returns.

STOCK OPTIONS - See Chapter 2.06 for CA Treatment of Stock Options

DEFERRED GAINS AND LOSSES (Like-kind exchanges IRC 1031)

A gain or loss from the sale or exchange of real or tangible personal property located in California is sourced to California at the time the gain or loss is realized. The TCJA limited the type of property eligible for tax deferral under IRC Sec 1031 to real property only, effective for exchanges after 2017. This TCJA provision was adopted by California in AB 91 (signed by the governor 6/27/2019), with two significant differences: the provision only applies to taxpayers with AGI of $500,000 or more ($250,000 for those filing single or married separate) and only applies to exchanges completed after January 10, 2019.

Nonresident - California property - If a taxpayer is a nonresident and exchanges real or tangible property located within California for real or tangible property located outside California, the realized gain or loss will be sourced to California. Tax will not be imposed until the gain or loss is recognized.

> ***Example:*** *As a resident of Texas, Mr. Round Tax exchanged a condominium located in California for like-kind property located in Texas. Mr. Round Tax realized a gain of $15,000 on the exchange that was properly deferred under IRC section 1031. He then sold the Texas property in a non-deferred transaction three years later and recognized a gain of $20,000.* ***Determination:*** *The $15,000 deferred gain (the lesser of the deferred gain or the gain recognized at the time he disposed of the Texas property) has a source in California and is taxable by California.*

Nonresident – Out-of-State Property - If a taxpayer exchanges real or tangible property located outside California for real or tangible property located within California, the gain recognized when the California property is sold or otherwise disposed of in a non-deferred transaction has a California source and is taxable by California.

> ***Example****: As a resident of Nevada, in 2018 the taxpayer exchanged Nevada business property for like-kind California business property. The taxpayer realized a $10,000 gain on the exchange that was properly deferred under IRC section 1031. A few years later, and while still a Nevada resident, he sold the California business property in a non-deferred transaction and recognized a gain of $50,000.* ***Determination:*** *Because the property is located in California, the $50,000 gain has a California source and is taxable by California.*

Sec 1031 Annual Reporting Requirement for Some 1031 Exchanges **-** Beginning with Sec. 1031 exchanges occurring on or after January 1, 2014, taxpayers who exchange California real property for like-kind property located out of state will be required to file an information return with the FTB for the sale year and each subsequent year the gain is deferred. (New R&TC §§18032, 24953 added by AB 92) See also chapter 3.20.

GAINS AND LOSSES FROM THE SALE OF TRADE OR BUSINESS PROPERTY

When taxpayers sell property used in a trade or business or certain involuntary conversions (IRC section 1231 property), losses are netted against gains. If section 1231 losses exceed section 1231 gains, the losses receive ordinary tax treatment. If section 1231 gains exceed section 1231 losses, the gains receive capital gain tax treatment. Section 1231 gains and losses retain this characterization regardless of whether the taxpayer changes their residency status. ***For purposes of computing California taxable income, net only California source section 1231 gains and losses.***

> ***Example – Sale of Trade or Business -*** *The taxpayer is a resident of Washington. His California and non-California source section 1231 gains and losses for the year included a $3,000 California gain, a $2,000 California loss, a $4,000 Washington gain and a $5,000 Washington loss. Based upon the netting of the taxpayer's total and California source section 1231 gains and losses, determine his capital gain or ordinary loss as follows:*

	Total taxable	***CA taxable income***
CA section 1231 gain	*$ 3,000*	*$ 3,000*
CA section 1231 loss	*<2,000>*	*<2,000>*
WA section 1231 gain	*4,000*	
WA section 1231 loss	*<5,000>*	
Capital gain	*$ 0*	*$1,000*

CAPITAL GAINS AND LOSSES

Always a Nonresident **-** If the taxpayer is always a nonresident of California, capital loss carryovers and capital loss limitations are based only upon California source income and loss items in order to compute California taxable income.

Change of Residency to California **-** If a taxpayer had capital loss carryovers and was a nonresident of California in prior years, the capital loss carryovers need to be restated as if the taxpayer had been a California resident for all prior years.

Change of Residency from California **-** If a taxpayer had capital loss carryovers from sales while a California resident, and then becomes a nonresident of California, the capital loss carryovers need to be restated as if the taxpayer had been a nonresident for all prior years.

Part-Year Resident **-** If a taxpayer changes residence during the year, they must compute income and deductions using resident rules for the period of the year they were a California resident and nonresident rules for the period of the year they were a nonresident. Compute any prior year carryover loss as if they were a California resident for all prior years and as if they were a nonresident for all prior years. Prorate both capital loss carryover amounts based upon the periods of California residency and nonresidency during the year.

PASSIVE ACTIVITIES

The laws provide rules for determining the amounts of allowed passive activity losses and suspended losses if taxpayers are nonresidents of California or if they change residency status.

Always a Nonresident **-** If the taxpayer has always been a nonresident, the allowed passive activity losses and suspended losses are determined based only upon California source passive income and loss items to compute California taxable income. Only California source passive losses carry forward into the following year.

Change of Residency to California **-** If a taxpayer had suspended passive losses and was a nonresident in prior years, the suspended losses need to be restated as if they were a California resident for all prior years.

Change of Residency from California **-** If a taxpayer had suspended passive losses and becomes a nonresident of California, the suspended losses need to be restated as if they were a nonresident for all prior years.

Part-Year Resident **-** Compute income and deductions using resident rules for the period of the year they were a California resident and nonresident rules for the period of the year they were a nonresident. Compute any suspended passive activity losses as if they were a California resident for all prior years and as if they were a nonresident for all prior years. Prorate both suspended passive loss amounts based upon the periods of California residency and nonresidency during the year.

NET OPERATING LOSSES

The taxpayer's net operating loss (NOL) deduction is not limited by the amount of NOL from all sources if taxpayers are nonresidents or part-year residents of California. The California NOL was suspended for the 2002 and 2003 taxable years; for taxable years 2008 and 2009, except for "small businesses" with net business income of less than $500,000; and for taxable years 2010 and 2011, except for taxpayers with modified AGI less than $300,000 or with disaster loss carryovers. See Chapter 3.16 for additional details.

Always a Nonresident **-** The taxpayer is allowed a net operating loss deduction carryover for California taxable income based upon California sourced income and deductions, regardless of whether they have an NOL in computing taxable income.

Change of Residency to California **-** If the taxpayer had NOL carryovers and was a nonresident of California in prior years, the NOL carryovers need to be restated as if they had been a California resident for all prior years.

Change of Residency from California **-** If the taxpayer had NOL carryovers and became a nonresident of California in prior years, their NOL carryovers need to be restated as if they had been a nonresident for all prior years.

Part-Year Resident **-** If the taxpayer changes residency during the tax year, the NOL deduction is computed using resident rules for the period of the year they were a resident and nonresident rules for the period of the year they were not a resident. Compute any NOL carryovers as if they were a California resident for all prior years and as if they were a nonresident for all prior years. Prorate both NOL carryover amounts based upon the period of California residency and the period of nonresidency during the year.

BASIS IN PASS-THROUGH ENTITIES

Pass-though entities include partnerships, S corporations and limited liability companies that elect to be treated as partnerships.

Always a Nonresident **-** The taxpayer's basis in a pass-through entity for California purposes is equal to their contributions to capital, adjusted by California sourced items only.

Change of Residency to California **–** A taxpayer's basis in a pass-through entity needs to be restated under California law as if they had been a California resident for all prior years. Basis is adjusted for their share of flow-through items, regardless of source, during their period of nonresidency.

Change of Residency from California **-** If the taxpayer becomes a nonresident of California, their basis in a pass-through entity needs to be restated as if they had been a nonresident of California for all prior years.

PARTNERSHIPS, S CORPORATIONS AND CERTAIN TRUSTS

Nonresident - Generally, California taxes taxpayers' distributive share of partnership, s-corporations and trust income derived from California sources if taxpayers are nonresidents of California.

***Example**: The taxpayer is a nonresident of California and holds a partnership interest in a California partnership. He received a Schedule K-1 from the California partnership that included net income of $10,000 from California sources. **Determination:** His $10,000 distributive share of partnership net income has a source in California and is taxable by California.*

<u>*Part-Year Resident*</u> **-** If a taxpayer changes their residency during the year, California taxes distributive shares of partnership, S Corp and certain trust income based upon the period of California residency and the period of nonresidency during the partnership's, S corp's or simple trust's (distributes income annually) taxable year.

Under **Legal Ruling 2003-1**, items of income and deductions are treated as though they were received ratably over the year and allocated according to the ratio of the amount of time the taxpayer was a resident and nonresident of California. Under this ruling, the allocation of income between the period of residency and nonresidency must be made in a manner that reflects the actual date of realization using a daily pro rata method unless the taxpayer has actual dates when income was realized by the entity.

***Example – Allocating Partnership Income**: Jim was a resident of Arizona until September 15 when he became a California resident. He has a 50% interest in the J&B Partnership that has a December 31 year-end. The partnership conducts business within and outside California. Jim's Schedule K-1 (565) from the partnership shows that he has $10,000 of taxable income from all sources, $5,000 of which is sourced to CA.*

Jim was a California nonresident for 257 days of the partnership's tax year and a resident for 108 days. He will include in California taxable income for the year, $6,480 of income from J&B, computed as follows:

- *Nonresident period: 257/365 X $ 5,000 = $3,521*
- *Resident period: 108/365 X $10,000 = $2,959*

<u>ALTERNATIVE MINIMUM TAX</u>

<u>*Nonresident & Part-year Resident*</u> - The AMT computation for nonresidents and part-year residents is parallel to the regular tax computation. The California AMT of a nonresident or part-year resident is the amount by which the California tentative minimum tax exceeds the prorated regular tax.

CA AMT = CA Tentative Minimum Tax – Prorated Regular Tax

$$\text{CA Tentative Min Tax} = \frac{\text{TTMT}}{\text{TAMTI}} \times \text{CAMTI}$$

Where:

- <u>**CAMTI (CA Alternative Minimum Taxable Income)**</u> - is the combined total of the following:
  - The **AMTI** derived from California sources for any part of the year the taxpayer was a nonresident. For the period of nonresidency, any carryovers, deferred income, suspended losses, or suspended deductions are included or allowable only to the extent they were derived from California sources.
  - The **AMTI** from all sources for any part of the taxable year the taxpayer was a resident.

- <u>**TAMTI (Total Alternative Minimum Taxable Income)**</u> **-** is the **AMTI** determined as if the nonresident or part-year resident were a California resident in both of the following:
  - Current year
  - All prior years for any carryovers, deferred income, suspended losses or suspended deductions.

- <u>**TTMT (Total Tentative Minimum Tax)**</u> **-** is the tax on the total alternative minimum tax income (TAMTI).

***Example**: Mr. Round Tax and his spouse moved to California and became residents on May 1. Combined wages for the year totaled $170,000. He received $100,000 after his move to California. On October 1 of the same year, he exercised an incentive stock option valued at $90,000, for which he paid $10,000 (preference amount $80,000). His total taxable income for the year was $150,000, with $20,000 in itemized deductions. Five thousand dollars ($5,000) of the itemized deductions were real and personal property taxes, which are preference items. The prorated regular tax was $6,000.*

Total alternative minimum taxable income		
Real and personal property tax preference	*5,000*	
Plus: Incentive stock option preference	*+ 80,000*	
Plus: Total taxable income	*+150,000*	
Total alternative minimum taxable income		***235,000***
Total tentative minimum tax		
Total alternative minimum taxable income	*235,000*	
Less: Exemption amount.	*95,373*	
Amount subject to AMT rate.		*139,627*
Alternative minimum tax rate		*.0700*
Total tentative minimum tax		***9,774***

California alternative minimum tax adjusted gross income

California (regular tax) adjusted gross income 100,000
Plus: Incentive stock option preference amount . . . . + 80,000
California alternative minimum tax adjusted gross income ***180,000***

Total alternative minimum tax adjusted gross income

Total alternative minimum taxable income 235,000
Total itemized deductions 20,000
Less: Real and personal property tax preference . . . . - 5,000
Total alternative minimum tax itemized deductions . . . . + 15,000
Total alternative minimum tax adjusted gross income ***250,000***

California alternative minimum taxable income

Total alternative minimum tax itemized deductions 15,000
Multiply by the ratio:

$$\frac{\text{CA AMT AGI}}{\text{Total AMT AGI}} = \frac{180{,}000}{250{,}000} = .72$$

Prorated alternative minimum tax itemized deductions (15,000 x .72) . . . . - 10,800
California alternative minimum taxable income (180,000 – 10,800). ***169,200***

California alternative minimum tax

California alternative minimum taxable income 169,200
Multiply by the ratio:

$$\frac{\text{Total Ten Min Tax}}{\text{Total Alt Min T.I.}} = \frac{9{,}774}{235{,}000} = .0416 \text{ (Effective AMT Tax Rate)}$$

California tentative minimum taxable income x effective rate (169,200 x .0416) 7,039
Less: Prorated regular tax . . . . - 6,000
California alternative minimum tax ***1,039***

GROUP NONRESIDENT RETURNS

A business entity, acting as an authorized agent, may choose to file a group nonresident return for certain nonresidents. To participate, nonresidents must receive distributive shares of income from business entities that derive income from CA sources, or that are doing business in California. The business entity pays tax on behalf of the nonresident taxpayers who elect to file a group return.

A group nonresident return is really a group of individual returns that meets the CA individual income tax return filing requirement. A qualified nonresident individual who elects to be included in the group nonresident return is not required to file a separate income tax return for the same tax year. Group nonresident returns may include less than two nonresident individuals. *(FTB Pub. 1067)*

If your clients filed as part of a group nonresident return, there are complex rules and requirements that often result in special handling. To expedite processing of these returns, follow these rules:

1. **Taxpayers where California taxable income exceeds $1 million.**
   These individuals are subject to an extra 1% Mental Health Services Tax. Even so, nonresident individuals with more than $1 million of California taxable income are eligible to be included in group nonresident returns. However, these individuals are subject to an additional 1% on their *entire* California taxable income when included in the group return. If each of these individuals filed their own return, only their taxable income in *excess* of $1 million is subject to the 1% surtax. So, these individuals should be made aware of this difference when making the election, which is irrevocable, to be included in the group return.
2. **Must use a calendar year for the group nonresident return, even if the business has a fiscal year end.** Any estimated tax payments must be made on a calendar-year basis.
3. **Use FTB 540-ES to make estimated tax payments for the group nonresident return.**
   Estimate payments made for a nonresident group return must be made on FTB Form 540-ES. Please see the example in FTB Pub. 1067 for detailed instructions on how to complete the estimate voucher.
4. **Use FTB Long Form 540NR - attach Schedule 1067A and signed FTB Form 3864.**
   The California Nonresident or Part-Year Resident Income Tax Return (Long Form 540NR) is required for filing a nonresident group return. The following FTB forms must be attached to the return:
   - Schedule 1067A Nonresident Group Return Schedule
   - Form 3864 Group Nonresident Return Election

   An authorized general partner, member-manager, corporate officer, or an attorney-in-fact **must sign** FTB Form 3864. A new election form must be signed and attached each year.

5. **Include only individuals in the group nonresident return.**
   Only individuals, not Partnerships, LLCs, C corporations, S corporations, Estates, or Trusts, are eligible to use a group return. There is an exception to this - grantor trusts, described under IRC Section 675-677, and not recognized as a separate taxable entity for income tax purposes.

   In addition, the individuals must be full-year nonresidents of California, and the only California source income must be from the business entity.
6. **Election to be included in the group nonresident return is irrevocable.**
   Make sure you tell your clients that once a group return is filed, it cannot be amended to either include or exclude a nonresident individual.
7. **Income is taxed at the highest marginal rate.**
   The income reported on a group nonresident return is taxed at the highest marginal rate, currently 12.3%.
8. **Moving estimated payments**
   Use Schedule 1067B to authorize FTB to move estimated tax payments from either the group to the individual's account, or the individual's account to the group.
9. FTB Pub. 1067 contains information regarding the Group Nonresident Returns.

<u>LLCs and FTB 3832</u>

When a multiple member LLC has one or more members who are nonresidents of California, taxpayers must use Form FTB 3832. The form lists the following information:

- The names and social security numbers or federal employer identification numbers (FEIN) of all such members; and
- The signatures of each nonresident member evidencing consent to the jurisdiction of the State of California to tax that member's distributive share of income attributable to California sources.

If an LLC member fails to sign a Form FTB 3832, the LLC is required to pay tax on the member's distributive share of income at the highest marginal rate (currently 12.3%). The tax paid by the LLC will be considered a payment made by the member (*Revenue & Taxation Code Sec 18633.5*). See FTB Form 568.

If the nonresident member has a spouse, the spouse must also sign Form FTB 3832.

When to File FTB 3832
- Filed for the first taxable period for which the LLC became subject to tax with nonresident members; or
- Filed for any taxable period during which the LLC had a nonresident member who has not signed FTB 3832.

Nonresidents Who Must File a California Return

Nonresident members (individuals, estates, trusts, corporations, etc.) are required to file the appropriate California tax returns, in addition to the Form FTB 3832. An individual nonresident must file a California nonresident or part-year resident return if the individual had income from California sources and meets California gross income and adjusted gross income filing requirements. See FTB Form 540NR for additional information.

Group Nonresident Member Return

Certain nonresident members of entities doing business in California may elect to file a group nonresident return using Form 540NR (Long). A group nonresident (composite) return may be filed by:

1. A business entity, acting as the authorized agent for its electing nonresident individual shareholders/partners/members, to report the distributive shares of income from the business entity (LLC, S-Corporation or Partnership) derived from California sources or from doing business in California. See Revenue and Taxation Code (R&TC) Section 18535.
2. A corporation, acting as the authorized agent for its electing nonresident directors, to report the directors' wages, salaries, fees, or other compensation from that corporation for director services performed in California, including attendance of board of directors' meetings in California. See R&TC Section 18536.

The business entity/corporation files the return and pays the tax on behalf of the electing nonresident individuals. A group nonresident return is considered a group of individual returns that meets the California individual income tax return filing requirement. Thus, a qualified nonresident individual who elects to be included in the group nonresident return does not file a separate personal income tax return for the tax year. The election is made on a yearly basis and once made is irrevocable for that year.

A group nonresident return is available to one or more nonresident individuals, and the income will be taxed at the highest CA marginal rate. For more information, see FTB Pub. 1067.

STATE/FEDERAL COMPENSATION ISSUES

This chapter deals with issues associated with employee compensation.

- **Maximum FICA Wage** (2019): 132,900
- **FICA Tax Rate** (2019): 6.2%
- **Maximum FICA Tax** (2019): 8,239.80
- **Medicare (HI) Rate** (2019): 1.45% - No cap
- **Additional HI Tax High Income Taxpayers**: 0.9%
- **Monthly Parking Exclusion** (2019): $265
- **Monthly Transit Pass** (2019)**:** $265
- **Monthly Vanpooling Exclusion** (2019)**:** $265
- **CA SDI Rate** 2019: 1.0%
- **CA SDI Max Wage** 2019: $118,371
- **CA SDI Max Tax** 2019: $1,183.71

Other Related Text References

Subject	Chapter
Add'l HI Tax High Incomes:	12.06
Clergy:	1.06
Household Employee:	11.04
ID Protection Services:	1.17
Independent Contractor:	3.09
Military:	1.08
Statutory Employee:	2.11
Stock Options:	2.06
Tips:	2.02

Related IRS Publications and Forms

- **Form W-2** – Wage and Tax Statement
- **Form 8919** – Uncollected Social Security and Medicare Tax on Wages
- **Pub 15** – Circular E, Employer's Tax Guide
- **Pub 15-A** – Supplemental Employer's Tax Guide
- **Pub 15-B** – Employer's Tax Guide – Fringe Benefits

RAPID FINDER

SOCIAL SECURITY & MEDICARE TAX WITHHOLDING:

If, due to having multiple employers, a taxpayer pays more than the annual maximum Social Security (FICA) tax, the amount in excess of the maximum for the year is refundable on the taxpayer's 1040. Medicare (Hospital Insurance) tax has no maximum and therefore never results in an overpayment. *Also see Chapter 8.03 on self-employment tax.*

BACK PAY & FICA:

The U.S. Supreme Court has held that back wages are subject to FICA and FUTA taxes for the year in which the wages are in fact paid, and not in the earlier year for which the wages are paid. *U.S. v. Cleveland Indians Baseball Co., (S Ct, 4/17/2001) 87 AFTR2d ¶ 2001-798.*

DIFFERENTIAL PAY NOT SUBJECT TO FICA:

Revenue Ruling 2009-11 (IRB 2009-18) provides that differential pay that employers pay to their employees that leave their job to go on active military duty is subject to income tax withholding, but is not subject to Federal Insurance Contributions Act ("FICA") or Federal Unemployment Tax Act ("FUTA") taxes. Additionally, the ruling provides that employers may use the aggregate procedure or optional flat rate withholding to calculate the amount of income taxes required to be withheld on these payments, and that these payments must be reported on Form W-2.

Historical Table - FICA Rates

Year	FICA Max Wage	FICA Rate	FICA Max Tax	HI Rate
2012	110,100	4.20	4,624.40	1.45
2013	110,100	6.20	7,049.40	1.45
2014	117,000	6.20	7,254.00	1.45
2015	118,500	6.20	7,347.00	1.45
2016	118,500	6.20	7,347.00	1.45
2017	127,200	6.20	7,886.40	1.45
2018	128,400	6.20	7,960.80	1.45
2019	132,900	6.20	8,239.80	1.45
2020		6.20		1.45

SSA Estimated Future Wage Base

The SSA provides three kinds of forecasts for Social Security wage bases (low, intermediate and high cost). The SSA intermediate forecasts through 2028 are as follows:

2020 – $136,800
2021 – $142,200
2022 – $149,100
2023 – $155,700
2024 – $162,300
2025 – $168,900
2026 – $175,800
2027 – $183,300
2028 – $191,100

Source: 2019 Annual Report of the Board of Trustees of the Federal Old-Age & Survivors Insurance & Federal Disability Insurance Trust Funds, Table V-C1, page 115

FICA Rates for other years are available at:
https://www.ssa.gov/oact/progdata/taxRates.html

WITHHOLDING COMPLIANCE:

The IRS advised employers they are not required to routinely submit to the IRS Forms W-4, Employee's Withholding Allowance Certificate, when employees claim complete exemption from withholding or claim a large number of allowances. However, the IRS may require employers to submit Forms W-4 in certain circumstances. (*IR 2005-45, 04/13/2005, IRC Sec(s). 3402*)

STUDENT FICA EXCEPTION:

The IRS has provided safe harbor guidelines for determining whether or not services performed by employees of certain institutions of higher education are eligible for the student exception from the Federal Insurance Contribution Act (FICA). (TDNR JS-2165; Rev. Proc. 2005-11)

The student exception to FICA applies with respect to services performed by a half-time undergraduate, graduate or professional student for an institution of higher education. An institution of higher education is defined as a public or private nonprofit school, college or university (SCU), or affiliated private foundations under Code Sec. 509(a)(3).

The "safe harbor" generally does not apply to full-time employees or employees that qualify for pension or employee benefit programs. Notwithstanding, an employee will not be ineligible under this safe harbor if receipt of employment benefits is mandated by state or local law.

The safe harbor also does not apply to post-doctoral students and fellows, medical residents, or medical interns. Services performed by these employees cannot be assumed to be incident to and for the course of study.

These standards, however, do not constitute the exclusive method for determining whether or not the student exception to FICA applies. Where the safe harbor does not apply, qualification for the student exception to FICA for services performed for a SCU is determined based on all the facts and circumstances.

Medical Residents and FICA Exemption - The Supreme Court handed down a unanimous decision in January 2011, ruling that Reg. § 31.3121(b)(10)-2(d(e)(iii) was valid, thus permitting the IRS to classify medical residents who worked over 40 hours per week as employees who are ineligible for the student FICA exemption and subject to FICA taxes ***(Mayo Foundation for Medical Education and Research, SCt, Jan. 12, 2011)***.

COMPENSATION VS. GIFT:

Under federal law, outright gifts aren't included in income. However, when received from someone who is also paying for services or who is receiving services without paying adequately for them, the "gifts" may be deemed compensation. To decide whether or not an item received is a gift or compensation, look at the payer's intent. If the payer takes no deduction for an amount on his/her own return, it is evidence that the amount paid is considered to be a gift (and vice versa).

SEVERANCE PAY AND FICA:

The Supreme Court, in U.S. v. Quality Stores, Inc., et al, (Sup Ct 03/25/2014), and reversing the Sixth Circuit Court of Appeals, has held that severance payments that were made to involuntarily terminated employees and that weren't tied to the receipt of State unemployment insurance, are subject to FICA taxes.

In Announcement 2015-8, the IRS announced it will disallow all claims for refund of FICA or Railroad Retirement Tax Act (RRTA) taxes paid with respect to severance payments that do not satisfy the narrow exclusion contained in Rev Rul 90-72, and will take no further action on appeal requests that were suspended pending the resolution of *Quality Stores.* This will allow the IRS to disallow more than 2,400 refund claims from companies and their ex-employees.

PAYROLL AGGREGATING: The Federal Circuit, affirming the Court of Federal Claims, has held that for purposes of calculating the FICA contribution and benefit wage base and the FUTA wage base, a payroll service company couldn't aggregate wages paid to workers who performed services during the year for several of its clients (Cencast Services L.P., (CA-FC 9/10/2013) 112 AFTR)

ELECTION WORKER COMPENSATION:

State and local governments hire individuals to work temporarily to perform services at polling places during primary and general elections. An individual so engaged is most often referred to as an election worker, but may also be known as an absentee ballot counter, ballot clerk, checker, deputy head moderator, machine tender, moderator, poll worker, polling place manager, or voting official. Compensation paid to these individuals, including for attendance at training or meetings related to the election, is includible as wage income and may or may not be subject to withholding for Social Security and Medicare (FICA) taxes. If these workers are reimbursed for mileage or other expenses, the reimbursement may be excludable from wages if it is made under an accountable plan.

Income tax is not required to be withheld from compensation paid to election workers but an employer and employee may agree to voluntary withholding from wages paid for the election services. FICA withholding is only required if the election worker's compensation is greater than $1,800 (2019), unless the worker is covered under a "Section 218 Agreement." A Section 218 agreement is a voluntary agreement between the Social Security Administration and a state government to provide Social Security and Medicare coverage for the state and local government employees. In some cases election workers are excluded from the Sec 218 Agreement and in other cases a threshold lower than $1,800 (2019) applies. If the election worker's compensation is $600 or more, or if less than $600 but FICA or income tax was withheld, the employing government is required to issue a Form W-2. When an election worker is also employed by the governmental entity in another capacity, separate W-2s may be issued for the two types of payments.

For more information on this topic, please see the IRS web site at: https://www.irs.gov/government-entities/federal-state-local-governments/election-workers-reporting-and-withholding.

EXCLUDABLE EMPLOYEE FRINGE BENEFITS:

Group Term Life Insurance - The first $50,000 of group term life insurance (GTLI) coverage provided by an employer is excluded from taxable income. The employer-paid cost of group term coverage in excess of $50,000 is taxable income to the taxpayer even if they never receive it (i.e., it is "phantom income"). If two or more employers provide GTLI coverage totaling more than $50,000, the wages reported on the W-2 forms will not be correct, and the taxable amount of GTLI coverage must be recalculated (see table below). Subtract any amount reported as Code C in Box 12 of the W-2 forms from the recalculated amount of GTLI cost, and then add the result to wages reported on the return.

Strategy - Group Life Policy – The first $50,000 of group term life insurance coverage provided by an employer is a tax-free fringe benefit that does not add anything to the employee's overall tax bill. But the cost of employer-paid group term coverage in excess of $50,000 is treated as taxable income and added to the W-2. What's worse, the cost of that insurance coverage is based on an IRS table that is frequently higher than the employer is actually paying for the insurance, which creates phantom income.

Cost of $1,000 of Protection per Month			
Age Bracket	**Cost**	**Age Bracket**	**Cost**
Under 25	$0.05	50-54	.23
25-29	0.06	55-59	.43
30-34	0.08	60-64	.66
35-39	0.09	65-69	1.27
40-44	0.10	70 Plus	2.06
45-49	0.15		

For older employees, the after-tax cost of the additional coverage frequently exceeds the cost for an individual term policy. It may be appropriate for certain employees to only utilize the first $50,000 in coverage and acquire an individual policy for any additional needed coverage.

IRS Regulation §1.79-3(d)(2) provides the table shown above to be used for figuring the cost of group term life insurance. These amounts have been in effect since July 1, 1999.

Exclusion for Qualified Employee Discounts - The amount of an employee discount on qualified property or services provided by an employer is excludable from the employee's income. The exclusion is limited to: (1) for property, the employer's gross profit percentage, and (2) for services, 20% of the price at which the employer sells the services to non-employee customers. Qualified property or services are property or services offered for sale to non-employee customers in the ordinary course of a line of business of the employer. For the exclusion to apply, the employee must provide substantial services in the line of business of the employer in which the employer offers the property or services in question to non-employee customers. The exclusion does not apply to highly compensated employees if the qualified employee discounts are available on a discriminatory basis.

Qualified transportation fringe exclusion **-** The amount an employee receives, as a fringe benefit must be included in income, based on its fair market value. But any fringe benefit that qualifies as a "qualified transportation fringe" is excluded from income up to the amount of the dollar limitation.

The amount of "qualified transportation fringe" that may be excluded is subject to certain dollar limitations. The amount of the limit depends on the type of benefits provided. The maximum amount of the monthly exclusion, adjusted for changes in the cost of living is shown in the table. Qualified transportation fringe exclusions include transit passes and transportation in a commuter highway vehicle (van pool), if in connection with travel between the employee's residence and place of employment.

A commuter highway vehicle has a seating capacity of 6 adults (excluding the driver) for which 80% of the mileage must be reasonably expected to be for employee commuting and to be for trips where the vehicle is half full (excluding the driver).

Qualified Monthly Transportation Fringes Maximum Monthly Exclusion Amounts			
Tax Year	Qualified Parking	Transit Passes, Commuter Transportation	Bicycle Commuting
2020	270	270	-0-
2019	265	265	-0-
2018	260	260	-0-
2017	255	255	20
2016	255	255	20
2015	250	250	20
2014	250	250	20
2013	245	245	20

If amounts not shown, they were not available at publication date

CAUTION: TCJA made the following changes for years after 2017.

TCJA

1. Bicycle commuting expense reimbursement is no longer treated as a nontaxable fringe benefit, through 2025.
2. Parking and mass transit reimbursement is still excluded by employees through 2025.
3. After 2017 employers can no longer deduct the amounts reimbursed for parking or mass transit. No deduction is permitted for reimbursing the employee for commuting expenses, except as necessary for ensuring the safety of an employee.

Value of clothing NOT exempt from taxation under de minimis fringe benefit rule – The IRS had previously issued a private letter ruling (PLR 201005014) that allowed employees to exclude the value of employer-provided clothing and related accessories from their taxable income as a de minimis fringe benefit. However, the IRS subsequently determined that based on the variations related to the acquisition and distribution of the clothing and other items that it could not conclude that the items were eligible to be de minimis fringe benefits. Therefore, the IRS revoked that exemption in PLR 201135022 (but did not make the revocation retroactive).

Health FSA Limit - Health FSAs are benefit plans established by employers to reimburse employees for health care expenses, such as deductibles and co-payments, and are usually funded by employees through salary reduction agreements. Sometimes employers may contribute as well. Qualifying contributions to and withdrawals from FSAs are tax-exempt.

Under a change included in the Affordable Care Act in order for a health FSA to be a qualified benefit under a cafeteria plan, the maximum salary reduction contribution an employee may make cannot exceed $2,500, indexed for cost-of-living adjustments as shown in the table below. The health FSA cap doesn't limit the amount permitted under other employer-provided coverage, such as an FSA for dependent care assistance (Notice 2012-40)

HEALTH FSA CONTRIBUTION LIMITS					
2015	**2016**	**2017**	**2018**	**2019**	**2020**
2,550	2,550	2,600	2,650	2,700	2,750

If amounts not shown, they were not available at publication date

<u>UNEMPLOYMENT BENEFITS</u>:

Although some states don't tax unemployment compensation, it is taxable income for Federal purposes.

<u>GOVERNMENT-FUNDED PAID FAMILY LEAVE</u>

Paid family leave (PFL) is a form of compensation paid to eligible individuals who are unable to work because they are caring for a seriously ill or injured family member, or bonding with a minor child within one year of the birth or placement of the child in connection with foster care or adoption.

Payments are a form of unemployment (Sec. 85) and reported on a 1099-G. For federal purposes, unemployment is taxable income to the extent it exceeds any basis the recipient might have in the payments (see later). For state purposes the PFL may or may not be taxable based upon a particular state's treatment of unemployment benefits. The Tax Foundation provides an overview of state taxation: https://taxfoundation.org/state-taxation-unemployment-benefits/

Generally PFL programs are funded through payroll taxes levied by the state. In IRS Chief Counsel Advice CCA 200630017 the IRS held that amounts mandatorily withheld by a state government from an employee's payroll under the PFL program are taxes, under Sec 164(a)(3), and a taxpayer who itemizes his or her deductions can deduct the amounts withheld as taxes (Note: Payments to a private plan would not be tax deductible but would form a basis as discussed below).

In that same CCA, the IRS noted that provisions of Regulation 1.85-1(b)(1)(iii) apply to those who do not itemize their deductions. Thus where taxpayers were unable to deduct the family temporary disability insurance contributions as an itemized deduction, they established a basis and PFL income can be reduced by the accumulated basis. Regulation 1.85-1(b)(1)(iii) actually says "which is not deductible by the employee"; thus taxpayers subject to AMT would also not be able to deduct the payments as taxes and therefore basis is also created.

As an aside, Regulation 1.85-1(b)(1)(iii) applies both to unemployment compensation taxes and temporary disability insurance contributions, but separately. The instructions for the 1099-G specifically require unemployment and PFL to be reported on separate 1099-Gs.

EMPLOYER-FUNDED PAID FAMILY LEAVE

TCJA

TCJA of 2017 provides a 2-year credit for employers who provide paid family and medical leave. However, the leave pay would be fully taxable to the employee. For details of that program see chapter 9.17.

RESIDENT APARTMENT MANAGER TAX ISSUES

Landlords will often hire a resident manager to handle the day-to-day tasks of running an apartment building. In some locales and depending upon the number of units in the apartment complex, resident managers are required. For example, in California, resident managers are required where there are 16 or more units, while the requirement applies for 9 units in NY City.

The managers may be compensated for their services, provided reduced or free rent, or a combination of both. The tax implications to the landlord and resident manager are:

Resident Manager – If the resident manager is compensated monetarily, they are treated as an employee and as such are subject to payroll withholding, and FICA. If they are provided reduced or free rent, that reduction is not included in taxable income (Reg. Sec. 1.119-1(b)) if:

1. The lodging is at the landlord's rental property,
2. The lodging is furnished for the convenience of the landlord, and
3. The manager is required, as a condition of employment, to live in the apartment building. (Code Sec 119 – Meals or lodging furnished for the convenience of the employer)

If the above conditions are **NOT** met, the rental FMV is taxable income to the manager reported on a W-2 by the landlord or other employer (Letter Ruling 9404005).

From Pub 15-B, pg 17 (2019):

> ***Example of nonqualifying lodging -*** *A hospital gives Joan, an employee of the hospital, the choice of living at the hospital free of charge or living elsewhere and receiving a cash allowance in addition to her regular salary. If Joan chooses to live at the hospital, the hospital can't exclude the value of the lodging from her wages because she isn't required to live at the hospital to properly perform the duties of her employment.*

Landlord **-** If the resident manager is compensated monetarily, then the manager is a W-2 employee of the landlord and subject to the normal W-2 withholding and reporting requirements. Where the landlord reduces or provides free rent, whether or not also compensating the manager monetarily, and the three conditions listed under resident manager are met, the landlord has no reporting requirements regarding the free rent and no deduction for the free rent since the lack of the rental income constitutes his adjustment for the lost rental income.

TAXABLE VALUE OF NONCASH PRIZES

Every so often tax practitioners will encounter a client who has won a noncash prize or vacation trip from a game show or won a car or even a house from the purchase of a charity raffle ticket. Whatever the noncash prize or the source of the prize, one thing is for certain, the winner must pay taxes on the fair market value (FMV) of the prize (Reg. Sec. 1.74-1(a)(2)).

This is where things get complicated. The definition of FMV that has been adopted by tax courts for general income tax purposes is *"the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."*

Where the prize value is $600 or more and no services were performed, the FMV of the prize is reported in box 3 of Form 1099-MISC (2019 1099-MISC Instructions, Pg. 5). Since the awarding entity has no way of determining what a willing buyer might pay a willing seller, they quite often use the manufacturer's suggested retail price of the item or some other means of determining the amount they enter in Box 3, which may not be the true measure of FMV.

Thus, the amount in box 3 is disputable if it can be reasonably established and documented that the FMV is different. Tax courts have frequently taken special factors into consideration in determining the fair market value of awards and prizes.

It is understandable that a prizewinner may not be able to resell the prize for as much as the awarding entity valued it. The Tax Court says in this situation, resale value, not cost, determines the amount of income reportable by the taxpayer (McCoy, Lawrence W, (1962) 38 TC 841, acq 1963-2 CB 5).

Where a taxpayer argued a trip prize was not worth the retail price to him, the court agreed (Turner, Reginald (1954) TC Memo 1954-38). In another case the court reduced the retail price to the discounted price the awarding entity paid for the trip (Wade, Nathan, (1988) TC Memo 1988-118). In the latter case, the court wrote: "In valuing taxable prizes and awards for Federal income tax purposes, courts do not always adopt the same methodology. In some situations, the retail value of prizes and awards is used. In other situations, a wholesale or other discounted value is used. Objective factors are emphasized, but subjective factors also are given weight in determining the value of prizes and awards to particular taxpayers."

For some items a retail advertisement for the item around the time the prize was won could help to determine FMV. If someone is lucky enough to buy the winning ticket for a high-value item such as a home, it might be appropriate to obtain a certified appraisal.

WORKERS' COMPENSATION

Amounts received under a workers' compensation act or similar law for personal injuries or sickness are excludable from the employee's (or survivor's) income. This rule doesn't apply to the extent payments are determined by reference to the employee's age or length of service or his prior contributions, even if his retirement is occasioned by occupational injury. (Reg § 1.104-1(b))

Workers' compensation is includible in income to the extent it's attributable to medical expense deductions taken in an earlier year. (Code Sec. 104(a)(1); Reg § 1.104-1(b)).

Legal costs are only deductible for the production or protection of taxable income. If the settlement is not taxable, then the legal expenses are not deductible. ***Caution***: The TCJA of 2017 suspended the tier 2 miscellaneous itemized deductions for years 2018 through 2025, so even if a settlement is taxable in those years, the legal expenses aren't deductible. The exception that permits an above-the-line deduction for legal fees and associated expenses related to certain unlawful discrimination awards is unaffected by the TCJA provision.

SICK PAY

The taxability of sick pay depends upon whether the taxpayer paid the sick pay insurance premiums, or the employer funded the sick pay.

Employee-Funded Sick Pay – Where the employee pays the premiums on sick pay insurance, the sick pay is tax free and not subject to withholding or payroll taxes. In such cases, the sick pay is not included in W-2 Box 1 as taxable wages and instead is included in Box 12, Code J.

Employer-Funded Sick Pay – Where the employer funds the sick pay, either by being self-insured or through a third-party insurer, the sick pay is taxable to the employee and subject to payroll taxes.

Sick pay may be included in the employee's regular W-2 or in a separate W-2 issued by the employer or by a third-party payee (including an insurance company) using the third party's EIN. Where the W-2 is issued by a third party, Box 13 will be checked "Third Party Sick-Pay".

In some cases, Box 13 will be checked, and Box 12 will be coded J, meaning the third-party payment is not taxable, in which case Box 1 of the W-2 should be blank.

Form W-4S – Where the sick pay is paid by a third-party payee that handles the payroll taxes, withholding, and reporting separately from the employer, Form W-4S must be filed with the third party by the employee in order to have tax withheld.

Railroad Sick Pay - Payments received as sick pay under the Railroad Unemployment Insurance Act are taxable and must be included in income. However, they are not included if they're for an on-the-job injury.

AUTOMOTIVE MANUFACTURERS' SALES INCENTIVES

It is common practice for automotive manufacturers to provide incentive payments, including bonuses, prizes, or other awards, to individual salespersons. These can be made directly to the individual or through the dealership that employs the salesperson.

Salespersons are under direct control of the dealership and are employees of the dealership and there is no employee/employer relationship with the manufacturer. Thus, the payments are not wages (Rev Ruling 70-337). These payments, whether paid directly by the manufacturer or through the dealer, are taxable but not subject to federal withholding tax or FICA (IRS Publication 3204).

These payments are generally reported on Form 1099-MISC and Publication 3204 provides the following guidance on reporting the incentive payments:

- Report the income as "other income" (line 8 of draft Schedule 1 of the 2019 Form 1040).
- **Do Not** report the income on a Schedule C, because recipients of these payments are not engaged in an individual trade or business and are therefore not self-employed. Similarly, no expenses may be taken on Schedule C to offset incentive payment income.
- Any expenses associated with this income are employee business expenses that, prior to 2018, would be reported on Schedule A, subject to the 2% of adjusted gross income limitation. However, per the TCJA of 2017 these types of expenses are not deductible for years 2018 through 2025.
- Since the payments are not considered to be self-employment income, they are not subject to self-employment tax.

MEDICAID WAIVER PAYMENTS

Background: As a means of reducing the government's cost of caring for individuals who otherwise would be institutionalized (because they require the type of care normally provided in a hospital, nursing facility, or intermediate care facility), Medicaid will pay wages to care providers to care for these ill individuals in the care provider's home under a state Medicaid Home and Community-Based Services waiver program. Until the release of Notice 2014-7, the IRS had taken the position that these payments, which generally are reported on a W-2 (but sometimes on a 1099-MISC), were taxable for the caregiver.

Notice 2014-7 changed all that. The IRS has given notice that it will no longer challenge the excludability of these wages and instead will treat them in the same manner as difficulty of care payments excludable from gross income under IRC Sec 131 (qualified foster care payments) if they meet certain requirements. Note: IRC Sec 131(a) specifies that the exclusion of qualified foster care payments is mandatory, and since the Medicaid waiver payments are considered difficulty of care foster care payments, a taxpayer may not choose to include them in gross income.

To qualify as compensation for the exclusion:

- The compensation must be required due to a physical, mental, or emotional handicap with respect to which the State has determined that there is a need for additional compensation.
- The care must be provided in the home of the foster care provider.
- The payments must be designated as qualified foster care or difficulty of care compensation.
- To be excludable, the care payments are limited to a maximum of five individuals age 19 and older or ten individuals age 18 and younger.

Only payments that are for the care of the disabled individual are excludable, so if payments to the care provider include vacation pay, for example, the vacation pay is not excludable. (IRS Website Q&A #8, 2/23/15)

If the agency paying the care provider considers the care provider an employee, the agency will issue a Form W-2. Box 1 of the W-2 should be blank if all of the payments are excludable; otherwise, only the amount of non-excludable wages should be reported in Box 1. (IRS Website Q&A #17, 2/23/15) (If the care provider is an employee of the agency, the excluded income is subject to FICA withholding of Social Security and Medicare taxes, but if the care provider is an employee of the care recipient the FICA tax rules for household employees will apply, so in some cases no FICA tax withholding is required.) (IRS Website Q&A #19, 2/23/15)

There may be cases where the amount in Box 1 of the W-2 erroneously includes Medicaid waiver payments that are excludable. If the client is unable to get a corrected W-2 from the paying agency, the full amount of the payments reported in box 1 should be reported on the wages line of Form 1040. Then the excludable portion of the amount in box 1 should be subtracted on lthe "Other income" line (draft 2019 Form 1040, Schedule 1, line 8) and "Notice 2014-7" should be the explanation for line 8 of Schedule 1.

CAUTION: If you follow these instructions, the computer program will still use the W-2 amount in the EITC computation. If you handle it that way, be sure to remove the W-2 waiver payments from the EITC computation.

Care providers who are not treated as employees will likely be issued a Form 1099-MISC. If the provider does not have a separate trade or business of providing these services (likely the situation if the care recipient is a relative), a zero should be entered on l line 8 of Form 1040, Schedule 1 (draft 2019), and "Notice 2014-7" noted on that line. In this case the payments are not subject to self-employment tax (IRS Website Q&A #13, 2/23/15).

If the care provider is a sole proprietor in the business of providing home care services, and the 1099-MISC included payments that are excludable under Notice 2014-7, these payments should be included on line 1 of Schedule C and then the excludable portion reported as an expense in Part V with "Notice 2014-7" as the explanation for the expense. In this manner the payments will not be subject to SE tax (IRS Website Q&A #14, 2/23/15) and won't be included as income for the EITC.

Live-In Self-Certification Program - The California Department of Social Services (CDSS) initiated a self-certification of "live-in" status for providers beginning in 2017. After the caregiver self-certifies that he or she lives in the same home as the recipient of the services, the state will no longer report the qualified Medicaid waiver payments (In-Home Supportive Services (IHSS) and/or Waiver Personal Care Services (WPCS)) on the caregiver's W-2. Form SOC2298 is used for self-certification.

Earned Income Tax Credit – The Tax Court in *Feigh, (2019) 152 TC No. 15* has ruled that Medicaid Waiver payments, even though excluded from income, are still earned income for purposes of claiming EITC and additional child tax credit. This is opposite to the IRS's position in Notice 2014-7 and may open the door to some substantial refunds from open years.

Background: IRS Notice 2014-7 specified the IRS would no longer challenge the excludability of Medicaid waiver wages and instead will treat the payments as excludable from gross income under IRC Sec 131 (qualified foster care payments) if they meet certain requirements. Note: IRC Sec 131(a) specifies that the exclusion of qualified foster care payments is mandatory, and since the Medicaid waiver payments are considered difficulty of care foster care payments, the notice ruled a taxpayer may not choose to include them in gross income.

This change was a double-edged sword, as some caregivers qualified for the earned income tax credit (EITC) and additional child tax credit (ACTC) in the past based upon this income. As a result of these payments being mandatorily excluded from income, these caregivers lost their EITC and ACTC based upon that income.

Tax Court Case: The taxpayers in the court case received payments under a state Medicaid waiver program for providing care to their adult disabled children in the family home, and excluded the Medicaid waiver payments from income but still treated them as earned income when computing the EITC and ACTC, disregarding Notice 2014-7. The IRS disallowed the credits and the taxpayers filed a timely Tax Court petition.

The Tax Court held that Notice 2014-7 could not reclassify the taxpayer's Medicaid waiver payment to remove a statutory tax benefit. Specifically, the Court found that where income does not fall within the plain text of a statutory exclusion from gross income, IRS cannot reclassify that income through a Notice so that it no longer qualifies as "earned income" for the purpose of determining tax credits.

The Court reasoned that IRS cannot remove a statutory benefit provided by Congress. Interpretive rulings do not have the force and effect of regulations, and they may not be used to overturn the plain language of a statute which was exactly what IRS sought to do with Notice 2014-7. The EITC and the ACTC are acts of legislative grace provided by Congress. While deductions and credits are allowed only to the extent authorized by statute, the IRS is not free to circumscribe the credits that the legislature has chosen to authorize through statute; that is a power only Congress has. Accordingly, to the extent IRS sought to use Notice 2014-7 to deprive the taxpayers of a benefit bestowed by Congress, the Court held that it was prohibited from doing so.

Not addressed in the Tax Court case was the question of whether the taxpayers should have included their Medicaid waiver payment in gross income as IRS did not raise this issue in its notice of deficiency or plead it in this case. IRS chose not to argue in the alternative that the taxpayers' Medicaid waiver payment should be included in gross income, but instead argued that the taxpayers were precluded by Notice 2014-7 from including their payment in gross income for purpose of the credits.

The IRS has since modified their Q&A on the subject. Q&A #9 asked whether a taxpayer could choose to include the Medicaid waiver payments in gross income (thus qualifying for EITC). The IRS's original answer was no. Now Q&A #9 says "reserved".

Amended Opportunity? This is an apparent amended opportunity for all open years. Even though the court case constitutes substantial authority, the IRS has not stated whether they will acquiesce to the case. So, since an amended return would be taking the court's position over Notice 2014-7, it would be wise to attach a Form 8275, Disclosure Statement, stating the Tax Court case as the reason for disregarding the provisions of Notice 2014-7. (See Reg Section 1.6662-3(a) & Reg Section 1.6662-4(d)(2) for rules for disclosure of return reporting positions that are contrary to an IRS Notice).

It may be best practice to wait and see how this plays out. Currently open years are not affected until April 15, 2020.

SURROGACY FEES

If you go on the Internet, you will find a wide variety of opinions related to the taxability of the surrogate fee to the surrogate mother. Some will say it is a gift; however, in a case decided by the U.S. Supreme Court (Commissioner vs. LoBue, Philip, (1956, S Ct)) to be a gift for tax purposes, gifts must be made out of a detached or disinterested generosity. Any payment made by the parents to a surrogate mother is hardly detached or disinterested, so surrogate fees are not gifts.

You will also find many surrogacy agencies are taking the position and advising their clients that surrogacy payments are for pain and suffering, and thus exempt under IRC Sec 104. The title of Sec 104 is "compensation for injury or sickness" and the term "pain and suffering" does not appear anywhere in that code section. Surrogacy hardly meets the definition of physical injury as would be found in a car accident, bungled surgery or other accidental injury. So, surrogacy fees hardly fall under the compensation exclusion for injury or sickness.

IRC Sec 61 states: "Except as otherwise provided, gross income means all income from whatever source derived." There is no exception in the code for surrogacy fees, and as a result, a surrogacy fee is taxable income to the surrogate mother. To complicate matters, the surrogate mother is providing a "personal service" and personal services are subject to self-employment tax as well as income tax when received in the course of a business. Does the surrogacy arrangement rise to the level of a trade or business? The answer depends on the facts and circumstances of each situation. If the surrogate has entered into such an arrangement before or intends to do so again, the fee would likely be considered self-employment income. But if being a surrogate is a one-time activity, an argument could be made that it is not a business, in which case the surrogate fee would be reported as "other income" (for 2019 on line 8 of draft Schedule 1 of Form 1040), but not subject to SE tax.

If the fee *is* self-employment income, it may be offset with benefits available to any self-employed taxpayer including the ability to deduct health insurance above-the-line rather than as an itemized deduction and to make deductible contributions to a self-employed retirement plan or IRA. Although there is not much in the way of deductible expenses, legal or other costs associated with drafting and executing the surrogate contract would be a deductible business expense.

A self-employment surrogacy activity would fall into the category of a specified service business for purposes of the new deduction for self-employed and pass-through businesses available in years 2018 through 2025. So provided the surrogate mother's return has a taxable income not exceeding $210,700 ($421,400 if she is married and files a joint return with her spouse) for 2019, she would be eligible for this Sec 199A deduction, generally equal to 20% of the net self-employment income.

Unfortunately, we have tax novices making their interpretations of the tax code on the Internet and a great many of them attempt to justify what they would like the result to be as opposed to what it actually is.

As a result, many, dare we say most, surrogate mothers are not reporting the income, and the IRS is not catching up with them because neither the parents nor the agency is issuing a 1099-MISC to surrogate mothers. The parents are under no obligation to issue a 1099-MISC because it is not related to a business for them. The agency on the other hand is a business, and if the surrogacy fee passes through them, they would have an obligation to issue a 1099-MISC.

RENTER LEASE BUY-OUT

What are the consequences of a landlord buying out the remaining lease term of a tenant either by cash or a period of free rent? Section 61 provides that a taxpayer's gross income includes all income from whatever source derived, except as otherwise provided by law. A taxpayer's Section 61 gross income is not limited to the actual receipt of gain, but also includes the receipt of any economic benefit unless excluded by law. See Glenshaw Glass Co. v. Commissioner, 348 U.S. 426 (1955).

Stotis v. Commissioner, T.C. Memo. 1996-431, involves the case of a residential leasehold. Mr. Stotis, the petitioner, leased space in an apartment building that he used as a residence. The landlord, desiring to use the real estate for other purposes, entered into a surrender agreement with the petitioner whereby the petitioner exchanged his right in the property for a cash payment. The Tax Court held that the petitioner's leasehold interest in a residence was a capital asset, and that the petitioner's sale of the leasehold interest constituted a sale or exchange, taxable as capital gain.

Further, a taxpayer's interest in a leasehold is either a capital asset under Section 1221 or real property used in a trade or business under Section 1231. Either way the sale of a leasehold interest is treated as a long-term capital gain if held over one year.

W-2 AFTER DEATH

When a taxpayer passes away, employers frequently incorrectly handle and report wage payments, often to their own detriment, and end up paying matching payroll taxes when they are not required to do so. According to the IRS W-2/W-3 Instructions (page 8):

- *Payment made after death but in year of death* – Withhold SS and Medicare taxes and only report the income in boxes 3 and 5 to ensure proper Social Security and Medicare credit was received. Do not show the payment in box 1. Also issue a 1099-MISC and report the payment in Box 3 for payment to the estate or beneficiary.

- *Payment made after the year of death* - Do not report it on Form W-2 (thus no withholding or payroll taxes). Issue a 1099-MISC and report the payment in Box 3 for payment to the estate or beneficiary.

Where an employer has handled the wage payment made in a year after death incorrectly, the correct thing to do would be to have the employer amend the W-2 to no W-2 and refund the taxpayer's estate all the withholding, payroll taxes and issue a 1099-MISC. No doubt the employer will be reluctant to do all that especially after the 1099 and W-2 due dates have gone by. As a work-around the estate could forego the SS and Medicare taxes and report the W-2 wages on a 1041.

UTILITY REBATE

Energy Conservation Rebates - Taxpayers can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit. This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand. (IRC Sec 136) However, the cost of the energy conservation property must be reduced by the amount of the nontaxable subsidy before computing any federal tax credit that's based on the costs of that property, as for example when claiming the 30% solar electric or solar water property credit. (2018 Form 5695 instructions)

Water Conservation Rebates – Federal tax law does not include water conservation rebates with energy rebates. Although there is extensive lobbying by utilities to change that law, at the present time it appears such rebates are taxable for federal purposes. This would also include the rebates to replace grass with artificial turf. Utilities require water conservation rebate recipients to complete a W-9 and will issue them a 1099 where the rebates are $600 or more.

EMPLOYEES MISCLASSIFIED AS INDEPENDENT CONTRACTORS:

The IRS has a form that is to be used by certain employees who have been misclassified as independent contractors by their employer. Form 8919 – Uncollected Social Security and Medicare Tax on Wages – is used to pay an employee's half of the Social Security and Medicare taxes when one of the following reasons applies.

Form 8919 - Reason for Filing Codes (2018 version) – One must be designated when filing the form.

Code A. I filed Form SS-8 and received a determination letter stating that I am an employee of this firm.
Code C. I received other correspondence from the IRS that states I am an employee.
Code G. I filed Form SS-8 with the IRS and have not received a reply.
Code H. I received a Form W-2 and a Form 1099-MISC from this firm [for the same tax year]. The amount on Form 1099-MISC should have been included as wages on Form W-2.

If none of the reason codes apply, but the worker believes he or she should have been treated as an employee, the form instructs that reason code G is to be indicated and the worker should file Form SS-8 on or before the date the return is filed. The SS-8 must be filed separately and not attached to the 1040. If code H is used, do not file an SS-8.

If reason code G is used, the employee or the firm that paid the employee may be contacted for additional information. Use of this reason code is not a guarantee that the IRS will agree with the worker's opinion as to his/her status. If the IRS does not agree that the worker is an employee, the worker may be billed for the additional tax, penalties, and interest resulting from the change to the worker's status.

Does the 8919 Mean Troubles for Employers? Employer information is also required on the form including the employer's firm name, federal ID number, associated "reason" code from the list above, date IRS determination or correspondence was received, whether a 1099-MISC was issued, and the dollar amount of the wages received without SS or Medicare tax withholding. See chapter 3.06 for additional details.

ITIN/SSN W-2 MISMATCH

Tax preparers should take extra care to confirm that the correct taxpayer identification number is reported on the tax return. This will avoid mismatch errors and correspondence from the IRS, and if filing the return electronically, will also prevent rejection of the return. IRS suggests confirming the number by seeing social security cards, ITIN letters, etc. The IRS requires taxpayers filing tax returns using an Individual Taxpayer Identification Number (ITIN) who are reporting wages paid to show the Social Security number under which the wages were earned. This creates an identification number (ITIN/SSN) mismatch. Taxpayers should use their correct ITIN as the number on the face of Form 1040, but when inputting Form W-2 information for electronic filing purposes, the taxpayer's SSN exactly as shown on the W-2 issued by the employer should be entered. (IRS Pub. 1345, page 11)

CALIFORNIA DIFFERENCES

CA WAGES ON FORM W-2:

Generally, the California wages reported on a taxpayer's W-2 will be the same as the federal. Watch for the following which could cause state wages to differ:

- Ridesharing benefits or sick pay: California excludes from income ridesharing benefits (see more below) and sick pay received under the Federal Insurance Contributions Act and Railroad and Retirement Act.
- Income exempted by U.S. tax treaties: Certain income may be excluded from a taxpayer's income under a U.S. tax treaty, or a taxpayer may claim a foreign earned income exclusion for federal purposes. This income is generally not excludable for California purposes.
- Health savings accounts: California has not adopted health savings accounts, so employer-provided contributions are not excludable from California wages.
- Health benefits for non-dependent RDPs: Unlike Federal, California does not tax employer-provided health insurance and medical reimbursements for registered domestic partners (RDPs) who are not dependents. See chapter 1.12.

LOCAL INCOME TAX: On Form W-2 from a California employer, an amount in the local income tax box normally reflects the amount of state disability insurance ***(SDI)*** withheld from wages. However, instead of SDI, certain voluntary plan disability insurance ***(VPDI)*** may be withheld if an employer elected to carry its own voluntary plan. Such a plan must be approved by the state of California and a portion of the premiums must be sent to the state.

Federal deductibility - For federal purposes, a taxpayer's SDI payments are treated for Schedule A as state income taxes paid. However, contributions to VPDI are not deductible as such ***(Rev Rul 81-194, 1981-2 CB 54)***.

California excess withholding credit - If a taxpayer pays more than the annual maximum into the disability insurance fund, the employee may take a credit on the state return for the excess amount which was withheld. According to the FTB, SDI (or VPDI) amounts withheld must be combined; then subtract the maximum contributions due for the tax year. The balance is a refundable credit. Remember that the credit may be claimed only if taxpayers had excess withholding because they had two or more employers who each withheld SDI or VPDI. For the purpose of claiming the credit, payments to both SDI and VPDI will count.

> ***Example*** *– Martin Lewis has two employers for 2019: One withholds $810 of SDI and the other withholds $475 of VPDI. On Martin's Schedule A he includes $810 of SDI as part of his state income tax deduction. The total of the SDI and the VPDI is $1,285. The maximum for 2019 is $1,183.71, giving Martin a $101.29 overpayment credit on his CA return.*

Historical SDI Rates

Year	2014	2015	2016	2017	2018	2019	2020
Tax %	1.0	0.9	0.9	0.9	1.0	1.0	
Max Wages	101,636	104,378	106,742	110,902	114,967	118,371	
Max Tax	1,016.36	939.40	960.68	998.12	1,149.67	1,183.71	

If values not shown, they were not available at publication time.

COMPENSATION FOR SERVICES: In general, California adopts the federal rules with regard to inclusion of compensation in income.

NON-RESIDENT COMPENSATION FOR PERSONAL SERVICES PERFORMED IN CALIFORNIA: A frequent question is what constitutes CA personal services income (i.e., wages) for an individual who is not a resident of California. The answer to that question generally depends on whether the services were performed in California (18 CA Reg § 17951-5). Thus, if all the services were performed in another state, none of the income is taxable to CA.

Example #1 - If a CA nonresident individual provides services to a CA resident or CA entity, but all of those services were performed outside of CA, the income for those services is not taxable to CA. Instead they are taxable to the state where the services were performed assuming that state has a personal income tax.

Example #2 – If a nonresident individual travels to CA and performs services in CA, the compensation for services he or she performs within CA are taxable to CA. Thus, his or her gross income will be allocated and apportioned between CA and other states where the individual has performed services. CAUTION: Where an individual has a workplace both in and outside of CA, and provides services to CA residents or CA entities both in the CA workplace and the out of state workplace, the proration burden of proof will lie with the individual and the allocation might be a hard hill to climb.

Example #3 - Where an individual who is not a CA resident is employed in California at intervals during the year, compensation received for personal services includes that portion of the total compensation for personal services which the total number of working days employed within CA bears to the total number of working days both within and without CA. (R&TC Regs Sec 17951-5(b))

See also chapter 1.50 for additional information on how California taxes income of nonresidents and part-year residents.

RIDESHARING FRINGE BENEFITS: Under federal law, qualified transportation benefits are excluded from gross income with monthly limits for parking and transit passes and commuter highway vehicle benefits (see table in federal section). California places no monthly limits for the exclusion on these benefits and California's definitions are more expansive. Therefore, income that was includible for federal purposes may be excludable from state income. California has not conformed to the TCJA change that prevents employers from deducting the costs of transportation fringe benefits provided to their employees.

QUALIFIED MEDICAID WAIVER PAYMENTS: In Notice 2014-7 the IRS announced that it is discontinuing its historical opposition to excluding these payments under Sec 131. California conforms to IRC Section 131.

PAID FAMILY LEAVE INSURANCE: California provides paid family leave insurance (PFL) benefits to eligible individuals who are unable to work because they are caring for a seriously ill or injured family member, or bonding with a minor child within one year of the birth or placement of the child in connection with foster care or adoption. Payments under this plan are reported on Form 1099-G, Certain Government Payments. The program is funded by increasing the SDI contribution rate by 0.08 percent (which is included in, not additional to, the annual SDI tax rate). The following table shows the amount a taxpayer can pay into that program based upon the maximum earnings for that year.

Year	2014	2015	2016	2017	2018	2019	2020
FTDI Tax	81.31	83.50	85.39	88.72	91.97	94.70	

If values not shown, they were not available at publication time.
Rate is 0.08% of the max SDI earnings for the year – For 2019: 118,371 *x .0008= 94.70*

In PLR CCA 200630017 the IRS held that amounts withheld from an employee's payroll under the PFL program were deductible as taxes (under Sec 164). In that same PLR the IRS held that the PFL payments were includable income as Sec 85 unemployment insurance but the provisions of Regulation 1.85-1(b)(1)(iii) apply to those who do not itemize their deductions. Thus where taxpayers were unable to deduct the family temporary disability insurance (FTDI) contributions as an itemized deduction, they established a basis and subsequent FTDI income can be reduced by the accumulated basis.

> ***Example:*** *Marcia went on paid family leave on Jan 1, 2019 to care for an injured son and collected $1,560 of PFL income. Assuming Marcia has worked continuously only since 2015, and has paid the maximum SDI in all of those years, she would have had $349.58 (the total of the amounts in the chart above for years 2015 through 2018) withheld. Assuming she did not itemize in all of those years, she established a basis of $350. Therefore only $1,210 of the $1,560 paid during the leave period would be taxable on her federal return.*

Other Issues: Taxpayers who itemized but received only partial benefit because of the tax benefit rule would seemingly be able to include in their basis the amount from which they received no benefit. Also those subject to the AMT (taxes are not deductible under AMT) received no benefit from the tax deduction, so it would seem that the no-benefit portion would also add to basis. This can become quite complicated.

UTILITY REBATES – An exclusion from gross income is allowed for vouchers, rebates or other financial incentives received from the California Energy Commission, the Public Utilities Commission or a local publicly-owned utility for the purchase and installation of specified energy production systems.

Water Conservation and Turf Removal Rebates - California law allows an income exclusion for rebates or vouchers from a local water agency, energy agency, or energy supplier for the purchase and installation of water conservation appliances and devices.

For taxable years beginning on or after January 1, 2014, and before January 1, 2019, taxpayers can exclude from CA gross income any amount received as a rebate, voucher, or other financial incentive issued by a local water agency or supplier for participation in a turf removal water conservation program (R&TC Secs 17138.2 and 24308.2).

Financial Incentive for Seismic Improvement - For tax years beginning on or after July 1, 2015 (i.e., 2016 for calendar year individuals), CA allows an income exclusion for loan forgiveness, grant, credit, rebate, voucher or other financial incentive issued by the California Residential Mitigation Program or California Earthquake Authority to assist a residential property owner or occupant with expenses paid, or obligation incurred for earthquake loss mitigation (seismic retrofitting). An adjustment will need to be made on CA Schedule CA, line 21 (2018), for income of this type that was included on the federal return.

TIP INCOME

Synopsis of Tip Reporting Requirements

Type of tips	Reported Form W-2?	Emp W/H FICA?	Need 4137?	Report As Wages?
Reported to employer	Yes	Yes	No	Yes
Allocated by employer	Yes	No	Yes	Yes Req'd
$20 or more per month NOT reported to employer	No	No	Yes	Yes
Less than $20 per month NOT reported to employer	No	No	No	Yes

RAPID FINDER

Related IRS Publications and Forms

- **Form 3800** – General Business Credit
- **Form 4070A** - Employee's Daily Record of Tips (in Pub 1244)
- **Form 4070** – Employee's Report of Tips to Employer (Pub 1244)
- **Form 4137** – SS and Medicare Tax on Tips
- **Form 8027** – Annual Informational Return
- **Form 8846** – Credit for Employer SS & Medicare Taxes Paid
- **Pub 1244** – Employee's Daily Record of Tips
- **Pub 5080** - Form 4137 Compliance Program Frequently Asked Questions

Employee Tip Reporting Requirements - Employees are required to ***report tips of $20 or more received while working with any one employer in any given month.*** The reporting is to be made in writing to the employer by the ***tenth day of the month following the receipt of tips.*** The employer withholds FICA (social security and (Medicare) hospital insurance) and income taxes on these reported tips and then includes the tips and wages on the employee's W-2. If tips aren't reported to the employer when required, the IRS can assess a penalty equal to 50% of the employee FICA on the tips. Employees may keep records of their tips on Form 4070A and submit Form 4070 to the employer (both forms are in the IRS Publication 1244). The online version of Pub 1244, available on the IRS web site, allows the employee to enter the information on Forms 4070A and 4070 and print out the completed forms. Alternatively, electronic reporting to the employer is permitted.

Tip Splitting and Cover Charges - Tips given to others under a "splitting" arrangement are not subject to the reporting requirement by the employee who initially receives them. That ***employee should report to the employer only the net tips received***. Service (cover) charges, which are arbitrarily added by the business establishment, are excluded from the tip reporting requirements. The employer should add the employee's share of service charges to the employee's wages.

> ***Example – Service Charge:*** *A restaurant's menu specifies that an 18% charge will be added to all bills for parties of 6 or more customers. A customer's bill for food and beverages for her party of 8 includes an amount on the "tip line" equal to 18% of the price for food and beverages and the total includes this amount. The restaurant distributes this amount to the wait staff and bussers. Under these circumstances, the customer did not have the unrestricted right to determine the amount of the payment because it was dictated by employer policy. And the customer did not make the payment free from compulsion. The 18% charge is not a tip within the meaning of IRC Sec 3121. The amount included on the tip line is a service charge dictated by the restaurant.*

> ***Example – Tip:*** *A restaurant includes sample calculations of tip amounts beneath the signature line on its charge receipts for food and beverages provided to customers. The actual tip line is left blank. A customer's charge receipt shows sample tip calculations of 15%, 18% and 20% of the price of food and beverages. The customer inserts the amount calculated at 15% on the tip line and adds this amount to the price of food and beverages to compute the total. Because the customer was free to enter any amount on the tip line or leave it blank and the customer determined who would get the amount, the amount entered on the tip line is a tip.*

Tips versus service fees - In ***Rev Rul 2012-18,*** which modifies and supersedes Rev Rul 95-7, the IRS clarified that the absence of any of the following factors creates a doubt as to whether a payment is a tip and indicates that the payment may be a service charge: (1) the payment must be made free from compulsion; (2) the customer must have the unrestricted right to determine the amount; (3) the payment should not be the subject of negotiation or dictated by employer policy; and (4) generally, the customer has the right to determine who receives the payment. All of the surrounding facts and circumstances must be considered. To the extent any portion of a service charge paid by a customer is distributed to an employee, it is wages for FICA tax purposes.

Payments from Clubs to Taxi Drivers for Delivering Patrons – In a Chief Counsel Advice (CCA 201106010), IRS determined that amounts paid by clubs to taxicab drivers who deliver passengers to the clubs are income to the drivers, but are not tips received by the drivers in the course of their employment with taxicab companies. Rather, the payments are for services separate and distinct from the drivers' employment, and the clubs making the payments are responsible for complying with 1099 reporting requirements.

Customers' Contributions to "Tip Jars" - A Chief Counsel Memo (CCM) concludes that customers' cash contributions to "tip jars" placed in each of a retailer's locations may be treated as tips (not wages) by the employer. As such, the amounts distributed to the employees from the tip jars are governed by Code Sec. 3121(q), which provides that unreported tips won't be subject to the employer share of FICA until IRS makes a notice and demand for taxes from the employer. PLR 200929004

FICA Taxes on Unreported Tips - No FICA (i.e., social security and (Medicare) hospital insurance taxes) is assessed on tips which are not required to be reported to the employer (i.e., if under $20 in a month), but this does not exempt those amounts from income taxes. All tips should be reported as wages on Form 1040. Tips not reported to the employer, and over the $20 monthly limit, are also reported on Form 4137, Social Security Tax on Unreported Income.

Form 4137 "Gotcha" Program - The IRS has a Form 4137 Compliance Program that uses data from employees' Forms 4137, Social Security and Medicare Tax on Unreported Tip Income, to determine the **employer's** share of Social Security and Medicare taxes on unreported tips. While employers in industries where tipping is common generally know that they must pay the employer's share of Social Security and Medicare taxes on tips, other employers may not realize that they also may be liable for these taxes on tips in excess of $20 per month that their employees don't report to them is intended to ensure the employers pay their share of the employment taxes on their employees' unreported tip income. However, the employer's liability for the employer's share does not arise until IRS issues a "Section 3121(q) Notice and Demand." Employers will be sent a Form 4520P "pre-notice" prior to receiving a notice (Form 4520) that requires them to pay the unreported FICA tax. An employer can request an extension. The IRS will not assess penalties or interest on the amount due if the employers cooperate and include the taxes owed on their next Form 941, Employers QUARTERLY Federal Tax Return. (Headliner Vol. 298, May 25, 2010, IRS web site; Pub 5080)

FICA Taxes on Reported Tips - FICA is assessed on both employee and employer for <u>all tips</u> the employee reports to the employer up to the FICA limits.

Employer Allocation of Tips - Tip allocation is applicable to "large food and beverage establishments" (i.e., food service businesses where tipping is customary and that have ten or more employees). These establishments must allocate a portion of their gross receipts as tip income to those employees who "underreport". Underreporting occurs if an employee reports tips which are **less than 8%** of the employee's applicable share of the employer's gross sale. The employer must allocate to those underreported employees the difference between what the employee reported and the 8%. The 8% allocation is made only among those employees who normally receive tips. The allocation amount is noted on the employee's W-2 but does not have to be reported as additional income if the employee has adequate records to show that the amount is incorrect. Note that the allocated tips are not included in the total wages shown on the employees' W-2. (The IRS has issued inquiries where the taxpayer's W-2 showed an allocation of tips and none were reported on the tax return.)

A Method of Lowering the Allocation Percentage - If customers at an establishment tip lower than the regular allocation percentage (8%), either the employer or a majority of the direct employees may petition to have the percentage reduced from 8% (but not below 2%). The petition is made in writing to the Internal Revenue Service, National Tip Reporting Compliance, 3251 N Evergreen Dr., NW, Grand Rapids, MI 49525. See the instructions to IRS Form 8027 for the specific information and documentation required to accompany the petition. Payment of the user fee for determination letters is required at the time the request for a lower rate is filed with the IRS.

Employer Social Security Credit (IRC Sec 45B) - Food and beverage establishments can get a tax credit for a part of employer social security taxes paid on their employees' cash tips. This credit is part of the general business credit (Form 3800); however, Form 8846 is used to compute the amount of credit. The credit amount is equal to the "excess employer social security tax" paid (or incurred) for the year. <u>The credit is elective by the employer in lieu of deducting the excess social security tax as a business expense.</u>

"Excess employer social security tax" is that social security tax paid by the employer on tips received and reported to the employer by the employee during the given month, to the extent the tips are:

- Considered to have been paid by the employer to the employee under Code Section 3121(q), and
- More than the amount by which the employees' actual wages for the month (without inclusion of any tips) are less than $5.15 an hour. If each employee was paid an amount equal to or more than $5.15 per hour (excluding tips), then the credit is computed on all reported tips. (Form 8846 line 2 instructions)

Example* – *Employer Social Security Credit: *Jerry, a waiter, worked 100 hours and reported $400 worth of tips to his employer during January. Jerry's regular wages (at $3.25 per hour), without considering tips, during that period were $325, bringing the total to $725. If Jerry had been paid $5.15 per hour, he would have received $515. The result is that only $210 ($725 - $515) of the employee's tips for January is taken into account for the purpose of computing credit. The employer's credit amount is $210 x .0765= $16.07. If Jerry's hourly wage had been $7.00, then his employer's credit would be $30.60 ($400 x .0765).*

Reporting Employee Tips on Tax Return - The tip allocation procedures often cause confusion when reporting tip income on an employee's tax return. The following example illustrates the employee tip reporting procedure.

Example – Tip Reporting, W-2 to 1040: *Jan is a waitress at Walton's, a large food and beverage establishment. She reported $2,000 in tips to her employer during the year, but did not keep adequate records of tip income. Jan's Form W-2 showed the following information:*

Wages, Tips, etc. (Box 1)	*9,200.00*	*Fed tax withheld (Box 2)*	*1,840.00*
SS Wages (Box 3)	*7,200.00*	*SS Tax Withheld (Box 4)*	*570.40*
Medicare Wages (Box 5)	*9,200.00*	*Medicare Tax Withheld (Box 6)*	*133.40*
SS Tips (Box 7)	*2,000.00*	*Allocated Tips (Box 8)*	*1,000.00*

Explanation of Jan's Tip Income *- Jan will report $10,200 in wages on her Form 1040 ($9,200 in wages plus $1,000 in allocated tips). The allocated tips indicate that the restaurant found a "shortfall" of $1,000 when comparing the tips Jan reported ($2,000) to 8% of her allocable share of the employers' gross sales. She did not keep a good record of tips so she had nothing to verify that she had only received $2,000. The allocated tips are added to Jan's wages and are reported on Form 1040, line 1 of the draft 2019 form. Since no social security tax was paid on the allocated tips, Jan must also complete Form 4137 as an attachment to her return – it will include the total OASDI and HI tax assessed on the allocated tips of $76.50. This amount must also be added to Jan's tax on (draft of 2019) Schedule 2, line 5, then carried as part of the Schedule 2 total to Form 1040, Page 2, line 15.*

Recordkeeping Regulations - Reg. Sec. 31.6053-4 explains that employees must keep a timely record or copies of receipts and charge slips showing their tips (oral statements generally are not enough). The record should include the taxpayer's name and signature, establishment's name, amounts, payments received from or made to other employees, and date.

Employer Tip Reporting Agreements (Ann 2000-19, 2000-19 IRB 973) – The Tip Rate Determination/Education Program (TRD/EP) is intended to improve tip-reporting of tipped employees by means of education and voluntary agreements (instead of the traditional audit). Under this program, employers can enter into either:

- ***Tip Rate Determination Agreements (TRDAs).*** With these agreements the IRS and employer determine the amount of tips employees generally receive and should report, or
- ***Tip Reporting Alternative Commitments (TRACs).*** Employers agree to educate employees and set up tip reporting procedures under TRACs. The agreements are available to taxpayers in food and beverage, cosmetology, barber, gaming, taxicab, limousine, skycap, and car wash operations.

TRDA and TRAC agreements can be advantageous to both employees and employers who follow them--the IRS won't initiate a tip-related audit of an employer or employees who adhere to the terms of the agreements.

Under TRACS in the food and beverage industry, employers agree to:

1. Provide education for newly hired employees and existing employees on cash and charged tip reporting requirements;
2. File all required federal tax returns for payroll taxes; and
3. Set up procedures to make certain employees report tips accurately.

With a TRAC agreement, the IRS agrees that when employees underreport tips to the employer, any notice and demand to the employer for FICA taxes on that underreported income will be based only on amounts shown on Form 4137 filed by the employees.

Tip compliance program for the gaming industry - Gaming Industry Tip Compliance Agreement Program is designed to promote tip compliance and to reduce disputes under Code § 3121(q), which allows IRS to serve a demand on employers for their share of FICA taxes on unreported tip amounts without also serving a demand on the employees.

Under the Gaming Industry Tip Compliance Agreement Program, a gaming industry employer and IRS may work together to reach a Gaming Industry Tip Compliance Agreement that objectively establishes minimum tip rates for tipped employees in specified occupational categories, prescribes a threshold level of participation by the employer's employees, and reduces compliance burdens for the employer and enforcement burdens for IRS. ***(Rev Proc 2003-35, Sec. 2)***

Deemed compliance with tip reporting provision - An employer who complies with the reporting requirements of Section V of its Gaming Industry Tip Compliance Agreement, and participating employees of the employer who report in accordance with the agreement, will be deemed to comply with the tip reporting requirements of Code Sec. 6053 for the tax periods during which the agreement remains in effect. ***(Rev Proc 2003-35, Sec. 5)***

IRS and Gaming Industry Partner on Voluntary Tip Compliance Agreements (IR-2003-145)
The Internal Revenue Service expanded its tip compliance agreement nationwide to the gaming industry. For employers, the agreement substantially reduces the recordkeeping and reporting burden. For employees, the improved income reporting procedures could potentially make them eligible for higher Social Security or other pension, Medicare, unemployment and worker's compensation benefits. This could also help qualify them when applying for loans or other financial arrangements.

The voluntary compliance process allows a gaming industry employer, employees and the IRS to work together to objectively determine tip rates for tipped employees in specified occupational categories.

There are several steps to the process:

- The employer and the IRS sign a Gaming Industry Tip Compliance Agreement, which incorporates tip rates specific to that employer's establishment and prescribes a minimum level of participation by the employer's employees.
- The employer recruits his employees to voluntarily participate.
- Participating employees must then report their tip income to their employer at or above the established tip rates, unless their tip logs can substantiate a lesser amount.
- The employer withholds income tax from the employees and reports income on the employees' Forms W-2 based on the rates or the substantiated lesser amount.

As long as tips are reported at or above the established tip rate, the compliance agreement generally prevents the IRS from auditing the employees' tip income. In addition, as long as the employer meets certain commitments, the IRS will not assert a liability against the employer with respect to the tip income of participating employees while the agreement is in effect. The agreement may be renewed every three years.

All employers operating a gaming establishment may participate in the Gaming Tip Compliance Agreement. Either the IRS or an employer may initiate participation.

For further details on the compliance agreement, see Revenue Procedure 2003-35, Gaming Industry Tip Compliance Agreement Program.

CALIFORNIA DIFFERENCES

California conforms to federal tip rules but does not have a credit similar to the Sec 45B credit for employers.

SOCIAL SECURITY BENEFITS

And Tier 1 Railroad Retirement

RAPID FINDER

- Taxable Thresholds – ½ SS plus other income
  - Married filing jointly – $32,000
  - Others (except MS lived together) – $25,000
  - MS lived together – 85% of all SS is taxable
- Excess Earnings limit (2019): $17,640
- Quarter of Coverage (2019): $1,360

The current law (IRC Sec 86) is a two-tier method of taxing Social Security benefits (or Tier 1 Railroad Retirement). Social Security benefits include **monthly survivor and disability benefits**, but not supplemental security income (SSI) payments, which aren't taxable. The following discussion refers to Social Security income only; however, the rules cited ***apply to Tier 1 Railroad Retirement as well***.

SS AND OPTIMIZING IRA DISTRIBUTIONS

For taxpayers, their Social Security (SS) income is not taxable until their modified AGI (MAGI), which is regular AGI (without Social Security income) plus 50% of their Social Security income plus tax-exempt interest income, and plus certain other infrequently encountered additions exceeds a specific threshold. The threshold is $32,000 for married taxpayers filing jointly, zero for married taxpayers filing separately and $25,000 for all others. Few taxpayers understand this threshold for SS taxation and do not employ strategies to minimize the SS taxability.

Generally, retired taxpayers attempt to avoid taking any more out of their IRA accounts than they actually need to and then take distribution for special purposes such as a new car. Many are not aware of the impact of the Required Minimum Distributions (RMD) once they reach age 70 ½. There is also an estate issue of leaving an IRA to a beneficiary who probably will be in a higher tax bracket than the decedent, or worse yet, the IRA gets taxed to the estate and the beneficiaries.

Strategy – Lower-Income Retirees - It may be appropriate for clients to withdraw enough from their IRA (or other qualified plans) so that the overall income closely matches the taxable Social Security AGI threshold, even if they do not need the funds. Then they can put those excess withdrawals away for a future major expense item and avoid a large distribution in one year that would cause the SS to be taxed. Also counsel your clients receiving SS to call you if they have large deductible expenses, such as medical (reducing their tax bracket), so you can determine an amount to maximize their IRA distributions for the year.

Example *– Married taxpayers, both age 64, have a pension income of $12,000, taxable Interest Income of $1,000 and a combined Social Security (SS) Income of $18,000. The wife also has an IRA account worth $400,000. They don't have any financial need to withdraw from the IRA account. Their AGI without SS is $13,000 ($12,000 + $1,000) and 50% of the SS = $9,000. $13,000 + $9,000 = $22,000, which is $10,000 short of the $32,000 SS threshold for married taxpayers. The wife could have withdrawn up to $10,000 from the IRA and they would still have avoided tax on their SS income. What does it cost them in tax (using 2019 rates) to withdraw $10,000? Nothing!*

Pension income	*12,000*	*12,000*
SS ($18,000)	*0*	*0*
Interest income	*1,000*	*1,000*
IRA distribution	*-0-*	*10,000*
Total	*13,000*	*23,000*
Standard deduction	*<24,400>*	*<24,400>*
Taxable	*-0-*	*-0-*
Tax	*-0-*	*-0-*

The wife could withdraw even more than $10,000 from her IRA, and pay little tax:

Pension income	*12,000*	*12,000*
Interest income	*1,000*	*1,000*
IRA distribution	*11,000*	*12,000*
SS	*500*	*1,000*
Total	*24,500*	*26,000*
Standard deduction	*<24,400>*	*<24,400>*
Taxable	*100*	*1,600*
Tax	*10*	*160*

By taking a distribution and reducing the IRA account balance, they are effectively reducing both the amount that is required to be distributed when the wife reaches 70 ½ and the amount of the Social Security that may be taxable in those years.

SOCIAL SECURITY - TAXABLE PORTION – WORKSHEET

1. Enter the total amount of all Social Security Income* . . . . **1.** _________

2. Enter one-half of line 1 . . . . **2.** _________

3. Total Income including tax-exempt interest but excluding SS income . . . . **3.** _________

4. Enter the total of any exclusions/adjustments for:

- Qualified U.S. savings bond interest
- Adoption benefits
- Foreign earned income or housing
- Certain income of bona fide residents of American Samoa or Puerto Rico …... **4.** _________

5. Add lines 2, 3, and 4 . . . . **5.** _________

6. Enter the total amount of all adjustments except for student loan interest, tuition and fees**, and for years before 2018 the domestic production deduction . . . . **6.** _________

7. Is the amount on line 6 less than the amount on line 5?
No. None of the social security benefits are taxable – Stop!
Yes. Subtract line 6 from line 5 . . . . **7.** _________

8. Enter one of the following amounts:

- **Married filing jointly**, enter $32,000
- **Married filing separately and lived with spouse at any time during tax year**, skip lines 8 through 15; multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17.
- **All others**, enter $25,000. . . . . **8.** _________

9. Is the amount on line 8 less than the amount on line 7?
No. None of the benefits are taxable– Stop!
Yes. Subtract line 8 from line 7 . . . . **9.** _________

10. Enter $12,000 if married filing jointly; $9,000 for all others. **10.** _________

11. Subtract line 10 from line 9. If zero or less, enter -0- . . . . **11.** _________

12. Enter the **smaller** of line 9 or line 10 . . . . **12.** _________

13. Enter one-half of line 12 . . . . **13.** _________

14. Enter the **smaller** of line 2 or line 13. . . . . **14.** _________

15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0- . . . . **15.** _________

16. Add lines 14 and 15 . . . . **16.** _________

17. Multiply line 1 by 85% (.85). . . . . **17.** _________

18. Taxable benefits. Enter the **smaller** of line 16 or line 17. . . . .**18.** _________

*Social Security income for line 1 is the amount from box 5 of Form SSA-1099; if filing a joint return, combine both spouses' SS amounts for line 1.

**Not applicable after 2017 unless Congress extends this adjustment

TAX WITHHOLDING ON SS BENEFITS

Taxpayers can elect to have federal income tax withheld from their Social Security benefits and/or the SSEB portion of Tier 1 Railroad Retirement benefits. Use Form ***W–4V***. They can choose one of the following withholding rates: ***7%, 10%, 12%, or 22%*** of the total benefit payment (flat dollar amounts aren't permitted).

LEGAL EXPENSES AND SOCIAL SECURITY

Sometimes individuals will incur legal expenses to produce or collect taxable income or in connection with the determination, collection, or refund of any tax. The legal expenses cannot be used to offset the SS benefits and can only be deducted as a Tier 2 miscellaneous itemized deduction. In addition, the deduction is limited to legal expenses for collecting only the ***taxable*** part of the taxpayer's benefits. Thus, prorate to determine the amount of legal expense attributable to the taxable Social Security (Rev Rul 87-102).

TCJA ***Caution***: The TCJA of 2017 suspended the Tier 2 miscellaneous itemized deductions for years 2018 through 2025, so even the legal fees prorated to the taxable Social Security award aren't deductible.

DIVORCE

An ex-spouse's benefits are the same as a spouse's as long as the marriage lasted at least 10 years and the ex-spouse who is receiving benefits has not remarried. Multiple ex-spouses can claim benefits if they meet the 10-year rule and have not remarried. If an ex-spouse remarries, the benefits cease and cannot be reclaimed. A worker will not be notified if an ex-spouse has applied for spousal benefits.

SURVIVOR BENEFITS

Unless the death was accidental, the couple must have been married for 9 months and the survivor must be at least 60 years of age (50 if disabled) to collect benefits. The benefits range from 71.5% to 99% of the deceased worker's basic amount. The survivor's benefits are the greater of the benefits that would be due to the decedent or the benefits the surviving spouse would be entitled to, based on their own work history. Other survivor benefits:

- Disabled widow or widower aged 50 through 59 -- 71½ percent;
- Widow or widower, any age, caring for a child under age 16 -- 75 percent.
- A child under age 18 (19 if still in elementary or secondary school) or disabled -- 75 percent. (Note: the benefits are taxable to the child on the child's tax return. But like any single individual the child's MAGI would have to exceed the $25,000 threshold before any of the SS is taxable.)
- Dependent parent(s) of the deceased worker, age 62 or older:
  - One surviving parent -- 82½ percent.
  - Two surviving parents -- 75 percent to each parent.

SAME-SEX MARRIED COUPLES

On June 26, 2015, the Supreme Court issued a decision in Obergefell v. Hodges, holding that same-sex couples have a constitutional right to marry in all states. As a result, more same-sex couples will be recognized as married for purposes of determining entitlement to Social Security benefits or eligibility for Supplemental Security Income (SSI) payments.

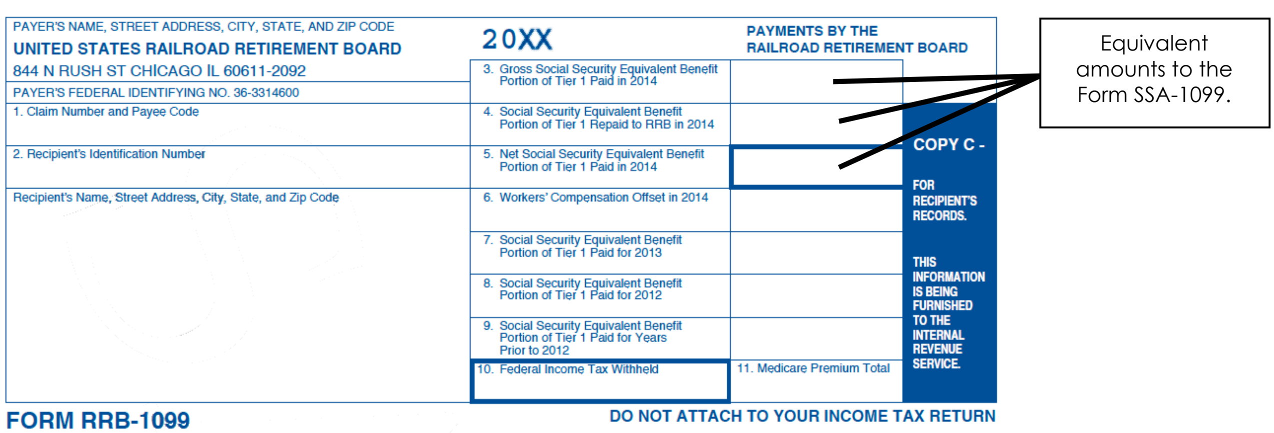
TIER 1 RAILROAD RETIREMENT BENEFITS

For railroad workers, Form RRB-1099 reports their social security equivalent benefits (SSEB) payments. The form is blue, as distinguished from RRB-1099-R which is green, and reports pension payments (see chapter 4.01 for pension reporting information).

The equivalent payments are reported as, and combined with, the taxpayer's Social Security benefits and taxed in the same manner as Social Security income.

Form RRB-1099 - is the Railroad equivalent to the SSA-1099. Boxes 3, 4 and 5 are same on both forms, and the RRB-1099 amounts are reported the same as SSA-1099 amounts.

Railroad Social Security Equivalent – RRB 1099



NONRESIDENT ALIENS

Nonresident aliens are not taxed on their SS benefits in the same manner as residents.

General rule - 85% of the Social Security benefits are taxed at the 30% rate unless exempt (or subject to a lower tax rate) by treaty. For example, a resident of Switzerland is taxed on 15% of total U.S. Social Security benefits received. Generally the Social Security Administration will withhold at the correct rate.

Countries where SS benefits are exempt from tax - Under treaties with the following countries, residents of those countries who are U.S. nonresident aliens are exempt from U.S. tax on U.S. Social Security benefits.

- Canada
- Egypt
- Germany
- India*
- Ireland
- Israel
- Italy
- Japan
- Romania
- United Kingdom

*Exempt only for individuals who are residents and nationals of India if the benefits are for services performed for the U.S., its subdivisions or local government authorities.

US - CANADIAN TREATY & SOCIAL SECURITY BENEFITS

Note: In the language of treaties, "State" means the United States or the foreign country that the treaty is with; it does not mean one of the 50 U.S. states or similar subdivisions of the foreign country.

Benefits under the social security legislation of a State (including tier 1 railroad retirement benefits, but not including unemployment benefits) paid to a resident of the other State shall be taxable only in the State of residence, subject to the following conditions:

(1) a benefit under U.S Social Security legislation paid to a resident of Canada is taxable in Canada as though it were a benefit under the Canada Pension Plan, except that 15% of the benefit is exempt from Canadian tax; ***Can. Treaty, Art. XVII(5)(a)*** and

(2) a benefit under Canadian social security legislation paid to a resident of the U.S. is taxable in the U.S. as though it were a benefit under the Social Security Act, except that a type of benefit that is not subject to Canadian tax when paid to residents of Canada is exempt from United States tax. ***Can. Treaty, Art. XVII(5)(b)***

Thus, a maximum of 85% of Canadian social security paid to a U.S. resident may be subject to U.S. taxes. However, if Canadian social security law is amended to make benefits means-tested at the source and not subject to tax, the benefits will not be subject to U.S. tax. ***Can. Protocol Treas. Tech. Expl. p4.***

GERMAN SOCIAL SECURITY BENEFITS RECEIVED BY U.S. RESIDENTS

Under the tax treaty with Germany, social security benefits paid by Germany to U.S. residents are treated for U.S. income tax purposes as if paid under U.S. legislation. In other words, these benefits are taxed the same way U.S. Social Security benefits are, with up to 85% of the German social security benefits subject to U.S. tax.

U.S. CITIZENS RESIDING ABROAD

A U.S. citizen who is a resident of one of the following countries is exempt from U.S. tax on their U.S. Social Security benefits:

Canada	Ireland	Romania
Egypt	Israel	United Kingdom
Germany	Italy (must also be a citizen of Italy)	

LUMP-SUM ELECTION

Taxpayers must include the taxable part of a lump-sum (retroactive) Social Security payment received during a tax year in that year's income, even if the payment includes benefits for an earlier year. However, this may cause the SS benefits to be taxed at a higher rate than they would have been if they had been reported in the prior year. To adjust for this inequity, a taxpayer may choose to use the lump-sum election if it generates a lower tax.

Lump-sum death benefits - Lump sum death benefit payments should not be confused with retroactive lump-sum payments. In some cases the SSA and the RRB will pay beneficiaries a lump-sum death benefit which is NOT subject to taxation.

Lump-sum computation - To determine if the lump-sum election is beneficial, complete the worksheets provided in IRS Publication 915. ***Revoking the lump-sum election*** - Once elected, the election can only be revoked with the consent of the Internal Revenue Service.

Reporting on the tax return - Most preparation software provides specific entries to accommodate the lump sum election. "LSE" is entered to the left of the Social Security reporting line on Form 1040 or Form 1040SR. The IRS instructions indicate there is no requirement to include the completed worksheets with the filed return.

REPAYMENTS MORE THAN GROSS BENEFITS

In some situations, a taxpayer may be required to repay Social Security benefits and the repaid benefits may exceed the gross benefits for the tax year. If this occurs, first combine the negative amount with benefits paid to the spouse if applicable. If the result is still negative and the repayments were for:

The current year - then no portion of the Social Security benefits is taxable and there is no other adjustment to make on the return.

A prior year - then to the extent that the negative amounts represent taxable Social Security in a prior year the taxpayer will have an itemized deduction or a credit.

TCJA

- ***Deduction $3,000 or less –*** *If the deduction is $3,000 or less, it can be claimed as a Tier 2 (subject to 2% of AGI reduction) miscellaneous itemized deduction under the "Claim of Right" doctrine. However, for years 2018 through 2025, the TCJA of 2017 does not allow Tier 2 miscellaneous deductions with the result that a taxpayer who has had to make a Social Security benefit repayment of $3,000 or less gets no tax deduction.*
- ***Deduction more than $3,000 -*** *If the deduction is more than $3,000 the taxpayer can choose between a Tier 1 miscellaneous deduction and a "Claim of Right" credit.*

See chapter 9.05 - Claim of Right for details on claiming the deduction or taking the credit.

SEPARATE FILERS MUST LIVE IN SEPARATE RESIDENCES TO REDUCE TAX ON SS BENEFITS

A married taxpayer who files a separate return and who lived with his or her spouse at any time during the year will generally be taxed on up to 85% of Social Security benefits. See line 8 of the worksheet above, where zero is entered, unless the taxpayer and spouse lived apart all year. The Tax Court has held that separate-filing spouses must live in separate residences to qualify as living apart, so that a smaller amount of their Social Security benefits would be includible in their gross incomes. Meaning of *"lived apart"* - The Tax Court concluded that living apart under Code Sec. 86 means living in separate residences. ***(McAdams, (2002) 118 TC No. 24))***

Nursing home as separate residence - It is not uncommon for one elderly spouse to live in a nursing home for the entire tax year while the other spouse lives in the marital residence with all mail for both spouses going to the marital residence. The spouse in the nursing home clearly should be considered to live in a separate residence. On the other hand the substantial medical deduction may preclude taxpayers from filing separately.

IRS CAN LEVY SS BENEFITS **-** The IRS can levy against SS benefits under a law enacted in 1997.

LIMITS ON EARNINGS AFTER RETIREMENT (EXCESS EARNINGS)

If a worker, spouse, divorced spouse, or minor child works after Social Security benefits start, special rules apply as to the amount of money that can be earned without impacting benefits. The following types of income will reduce the amount of a Social Security check if they exceed the limits:

(1) Gross wages,
(2) Net earnings from self-employment,
(3) Some government pensions,
(4) Insurance renewals, sales commissions, royalties and severance pay.

In the case of items (3) and (4), complicated rules apply. Call the Social Security Administration for additional information. The following types of income are not considered when computing the limitation:

Rental income [1]	Inheritances
Pension income [4]	Court case settlements
Interest & dividends [2]	Worker's compensation
Unemployment compensation	Lottery/contest winnings
Sick pay (after 6 months of retirement)	Tips less than $20 per month
Reimbursement for moving [3]	Reimbursement for travel [3]
Jury duty pay	Delayed payment from self-employment [5]

[1] If not in the real estate business. [2] If not in the broker business. [3] Income not counted by the IRS. [4] Some government pensions can reduce the amount of Social Security benefits. [5] SE income paid in a year after the year of entitlement to Social Security that is attributable to services performed prior to the first month of entitlement to Social Security

The earnings limit for those under full retirement age for 2019 is $17,640 (up from $17,040 in 2018). If full retirement age is reached in 2019, the earnings limit is $3,910 per month for each month in 2019 prior to the month full retirement age is attained.

Excess Earnings Reduction Amount - An individual can get Social Security retirement benefits and work at the same time. However, if the retiree is younger than full retirement age and makes more than the yearly earnings limit, the benefits will be reduced $1 for every $2 of earnings exceeding the annual limit. The annual limit for 2019 is $17,640 (up from $17,040 in 2018). Starting with the month the individual reaches full retirement age, the benefits will no longer be reduced.

In the year the individual reaches full retirement age the benefits will be reduced $1 for every $3 of earnings exceeding $46,920 (up from $45,360 in 2018). The earnings for this limit only include earnings prior to the month the iindividual reached full retirement age.

Mid-year Retirement **–** Some people who retire in mid-year have already earned more than their yearly earnings limit. That is why the Social Security Administration has **a special rule that applies to earnings for one year**, usually the first year of retirement. The special rule allows the Social Security Administration to pay a full Social Security check for any whole month they consider an individual retired, regardless of yearly earnings. If the individual will:

- Be under full retirement age for all of 2019, they are considered retired in any month that their earnings are $1,420 (2019) or less **and** they did not perform substantial services in self-employment.
- Reach full retirement age in 2019, they are considered retired in any month that their earnings are $3,910 or less **and** they did not perform substantial services in self-employment. "Substantial services in self-employment" means the individual devoted more than 45 hours a month to the business or between 15 and 45 hours to a business in a highly skilled occupation.

Full Retirement Age or Over – The excess earnings limitation does not apply to individuals who have reached full retirement age or over beginning the month that full retirement age is attained.

BIRTH YEAR*	FULL RETIREMENT AGE	BIRTH YEAR*	FULL RETIREMENT AGE
1937 or earlier	65	1955	66 and 2 months
1938	65 and 2 months	1956	66 and 4 months
1939	65 and 4 months	1957	66 and 6 months
1940	65 and 6 months	1958	66 and 8 months
1941	65 and 8 months	1959	66 and 10 months
1942	65 and 10 months	1960 and later	67
1943–1954	66		

**If born Jan 1 refer to previous year*

Quarter of Coverage (QC) - Is the basic unit for determining whether a worker is insured under the Social Security program. No matter how high the earnings may be, an individual cannot earn more than 4 QC's in one year.

Year	Earnings
2014	$1,200
2015	$1,220
2016	$1,260
2017	$1,300
2018	$1,320
2019	$1,360

If amount not shown it was not available at date of publication

CALIFORNIA DIFFERENCES

California does not tax Social Security benefits or Tier 1 Railroad retirement benefits which are treated the same as Social Security benefits.

FEDERALLY EXEMPT FOREIGN PENSIONS TAXABLE TO CA

The California BOE has a long-held position that U.S. treaties with foreign countries do not apply to California tax. So California does not conform to the Internal Revenue Code as it relates to treaties that exempt certain income from federal taxation. ***The result is that, although foreign pensions and social security may be exempt from federal taxation under U.S. treaties, the income is subject to California tax***.

In the ***Appeal of George S. Gilmour****, November 28, 2000, Case No. 34337* the taxpayer argued that a treaty between the U.S. and Great Britain exempts Social Security from taxation and Social Security is exempt from taxation by statute. The BOE position has been that tax treaties between the U.S. and other countries do not prevent California from taxing persons otherwise covered by such treaties *(****Appeal of M.T. de Mey van Streefkerk****, Cal. St. Bd. Of Equal., Nov. 6, 1985).* In support of this position, the U.S. Supreme Court has ruled that tax treaties the U.S. enters into generally do not prohibit the taxing activities of sub-national governments.

Only U.S. Social Security Benefits Exempt From CA Taxation - R&TC Sec. 17087(a) exempts only U.S. Social Security and there is no provision under either the California statute or the Internal Revenue Code to specifically exempt foreign social security from taxation by California.

SCHEDULE D ISSUES

- **Holding period for capital gains rates**: Over one year
- **Capital Gains Rates**
  - 0 %, 15% or 20%
  - See chapter details for breakpoints
- **Excluded from 0%, 15%, and 20% rates:**
  - Unrecaptured Sec 1250 gain – Maximum 25%
  - Collectibles – Maximum 28%
- **Annual Loss Limitation**
  - $3,000 ($1,500 MFS)
- **Capital Gain Deferral:** Election to invest capital gains in Opportunity Zone Funds defers and potentially eliminates tax – see Chapter 2.18

For several years, long-term capital gains (LTCG) and qualified dividends have been taxed at preferential rates of 0%, 15% or 20%, with the capital gains rate depending on the taxpayer's ordinary income tax bracket. If ordinary income was generally taxed at a rate below 25%, the capital gains and qualifying dividends were taxed at a 0% rate. If subject to a 25%-or-greater, but less than 39.6%, rate on ordinary income, the rate on LTCG and qualified dividends was 15%. For individuals whose taxable income exceeded the threshold for the 39.6% rate, the LTCG and qualifying dividends rate was 20%.

The Tax Cuts and Jobs Act, passed in December 2017, retained the 0%/15%/20% capital gains rates but specified taxable income amounts determine the breakpoints for the 15% and 20% rates instead of tax brackets. These amounts are shown on page 2.04.03 and are subject to inflation adjustment for years after 2018.

The maximum rate continues to be 28% for collectibles, and 25% for recaptured Sec. 1250 gains. The thresholds at which the 3.8% surtax on net investment income (see Chapter 12.05) apply do not match the capital gains rate thresholds and were not changed by the TCJA.

Related IRS Publications and Forms

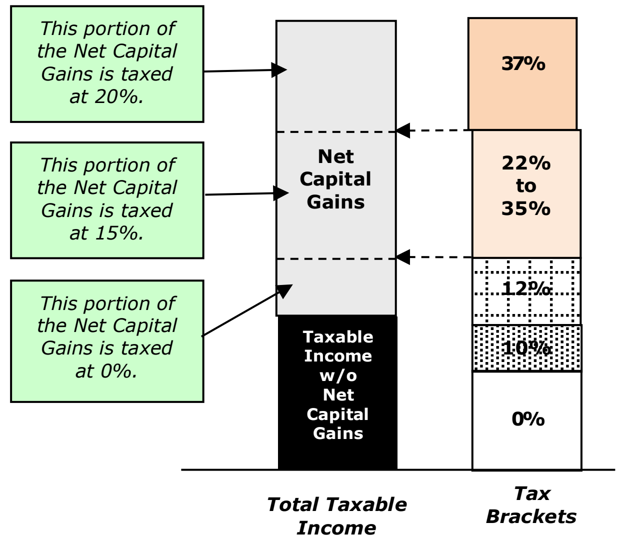
- **Form 1040 Schedule D –** Capital Gains & Losses
- **Instructions 1040 (Schedule D)**
- **Form 8949 –** Sales and Other Dispositions of Capital Assets
- **Instructions Form 8949**
- **Form 8937** – Report of Organizational Actions Affecting Basis of Securities
- **Form 6781** – Gains & Losses From Section 1256 Contracts and Straddles
- **Pub 537 –** Installment Sales
- **Pub 544 –** Sales and Other Dispositions of Assets
- **Pub 551 –** Basis of Assets

TCJA CHANGES	SEE PAGE
Rate breakpoints based on TI	02.04.03
Patent, etc., not a capital asset	02.01.13

RAPID FINDER

UNDERSTANDING THE SCHEDULE D COMPUTATION (POST-2012):

The Schedule D has become one of the most complicated calculations on a tax return. Although the IRS publishes lengthy worksheets, and computerized tax programs transparently make the calculations (if data has been entered correctly), tax practitioners need to have an understanding of how the tax is determined (computed) on the Schedule D. Adjacent is a graphic 3-step illustration of the Schedule D tax computation.



Determine NET CAPITAL GAINS.

(+) Qualified Dividends

(-) Dividends Elected to be Treated as Investment Income (for Form 4952 limitation) (not exceeding the qualified dividends)

(+) Net Long-Term Gains

(-) 25% and 28% Gains (not exceeding the long-term gains)

NET CAPITAL GAINS

Net capital gains are taxed in the sequence shown in the illustration to the right. Where there are unrecaptured Sec 1250 gains taxed at 25%, or long-term collectibles and qualified small business stock gain taxed at 28%, the computation can become very complicated and the Schedule D and associated worksheets must be used to determine the tax.

DEFINITION OF NET CAPITAL GAIN:

For purposes of the maximum capital gains rates, the term "adjusted net capital gain" means the sum of:

(1) The excess of net long-term capital gains over net short-term losses, subject to certain netting rules, but *without* taking into account the otherwise applicable increase for qualified dividend income, reduced (but not below zero) by the sum of:
- (a) Unrecaptured Section 1250 gain, and
- (b) "28% rate gain", plus

(2) Qualified dividend income.

CAPITAL LOSSES:

When the net result on the Schedule D line 16 is a loss, the loss is limited to a maximum of $3,000 ($1,500 if married filing separately). Losses in excess of those limits can generally be carried forward to future years.

Preserving Capital Loss Carryovers - The question frequently arises whether or not an individual must file a return, even if not otherwise required to file, in order to preserve a capital loss carryover.

In reading the IRS instructions, it seems the answer is no based upon the following statement that appears in both IRS Publications 550 (Pg. 66) and 17 (Pg. 116), 2018 versions:

> *"When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it and whether or not you filed a return for the current year".*

However, to claim a capital loss carryover the Schedule D instructions indicate the taxpayer needs a copy of their prior year 1040 and Schedule D to complete the capital loss worksheet to determine how much loss is carried forward from the prior year.

In figuring the carryover, the amount of the capital loss carryover is the amount of taxpayer's total net loss that is more than the **lesser** of the taxpayer's:

1. Allowable capital loss deduction for the year, $3,000 (1,500 MFS), or

2. Taxable income increased by the taxpayer's allowable capital loss deduction for the year and, in years before 2018 and after 2025, the taxpayer's deduction for personal exemptions.

It appears there is no actual requirement to file a return where one is not otherwise required to be filed. However, since the carryover is based upon the results of a prior year return, the taxpayer would have to be able to reconstruct the prior year return to prove the carryover if challenged on the amount of the carryover.

According to the Tax Court, and referencing Reg. Sec. 1.6001-1(e), if a capital loss is to be carried forward from one year to another, the taxpayer must keep records substantiating (1) that the taxpayer incurred a loss, (2) that the taxpayer is entitled to deduct the loss, (3) the character of the loss, and (4) the amounts of any capital gain offset during any subsequent years. (Xing F. Wang and Kathleen P. Lee v. Commissioner, T.C. Memo. 2017-081, May 15, 2017). So, not only is it necessary to keep a copy of the tax return and the documentation of the transactions that created the loss (1099-B, purchase records, etc.) for the year the loss originated, the taxpayer will need these records for each year until the loss is used up (plus at least 3 years thereafter for the statute to run out).

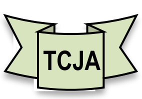
Best Practice: We believe that the best practice may be to actually file a return and run the statute of limitations even though a return is not actually required.

QUALIFIED DIVIDENDS:

Qualified dividends are also taxed at capital gains rates. To be "qualified" dividends, the dividends must generally be from a domestic corporation or a "qualified foreign corporation," and the taxpayer must have owned the stock for 60 days during the 121-day period beginning 60 days before the ex-dividend date (in the case of preferred stock, 90 days during the 181-day period beginning 90 days before the ex-dividend date).

TAX STRATEGIES & REMINDERS:

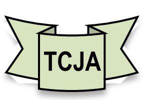
- **Reduced tax rates on homes** - Homeowners benefit from the reduced maximum capital gain rate which cuts taxes on sales of homes on which gains exceed the $250,000/$500,000 exclusion limits.
- **Reduced tax rates on second homes** - Second homes that are sold do not qualify for the home sale gain exclusion, but the owners benefit from the reduced capital gains rates.
- **Level I - 0% Tax Rate** - The 0% rate for net capital gains of taxpayers with taxable income below the amounts shown in the 15% table will be available for gains on stock transferred to low-bracket children and grandchildren who are not subject to the Kiddie Tax rules.
- **Level II - 15% Tax Rate** – The 15% rate applies to the portion of the gain starting at the amounts shown in this table and up to the amount in the 20% table.
  - **Taxable Income Where the 15% Capital Gains Rate Kicks in**



Filing Status	2015	2016	2017	2018	2019	2020
Single	$37,450	$37,650	$37,950	$38,601	39,376	40,001
Head of household	$50,200	$50,400	$50,800	$51,701	52,751	53,601
Married Joint	$74,900	$75,300	$75,900	$77,200	78,751	80,001
Married Separate	$37,450	$37,650	$37,950	$38,601	39,376	40,001

If values not shown they were not available at publication date.

- **Level III - 20% Tax Rate** – The 20% rate applies to the portion of the gain that exceeds the amounts shown below.



Filing Status	2015	2016	2017	2018	2019	2020
Single	$413,200	$415,050	$418,400	$425,800	434,550	441,451
Head of household	$439,000	$441,000	$444,550	$452,400	461,700	469,051
Married Joint	$464,850	$466,950	$470,700	$479,000	488,850	496,601
Married Separate	$232,425	$233,475	$235,350	$239,500	244,425	248,301

If values not shown they were not available at publication date.

- **Use Appreciated Stock to Help Support Low-Income Parents** – Aging parents with limited income often receive financial help from their more affluent adult children. Instead of giving the parent(s) after-tax cash, a child (taxpayer) who owns long-term appreciated stock should consider gifting the stock to the parent, who would then sell the stock and keep the proceeds. Depending on the parent's other income, there may be zero tax due on all or part of the gain from selling the stock.

While tax law generally restricts the transfer of assets (gifts) between individuals, an annual exclusion allows up to $15,000 (for 2019) to be transferred without gift or estate tax implications. This annual exclusion applies to each taxpayer and to each recipient. So a taxpayer could gift up to $15,000 to each parent per year. Non-cash gifts are valued at fair market value.

Careful planning is required, however, to maximize the amount of the gift while ensuring that the capital gain from selling the stock doesn't increase the parent's AGI to the point that other tax benefits are adversely affected (for example, making Social Security benefits taxable) or cause a jump in taxable income so that the zero capital gains tax rate won't apply.

- **Off-Set Short-Term Gains with Long-Term Capital Losses -** Short-term capital gains do not receive benefits of the special rates afforded long-term capital gains. Long-term capital losses, if used to offset long-term capital gains, reduce a gain that would be taxed at no more than 20%. The problem:
  - ST capital gains are taxed at regular rates.
  - LT capital losses if used to offset LTCG reduce 10% or 15% income.

  Therefore, taxpayers achieve a better overall tax benefit if they can arrange their transactions so as to offset short-term capital gains with long-term capital losses. Although this cannot always be achieved in light of investment strategies, when implemented, it will offset income that would otherwise be taxed at ordinary rates.

TRANSACTIONS EXCLUDED FROM THE SPECIAL RATES:

The following types of transactions are not eligible for the general reduced capital gains rates and instead are taxed at their own specific maximum rate:

- Collectibles (taxed at 28%),
- Unrecaptured Section 1250 gain (taxed at 25%), and
- Section 1202 gain on small business stock (taxed at 28% in some cases) – See Chapter 2.07.

Section 1202 Gain **–** Unless the gain qualifies to be 100% excluded, Sec. 1202 gain is equal to the gain on the sale of small business stock that is not excluded from gross income under Code Sec. 1202. This amount usually is 25% or 50% of the gain depending on when the qualifying stock was issued and whether the total gain on the sale of small business stock exceeds certain specified levels. ***Caution: A portion of Sec. 1202 gains is a tax preference item (unless the gain is 100% excludable). See special chapter on Small Business Stock – Chapter 2.07.***

Recaptured and Unrecaptured Real Estate Rental Section 1250 Gain

A frequent question we receive is the tax treatment of recaptured depreciation from the sale of real estate rental property. Gain from selling Sec 1250 property (real estate) is subject to recapture – the excess of the actual amount of depreciation previously claimed for the property over the amount of depreciation that would have been allowable under the straight-line method, limited to the gain on the sale, is taxed as ordinary income. However, this means that as long as the property is being depreciated using a straight-line method and held over a year, there is no Sec 1250 recapture but there will be "unrecaptured Sec 1250 gain," which is taxed at a maximum rate of 25%. The balance of the gain, if any, is taxed at the normal capital gains rate as explained above.

Rental real estate depreciation rates have been mandatorily straight line since 1987 with residential rentals being depreciated over 27.5 years and commercial property depreciated over 31.5 years or 39 years if placed in service after 5/12/1993. Thus in nearly all cases it is impossible for real estate property sold these days to have been depreciated at other than straight-line, and therefore no amount of depreciation is recaptured as Sec 1250 gain (Code Sec. 168(b)(3)(A)). But the amount of depreciation claimed on Sec 1250 property that is not recaptured as ordinary income under the Sec 1250 recapture rules is unrecaptured section 1250 gain, and is subject to a special capital gain tax rate of 25%.

> ***Example:*** *Jack, an individual, sells nonresidential real property on Aug. 15 for $200,000, realizing a gain of $50,000. This is Jack's only transaction involving a capital asset for the year. Jack held the property for more than one year. He depreciated the property using MACRS (straight-line), and claimed $25,000 of depreciation during his ownership. There is no depreciation recapture under Sec 1250 because Jack didn't claim accelerated depreciation. However, $25,000 of Jack's gain, representing depreciation deductions he had claimed, is unrecaptured Sec. 1250 gain. Lines 26a and 26g of Jack's Form 4797 will be zeroes because straight-line depreciation was used. The Unrecaptured Section 1250 Gain Worksheet in the Schedule D instructions will need to be completed before Jack's Schedule D Tax Worksheet can be computed. The* ***maximum*** *amount of tax he'll pay on the $25,000 of unrecaptured Sec 1250 gain is $6,250 (25% x $25,000) but his tax on the unrecaptured 1250 gain could be much less depending on his other income and the tax bracket he falls into.*

Special Recapture Situations

Even if straight-line depreciation is used to claim the regular depreciation deduction, depreciation recapture will apply in the following situations:

- *Bonus Depreciation* – If bonus depreciation is claimed on qualified leasehold improvement property placed in service before 2016 or qualified improvement property placed in service after 2015, the Sec 1250 recapture rules apply. The recapture amount is equal to the difference between the bonus deduction claimed and straight-line depreciation that could have been claimed on the bonus deduction.
- *Sec 179* - If a Sec 179 deduction is claimed on Sec 1250 property (e.g., qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property), the Sec 179 allowance is subject to recapture under the recapture rules of Sec 1245. In this case, to the extent the gain is allocable to the expensed portion of the property, the Sec 179 amount may be recaptured in full as ordinary income.

1244 Stock – Section 1244 allows an ordinary loss (Form 4797) on the sale of stock from a domestic corporation of up to $50,000 annually ($100,000 on a joint return, even if the stock is only owned by one of the spouses), even though the loss would otherwise be treated as a capital loss. Losses in excess of the ordinary loss treatment retain the capital loss treatment. Sec 1244 stock sold at a gain is eligible for capital gain treatment. A corporation's stock generally qualifies for this treatment if, at the time the stock was issued, the corporation's gross receipts did not exceed $1 million. This is for awareness only; consult Sec 1244 rules for further details.

GENERAL RULES FOR CAPITAL TRANSACTIONS:

Income from gains on dispositions of property may be classified as either ordinary or capital gain, depending on the type of property involved in the disposition. Capital gains (and more favorable tax rates) are generated from the sale of "capital assets."

Capital assets include:

- Personal or investment-use property;
- Options, if the underlying property is capital.

Capital assets do not include:

- Inventory;
- Accounts or notes receivable;
- Supplies of a type regularly used or consumed in the ordinary course of a trade or business;
- Depreciable property used in business (this may receive capital gain treatment, however);
- Hedging transactions;
- Certain financial instruments held by commodities derivative dealers;
- Copyrights or letters created by the taxpayer;
- Government publications received free or at a discount; and
- Effective for dispositions after December 31, 2017, self-created property such as a patent, invention, model or design (whether or not patented), and a secret formula or process.

HOLDING PERIOD:

Whether a sale of a capital asset generates a long- or short-term capital gain depends on the length of time the asset sold has been held by a taxpayer. Under current law the short-term holding period is one year or less and the long-term period is more than one year. Start counting the holding period the day after the property is acquired and continue through the date of sale. Use the trade date as the disposition date for the sale of stocks and bonds.

Special holding period rules:

- If a taxpayer ***acquires an asset in exchange*** for another and the basis of the new asset is dependent on the basis of the old, the holding period of the new property includes the holding period of the old.
- For dispositions prior to 2018, ***patent property*** is generally deemed to have been held long-term, no matter how long the taxpayer held it.
- ***Inherited property*** is generally considered held long-term regardless of how long either the decedent or heir owns it.
- The holding period of ***repossessed property*** includes the time the taxpayer held it before original sale plus the time owned after repossession.
- ***Nonbusiness bad debts*** are always short-term.
- ***Worthless stock*** is treated as if sold on the last day of the tax year, and accordingly will be either long- or short-term depending when it was acquired.

CAPITAL GAINS RATES

2013 THRU 2017

Ordinary Income Bracket	Long-Term
To the extent the bracket is 10% or 15%	0%
To the extent the bracket is 25%, 28%, 33% or 35%	15%
To the extent income exceeds 39.6% bracket threshold*	20%
Unrecaptured Sec 1250 Gain	25%
Qualified Small Business Stock – 25% or 50% of Gain	Max 28% (AMT Pref)
Collectibles	28%

*thresholds are subject to inflation adjustment

Caution:
Capital gains are included in investment income and are subject to the 3.8% surtax on net investment income unless derived from a non-passive trade or business.

2019

Capital Gains Tax Rate	MFJ	MFS	HH	SINGLE
Zero	0 to 78,750	0 to 39,375	0 to 52,750	0 to 39,375
15%	78,751 to 488,850	39,376 to 244,425	52,751 to 461,700	39,376 to 434,550
20%	488,851 & Up	244,426 & Up	461,701 & Up	434,551 & Up
25%	Unrecaptured Sec 1250 Gain			
28% Max. (AMT Pref)	Qualified Small Business Stock – 25% or 50% of Gain			
28%	Collectibles			

2018

Capital Gains Tax Rate	MFJ	MFS	HH	SINGLE
Zero	0 to 77,200	0 to 38,600	0 to 51,700	0 to 38,600
15%	77,201 to 479,000	38,601 to 239,500	51,701 to 452,400	38,601 to 425,800
20%	479,001 & Up	239,501 & Up	452,401 & Up	425,801 & Up
25%	Unrecaptured Sec 1250 Gain			
28% Max. (AMT Pref)	Qualified Small Business Stock – 25% or 50% of Gain			
28%	Collectibles			

<u>NETTING CAPITAL GAINS AND LOSSES</u>:

The law provides that capital gains and losses are netted as outlined below.

1. Short-term capital losses (including any short-term loss carryover) are applied first to reduce short-term capital gains.
   a. The net short-term capital loss is then applied to reduce any net long-term capital gain from the 28% rate group.
   b. Any remainder after the reduction in (a) is used to reduce unrecaptured section 1250 gain (25% rate group), and
   c. Finally, after the reductions in (a) and (b), the balance is used to reduce adjusted net capital gain 0%/15%/20% group.

   Thus, a net short-term capital loss reduces adjusted net capital gain only to the extent it exceeds the sum of 28% rate gain and 25% rate gain.

   Example – Netting capital gains and losses - *Marie has a short-term capital loss of $20,000. She also has:*
   - *Collectibles gain of $10,000 in the 28% rate group,*
   - *Unrecaptured section 1250 gain of $15,000 in the 25% rate group, and*
   - *Long-term capital gain of $25,000 in the 0%/15%/20% rate group.*
   - *Her net capital gain is $30,000.*

   Result:
   - *Marie's short-term capital loss is first used to completely offset the collectibles gain of $10,000.*
   - *The balance is then used to offset $10,000 of the unrecaptured Sec 1250 gain of $15,000.*
   - *No part of the short-term capital loss is available to offset any of the gain in the 0%/15%/20% group.*

2. Within each of the three long-term capital gain groups, gains and losses are netted to arrive at a net capital gain or a net capital loss for the group.
3. A net loss from the 28% rate group (including long-term capital loss carryovers) is used first to reduce gain from the 25% rate group. Any balance is then used to reduce net gain from the 0%/15%/20% rate group.
4. A net loss from the 0%/15%/20% rate group is used first to reduce gain from the 28% rate group. Any balance is then used to reduce net gain from the 25% rate group.

There can only be a capital loss in the 28% and 0%/15%/20% rate groups since the 25% group only applies to gain on the recapture of depreciation. If there were a loss on the sale of Sec 1250 property, the loss would be a Form 4797 ordinary loss that totally bypasses the Schedule D computation.

DIFFERING BASIS AMT AND REGULAR TAX

Depreciated Assets **–** Certain assets are depreciated differently for AMT than for Regular tax and consequently have a different basis (generally higher) for AMT purposes than for regular tax purposes even if the taxpayer has never been subject to the AMT. For example residential real estate rentals placed in service before 1999 are depreciated 27.5 Years for regular tax purposes and 40 Years for the AMT.

ISO Shares - If a stock option is a qualified option, sometimes referred to as an incentive stock option (ISO), generally no amount of income is included in income either at the time the option is granted or at the time it is exercised for regular tax purposes but not for AMT purposes. Income or loss is recognized when the stock is sold. Stock acquired under an ISO option is treated as a capital gain or loss if it is held:

- ***More than 1 year after*** the stock option was ***exercised***, ***and***
- ***More than 2 years after*** the option was, ***granted.***

Clients are not generally aware of the alternative minimum tax (AMT) and will forget that the stock acquired through an ISO has one basis for regular tax purposes and another for alternative minimum tax.

- **Regular Tax Basis** – is the option price per share.
- **AMT Tax Basis** – is the exercise price per share.

Thus, in the sale year, there is a negative adjustment for AMT purposes which will lower the tentative minimum tax, reducing or eliminating the AMT and possibly allowing a larger AMT tax credit if the tentative minimum tax is less than the regular tax.

BROKER BASIS REPORTING:

Every broker that is required to file an information return reporting the gross proceeds of a "covered security" must include in the return the customer's adjusted basis in the security and whether any gain or loss with respect to the security is short-term or long-term. (Code Sec. 6045(a))

The customer's adjusted basis is determined:

1. **Average Basis Method Not Permitted** - In the case of any security (other than any stock for which an average basis method is permissible under Code Sec. 1012), in accordance with the first-in first-out (FIFO) method unless the customer notifies the broker by means of making an adequate identification of the stock sold or transferred, and
2. **Average Basis Method Permitted** - In the case of any stock for which an average basis method is permissible under Code Sec. 1012, in accordance with the broker's default method unless the customer notifies the broker that he elects another acceptable method under Code Sec. 1012 with respect to the account in which the stock is held.
3. **Wash Sales** - Customer's adjusted basis is determined without regard to the wash sales rules unless the transactions occur in the same account with respect to identical securities. This will create matching problems for those sales where the basis has been adjusted under the wash sale rules.

Covered Security **-** The term "covered security" means any "specified security" acquired on or after January 1, 2011 (January 1, 2012 where the average basis method is permissible) if the security was:

1. Acquired through a transaction in the account in which the security is held, or
2. Was transferred to the account from an account in which the security was a covered security, but only if the broker received a statement under Code Sec. 6045A with respect to the transfer.

Short Sale - Reporting is in the year in which the sale is closed.

Specified Security - The term "specified security" means any:

(a) Share of stock in a corporation,

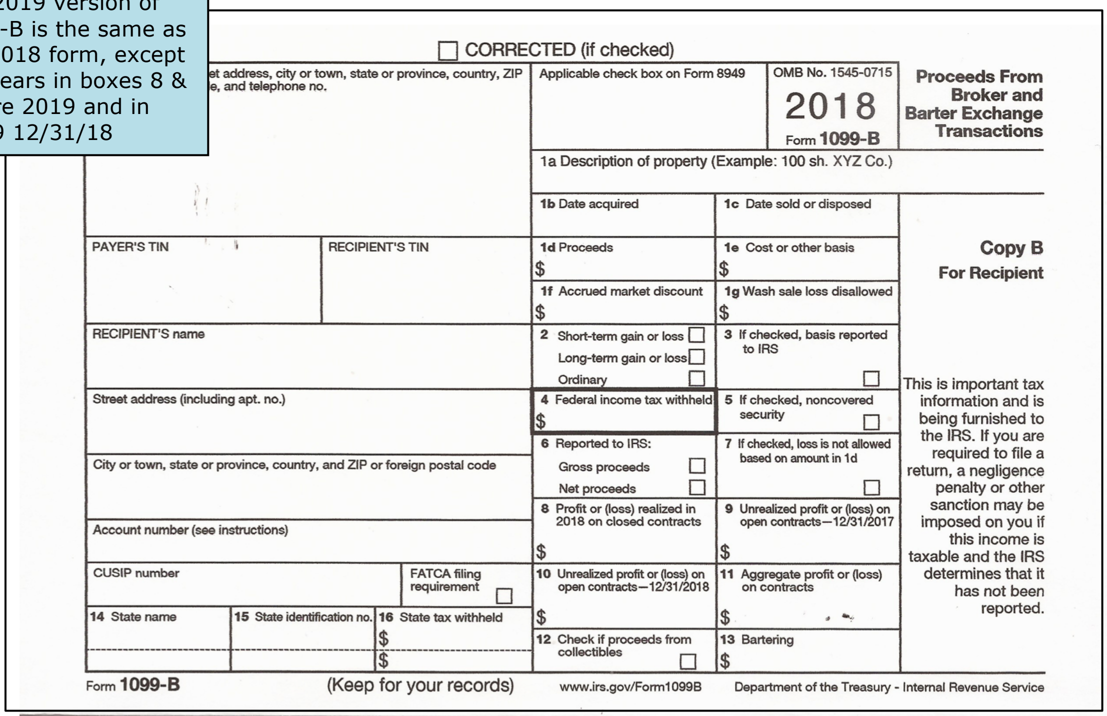
(b) Note, bond, debenture, or other evidence of indebtedness – to apply to acquisitions of less complex debt instruments acquired on or after 1/1/14 (see Reg. 1.6045-1(a)(14)(ii) and (n)(2) for definitions) and to more complex debt instruments with a fixed yield and maturity date and for more complex debt without a fixed yield and maturity date acquired on or after 1/1/2016 (Reg. 1.6045-1(a)(14)(ii) and (n)(3)),

(c) Commodity, or contract or derivative with respect to the commodity, if IRS determines that adjusted basis reporting is appropriate, and

(d) Other financial instrument with respect to which IRS determines that adjusted basis reporting is appropriate.

Form 1099-B – The 1099-B includes the basis and profit or loss information required by the broker reporting rules. The official format is shown below. Substitutes from brokers that incorporate the same information as required on the official form are permitted. Unfortunately, it seems no two are alike, making interpreting the information and entering it correctly into software a challenge to the return preparer. Broker statements that aren't categorized in such a fashion that permit copies of the statements to be submitted, and allow the practitioner to say "see attached" on the Form 8949, means that each transaction has to be separately listed – a real nightmare with clients who have a significant number of transactions for the year. IRS instructions clearly state that it is not permissible to enter "available upon request" and summary totals in lieu of reporting details on summary statements or Form 8949.

The 2019 version of 1099-B is the same as the 2018 form, except the years in boxes 8 & 10 are 2019 and in box 9 12/31/18


CORRECTED (if checked)

...et address, city or town, state or province, country, ZIP ...e, and telephone no.

Applicable check box on Form 8949

OMB No. 1545-0715

2018

Form 1099-B

Proceeds From Broker and Barter Exchange Transactions

1a Description of property (Example: 100 sh. XYZ Co.)

1b Date acquired

1c Date sold or disposed

PAYER'S TIN

RECIPIENT'S TIN

1d Proceeds $

1e Cost or other basis $

Copy B For Recipient

1f Accrued market discount $

1g Wash sale loss disallowed $

RECIPIENT'S name

2 Short-term gain or loss ☐ Long-term gain or loss ☐ Ordinary ☐

3 If checked, basis reported to IRS ☐

Street address (including apt. no.)

4 Federal income tax withheld $

5 If checked, noncovered security ☐

City or town, state or province, country, and ZIP or foreign postal code

6 Reported to IRS: Gross proceeds ☐ Net proceeds ☐

7 If checked, loss is not allowed based on amount in 1d ☐

Account number (see instructions)

8 Profit or (loss) realized in 2018 on closed contracts $

9 Unrealized profit or (loss) on open contracts—12/31/2017 $

CUSIP number

FATCA filing requirement ☐

10 Unrealized profit or (loss) on open contracts—12/31/2018 $

11 Aggregate profit or (loss) on contracts $

This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

14 State name

15 State identification no.

16 State tax withheld $ $

12 Check if proceeds from collectibles ☐

13 Bartering $

Form 1099-B (Keep for your records) www.irs.gov/Form1099B Department of the Treasury - Internal Revenue Service

Form 8949 – It is used to show the individual transactions and Schedule D is used for summary and calculation. For Form 8949 the transactions must be segregated into three categories for both long-term and short-term transactions. This will facilitate the IRS' ability to match transactions with the broker reporting requirements. The three categories are:

- Gains and Losses when 1099-B, Box 3 is checked – basis has been provided (check box A (Part I) or D (Part II) on 8949).
- Gains and Losses when 1099-B, Box 3 is not checked – basis is not provided (check box B (Part I) or E (Part II) on 8949).
- Gains and Losses where no 1099-B received (check box C (Part I) or F (Part II) on 8949).

The three categories cannot be mixed on a single Form 8949. Thus for example if you have one transaction in each category for long-term and one each for short-term, six separate 8949s will be required.

Part I is for the short-term transactions and Part II is for the long-term transactions.

Form 8949 has space for an entry for each transaction called "Adjustment, if any, to Gain or Loss." For example, this box is used to adjust for wash sales or to make an adjustment when the taxpayer disagrees with the broker's basis determination. A code corresponding to the reason for the adjustment must be entered in column (f). The list of codes and instructions for column (g) entries is included at the end of the chapter.

Example – Wash Sale*: Joe purchased 100 shares of X Corp on April 4, 2019 for $1,200 and sold the shares on August 8, 2019 for $1,000, resulting in a short-term capital loss of $200. On August 14, 2019 he purchased 100 shares of X Corp for $1,100. Because he purchased identical shares within 30 days of selling the first batch of X Corp at a loss, Joe has a wash sale and cannot deduct the $200 loss from the sale. On Form 8949, in addition to entering the description, purchase and sale dates, and sales price and cost amounts, he will enter 200 (positive number) in column (g) and code "W" in column (f). The positive 200 in column (g) offsets the $200 loss from the sale, thus resulting in zero gain or loss for the transaction.*

Form **8949** Department of the Treasury Internal Revenue Service

Sales and Other Dispositions of Capital Assets

► Go to *www.irs.gov/Form8949* for instructions and the latest information.

► File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074 2019 Attachment Sequence No. **12A**

Name(s) shown on return: JOE EXAMPLE | Social security number or taxpayer identification number: 111-11-1111

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are generally short-term (see instructions). For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☑ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
100 SH X CORP	4/4/19	8/8/19	1000	1200	w	200	0

Entering multiple transactions on Form 8949 – For individuals, instead of reporting each transaction on a separate row of Part I or Part II, a statement containing all the same information and in a similar format to the 8949 may be attached. The combined short-term total from all of the statements is entered in Part I with the appropriate box A, B, or C checked and the long-term total is entered in Part II with box D, E or F checked. If attaching a broker-provided statement, enter the name of the broker followed by the words "see attached statement" in column (a). Leave columns (b) and (c) blank. Enter code M in column (f), along with any other applicable codes. If there are statements for more than one broker, report the totals from each broker on a separate row. E-filers who don't report each transaction on a separate row must either include the 8949 as a PDF attachment to the return or attach the 8949 to Form 8453 and mail the forms to the IRS. Statements that are in the same format as the 8949 may be attached instead. (Form 8949 instructions, 2018)

Form 8949 not required in some cases – Certain transactions may be aggregated and reported directly on either line 1a (short-term) or 8a (long-term) of Schedule D in lieu of completing Form 8949. This option applies to transactions (other than sales of collectibles) for which:

- Form 1099-B or substitute statement shows basis was reported to the IRS and does not show any adjustments in box 1(f) (accrued market discount) or 1(g) (disallowed wash sale loss),
- The ordinary box in box 2 isn't checked, and
- No adjustments to basis, type of gain or loss (long- or short-term), or to the gain or loss are needed.

This exception for completing Form 8949 can be used for some of the transactions and the attachment of broker's statements may be used for other transactions to eliminate the need to list all transactions separately on the 8949. (Form 8949 instructions, 2018)

Schedule D **-** The column totals on Form 8949 for sales price (gross proceeds), basis and adjustments to gain or loss are transferred to the Schedule D. Also entered on Schedule D are the capital gains and losses passed through from partnerships, S corps, estates and trusts; amounts transferred from Forms 4797, 6252, etc.; capital gain distributions; and capital loss carryforwards. Thus the Schedule D is used to summarize and combine the information flowing from one or more Form 8949s and other forms.

Practice Tip

Most larger brokerage firms can generally provide the transactions on an Excel spreadsheet and most tax preparation software will map and read the spreadsheet data into the tax program, although you may still have to tag each transaction to denote whether it is a covered or uncovered transaction – covered transactions being those that are "covered" by the basis reporting requirements.

DETERMINING BASIS WHEN DOCUMENTATION IS MISSING:

The rules requiring brokers to report basis when stock is sold only apply to stocks acquired on January 1, 2011 or after. Even so, many brokers will report basis information, when known, for uncovered securities, such as those purchased before 2011 or otherwise not considered a covered security. Not only do clients need to confirm that the basis information reported by the broker is correct, but they may need to supply basis information for stocks for which the broker has no basis information. If the taxpayer cannot prove their basis amount (such as with trade confirmation tickets or brokerage statements), there may be no option but to use a zero basis. Sometimes internet research can help. For example, say a client inherited stock but doesn't know what the value was on the date of death, but does know what that date was. Using web sites such as http://bigcharts.marketwatch.com/historical/ to get the historical data could provide enough information to establish a basis.

Form 8937 – Report of Organizational Actions **–** Issuers of "specified securities" are required to file Form 8937, Report of Organizational Actions Affecting Basis of Securities, with the IRS when events occur such as nontaxable cash distributions or nontaxable stock distributions to shareholders, including stock splits. The report need not be filed with IRS and a copy is not required to be given to individual shareholders if the company posts a completed copy of the 8937 on its web site and keeps it accessible to the public for 10 years. The information included on the form may be helpful in determining basis when there have been mergers or spin-offs and your client doesn't have the details of how their original basis should be adjusted.

MONEY MARKET FUNDS:

A money market fund (MMF) is a type of mutual fund that generally holds short-term and low risk securities such as cash or cash equivalents, with the result that shares in these funds have typically been issued, valued and redeemed at $1.00 per share, and therefore no gain or loss resulted when shares were redeemed. However, the Securities and Exchange Commission (SEC) issued final rules in July 2014 that would require certain MMFs to value securities using market-based factors (floating value) that could result in redeemed MMF shares producing a gain or loss.

In response to the SEC's rules change, the IRS proposed regulations to simplify the recognition of gain or loss on floating-net asset value (NAV) MMF shares; the regulations were finalized, generally applicable to tax years ending on or after July 8, 2016. (Reg. Sec. 1.446-7; T.D. 9774, 7/7/16) Under the accounting method permitted and described in the regulations, aggregate gain or loss is determined for each "computation period," and no gain or loss is determined for any particular redemption of a taxpayer's shares in the MMF. Generally, under the NAV method, the net gain or loss for each computation period for the shares in an MMF to which the NAV method applies equals the ending value, minus the starting basis, minus the net investment in the MMF for the computation period. The net gain or loss for a tax year on shares in an MMF is the sum of the net gains or losses on shares in the MMF for the computation period or periods that make up the tax year. The final rules allow computation periods to be of equal or varying length whereas the proposed regs required them to be of approximately equal duration.

The proposed regs had allowed only floating-NAV MMFs to use the NAV method, while the final rules allow stable-NAV MMFs to use the NAV method as well. Capital gains and losses determined under the NAV method are treated as short-term capital gains and losses. The final regs allow MMF shareholders to use different methods of accounting for shares in different MMFs or for shares in a single MMF held in different accounts.

Accounting Method Change - Reg Sec 1.446-7(c)(8) provides that a change to or from the NAV method is a change in method of accounting and as such, the taxpayer will need to secure the consent of the Commissioner before changing accounting methods. Rev Proc 2016-39, issued as a companion to the final regs, provides that, under certain circumstances, such a change must be made under the automatic change procedures in Rev. Proc. 2015-13. Any such change will be made on a cut-off basis, and therefore no Sec 481(a) adjustment will be required or permitted.

In certain circumstances, Rev. Proc. 2016-39 permits taxpayers to change to the NAV method without filing a Form 3115, "Application for Change in Accounting Method." This simplified procedure applies to a taxpayer that holds shares in a stable-NAV MMF and wants to change to the NAV method for a taxable year if (1) the taxpayer has not used the NAV method for shares in the MMF for any taxable year prior to the year of change, and (2) prior to the beginning of the year of change, either (a) the taxpayer's basis in each share of the MMF has been at all times equal to the MMF's target share price ($1 in most cases), or (b) the taxpayer has not realized any gain or loss with respect to shares in the MMF.

Information Reporting - Brokers are not required to include the sale of NAV method shares on Form 1099-B for a sale of shares in a money market fund, effective for sales of shares in calendar years beginning on or after July 8, 2016 (i.e., 2017 for calendar year taxpayers). However, taxpayers and brokers can rely on the rules for sales of shares in calendar years beginning before July 8, 2016.

Wash Sales – See chapter 2.05.

INSURANCE COMPANY DEMUTUALIZATIONS:

Demutualization is the term that is used when a mutual owned insurance company converts to a stock company. ***Tax consequences for policyholders receiving stock or cash -*** IRS has issued a number of private letter rulings in which a conversion from a mutual life insurance company to a stock life insurance company in which policyholders exchange their membership interests in the company for stock is treated as a tax-free recapitalization under Code Sec. 368(a)(1)(E) with these results for policyholders (see e.g., PLR 200111013 and PLR 200112014):

- **No gain or loss recognized** – Policyholders don't recognize gain or loss on their exchange of membership interests for company stock under Code Sec. 354(a)(1).
- **Holding period includes membership period** - Under Code Sec. 1223(1), their holding period for the stock includes the period they held the membership interest if it was held as a capital asset on the date of the exchange.
- **Capital gain** - Policyholders receiving cash for their membership interests generally recognize capital gain under Code Sec. 302 and Code Sec. 1001. See holding period above to determine if gain is long- or short-term.
  - **Stock Basis –** The IRS position related to basis of stock received in a demutualization is that it is zero. However in *Fisher v. United States, 2008-2 ustc ¶50,481* a taxpayer was ruled to have no gain from a cash option (in lieu of stock) received in demutualization. That position was upheld by the U.S. Court of Appeals. The IRS decided not to appeal to the U.S. Supreme Court. However, although the IRS lost this case, the Service has not acquiesced; their position that the stock received from the demutualization has a zero basis has not changed. In another case the U.S. District Court of Arizona held that shareholders had basis in stock received in a demutualization, but the Ninth Circuit reversed this decision and agreed with the IRS that the taxpayers' basis in the stock received was zero. (*Dorrance v. United States, D. Ariz., 2013-1 ustc ¶50,236, rev'd, CA-9, 2015-2 ustc ¶50,588)*

CAPITAL GAINS ON INHERITED PROPERTY:

Holding period - Property acquired from a decedent is treated as having been held for more than a year if:

1. The person selling the property has a basis that is determined under the rules for inherited property, and
2. The property is disposed of within one year after the date of the decedent's death. Of course, if the person who received the property held it for more than one year before selling it, the sale would get long-term treatment under the normal holding period rules.

Basis - Under the rule of Code § 1014(a), the basis of inherited property is ordinarily stepped-up (or down) to its fair market value as of the date of decedent's death or alternate valuation date. The alternate valuation date is the date six months after a decedent's death, or if the property has been distributed within that six months, then the date of the distribution. *Code Sec. 1014(a); Code Sec. 2032* However, an alternate valuation date only applies if there is a taxable estate and using the alternate valuation results in a lower estate tax. (**Caution:** these rules do not apply to property inherited from an individual who died in 2010 if the "no estate tax" provision was elected by the executor – See Chapter 1.05).

Consistency reporting – When an estate tax return is filed after July 2015, an estate and others who are required to file Form 706 must complete and file Form 8971 and Schedule A to report the final estate tax value of property distributed or to be distributed from the estate. A copy of Schedule A must be provided to the beneficiary of the property. A beneficiary may not use a value higher than the value reported on Schedule A of Form 8971 as their initial basis in the property, and if the beneficiary reports a basis that is inconsistent with the amount reported on Schedule A, the beneficiary may be liable for a 20% accuracy-related penalty. The consistency in reporting applies only to property that was includible in the decedent's gross estate and resulted in increased estate tax liability (reduced by applicable credits) on the estate. If a 706 is not required because the value of the estate is less than the lifetime exclusion amount, but is filed only to preserve the deceased spouse's unused exclusion for the surviving spouse, Form 8971 is not required to be filed.

If no Federal estate tax return is required, an appraisal as of the date of the decedent's death for state inheritance or other transmission (e.g., legacy) taxes is used for basis purposes. In this situation, no alternate valuation date is used. These appraisals govern unless there is sufficient evidence of another value. *(Reg § 1.1014-3(a))*

GAINS ON BONDS PURCHASED AT A PREMIUM:

If you buy a bond at a premium, the following rules apply:

- *Tax Exempt Bonds* - the premium **must** be amortized over the term of the bond (Code Sec. 171(a)(2)). While no deduction is permitted for the amount of premium amortized in each year, the effect is to reduce basis in the bond by a corresponding amount. Thus, if the taxpayer holds it to maturity, no loss is recognized when the bond is paid off.
- *Taxable Bonds* - the premium **may** be amortized at the holder's election.

Normally, the sale, call before maturity or redemption of a municipal bond is treated the same as a taxable bond. If the bond was held long enough, any gain is taxed at long-term capital gain rates.

MARKET DISCOUNT BONDS (IRC SECTIONS 1276 & 1278):

If the value of a bond decreases after its issue date (usually because interest rates have increased), it is considered to have market discount. Bonds purchased on the secondary market at less than face value often have market discount. However, market discount bonds do NOT include obligations maturing within one year of issue, tax-exempt obligations purchased before May 1, 1993, U.S. savings bonds, and installment bonds.

What is Market Discount? – Market discount is the amount of the stated redemption price of the bond at maturity that is more than the taxpayer's basis in the bond immediately after it is acquired. Under a *de minimis* rule, market discount is zero if it is less than 1/4 of 1% (.0025) of the stated redemption price of the bond multiplied by the number of full years to maturity after acquisition by the taxpayer.

Election to Report Accrued Market Discount Currently - Taxpayers who purchase market discount bonds may elect to accrue the market discount and include the discount in income each year the bond is owned. The amount is reported as interest income. Additionally, the bond's basis is increased by the accrued discount. Once this method is elected, it applies to all market discount bonds acquired during the tax year and in future years. The election is irrevocable without consent of the IRS. To make the election, attach a statement to a timely filed return that states the market discount has been included in gross income for the year under IRC Sec 1278(b) and describe the method used to figure the accrued market discount for the year.

In the year the bond matures or is sold, Form 1099-B may show accrued market discount in box 1f. In that case, enter code "D" in column f and zero in column g of Form 8949; if the basis reported in box 1e of the 1099-B hasn't been increased by the accrued market discount for all years, also enter code "B" in column f of the 8949 and increase the basis entered in column e as necessary.

How to Report if Election Not Made - If the taxpayer does not elect to include the discount in income as it accrues, then when the bond is disposed of, any gain is treated as ordinary interest income, rather than capital gain, up to the amount of the accrued market discount. In either the long-term or short-term section of Form 8949, as applicable, report the sale as usual, but enter the accrued market discount amount included in box 1f of Form 1099-B as a negative amount in column g and enter code "D" in column (f). Also report the accrued market discount as interest income. (Caution: if the broker has provided a basis that is already adjusted for the accrued market discount amount, but the taxpayer did not make the election to report the discount annually, use code B in column f and in column g adjust the gain by the amount needed to correct the basis that was reported.) While each tax program functions slightly differently, the following entries should work on most programs – this example assumes that the broker had not adjusted the acquisition cost by the accrued market discount:

Description	Date Acq.	Date Sold	Sales Price	Cost	Col f Code	Adjust-ment	Gain/ (Loss)
2000 ABC Inc 4.5% 8/1/19	11/25/17	8/1/19	2000	1829	D	(171)	0

Also report the amount of accrued market discount as interest income on Schedule B, identified as "accrued market discount." In the illustration above, $171 will be entered in the interest income section of Schedule B.

Figuring Accrued Market Discount – The simplest way to figure the accrued market discount is the ***ratable method***: treat the market discount as accruing in equal daily installments during the period the bond is held. The daily amount is figured by dividing the market discount by the number of days after the date the taxpayer acquired the bond, up to and including the maturity date, and multiplying the result by the number of days the bond was held.

An alternative method is the constant yield method. Once made for a particular bond, this method cannot be changed. For information on computing the constant yield method, see IRS Pub. 1212.

Other Issues – See IRS Pub. 550, Chapter 1, for information on the effect on market discount bonds if the bond was originally issued at a discount, the treatment of partial principal payments and how to handle the discount on obligations with a fixed maturity date of one year or less from the issue date.

SECTION 1256 CONTRACTS & REGULATED FUTURES CONTRACTS:

Taxpayers report gains and losses from regulated futures contracts and other "Section 1256 contracts" annually under the "mark-to-market" rules. All Section 1256 contracts must be marked to market at year-end. Each contract held by a taxpayer is treated as if it were sold for FMV on the last business day of the year.

If a taxpayer holds Section 1256 contracts at the beginning of a tax year, any gain or loss later realized on the contracts must be adjusted to reflect any gain or loss taken into account with respect to the contracts in an earlier year. Any capital gain or loss on a Section 1256 futures contract is treated as if 40% of the gain or loss is short-term capital gain or loss, and 60% of the gain or loss is long-term capital gain or loss. Use Form 6781.

SETTLEMENT WITH STOCKBROKER YIELDED CAPITAL GAIN:

The IRS has privately ruled that an amount taxpayers received under a settlement agreement with their stockbroker after they accused him of mishandling their account was properly reportable as capital gain rather than as ordinary income. The IRS ruling specifies the loss recovery takes on the same character as the original losses, and therefore is treated as a long-term capital gain on Schedule D rather than ordinary income. (PLR 200724012)

CAPITAL GAINS FOR SELF-CREATED MUSICAL WORKS:

Capital gains treatment is allowed for musical compositions or copyrights of musical works created by the taxpayer's personal efforts when so elected by the taxpayer. (IRC Sec 1221(b)(3)) The election is made separately for each composition or copyright in a musical work by treating the sale as the sale of a capital asset, in accordance with the Schedule D/Form 8949 and its instructions. The election must be made on or before the extended due date of the return for the year of the sale.

PATENTS NO LONGER GET CAPITAL GAIN TREATMENT:

Prior to 2018, IRC Sec 1235 allowed the transfer (other than by gift, inheritance, etc.) of all substantial rights in a patent by an inventor and by certain individuals who acquired their interest before the invention was put into use to be treated as a sale or exchange of a capital asset held more than a year.

TCJA

The TCJA, effective for dispositions after December 31, 2017, amends section 1221(a)(3), which defines "capital asset," resulting in the exclusion of a patent, invention, model or design (whether or not patented), and a secret formula or process from the definition of a "capital asset." This change applies to the taxpayer who created the property and a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created). Thus, even though Sec 1235 wasn't repealed by TCJA, because of the change to Sec 1221, gains or losses from the sale of a patent, etc., will not receive capital gain treatment.

SHORT-SALE HOLDING PERIOD RULES:

Even if property used to cover a short sale was held more than the short-term holding period, under Code Section 1233(b) capital gain on the short sale is treated as short-term capital gain if the seller owns substantially identical property for not more than the short-term holding period. If property covering a short sale was held not more than the short-term holding period, capital loss on the sale is treated as long-term capital loss if the seller owns substantially identical property held for more than the short-term holding period.

STOCK OPTIONS:

Call Options – A call option (or simply a "call") is an option contract giving the owner thereof the right to purchase from the writer of the call, at any time before a specified future date and time, a stated number of shares of a particular stock at a specified price (the "strike price"). *(Rev Ruling 78-182, 1978-1 CB 265; 58-234, 1958-1 CB 279)*

Put Options – A put option (or simply a "put") is an option contract giving the owner thereof the right to sell to the writer of the put (i.e. "put it to him"), at any time before a specified future date and time, a stated number of shares of a particular stock at a specified price. *(Rev Ruling 78-182, 1978-1 CB 265; 58-234, 1958-1 CB 279)*

> ***Why options?*** Typically, an individual purchases a call option expecting the value of the stock to increase. The option writer expects the value to remain the same or decline. The option holder will exercise the option if the price of the stock increases beyond the strike price, but if the value declines, the holder will allow the option to lapse.

Caution - *Adverse tax effects can be triggered if the purchaser or seller of an option also has a position in the underlying security. The following are some of the potential tax ramifications:*

- *Certain combinations of options held contemporaneously with offsetting positions which have the effect of reducing both the taxpayer's risk of loss and opportunity for gain may trigger constructive sales treatment under IRC Sec 1259.*
- *Purchase of an option may trigger the wash sale rules if it occurs 30 days before or after the sale of substantially identical stock or securities (IRC Sec 1233(b)).*
- *The purchase of a put is treated under Section 1233(b) in the same manner as a short sale and may result in the creation of a tax straddle with respect to the underlying stock.*
- *If the underlying stock upon which the option contract is written becomes worthless, a contract will be deemed closed. (IRC Sec 1233(h)(1))*

Treatment by the Option Owner (Purchaser):

Purchase of Option – Puts and calls are capital assets in the hands of an investor. The amount the purchaser pays the writer of the option is referred to as the "premium" or the "option premium". Generally, no gain or loss is incurred upon the purchase of puts or calls and expenses incurred are not deductible but are added to the basis.

Sale of Call or Put Options before Exercise or Expiration – If a call option is sold prior to being exercised or expiring, the transaction is treated as the sale of a capital asset and any gain or loss is a capital gain or loss. Holding period will determine whether it is long- or short-term.

Put options other than "married options" are deemed to be short-term. The taxpayer's basis in the option is the total "premium" paid plus commissions.

Closing Sale – Listed Call or Put Options – A closing sale (i.e., the sale in the market of a call option identical to the one held) is taxed as the sale of a capital asset. To the extent any premium received in the sale (less commissions) exceeds the taxpayer's basis in the call option, the taxpayer will recognize a capital gain. If the taxpayer's basis exceeds the premium received, the taxpayer will recognize a capital loss. Holding period for call options will determine if it is long- or short-term. Put options other than "married options" are deemed to be short-term.

Call or Put Option Expires – If the option expires, it is deemed sold on the expiration date and the taxpayer recognizes a loss to the extent of the basis in the option. Holding period will determine if it's long- or short-term.

Call Option Exercised – If the taxpayer exercises the call option, no taxable event takes place. The taxpayer's basis in the call is added to the purchase price of the stock.

Put Option Exercised – When a put is exercised, the owner of the put sells the underlying stock to the writer of the put and it is the sale of the stock that is taxed. The put premium paid is added to the basis of the underlying stock. Any gain or loss resulting from the transaction is a capital gain or loss.

"Married" Put Options – Married put options receive special treatment when all of the following conditions apply:

- The put must be purchased on the same day as the stock the taxpayer intends to use for exercising the option, and
- The option must specify that such stock is to be used in exercising the option of the taxpayer within 15 days of when it identifies it as such, and
- If the put is exercised, it must be exercised through the stock identified. If all of the conditions are met, the sale will not be treated as a short sale for tax purposes.

Treatment by the Option Writer (Seller)***:***

Sale of an Option – There is no taxable event at the time the option is sold. It is treated as an uncompleted transaction until such time as the option is exercised, sold, lapses, or until the writer's obligation is terminated in closing the transaction.

Sales Commissions – The sales commissions are not deductible as investment expenses. They reduce the amount of premium recognized from the sale of the option(s).

Put or Call Expires – When a put or call expires, the writer recognizes a short-term capital gain to the extent of the deferred premium income less commissions.

Call Exercised – When the owner exercises the call, the call writer sells the underlying stock to the owner. For the option writer, the call premium is added to the strike price received and the gain or loss, recognized on the date of sale, is the difference between the total amount realized and the writer's basis in the stock. Short-or long-term treatment is based upon the holding period for the underlying stock.

Put Exercised – When the owner exercises a put, the writer is forced to buy the underlying stock from the owner. This is treated as the purchase of a security and the premium received by the writer reduces the basis in the stock. The holding period for the stock purchased begins when the stock was purchased, not when the put was sold (Rev Ruling 78-182, 1978-1 CB 265).

Closing Purchase – Listed Call or Put Options – A closing sale (i.e., the sale in the market of a call option identical to the one held) is taxed as a short-term capital gain or loss. The gain or loss is determined by subtracting the premium paid for the closing purchase from the premium received from the original sale of the option.

Repurchases Unlisted Options from the Holder – If the writer repurchases the option contract from the holder, the taxpayer will recognize a short-term capital gain or loss to the extent of the difference between the premium paid and the premium received.

NONRECAPTURED SECTION 1231 LOSSES/GAINS:

Under Code Section 1231(c), net Section 1231 gain for a tax year is treated as ordinary income to the extent of nonrecaptured net Section 1231 losses (if any) for the five most recent preceding tax years. If any amount is treated as ordinary income under Code Sec. 1231(c), that amount is to be allocated among the categories of net Section 1231 gain as indicated in IRS forms or regulations.

DAY TRADER:

Very active traders generally are in the same boat as regular investors when it comes to gains and losses. Regardless of how frequently they trade, their sales generate long- or short-term capital gain or loss reported on Schedule D.

Whether a taxpayer's investment activities are sufficient to constitute carrying on a trade or business requires an examination of the facts in each case.

CAUTION

The vast majority of taxpayers who manage their own investments are investors rather than traders. **Proving that one's investment activities rise to the level of carrying on a trade or business is a difficult hill to climb**.

In determining whether a taxpayer who manages his own investments is a trader, who is engaged in a trade or business, or an investor, who isn't, courts consider the:

- Taxpayer's investment intent;
- Nature of the income to be derived from the activity; and
- Frequency, extent, and regularity of the taxpayer's securities transactions.

According to the Tax Court (and this issue has frequently been there), the distinction between a trader and an investor is that a trader buys and sells securities with reasonable frequency in an effort to catch the swings in the daily market movements and thus profit on a short-term basis. On the other hand, an investor purchases securities to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market.

Written Election Required – To be a day trader a taxpayer must make the mark-to-market (MTM) rules election. To make that election, the taxpayer generally must file a required statement no later than the due date (without regard to extensions) of the original federal income tax return for the tax year immediately *preceding* the "election year." The statement must be attached to that return or, if applicable, to a request for an extension of time to file that return. (Rev Proc 99-17, 1999-7 IRB 52, 5.03(1))

It May Be Too late
For the election to apply to the 2019 year, it must have been made by Apr. 15, 2019.

Tax Treatment - Day traders who have elected to follow the mark-to-market (MTM) rules apply the following tax treatment to their transactions:

(1) Gain or loss is recognized on any security (or commodity) held in connection with his trade or business at the close of any tax year as if the security (or commodity) were sold for its fair market value on the last business day of the tax year, and

(2) Gain or loss is taken into account for the tax year as ordinary income or loss.

(3) Wash sale rules do not apply.

(4) Form 4797 and not Schedule D/Form 8949 is used to report the gains and losses.

In other words, a stock trader who closes out the year with a net loss can use it to offset ordinary income without any limitations, and may wind up with a net operating loss that, starting in 2018, can be carried forward. NOLs occurring prior to 2018 could be carried back 2 years and forward 20 years.

MATCHING GROSS PROCEEDS:

One of the most important aspects of preparing a Schedule D is making sure the gross proceeds from all transactions for the year are reported. Failing to match gross proceeds reported to the IRS will certainly trigger service center inquiry and on occasion, when a large discrepancy exists, it can trigger an audit.

However, frequently for a variety of reasons, it is necessary to make adjustments in the gain or loss. When this happens, be sure to report the full gross proceeds and make adjustments in the cost basis or adjust the gain or loss by entering an adjustment amount and using the appropriate adjustment code on Form 8949, if applicable.

Example – Matching gross proceeds - *After they are divorced, John and Jane sell their jointly-owned investment land for $300,000 ($150,000 allocated to each), but the entire gross proceeds are reported under John's social security number on Form 1099-S. Their basis in the property is $100,000 ($50,000 each), which results in a gain of $100,000 each for John and Jane. John's return might be prepared showing the entire $300,000 as the sales price and $200,000 as his basis, resulting in the correct gain of $100,000. However, this overstates his basis. Instead, a more accurate reporting method would be to enter John's basis on Form 8949 as $50,000 (his true basis) and an adjustment in col (g) of the 8949 of 150,000 and code the transaction with an N (nominee). Jane's return reports her sales price as $150,000 with a $50,000 basis, which also results in a $100,000 gain.*

Short Sale – Short sale transactions are not a taxable event until the short sale position is closed out. Prior to 2011, short sales that were still open at the close of the tax year resulted in a taxpayer having unaccounted for gross proceeds to deal with (because the broker was required to report the proceeds on Form 1099-B even if the position hadn't been closed). For sales closed on or after January 1, 2011, brokers will report as follows:

- If using covered securities, both the information concerning the securities sold to open the short sale and the information concerning the securities acquired to close the short sale will be reported on a single information return (1099-B).
- If using non-covered securities, brokers will report only the information related to the securities sold to open the short sale. Brokers may, but are not required, to report adjusted basis for the securities acquired to close the short sale and whether any gain or loss on the short sale is long-term or short-term.

When completing Form 8949, the following instructions apply for the dates in columns (c) and (d):

Acquisition date - col. (c): Enter the dat 02.04.16 acquired the stock delivered to the broker to close the short sale.

Sale date – col. (d): Enter the date the taxpayer delivered the stock to the broker to close the short sale.

Completing Form 8949, Columns (f) and (g) - The following chart is adapted from Form 8949 Instructions (2018).

NOTES: (1) Where "1099-B" is used, the same instructions apply if a substitute statement were received. (2) When instructed to enter a negative number, enter in parentheses. (3) If more than one code applies, net the adjustment amounts for entry in column (g).

Situation	Code to Enter in Col (f)	Other actions required
Received a Form 1099-B (or substitute statement) and the basis shown in box 1e is incorrect.	B	▪ If box B is checked at the top of Part I or if box E is checked at the top of Part II, enter the correct basis in col. (e) and -0- in col. (g). ▪If box A is checked at the top of Part I or if box D is checked at the top of Part II, enter the basis shown on Form 1099-B (or substitute statement) in column (e), even though that basis is incorrect. Correct the error by entering an adjustment in column (g). To figure the adjustment needed, see Worksheet for Basis Adjustments in Column (g) in 8949 instructions.
Form 1099-B received and the type of gain or loss (short-term or long-term) shown in box 2 is incorrect *If box 2 (Ordinary) is checked on the 1099-B and the security is a taxable contingent payment debt instrument subject to the noncontingent bond method, enter code O in column (f); use the* Worksheet for Contingent Payment Debt Instrument Adjustment in Column (g) *in the 8949 instructions.*	T	Enter -0- in col. (g) unless adjustment is required due to another code. Report the gain or loss in the correct part of Form 8949.
Form 1099-B or 1099-S received as a nominee for the actual owner of the property	N	Report the transaction on Form 8949 as if the actual owner, but also enter any resulting gain as a negative adjustment in column (g) or any resulting loss as a positive adjustment in column (g). As a result of this adjustment, the amount in column (h) should be zero. However, if the taxpayer received capital gain distributions as a nominee, report them instead as described under *Capital Gain Distributions* in the Instructions for Schedule D (Form 1040).
Sold or exchanged main home at a gain, must report the sale or exchange on Part II of Form 8949 (as explained in Sale of Your Home in the Instructions for Schedule D (Form 1040)), and can exclude some or all of the gain.	H	Report the sale or exchange on Form 8949 as if no exclusion were being claimed. Then enter the amount of excluded (nontaxable) gain as a negative number in column (g). See the example in the 8949 instructions for column (g)
Form 1099-B shows accrued market discount in box 1(f)	D	Use the *Worksheet for Accrued Market Discount Adjustment in Column (g)* in the instructions to figure the amount to enter in column (g). However, if a partial payment of principal on a bond was received, do not use the worksheet. Instead, enter the smaller of the accrued market discount or the proceeds in column (g). Also report it as interest income. If market discount has been included in income currently (i.e., each year), enter -0- in column (g). Before figuring the gain or loss, increase basis in the bond by the market discount included in income for all years. See the instructions for code B, above. If the disposition of a market discount bond results in a loss subject to the wash sale rules, enter "W" in column (f) and enter only the disallowed wash sale loss in column (g).
Sold or exchanged qualified small business stock and can exclude part of the gain.	Q	Report the sale or exchange on Form 8949 as if not taking the exclusion and enter the amount of the exclusion as a negative number in column (g). However, if the transaction is reported as an installment sale, see "Gain from an installment sale of QSB stock" in the Instructions for Schedule D (Form 1040)
All or part of gain for DC Zone assets or qualified community assets is excludable (see Sch D. instructions for further details)	X	Report the transaction on 8949 as if not taking an exclusion. Then enter the exclusion amount as a negative number in col. (g).

NOTES: (1) Where "1099-B" is used, the same instructions apply if a substitute statement were received. (2) When instructed to enter a negative number, enter in parentheses. (3) If more than one code applies, net the adjustment amounts for entry in column (g).

Situation	Code to Enter in Col (f)	Other actions required
Electing to postpone all or part of the gain under the rules explained in the gain under Schedule D instructions for any rollover of gain (for example, rollover of gain from QSB stock or publicly traded securities).	R	Report the transaction on 8949 as if not making the election. Then enter the amount of postponed gain as a negative number in col. (g).
Wash sale (nondeductible loss)	W	Enter the amount of the nondeductible loss as a positive number in col. (g). If the amount shown on Form 1099-B, box 1g (nondeductible loss) is incorrect, enter the correct amount of the nondeductible loss as a positive number in column (g) of the 8949, and if this amount is less than that shown on the 1099-B, attach an explanation of the difference. If no part of the loss is a nondeductible loss from a wash sale, enter -0- in column (g).
Nondeductible loss for other than a wash sale	L	Enter the amount of the nondeductible loss as a positive number in col. (g).
An expense of sale or certain option premiums are not reflected on 1099-B or 1099-S (or substitute statement) by an adjustment to either the proceeds or basis shown	E	Enter in column (d) the proceeds shown on the form or statement received. Enter in column (e) any cost or other basis shown on Form 1099-B (or substitute statement). In column (g), enter as a negative number any selling expenses and option premium paid (and that are not reflected on the form or statement received) and enter as a positive number any option premium received (and that is not reflected on the form or statement received).
Loss from sale, exchange or worthlessness of Sec 1244 (small business) stock that exceeds the maximum amount that can be treated as an ordinary loss	S	See "Small Business (Section 1244) Stock" in the Schedule D (Form 1040) instructions.
Collectibles were disposed	C	Report the disposition as usual but enter -0- in col. (g).
Multiple transactions are reported on a single row of Form 8949	M	See "Reporting" in text. Enter -0- in col. (g) unless another adjustment applies.
Adjustment not explained in this chart	O	Enter the adjustment amount in col. (g). Although the instructions don't require attachment of an explanation, doing so is recommended by the author.
Electing to postpone all or part of gain invested in Qualified Opportunity Funds (QOF)	Z	Report the transaction that generated the gain being deferred as usual (do not make any deferral adjustments in col. (g)). Report the deferral on its own row of Form 8949; check box C on Part I or Part II depending whether the holding period of the gain being deferred is short- or long-term. In col. (a), enter only the EIN of the QOF into which the gain was invested. In col. (b) enter the date invested in the QOF. Leave columns (c), (d) and (e) blank. Enter "Z" in col. (f), and in col. (g) enter as a negative the amount of deferred gain. Use separate lines if multiple investments were made in different QO Funds or in the same QO Fund on different dates. Gains of the same character (but from different transactions) that were invested on the same date into the same QOF, can be grouped on the same row.

CALIFORNIA DIFFERENCES

California does not have capital gains rates and all such income is taxed at the regular tax rates.

California does not conform to the TCJA amendment to IRC Sec 1221 that excludes a patent, invention, model or design (whether or not patented), and a secret formula or process held by the taxpayer who created the property (and certain other taxpayers) from the definition of a capital asset. Sales of these assets should be reported as capital assets on Schedule D (540), California Capital Gain or Loss Adjustment.

California does not conform to the deferral and exclusion of capital gains reinvested or invested in qualified opportunity zone funds under IRC Sections 1400Z-1 and 1400Z-2.

WASH SALES

WASH SALE DEFINITION: A "wash sale" is a sale or other disposition of stock or securities, **resulting in a loss**, in which the seller, within a ***61-day period (which begins 30 days before and ends 30 days after the date of such sale or disposition),*** replaces the stock or securities by acquiring (by way of purchase or exchange on which the full gain or loss is recognized for tax purposes), or entering a contract or option to acquire, substantially identical stock or securities. (IRC Sec. 1091(a); Reg. Sec. 1.1091-1(a))

RAPID FINDER

OBJECTIVE OF A WASH SALE: Typically, the objective of a wash sale would be to take advantage of the deduction for any capital losses, and then repurchase the shares immediately thereafter.

TAX TREATMENT:

Gains - No special tax rules apply if an investor realizes a gain on a wash sale of stock or other securities; rather, the sale will be taxed under the rules peculiar to both the type of disposition and to the particular stock or securities sold.

Losses - On the other hand, to the extent that shares of stock or securities sold are replaced in a wash sale, any loss realized on the stock or securities sold ***may not be recognized for income tax purposes.*** (IRC Sec. 1091(b); Reg. Sec 1.1091-1(c))

REPLACEMENT:

By gift, inheritance or tax-free exchange - The replacement of stock and securities by way of gift, inheritance, or tax-free exchange will not result in a wash sale. See Reg. Sec. 1.1091-1(f).

Stock warrants, convertible stock - For purposes of the wash sale rule, a stock warrant is considered to be an option to acquire stock of the issuing corporation. (Rev Rul 56-406, 1956-2 CB 523) Preferred stock which is convertible into common stock of the same corporation without restriction is considered to be an option to acquire such common stock. (Rev Rul 77-201, 1977-1 CB 250)

Reducing purchaser's holdings - A bona fide sale of a portion of the shares of stock purchased in a single lot for purposes of reducing the purchaser's holdings in that stock is not a wash sale even though the sale occurs within 30 days after the lot was acquired. (Rev Rul 56-602, 1956-2 CB 257)

Delayed stock delivery - A disposition of stock or securities may not be taken out of the definition of a "wash sale" by merely postponing delivery until more than 30 days after the date of the shares of stock or securities are replaced. (Rev Rul 59-418, 1952-2 CB 184) A purchase of substantially identical stock or securities during the 61-day period will trigger the wash sale rule even though the purchase is made on margin or pursuant to subscription rights acquired prior to the beginning of the 61-day period. See Rev Rul 71-316, 1971-2 CB 311; Rev Rul 71-520, 1971-2 CB 311.

Stock bonus shares - Where a taxpayer received 10 shares of stock as a bonus from his employer, sold them at a loss, and then within the 61-day period received another bonus of 10 shares of the same stock, the Service ruled that a wash sale had occurred; the tax basis of shares received as a bonus is their fair market value at the time of payment. (Rev Rul 73-329, 1973-2 CB 71)

Employee stock options - An employee who, under an employer-employee restricted stock option plan was granted an option to purchase stock of his employer was deemed for purposes of the wash sale rule to have entered into an option to acquire that stock on the date the option is granted; the stock purchased pursuant to such option is deemed to have been acquired on the date the certificates are issued. (Rev Rul 56-452, 1956-2 CB 525)

REPLACEMENT STOCK OR SECURITIES BASIS: The code does not disallow the loss permanently. The code provides that:

1. The ***tax basis*** of the replacement stock must be adjusted to account for the unallowed loss. (This generally has the effect of adding the amount of the unrecognized loss to the cost basis of the replacement stock or securities.) IRC Sec. 1091(d); Reg Sec 1.1091-2, and
2. The ***holding period*** of the replacement stock or securities must be adjusted. This is accomplished by tacking on the holding period of the security sold to the holding period of the replacement securities.

MATCHING TRANSACTIONS: Where identical quantities of stock or securities are sold and replaced in a wash sale, there is little problem in applying the rules discussed above. However, where unequal quantities are sold and replaced or where sales and/or replacements are made in multiple lots (or transactions), the stock or securities sold and the replacement stock or securities must be matched on a chronological basis (beginning with the earliest loss and earliest replacement) before the rules can be properly applied. (IRC Secs. 1091(b) and (c); Reg. Sec. 1.1091-1)

SUBSTANTIALLY IDENTICAL: Whether stocks or securities are substantially identical depends on the facts and circumstances of each case. (Reg. Sec. 1.1233-1(d)(1)) Ordinarily, stocks or securities of one corporation are not substantially identical to stocks or securities of another corporation; however, a different result may occur as, for example, in a reorganization, where facts and circumstances indicate that the stocks and securities of predecessor and successor corporations are substantially identical. (Reg. Sec. 1.1233-1(d)(1)) Where voting trust certificates eventually could be exchanged for common stock held by the trust, the certificates were held to be substantially identical to the common stock of the same corporation. See Kiddler v. Comm., 30 BTA 59 (1934).

Convertible preferred - Where preferred stock is convertible into common stock of the same corporation, the relative values, price changes and other circumstances may make the preferred and common stocks substantially identical. (Reg. Sec. 1.1233-1(d)(1); Rev Rul 77-201)

Stock warrants - A sale of a stock warrant followed within 30 days by purchase of stock are substantially identical only if the relative values and price changes are similar. (GCM 39036 (9-22-83))

Options - Options to buy securities apparently can be considered substantially identical not only to the underlying stock, but to other options or contracts to buy stocks or securities. (Sec 1091(a))

Bonds - Generally, bonds are substantially identical if they are not substantially different in any material feature and are not substantially different in several material features considered together (each of which, if considered alone, would not be regarded as substantial). (Rev. Rul. 58-211) The following are considered material features:

- The interest rate of a bond – Rev Rul 60-195, 1960-1 CB 300
- Maturity dates - Rev Rul 76-346, 1976-2 CB 247
- Differences in bonds as they exist at purchase and at sale - Rev Rul 58-211

MONEY MARKET FUNDS

If a shareholder of a floating-NAV MMF (see Chapter 2.04 for details on this type of money market fund) were to report each redemption of their funds as a sale, then that shareholder would typically experience frequent wash sales. Revenue Procedure 2014-45 provides relief for such a shareholder. If the redemption results in a loss, the IRS will not treat the redemption as part of a wash sale. (Rev. Proc. 2014-45) The final regulations issued in July 2016 did not extend the exemption in Rev Proc 2014-45 to stable-NAV MMFs because the regulations allow shareholders of stable-NAV MMFs to use the NAV accounting method, under which net gain or loss is determined for each computation period rather than each redemption. Thus without a loss on a specific redemption, the wash sale rule does not apply.

WASH SALES & IRA ACCOUNTS: Where a taxpayer sells securities at a loss and purchases substantially identical securities in the taxpayer's IRA or Roth IRA, the IRS in Revenue Ruling 2008-5 has determined that the wash sale rules apply to such a sale and the loss is disallowed. The basis of the securities in the IRA is increased by the amount of the loss (but the basis of the IRA itself is not increased).

CALIFORNIA DIFFERENCES California conforms to the federal wash sale rules.

EMPLOYEE STOCK OPTIONS

Overview

- **Non-qualified stock options**
  - FMV at exercise minus option price = W-2 Income at time of exercise
  - Basis for later sale: FMV at exercise
- **Qualified stock option**
  - Also known as Incentive Stock Options (ISO)
  - Regular tax basis: Option price
  - AMT tax basis: FMV at exercise
  - AMT Preference in year of exercise: FMV at exercise minus option price
  - Qualifications - holding period for capital gains treatment at sale:
    - **More than 1 year after** the stock option was **exercised**, **and**
    - **More than 2 years after** the option was **granted**.
    - Otherwise treatment similar to non-qualified option

RAPID FINDER

Related IRS Publications and Forms

Pubs Forms

- **Pub 525** – Taxable and Non-Taxable Income
- **Form 3921** - Exercise of an Incentive Stock Option Under Section 422(b)
- **Form 3922** - Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c)

Note: As complicated as this subject is, there is no specific IRS publication dealing with the sale of qualified (ISO) and non-qualified options.

The Details

This section will explore the two types of stock options, nonstatutory and incentive stock options (statutory) plus the tax treatment for various transactions involving those two options. In order to provide comparative examples of the various tax treatments, ***the same set of circumstances (illustrated below) will be used for all examples.*** Assume no sales costs.

Comparative Example Data: Employer Stock: Sharp, Inc.
Number of Shares…………………………..1,000
Exercise FMV (per share)…….…..$ 120.00
Option Price (per share)……………….$20.00
Bargain Element (per share)….…..$100.00
Regular W-2 Wages (for year)……$75,000
Filing status: Single

<u>NONSTATUTORY OPTIONS</u>

In the year a nonstatutory option is exercised, the taxpayer's employer will usually include the bargain element gain in the taxpayer's W-2 for that year and treat that income as wages subject to the usual withholding (income tax, FICA, etc.) The amount included in wages should be noted and coded "V" in Box 12 of the W-2.

<u>When is the Option Taxable?</u> If the FMV of the stock on the date the option is granted is greater than the option price, the taxpayer will generally incur taxable income in the year of the grant to the extent of the difference between the grant price and the FMV. If the exercise price at the time of the grant is higher than the FMV, or if the FMV of the stock is not readily determined, the income is included in the year the stock option is exercised.

<u>Stock Sold in Year of Exercise -</u> Typically, the stock is sold by a brokerage house, withholding taxes deducted and remitted to the employer, and the taxpayer issued the net check. Since the gain is already included in the taxpayer's W-2, the stock transaction may or may not need to be reported on Form 8949 as short-term with the cost basis being equal to the FMV at exercise and the sale price being the proceeds amount per the 1099-B (if one is issued or the same amount as the cost basis if not). If the cost and sales price amounts are the same, there will be zero net gain or loss. Otherwise there may be a small loss, accounting for the sales costs. You may wish to use a special ID for the transaction's description such as "[Company Name] NQ Opt" or "NQ Stk Opt – W2 Gain". If a 1099-B was issued and the proceeds amount has not been reduced by selling expenses (e.g., commissions), enter the amount of the selling expenses as an adjustment in column (g) of Form 8949 and use adjustment code E in column (f). If no 1099-B was issued, reduce the gross proceeds by the selling expenses, but do not make a code E adjustment for columns (f) and (g). If no 1099-B was issued and no selling expenses were incurred, the transaction does not need to be included on Form 8949 (taxable income has been included in W-2 wages).

Description	Acquired	Sold	Sales Price	Cost Basis	Gain
NQ Stk Opt - W2 Gain	06/12/19	06/12/19	120,000	120,000	-0-

Gain added to W-2 ($100 x 100)………………..	$ 100,000
Stock Basis for Regular Tax Purposes………..	$ 120,000
Stock Basis for AMT Purposes………………….....	$ 120,000
Tax Preference……………………………...........	None (1)
AMT Tax Credit Carryover……………………….....	No (1)

(1) Unlike Incentive Stock Options (ISO), non-qualified options do not in themselves create an Alternative Minimum Tax. There is no deferral preference; then there can be no AMT Tax Credit Carryover as a result of a non-qualified option.

Stock Not Sold in Year of Exercise: This would be an extremely rare case since the taxpayer would be required to front both the cost of the stock ($20,000 in our example) and be required to pay the employer an amount equal to the withholding taxes on the imputed gain ($100,000 in our example) which is being added to the taxpayer's W-2. If this occurs, nothing is required other than to report the W-2 income. The stock basis will be the exercise price ($120/per share in our example) and the holding period starts on the date the option was exercised (stock was purchased). The decision to hold the stock is an investment decision and the tax implications are the same as having purchased the stock on the open market on the date of the exercise.

Planning Issues:

1. The taxpayer's tax bracket in the year of exercise. Try to plan the exercise in a year when the bracket is low or there are offsetting deductions.
2. FICA Limit. Since the gain will be subject to FICA taxes, the taxpayer would minimize those taxes by exercising the option in a year the taxpayer will have already reached the maximum Social Security wages. The gain will also be subject to the additional 0.9% Medicare (Hospital Insurance) withholding tax if the taxpayer's FICA wages exceed $200,000. Since the gain is treated as ordinary (wage) income, it will not be subject to the 3.8% net investment income surtax, but its inclusion in income does count toward the employee's MAGI, and could push the employee above the threshold at which the 3.8% surtax applies.

Restricted Stock Units **-** Restricted stock units (RSUs) are not the same as restricted stock options. RSUs are an unsecured promise by the employer to grant a set number of shares of stock to the employee upon the completion of a vesting schedule. The stock is not issued at the time of the grant but only after the recipient of the unit satisfies the vesting requirements, which may be met once a predetermined amount of time has gone by or by either the company or the individual attaining pre-established, objective performance goals. If the requirements are not met or the employee leaves the employ of the company prior to the end of the vesting period, the units are typically forfeited to the company. Some types of plans permit a cash payment to be made in lieu of the stock, while most plans require that actual shares of the stock can't be issued until the underlying vesting requirements are met.

Taxation of RSUs **-** Normally, an employee receiving restricted stock units is not taxed at the time of the grant but at vesting, when the restrictions lapse and the employee actually takes receipt of the shares or cash equivalent (depending on the company's plan rules). The amount of income subject to tax is the difference between the fair market value of the grant at the time of vesting, minus the amount paid for the grant, if any. This income is ordinary (compensation) income. There is **no AMT preference** as there is with ISOs. However, the taxpayer could still end up in AMT territory, but this would be due to the increased income, not any other specific attribute of the RSU.

Treatment When Shares Are Sold - When the shares acquired through the RSU plan are sold, the employee recognizes capital gain income or loss, either short- or long-term depending on the actual time the shares are held. The holding period of the shares begins at the date the shares are distributed (which may or may not coincide with the vesting date). The basis of the shares is equal to the amount paid for the stock plus the amount included as ordinary income.

Strategies

Strategy – for same day sales of stock acquired via a stock option, ***Rev. Proc. 2002-50*** provides that the broker is not required to issue Form 1099-B if certain conditions are met, such as when the broker doesn't charge a commission and the employer certifies in writing to the broker that any compensation income generated in the transaction will be reported in the employee's W-2 (or 1099 for an independent contractor).

When the exception in Rev. Proc. 2002-50 doesn't apply, the broker must report the gross proceeds of sale for the transaction on Form 1099-B. In turn, even though the profit is included in the employee's W-2, the taxpayer must report the sale on Form 8949 for the Schedule D to account for those gross proceeds of sale or risk generating correspondence from the IRS. However, frequently overlooked are the broker sales charges, which can generate a short-term capital loss. For example, assuming a 1099-B shows gross proceeds of $55,000, the option cost was $5,000, a brokerage charge of $300 was not reflected in the proceeds amount, and a nonstatutory gain of $50,000 was added to the W-2, there would be a short-term capital loss of $300, and the Form 8949 entry for the transaction would look like:

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Non-stat Opt (Gain in W-2)	7/3/19	7/3/19	55,000	55,000	E	(300)	(300)

INCENTIVE STOCK (STATUTORY) OPTIONS

TCJA

Note: Under TCJA the AMT exemption amounts have been increased and the phase-out threshold for the exemptions has been substantially increased (see chapter 8.00). As a result, larger blocks of incentive option stock can be exercised and held long term without triggering the AMT. Of course you will have to run the numbers to determine where the AMT is triggered.

If the option is an incentive stock option, generally no amount of income is included in income either at the time the option is granted or at the time it is exercised. <u>Income or loss is recognized when the stock is sold</u>. If the stock acquired under the option is held for:

- ***More than 1 year after*** the stock option was ***exercised***, ***and***
- ***More than 2 years after*** the option was ***granted***,

the gain or loss from the sale of the stock is generally a capital gain or loss. The gain for regular tax purposes will be the difference between the exercise price and the sales price. If the stock is sold prior to the required holding period, the income to the extent of the bargain element will be treated as ordinary income (wages).

<u>No FICA Tax on ISOs</u> **-** Both the income from exercising an ISO and the proceeds received upon disposition of the stock acquired in exercising the ISO are exempt from FICA tax. Thus, if not considered FICA wages, the income from exercising the ISO won't be subject to the extra 0.9% Medicare (Hospital Insurance) withholding when wages exceed $200,000. This also means that the ISO income isn't taken into account for purposes of determining Social Security benefits. (This provision does not apply to nonstatutory stock options; when income from a nonstatutory stock option is recognized, it is subject to FICA.) However, when the stock acquired from the ISO is sold in a qualifying disposition, any capital gain from the sale is considered investment income for purposes of the 3.8% surtax on net investment income when the taxpayer's MAGI exceeds the NII MAGI threshold.

<u>AMT Deferral Preference</u> **-** When a taxpayer exercises an incentive stock option, he/she generally recognizes alternative minimum taxable income equal to the excess of the fair market value of the stock on the exercise date over the exercise price; since the ISO preference is a deferral item of preference, an Alternative Minimum Tax Credit carryover may be generated. The basis of the purchased stock, for alternative minimum tax purposes, would be increased by the amount of the AMTI that was recognized when the stock was purchased via the exercise of the option.

The best way to understand incentive stock options is to look at the various possibilities using our comparative example.

Example - Year of Exercise - Stock Sold: This is the more frequently encountered situation, simply because if the stock is held, the taxpayer must have the available financial resources to purchase and hold the stock. More typically the stock is purchased and sold immediately without any cash being required from the taxpayer. The bargain element portion is added to the taxpayer's W-2. The stock transaction is reported on Schedule D with the sales price and the cost basis being the same when entered on Form 8949. On rare occasions, the brokerage firm may sell the stock higher or lower than the exercise price, which will cause some gain or loss on the 8949 and Schedule D.

Year of Exercise & Sale:

Single Filing Status
Gain added to W-2…………………………………….. $100,000
Tax Preference in Year of Exercise…………… None
AMT Tax Credit Carryover……………………….. Not Applicable

Form 8949: *Result is zero gain to Schedule D*

Description	Acquired	Sold	Sales Price	Cost Basis
NQ Stk Opt - W2 Gain	6/12/19	06/12/19	120,000	120,000

Tax Computation:

Description		Reg Tax	AMT
W-2 Income...............................		150,000	150,000
Gain Added to W-2…………………...		100,000	100,000
Deductions:			
Taxes.......................	4,520		
Home Interest...........	15,400		<15,400>
Contributions.............	600		< 600>
Deduction Total............................		<20,520>	
Exemptions …………………………….		-0-	<71,700>
Exemption Phase Out.............		-0-	-0-

Taxable Income......................	229,480	162,300
Tentative AMT........................		**42,198**
Regular Tax...........................	**55,512**	**<55,512>**
AMT		**-0-**

Example - Option Exercised – Stock Not Sold: In order to obtain long-term capital gain treatment on the ultimate sale of the stock, the taxpayer must hold the stock for more than one year after the exercise and two years after the option was granted. In this situation, the bargain element becomes a tax preference item, which may, depending upon the size of the bargain element, create an AMT in the year of the exercise. ISO preference is a "deferral" item of preference, which, if the AMT applies, will generally create an AMT Tax Credit Carryover.

Year of Exercise:

Gain added to W-2...	None
Tax Preference in Year of Exercise................	100,000
AMT Tax Credit Carryover..............................	Yes
Form 6251 - Line 2i (2018 version)..........	100,000
Schedule D...	No

Tax Computation:

Description		Reg Tax	AMT	AMT w/o Pref
W-2 Income..............................		150,000	150,000	150,000
ISO Preference..........................			100,000	
Deductions:				
Taxes................	4,520			
Home Interest....	15,400		<15,400>	<15,400>
Contributions......	600		< 600>	< 600>
Deduction Total...............................		<20,520>		
Exemptions...............................		-0-	<71,700>	<71,700>
Exemption Phase out........................		-0-	-0-	-0-
Taxable Income.........................		129,480	162,300	62,300
Tentative AMT...........................			**42,198**	**16,198**
Regular Tax...............................		**25,250**	<25,250>	<25,250>
Alternative Minimum Tax.................................			**16,940**	- 0 -
Tentative AMT Credit Carryover..............................				**16,940** (16,940 - 0)

Tax Planning Considerations:

- **State income taxes** - *Since state income tax is not deductible against the AMT, care should be taken not to pay more during the year than can be used without incurring the AMT (in this example, none). Generally defer to the 4th quarter paid in January of the following year. It may even be appropriate to reduce withholding. But consider if incurring the underpayment penalty, if any, is worth it.*
- **Other taxes** - *Since taxes are not deductible against the AMT, attempt to prepay in a prior year or defer to the next year if the deduction will be wasted in the current year, also keeping in mind the TCJA imposed $10,000 annual deduction limit for state and local taxes.*

Year of Qualified Stock Sale: After meeting the qualified holding period of more than one year after the exercise and two years after the option was granted, the taxpayer qualifies for the long-term treatment and sells the stock. When this occurs, there is a stock basis for regular tax ($20,000) purposes and another for AMT ($120,000). This will create a negative capital gains adjustment on Form 6251 of $100,000 ($20,000 - $120,000). There is also an AMT Credit carryover in the amount of $16,940 (assuming the taxpayer did not utilize the credit in the intervening years).

Year of Qualified Sale:

Stock Basis for Regular Tax Purposes	20,000
Stock Basis for AMT Purposes	120,000
Tax Preference Adjustment (120,000 - 20,000)	
Form 6251 - Line 2k (2018 version)	<100,000>
AMT Tax Credit	Perhaps*

Form 8949: Result to Sch. D is $100,000 gain

Description	Acquired	Sold	Sales Price	Cost Basis
Stock Sale	06/12/19	10/16/21(2)	120,000	20,000

*The AMT tax credit is used against the regular tax but cannot reduce the regular tax below the AMT. Whether or not there will be an AMT tax credit depends upon whether one was generated in a prior year(s) and if so, is the regular tax greater than the AMT tax.

Tax Computation:

Description		Reg Tax	AMT
W-2 Income...		150,000	150,000
Capital Gains.......................................		100,000	100,000
AMT Capital Gains Adjustment.....................			<100,000>
Deductions:			
Taxes................	4,520		
Home Interest....	15,400		<15,400>
Contributions......	600		< 600>
Deduction Total....................................		<20,520>	
Exemptions.........................		-0-	<71,700>
Taxable Income..........................		229,480	62,300
Tentative AMT............................			**16,198**
Regular Tax (using cap gains rates)		**40,250**	<40,250>
Alternative Minimum Tax..			-0-
Tentative AMT Credit Carryover......		**<16,940>**	
Tax Due**.................................		**23,310**	

*** Greater of Regular Tax (figured using capital gains tax rates) less AMT Credit or AMT*

(2) Uses 2019 rates and values since the 2020 and values were not available when the example was prepared.

EMPLOYER REPORTING

Under final regulations § 1.6039-1 and § 1.6039-2, corporate employers are required to make an information return with the IRS, in addition to providing information to the employee, about the transfer of stock pursuant to the exercise of an incentive stock option (ISO), and certain stock transfers regarding employee stock purchase plans (ESPPs).

ISO reporting - For ISOs, the information that is required in the information return to IRS and the statement furnished to employees consists of:

1. The name, address, and employer identification number (EIN) of the corporation transferring the stock, or, if other than the corporation, the name, address and EIN of the corporation whose stock is being transferred;
2. The name, address, and identifying number of the person to whom the share or shares of stock were transferred pursuant to the option exercise;
3. The date the option was granted to the person;
4. The exercise price per share, the date the option was exercised, and the fair market value of a share of stock on the date the option was exercised; and
5. The number of shares of stock transferred pursuant to the exercise of the option.

ESPP reporting - For transfers of stock by the employee under an ESPP where the stock was acquired pursuant to the exercise of an option described in Code Sec. 423(c), and where the exercise price is less than 100% of the value of the stock on the grant date or is not fixed or determinable on the grant date, the regs require the following information to be provided to IRS and the employee:

1. The name, address, and identifying number of the transferor (the person who acquires the shares pursuant to exercising the option);
2. The name, address and EIN of the corporation whose stock is being transferred;
3. The date the option was granted to the transferor;
4. The fair market value of the stock on the date the option was granted;
5. The actual exercise price paid per share;
6. The exercise price per share determined as if the option were exercised on the date the option was granted to the transferor (only required if the exercise price per share is not fixed or determinable on the grant date);
7. The date the transferor exercised the option and the FMV on that date;
8. The date the legal title of the shares was transferred by the transferor; and
9. The number of shares to which legal title was transferred by the transferor.

Forms 3921 and 3922– To accomplish these reporting requirements IRS has developed two forms: Form 3921 is for ISO reporting and Form 3922 is for ESPP reporting.

RESTRICTED STOCK UNDER SEC 83

CAUTION: The following is an overview of restricted stock under Sec 83. Consult the regulations for additional details.

Under normal circumstances where an employer compensates an employee for his or her service in the form of stock, the excess of the fair market value of the stock over any amount paid for the stock is treated as income to the employee at the time he or she receives the stock.

However, if the stock is subject to substantial risk or forfeiture because it is restricted (cannot be sold) then income is deferred until the interest in the property either: (1) is no longer subject to that risk, or (2) becomes transferable free of the risk, whichever occurs earlier.

The employee has the option to include the FMV of restricted stock (less any amount paid for the stock) in income in the year the stock is received by filing the so-called Sec 83(b) election within 30 days of the transfer of the restricted stock. The amount of the income recognized as a result of the election is based on the fair market value (FMV) of the shares on the date of grant less any amount the employee paid for the stock. This amount becomes the basis of the stock. The stock's FMV isn't reduced to reflect the restrictions on the stock, unless there is a permanent limitation on the transfer of the stock that would require the employee to resell the stock to the employer at a price determined under a formula.

The benefit of making the election is to permanently fix the compensation element and then any appreciation over and above the basis (the compensation that was included in income) will be eligible for long-term capital gains rates if the stock is held for more than one year (two years if the stock is acquired from an incentive stock option). Caution: If the stock is subsequently forfeited, any loss is a capital loss subject the annual $3,000 overall capital loss limitation.

Note: Prior to 2016 a copy of the Sec 83(b) election had to be attached to the filed 1040. Since many software packages are unable to include attachments, per the final Sec 83 regulations it will no longer be a requirement to attach it to the 1040 (applicable for property transferred on or after January 1, 2016). Rev Proc 2012-29 includes sample language an employee may use for making the election statement.

New Sec 83 Gain Deferral Option

TCJA

Code Sec. 83 governs the amount and timing of income inclusion for employer stock, transferred to an employee in connection with the performance of services. Under Code Sec. 83(a), an employee must generally recognize income for the tax year in which the employee's right to the stock is transferable or isn't subject to a substantial risk of forfeiture. The amount includible in income is the excess of the stock's fair market value at the time of substantial vesting over the amount, if any, paid by the employee for the stock.

Elective Gain Deferral – Under TCJA and generally effective for stock options exercised or restricted stock units (RSUs) settled after Dec. 31, 2017 (subject to a transition rule), a qualified employee can elect to defer, for income tax purposes, recognition of income attributable to qualified stock transferred to the employee by the employer. The election applies only for income tax purposes; the application of FICA and FUTA is not affected. (Code Sec. 83(i))

Timing - The election must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

Deferral Period - If the election is made, the employer has to include the deferred income in the employee's income for the tax year that includes the ***earliest*** of:

(1) The first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer.

(2) The date the employee first becomes an "excluded employee" (i.e., an individual: (a) who is one-percent owner of the corporation at any time during the 10 preceding calendar years; (b) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity; (c) who is a family member of an individual described in (a) or (b); or (d) who has been one of the four highest compensated officers of the corporation for any of the 10 preceding tax years.

(3) The first date on which any stock of the employer becomes readily tradable on an established securities market;

(4) The date five years after the first date the employee's right to the stock becomes substantially vested; or

(5) The date on which the employee revokes his or her election. (Code Sec 83(i)(1)(B))

Thus, under the Sec 83(i) election the longest possible deferral period is 5 years.

Qualified Stock - The election is available for "qualified stock" (defined in Code Sec. 83(i)(2)(A), attributable to a statutory option. In such a case, the option is not treated as a statutory option, and the rules relating to statutory options and related stock do not apply. In other words, if an employee makes a Section 83(i) election with respect to the exercise of an incentive stock option (ISO), the ISO preferential tax treatment will no longer apply.

Deferred income inclusion also applies for purposes of the employer's deduction of the amount of income attributable to the qualified stock. That is, if an employee makes the election, the employer's deduction is deferred until the employer's tax year in which, or with which, ends the tax year of the employee for which the amount is included in the employee's income as described in (1) - (5) above.

The new election applies for qualified stock of an eligible corporation. A corporation is treated as such for a tax year if: (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and (2) the corporation has a written plan under which, in the calendar year, not less than 80% of all employees who provide services to the corporation in the US (or any US possession) are granted stock options, or restricted stock units (RSUs), with the same rights and privileges to receive qualified stock. (Code Sec. 83(i)(2)(C))

Detailed employer notice, withholding, and reporting requirements also apply with regard to the election. (Code Sec. 83(i)(6))

As noted above, the income deferral election generally applies with respect to stock attributable to options exercised or RSUs settled after Dec. 31, 2017. However, under a transition rule, until IRS issues regs or other guidance implementing the 80% and employer notice requirements under the provision, a corporation will be treated as complying with those requirements if it complies with a reasonable good faith interpretation of them. The penalty for a failure to provide the notice required under the provision ($100 per failure, subject to a $50,000 maximum penalty for all failures during a calendar year) applies to failures after Dec. 31, 2017. (Code Sec. 6652)(p), as amended by Act Sec. 13603(e)) In December 2018, the IRS released initial guidance (IR-2018-246) on Code Sec. 83(i) that covers the following topics:

- The requirement that eligible corporations must make grants to not less than 80% of all employees who provide services to the corporation in the U.S.;
- Federal income tax withholding regarding the deferred income related to the qualified stock; and
- An employer opt out of permitting employees to elect the deferred tax treatment even if the requirements under Code Sec. 83(i) are otherwise met.

Please see IR-2018-246 on the IRS web site for details: https://www.irs.gov/site-index-search?search=IR-2018-246&field_pup_historical_1=1&field_pup_historical=1 The IRS plans to issue further guidance on these and other issues in the form of proposed regulations at a later date.

CALIFORNIA DIFFERENCES

California conforms to the same treatment as the federal return, but has its own AMT and nonrefundable AMT credit carryover computation based upon the California Alternative Minimum Tax computation. It is conceivable that the AMT could apply to either the federal or CA and not the other depending upon all the factors affecting the make-up of the tax return. At this time it is unknown if CA will conform to the new 83(i) election.

The California Franchise Tax Board has issued guidance ***(California Tax News, May 2001)*** explaining how the state taxes stock option income when taxpayers change their state of residence to or from California. It also addresses the incentive stock option (ISO) alternative minimum tax adjustment.

TAXABILITY OF STOCK OPTIONS TO CA NONRESIDENTS – OVERVIEW

When an individual was a CA resident when the option was granted and is a nonresident when the option is exercised. . .

- **Nonqualified Options (NQSO)** – Always treated as CA source income and taxable to CA.
- **Qualified Options (ISOs)**:
    - *Qualified Disposition* – If the disposition meets the requirements of a "qualified" ISO disposition then the gain is **NOT** taxable to CA.
    - *Nonqualified Disposition* – Where the disposition does not meet the requirements of a "qualified" ISO disposition then the disposition is treated as a NQSO and thus the gain **IS** taxable to CA.

See below for additional details of CA Non-resident taxation

NONQUALIFIED STOCK OPTIONS

- **Change of residency to California.** When a taxpayer is granted an NQSO while a nonresident of California and later exercises it while a California resident, the difference between the fair market value of the stock on the date of exercise and the option price is subject to California tax. The state recognizes income at the point of exercise because the taxpayer acquires stock with a value greater than the exercise price. The income is subject to California tax because the taxpayer is a California resident when the income is recognized.
- **Change of residency from California.** When a taxpayer is granted an NQSO while a California resident and later exercises it while a nonresident, the Franchise Tax Board will properly characterize the income from its exercise as compensation for services with a source in-state where the taxpayer performed the services. Nonresident taxpayers who performed services both within and outside of California must allocate to California that portion of total compensation reasonably attributed to services performed in California (California Regulation §17951-5). One reasonable method is an allocation based on time. The period of time includes the total amount of time from the date of grant to the date of exercise (or the date employment ended, if earlier). The basis for this position is that the state properly characterizes the income upon exercise as compensation for services during the time the stock increased in value.

Income taxable by CA = total stock option income × allocation ratio.

*The **allocation ratio** is California workdays from date of grant to date of exercise ÷ total workdays from date of grant to date of exercise.*

If a taxpayer performs services for the corporation entirely within California, but exercises the option after terminating employment and becoming a nonresident, the difference between the fair market value of the stock on the date of exercise and the option price has a source in California even though the underlying value of the stock may have increased after the taxpayer became a nonresident.

INCENTIVE STOCK OPTIONS

- **Change of residency to California**. When a taxpayer exercises an ISO while a nonresident of California and later sells the stock in a qualifying disposition (the holding period requirements under ***IRC §422*** are met) while a California resident, California taxes the difference between the amount realized on the sale and the option price because the taxpayer is a California resident when the stock is sold.
- **Change of residency from California.** When a taxpayer exercises an ISO while a California resident or while a nonresident and then disposes of the stock in a disqualifying disposition (the holding period requirements under ***IRC §422*** are not met) while a nonresident, the income from the disqualifying disposition is functionally equivalent to income from the exercise of an NQSO and the FTB will properly characterize it as wages. The wage income is equal to the difference between the fair market value (FMV) of the shares on the date of exercise (or the sale price, if lower) and the amount paid for the shares. If the FMV of the shares on the date of sale is greater than the FMV of the shares on the date of exercise, the FTB will treat the further increase in value as capital gain income. ***(Proposed Treasury Regulation §1.422A-1(b)(3))***

Example 1 - ISO Change of residency from California: *Mr. Smith, a resident of California, worked for X Company. He performed all his services in California during his entire career. On April 1, 2015, Mr. Smith's company granted him an option to purchase stock under its incentive stock option plan. On April 1, 2018, while still living and working in California, Mr. Smith exercised his option to purchase 30,000 shares of his company's stock. The option price on April 1, 2015 was $10 per share. The FMV on April 1, 2018 was $50 per share. On December 30, 2015, Mr. Smith retired and permanently moved to Florida. On March 15, 2019, he sold the 30,000 shares for $35 per share. The FTB will characterize income from the disqualifying disposition of ISOs as wages. Because Mr. Smith performed all his services in California between the grant date and the date of exercise of the option, 100% of the income is treated as wages from a California source as follows:*

- *FMV of stock, date of sale: $1,050,000 (30,000 shares @ $35* per share)*
- *Less: Option price, date of grants: $300,000 (30,000 shares @ $10 per share)*
- *Equals: Wage income, California source: $750,000.*

**The FTB used the sale price of $35 to compute the wage income because it is less than the exercise price of $50.*

Example 2 - ISO Change of residency from California: *Assume the same facts as Example 1, except Mr. Smith sold the stock on March 15, 2020, when the FMV of the stock was $60 per share. The FTB will determine the amount of income treated as wages from a California source as follows:*

- *FMV of stock, date of exercise: $1,500,000 (30,000 shares @ $50 per share)*
- *Less: Option price, date of grant: $300,000 (30,000 shares @ $10 per share)*
- *Equals: Wage income, California source $1,200,000.*

The FTB characterized the increase in the FMV of the stock from the exercise price of $50 to the sale price of $60 as capital gain income. The capital gain income has a source in Florida, Mr. Smith's state of residence when he sold the stock.

- *FMV of stock, date of sale: $1,800,000 (30,000 shares @ $60 per share)*
- *Less: FMV of stock, date of exercise: $1,500,000 (30,000 sh @ $50 per sh)*
- *Equals: Capital gain, Florida source $300,000.*

- **Incentive stock option alternative minimum tax adjustment.** For federal and California AMT, the taxpayer must include, as an adjustment in figuring alternative minimum taxable income, the amount by which the FMV of the stock exceeds the option price in the year the stock is substantially vested (the taxpayer's rights in the stock are transferable or no longer subject to substantial risk of forfeiture). The FTB requires no adjustment if the taxpayer disposes of the stock in the same year of exercise.

Summary of California Treatment of NQOs and ISOs – Residents/Nonresidents

Type of Stock Option	If a California Resident. . .	If a California Nonresident. . .
Nonqualified stock option (NQO)	**on the date NQO is exercised:** ▸CA taxes the wage income. ▸Possible other state tax credit.	**on date NQO is exercised:** ▸CA taxes the wage income to the extent services were performed in CA from the grant date to the exercise date. ▸Possible other state tax credit.
	on the date stock is sold: ▸CA taxes the capital gain.	**on the date stock is sold:** ▸CA does not tax the capital gain.
Incentive stock option(ISO)	**on the date ISO is exercised:** ▸Make an AMT adjustment if stock is not sold in year of exercise. ▸Increase AMT basis by the AMT adjustment.	**on the date ISO is exercised:** ▸Make an AMT adjustment if stock not sold in year of exercise. ▸Include an AMT adjustment to the extent services were performed in CA from the grant date to the exercise date. ▸Increase AMT basis by the AMT adjustment.
	on the date stock is sold in a qualifying disposition at a gain: ▸CA taxes the capital gain. ▸Possible AMT credit.	**on the date the stock is sold in a qualifying disposition at a gain:** ▸CA does not tax the capital gain. ▸Possible AMT credit.
	on the date stock is sold in a disqualifying disposition: ▸CA taxes the wage income and capital gain (if any). ▸Possible other state tax credit. ▸Possible AMT credit.	**on the date stock is sold in a disqualifying disposition:** ▸CA taxes the wage income to the extent services were performed in CA from the grant date to the exercise date. ▸CA does not tax the capital gain (if any). ▸Possible other state tax credit. ▸Possible AMT credit.

NOTES

QUALIFIED SMALL BUSINESS STOCK

Overview

- Definition
  - C-corporation stock
  - **Does not apply to S-Corp Stock**
  - Assets not in excess of $50M when stock issued
  - Meets "active business requirement"
- Sec 1202 Treatment – Is not elective
- Holding requirements: 5 Years
- Gain Exclusion: 50%, 75% or 100%, depending when stock issued
- Maximum tax: 28% on non-excluded gain
- AMT: 7% of the excluded amount treated as a preference when 50% or 75% of the gain is excluded
- Investor Exclusion Limitations – cannot exceed:
  - $10 million ($5M if MS) or
  - 10 times taxpayer's adjusted basis
- May apply to gain from pass-throughs that sold QSBS stock
- Rollover to another Sec 1202 – within 60 days

RAPID FINDER

Pubs
Forms

Related IRC and IRS Publications and Forms

- **Pub 550 –** Investment Income
- **IRC Section 1202**
- **Form 8949 –** Sales and Other Distributions of Capital Assets

The Details

GAIN EXCLUSION - Noncorporate taxpayers may ***exclude 50%*** (60% in empowerment zones for gains realized before 2019 on stock acquired after 12/21/2001), ***75% or 100%,*** *depending when the stock was issued,* ***of any gain*** realized on the sale or exchange of ***"qualified small business stock" held more than 5 years.***

Congress has authorized exclusion amounts for qualified stock meeting the more than 5 year holding period as follows:

- **50% gain exclusion for stocks issued** after 8/10/1993 and before 2/18/2009. Of the excluded gain, 7% is a tax preference item.
- **75% gain exclusion for stocks issued after 2/17/2009 and through 9/27/2010.** However, 7% of the excluded gain is a tax preference item. Caution: Not all Sec 1202 stock issued in 2009 or 2010 that is sold in 2019 will qualify for the 75% exclusion – check the **issued** date carefully.

Example – Qualifies for 50% exclusion *– On February 1, 2009, Andrew purchased Sec 1202 stock that was issued on January 15, 2009. He sold the stock on August 1, 2019 for a gain of $20,000. He can exclude $10,000 of the gain. He held the stock over 5 years, but because it was issued before February 18, 2009, his exclusion will be 50% rather than 75% of the gain. $700 (7% x $10,000) of the gain will be a preference item for AMT.*

Example – Qualifies for 75% exclusion *– On March 1, 2010, Corporation X issued Sec 1202 stock, which Barbara bought on March 15, 2010. She sold the stock for a gain of $28,000 on November 1, 2019. Because she held it for over 5 years and the stock was issued after February 17, 2009 and before Sept. 28, 2010, 75% of her gain, or $21,000, is excludable. Of the $21,000, $1,470 (7%) is included as an AMT preference item.*

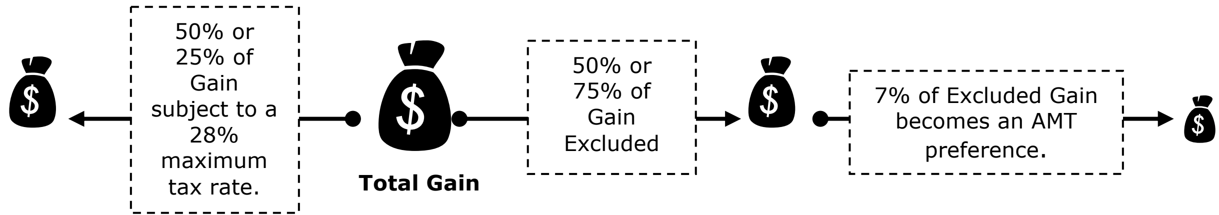
- **100% gain exclusion for stocks issued after September 27, 2010.** There is no AMT preference when the exclusion percentage is 100%. The 100% gain exclusion was initially intended as a temporary economic stimulus, but the provision was made permanent by the PATH Act of 2015.

Example –Qualifying for the 100% exclusion *– If Corporation X from the prior example had issued the Sec 1202 stock on October 1, 2010 instead of March 1, 2010, and Barbara had purchased the stock on October 15, 2010, her entire gain from the sale on Nov. 1, 2019 would be excludable and she would have no AMT preference related to this stock sale.*

CAUTION! Gain from the sale of Sec 1202 stock that isn't excludable does not benefit from the current 0%, 15% and 20% capital gains rates. The maximum tax rate for the taxable portion of 1202 stock is 28%.

IS SEC 1202 TREATMENT ELECTIVE? Should circumstances make it more beneficial for a taxpayer to treat the stock sale as an investment sale, can a taxpayer disregard the Sec 1202 provisions? Sec 1202(a)(1) says: "*In the case of a taxpayer other than a corporation, gross income **SHALL** not include 50 percent of any gain from the sale or exchange of qualified small business stock held for more than 5 years."* [Substitute 75% or 100% as applicable based on issue date.] This language seems definitive and there is no mention of an election other than the rollover election discussed below.

AMT RAMIFICATIONS: 7% of the 50% or 75% excluded Sec 1202 gain is treated as a tax preference. However, for dispositions of qualified Sec 1202 stock issued after September 27, 2010, and held for over 5 years, the excluded gain (100%) does not count as a preference item. (Code Sec. 1202(a)(4)). The illustration below applies only when 50% or 75% of the gain is excluded.



***Example – Sale of QSBS -** Assume a taxpayer has a gain of $100,000 from the sale of QSBS to which the 50% exclusion applies. If the taxpayer is being taxed by the AMT method at the highest rate, the tax on the QSBS can be estimated as follows:*

CG Tax = ($100,000 x .50 x .28) =	*$ 14,000*
AMT Tax = ($100,000 x .50 x .07 x .28) =	*$ 980*
TOTAL TAX =	***$14,980***

DEFINITION OF QSBS ***(Sec 1202(c)(1))***

The term "qualified small business" means any domestic corporation which is a C corporation if:

(A) The aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993, and before the issuance did not exceed $50M,
(B) The aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed $50M, and
(C) Such corporation agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section.
(D) Meet the "Active Business Requirement".

Options to Acquire Stock - The Tax Court has concluded that the term "stock" for purposes of the exclusion from gain on the sale of "qualified small business stock" (QSBS) in Code Sec. 1202 doesn't include options to acquire stock. (Natkunanathan, TC Memo 2010-15)

ACTIVE BUSINESS REQUIREMENT ***(IRC § 1202(c)(2))***

During substantially all of the taxpayer's holding period for the stock, at least 80% of the value of the corporation's assets must be used by the corporation in the active conduct of one or more "qualified trades or businesses."

A qualified trade or business ("QTOB") is any trade or business ***other than:***

(A) One involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services;
(B) One where the principal asset of the trade or business is the reputation or skill of one or more of its employees;
(C) Any banking, insurance, financing, leasing, investing, or similar business;
(D) Any farming business, including the business of raising or harvesting trees;
(E) Any business involving the production or extraction of products of a character for which percentage depletion is allowable; and
(F) Any business of operating a hotel, motel, restaurant or similar business.

INVESTOR (STOCKHOLDER) EXCLUSION LIMITATION: The amount of gain eligible for exclusion for each taxable year of the investor can't exceed:

(a) $10 million ($5 million, if married separate), less the amount of gain taken into account under these rules by the taxpayer with respect to dispositions of stock issued by that corporation in an earlier year, or
(b) 10 times the taxpayer's adjusted basis in the stock of that corporation. The gain that qualifies for exclusion is allocated equally between spouses filing joint returns.

Stock Disqualification - Generally, stock will not be treated as small business stock if:

(1) The issuing corporation directly or indirectly purchased any of its stock from the shareholder (or party related to the shareholder as defined in ***§267(b) or §707(b)***, anytime during the period beginning two years before or after the stock issue date, or

(2) During the two-year period that starts on the date that is one year before the stock is issued, the issuing corporation purchased some of its own stock at the beginning of the two-year period.

Transfers of small business stock by gift or bequest - Such stock received as a gift or inheritance does not lose its character as small business stock. The transferee picks up the transferor's holding period in the stock.

PASSTHROUGH ENTITIES: Gain from disposition of a qualified small business stock by a partnership, S corporation, regulated investment company, or common trust fund that is taken into account by a partner, shareholder or participant (other than a C corporation) is eligible for the exclusion if:

(1) all eligibility requirements with respect to qualified small business stock are met;

(2) the stock was held by the entity for more than five years; and

(3) the partner, shareholder, or participant held his interest in the entity on the date the entity acquired the stock and at all times thereafter before the disposition of the stock.

The limits on the amount that can be excluded from income are applied at the ownership level and not the entity level.

Partnership acquiring QSBS for partners - Reg. 1.1045-1 allows a partnership to acquire qualified small business stock on behalf of its partners, thereby allowing the partners to defer any gains they may have realized on sales of qualified small business stock. The partnership must acquire the replacement stock within 60 days of the partnership's sale of the relinquished stock. All of the other requirements for the stock to be treated as qualified small business stock also apply. The regulation also provides guidance for determining a partner's basis in the partnership that acquires the replacement stock.

ROLLOVER OF GAIN ON QUALIFIED SMALL BUSINESS STOCK (*IRC § 1045*): The gain from the sale of qualified small business stock held by a taxpayer (not a corporation) for more than six months can be rolled over tax-free to other qualified small business stock. This means that the benefit of a tax-free rollover on sale of qualified small business stock by a partnership will flow through to a partner who is not a corporation, if the partner held its partnership interest at all times that the partnership held the small business stock. A similar rule applies to S corporations. There is no provision limiting the types of partners or shareholders that a partnership or S corporation may have for the benefits of the rollover rules to apply to a noncorporate partner or shareholder. Thus, even if a corporation is the majority partner in a partnership, it won't prevent any noncorporate partner from being able to exclude from income his share of the gain on the sale of qualified small business stock that is rolled over into other qualified small business stock.

How the rollover works - The rollover rules let taxpayers electively roll over capital gain from the sale of qualified small business stock held for more than 6 months by buying other qualified small business stock within 60 days of the sale of the original stock. If the rollover option is chosen, no tax is due currently on the transaction. In addition, the QSBS gain exclusion can be used later when the replacement stock is sold.

If rollover is elected, capital gain from the sale is recognized only to the extent that the amount realized from the sale exceeds:

- The cost of any replacement QSBS purchased within the 60-day period, reduced by
- Any portion of the cost previously taken into account under this rollover rule.

Example - Small Business Stock Rollover - *Tim had the following transactions in small business stock during the year:*

DATE	*DESCRIP.*	*ORIG. COST*	*AMT. REALIZED*	*TIME HELD*
04/01	*Sale-ABC Stock*	*$100,000*	*$500,000*	*9 months*
04/02	*Sale-XYZ Stock*	*50,000*	*300,000*	*5+ years**
05/30	*Buy-RST Stock*	*700,000*	*N/A*	

**assume stock was issued other than during the periods for which 75% or 100% of gain is excludable*

RESULT:

- *Tim elects to roll over gain from the sale on 04/01 so none of the $400,000 of gain from that sale will be recognized (because the amount realized, $500,000, doesn't exceed the $700,000 he paid for the replacement stock purchased 05/30).*
- *He also elects to roll over gain from the sale on 04/02. The amount of gain that isn't recognized is $150,000, while gain recognized is $100,000 (i.e., $300,000, the amount realized on the 04/02 sale, less $200,000, the amount of the $700,000 left after the rollover from the 04/01 sale).*
- *Since the XYZ Corp stock had been held by Tim for more than five years, $50,000 of the recognized gain can be excluded from income under the rules for small business stock ($100,000 x 50%). The remaining $50,000 is a capital gain.*

Gain from any sale not recognized due to the rollover election reduces the basis for determining gain or loss of any qualified business stock purchased by the taxpayer during the 60-day period beginning on the date of the sale.

> ***Example - Basis Reduction Rule -*** *On 04/01, Ted sold small business stock in DEF Corp; he had owned the stock for 2 years. He realized $500,000 from the sale and his basis was $100,000. On 05/29, he purchased more small business stock in GH Corp for $150,000. On 05/30, he purchased small business stock in LM Corp for $600,000. Ted's basis in the GH Corp stock is zero and his basis in the LM Corp is $350,000 ($600,000 minus $250,000 (the amount left after $400,000 of unrecognized gain on the DEF Corp stock is reduced by the $150,000 of unrecognized gain applied against the basis of the GH Corp stock)).*

Partners may opt out of partnership's Sec. 1045 election (Reg. Sec. 1.1045-(b)(4) and (5)) - An eligible partner may opt out of the partnership's Sec. 1045 election with respect to QSB stock either by recognizing the partner's distributive share of the partnership Sec. 1045 gain, or by making a partner Sec. 1045 election with respect to the partner's distributive share of the partnership section 1045 gain. Opting out of a partnership's election does not constitute a revocation of the partnership's election, and such election continues to apply to other partners of the partnership. An eligible partner that opts out of a partnership's Sec. 1045 election must notify the partnership, in writing, that the partner is opting out. Effective for sales 8/14/2007 and after.

COMPLETING FORM 8949: For sales of QSBS where part of the gain is excludable, report the sale on Form 8949, line 1 (Part II, long-term) as if not taking the exclusion. Then enter code Q in column (f) and the amount of the exclusion as a negative number (in parentheses) in column (g). (2018 Form 8949)

If qualified to postpone all or part of the gain and to make the rollover election, report the sale on line 1 of either Part I or Part II (depending on holding period) of Form 8949 as if not making the election. Then, enter code R in column (f) and the amount of the postponed gain as a negative number (in parentheses) in column (g).

CALIFORNIA DIFFERENCES

California does not allow an exclusion or deferral of gain from the sale of small business stock for sales after December 31, 2012.

SALE OF HOME

Overview

RAPID FINDER

- **Maximum Gain Exclusion** on the sale of a ***principal home*** is:
  1) **$250,000** ($500,000 surviving spouse who meets certain requirements), or
  2) **$500,000** if all of the following are true. The taxpayer is married and files a joint return for the year, and
     a) **Either** the taxpayer or spouse meets the **ownership test**.
     b) **Both** the taxpayer and spouse meet the **use test**.
     c) During the 2-year period ending on the date of the sale, neither excluded gain from another sale.
- **Qualifications** to exclude: During the five-year period preceding the sale:
  1) ***Owned*** the home for at least ***2 years (5 years*** *if acquired by* ***§1031***), ***and***
  2) ***Lived in*** the home as the taxpayer's main home for at least ***2 years.***
- **Military – Change of station -** use period suspended up to 10 years – Min 50 miles & 90 days
- **Short temporary absences** - Such as for vacation or other seasonal absence *(even though accompanied with rental of the residence)*, are counted as periods of use.
- **Divorce** – where one spouse continues to live in home and then later jointly sell – out-spouse's use period mirrors in-spouse's use period.
- **Disability exception** – Taxpayers who are physically or mentally unable to care for themselves, *and who during the five-year period before the sale,* ***lived in the home at least 1 year are considered*** to have lived in the home during any time they live in a licensed care facility.
- **Home used as rental –** Ok if otherwise meets the ownership & use tests except that gain from nonqualified use is not excludable.
- **Non-Qualified Use** – Any use after 2008 in which the home was not used as taxpayer's principal residence.
- **Depreciation - Prior to 5/7/97** adjusts basis
  - Post 5/6/97 adjusts basis, plus gain up to this depreciation amount cannot be excluded and can be taxed up to a 25% tax rate.
- **Home Mortgage Debt Relief Forgiveness (2007 –2017)** – basis reduced by exclusion if home retained.
- **Sale of Partial Interest** – can exclude but reduces exclusion on future sale.
- **Sale of Attached Land** – can exclude but must sell rest of home 2 years before or after; is also treated as a sale of a partial interest.
- **Each spouse sells a separate home** – base each sale as a separate sale by a single individual.
- **Reduced exclusion** – taxpayer(s) do not meet the ownership & use tests because of:
  - **Change of employment** – 50 mile rule – tp, sp, co-owner, and occupant.
  - **Medical Reasons** – tp, sp, co-owner, occupant, and family.
  - **Unforeseen circumstances –** includes foreclosure.
  - **Pro-ration** – (qualifying days /730) x exclusion amount.
- **Prior Section 1034 gain deferral** – adjust home basis in determining gain before exclusion.
- **Home office sale**
  - Same structure (and day care use) – treat as one sale – losses not deductible
  - Separate structures – treat as separate sales – losses deductible on office portion
- **Qualifies for both §121 and §1031** – apply §121 first and §1031 to the balance
- **Peace Corp Volunteers** – can suspend 5-year period while in service (post 2007)
- **Intelligence Community Employees** – can suspend 5-year period while in service (post 12/20/06)
- **Life Estate** – Donor still owner for tax purposes and for Sec 121 exclusion

Related IRC and IRS Publications and Forms

- **Form 982** – Reduction of Tax Attributes
- **Form 1099-S** – Proceeds from RE Transactions
- **Form 4797** – Sale of Business Property
- **Form 8949** – Sales and Other Distributions of Capital Assets
- **Pub 523** – Selling Your Home
- **Pub 544** – Sales and Other Dispositions of Assets
- **Pub 551** – Basis of Assets
- **IRC Sec 121**

CAUTION - If a residence is sold that qualified for a federal or state homebuyer credit when it was purchased, recapture of the credit may be required, depending on how long the home was used as a principal residence. See Chapter 9.14 for details.

EXCLUSION OF GAIN

If a taxpayer meets the ownership and use tests, they can exclude the gain on the sale of their ***principal home*** up to:

1) **$250,000**, or
2) **$500,000** for surviving spouse (see details in text), or
3) **$500,000** if all of the following are true.

a) The taxpayer is married and files a joint return for the year.
b) Either the taxpayer or spouse meets the ownership test.
c) Both the taxpayer and spouse meet the use test.
d) During the 2-year period ending on the date of the sale, neither the taxpayer nor spouse excluded gain from the sale of another home (not counting any sales before May 7, 1997).

OWNERSHIP AND USE TESTS

To claim the exclusion, the taxpayer must meet the ownership and use tests. This means that during the ***5-year period*** ending on the date of the sale, the taxpayer must have:

1) ***Owned*** the home for at least ***2 years*** (the ownership test), ***and***
2) ***Lived in*** the home as the taxpayer's main home for at least ***2 years*** (the use test).

The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 x2). *(Reg. §1.121-1(c))*

Special Rule for Decedents Dying in 2010 - if a decedent's estate or heir sells the decedent's principal residence, $250,000 of gain can be excluded provided the decedent met the two-out-of-five years use and ownership requirements. In addition, if an heir occupies the property as a principal residence, the decedent's period of occupancy and ownership can be added to the heir's when determining if the Sec 121 requirements have been met.

$500,000 EXCLUSION FOR SURVIVING SPOUSE

For sales and exchanges after Dec. 31, 2007, surviving single spouses qualify for the up-to-$500,000 exclusion if the sale occurs not later than 2 years after their spouse's death and the requirements for the $500,000 exclusion under Code Sec. 121(b)(2)(A) were met immediately before the spouse's death. (Code Sec. 121(b)(4)).

Note: Keep in mind that the surviving spouse, depending upon the state of residence and the manner in which title is held, will have a 50% or 100% step up (or step down) in basis of the home as a result of the spouse's death. This comment may not apply for a home inherited from a decedent who died in 2010 if the executor chose to use the modified carryover basis rules.

GAIN ATTRIBUTABLE TO NONQUALIFIED PERIODS NOT EXCLUDABLE

Effective for sales beginning in 2009, the amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

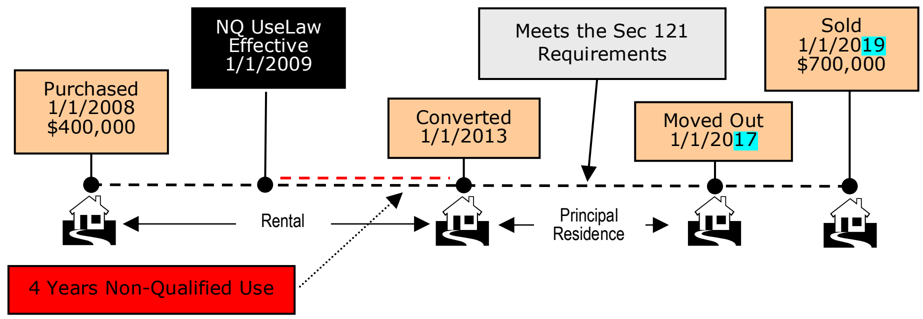
Nonqualified Use - A period of nonqualified use means any period during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence except as noted below. Examples of nonqualified use include using the home as a vacation residence, renting it out, allowing a relative to live in it, and simply letting it stand vacant. For this purpose periods of nonqualified use **do not include** any period:

- Before January 1, 2009
- After the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period), and
- Not to exceed two years that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

The present-law election for the uniformed services, Foreign Service and employees of the intelligence community is unchanged.

If any gain is attributable to post-May 6, 1997 depreciation, the exclusion does not apply to that amount of gain and that gain is not taken into account in determining the amount of gain allocated to nonqualified use.

Example *–Assume that a married couple buys a property on January 1, 2008, for $400,000, and uses it as rental property for five years claiming $30,000 of depreciation deductions. On January 1, 2013, the taxpayers convert the property to be their principal residence. On January 1, 2017, the taxpayers move out, and they sell the property for $700,000 on January 1, 2019.*



Without considering purchase or sales costs and assuming there were no improvements or other basis adjustments, the sale would result in a gain of $330,000 ($700,000 – (400,000 – 30,000)). The $30,000 gain attributable to the depreciation deductions is included in income. Of the remaining $300,000 gain, 36.4% of the gain (4 years of non-qualified (2009-2012) use divided by the 11 years of total ownership), or $109,200 is attributable to the non-qualified use period. Since it is less than the maximum gain of $500,000 that may be excluded, the remaining gain of $190,800 ($300,000 - $109,200) is excluded from gross income.

MILITARY, FOREIGN SERVICE AND INTELLIGENCE COMMUNITY 5-YEAR TEST

Military personnel often retain ownership of a home while away on duty but eventually sell it without returning to live in it, perhaps failing the use test completely. Those on qualified extended duty in the U.S. Armed Services or the Foreign Service can suspend this five-year test period for up to 10 years of such duty time, effective for home sales after May 6, 1997. A taxpayer is on qualified extended duty when at a duty station that is at least 50 miles from the residence sold, or when residing under orders in government housing, for more than 90 days or for an indefinite period.

A taxpayer may use this provision for only one property at a time and may exclude gain on only one home sale in any two-year period.

Example *– Sarge bought and moved into a home in 2011 that he lived in as his main home for 2½ years. For the next 6 years, he did not live in the home because he was on qualified official extended duty with the Army. He sold the home for a gain in 2019. To meet the use test, Sarge chooses to suspend the 5-year test period for the 6 years he was on qualifying official extended duty – he disregards those 6 years. Sarge's 5-year test period consists of the 5 years before he went on qualifying official extended duty. He meets the ownership and use tests because he owned and lived in the home for 2½ years during this test period.*

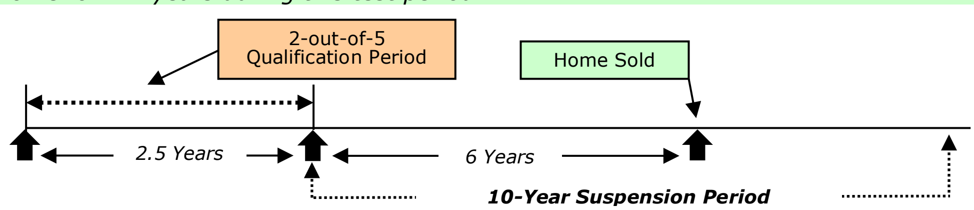


Illustration – Meeting the Qualification Period

Example *– Col. Potter owned and lived in his home for 3 years in Virginia until he was stationed overseas in January 2004. He was still overseas in January 2019 when he sold the house. He may disregard just 10 of the 15 years he was overseas, with the result that the 5-year test period covers only years he did not live in the house. Col. Potter will not be eligible for the home sale gain exclusion.*

Illustration – NOT Meeting the Qualification Period

PEACE CORP VOLUNTEERS – SUSPENSION OF FIVE-YEAR PERIOD

Peace Corps volunteers have a rule similar to the suspension rules applicable to members of the uniformed services, Foreign Service, and intelligence community. At the election of an individual with respect to a property (i.e., the residence), the running of the five-year ownership and use period in Sec 121 is suspended during any period that the individual or the individual's spouse is serving outside the U.S on qualified official extended duty as an employee of the Peace Corps, or as an enrolled volunteer or volunteer leader under §5 or §6 of the Peace Corps Act (22 USC 2504, 22 USC 2505). Thus, an individual may elect to suspend the five-year test period for ownership and use during certain absences due to volunteer service in the Peace Corps. (Com Rept)

INTELLIGENCE COMMUNITY EMPLOYEES – SUSPENSION OF FIVE-YEAR PERIOD

Employees of the CIA, National Security Agency, Homeland Security, Defense Department and other governmental intelligence agencies (defined in IRC Sec 121(d)(9)(C)(iv)) have the option to elect to suspend the running of the 5-year test period for purposes of the home sale gain exclusion while they are serving on official extended duty (i.e., serving at a duty station at least 50 miles from their main home or living in government quarters under government orders; for more than a 90-day period or indefinitely).

HOME ACQUIRED VIA TAX-DEFERRED EXCHANGE

Taxpayers will sometimes occupy a property that has been used as a rental and then live in that property long enough to meet home sale gain exclusion qualifications (own and use as their primary residence for the two out of five years prior to sale). They then qualify for the exclusion to the extent the gain exceeds the taxable depreciation recapture. Taxpayers can also exchange other real estate property for a single-family residence and then later occupy that residence. If the ownership and use tests are subsequently met, the home sale exclusion can be utilized to the extent the gain exceeds the taxable depreciation recapture.

- ***Five-Year Ownership Requirement*** - If a home was originally acquired via a §1031 tax-deferred exchange, the home must be owned for a ***minimum of five years*** before the home sale exclusion can be utilized, provided the taxpayer also meets the 2-year use test. *Code Sec. 121(d)(10).*

  Example – Exclusion not Qualified *- On 1/1/Yr#1 Jack acquires a residence to be used as rental property in a §1031 tax-deferred exchange. Jack rents the residence to unrelated parties during Years #1 and #2. Then on 1/1/Yr#3, Jack moves into the rental and uses it as his principal residence until he sells it on 1/2/Yr#5. Because Jack acquired the residence in a tax- deferred like-kind exchange four years before the date of the sale, the five-year holding period has not been satisfied. Therefore, Jack does not qualify for the §121 home gain exclusion even though he met the two-year ownership and use requirements for the exclusion.*

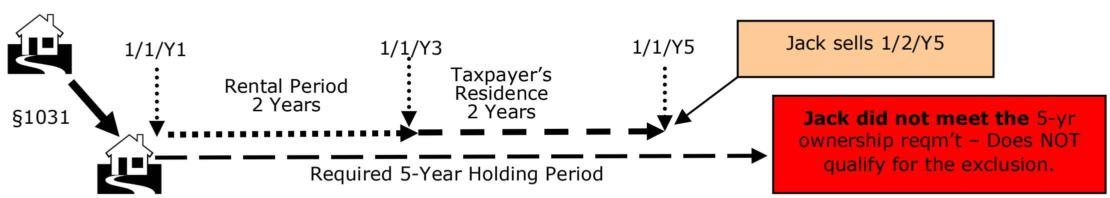


Illustration - Exclusion not Qualified

- ***Reduced Exclusion*** - This 5-year ownership restriction also applies to partial exclusions. Under the §121 reduced exclusion rules, a taxpayer who does not meet the two-year ownership and use requirements by reason of a change in place of employment, health or unforeseen circumstances is allowed a prorated exclusion as discussed later in this course. However, partial exclusions DO NOT apply to a home acquired via a §1031 tax-deferred exchange unless the five-year ownership requirement is met.
- ***Transfer Date*** – The five-year period begins on the date the property is acquired.
- ***Like-Kind Property*** - For a like-kind exchange to be tax-deferred under §1031, both the property exchanged ("relinquished property") and the property received in the exchange ("replacement property") must be held by the taxpayer either for productive use in a trade or business or for investment. Neither may

be used for personal purposes, such as a residence. *Code Sec. 1031(a)(1); IRS Pub No.544 (2017), p. 12.* A limited exception applies for certain vacation home rentals that have been used personally – see Chapter 3.20.

- ***Possible Scenarios*** – Virtually any real estate within the U.S. exchanged for any other real estate in the U.S. is considered like for like under §1031, provided that both the property relinquished and the property acquired in the exchange are used for the active conduct of a trade or business or held for investment. It also must be your client's **intent** to acquire the replacement property for business or investment; if that is not the case, the replacement property is not like-kind. Since both primary and second homes (not rented) are "personal use" property and not "business or investment," they are NOT like-kind real estate. The following are some possible acceptable scenarios you may encounter:
    - **Vacant land** §1031 exchanged for **residential rental** then converted to primary residence.
    - **Residential rental** §1031 exchanged for **residential rental** then converted to primary residence.
    - **Residential apartment building** §1031 exchanged for **residential rental** then converted to primary residence.
    - **Commercial real estate** §1031 exchanged for **residential rental** then converted to primary residence.
- ***Intent*** – Intent is an important issue. If a taxpayer exchanges into a property with the intent of not using that property for business or investment, then the property is not like-kind and therefore would not qualify for gain deferral. There is little to go on in regards to "intent" other than the two citations below:
    - ***Click, Dollie (1982) 78 TC 225*** - If a taxpayer had an intent at the time of the exchange to make a gift of the exchange property (i.e., the replacement property received in the exchange), the exchange does not qualify as a like-kind exchange because the taxpayer did not intend to hold the replacement property for productive use in a trade or business or for investment. For example, an exchange didn't qualify for non-recognition treatment, where seven months after the exchange of a farm for two residential properties, the taxpayer gave the residential properties to her two children and their families who then occupied them. The children selected the properties and paid insurance on them from the inception. Furthermore, the taxpayer was 72 years old and was working on an estate plan with her attorney. Under those circumstances, the court held that the taxpayer acquired the residences with the intent of making gifts of them to her children and not to hold as investments.
    - ***IRS Letter Ruling 8429039*** - Exchange by a trust where the trust represented that the property to be received would be held for productive use in a trade or business or for investment for a period of at least two years after the exchange. Under the facts of the ruling, the trust owned a beach house that had been rented out. An individual who owned a personal residence wanted to exchange the residence for the beach house held by the trust. The residence had been rented to an unrelated party. The trust represented that the property to be received would be held as rental property for at least two years. IRS ruled that the two-year period is sufficient to ensure that the residence to be acquired will meet the holding period test prescribed by Code Sec. 1031.

      Note: In the case of exchanges between related persons, non-recognition treatment under Code Sec. 1031 doesn't apply if either the property transferred or the property received is disposed of within **two years** after the exchange. (Code Sec. 1031(f))

INHERITED HOME

A beneficiary who inherits the residence of a decedent generally acquires it with a basis equal to the fair market value at the decedent's date of death, and since it is inherited property, it is treated as held for long-term. (Rules for the basis of inherited property acquired from decedents dying in 2010 may be different depending on the election of the executor. These rules are covered in Chapter 1.05.) Generally, a beneficiary will sell the residence through a broker and will have substantial sales costs. These sales costs quite often translate into a loss on the sale (Sales price – sales costs – inherited basis).

Beneficiary loss - Loss on the sale of inherited property which was the residence of the decedent can be deductible if the beneficiary immediately attempts to rent or sell the property. *(Campbell, N. Stuart, (1945) 5 TC 272; Carnrick, George, (1947) 9 TC 756, acq.)* If the beneficiary was living in the house at the decedent's death, a loss will be allowed if he indicates his intention to move and does so as soon as he can locate other quarters. A reasonable time is allowed to do this. *(Crawford, Mary, (1951) 16 TC 678, acq.)*

PRINCIPAL RESIDENCE DEFINED

The home sale exclusion only applies to the taxpayer's principal residence. Final regulations address the definition of principal residence. In the case of a taxpayer using more than one property as a residence, which one qualifies depends upon all the facts and circumstances. If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a ***majority of the time during the year will ordinarily be considered the taxpayer's principal residence***. *(Reg. §1.121-1(b))*

Relevant factors – In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence include, but are not limited to (*Reg. §1.121-1(b)):*

- The taxpayer's place of employment;
- The principal place of abode of the taxpayer's family members;
- The address listed on the taxpayer's Federal and state tax returns, driver's license, automobile registration, and voter registration card;
- The taxpayer's mailing address for bills and correspondence;
- The location of the taxpayer's banks; and
- The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

Example #1 – Taxpayer owns two residences *- Taxpayer K owns two residences, one in New York and one in Florida. From 2015 through 2019, K lives in the New York residence for 7 months and the Florida residence for 5 months in each year. Thus, K used the New York residence a majority of the time in each year from 2015 through 2019. Therefore, in the absence of facts and circumstances indicating otherwise, the New York residence is K's principal residence, and only the New York residence would be eligible for the §121 exclusion if it were sold at the end of 2019.*

NEW YORK HOME Months			FLORIDA HOME Months	
Lived In	**Qualified**	**Year**	**Lived In**	**Qualified**
7	7	2015	5	0
7	7	2016	5	0
7	7	2017	5	0
7	7	2018	5	0
7	7	2019	5	0
35	**35**	Total	25	**0**

Figure #1 *– Example #1*

Note: *Example #1 is interesting in the fact that even though both properties meet the 24-month use and ownership tests, only the New York property qualified as the primary residence during any of the five-year-period. Therefore, only the New York home will qualify for the exclusion. In example #2 that follows, both properties qualified as a primary residence during the 60-month qualification period.*

Example #2 – Taxpayer owns two residences *- Taxpayer L owns two residences, one in Virginia and one in New England. During 2015 and 2016, L lives in the Virginia residence. During 2017 and 2018, L lives in the New England residence. During 2019, L lives in the Virginia residence. L's principal residence during 2015, 2016 and 2019 is the Virginia residence. L's principal residence during 2017 and 2018 is the New England residence. Either residence would be eligible for the 121 exclusion if it were sold during 2019.*

VIRGINIA HOME Months			NEW ENGLAND HOME Months	
Lived In	**Qualified**	**Year**	**Lived In**	**Qualified**
12	12	2015	0	0
12	12	2016	0	0
0	0	2017	12	12
0	0	2018	12	12
12	12	2019	0	0
36	**36**	Total	24	**24**

Figure #2 *– Example #2*

Example #3–Taxpayer owns two residences *– This uses the same homes as example #2 except the lived-in and qualifying months have been changed to demonstrate that it is possible to have two homes with neither clearly qualifying as principal residence. When a situation like this occurs, you will have to rely on "facts and circumstances" to determine if the home being sold qualifies as the taxpayer's principal residence.*

VIRGINIA HOME Months			NEW ENGLAND HOME Months	
Lived In	**Qualified**	**Year**	**Lived In**	**Qualified**
9	9	2015	3	0
12	12	2016	0	0
5	0	2017	7	7
5	0	2018	7	7
5	0	2019	7	7
36	**21**	Total	24	**21**

Figure #3 *– Example #3*

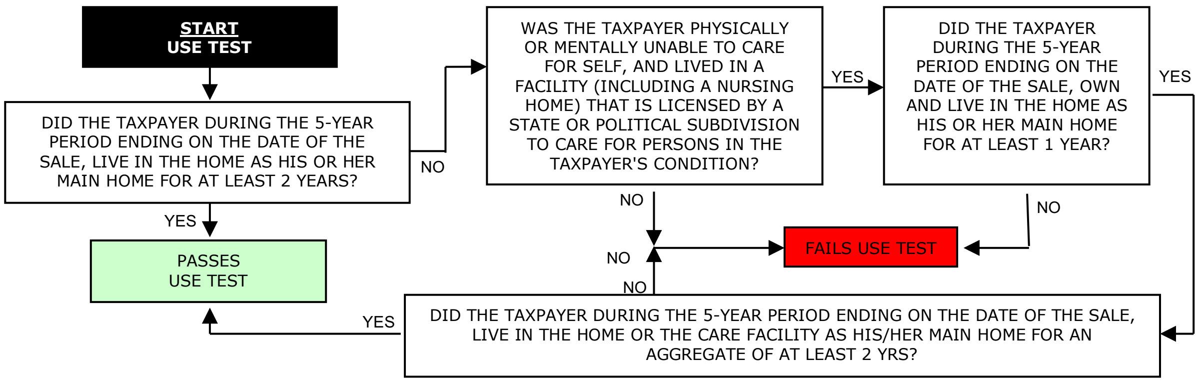
EXCEPTION FOR INDIVIDUALS WITH A DISABILITY *(Reg. §1.121-1(c)(2)(ii))*

There is an exception to the ***use test*** if, during the 5-year period before the sale of the home the taxpayer:

1) Becomes physically or mentally unable to care for themselves, ***and***
2) Owned and lived in the home as their main home for a total of at least 1 year.

Under this exception, the taxpayer is considered to have lived in the home during any time that he or she owns the home and lives in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in the taxpayer's condition. A taxpayer meeting this exception to the use test, still has to meet the 2-out-of-5-year ownership test to claim the exclusion.

Use Test Qualification Chart - Before using this chart, refer to the Use Test Chart for each taxpayer to see if they meet the use test or use test exemption**.** **CAUTION: This is the use test only - do not confuse it with the separate ownership test.**



TEMPORARY ABSENCE - USE TEST *(Reg. §1.121-1(c)(2)(i))*

The taxpayer must occupy the residence (except for short temporary absences) for at least 2 years during the 5-year period ending on the date of the sale or exchange. However, short temporary absences, such as for vacation or other seasonal absence ***(even though accompanied with rental of the residence)***, are counted as periods of use.

> ***Example – Meeting Use Requirements*** - *Taxpayer D, a college professor, purchased and moved into a house on May 1, 2017. He used the house as his principal residence continuously until September 1, 2018, when he went abroad for a 1-year sabbatical leave. On October 1, 2019, 1 month after returning from the leave, D sold the house. Because his leave is not considered to be a short temporary absence for purposes of §121, the period of the leave may not be included in determining whether D used the house for periods aggregating 2 years during the 5-year period ending on the date of the sale. Consequently, D is not entitled to exclude gain under section 121.*

TEMPORARY ABSENCE & HOME-USE TEST

Generally, taxpayers must occupy their residence (except for short temporary absences) for at least 2 years during the 5-year period ending on the date of the sale or exchange in order to take advantage of the home sale exclusion.

Exception – Temporary Absence - However, short temporary absences, such as for vacation or other seasonal absence (even though accompanied with rental of the residence), are counted as periods of use. *(Reg. §1.121-1(c)(2)(i))* Two-month vacations are short temporary absences, but a one-year stay abroad (e.g., while on sabbatical) is not. *(Reg. § 1.121-1(c), Exs. (4) and (5))*

> ***Example:*** *John and Maria celebrate John's retirement by taking a nine-month tour of the United States in their motor home. They were concerned about leaving their home vacant for that length of time so they rented it out while they were gone. Under the temporary absence rule, their use period includes the 9 months they were on their tour of the U.S. even though the home was rented out while they were absent.*

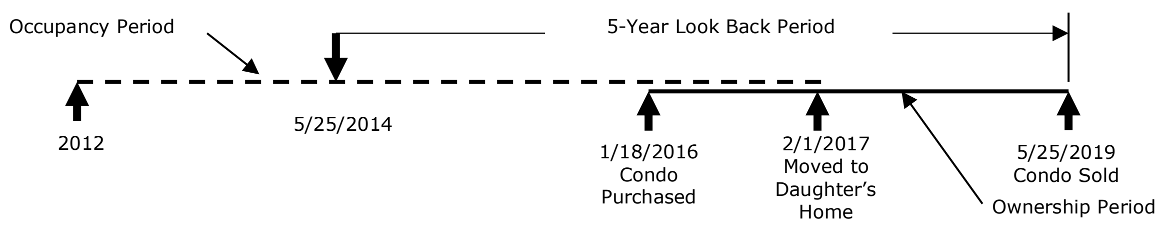
HOME USED AS A RENTAL *(Reg. §1.121-1(c)(4))*

The fact that a home is rented for some period of time does not preclude the home sale from qualifying for the exclusion, provided the nonqualified use rules discussed above do not apply. As long as the ownership and use tests are satisfied, the exclusion can be used (but will be limited if there has been nonqualified use). However, any gain to the extent of the depreciation taken after May 6, 1997 would not be excludable and would be treated as §1250 gain.

Example – Home Used as a Rental *- Taxpayer A owned and used his house as his principal residence from 2004 until January 31, 2017, when A moved to another state. A rents his house to tenants from that date until April 18, 2019, when he sells it. A is eligible for the section 121 exclusion because he has owned and used the house as his principal residence for at least 2 of the 5 years preceding the sale. The taxpayer will not run afoul of the nonqualified use rule that would limit exclusion of gain from the sale because he meets the exception of not using the house as his principal residence from the time he moved out of the house and it was sold.*

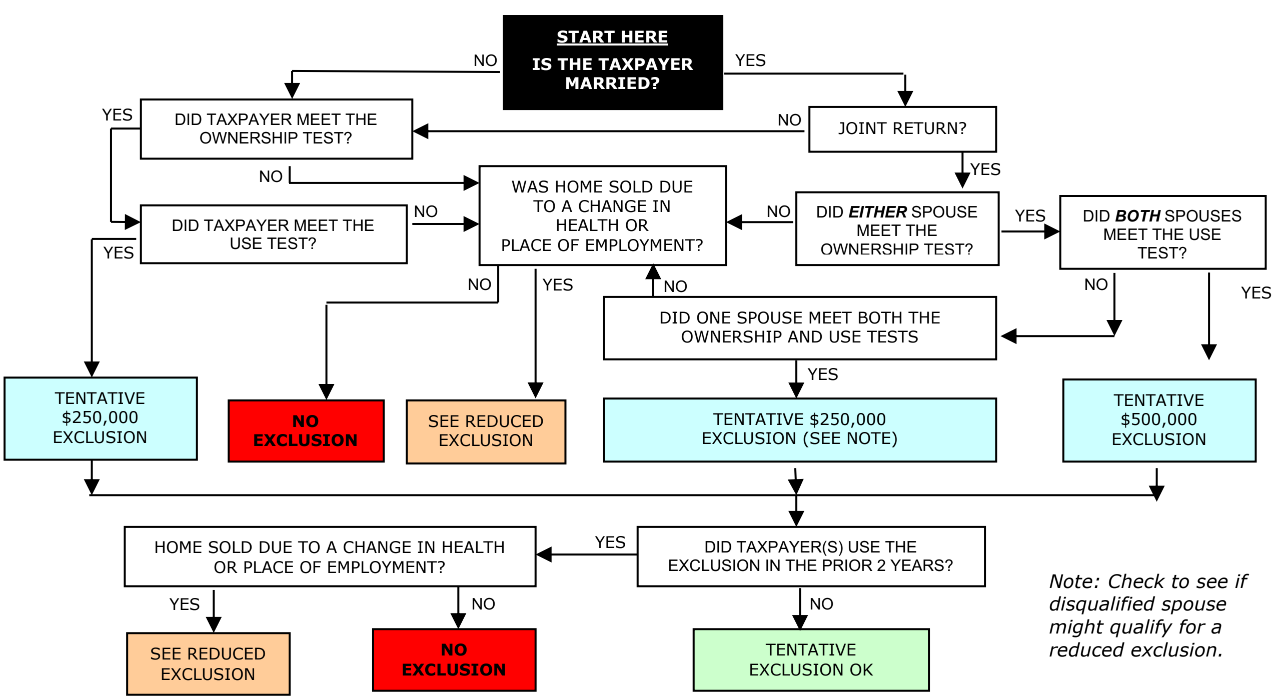
OWNERSHIP & USE TEST PERIODS ARE DIFFERENT *(Reg. §1.121-1(c)(4)):*

Example – Ownership & Use Periods Different *- Taxpayer C lives in a townhouse that he rents from 2012 through 2015. On January 18, 2016, he purchases the townhouse. On February 1, 2017, he moves into his daughter's home. On May 25, 2019, while still living in his daughter's home, he sells his townhouse. The section 121 exclusion will apply to gain from the sale because C owned the townhouse for at least 2 years out of the 5 years preceding the sale (from January 19, 2016 until May 25, 2019) and he used the townhouse as his principal residence for at least 2 years during the 5-year period preceding the sale (from May 25, 2014 until February 1, 2017).*



Exclusion Qualification Chart

Exclusion Flow Chart - Before using this chart, refer to the "Use Test Qualification Chart" for each taxpayer to see if they meet the use test or use test exemption.



ONE-SALE-EVERY-TWO-YEARS LIMIT

The exclusion doesn't apply to any sale if, during the two-year period ending on the date of the sale, there was any other sale by the taxpayer to which the exclusion applied. The exclusion is allowed each time a taxpayer meets the eligibility requirements, but generally no more frequently than once every two years.

Marital Issue – One Spouse Violates the One-Sale-Every-Two-Years Rule - If a single taxpayer who is eligible for an exclusion marries someone who has used the exclusion within the two years before the marriage, the newly-married taxpayer is allowed a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude $500,000 of gain on their joint return.

Marital Issue – Both Spouses Qualify With Separate Residences - This rule limiting the exclusion doesn't prevent a husband and wife filing jointly from each excluding up to $250,000 of gain on the sale or exchange of each spouse's principal residence provided that each spouse would be permitted to exclude up to $250,000 of gain if they filed separate returns.

REDUCED EXCLUSION

The reduced exclusion applies to any sale or exchange if a taxpayer doesn't meet the ownership, use or once-every-two-years requirements due to ***a change in the place of employment, health or (to the extent provided in regs) unforeseen circumstances.*** The reduced exclusion applies if any of the following are true:

(1) Taxpayer did not meet the ownership and use tests for a home sold due to a change in health, place of employment or unforeseen circumstances (as defined in regulations), **or**

(2) Exclusion would have been disallowed because taxpayer sold more than one home during the two-year period, except if the taxpayer sold the home due to a change in health, place of employment or regulations-defined unforeseen circumstances.

Change in Employment - is a change in the location of the employment (including self-employment) of a qualified individual (taxpayer, spouse, co-owner of the residence, or a person whose principal place of abode is in the same household as the taxpayer). This condition is treated as met (a safe harbor) if: (1) the new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment (for the unemployed, 50 miles between the new place of employment and the residence sold or exchanged); and (2) the change in place of employment occurs during the period of the taxpayer's ownership and use of the home as his principal residence. *(Reg. § 1.121-3(c))*

The Health Condition - is met if the primary reason for the sale is: (1) To obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or (2) To obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury.

A qualified individual is:

- The taxpayer,
- The taxpayer's spouse,
- Co-owner of the residence,
- A person whose principal place of abode is in the same household as the taxpayer,
- Family members (son/daughter and descendants; stepson/stepdaughter; brother/sister/step-brother/step-sister; father/mother and ancestors; stepfather/stepmother; son/daughter of sister/brother; sister/brother of father/mother; son-/daughter-in law, father-/mother-in law, brother-/sister-in law) of any individual in the four bullets above, even if they aren't the taxpayer's dependents, or
- Descendants of the taxpayer's grandparent (e.g., first cousins).

A sale or exchange doesn't qualify for the health condition if it is merely beneficial to the general health or well-being of the individual. The health condition is treated as met if a doctor recommends a change of residence for the health reasons listed above in (1) and (2). *(Reg. § 1.121-3(d))*

Strategies - The definition of a **"qualified individual"** opens up some interesting possibilities and, although we cannot cover all of them, the following are some examples:

Incapacitated Parent – Suppose an elderly parent for health reasons can no longer care for themselves. A child, or other qualified relative, could sell their home and use the partial exclusion in order to relocate closer to an elderly parent or vice versa.

Joint Owners – Suppose two unrelated individuals buy a home together. Things don't work out and one loses a job, etc., while the other relocates and changes jobs (meeting the 50-mile requirement). Because the co-owner is a qualified individual, the owner that did not relocate can still utilize the partial exclusion.

Unforeseen Circumstances - The regulations for partial home sale exclusions are quite liberal. Some taxpayers who are unaware of the unforeseen circumstances reduced exclusion provisions may have unnecessarily paid taxes on gain when they sold their homes. Taxpayers who would otherwise qualify under this section to exclude gain from a sale or exchange on or after May 7, 1997, may elect to apply all of the provisions of this section for any years for which the statute of limitations has not expired.

Foreclosure & Unforeseen Circumstances
Loss of a home due to foreclosure or voluntary reconveyance would be unforeseen circumstances.

(1) In general - A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence.

If the taxpayer qualifies for a safe harbor described in this section, the taxpayer's primary reason is deemed to be a change in place of employment, health, or unforeseen circumstances. If the taxpayer does not qualify for a safe harbor, factors that may be relevant in determining the taxpayer's primary reason for the sale or exchange include (but are not limited to) the extent to which:

- The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;
- The suitability of the property as the taxpayer's principal residence materially changes;
- The taxpayer's financial ability to maintain the property materially changes;
- The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;
- The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and
- The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

(2) **Specific safe harbor events** - The primary reason for the sale or exchange is deemed to be unforeseen circumstances if any of the events specified below occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence. *(Reg. § 1.121-3(e)(2))*

(1) **Involuntary conversion of the residence**; *Reg. § 1.121-3(e)(2)(i)*

(2) A natural or manmade **disaster or act of war or terrorism** resulting in a casualty to the residence; *Reg. § 1.121-3(e)(2)(ii)*

(3) **Death of a qualified individual**; *Reg. 1.121-3(e)(2)(iii)(A)*

(4) A qualified individual's **cessation of employment making him eligible for unemployment compensation**; *Reg. § 1.121-3(e)(2)(iii)(B)*

(5) A qualified individual's **change in employment or self-employment** status that results in the taxpayer's **inability to pay housing costs and reasonable basic living expenses** for the taxpayer's household – but not for maintenance of an affluent or luxurious standard of living; *Reg. § 1.121-3(e)(2)(iii)(C)*

(6) A qualified individual's **divorce or legal separatio**n under a decree of divorce or separate maintenance; *Reg. § 1.121-3(e)(2)(iii)(D)* and

(7) **Multiple births** resulting from the same pregnancy of a qualified individual. *Reg. § 1.121-3(e)(2)(iii)(E)*

A qualified individual is defined the same way as for the change-in-employment condition. IRS may designate other events or situations as unforeseen circumstances.

Sale to Facilitate Adoption - The IRS has concluded that the sale of a home and rental of a larger one to facilitate an adoption was an "unforeseen circumstance" for purposes of the reduced home sale exclusion rule. (PLR 200613009)

Home Sale to Accommodate Pregnant Joint Owner - Two unmarried taxpayers jointly purchased a home and used it as their principal residence. Approximately seven months after buying the home, the female partner became pregnant. The mother to be and the father of the expected child were no longer in a relationship and plan to sell the home and find separate residences because the home isn't large enough to accommodate two adults and a child and neither one of them can afford to make the monthly mortgage payments on the home alone. The private ruling concludes that the sale qualified as an unforeseen circumstance. (PLR 200652041)

Big Family Qualified for Reduced Maximum Exclusion - IRS has privately ruled that a taxpayer's second marriage and resulting large combined new family were unforeseen circumstances under the home sale exclusion rules. As a result, he qualified for a reduced maximum exclusion for gain on the sale of a home he had owned and used as a principal residence for less than 2 of the preceding 5 years. (PLR 200725018)

Birth of Second Child Qualified for Reduced Maximum Exclusion – In a private letter ruling, the IRS allowed a married couple to use the reduced maximum gain exclusion when they sold their home after the birth of their second child. When they purchased the 2-bedroom condo, the couple had only one child. The child's bedroom was also used as the husband's home office and a guest room. After having a second child, the taxpayers moved out of the condo and sold it. The IRS approved the reduced maximum exclusion on the basis of unforeseen circumstances and that the suitability of the residence changed significantly with the arrival of the second child. (PLR 201628002)

Caution: *Other taxpayers shouldn't assume that the decision to sell a home in order to facilitate an adoption or expansion of the family automatically qualifies as an unforeseen circumstance. Under Reg. § 1.121-3(e)(3), unforeseen circumstances include events determined by IRS to be unforeseen to the extent provided in published guidance of general applicability or in a ruling directed to a specific taxpayer. A ruling directed to a specific taxpayer (i.e., a private letter ruling) does not establish a generally applicable safe harbor.*

Specific Examples

Example (1) *- In 2018, A buys a house in California. After A begins to use the house as her principal residence, an earthquake causes damage to A's house. A sells the house in 2019. The sale is within the safe harbor of item (2), above, and A is entitled to claim a reduced maximum exclusion.*

Example (2) *- H works as a teacher and W works as a pilot. In 2018, H and W buy a house that they use as their principal residence. Later that year, W is furloughed from her job for six months. H and W are unable to pay their mortgage during the period W is furloughed. H and W sell their house in 2019. The sale is within the safe harbor of item (5), above, and H and W are entitled to claim a reduced maximum exclusion.*

Example (3) *- In 2018, H and W buy a two bedroom condominium that they use as their principal residence. In 2019, W gives birth to twins and H and W sell their condominium and buy a four bedroom house. The sale is within the safe harbor of item (7), above, and H and W are entitled to claim a reduced maximum exclusion.*

Example (4) *- B buys a condominium in 2018 and uses it as his principal residence. B's monthly condominium fee is $X. Three months after B moves into the condominium, the condominium association decides to replace the building's roof and heating system. Six months later, B's monthly condominium fee doubles. B sells the condominium in 2019 because B is unable to pay the new condominium fee along with the monthly mortgage payment. The safe harbors listed above do not apply. However, under the facts and circumstances, the primary reason for the sale is unforeseen circumstances, and B is entitled to claim a reduced maximum exclusion.*

Example (5) *- In 2018, C buys a house that he uses as his principal residence. The property is located on a heavily trafficked road. C sells the property in 2019 because the traffic is more disturbing than he expected. C is not entitled to claim a reduced maximum exclusion under Section 121(c)(2) because the safe harbors of the regulations (listed above) do not apply and, under the facts and circumstances, the traffic is not an unforeseen circumstance.*

Example (6) *- In 2018, D and her fiancé E buy a house and live in it as their principal residence. In 2019, D and E cancel their wedding plans and E moves out of the house. Because D cannot afford to make the monthly mortgage payments alone, D and E sell the house in 2019. The safe harbors do not apply. However, under the facts and circumstances, the primary reason for the sale is unforeseen circumstances, and D and E are each entitled to claim a reduced maximum exclusion.*

CAUTION – UNFORESEEN CIRCUMSTANCES

Taxpayer Preference or Financial Gain - The final regulations clarify that a sale because of unforeseen circumstances (other than a sale within a safe harbor) does not qualify for the reduced maximum exclusion if the primary reason for the sale is a preference for a different residence or an improvement in financial circumstances. (Reg. § 1.121-3(e)(1))

Published Guidance - The final regulations clarify that taxpayers may rely on only those determinations made by IRS in published guidance of general applicability. A ruling directed to a specific taxpayer (i.e., a private letter ruling) does not establish a safe harbor of general applicability. (Reg. § 1.121-3(e) (3))

Amount of Reduced Exclusion - For those who qualify for the reduced exclusion, the gain excluded from gross income can't be more than the $250,000/$500,000 maximum exclusion amount multiplied by a fraction. The denominator of the fraction is <u>730</u> and the numerator of the fraction is of the ***shorter of***:

(1) the number of days, during the five-year period just prior to the current sale that the property was owned and used by the taxpayer as his/her principal residence, ***or***

(2) the number of days after the date of the most recent earlier sale to which the exclusion applied and which occurred before the date of the current sale.

Reduced Exclusion Worksheet

Complete both columns if married filing a joint return.

		(A) *Taxpayer*	(B) *Spouse*
1.	Maximum amount………………………………………………………………………………	250,000	250,000
2a.	Number of days that taxpayer used the property as a main home during the 5-yr period ending on the date of sale. (If filing jointly, fill in col (A) and (B)) …………..	________	________
2b.	Enter the number of days the taxpayer owned the property during the 5-yr period ending on the date of sale. (If filing jointly and one spouse owned the property longer than the other spouse, both spouses are treated as owning the property for the longer period)…..	________	________
2c.	Enter the smaller of line 2a or 2b………………………………………………………………	________	________
3.	Did the taxpayer (or spouse if filing jointly) exclude gain from the sale of another home during the 2-yr period ending on the date of this sale? **NO.** Skip line 3 and enter the number of days from line 2c on line 4. **YES.** Enter the number of days between the date of the most recent sale of another home on which t/p excluded gain and the date of sale of this home……………..	________	________
4.	Enter the smaller of line 2c or 3..………………………………………………………………	________	________
5.	Divide the amount on line 4 by 730 days. Enter the result as a decimal (rounded to at least 3 places). Do not enter an amount greater than 1.000…………………………..	________	________
6.	Multiply the amount on line 1 by the decimal amount on line 5 ……………….………….	________	________
7.	Add the amounts in column (A) and (B) of line 6. This is the reduced maximum exclusion. …………………………………………………………………………………………..		________

Example - Reduced Exclusion Calculation - *Sally sold her principal residence because she got a new job in another city. On the date of the sale, she had used and owned the home as her principal residence for the last 18 months; she had never excluded gain under these rules before. However, since she fails to meet the full use and ownership requirements (i.e., two years of five) by the sale date, the amount of gain she can exclude is reduced using the following calculation (computed using months):*

$250,000 (maximum exclusion for Sally is limited to her gain)
times
[18 months (aggregate time of use under (1) above)/24 months]

Result: Sally can exclude up to $187,500 (250,000 x (18/24)) of her gain on the sale of her principal residence.

Strategies

Partial Home Sale Exclusion and the Sale of a Rental - A single taxpayer sells a home for $600,000. The home was originally purchased on January 1, 2009 for $250,000. The taxpayer lived in the home through March 31, 2015 at which time the taxpayer began renting the home out. It continued to be used as a rental up to the date of sale on February 28, 2019. The reason the taxpayer sold the home was due to a job-related move to Florida in February of 2019. The sales costs were $32,000, and the depreciation taken during the rental period was $27,800. What is the taxpayer's taxable gain from this sale?

This problem is unique in that the taxpayer sold the home while it was in rental service, and the underlying question is whether the taxpayer qualifies for a partial exclusion. The answer to that question lies in Code Sec. 121(c)(2), which says:

The reduced exclusion applies to any sale or exchange of a principal residence if:

- *The exclusion would not (but for these rules relating to the reduced exclusion) apply to the sale or exchange by reason of:*

  (1) A failure to meet the ownership and use requirements, or

  (2) The limit of only one sale every two years, and

- *The sale or exchange is by reason of a change in place of employment, health, or (to the extent provided in regulations), unforeseen circumstances.*

Therefore, the partial exclusion applies to **any** sale or exchange of a principal residence, and in this case, by virtue of the job-related move by the taxpayer. Thus, since the taxpayer used the home as a residence for 13 months of the 60-month qualifying period, the solution is as follows:

- Home used as a rental - April 1, 2015 to February 28, 2019= **47 Months**
- Home used several years prior to April 1, 2015 as principal residence = **13 Months** of the 60-month look back period.
- Section 121 Exclusion: (13/24) x $250,000 = **$135,425**
- Total time owned: 2009 thru 2018 = 10 yrs x 12 mos = 120 + 2 mos in '19 = 122 mos.

Sales price:		$ 600,000
Cost	$ 250,000	
Depreciation	<$ 27,800>	
Basis		<$ 222,200>
Sales costs		<$ 32,000>
Gain before Exclusion		$ 345,800
Section 121 Exclusion		<$135,425>
Taxable Gain		**$210,375**

Note: if the exclusion had been figured based on the number of days instead of months, the exclusion would be $200 more: 396 days/730 = .5425 x 250,000 = 135,625.
In addition, part or all of the balance of the gain could be deferred under Section 1031 if the taxpayer acquired a replacement rental and meets all the requirements for a Section 1031 exchange.

FORECLOSURE & DEBT RELIEF ISSUES – Also see chapter 2.09 Foreclosures & Abandonment

Sales Price Determination – When there is a foreclosure or voluntary reconveyance the sales price is determined based upon whether there is debt relief or not. Where the debt is a non-recourse debt the sales price is the balance of the loan at the time of disposition. Where the debt is recourse, the sale price is the FMV of the home at the time of disposition.

Debt Relief Basis Adjustments – There may be a home basis adjustment to be accounted for in a debt relief computation. Where the taxpayer excludes gain under the insolvent taxpayer exclusion there is no home basis adjustment. However, if a taxpayer utilizes the special homeowner's exclusion for 2007 through 2017, then the homeowner must reduce the basis of the home for which the debt relief income is attributable. This basis adjustment must be reported on IRS Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, by checking box 1e of Part I of that form and entering the amount of basis reduction on line 10b of Part II. This in effect transfers the debt relief to the home where it can be excluded under Sec 121, or if any portion of it is taxable, it becomes capital gains income.

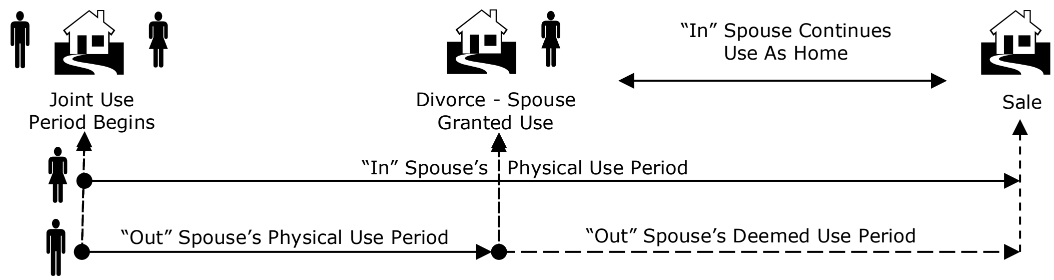
LOSS OF EXCLUSION WHEN PRIOR PRINCIPAL RESIDENCE REACQUIRED (BUYERS DEFAULT)

The Tax Court has concluded that, where a taxpayer sold his primary residence and excluded gain under Code Sec. 121, then reacquired the property after the buyers defaulted, the taxpayer had to recognize long-term capital on the reacquisition including amounts previously excluded under Code Sec. 121. The Court found that subjecting the taxpayer to the general gain recognition rules of Code Sec. 1038 was required under the statute and consistent with the economics of the transaction. Debough, (2014) 142 TC No. 17

SPECIAL RULES FOR MARRIED TAXPAYERS

Transfers between spouses or transfers related to divorce - For an individual holding property transferred between spouses or transfers incident to divorce, the period the individual owns the property includes the period the transferor owned the property. However, the period that the transferor spouse or former spouse used the property is not included in the period that the individual used the property. So, it seems that the transferee spouse would still have to satisfy the use requirement in order to qualify for the exclusion. ***(Reg. §1.121-4(b)(1))***

Sale after ex-spouse retains property for some period of time - Only for purposes of this exclusion is an individual treated as using property as the individual's principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument. This means that if a husband (or wife) continues to own the home after a divorce, and his/her former wife (husband) is granted use of the property under a divorce instrument, the exclusion could be available when the husband (wife) sells the house if he (she) meets the ownership requirement and his wife (her husband) meets the use requirements. ***(Reg. §1.121-4(b)(2))***



Deceased spouse's property – A surviving spouse is treated as owning and using property as the taxpayer's principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence before death if ***(Reg. §1.121-4(a):***

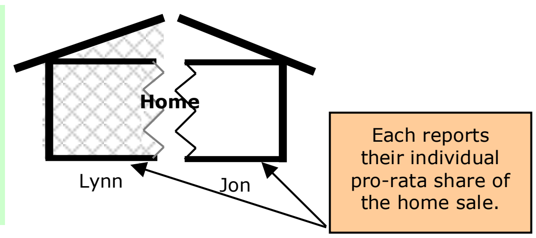
1) The taxpayer's spouse is deceased on the date of the sale or exchange of the property; and
2) The taxpayer has not remarried at the time of the sale or exchange of the property.

Special Note: *Remember a surviving spouse will have a step-up (or step-down) in basis for half or all of the property. In addition, the capital gains holding period for inherited property is always long-term.* (This note is not applicable for property acquired from a decedent dying in 2010 if the executor chose the "no estate tax" and carryover basis method.)

OTHER RULES

Jointly Owning a Home – Unmarried Individuals - (Reg. §1.121-2(a)(4), Ex. 1). If two unmarried individuals jointly own and use one principal residence, the $250,000 exclusion provisions apply independently to each upon a sale of the residence. Each individual must report their separate gain (or loss) on their personal tax return and, therefore, may be eligible to exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property.

Example – Unmarried Taxpayers - *Lynn and Jon, who are unmarried, own a house as joint owners, each owning a 50-percent interest in the house. They sell the house after owning and using it as their principal residence for 2 full years. The gain realized from the sale is $256,000. Lynn and Jon are each eligible to exclude $128,000 of gain because the amount of realized gain allocable to each of them from the sale does not exceed the available limitation amount of $250,000 available to each separately.*

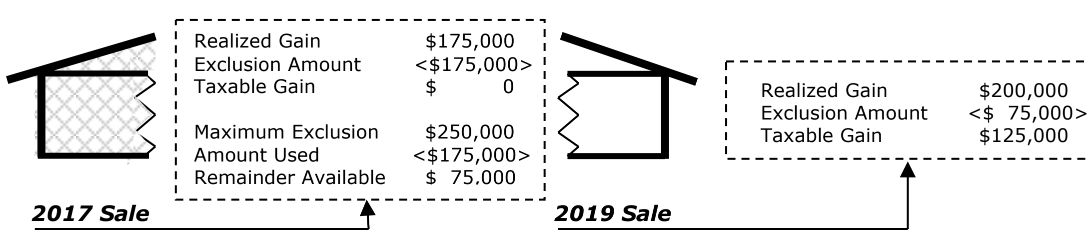


Sales of Partial Interests and Remaining Interests - (Reg §1.121-4(e)(1)(ii))

Only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of the partial interests. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer's full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, and each spouse is treated as excluding one-half of the gain from a sale or exchange relating to the limitation for certain joint returns apply.

Caution: *The provisions for sales of partial interests do not apply to sales or exchanges to related parties.*

Example – Sale of a Partial and Remaining Interest - *In 2011, Gil buys a house that he uses as his principal residence. In 2017, Gil's friend Dave moves into Gil's house and Gil sells Dave a 50-percent interest in the home. Gil realized a gain of $175,000 in the transaction. Gil may exclude the $175,000 of gain. In 2019, Gil gets married and Gil's new wife Connie owns a home. Gil and Connie decide to live in Connie's home so Gill sells his remaining 50-percent interest in the home to Dave, realizing an additional gain of $200,000. Gil may exclude $75,000 ($250,000 - $175,000) of gain from sale of his remaining interest and the balance of $125,000 will be taxable.*

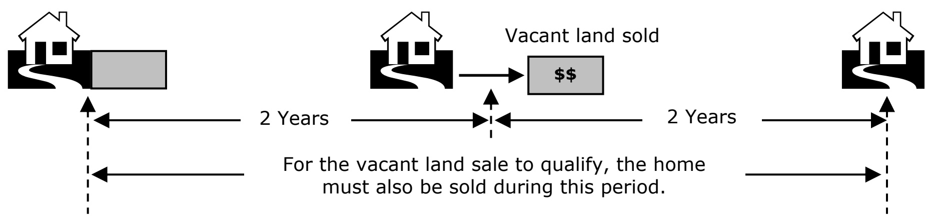


The one-sale-every-two-year rule is disregarded for sales of partial interests in the same home. However, in the example above, the taxpayer could not have had another sale two years prior to the 2017 sale nor can he have one for two years after the 2019 sale. Should he, for some reason, wish to elect not to take the exclusion on the 2019 sale, he can do so by reporting the gain on his 2019 return in which case the one-sale-every-two-year rule would be based solely on the 2017 sale date.

Sale of Vacant Land Adjacent to a Home - (Reg. §1.121-1(b)(3))

In general, the sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless:

- The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;
- The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;
- The vacant land was not used for non-residential purposes (Reg § 1.121-1(e)(1));
- The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of Section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and
- The requirements of Section 121 have otherwise been met with respect to the vacant land.



The gain exclusion for the two transactions would be in accordance with the provisions of selling partial or remaining interests discussed previously. **Caution:** The Sec. 121 provisions do not apply for partial interest and remaining interest sales to related parties.

Home Sale - Revocable Trust - If a residence is owned by a trust, for the period that a taxpayer is treated as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of Section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer. *(Reg. § 1.121-1(c)(3)(i))*

Home Sale Exclusion – Irrevocable Trusts - Some individuals use revocable trusts as an alternative to having their property transferred by will. While there is no income or estate tax advantage to a revocable trust, there is a benefit in having the property pass to beneficiaries on the death of the owner without having to go through the probate process. A private ruling reveals a potential pitfall where a married couple transfers their residence to a revocable trust that becomes irrevocable after the first spouse dies – the $250,000 home sale exclusion may be completely lost or available only to a limited extent even though the surviving spouse has the continued right to occupy the residence.

In the ruling (PLR 200104005), the exclusion was available only to the extent the survivor was considered to own trust property. The couple, living in a community property state, established a revocable trust while both were living. Upon the death of the spouse, the trust was split into two trusts, the irrevocable bypass trust and the survivor's revocable trust. The home was assigned to the irrevocable bypass trust and the survivor was only allowed to withdraw from the principal of the trust in each calendar year an amount not to exceed the greater of $5,000 or 5% (5 or 5 power) of the then aggregate market value of all property included in the trust.

In the letter ruling, the IRS concluded that gain on the trust's sale of the residence is taxable to the trust except for the portion of the gain that is taxable to the surviving spouse, by virtue of his 5 or 5 power. Thus, the surviving spouse may only use the Code Sec. 121 exclusion to shelter gain on the portion of the residence attributable to his 5 or 5 power.

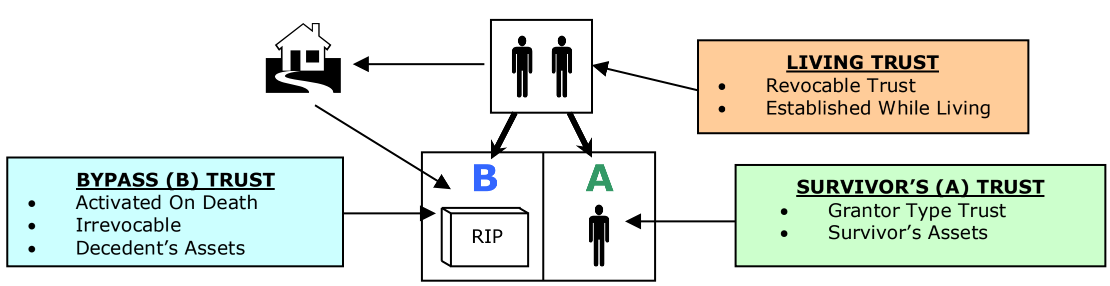


Figure #4 – Home in Irrevocable Bypass Trust

***Example** – Assume the taxpayers have a revocable living trust. Upon the first spouse's death, the irrevocable bypass (B) trust is created. If some portion of the taxpayers' home is assigned to the bypass trust, that portion of the home does not qualify for future § 121 gain exclusion. This initially creates no problem, because the home's basis is stepped up when it goes into the trust (and it won't be stepped up again when the surviving spouse passes). However, if the surviving spouse continues to use the home for a number of years and the home appreciates in value and is then sold, the resulting gain for the portion of the home in the irrevocable trust would not be excludable under § 121.*

<u>RESIDENCE USED PARTIALLY FOR BUSINESS – MIXED-USE PROPERTY</u>

The final regulations provide that no allocation of gain is required if both the residential and nonresidential portions of the property are within the same dwelling unit; gain to the extent of any post-May 6, '97, depreciation adjustments isn't excludible. However, gain is allocated if the portion of the home used for business is separate from the dwelling unit and the separate structure fails the residential qualification tests. *(Reg. § 1.121-1(e)(1))*

Treatment where business use is within the same dwelling unit:

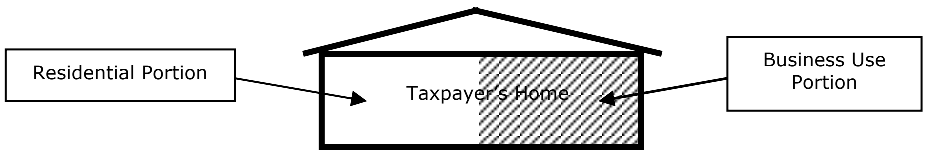


Illustration – Business Use within Home Structure

No allocation of gain is required if both the residential and nonresidential portions of the property are within the same dwelling unit. The gain from the sale is treated as if the entire home qualified for the home gain exclusion except that any gain to the extent of any post-May 6, '97 depreciation adjustments isn't excludible. Any depreciation taken, including post-May 6, '97 depreciation, adjusts the basis of the home.

Example #1 – Assuming a single taxpayer and the home meets the exclusion qualifications:

1.	Sales price		$450,000
2.	Sales expenses		< $35,000>
3.	Basis	$250,000	
4.	Improvements	$ 15,000	
5.	Depr. pre-5/7/97	<$ 1,200>	
6.	Depr. post-5/6/97	<$ 1,000>	
7.	Adjusted basis	$262,800	<$262,800>
8.	Pre-exclusion gain		$152,200
9.	Depr. Post-5/6/97		<$ 1,000>
10.	Gain		$151,200
11.	Tentative exclusion		$250,000
12.	Exclusion (smaller of LN10 or LN11)		<$151,200>
13.	Gain		$ 0
14.	Unrecaptured Sec 1250 Gain (smaller of LN8 or LN9)		$1,000
15.	Capital Gain (LN13 less LN14)		$0

<u>HOME QUALIFYING FOR SEC 121 EXCLUSION AND SEC 1031 DEFERRAL</u>

Rev Proc 2005-14 has made it quite clear that the ***exchange*** of a home can qualify for both the §121 home sale exclusion and §1031 like-kind exchange deferral treatment. This can occur where the property was used as a principal residence and a business <u>consecutively</u> (e.g., used as a principal residence followed by rental of the property) or <u>concurrently</u> (a portion of the home used as a principal residence and a portion used as a home office). (Rev. Proc. 2005-14) **Caution:** in real life, how many people selling their principal residence would structure the deal as an exchange? Merely selling a home where part has been used as an office and buying a new one where part is going to be used as an office won't qualify as an exchange.

Consecutive Use – This would occur when a taxpayer's home is converted to a rental property and is still being used as a rental property at the time of the exchange AND still meets the two-out-of-five ownership and use qualifications. Thus, the §121 home sale exclusion would apply and since the property is in business use, it also would qualify for §1031 like-kind exchange deferral treatment.

Example #2 *– Jack buys a house for $210,000 that he uses as his principal residence from 2014 to 20172018. From 2018 until 2019, he rents the house to tenants and claims depreciation deductions of $20,000. In 2019, Jack, who is single, exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000. Jack intends to use the townhouse as rental property. This is the way the transaction plays out:*

The Exchange	***GIVEN***	***RECEIVED***
Fair Market Value	*470,000*	*460,000*
Cash		*10,000*
Total	*470,000*	*470,000*

***Gain Computation**:*	
FMV of Property Given	*$470,000* (1)
Less cost	*<210,000>*
Depreciation	*20,000*
Gain	*$280,000*
§121 Exclusion	*<250,000>*(2)
Profit	*$ 30,000*
§1031 Deferral	*< 30,000>* (3)
Taxable Gain	*0*

(1) Townhouse worth $460,000 plus $10,000 in cash.
(2) There is no limitation on the exclusion for "nonqualified use" because the rental occurred after the last date the property was used by Jack as his principal residence.
(3) Jack defers the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under Code Sec. 1031. Moreover, although Jack received $10,000 of cash (boot) in the exchange, he is not required to recognize gain because the boot is taken into account for purposes of Code Sec. 1031(b) only to the extent the boot exceeds the amount of excluded gain.

Concurrent Use – This would occur when a taxpayer's home is used as a primary residence and for business purposes at the same time. A frequently encountered example would be a taxpayer with a home office.

Example #3 *- Charlie pays $210,000 for a house that constitutes a single dwelling unit (1). From 2015 until 2019, he uses 2/3 (by square footage) as his principal residence and 1/3 as an office in his business. In 2019, he exchanges the entire property for a residence and a separate property to be used as an office in his business. The total FMV of the replacement properties is $360,000. The FMV of the replacement residence is $240,000 and the FMV of the replacement business property is $120,000, which is equal to the FMV of the business portion of the relinquished property. From 2015 to 2019, Charlie claims depreciation deductions of $30,000 for the business use. Thus, he realizes gain of $180,000 on the exchange ($360,000 amount realized − $180,000 adjusted basis ($210,000 cost − $30,000 depreciation)). Charlie is single. There was no "nonqualified use." He qualifies for both tax breaks as follows:*

	TOTAL	HOME	OFFICE
Sales Price	*360,000*	*240,000*	*120,000*
Home Cost	*<210,000>*	*<140,000>*	*<70,000>*
Depreciation	*30,000*	*---*	*30,000*
Realized Gain	*180,000*	*100,000*	*80,000*
§121 Exclusion	*<150,000>* (2)	*<100,000>*	*<50,000>* (2)
Tentative Taxable Gain	*30,000*	*0*	*30,000*
§1031 Deferral	*<30,000>*(3)	*---*	*<30,000>* (3)
Taxable Gain	*0*	*0*	*0*

(1) Under Code Sec. 1.121-1(e)(2) the sale of a home that is a single dwelling unit and is also used for business purposes is treated as one sale and the §121 exclusion applies to all gain except that gain attributable to depreciation taken after May 6, 1997.

(2) Under Reg. § 1.121-1(e), Charlie may exclude $50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit and any gain in excess of the depreciation taken after May 6, 1997 is subject to the §121 exclusion.

(3) Charlie defers paying tax on the office portion since he acquired a replacement. His basis in the separate replacement business property is $90,000 ($40,000 basis in the relinquished business property at the time of the exchange + $50,000 gain excluded under Code Sec. 121 attributable to the relinquished business property). (Code Sec. 1031. (Rev Proc 2005-14, Sec. 5, Ex. 3))

Treatment where business use is in a separate structure *(Reg. § 1.121-1(e)(1)):*

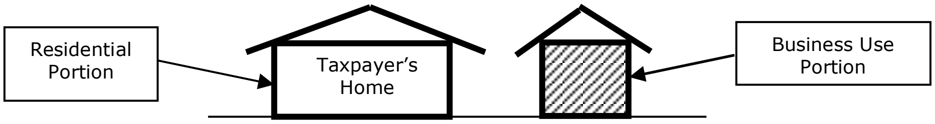


Illustration – Business Use in a Separate Structure

If the residence was mixed-use property and the business portion was in a separate structure, only that part of the gain allocable to the residential portion is excludable under §121. Therefore, the 2-out-of-5 years rule must be applied separately to the separate structure used for nonresidential (business) purposes.

EXCLUSION TEST: Does the separate structure meet the 2-out-of-5 years qualification rules?

Yes – Then the separate structure qualifies for the home sale exclusion right along with the rest of the home and the gain computation will be the same as if it were included in the same structure as illustrated previously.

No – Then the two structures are treated as separate sales. No part of the gain on the separate structure used for nonresidential purposes will qualify for the §121 exclusion. The same rules will apply to depreciation recapture with depreciation after May 5, 1997 treated as unrecaptured §1250 gain. Depreciation before May 6, 1997 adjusts the basis of the separate structure.

Example #4– Same as example #1 except that the business-use portion was in a separate structure representing 10 percent of the overall home unit. In this case, the home portion (A) and the business portion (B) must be treated as separate sales:

		A		B
1. Sales price		405,000		45,000
2. Sales expenses		< 31,500>		< 3,500>
3. Basis	225,000		25,000 (1)	
4. Improvements	13,500		1,500 (1)	
5. Depr. pre-5/7/97	< 0> (2)		< 1,200>	
6. Depr. post-5/6/97	< 0> (2)		< 1,000>	
7. Adjusted basis......................	238,500	<238,500>	24,300	<24,300>
8. Pre-exclusion gain		135,000		17,200
9. Depr. Post-5/6/97		< 0>		< 1,000>
10. Gain		135,000		16,200
11. Tentative exclusion	250,000 (3)		0	
12. Exclusion (smaller of LN10 or LN11)		<135,000>		< 0>
13. Gain		0		16,200
14. Sec 1250 Gain (smaller of LN8 or LN9) ...		0		1,000
15. Capital Gain (LN13 less LN14)		0		15,200

(1) In the example, the improvements have been allocated 90% to the home structure and 10% to the business structure. In actual application, the improvements are allocated to the structure where the improvements were made. If the separate business structure was built or required substantial improvements after the home structure was acquired, the specific allocation of improvements can provide a substantial benefit to a client.

(2) The depreciation may not always be allocated all to the separate structure. There could be situations where the business use was originally in the home structure and later moved to the separate structure.

(3) The tentative exclusion would be $250,000 for an individual or $500,000 for a qualifying couple. The amount could also be a partial exclusion based on either of those two amounts.

LOSS ON SALE WITH AN OFFICE

The question may arise on how to treat a loss on a home sale where the home was also used for business.

- **Mixed Use** - If the home was "mixed use" property at the time of sale, no loss is allowed. Mixed use means it is used both for personal and business use. ("Reg 1.165-9(a) LOSSES NOT ALLOWED. A loss sustained on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible under section 165(a)." Thus, this regulation presumably applies in a mixed use situation.)

- **Separate Structure** - If the business use was in a separate structure then there would be two separate sales with no loss allowed on the personal use portion. The gain or loss would be recomputed for the business use portion taking into account the depreciation taken. If the result is a loss, the loss is allowed on the business part (Form 4797). If the result is a gain, the gain is taxable and does not qualify for the Sec 121 exclusion.

SPECIAL CONSIDERATIONS

Nonexclusive use of home as a daycare facility – The liberalized rules for mixed-use property generally clarify the issues pertaining to a home used as a daycare center. But what happens if the daycare operation utilizes a separate structure but not exclusively? The space in a home that is used as a daycare facility does not have to be used exclusively for providing daycare services to children, handicapped individuals and the elderly. (S Rept No. 95-66 (PL 95-30) p. 91) Neither the IRS Publications nor the temporary regulations deal with this issue. However, if the business use is generally only 5 or 6 days a week and only 8 to 10 hours a day, then the residential use is the predominate use and one could take the position that the separate structure also qualifies for the exclusion to the extent of any gain in excess of the post May 6, 1997 depreciation.

Main home - The definition of the term "main home" usually means the home the taxpayer lives in most of the time and can be a:

- House,
- Houseboat,
- Mobile home,
- Cooperative apartment, or
- Condominium.

Tenant-stockholder in cooperative housing corporation - The exclusion is available for a tenant-stockholder in a cooperative housing corporation. The ownership requirements apply to the holding of the stock, and the use requirements apply to the house or apartment underlying the stock. ***Reg. §1.121-4(c)***

Life Estate – It is not uncommon for elderly parents, and sometime others, to deed over their property to their children or other relatives, thinking that is a way to avoid inheritance issues down the road. In actuality it is not the thing to do since the gift beneficiaries assume the property at the donor's basis and cannot exclude any property gain from the Sec 121 home sale exclusion if the home is sold while still in possession of the donor. However, such actions generally create a life estate which would still permit a Sec 121 exclusion should the property be sold while the donor is living and in possession of the property and allow a basis adjustment when the donor passes while still in possession of the property. See page 11.05.03 for a more detailed discussion of Life Estates.

Involuntary conversions - For purposes of the exclusion, the destruction, theft, seizure, requisition, or condemnation of property is treated as sale of the property. In applying the rules for involuntary conversions, the amount realized from the sale is deemed to be the amount determined without regard to this exclusion, reduced by the amount of gain not included in gross income under the exclusion. ***Reg. §1.121-4(d)(3)***

> ***Example – Involuntary conversion*** *- On February 18, 2019, a fire destroys the taxpayer's house that has an adjusted basis of $80,000. She had owned and used this property as her principal residence for 20 years prior to its destruction. Her insurance company pays her $400,000 for the house, and she realizes a gain of $320,000 ($400,000 - $80,000). On August 27, 2019, she purchases a new house at a cost of $100,000.*
>
> *Because the destruction of the house is treated as a sale for purposes of Section 121, she will exclude $250,000 of the realized gain from the sale. For purposes of the involuntary conversion rules of §1033, the amount realized is then treated as being $150,000 ($400,000 - $250,000) and the gain realized is $70,000 ($150,000 amount realized - $80,000 basis). She elects under § 1033 to recognize only $50,000 of the gain ($150,000 amount realized - $100,000 cost of new house). The remaining $20,000 of gain is deferred and her basis in the new house is $80,000 ($100,000 cost - $20,000 gain not recognized).*
>
> *She will be treated as owning and using the new house as her principal residence during the 20-year period that she owned and used the destroyed house. After the two-year period expires for the one-sale-every-two-years rule, she may sell the replacement home and utilize the full home gain exclusion.*

EXCEPTIONS TO THE EXCLUSION RULES

Recognition of gain attributable to depreciation: The exclusion doesn't apply to that part of the gain from the sale of any property that doesn't exceed the portion of the depreciation adjustments (under ***§1250(b)(3)***) for periods after 05/06/97. Thus, a taxpayer recognizes gain to the extent of any depreciation allowable with respect to the rental or business use of the principal residence for periods after 05/06/97.

Denial of exclusion to expatriates: The exclusion doesn't apply to any sale by an individual to whom the rules related to expatriation to avoid tax apply.

Election out of the exclusion: The exclusion does not apply to any sale if the taxpayer elects out. This could be an advantage where a taxpayer has owned and used two residences as principal homes at different times during the five-year period prior to sale and he/she is planning to sell both of the residences within two years of each other. If the sale of one residence would generate a smaller gain than the other, he/she may want to elect out of the exclusion for the sale of the residence with the smaller gain in order to preserve the benefits of the exclusion for the other sale.

HOME SALE TRANSACTIONS GET BREAK ON INFORMATION REPORTING REQUIREMENTS

For sales relating to the Sec 121 exclusion, the law creates an exception from the real estate transaction reporting requirements for any sale or exchange of a residence for $250,000 or less ($500,000 or less for a married taxpayer). To take advantage of the exception, however, the reporting person must receive written assurance, in a form the IRS approves, from the seller that:

- The residence is the seller's principal home,
- If the real estate sale information return requires disclosure about whether there is federally subsidized mortgage financing assistance for the mortgage on the residence (whether old mortgage or new mortgage is unspecified in the law), that there is no such assistance,
- The full amount of the gain on the sale is excludable from gross income, and
- There has been no period of nonqualified use after December 31, 2008.

Strategies

Avoid CP-2000 Notice – Home Sale Gross Proceeds

The instructions for 1099-S, "Proceeds from Real Estate Transactions", generally require the gross proceeds of sale to be reported for real estate transactions. However, it provides for an exception for the sale or exchange of a principal residence as noted above.

Problem – The instructions say the escrow company *may* issue a 1099-S even if the transaction meets the principal residence exclusion. Just because the selling price of a client's home is under the exclusion limits, don't assume a 1099-S has not been issued. Many times they are and the client may not be aware that one was issued.

Solution – Always report the sale on Form 8949 even if the sales price is under the $250,000/$500,000 gain exclusion limits.

Example: *Married taxpayers sell their home for $400,000. Their home's basis is $300,000 and they qualify for the exclusion. No Form 1099-S was received. The sale is reported in Part II of Form 8949, where Box F is checked.*

Description	***Purchase Date***	***Sale Date***	***Sales Price***	***Cost Basis***	***Col. (f) Code***	***Col. (g) Adj***	***Gain or Loss***
Home	*9/10/09*	*8/15/19*	*400,000*	*300,000*	*H*	*(100,000)*	*0*

PROCEDURE TO EXEMPT GAIN FROM 1099-S REPORTING (REV PROC 2007-12)

The IRS has issued a set of written assurances (certification) that a real estate reporting person must obtain from the seller of a primary residence in order to exempt the sale from the 1099-S reporting requirements. The procedure is effective for sales occurring after 1/22/2007. The certification must be signed by each owner of the residence and must include the following:

(1) The seller owned and used the residence as his principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence.

(2) The seller has not sold or exchanged another principal residence during the 2-year period ending on the date of the sale or exchange of the residence.

(3) No portion of the residence has been used for business or rental purposes after May 6, '97 by the seller (or by the seller's spouse or former spouse, if the seller was married at any time after May 6, '97).

(4) At least one of the following three statements applies:

- The sale or exchange is of the entire residence for $250,000 or less.
- The seller is married, the sale or exchange is of the entire residence for $500,000 or less, and the gain on the sale or exchange of the entire residence is $250,000 or less.
- The seller is married, the sale or exchange is of the entire residence for $500,000 or less, and (a) the seller intends to file a joint return for the year of the sale or exchange, (b) the seller's spouse also used the residence as her principal residence for periods aggregating 2 years or more during the 5-year period ending on the sale date, and (c) the seller's spouse also has not sold or exchanged another principal residence during the 2-year period ending on that date.

(5) During the 5-year period ending on the date of the sale or exchange of the residence, the seller did not acquire the residence in an exchange to which Code Sec. 1031 applied.

(6) In cases where the seller's basis in the residence is determined by reference to the basis in the hands of a person who acquired the residence in an exchange to which Code Sec. 1031 applied, the exchange to which Code Sec. 1031 applied occurred more than 5 years before the sale date.

Rev. Proc. 2007-12 does not reflect a law change made after its release which added IRC Sec. 121(b)(4 [sic (5)]). The sample certification in Rev. Proc. 2007-12 does not include an assurance that there has been no period of nonqualified use after December 31, 2008. Also, the sample certification included in Rev. Proc. 2007-12 does not include an assurance, as required by Sec. 6045(e)(5)(A)(iii), that the full amount of the gain from the sale is excludable under Sec. 121.

The following provisions apply to the real estate reporting person:

- The certification may be obtained no later than February 15 of the year following the year of sale. The sample certification form included in Rev Proc 2007-12 (modified to account for the two items noted above in the preceding paragraph) may be used or a substitute form containing all the required information may be used.
- The reporting person will not be liable for "failure to file an informational return" or "failure to provide statement to the seller" penalties if the certification is obtained, unless the reporting person has actual knowledge that the certification is incorrect.

CALIFORNIA DIFFERENCES

California generally conforms to Federal Home Sale Exclusion Rules except for the following differences.

- **Peace Corp Home Sale Exception** - For sale or exchanges after 5/6/97, federal law allows an exclusion of gain on the sale of a personal residence in the amount of $250,000 ($500,000 if married filing jointly). The taxpayer must have owned and occupied the residence as a principal residence for at least 2 of the 5 years before the sale. California conforms to this provision. However, California taxpayers who served in the Peace Corps during the 5 year period ending on the date of the sale may reduce the 2 year period by the period of service, not to exceed 18 months.
    - California does not conform to the provision that, for federal purposes, extends to Peace Corps volunteers the same election opportunity as is granted to certain military members and employees of governmental intelligence agencies allowing suspension of the 5-year use and ownership test period for up to 10 years while on extended active duty. (California does conform to this benefit for military and intelligence community members.)
- **Assisted Living Housing Development Sale Exclusion** - Federal law does not allow special treatment on gains related to the sale of certain assisted housing for low-income residents. California law permits the deferral of such gain, under certain conditions, if the proceeds are reinvested in residential real property (other than a personal residence) within two years of the sale. See R&TC §§ 18041.5 and 24955 for details.
- **Home Mortgage Debt Relief Basis Adjustment** – California belatedly (September 25, 2008) enacted its own version of mortgage debt relief that was effective for years 2007 and 2008, and in mid-2010 enacted conformity – with major differences – effective for principal residence debt relief occurring from January 1, 2009 through 2012. This provision was extended through 2013 (the extension is through 2017 for federal). Therefore, the basis of the home may be different for federal and California because the amount of the basis adjustment, if any, resulting from home mortgage debt relief may not be the same. Governor Brown vetoed AB 99 in October 2015; this bill would have extended California principal residence debt relief for another year. Subsequently, another bill (SB907) passed by the California legislature that would retroactively extend the California principal residence debt relief provisions through 2016, but it was also vetoed by the governor. Many taxpayers may qualify for relief by using the insolvency provision. See Chapter 2.09.
- **Surviving Spouse $500,000 exclusion** – For sales occurring on or after January 1, 2010, California conforms to the $500,000 exclusion of gain for surviving spouses who would have qualified for the $500,000 exclusion immediately prior to their spouse's death, and where the sale takes place within 2 years of the spouse's death. For federal purposes, the effective date was January 1, 2008; thus for CA purposes, prior to conformity the surviving spouse was limited to a $250,000 exclusion.
- **Nonqualified Use Exclusion Reduction** –For sales on or after January 1, 2010, California conforms to the federal rule (effective for federal purposes for principal residence sales in 2009 and later) that limits the home sale gain exclusion when there have been periods of nonqualified use after 2008.
- **Special Rule for Decedents Dying in 2010** - California does not conform to the provisions of IRC Sec 121(d)(11) allowing (a) up to $250,000 gain exclusion to the estate or heir of a decedent dying in 2010 if the estate or heir sells the decedent's principal residence and the decedent had met the two-out-of-five years use and ownership tests, and (b) tacking on the decedent's ownership and use periods to that of an heir who occupies the home as a principal residence to determine if the heir meets the two-out-of-five years tests.

HOME SALE WORKSHEETS:

On the following pages are worksheets for the sale of a home that was or is also used for business (home office).

ADJUSTED BASIS OF HOME – WORKSHEET #1

Use this worksheet to determine the basis of the home before using Worksheets 3 or 4.

Part 1. General Information

Taxpayer Name: ______________________ Last Four Digits of SSN: __________

Property Description: ______________________

Method of Acquisition: ❑Purchase ❑Gift ❑Inherited ❑Other: __________

Date Acquired .... ____/____/______

Date Sold: .... ____/____/______

Part 2. Gain or (Loss) on Sale

1. Enter the purchase price of the home sold. (If the taxpayer(s) filed Form 2119 when they originally acquired that home to postpone gain on the sale of a previous home before May 7, 1997, enter the adjusted basis of the new home from that Form 2119.)........................1. ________
2. Seller-paid points for home.
   Do not include any seller-paid points already subtracted to arrive at the amount entered on line 1........................2. ________
3. Subtract line 2 from line 1........................3. ________
4. Settlement fees or closing costs (do **not** include fees/costs for getting a mortgage loan).:
   If line 1 includes the adjusted basis of the new home from Form 2119, skip lines 4a–4g and 5; go to line 6.
   a. Abstract and recording fees........................4a. ________
   b. Legal fees (including fees for title search and preparing documents)........................4b. ________
   c. Survey fees........................4c. ________
   d. Title insurance........................4d. ________
   e. Transfer or stamp taxes........................4e. ________
   f. Amounts that the seller owed that the buyer agreed to pay (back taxes or interest, recording or mortgage fees, and sales commissions)........................4f. ________
   g. Other.:__________________........................4g. ________
5. Add lines 4a through 4g........................5. ________
6. Cost of additions and improvements. Do not include any additions and improvements included on line 1........................6. ________
7. Special tax assessments paid for local improvements, such as streets and sidewalks........................7. ________
8. Other increases to basis........................8. ________
9. Add lines 3, 5, 6, 7, and 8........................9. ________
10. Depreciation allowed or allowable, related to the business use or rental of the home........................10. ________
11. Other decreases to basis........................11. ________
12. Add lines 10 and 11........................12. ________
13. Adjusted basis of home sold. Subtract line 12 from line 9........................13. ________

SEC 121 REDUCED EXCLUSION AMOUNT – WORKSHEET #2

Use this worksheet to determine the Sec 121 exclusions where the full amount is not available before using Worksheets 3 or 4.

Part 1. General Information

Taxpayer Name: ____ Last Four Digits of SSN: ______________

Property Description: ____

Method of Acquisition: ❑Purchase ❑Gift ❑Inherited ❑Other: ____________________

Date Acquired .... _____/_____/________

Date Sold: ...._____/_____/________

1. Maximum amount..	1.	$250,000	$250,000
2a. Enter the number of days (or months) that the property was used as a main home during the 5-year period* ending on the date of sale..	2a.	_________	_________
2b. Enter the number of days (or months) that the taxpayer owned the property during the 5-year period* ending on the date of sale. If days were used on line 2a, days must also be used on this line and on lines 3 and 5. If months were used on line 2a, months must also be used on this line and on lines 3 and 5. (If married filing jointly and one spouse owned the property longer than the other spouse, both spouses are treated as owning the property for the longer period.)..	b.	_________	_________
2c. Enter the smaller of line 2a or 2b..	c.	_________	_________
3. Has the taxpayer (or spouse, if filing jointly) excluded gain from the sale of another home during the 2-year period ending on the date of this sale? ☐No ☐Yes **No** - Skip line 3 and enter the number of days (or months) from line 2c on line 4. **Yes** - Enter the number of days (or months) between the date of the most recent sale of another home on which gain was excluded and the date of sale of this home......	3.	_________	_________
4. Enter the smaller of line 2c or 3..	4.	_________	_________
5. Divide the amount on line 4 by 730 days (or 24 months). Enter the result as a decimal (rounded to at least 3 places). But do not enter an amount greater than 1.000.....................	5.	_________	_________
6. Multiply the amount on line 1 by the decimal amount on line 5..	6.	_________	_________
7. Reduced maximum exclusion. Add the amounts in columns (a) and (b) of line 6.................	7.	_________	

*If the taxpayer was a member of the uniformed services or Foreign Service, an employee of the intelligence community, or an employee or volunteer of the Peace Corps during the time the home was owned the 5-year period may have been suspended (extended) while on assignment. See details in chapter.

SALE OF A HOME – WORKSHEET #3

The worksheet can be used for all principal residence sales except where a home office is a separate structure

Part 1. General Information

Taxpayer Name: ______________________ Last Four Digits of SSN: __________

Property Description: ______________________

Method of Acquisition: ❑Purchase ❑Gift ❑Inherited ❑Other: __________

Date Acquired .... ____/____/______

Date Sold: .... ____/____/______

Part 2. Gain or (Loss) on Sale

1. Selling price of home..1. __________
2. Selling expenses (including commissions, advertising and legal fees, and seller-paid loan charges)………..............2. __________
3. Subtract line 2 from line 1. This is the amount realized..3. __________
4. Adjusted basis of home sold (including § 1034 deferrals). Amount from Worksheet #1 if used ....4. __________
5. Gain or (loss) on the sale. Subtract line 4 from line 3. If this is a loss, stop here..5. __________

Part 3. Exclusion and Taxable Gain

6. Enter any depreciation allowed or allowable on the property for periods after May 6, 1997.If none, enter -0-............6. __________
7. Subtract line 6 from line 5. If the result is less than zero, enter -0-..7. __________
8. Aggregate number of days of nonqualified use after 12/31/2008..8. __________
9. Number of days taxpayer owned the property..9. __________
10. Divide the amount on line 8 by the amount on line 9. Enter the result as a decimal (rounded to at least 3 places). But do not enter an amount greater than 1.00..10. __________
11. Gain allocated to nonqualified use. (Line 7 multiplied by line 10)..11. __________
12. Gain eligible for exclusion. Subtract line 11 from line 7..12. __________
13. If the taxpayer(s) qualify to exclude gain on the sale, enter the maximum exclusion ($250K or $500K).
    If the taxpayer(s) qualify for a reduced maximum exclusion, enter the amount from Worksheet 2, line 7.
    If taxpayer(s) do not qualify to exclude gain, enter -0-........ ....13. __________
14. Exclusion. Enter the smaller of line 12 or line 13..14. __________
15. Taxable gain. Subtract line 14 from line 5.
    If the amount on this line is zero, do not report the sale or exclusion on the tax return.
    If the amount on line 6 is more than zero, complete line 16..15. __________
16. Enter the smaller of line 6 or line 15.
    Enter this amount on line 12 of the Unrecaptured Section 1250 Gain Worksheet in the instructions
    for Schedule D (Form 1040)..16. __________

SALE OF A HOME – WORKSHEET #4

Use this worksheet where a home office is in a separate structure

Part 1. General Information

Taxpayer Name: ______________________ Last Four Digits of SSN: __________

Property Description: ______________________

Method of Acquisition: ❑Purchase ❑Gift ❑Inherited ❑Other: __________

Date Acquired…… ____/____/______

Date Sold: …… ____/____/______

Home Office or Other Business Use:

A. Enter the number of days in the five-year period immediately preceding the sale that the separate structure was used for ***residential*** purposes…… __________

> ***NOTE:*** *If line A is 730 or more days,* ***STOP!*** *Do not use this worksheet!* ***Use Worksheet #1****. The office portion of the gain also qualifies for §121.*

B. Enter the office area of the home in square feet…… __________

C. Enter the total home area in square feet…… __________

D. Business (Office) use (separate structure) percentage ((line B divided by line C) Enter the result as a decimal (rounded to at least 3 places). But do not enter an amount greater than 1.00…… __________

E. Home use percentage - §121 qualified (1.00 minus line D)…… __________

Allocate the sales price and selling expenses (lines 1 and 2 below) according to the home and business percentages (lines E and D above).

Part 2. Gain or (Loss) on Sale

		Total (A)	Home (B)	Office (C)
1. Selling price of home……	1.	________	________	________
2. Selling expenses……	2.	________	________	________
3. Subtract line 2 from line 1. This is the amount realized……	3.	________	________	________
4. Adjusted basis of home sold (excluding depreciation)** ……	4.	________	________	________
4a. Depreciation taken**……	4a.		________	________
5. Gain or (loss) on the sale (line 3 less lines 4 and 4a)……	5.		________	________

If line 5 column B is a loss, the loss is not allowable and there is no need to complete column B past line 5. Report the sale information in column C on Form 4797.

** **Caution**: The depreciation taken on the home portion and separate structure office portion must be accounted for separately as they are sold as separate parcels. Do not reduce the adjusted basis on line 4 for any depreciation taken. Instead, enter the depreciation claimed on each separate portion on line 4a.

Continued Next Page

SALE OF A HOME – WORKSHEET #4
(Continued)

Part 3. Exclusion and Taxable Gain of Home Portion

	Total (A)	Home (B)	Office (C)
6. Enter any depreciation allowed or allowable for periods after May 6, 1997.If none, enter -0-...6.		__________	
7. Subtract line 6 from line 5. If line 7 column B is less than zero, enter -0-..7.		__________	
8. Aggregate number of days of nonqualified use after 12/31/2008.............8.	__________		
9. Number of days taxpayer owned the property...9.	__________		
10. Divide the amount on line 8 by the amount on line 9. Enter the result as a decimal (rounded to at least 3 places). But do not enter an amount greater than 1.00...10.	__________		
11. Gain allocated to nonqualified use. (Line 7 multiplied by line 10).............11.		__________	
12. Gain eligible for exclusion. Subtract line 11 from line 7............................12.		__________	
13. If the taxpayer(s) qualify to exclude gain on the sale, enter the max exclusion ($250K or $500K). If the taxpayer(s) qualify for a reduced maximum exclusion, enter the amount from Worksheet 2, line 7. If taxpayer(s) do not qualify to exclude gain, enter -0-..............................13.		__________	
14. **Exclusion.** Enter the smaller of line 12 or line 13...................................14.		__________	
15. **Taxable gain**. Subtract line 14 from line 5. If the amount in Column B is less than zero, enter zero in Column B......15.		__________	
16. Recaptured Sec. 1250 Gain (smaller of line 6 or line 15). Include amount on line 12 of the Unrecaptured Section 1250 Gain Worksheet in the instructions for Schedule D (Form 1040)………………….……… 16.		__________	

NOTES

DEBT CANCELLATION AND FORECLOSURE ISSUES

Overview

Debt Relief Income - Whenever a debt of a taxpayer is forgiven, whether it is credit card debt, home mortgage debt or other debt, the forgiven debt (debt relief) is generally taxable income to the taxpayer unless: (1) the debt was discharged in a bankruptcy proceeding or (2) the taxpayer qualifies for one of the **exclusions** providing relief from cancellation of debt (COD) income.

Exception Overview – The tax code provides for a number of exceptions to the recognition of debt cancellation income. The following is an overview of the various aspects of exceptions:

- **In General:**
  - Non-recourse loan forgiveness = no COD income.
  - Attributes and carryovers of and to the year of discharge can be used in year of discharge and carried back to prior years before being reduced in the subsequent year.
  - Attributes are reduced 1st day of subsequent tax year (see exception under Real Property Business Indebtedness Exclusion).
  - The total of the COD income reported in box 2 of the 1099-C must appear as income on the 1040 (see where to report in text), and/or to the extent excludable, included on Form 982 line 2.
  - Generally multiple exclusions can be used if applicable.
  - Use only one Form 982 per tax return.
  - If Box 3 of the 1099-C would have been deductible if paid, reduce the amount of Box 2 by the amount in Box 3.
  - Basis reduction generally recaptures as ordinary income in future years.
  - California conforms to federal except for Principal Residence Acquisition Debt Relief.
- **Insolvency Exclusion:**
  - Used first unless debtor elects to use Principal Residence Acquisition Debt Relief (when available).
  - Good for both **acquisition and equity debt exclusion**.
  - Exclusion allowed to the extent of insolvency.
  - Insolvency is determined immediately before the debt discharge.
  - Must reduce tax attributes to the extent of the exclusion (exclusion can exceed attributes).
- **Principal Residence Acquisition Debt Relief Exclusion:**
  - Available only for debt discharged on or after 1-1-2007 and before 2018. Is on Congress' possible extender list.
- **Real Property Business Indebtedness Exclusion:**
  - If the taxpayer is insolvent, must use insolvency exclusion first.
  - Limited to **acquisition debt exclusion only**.
  - Limited to basis in depreciable property.
  - Limited to Mortgage over FMV (equity limit)
  - Reduce basis in depreciable property – no other attribute reduction required.
  - **Caution:** If property is disposed of in the year of debt relief the basis of the property must be reduced immediately prior to the disposition.

RAPID FINDER

NOTE - Bankruptcy

One method of discharging debts is through bankruptcy. Basically what happens in a bankruptcy stays in a bankruptcy and does not impact an individual's 1040 return. This material only deals with issues that must be reported on a taxpayer's 1040 and **only provides a very basic overview of what occurs in a bankruptcy**. COD income that results from a bankruptcy discharge is reportable on the return for the bankruptcy estate not on an individual's 1040. Any debt which is forgiven under a Title 11 bankruptcy is excludable from income.

Overview of Debt Discharge in Bankruptcy - When an individual files a Chapter 7 (liquidation) or Chapter 11 (reorganization) petition, a bankruptcy estate is established! A bankruptcy estate is treated as a separate taxable entity from the individual debtor and generally includes all legal and equitable interests in property of the debtor as of the initiation of the case. A bankruptcy estate continues until the bankruptcy proceeding is closed and the bankruptcy trustee is responsible for filing the estate's tax returns and paying its taxes (Sec 6012(b)(4)).

When a bankruptcy petition is filed, tax attributes of the individual debtor that existed on the first day of the debtor's taxable year (i.e., January 1st for calendar year filers) are deemed to be transferred to the bankruptcy estate. (Sec 1398(g)) These "tax attributes" include:

1. NOL Carryovers
2. Charitable contribution carryovers
3. Recovery of tax benefit items
4. Tax credit carryovers
5. Capital loss carryovers
6. Asset basis
7. Asset holding periods
8. Character of assets
9. Method of accounting
10. Unused passive losses
11. Unused losses limited by at risk rules
12. Principal residence exclusion and
13. Other tax attributes as provided by the regulations

Upon termination of the bankruptcy estate, the unused portions of the same tax attributes are deemed to be transferred back to the debtor (Sec 1398(i)). COD income that results from a bankruptcy discharge is reportable on the return for the bankruptcy estate. For Chapter 7 and 11 cases, the tax attributes to be reduced are those of the bankruptcy estate not the individual debtor (Sec 108(d)(8)).

Principal Residence Acquisition Debt Relief Exclusion – Expired at the end 2017, except for discharges made under a binding written agreement entered into in 2017. Originally expired after 2016; extended on 2/9/18 as part of the Budget Reconciliation Act of 2018. Will Congress extend again? Stay tuned.

Related IRC and IRS Publications and Forms

- **Code Section 108** - Income from Discharge of Indebtedness
- **Code Sec 1017** – Discharge of Indebtedness
- **Form 1099-A** – Acquisition or Abandonment of Secured Property
- **Form 1099-C** – Cancellation of Debt
- **Form 982** – Reduction of Tax Attributes Due to Discharge of Indebtedness
- **Instructions** – Form 1099-A and 1099-C
- **Pub 908** - Bankruptcy Tax Guide
- **Pub 4681** – Canceled Debts, Foreclosures, Repossessions and Abandonment
- **Insolvency Worksheet** – Page 6 of Publication 4681 (2018)
- **IRS Real Estate Property Foreclosure and Cancellation of Debt Audit Technique Guide (2/22/19)** - http://www.irs.gov/pub/irs-utl/real_estate_foreclosure_atg.pdf

Step-by-step Approach – Although the issues related to debt relief and foreclosure can seem overwhelming, it can be greatly simplified by approaching it in a step by step manner:

Step #1 – Determine if there is COD income and if so the amount and applicable year.
Step #2 – Determine if the taxpayer qualifies for one or more of the exclusions.
Step #3 – Determine if there is also an asset sale that must be dealt with.
Step #4 – Complete Form 982 and reduce tax attributes if required.

STEP #1 – DETERMINE IF THERE IS COD INCOME AND IF SO THE AMOUNT

Determining the amount of the COD income and the year in which it is taxable is not always readily apparent for the following reasons:

1. **Personal Liability** – There is no COD income where the debtor is not personally liable for the debt. That is where the lender's only recourse is against the property secured by the debt.
2. **Date of Debt Discharge** – Debt discharge generally does not occur until the lender no longer has any legal opportunity for collection from the debtor, which is defined by IRS Regulations as an identifiable event. See list of identifiable events in the "Date of Debt Discharge" paragraph below.

Determining if a Loan is Recourse or Non-Recourse – Determining whether a loan is recourse or non-recourse has a huge bearing on how the COD is treated on the borrower's tax return. If a loan is non-recourse then the borrower is not personally liable for a deficiency and the lender's only recourse is against the secured property. Where the borrower is not personally liable there is no COD income. Therefore it is extremely important to determine if the borrower is personally liable. Generally it is necessary to read the actual loan documents to determine whether a loan is recourse or non-recourse. Both the 1099-A and 1099-C include an entry (Box 5) for the lender to indicate whether the taxpayer is personally liable or not, but the box is frequently left blank or in some cases answered incorrectly.

Several states have statutes that prohibit lenders from seeking deficiencies from borrowers and are referred to as non-recourse states. Each non-recourse state has its own anti-deficiency statutes that prohibit lenders from seeking judgments. Not all non-recourse statutes are the same so it is important to understand the law as it applies to your state. For example in California the statutes only apply to purchase money loans (acquisition debt) and then only if the loan is for 4 residential units or less and at least one unit is owner occupied. Almost all home equity line of credit loans – abbreviated HELOCs – and home equity loans are considered recourse loans, and lenders for these loans may sue borrowers to recoup loss, although most do not go to that expense.

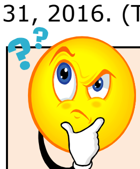
The following is a list of anti-deficiency/non-recourse states. The list is from the IRS' Real Estate Property Foreclosure and Cancellation of Debt Audit Technique Guide (2/22/19). Each of these states has its own rules and the anti-deficiency rules are not applied in the same manner.

Alaska	**California**	**North Carolina**	**Minnesota**	**Utah**	
Arizona	**Connecticut**	**Idaho**	**North Dakota**	**Texas**	**Washington**

Date of Debt Discharge – The debt discharge generally does not occur until the lender no longer has any legal opportunity for collection from the debtor. IRS regulations (§ 1.6050P-1(a)(1)) set forth identifiable events that trigger cancellation of debt income **whether or not an actual discharge of indebtedness has occurred <u>on or before</u> the date on which the identifiable event has occurred**. Although the list is long the following are the more commonly encountered identifiable events:

- Discharge of indebtedness under title 11 of the United States Code (bankruptcy);
- Cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or State court;
- A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness;
- A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;
- A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
- A discharge of indebtedness pursuant to an agreement between an applicable entity and a debtor to discharge indebtedness at less than full consideration; or
- A discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt.

In the past, an identifiable event included the expiration of a nonpayment testing period, generally a 36-month period ending on December 31. If a bank, savings and loan, credit union, or certain government agencies hadn't received a payment on the debt of a taxpayer during that period, the lender was required to issue an information return (1099-C) reporting the debt as being canceled. However, this rule created confusion for taxpayers and, according to the IRS, did not increase tax compliance by debtors or provide the IRS with valuable third-party information that could be used to ensure taxpayer compliance. In regulations finalized in November 2016, the IRS dropped this testing period rule, applicable to information returns required to be filed, and payee statement required to be furnished, after December 31, 2016. (T.D. 9793)



No 1099-C or a 1099-C Issued in a Subsequent Year

Because of the identifiable event rules the 1099-C may show up in a year other than the year when a 1099-A is issued. The IRS provides no special guidance in situations such as this <u>even though the regulations acknowledge that the debt relief may have occurred prior to the issuance of the 1099-C</u>.

To deal with this problem, a practitioner needs to carefully review the facts and circumstances to determine when and if debt relief actually took place. It may not necessarily be in the year when the 1099-C was issued and may have not occurred at all. Financial institutions frequently do not actually relieve the debt in the year of the foreclosure. Others may not relieve the debt at all in hopes of collecting on the liability in a future year before the state statute for the collection of a debt expires. When no 1099-C is issued there is generally no debt relief and a practitioner should exercise caution in arbitrarily adding COD income to a client's tax return.

Where no 1099-C is issued and the practitioner has determined debt relief has occurred, the amount of the debt relieved is generally the amount in 1099-A Box 2 minus the amount in Box 4. Practitioners may wish to utilize the Form 8275 Disclosure Statement to provide an explanation of why the COD income was reported in a year when a 1099-C was not issued or why the COD income is not included in the year the 1099-C was issued.

A 1099-C issued many years after a taxpayer defaults on a debt may be incorrect, as the debt relief may actually have taken place long before the year of issuance. The taxpayer and practitioner need to examine all of the events surrounding the COD to determine whether the 1099-C was issued for the correct year, as the following case demonstrates. In a Tax Court summary opinion (which cannot be treated as precedent), the court ruled against the IRS, which contended debt was discharged in 2008 when the 1099-C was issued, and agreed with the taxpayer that, while it is often impossible to find just one event that clearly establishes the moment at which a debt is discharged, there was no cancellation of debt in 2008 because the debt was discharged at the end of the 36-month nonpayment testing period, which was in 1999. (TC Summary Opinion 2012-46)

1099-C & 1099-A

Box 6 –Codes are as follows:
A – Bankruptcy
B – Other judicial debt relief
C – Statute of limitations or expiration of deficiency period
D – Foreclosure election
E – Debt relief from probate or similar proceeding
F – By agreement of creditor and debtor
G – Decision or policy of creditor to discontinue collection
H– Other actual discharge before identifiable event

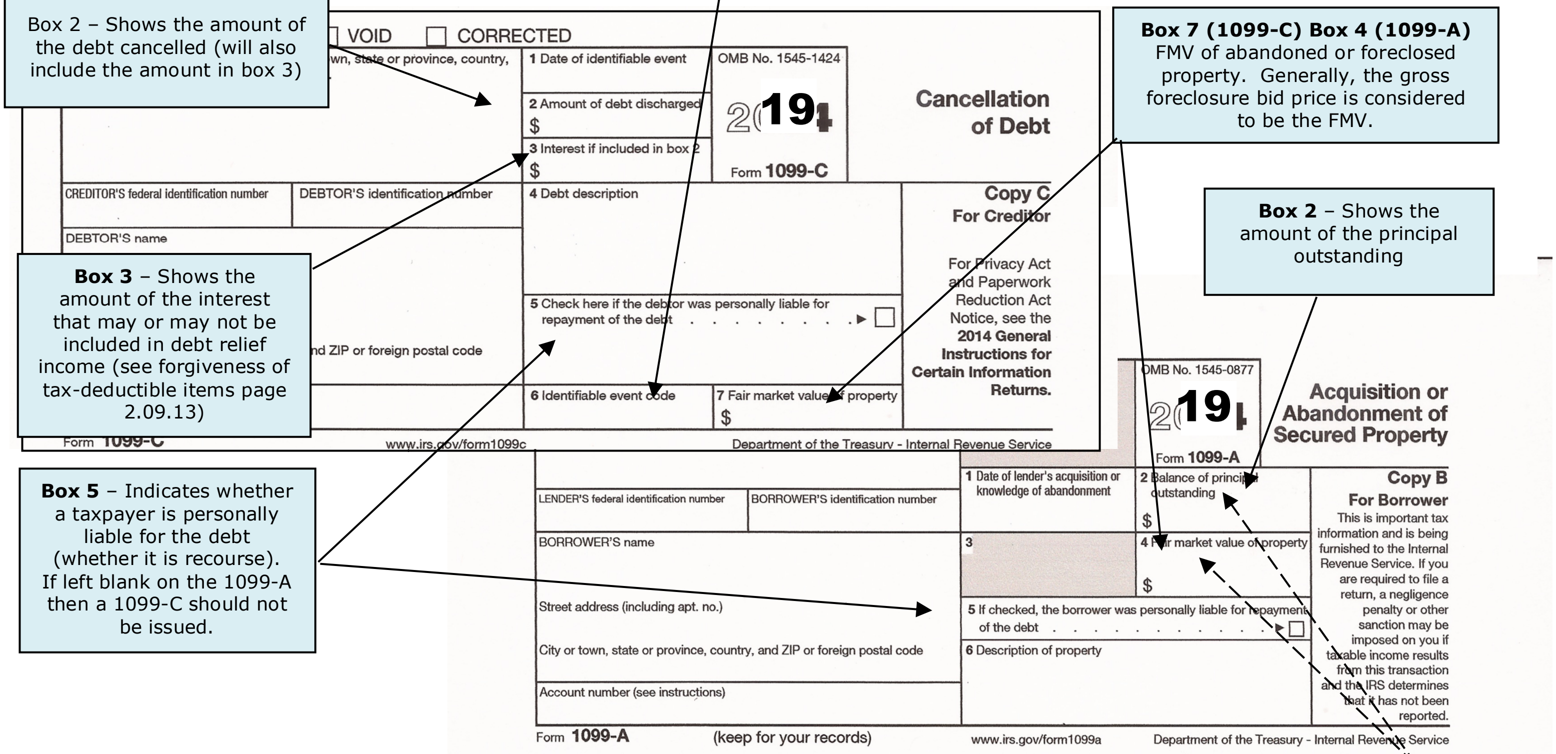
Box 2 – Shows the amount of the debt cancelled (will also include the amount in box 3)

Box 7 (1099-C) Box 4 (1099-A) FMV of abandoned or foreclosed property. Generally, the gross foreclosure bid price is considered to be the FMV.

Box 2 – Shows the amount of the principal outstanding

Box 3 – Shows the amount of the interest that may or may not be included in debt relief income (see forgiveness of tax-deductible items page 2.09.13)

Box 5 – Indicates whether a taxpayer is personally liable for the debt (whether it is recourse). If left blank on the 1099-A then a 1099-C should not be issued.



1099-A - FMV (Box 4) Greater than Balance of Mortgage (Box 2)

It is not uncommon for a 1099-A to have the amount shown in Box 4 – "Fair market value of property" – to be equal to or greater than the "Balance of principal outstanding" shown in Box 2. If the FMV of the property is greater than the debt then there is no cancellation of debt income and only the disposition of the property need be dealt with. Generally, the gross foreclosure bid price is considered to be the FMV.

CAUTION - In some cases there may be additional mortgages on the property which may make the outstanding debt greater than the property's FMV. Check for other subordinate mortgages and additional 1099-C forms.

1099-C: A financial institution, credit union, federal government agency or others in the business of lending money must issue a 1099-C if the debt relief is $600 or more. Individual lenders such as the seller of the property are not required to file the 1099-C. This form will generally provide the information needed to determine the amount of debt relief. The 1099-C can be issued for a variety of circumstances related to debt forgiveness including credit card debt, vehicle repossessions, home foreclosures, etc.

1099-A: A lender who acquires an interest in a property in a foreclosure or repossession should issue Form 1099-A showing the information needed to figure the taxpayer's gain or loss. However, if the lender also cancels part of the debt and must file Form 1099-C, the lender can include the information about the foreclosure or repossession on that form instead of on Form 1099-A. The 1099-A includes the amount of the debt relieved and the FMV of the property which should be the auction price.

Multiple Debtors - For debts for more than $10,000 that involve debtors who are jointly and severally liable for the debt, the 1099-C instructions tell the creditor (lender) to report the **entire** amount of the canceled debt on **each** debtor's Form 1099-C. Multiple debtors are jointly and severally liable for a debt if there is no clear and convincing evidence to the contrary. However, the amount, if any, of the canceled debt income that each debtor must report depends on all the facts and circumstances, including:

- State law,
- The amount of debt proceeds each person received,
- How much of any interest deduction from the debt was claimed by each person,
- How much of the basis of any co-owned property bought with the debt proceeds were allocated to each co-owner, and
- Whether any of the COD income qualifies for any of the COD exclusions or exceptions.

If joint and several liability does not exist, a 1099-C is required for each debtor for whom canceled debt is $600 or more. The lender is only required to issue Form 1099-C for the primary or first-named debtor for debts of less than $10,000.

If the lender knows that the multiple debtors were husband and wife who were living at the same address when the debt was incurred, and the lender has no information that these circumstances have changed, then only one 1099-C need be filed. Where there are co-signers, the COD income can be allocated according to the facts and circumstances of the situation. (Chief Counsel Advice 200023001) For example where parents co-sign for a child and the child made all the payments, it would be appropriate to allocate the entire COD income to the child.

Pass-through entities - If a partnership's liability is discharged, the partnership allocates the income from discharge of debt to the partners as a separately stated item. The debt relief is thus reported on Form 1040 by the partners. Any available exclusion is also applied at the partner level.

- ***Special rules for partnerships*** - Under the final regs, partnerships don't have to inform their partners of COD income before the date the partnership return is filed.

  Instead of reducing tax attributes according to the usual order specified by Code Sec. 108(b)(2), a taxpayer may elect under Code Sec. 108(b)(5) first to reduce the adjusted bases of depreciable property to the extent of excluded COD income. Excluded COD income from cancelled qualified real property business debt must, under Code Sec. 108(c), be applied against depreciable real property. A partnership interest is treated as depreciable property when applying Code Sec. 108(b)(5), and as depreciable real property when applying Code Sec. 108(c), to the extent the partnership correspondingly reduces the partner's proportionate interest in the adjusted bases of depreciable property (or depreciable real property) held by the entity (inside basis). (Code Sec. 1017(b)(3)(C))

  Partnership Consent - A partnership must consent to reduce its partners' shares of the partnership's depreciable basis in property only if consent is requested by:

  (a) partners owning (directly or indirectly) an aggregate of more than 80% of the partnership's capital and profits interests, or

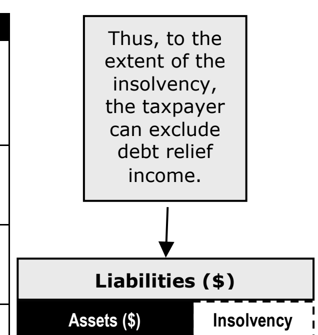
  (b) five or fewer partners directly or indirectly owning more than 50% of those interests.

  If partners meeting either of these tests elect to exclude COD income from the partnership, the partnership must consent to reduce the basis of its depreciable property (or depreciable real property). (Reg. § 1.1017-1(g)(2)(ii)) In other situations, partners may request the partnership to reduce basis and the partnership may or may not consent to do so.

  The partner must request and receive the consent of the partnership before the due date (including extensions) of the partner's return for the year the COD income is received. However, the partnership does not have to attach its consent statement to its return until the filing date for the tax year following the year that the partner excludes the COD income. (Reg. § 1.1017-1(g)(2)(iii))

STEP #2 – DETERMINE IF THE TAXPAYER QUALIFIES FOR ONE OR MORE EXCLUSIONS.
Choosing an Exclusion Method – Generally the insolvency exclusion takes precedence over the other available exclusions except in the case of the principal residence (for years when available) and student loan exceptions. Not all incidences of debt relief qualify for the possible exceptions. The table below matches type of debt with possible exceptions:

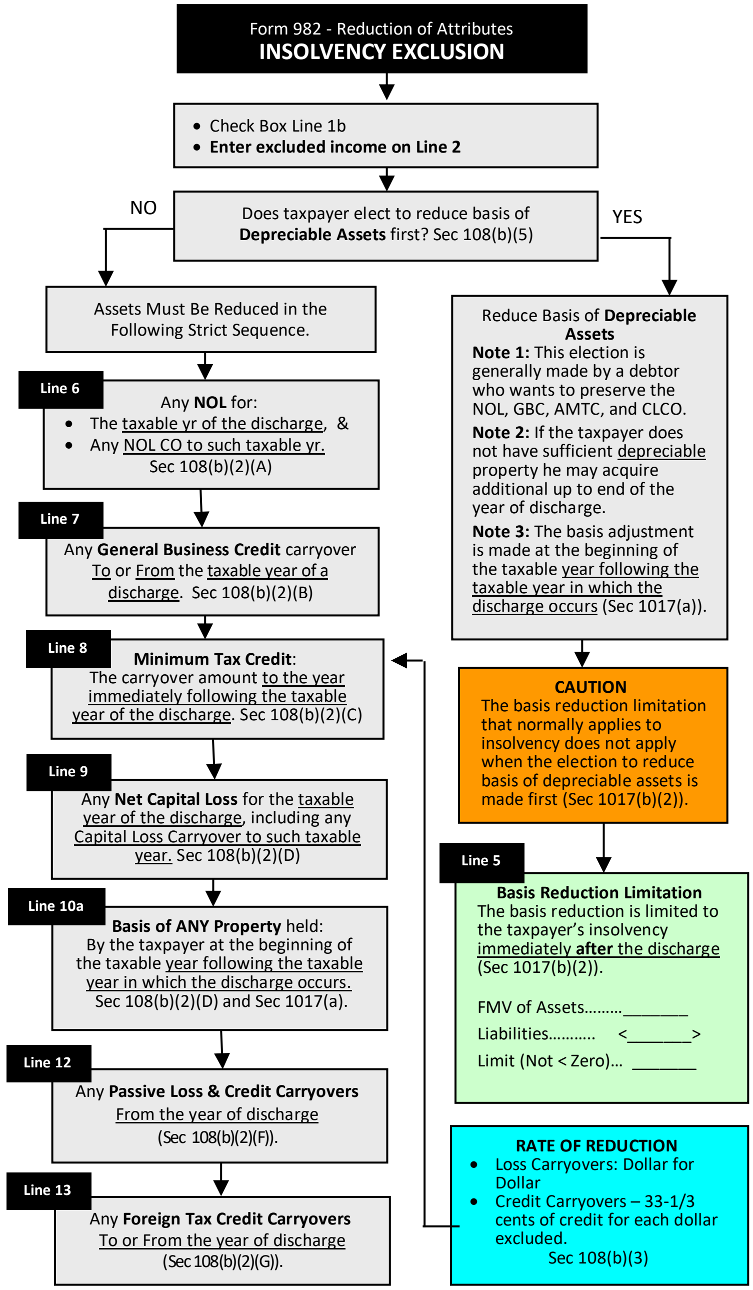
Type of Debt	Possible COD Exceptions
Primary Residence	Home Mortgage Debt Relief Income (Applied 1st unless taxpayer elects otherwise (Sec 108(2)(C)) – limited to acquisition debt. '07 – '17 only (or '18 if prior binding agreement). Insolvency
Second Home Vacant Land Credit Card	Insolvency
Rental Commercial Real Estate	Insolvency (Must be applied 1st to extent insolvent (Sec 108(2)(B))) Qualified Real Property Indebtedness – generally limited to acquisition debt
Student Loans	Insolvency Student Loan Exception
Farm Debt	Insolvency (Must be applied 1st to extent insolvent (Sec 108(2)(B))) Qualified Farm Indebtedness - indebtedness is attributable to the trade or business of farming.



INSOLVENCY EXCLUSION

If the indebtedness is discharged when the debtor is insolvent (but not in a bankruptcy case), the discharge is excluded from the debtor's gross income up to the amount of the insolvency (Sec 108(a)(1)(B)).

> **Note:** COD income to a grantor trust or disregarded entity is treated as income of the owner of the grantor trust or disregarded entity.



Definition of Insolvent - The term "insolvent" means the excess of liabilities over the fair market value (FMV) of assets determined with respect to the taxpayer's assets and liabilities immediately before the discharge.

This means that the discharged debt counts as a liability and the property's FMV as an asset (unless the discharge is in a subsequent year and the taxpayer no longer owns the property) for purposes of determining the taxpayer's insolvency. The taxpayer's financial status immediately after the discharge is irrelevant. (Code Sec. 108(d)(3))

Calculating Insolvency – There are a number of court cases and rulings that need to be taken into consideration when determining insolvency:

- **Some debt may not count as liabilities** - A taxpayer claiming to be insolvent must prove by a preponderance of the evidence—i.e., must prove that it is more likely than not—that he or she will be called upon to pay an obligation claimed to be a liability, and that the total amount of liabilities so proved exceeds the FMV of his or her assets. (Merkel, Dudley B. v Commissioner, 1999, CA9).
- **Nonrecourse liabilities** - Where a debtor has property subject to nonrecourse debt in excess of the value of the property, the excess of the amount of the nonrecourse debt over the FMV of the property securing the debt is taken into account in determining whether, and to what extent, the debtor is insolvent only to the extent that the excess debt is discharged. The reason is that the excess nonrecourse debt that isn't discharged does not affect the debtor's solvency. So even though the cancellation of nonrecourse debt in excess of the value of the property is treated as taxable income, the excess nonrecourse debt is not taken into account in determining solvency. (Rev Rul 92-53, 1992-2 CB 48).
- **Assets exempt from claims of creditors** - Tax courts have ruled that assets exempt from claims of creditors must be included as assets for purposes of determining insolvency.
- **Pension Plans** – Although they are exempt from creditors, pensions or annuities (including Social Security) must be taken into account when adding the assets. The IRS says the value of an individual's benefits under a *defined contribution* plan is simply the value of the individual's account or accounts under the plan. If an individual has started receiving benefits under a *defined benefit* plan and has elected to receive benefit payments as an annuity or in installment payments, the value of the benefit should be the actuarial present value of the payments as of the date on which the insolvency determination is made. If the individual has not started receiving benefits, then the value of the benefit should be the greater of (1) the actuarial present value of the accrued benefit payable at the plan's normal retirement age or (2) the amount of any single-sum distribution that the participant could receive under the plan on the date insolvency is determined. (Service Center Advice 1998-039) The Tax Court has held that the part of a retirement plan that can be withdrawn as a loan is an asset. If an outstanding plan loan is listed as a liability, then the collateral that secures the loan must be listed as an asset. (Shepherd, Bernard R., (2012) TC Memo 2012-212)

- **Married Taxpayers** - The filing of a joint return by taxpayer and a spouse, who isn't insolvent, doesn't cause the spouse's separate assets to be taken into account in determining the taxpayer's insolvency. (IRS Letter Ruling 8920019).
- **Measuring partner's insolvency when partnership discharges excess nonrecourse debt** – For purposes of measuring a partner's insolvency, each partner treats as a liability an amount of the partnership's discharged excess nonrecourse debt that is based on the allocation of debt relief income to that partner under IRC Sec. 704(b) and the regs. (Rev. Rul. 2012-14)

When is Insolvency Determined? – Immediately before the debt is discharged. (Code Sec. 108(d)(3))

Reduction of Tax Attributes – If the debtor has tax attributes, they must be reduced to the extent of the insolvency exclusion. If the attributes are less than the exclusion, they are simply reduced to zero and the debtor is still able to exclude the debt to the extent of insolvency. (Code Sec. 108(b)(3))

> If, after going through the attribute reductions sequence shown below, and the taxpayer surrenders attributes with a total value of LESS than the excludable debt relief, the balance of the debt relief is still forgiven and there is never a tax impact.

Sequence of Attribute Reduction - Attributes include loss and credit carryovers and basis in assets. Credit carryovers are reduced 33-1/3¢ per dollar of debt discharge amount while the others are reduced dollar for dollar. For insolvency, attributes are reduced in this strict order (but see a special election to first reduce the basis of depreciable assets on the next page).

(1) Any **NOL** for: the taxable year of the discharge, and any NOL carryover to such taxable year, dollar for dollar. (Sec 108(b)(2)(A))

(2) **General business credit carryovers** to or from the taxable year of discharge are reduced, $1 for each $3 of debt relief. (Sec 108(b)(2)(B))

(3) **Minimum tax credits** - The carryover amount to the year immediately following the taxable year of the discharge is reduced $1 for each $3 of debt relief. (Sec 108(b)(2)(C))

(4) Any **Net Capital Loss** for the taxable year of the discharge, including any Capital Loss Carryover (CLCO) to such taxable year. (Sec 108(b)(2)(D))

> **Carryovers and Carrybacks**
> Sec 108(b) – Makes it clear that a taxpayer may:
> (1) Utilize carryovers to the year of discharge
> (2) Utilize carrybacks from the year of discharge to prior years before reducing the attributes in the subsequent year.

(5) **Basis of assets -** is reduced at the beginning of the year *following the year* of debt cancellation, based on the assets owned at that time. Here again, there is a strict ordering for which property bases get reduced first:
   (a) Trade or business property purchased with the proceeds of the debt which was forgiven;
   (b) Trade or business property securing the loan;
   (c) All other trade or business assets;
   (d) Inventory and notes and accounts receivable;
   (e) Property held for investment;
   (f) Other assets.

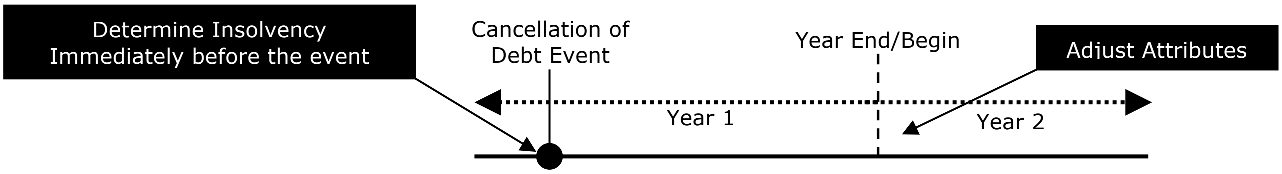
   The limit for basis reduction under the insolvency rule is the extent to which basis of assets (not the FMV) after debt relief exceeds liabilities after the debt relief. This limit will not apply if the taxpayer elects to reduce basis first (see special election below).

   Where there are multiple assets in a particular category the basis reduction is allocated to the basis of the properties in proportion to their aggregate basis.

(6) **Suspended passive losses** - Reduce the suspended passive activity losses from the year of discharge $1 for each $1 of excluded debt relief; reduce suspended passive loss credits from the year of discharge by $1 for each $3 of excluded debt relief (Sec 108(b)(2)(F)).

(7) **Foreign tax credit carryovers** - Reduce the foreign tax credit carryovers from the year of discharge $1 of credit for each $3 of debt relief (Sec 108(b)(2)(G)).

When Are the Attributes Reduced? - The reductions are generally made after the tax is computed for the tax year of the discharge (but see NOL and Capital Loss details above). That means a calendar year taxpayer will adjust the attributes at the beginning of the year subsequent to the debt relief year. Thus, the debtor can utilize many of the attributes in the year of the relief. (Code Sec. 108(b)(4)(A)).



Election To First Reduce The Basis of Depreciable Assets - Rather than reduce the loss and credit carryovers first, a taxpayer can elect (on Form 982) to apply any or all of the excluded amount *first* to reduce his basis in *depreciable* assets (or real property held as inventory) before any other tax attributes are reduced under the normal ordering rules. (Code Sec. 108(b)(5)(A))

This special rule may be attractive to taxpayers who have net operating losses or other attributes that can be carried over and used in subsequent years and where the concern for basis reduction is a secondary issue. However, it should be noted that if the basis reduction is insufficient to offset the COD income, then the other tax attributes must be reduced beginning in the normal manner.

Reason for Making the Basis Reduction Election

This election is generally made by a debtor who wants to preserve the Net Operating Loss deduction, General Business Credit, Alternative Minimum Tax Credit, and Capital Loss Carryovers. If the taxpayer does not have sufficient depreciable property basis to cover the excluded debt income he may acquire additional up to end of the year of discharge. However, the reduced basis will recapture as ordinary income when and if the property whose basis was reduced is sold. So the decision is whether or not to utilize the tax benefit currently and suffer the consequences in the future.

Basis Reduction limitations - A debtor making the election to first reduce basis may not reduce the aggregate adjusted bases of his depreciable property below zero, and can't elect to have excluded debt discharge income applied to first reduce depreciable property basis in an amount greater than the aggregate adjusted bases of depreciable property held by the debtor as of the beginning of the tax year following the tax year in which the discharge occurs. (Code Sec. 108(b)(5)(B))

Special Election – Dealers in Real Property **-** Dealers in real property may elect to treat real property held for sale in the ordinary course of business as depreciable. This election must be made on the original return for the year of debt forgiveness and can only be revoked or elected on a later return with reasonable cause and IRS consent. (Sec. 1017(b)(3)(E))

Calculating Insolvency **–** The IRS provides an insolvency worksheet in Publication 4681 – page 6 (2018). Another possibility would be to use Form 433-A (for individuals) or 433-B (for businesses) that IRS Collections uses as a financial statement.

PRINCIPAL RESIDENCE ACQUISITION DEBT FORGIVENESS EXCLUSION

This provision allows taxpayers to exclude home debt forgiveness income from their income. The following is an overview of the provision:

- **Effective:** For tax years 2007 through 2017 (2018 if the discharge is made under a binding written agreement entered into in 2017). If Congress acts in 2019 on "extenders," verify if this exclusion is included in the bill.
- **Exclusion:** Up to $2 Million ($1 Million MS)
- **Home:** Principal Residence Only (same definition as for Sec 121 gain exclusion rules)
- **Debt:** Acquisition Debt Only
- **Basis of Home:** Reduced by the amount of the exclusion if retained after relief

Application - This exclusion applies where a taxpayer:

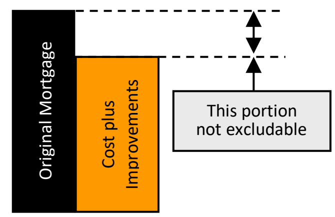
- Restructures the acquisition debt on a principal residence,
- Loses a principal residence in a foreclosure, or
- Sells a principal residence in a short sale.

Limitations:

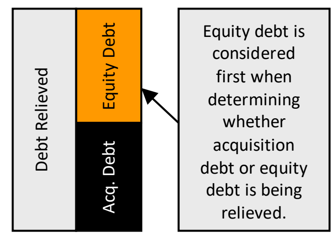
- The exclusion **does not** apply to a taxpayer's designated 2nd (vacation) residence.
- The exclusion doesn't apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the taxpayer's financial condition.
- The exclusion **only applies to the discharge of qualified principal residence acquisition debt**. Thus equity debt is not included as part of the exclusion. Acquisition indebtedness of a principal residence is indebtedness incurred in the acquisition, construction, or substantial improvement of an individual's principal residence that is secured by the residence. It includes refinancing of debt to the extent the amount of the refinancing doesn't exceed the amount of the refinanced indebtedness. (Joint Committee on Taxation, JCX-86-07)

- Debt used to refinance qualified principal residence indebtedness is eligible for the exclusion up to the amount of the old mortgage principal just before the refinancing. (H Rept No. 110-356 (PL 110-142) p. 5)
- If the amount of the taxpayer's original mortgage is more than the cost of the principal residence plus the cost of any substantial improvements, only the debt that doesn't exceed the cost of the principal residence plus improvements is qualified principal residence indebtedness. (Form 982 Instructions, 3/2018, p. 3)

- **Forgiveness ordering rule** -If only a part of a loan is qualified principal residence indebtedness, the exclusion applies only to the extent the amount discharged exceeds the amount of the loan (immediately before the discharge) that is not qualified principal residence indebtedness.

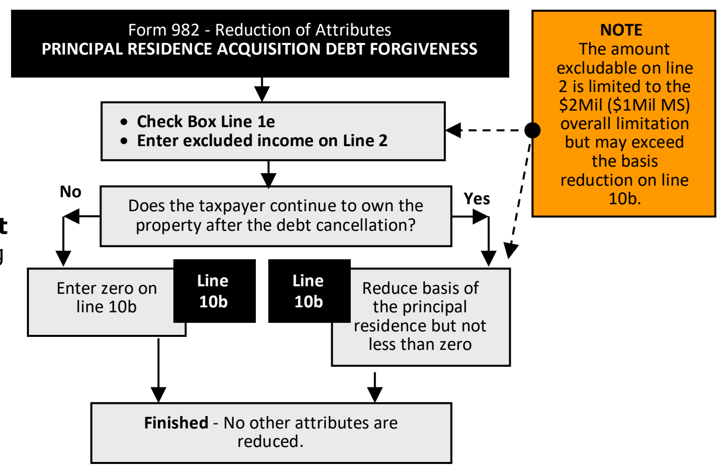


***Example** - assume a principal residence is secured by a debt of $1 million, of which $850,000 is qualified principal residence indebtedness. If the residence is sold for $800,000 and $200,000 of debt is discharged, only $50,000 of the debt discharged can be excluded (the $200,000 that was discharged minus the $150,000 of nonqualified debt). The remaining $150,000 of nonqualified debt may qualify in whole or in part for one of the other exclusions, such as the insolvency exclusion.*



Definitions:

- **Qualified principal residence indebtedness** - Qualified principal residence indebtedness means acquisition indebtedness on the taxpayer's principal residence, up to a $2 million limit ($1 million for married individuals filing separately).
- **Acquisition indebtedness** - Acquisition indebtedness is defined as in Code Sec. 163(h)(3)(B) for purposes of the interest deduction rules. (Code Sec. 108(h)(2))



<u>*Ordering rule*</u> **-** The principal residence exclusion takes precedence over the insolvency exclusion **unless elected otherwise** (Code Sec 108(a)(2)(C)). If only a part of a loan is qualified principal residence indebtedness, the exclusion from income for canceled qualified principal residence indebtedness applies only to the extent the amount canceled exceeds the amount of the loan (immediately before the cancellation) that is **not** qualified principal residence indebtedness. The remaining part of the loan may qualify for another Sec 108 exclusion.

<u>*Basis Adjustment*</u> **-** If the taxpayer excludes canceled qualified principal residence indebtedness from income **and continues to own the residence after the cancellation**, the taxpayer must reduce the basis of the residence (but not below zero) by the amount of the canceled qualified principal residence indebtedness excluded from income. Enter the amount of the basis reduction on line 10b of Form 982. Thus basis adjustment would be required in a loan modification where the taxpayer retains the home. However, no basis adjustment is required in a foreclosure, short sale or abandonment because the taxpayer no longer owns the residence.

This may or may not create a problem in the future since any gain will be subject to the Sec 121 home sale gain exclusion. But keep in mind: any basis adjustment as a result of COD exclusion recaptures as ordinary income and cannot be excluded using the Sec 121 exclusion (same treatment as depreciation recapture).

<u>*Electing Out of Mortgage Relief Exclusion*</u> **–** An insolvent taxpayer (other than one in a Title 11 bankruptcy) can elect to have the mortgage forgiveness exclusion not apply and can instead rely on the Code Sec. 108(a)(1)(B) exclusion for insolvent taxpayers. (Code Sec. 108(a)(2)(C)) Thus, where a taxpayer has significantly tapped the equity in the home, and has a significant amount of debt discharge that does not qualify for the exclusion, it may be to their advantage to forgo the mortgage relief exclusion and instead use the insolvent taxpayer exclusion.

Things to Consider

- The home mortgage debt forgiveness only applies to "Acquisition Indebtedness" while the insolvency rule applies to all debt.
- The home mortgage forgiveness rule allows up to $2 mil of debt relief while the insolvency exclusion only allows exclusion to the extent of insolvency.
- Some states do not conform to the home mortgage forgiveness rule and only allow the insolvent taxpayer exclusion.

DISCHARGE OF QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS

Rental as a Trade or Business - Some practitioners have reported that auditors are taking the position that a passive rental is not a trade or business for purposes of this exclusion. However, the authors disagree based upon the following. (See also the discussion in Chapter 3.24 relating to rental real estate as a trade or business.)

- Rentals qualify for trade or business ordinary (4797) loss as opposed to capital loss and a rental loss may result in an NOL.
- Publication 4681 details where to report non-excludable COD income. It indicates that non-business COD income is reported on the "other income" line of the 1040 [line 8 of Schedule 1, draft 2019 1040] and goes on to describe in detail where business income is reported, including rental income on the Schedule E. Further, in defining qualified property for this exclusion, Pub 4681 (page 8, 2018 edition) says, "*Residential rental property generally qualifies as real property used in a trade or business unless you also use the dwelling as a home."*
- Rental property has always been held to be used in a trade or business where:
    - An investor in mortgages rented out properties acquired by foreclosure, pending resale (Gibney, Annie Est, (1945) PH TCM ¶45290, 4 CCH TCM 878).
    - A taxpayer rented out his former residence (Hazard, Leland, (1946) 7 TC 372, acq; Wasnok, Stephen, (1971) TC Memo 1971-6, PH TCM ¶71006, 30 CCH TCM 39).
    - A taxpayer rented out a single house (Hajos, Stephen, (1964) TC Memo 1964-328, PH TCM ¶64328, 23 CCH TCM 2015.
    - The inheritor of a residence immediately offered it for rent or sale (Campbell, N. Stuart, (1945) 5 TC 272).
    - A lawyer rented out a business building he held under a 99-year renewable lease (Fackler, John v. Com., (1943, CA6) 30 AFTR 932, 133 F2d 509, 43-1 USTC ¶9270).
    - A corporation (insurance brokers) sold rental property (Mather & Co (1949, CA3) 37 AFTR 689, 171 F2d 864, 49-1 USTC ¶9127).

The exclusion of income from the discharge of qualified real property business indebtedness applies only to taxpayers who are not C corporations and **applies only where the insolvency exception does not apply** (Code Sec. 108(a)(2)(B)). The exclusion is limited to the taxpayer's equity in depreciable properties **and the basis cannot be reduced below zero.** (Sec 108(c)(2)(A)(ii))

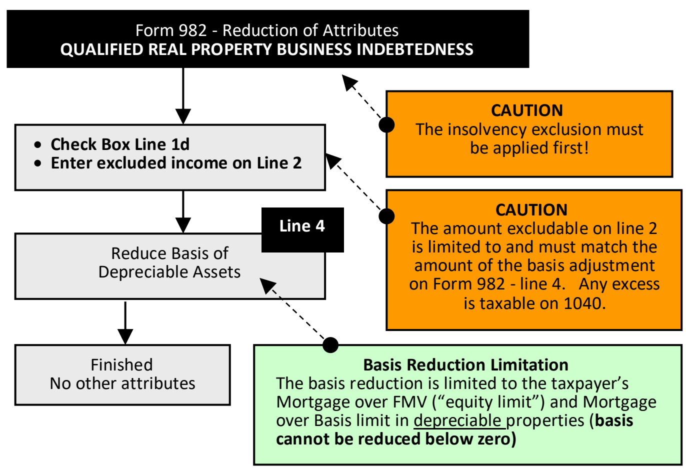
Disregarded Entity - Rev Proc 2014-20 provides a safe harbor, effective for taxpayers (other than a C corp) who make an election under § 108(c)(3) (qualified real property business indebtedness) regarding discharged indebtedness on or after February 5, 2014, under which the IRS will treat indebtedness that is secured by 100% of the ownership interest in a disregarded entity holding real property as indebtedness that is secured by real property. See the revenue procedure for the requirements that must be satisfied.

Limitations – In addition to the basis in depreciable property there are two limitations on the amount that can be excluded.

- *Mortgage over FMV ("equity") limit* - The amount eligible for the exclusion is limited to the excess (if any) of:

    (1) The outstanding principal amount of the qualified real property business indebtedness immediately before the discharge, over

    (2) The fair market value of the real property immediately before the discharge, less the outstanding principal amount of any other qualified real property business indebtedness secured by the property at that time. (Code Sec. 108(c)(2)(A)(ii))



- *Mortgage over Basis Limit* - The exclusion cannot reduce the basis below zero, thus the depreciated basis of the property also becomes a limit. (Code Sec. 108(c)(2)(B))

Example: *Jack, who qualifies as a real estate professional, owns a rental with a FMV of $200,000 and a depreciated basis of $80,000 that is subject to a first mortgage of $160,000 and second mortgage of $90,000. Jack makes a deal with the second mortgagee to reduce the second mortgage to $30,000. This results in debt relief income of $60,000.*

Mortgage over FMV = 90K – (200 – 160) =	***$50,000*** *(FMV Limit)*
Depreciated Basis =	***$80,000*** *(Basis Limit)*
Exclusion is limited to lesser of the two or:	***$50,000***

Thus in this example, of the $60,000 debt relief only $50,000 can be excluded and the $10,000 balance is added to gross income.

Definition Of Qualified Real Property Business Indebtedness (QRPBI) - Qualified Real Property Business Indebtedness is indebtedness (Code Sec 108(c)(3):

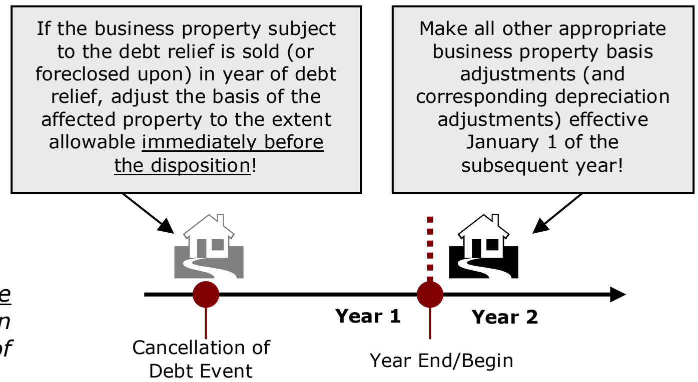
- that was **incurred or assumed** by the taxpayer in connection with real property used in a trade or business;
- that is **secured by the real property**, at the time the debt is incurred or assumed;
- that is qualified acquisition indebtedness (including refinanced acquisition debt); and
- which the taxpayer elects to treat as qualified real property business indebtedness.

The IRS has said that if a taxpayer holds real property and develops it for lease in its leasing business, it qualifies as real property used in a trade or business for the purpose of Sec 108(c)(3). But if the real property is developed and held by the taxpayer primarily for sale to customers in the ordinary course of business, the indebtedness on this property is not eligible for this exclusion. When claiming the QRPBI cancellation of debt exclusion, the taxpayer must reduce basis in depreciable real property by the same amount. Property held for sale to customers is not depreciable, so debt incurred or assumed in connection with this type of property is not QRPBI, and thus relief if the indebtedness is canceled is not excludable. (Rev. Rul. 2016-15, obsoleting Rev Rul 76-86)

Definition of Qualified Acquisition Indebtedness - qualified acquisition indebtedness means indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

When Does the Basis Adjustment Take Place?

- *If the taxpayer retains the property*, the basis adjustment takes effect on the first day of the tax year following the tax year in which the discharge takes place. (Code Sec. 1017(a))
- *If the taxpayer disposes of the real property before the beginning of the next tax year, the reduction in basis is made immediately before the disposition of the property. Code Sec. 1017(b)(3)(F)(iii).*



SPECIAL NOTE: Under special rules for Qualified Real Property Indebtedness (Code Sec. 1017(b)(3)(F)) the basis of the property subject to the debt relief must be reduced in the year of debt relief. This substantially mitigates the benefits of this exclusion method.

What is the advantage of claiming the Qualified Real Property Business Indebtedness exclusion? When the property is disposed of in the same year as the debt relief, using this exclusion reduces the loss or increases the gain and at first glance results in the same net result as not taking the exclusion (a wash). In either case the result is ordinary income (not capital gains), since basis reduction recaptures as ordinary income.

However, should the taxpayer have any Sec 1231 gains in the next five years, the gain would be treated as ordinary gain to the extent of any unrecaptured Sec 1231 losses that occurred in the prior five years. By claiming the exclusion and minimizing the Sec 1231 loss, any potential Sec 1231 ordinary recapture is minimized in the future.

Disposition of a Passive Activity - In Chief Counsel Advice, 201415002, the IRS has concluded that a foreclosure on real property subject to recourse debt qualifies as a fully taxable disposition for purposes of the disposition-of-passive-activity rules, even though the taxpayer's cancellation of debt (COD) income that resulted from the foreclosure was excluded under Code Sec. 108.

DISCHARGE OF QUALIFIED FARM INDEBTEDNESS

The qualified farm indebtedness exclusion applies only to the discharge of qualified farm indebtedness by a qualified person. No amount is included in a debtor's gross income by reason of a discharge of qualified farm indebtedness. Indebtedness of a taxpayer is treated as qualified farm indebtedness (Code Sec. 108(g)(2)) if:

(1) The indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and

(2) 50% or more of the aggregate gross receipts of the taxpayer for the three tax years before the tax year in which the discharge of the indebtedness occurs is attributable to the trade or business of farming.

Limitations

- **Only Applies to Amount if Solvent** - This exclusion is applied after the insolvency exclusion. Thus, it doesn't apply to the extent the debtor is insolvent. (Code Sec. 108(a)(2))

- **Limited to Adjusted Tax Attributes & Basis of Qualified Property** - The amount excluded from income can't exceed the sum of the adjusted tax attributes of the taxpayer and the aggregate adjusted bases of qualified property (defined below) held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs. (Code Sec. 108(g)(3)(A))

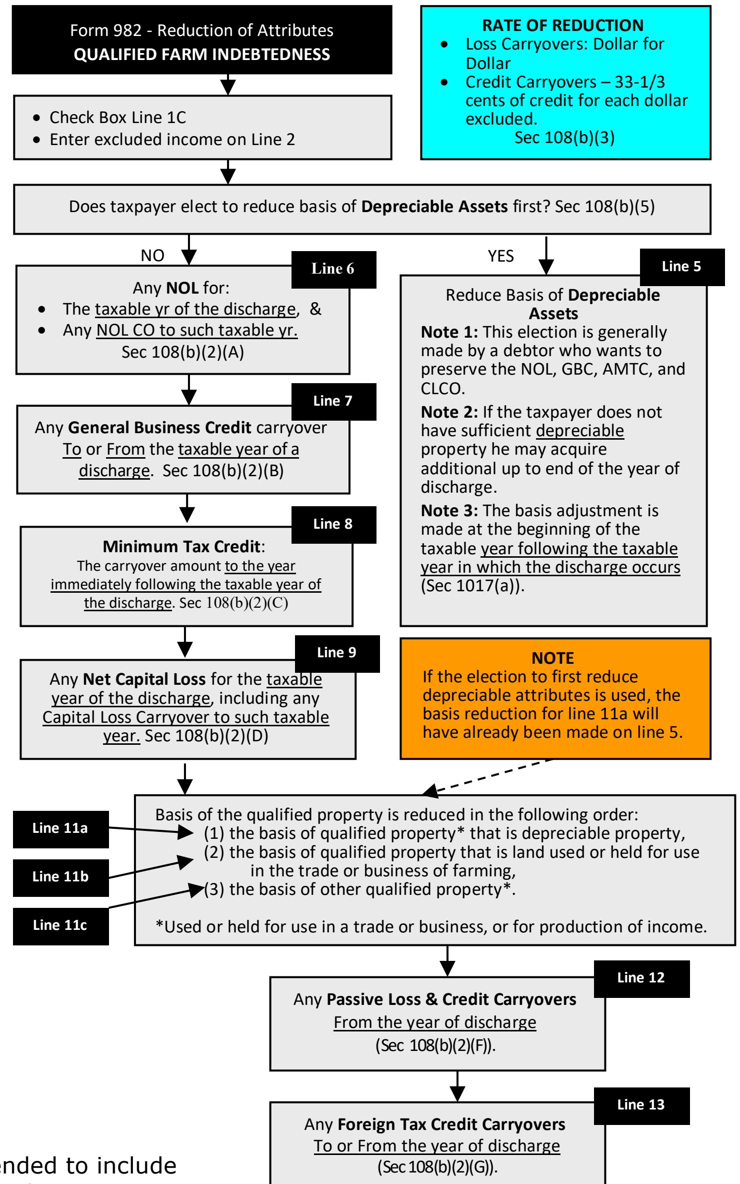
  To the extent there is unabsorbed discharge of indebtedness income after the taxpayer has reduced tax attributes and basis, income is recognized. (H Rept No. 100-795 (PL 100-647) p. 29)

<u>*Definitions*</u> –

- **Qualified Property** - Qualified property means any property used or held for use in a trade or business or for the production of income. (Code Sec. 108(g)(3)(C))
- **Qualified Person** - A qualified person generally means a lender who is unrelated to the debtor or to the seller of the property. In addition, the term qualified person includes any federal, state or local government or agency or instrumentality of a government. (Code Sec. 108(g)(1)(B)).

<u>*Order of Basis Reduction (Code Sec. 1017(b)(4)(A)(ii))*</u> – Basis of the qualified property is reduced in the following order:

(1) the basis of qualified property that is depreciable property,
(2) the basis of qualified property that is land used or held for use in the trade or business of farming,
(3) the basis of other qualified property.



STUDENT LOAN CANCELLATION FORGIVENESS

An individual does not include as income COD income if the discharge was made under a provision of the loan that all or part of the indebtedness would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of <u>generally public employers</u>. An example is a doctor for any public hospital in a rural area of the U.S. (Code Sec. 108(f)(1))

> ***Example:*** *Taxpayer student received $200,000 under a medical educational loan program. Under the terms of the program, one-fifth of the loan (or $40,000) is canceled each year he practices medicine in a qualifying state hospital. He doesn't include the forgiven amounts in income.*

As part of the Affordable Care Act, the law has been amended to include amounts received by an individual in tax years beginning after Dec. 31, 2008; the gross income exclusion for amounts received under the National Health Service Corps loan repayment program or certain State loan repayment programs is modified to include <u>any amount</u> received by an individual under <u>any State loan repayment or loan forgiveness program</u> that is intended to provide for the increased availability of health care services <u>in underserved or health professional shortage areas</u> as determined by the State. (<u>Code Sec. 108(f)(4)</u>)

The Tax Cuts and Jobs Act (TCJA) of 2017 includes a provision that the discharge of an eligible student loan in 2018 through 2025 because of the student's death or total and permanent disability does not result in discharge of debt income. (Code Sec. 108(f)(5)(A))

The IRS has said that certain discharged student loans are not considered income. These include discharges under the Department of Education's Defense to Repayment or Closed School programs for loans taken out to finance attendance at schools owned by Corinthian Colleges, Inc. (CCI), (Rev Proc 2015-57) and American Career Institutes, Inc. (ACI)

(Rev Proc 2017-24), as well as loans discharged based on a settlement of a legal cause of action against CCI, ACI, or certain private lenders (Rev Proc 2018-39).

Forgiveness of Tax-Deductible Items

Discharge of a liability that would have given rise to a deduction by the debtor doesn't result in debt cancellation income. (**Code Sec. 108(e)(2))** Typically this is encountered when the lender includes unpaid interest with the principal amount of debt cancelled on the 1099-C. The key here is to remember that to be excluded from COD income the interest would have had to be deductible had the taxpayer paid it.

Example – Credit Card Debt Cancellation – *Rob had credit card consumer debt cancelled. In Box 2 of the 1099-C was an amount of $10,000 and in Box 3 an amount of $1,000. The $1,000 represents unpaid consumer interest which is not deductible so the COD income is $10,000 which includes the $1,000 interest. However, if the card had been used exclusively for Rob's Schedule C business, the COD income would only be $9,000 ($10,000 - $1,000) since the interest would have been deductible as a business expense.*

Example – Home Mortgage Debt Cancellation *– Mike lost his home to foreclosure in 2017. He had refinanced the home's original purchase money debt of $270,000 and at the time of the foreclosure the debt was $500,000. None of the extra debt was used for substantial home improvements nor can any excess debt be traced to other deductible purposes. Mike's original loan would have been $250,000 at the time of the foreclosure. The amount in Box 2 of the 1099-C is $200,000 and Box 3 includes an amount of $55,000. Thus the amount in Box 3 must be prorated between deductible and non-deductible interest. Mike can deduct the interest for acquisition debt and $100,000 of equity debt. Thus the amount of the interest that would have been deductible is $38,500 (((250,000 +100,000)/$500,000) x $55,000). As a result Mike's COD income is reduced to $161,500 ($200,000 - $38,500). If the foreclosure were to occur after 2017 but before 2026 when equity debt interest isn't deductible, only the acquisition debt portion of the interest will be deductible and the COD income will be reduced to $172,500 ($200,000 – (250,000/500,000 x $55,000)).*

Example – Business Debt - *Suppose you are the accountant for a small cash basis business. The business falls on hard times and cannot meet all of its liabilities. You decide to forgive a portion of the amount the business owes you. The forgiven amount becomes debt relief income to the business but is excluded from that company's income because it would have been deductible if paid.*

Gift Exception

If a debt cancelled by a private lender, such as a relative or friend, is intended as a gift, there is no income. Likewise, a debt cancelled by a private lender's Last Will and Testament triggers no income to the borrower. (Code Sec. 102)

Reduction of Purchase Price

If a debt from a **solvent** buyer of property to the seller which arose out of the purchase is reduced, the reduction is treated as an adjustment of the purchase price not as debt cancellation income. (Code Sec. 108(e)(5)(A))

Caution - this exclusion only applies where the seller is also the lender. If the lender is a third party the reduction is COD income.

Example *– Ken purchased property from Jeff for $125,000. Ken made a $25,000 down payment and Jeff carried back the $100,000 balance secured by the property. In year three, Jeff agreed to reduce the $100,000 debt by $20,000. Assuming Ken wasn't in bankruptcy and remained solvent, the $20,000 debt reduction was an adjustment to the purchase price rather than debt cancellation income. If instead of Jeff financing Ken's purchase, Ken had gotten a loan from a bank (the third party), and in Year 3 the bank had agreed to reduce the debt by $20,000, the debt reduction can't be treated as a price reduction, and Ken would have $20,000 of debt cancellation income.*

However, in third-party lender cases the IRS will allow a debt reduction to be treated as a purchase price adjustment if the debt reduction is based on an "infirmity" that clearly relates back to the original sale, such as if the seller induced the purchaser to pay a higher purchase price by fraud or misrepresentation of a material fact (Rev Rul 92-99, 1992-2 CB 35).

STEP #3 – DETERMINE IF THERE IS ALSO AN ASSET SALE THAT MUST BE DEALT WITH.

If the debt cancelled was secured by an asset, then the disposition of the asset must also be taken into account. Here are some possible scenarios:

- **Short Sale** – In a short sale, by agreement with the lender, the property is sold for a value less than the mortgage balance. Even though the lender ends up with all the net proceeds from the sale, the borrower must report the transaction as a sale on the tax return in the normal manner. Determine the sales price from the table below.
- **Foreclosure (or abandonment)** – In a foreclosure, the lender has taken possession of the property through legal channels. This usually generates a Form 1099-A. The property sale must be reported on the tax return in the normal manner. Determine the sales price from the table below.

- **Repossession** – Generally a term associated with having a vehicle reclaimed by the lender of personal property. If that personal property was also business property (in whole or in part) the disposition of the business portion of the property must be reported as a sale. Report the sale in the normal manner for the asset using the table below. Note: Generally all debts on personal property are recourse; thus the sales price would be the lesser of the FMV or the loan balance.

> **Caution:** Remember that personal use property such as a principal residence, 2nd home, personal use vehicles, etc., cannot result in recognizable loss. So when reporting the sale the loss must be zeroed out. On Form 8949, enter code "L" in col. (f) and the nondeductible amount as a positive number in col. (g)

Computing "Sale Price"

	"SALE" PRICE OF PROPERTY	
Type of Loan	**Foreclosure (or abandonment)**	**Voluntary Reconveyance (also "short sale")**
Recourse	Lesser of: FMV or Loan Bal.	Lesser of: FMV or Loan Bal.
Nonrecourse	Greater of: Loan Bal. or FMV	Loan Balance

IMPORTANT ISSUE – HOME SALE

If a property subject to the debt relief is the taxpayer's primary home then the Sec 121 (home sale gain) exclusion applies, or if needed, the unforeseen circumstances reduced-gain exclusion applies. If there is a loss, the loss would not be deductible since it is personal use property.

- If the home was partially business "mixed use" property at the time of sale, no loss is allowed. Mixed use means it is used both for personal and business use. ("Reg 1.165-9(a) LOSSES NOT ALLOWED. A loss sustained on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible under section 165(a)." Thus this regulation presumably applies in a mixed use situation.)
- If the business use was in a separate structure then there would be two separate sales with no loss allowed on the personal use portion. The gain or loss would be recomputed for the business use portion taking into account the depreciation taken. If the result is a loss, the loss is allowed on the business part. If the result is a gain, the gain is taxable and does not qualify for the Sec 121 exclusion.
- The sale of the home must be reported on Form 8949 if there's a gain and all of the gain isn't excludable under Sec 121, or if Form 1099-S was received for the sale, even if the sale results in a nondeductible loss.

Example 1 – Car Repossession *– Sonja purchased a car for $15,000 which was not used for business. She paid $2,000 down and took out a $13,000 recourse loan from a credit company. Sonja stopped making her loan payments and the credit company repossessed the car. The balance on the loan at the time of repossession was $10,000 and the FMV of the car was $9,000. The credit company decided they would not be able to collect the $1,000 balance on the loan because Sonja had insufficient assets and forgave it. Following the worksheet provided in Publication 4681, we compute the cancellation of debt income and the gain or loss resulting from the repossession:*

PART I

1a *Enter the amount of outstanding debt immediately before the transfer of property........ $10,000*

1b *Enter any amount of line 1a for which the taxpayer remains personally liable* *<u>immediately after the transfer of property</u>*........ *0*

1c *Subtract 1b from 1a $10,000*

2. *Enter the fair market value of the transferred property........ 9,000*

3. Ordinary income from the cancellation of debt
(Subtract line 2 from line 1c. If less than zero, enter zero)........ $1,000

PART II

4. *If Part 1 was completed enter the* ***smaller*** *of line 1c or line 2. If Part 1 was not completed, enter the amount of outstanding debt immediately before the transfer of property........ $9,000*

5. *Enter any proceeds the taxpayer received from the foreclosure sale... .... 0*

6. *Add line 4 and line 5 .... $9,000*

7. *Enter the adjusted basis of the transferred property........ $15,000*

8. Gain or loss from foreclosure or repossession.
Subtract line 7 from line 6........ <$6,000>

> ***Note:*** *Just because the worksheet results in ordinary income does not necessarily mean it is taxable. It may be excludable under one of the provisions discussed in Step #2.*

Sonja's tax return: *1040, Schedule 1, Line 8 (draft 2019) – If no exclusion applies enter $1,000*
Since it was personal use property (no loss allowed) and no gross proceeds have been reported on a 1099-B or 1099-S, there is no need to report the non-deductible loss.

Note: *Since the car was personal use property the loss is not allowed. Had it been partially business use property, the business portion of the gain or loss after taking into account the depreciation recapture would be reportable on Form 4797.*

Example 2 – Home Foreclosure - *Joan paid $200,000 for her home. She paid $15,000 down and took a recourse loan of $185,000 from a bank. Joan was unable to continue making payments and the bank foreclosed. When the bank foreclosed on the loan, the balance due was $180,000, the FMV of the house was $170,000, and Joan's adjusted basis was $175,000 due to a casualty loss she had previously deducted. At the time of the foreclosure, the bank forgave the $10,000 debt in excess of the FMV ($180,000 minus $170,000). In this case, Joan has ordinary income from the cancellation of debt in the amount of $10,000. Following the worksheet provided in Publication 4681:*

PART I

1a	*Enter the amount of outstanding debt immediately before the transfer of property……*	*$180,000*
1b	*Enter any amount of line 1a for which the taxpayer remains personally liable immediately after the transfer of property……*	*0*
1c	*Subtract 1b from 1a ……*	*$180,000*
2.	*Enter the fair market value of the transferred property……*	*$170,000*
3.	***Ordinary income from the cancellation of debt*** *(Subtract line 2 from line 1c. If less than zero, enter zero)……*	*$10,000*

PART II

4.	*If Part 1 was completed enter the* ***smaller*** *of line 1c or line 2. If Part 1 was not completed, enter the amount of outstanding debt immediately before the transfer of property……*	*$170,000*
5.	*Enter any proceeds taxpayer received from the foreclosure sale…… ….*	*0*
6.	*Add line 4 and line 5 ……*	*$170,000*
7.	*Enter the adjusted basis of the transferred property……*	*$175,000*
8.	***Gain or loss from foreclosure or repossession.*** *Subtract line 7 from line 6……*	*<$5,000>*

Note: *Assuming the home is personal use property the loss is not allowed. But see "Important Issue – Home Sale" above.*

Note: *Just because the worksheet results in ordinary income does not necessarily mean it is taxable. It may be excludable under one of the provisions discussed in Step #2.*

Joan's tax return: *1040, Schedule 1, Line 8 (draft 2019) – If no exclusion applies enter $10,000.*
Form 8949 *– When a 1099-A is issued there is a presumption of a sale. When a home's sale price is less than the Sec 121 exclusion, and a 1099-S hasn't been issued, technically the home sale need not be reported. However, those, including the author, who like to ensure all gross proceeds are accounted for on the tax return can show the transaction on Form 8949, and then enter the loss amount as a positive number in column (g) as an adjustment, thus zeroing out the loss. Code L is entered in column (f) to indicate a nondeductible loss.*

Example 3 – Rental foreclosure - Gain *– Joe purchased a rental six years ago for $120,000. He had refinanced the original $100,000 acquisition debt and used the refinanced funds for uses other than substantial improvements on the rental. The debt is recourse and in the current year the bank foreclosed on the rental since Joe had stopped making payments. The outstanding debt at the time of the foreclosure was $225,000 and the FMV was $150,000. The accumulated depreciation to the date of foreclosure was $16,000. The 1099-C shows a FMV in Box 7 of $150,000 and the debt relieved in box 2 of $87,000 and $12,000 in Box 3. As a result of the foreclosure Joe has the sale of a rental and COD income.*

Sale Computation *– Sales price for a recourse loan in foreclosure is the lesser of FMV or loan balance.* ***Thus reported on Form 4797:***

Sales Price (FMV)		*$150,000*
Cost	*120,000*	
Depreciation	*<16,000>*	
Basis		*<104,000>*
Net Gain		***46,000***

COD Income Determination *– This example assumes the lender correctly completed the 1099-C.*

Mortgage	*$225,000*	
FMV (Box 7)	*<150,000>*	
Debt Relief		*75,000*
Unpaid Interest (Box 3)		*12,000*
Debt Cancelled (Box 2)		*87,000*
Unpaid Acquisition debt Interest		*< 5,400>*
COD Income (Line 8 – 1040, Sch 1)		***81,600***

Where the unpaid interest would have been deductible if paid, it can be excluded from COD income. However, in this case the loan is only partially acquisition debt. For the example, assume the refinanced loan is attributed 45% to the acquisition debt and the balance is untraceable to another deductible use.

Excludable?
Because it represents equity debt, only with insolvency exclusion!

Joe's tax return: *1040, Schedule 1, Line 8 (draft 2019) – If no exclusion applies enter $81,600.*
4797 *– Report the sale of a rental – Result will be $16,000 carried to line 4 of 1040, Schedule 1 (draft 2019), And $30,000 to Schedule D as a long-term capital gain**.** **Form 982*** *– Form 982 is only required if a portion of the debt relief is excludable*

Example 4 – Rental foreclosure – Loss *– Assume the facts as in example #3 except the purchase price of the rental was $300,000 and the loan is the original recourse acquisition debt. In such situations the ordinary loss from the rental can offset some or all of the COD income.*

Sale Computation *– Sales price for a recourse loan in foreclosure is the lesser of FMV or loan balance. Thus:*

Sales Price (FMV)		*$150,000*
Cost	*300,000*	
Depreciation	*<16,000>*	
Basis		*<284,000>*
Net Ordinary 4797 Loss		***<134,000>***

COD Income Determination *– This example assumes the lender correctly completed the 1099-C.*

Mortgage	*$225,000*	
FMV (Box 7)	*<150,000>*	
Debt Relief		*75,000*
Unpaid Interest (Box 3)		*12,000*
Debt Cancelled (Box 2)		*87,000*
Unpaid Acquisition debt Interest		*< 12,000>*
COD Income		***75,000***

Exclusion & Basis

In this example, if Joe is insolvent he can exclude the COD income to the extent he is insolvent and still benefit from the 4797 loss. However, if the loss generates an NOL, that NOL will be subject to the attribute reductions shown in Step #4. If, to the extent he is solvent, he attempts to use the qualified real property business indebtedness exclusion he would have to reduce the sale basis by the amount of the forgiven debt, which would reduce the loss by the same amount of the COD income exclusion, simply offsetting each other and providing no benefit.

Example 5 – Rental Mortgage Modification *– Pete, who is not insolvent, owns a rental that cost $200,000 on which the mortgage has a current balance of $150,000. The FMV of the rental is $110,000. Pete negotiates a loan modification with the bank and they reduce the mortgage to $110,000 and issue Pete a 1099-C in the amount of $40,000. Pete can utilize the Qualified Real Property Business Indebtedness exclusion rules and defer this $40,000 of COD income by reducing the basis of his rental property by $40,000 on January 1 of the succeeding year.*

Pete's tax return: *1040, Schedule 1, Line 8 (draft 2019) – No entry (or enter "see Form 982") Form 982 - check Box 1d, enter $40,000 on line 2 and $40,000 on line 11a.*

Step #4 – Complete Form 982 and Reduce Tax Attributes if Required

The final step is completing Form 982 and reducing tax attributes as required for the particular exclusion method.

Only One Form 982 – Potential for Confusion

It is possible that a taxpayer can have multiple discharges of debt during the year or use multiple exclusion methods for a single discharge of debt. However, only one Form 982 can be submitted. The instructions for the 982 say to check the appropriate box(es) indicating the type of exclusion or exclusions used. This can create some confusion down the road if the exclusion of income or reduction of attributes is subsequently challenged. The author recommends that practitioners complete a separate Form 982 (use it as a worksheet) for each separate event and each different exclusion method used for each event. Number them in sequence and combine the results for the single Form 982 to be filed. This will provide an audit trail for the future.

Supplemental Attachment to Identify Property Subject to Basis Reduction – The instructions for Form 982 state that when basis is required to be reduced under Code Section 1017 a list of the property and the amount of basis reduction for each must be attached to the filed return. The following is a suggested format for such a statement.

FORM 982 - Supplemental Worksheet
Identifying Property Subject to Basis Reduction (Sec 1017)

Transaction Creating Basis Reduction: ____________________

Date of Event: __________

Property Subject to Reduction	Adjusted Basis Before Reduction	Amount of Reduction	Basis After Reduction

CAUTION - Basis Reduction Recaptures As Ordinary Income!

To ensure that ordinary income treatment eventually will be given to the full amount of basis reduction made to depreciable or non-depreciable assets when debt discharge amounts are excluded from a debtor's income, any gain upon a debtor's subsequent disposition of reduced-basis property is generally subject to recapture as y income. For recapture purposes, any reduction of the basis of property due to debt discharge amounts is treated as a deduction allowed for depreciation. (Code Sec. 1017(d)(1)(B)). This rule even applies to the sale of a home where the Sec 121 exclusion cannot be used to offset gain that is depreciation recapture.

Exception – With respect to Sec 1250 property, the amount of basis reduction that is recaptured as ordinary income is reduced whenever the taxpayer's depreciation deductions are reduced because of the basis reduction (H Rept No. 103-11 (PL 103-66) p. 625.)

Because each exclusion method has a different sequence of attribute reductions and specials rules pertaining to the exclusion method the following charts were developed to assist with this final task.

Form 982 - Part I – This part is completed to indicate which method(s) of discharge was used

Most recent revision is March 2018 – no significant differences to this version

Form **982**
(Rev. January 2016)
Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ Attach this form to your income tax return.

OMB No. 1545-0046
Attachment

Name shown on return

Check appropriate boxes.

Part I **General Information** (see instructions)

1 Amount excluded is due to (check applicable box(es)):
a Discharge of indebtedness in a title 11 case ☐
b Discharge of indebtedness to the extent insolvent (not in a title 11 case) ☐
c Discharge of qualified farm indebtedness ☐
d Discharge of qualified real property business indebtedness ☐
e Discharge of qualified principal residence indebtedness ☐
2 Total amount of discharged indebtedness excluded from gross income 2
3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? ☐ Yes ☐ No

Enter the amount of COD excludable

Form 982 - Part II – This part is used when the taxpayer has tax attributes that must be reduced by the amount of the excluded debt relief or when the special rule for qualified principal residence indebtedness applies.

customers in the ordinary course of a trade or business, as if it were depreciable property

Part II **Reduction of Tax Attributes.** You must attach a description of any transacti basis under section 1017. See Regulations section 1.1017-1 for basis reduction required partnership consent statements. (For additional information, see the

Enter attribute reductions in appropriate boxes

Enter amount excluded from gross income:

4 For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	4	
5 That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	
6 Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	
7 Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8 Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	
9 Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge	9	
10a Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness.*	10a	
b Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	10b	
11 For a discharge of qualified farm indebtedness, applied to reduce the basis of:		
a Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5	11a	
b Land used or held for use in a trade or business of farming	11b	
c Other property used or held for use in a trade or business, or for the production of income	11c	
12 Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13 Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13	

Where To Report COD Income

1. To the extent it is excludable, the COD income would be reported on line 2 of the Form 982.
2. To the extent it is taxable, report as follows (Pub 4681):
   - Nonbusiness debt – pre-2018: line 21 on Form 1040 or Form 1040NR; 2018 – line 21 is on Schedule 1; 2019 – line 8 on Schedule 1
   - Non-farm sole proprietorship – Line 6 Schedule C or Line 1 Schedule C-EZ
   - Non-farm rental of real property – Schedule E, line 3
   - Farm rental activity – Form 4835, line 6
   - Farm debt and the taxpayer is the farmer – Schedule F, line 8

COD Income as Investment Income – If the COD income is from property held for investment, then it is treated as investment income and increases the limitation for deducting investment interest expense and allows a larger deduction of investment interest. (IRS Letter Ruling 200952018, 9/17/2009). As investment income it could also be subject to the 3.8% net investment income tax should the taxpayer's AGI exceed the taxation threshold.

Home Affordable Modification Program (HAMP)

The HAMP program expired at the end of 2016. However the tax consequences continue through 2018:

Mortgage Reduction – Where the borrower satisfies certain conditions during a trial period, the principal of the borrower's mortgage may be reduced over three years by a predetermined amount called the "PRA Forbearance Amount."

Trial Period – Before a loan modification becomes permanent, the borrower must meet certain conditions during a three-year trial period. If those conditions are met, the borrower will be offered a permanent modification of the terms of the mortgage loan. Until the effective date of a permanent modification, the terms of the existing mortgage loan continue to apply.

After the mortgage loan is permanently modified under HAMP, if the loan is in good standing on the first, second and third annual anniversaries of the effective date of the 3-year trial period, the loan servicer reduces the unpaid principal balance of the loan by one-third of the initial PRA Forbearance Amount on each anniversary date. Accordingly, if the borrower continues to make timely payments on the loan for three years, the entire PRA Forbearance Amount is forgiven.

Tax Consequences (Rev Proc 2013-16)

- **COD Income** - The borrower realizes COD income equal to any excess of the balance of the old mortgage loan (which was satisfied in the deemed exchange) over the issue price of the new (post-modification) mortgage loan.
- **Exclusions** – Where the taxpayer qualifies, the COD income can be excluded using either or both the Sec 108(a)(1)(B) insolvency exclusion and the Sec 108(a)(1)(E) principal residence acquisition debt relief exclusion. The latter exclusion is only available through 2017 (2018 if the discharge is made under a binding written agreement entered into in 2017), unless further extended by Congress.
- **When Income Is Realized** – To the extent the COD income cannot be excluded, the borrower may treat the COD income as being realized in either of the following ways (Rev Proc 2013-16, Paragraph 4.5) —

  (1) One hundred percent of the PRA Adjusted Forbearance Amount at the time of the permanent modification; or

  (2) One third of the PRA Adjusted Forbearance Amount on each of the first three annual anniversaries of the trial period plan effective date, when, as required by the terms of the new mortgage loan, the servicer reduces the unpaid principal balance of the new mortgage loan. If some or all of the reduction in the unpaid principal balance is accelerated because the HAMP-PRA borrower prepays the non-forbearance portion of the mortgage loan, then the HAMP-PRA discharge represented by the amount of the reduction that was accelerated is treated as being realized at the time of the accelerated reduction.
- **Incentive Payments to Lenders** – Incentive payments made by the HAMP administrator to mortgage lenders to encourage their participation in the program are treated as payments on the mortgage loans by the U.S. government on behalf of the borrowers. The borrower treats these payments as follows:
  - *Personal residence* - Under the "general welfare exclusion" (Rev Rul 2005-46; Rev Rul 75-246) the borrower excludes the incentive payments from income if the property that is encumbered by the mortgage is used by the borrower as his principal residence or the property is occupied by his legal dependent, parent, or grandparent without rent being charged or collected. No information return (1099) will be issued.
  - *Rental property* - If the borrower uses the property as a rental, or it is vacant but available to be rented, the incentive payments made to the lender are includible in the borrower's income in the year in which the payments are applied to the loan. The lender is obligated to issue a Form 1099-MISC reporting the amount.

TENANT RIGHTS IN FORECLOSURE – The Protecting Tenants at Foreclosure Law (PL 111-22), enacted in 2009, offers some protection to those who are renting a home that has been foreclosed upon and is based upon whether the new owner of the property intends to occupy the property or not.

- *New Owner Plans to Occupy* - The tenant must be given 90-day notice to vacate.
- *New Owner Does Not Plan to Occupy* – The tenant must be given 90-day notice to vacate. If the tenant has a valid lease the new owner must honor the term of that lease.

However, for the provisions of this law to apply, the tenant must be "bona fide," the rental agreement must be for fair rental value and must be the result of an "arm's-length" transaction. There also must be documented evidence of rent paid. The previous owner's spouse, children and parents are specifically excluded from the terms of this law.

UNPAID EMPLOYER LOAN - The Tax Court (John. E. McAllister, Jr., TC Memo 2013-96) has held that an individual who received loans from his former employer (Suncoast Roofers) that went unpaid did not receive fully taxable compensation but rather cancellation of debt (COD) income. Furthermore, the Court found that a portion of the income qualified for the insolvency exclusion under Code Sec. 108.

CO-SIGNER HAD NO COD – The Tax Court (F. Bullock, TC Memo. 2017-219) held that a taxpayer did not receive cancellation of debt income because she was not the primary obligor on the loan that her son and daughter-in-law had taken out. The Court reasoned that her net worth had not increased over what it would have been if the original transaction had never occurred. She was merely a secondary obligor who did not realize until trial that she had unwittingly signed paperwork indicating that she was the primary obligor on the loan. The lender was aware that the taxpayer only intended to be a cosigner, had never contacted her for repayment (although Form 1099-C was issued to her), and that the son and daughter-in-law were responsible for the loan payments.

TAX PROFESSIONAL ISSUING 1099-C TO NONPAYING CLIENTS - IRS's Office of Professional Responsibility (OPR) did not look kindly on a proposal by a Cir 230 tax practitioner to send Form 1099-C, Cancellation of Debt, to delinquent or nonpaying clients. Said OPR, "If a tax professional repeatedly uses Forms 1099-C, as a business strategy to collect unpaid fees, when the tax professional knows, or should know, that the facts and circumstances do not provide a basis for doing so, the conduct calls into question the tax professional's fitness to practice before IRS. A pattern of issuing Form 1099-C with a reckless disregard as to the existence of a debt (because, for example, the former client does not have a fixed contractual liability to **repay** a sum previously received), or the absence of an "identifiable event" triggering a reporting requirement, is inconsistent with the standards of competency and professionalism embodied in the rules of practice." Bottom line: it isn't a good idea. For those who wish to read OPR's full discussion, go to: http://content.govdelivery.com/accounts/USIRS/bulletins/eee455

CALIFORNIA DIFFERENCES

California law generally conforms to the provisions of the IRC Sec 108. Thus it conforms to all the federal debt relief income exclusions with the exception of the home mortgage debt relief exclusion. California's version of the principal residence debt relief exclusion expired at the end of 2013. California is an anti-deficiency (non-recourse) state (see page 2.09.02). In addition CA has a special anti-deficiency law for short sales (see below).

New Law & Stuff

AB 91 (signed by the governor 6/27/2019) conforms California law to the TCJA provision that certain student loan debt cancelled upon the death or disability of the student is not taxable, effective for loans cancelled after December 31, 2018**. Note:** That means for 2018, CA did not conform.

California Primary Residence Purchase Money Trust Deed Anti-Deficiency Law – Sec 580b of the California Code of Civil Procedure, provides that no deficiency shall be owed or collected, and no deficiency judgment shall be awarded, with regard to a purchase money trust deed on a dwelling for not more than four families given to a lender to secure repayment of a loan that was used to pay all or part of the purchase price of that dwelling, occupied entirely or in part by the purchaser. Under Sec 580b(a)(3), a "purchase-money loan" includes a loan used to refinance a purchase-money loan, or subsequent refinances of a purchase-money loan, except to the extent that lender lends new principal that is not applied to an obligation owed or to be owed under the purchase-money loan.

Thus in such cases there is no COD income as a result of the foreclosure or short sale of such property. The COD income is not included on the return and no Form 982 is required. Report only the disposition of the property as if the loan was non-recourse and use a sale price as determined from the table on page 2.09.14. If a 1099-C is issued it may be appropriate to attach a Form 8275 – Disclosure Statement explaining why the COD income is not dealt with on the 1040. Suggested wording for the 8275 is shown below.

FORM 8275 - The taxpayer is not reporting cancellation of debt income that was included on the Form 1099-C issued by (enter lender's name) because the 1099-C was the result of a disposition of the taxpayer's primary residence secured by a purchase money trust deed that is non-recourse under California Anti-Deficiency Law (California Code of Civil Procedure Section 580b). Under this law, no deficiency shall be owed or collected, and no deficiency judgment shall be requested or rendered, for any deficiency with regard to a purchase money trust deed on a dwelling for not more than four families given to a lender to secure repayment of a loan that was used to pay all or part of the purchase price of that dwelling, occupied entirely or in part by the purchaser.

California Short Sale Anti-Deficiency Law - Section 580e of the California Code of Civil Procedure was amended by SB 458 and was signed by Governor Brown on July 11, 2011. Under this law, no deficiency shall be owed or collected, and no deficiency judgment shall be requested or rendered for any deficiency upon a note secured solely by a deed of trust or mortgage for a dwelling of not more than four units, in any case in which the trustor or mortgagor (borrower) sells the dwelling for a **sale price less than the remaining amount of the indebtedness outstanding at the time of sale**. These rules only apply where:

- The short sale is in accordance with the **written consent of the** holder of the deed of trust or mortgage (**lender**).
- **Title has been voluntarily transferred** to a buyer by grant deed or by other document of conveyance that has been recorded in the county where all or part of the real property is located.
- The **proceeds of the sale have been tendered to the** mortgagee, beneficiary, or the agent of the mortgagee or beneficiary (**lender**), in accordance with the parties' agreement.
- A holder of a note (**lender**) **shall not require the** trustor, mortgagor, or maker of the note (**borrower**) to **pay any additional compensation**, aside from the proceeds of the sale, in exchange for the written consent to the sale.
- **No fraud or waste has been committed** with respect to the real property secured by the debt. If fraud or waste was committed, then the holder of the deed of trust or mortgage (lender) may seek damages and use existing rights and remedies against the trustor or mortgagor (borrower) or any third party for fraud or waste.

Section 580e applies the same treatment to any secondary or junior loans involved in the transaction.

IRS's Views on CA's Sec 580e of the CCP – Originally in a letter to then-CA Senator Boxer, the IRS Office of Chief Counsel indicated that a homeowner's obligation under the anti-deficiency provision of section 580e would be a nonrecourse obligation to the extent that, for federal income tax purposes, the homeowner will not have cancellation of indebtedness income.

A few months later the IRS Office of Chief Counsel decided to change their position, and said the short sale legislation does not change the character of a recourse loan to non-recourse. A lot of unanswered questions remain related to this issue, and the Chief Counsel's letters indicate the Service's opinion and are not statutory. The aggressive position would be to treat a short sale with recourse debt as non-recourse for purposes of cancellation of debt. If doing so, the 8275 disclosure form is probably appropriate and suggested language is provided below.

FORM 8275

The taxpayer is not reporting cancellation of debt income included on a 1099-C because the 1099-C was the result of a short sale qualifying under California Short Sale Anti-Deficiency Law (California Code of Civil Procedure Section 580e).

Under this law, no deficiency shall be owed or collected, and no deficiency judgment shall be requested or rendered for any deficiency upon a note secured solely by a deed of trust or mortgage for a dwelling of not more than four units, in any case in which the trustor or mortgagor (borrower) sells the dwelling for a sale price less than the remaining amount of the indebtedness outstanding at the time of sale.

Thus the loan subject to this short sale is non-recourse and does not result in any cancellation of debt income. This position is confirmed by IRS Office of Associate Chief Counsel letter number 2013-0036 (9/19/13) addressed to then-CA Senator Barbara Boxer. The following is an excerpt from that letter: *"We believe that a homeowner's obligation under the anti-deficiency provision of section 580e of the CCP would be a nonrecourse obligation to the extent that, for federal income tax purposes, the homeowner will not have cancellation of indebtedness income."*

Since the loan is treated as non-recourse and this is a short sale, the sales price used for the property disposition is the balance of the outstanding loans on the property.

California Acquisition Debt and Acquisition Refinanced Debt Anti-Deficiency Protection (589b(c)) - California homeowners who default on their refinance loans may be protected against personal liability for any deficiency following foreclosure. Under pre-2013 anti-deficiency law, a borrower is protected from personal liability for a purchase money loan secured by an owner-occupied property with one-to-four residential units.

The new law extends that anti-deficiency protection to include any loan used to refinance the purchase money loan, plus any loan fees, costs, and related expenses for the refinance. The anti-deficiency protection, however, does not extend to any cash out in a refinance. This new law only applies to refinance loans or other credit transactions used to refinance a purchase money loan, or subsequent refinances of a purchase money loan, that are **executed on or after January 1, 2013**.

For purposes of this law, any payment of principal shall be deemed to be applied first to the principal balance of the purchase money loan, and then to the principal balance of any new advance and interest payments shall be applied to any interest due and owing. Senate Bill 1069 (codified as Cal. Code of Civ. Proc. § 580b(c)) (effective January 1, 2013).

Multiple Loans – If the same lender holds both the first and second mortgages and foreclosed using the non-judicial foreclosure procedure, the second mortgage is deemed cancelled (California Code of Civil Procedure Section 580b).

NOTES

DAMAGES

RAPID FINDER

- **Nontaxable** (by suit or agreement)
  - Physical injury
  - Physical illness
  - Wrongful Incarceration
- **Taxable** (examples)
  - Emotional Distress
  - Employment Discrimination
  - Sexual Harassment
  - Punitive damages - always taxable

- **Business damages** (examples)
  - Related to employment – taxable as ordinary income
  - Injury to capital – reduce basis – excess taxable
  - Lost profits – ordinary income
- **Legal expenses**
  - Nontaxable income = nondeductible expenses
  - Taxable income:
    - If related to business entity – on that entity's schedule
    - If related to personal – Is a Schedule A Tier 2 deduction (subject to the 2% of AGI floor), suspend by TCJA. for years 2018 through 2025. Thus, for those years no federal deduction is allowed.
    - If related to capital – add to basis
    - Exceptions – see text page 02.10.05

Related IRC and IRS Publications and Forms

- **Pub 525** – Taxable and Non-taxable Income
- **Pub 529 -** Miscellaneous Deductions
- **Pub 957 –** Reporting Back Pay and Special Wage Payments to the Social Security Administration
- **IRC Sec 104**
- **IRC Sec 139F**

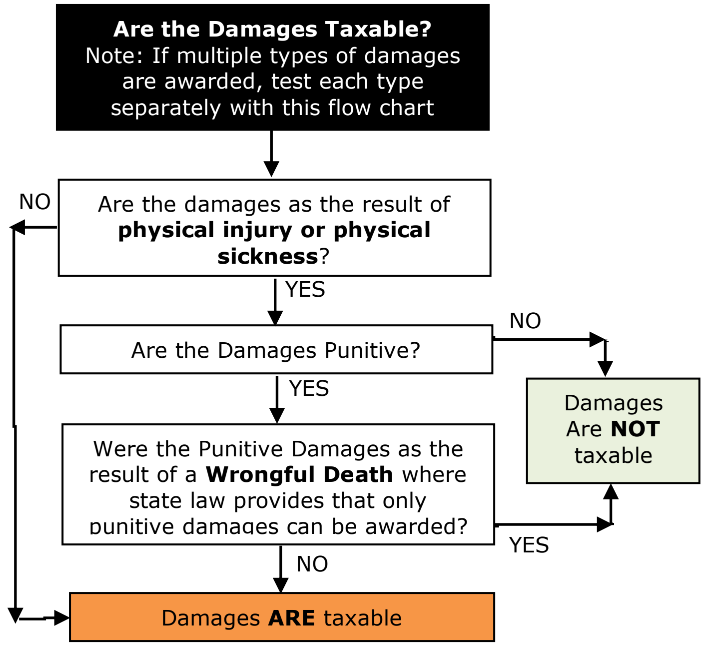
The following table is a summary of the Chief Counsel Memo (CCM) 2009-035, which provides a detailed account of IRS's position on how to handle the income and employment tax consequences and reporting duties relating to employment related judgments and settlements.

Type of Judgment or Settlement	Document	Taxable	ITW	FICA
Back Pay (1)	W-2	Yes	Yes	Yes (2)
Severance Pay	W-2	Yes	Yes	Yes
Front Pay	W-2	Yes	Yes	Yes
Compensatory damages				
Physical injury or physical sickness	None	No	No	No
Emotional distress	1099-MISC	Yes	No	No
Other	1099-MISC	Yes	No	No
Punitive/liquidated damages (3)	1099-MISC	Yes	No	No

(1) *Back pay (other than for lost wages received on account of personal physical sickness or physical injury) is taxable, subject to FICA and income tax withholding (ITW) and must be reported on Form W-2. The CCM reiterates IRS's rulings position that back pay awarded for an illegal refusal to hire is wages for federal employment tax purposes but acknowledges the Eighth Circuit's decision to the contrary in Newhouse v. McCormick & Co., (CA 8 10/2/1998). There, the Eighth Circuit (covering Minnesota, North and South Dakota, Iowa, Nebraska, Missouri, and Arkansas) held that FICA tax and ITW do not apply unless an actual employer-employee relationship existed.*

(2) FICA tax based on rates and limits for year paid and included on a W-2 in the year of payment. However, IRS Pub. 957 notes that payments for back pay awarded under a statute will remain posted to the employee's social security earnings record in the year reported on Form W-2, unless the employee or employer notifies the SSA of such a payment, via a separate special report procedure explained in IRS Pub. 957.

(3) See exception for wrongful death under physical sickness or physical injury



PHYSICAL INJURY OR SICKNESS:

Damages received on account of ***personal physical injuries or physical sickness*** are excludable from income whether:

- Recovery is by suit or agreement, or
- Amounts are received as a lump sum or in periodic payments.

Damages for personal injuries are monetary amounts (other than worker's compensation payments) received as the result of a judgment or settlement. Final regulations removed the requirement that, to qualify for exclusion from gross income, damages received from a legal suit, action or settlement agreement must be based upon "tort or tort type rights." Instead, the exclusion may apply to damages recovered for a personal physical injury or physical sickness under a statute that does not provide for a broad range of remedies, and that the injury need not be defined as a tort under state or common law. For example, damages for personal physical injuries or physical sickness awarded under "no-fault" statutes are eligible for exclusion.

When an action originates with a ***physical injury or physical sickness***, then all damages (other than punitive) are treated as payments due to physical injury or physical sickness (***whether or not the recipient of the damages is the injured party***).

- ***Wrongful Death*** – Is considered physical injury or physical sickness for purposes of the income exclusion. In addition, where state law provides that only punitive damages can be awarded in wrongful death suits, punitive damages are excludable (Code Sec. 104(c)).
- ***Emotional Distress -*** Emotional distress isn't considered physical injury or physical sickness for purposes of the income exclusion.
- ***Employment Discrimination -*** No exclusion is allowed for damages received in a suit involving employment discrimination or injury to reputation, which is accompanied by a claim of emotional distress. However, the exclusion would apply to a claim of emotional distress, which was related to a physical injury or physical sickness.

WRONGFULL INCARCERATION

Gross income doesn't include compensation received for a wrongful incarceration. A wrongfully incarcerated individual is defined as either (Code Sec. 139F):

(1) an individual who was convicted of a criminal offense under Federal or state law, who served all or part of a sentence of imprisonment relating to such offense, and who was pardoned, granted clemency, or granted amnesty because of actual innocence of the offense; or

(2) an individual for whom the conviction for such offense was reversed or vacated and for whom the indictment, information, or other accusatory instrument for such offense was dismissed or who was found not guilty at a new trial after the conviction was reversed or vacated.

The Bipartisan Budget Act of 2018 provision that allowed wrongfully incarcerated individuals that previously received an award, and did not exclude it, to file a related refund claim expired on Dec. 17, 2018.

SEXUAL HARASSMENT DAMAGES AND SETTLEMENTS

Impact on a Business - Under TCJA, and effective for amounts paid or incurred after December 22, 2017, no business deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement (IRC Sec. 162(q)(1) as amended by TCJA Sec. 13307(a)).

Impact on an Award Recipient – Damages for sexual harassment and gender discrimination are not excludable under Code Sec. 104(a)(2) and thus are fully taxable. The issue of sexual harassment qualifying as excludable physical injury or sickness has been in court on several occasions, always with the same result. Here is an example:

> *Payment was received to settle a sexual harassment/discrimination law suit against an employer. The employee did not allege physical injury or sickness in his complaint, but the settlement agreement was broad and encompassed all possible causes of action, including physical injuries. However, there was no allocation of a specific amount of the settlement as compensation for physical injuries or physical sickness. Accordingly, without the allocation, no amount of the settlement proceeds was excludable from income. (Hellesen, Jon. E., (2009) TC Memo 2009-143),*

Recipients of settlements or payments related to sexual harassment or sexual abuse, whose settlement or payment is subject to a nondisclosure agreement, are not precluded by section 162(q) from deducting attorney's fees related to the settlement or payment, if otherwise deductible. (IRS website; Section 162(q) FAQ)).

However, the deduction for legal fees is a Tier 2 miscellaneous itemized deduction and these deductions are suspended 2018 through 2025, thus not deductible during that period of time.

EMOTIONAL DISTRESS DAMAGES

A frequent question has to do with the taxation of damages awarded for emotional distress. Damages for physical injury or physical sickness are clearly tax-exempt and damages for emotional distress are generally taxable.

However, Code Sec. 104(a) allows the exclusion of damages received for emotional distress to the extent not in excess of the amount paid for medical care related to emotional distress.

Care should be taken in identifying the portion of the damages awarded for emotional distress, especially where the total of the damages includes awards for both physical injury or sickness and emotional distress.

Chief Counsel Memo (CCM) 2009-035, provides a detailed account of IRS's position on how to handle the income and employment tax consequences and reporting duties relating to employment related judgments and settlements. In that memo, the Chief Counsel indicates the following:

- For **physical injury** or physical sickness, no 1099 shall be issued and damages are not taxable.
- For **emotional distress**, a 1099 shall be issued and the damages are taxable.

Sometimes a suit for damages will be settled out of court. When this occurs, and no allocation is specified in the settlement, it is generally necessary to look back at the original suit and prorate (allocate) the settlement according to the original suit.

Care should also be taken with any advice provided by the taxpayer's attorney. It is not uncommon for them to suggest that emotional distress is tax exempt.

OTHER ISSUES

Allocating Awards - If a taxpayer receives an award, which is only partially excludable from income, he/she must establish the amount of the award that is excludable. Generally, look to the original complaint to make the proration between taxable and nontaxable.

> ***EXAMPLE - Allocating Injury Awards*** *- Drew filed a personal injury claim for $10,000. His claim was for $5,000, physical injury; $1,000, lost wages; $4,000, punitive damages. Drew received a settlement of $2,000 with no stipulation between the various kinds of award. One thousand dollars of the award is nontaxable ($2,000 x $5,000/$10,000).*

Compensatory vs. Punitive Damages - State law determines whether damages are compensatory or punitive.

- **Compensatory damages** are payments made as a substitute or to make amends for the injury sustained. These payments are intended to "make the injured party whole." Such payments are nontaxable if they meet the rules outlined above for personal physical sickness or physical injury.

- **Punitive damages** are made as a punishment for unlawful conduct. **Punitive damages are always taxable**; they cannot be excluded from income as damages received on account of personal physical injury or physical sickness except as noted above for wrongful death.

***Interest* (also referred to as delayed interest) -** The portion of a judgment that's attributable to interest because of delay in receiving settlement proceeds (or because the proceeds are received in periodic payments) is taxable income. It doesn't matter that the judgment itself is nontaxable.

Payments for Pain and Suffering to Egg Donor Are Taxable - The Tax Court ruled that the payments received by a woman to provide her eggs for infertile couples was taxable as compensation for services rendered and was not tax-free damages for the pain and suffering she incurred during a prolonged series of painful injections, operations and physical injuries that she endured as part of the egg-retrieval process, even though the contracts between the egg donor and the egg recipients identified the sums she was to receive as compensation for pain and suffering. The Tax Court concluded that compensation for pain and suffering resulting from the consensual performance of a service contract is not "damages" under Code Sec. 104(a)(2), and is therefore taxable. (*Nichelle G. Perez v. Commissioner, Jan. 22, 2015*)

DAMAGES RELATED TO BUSINESS INTERESTS

- Damages received ***related to employment*** are normally taxable as ordinary income. Such payments could include awards to employees for breach of an employment contract by an employer or awards for back pay.
- When a taxpayer receives damages for ***injury to capital*** the basis of the property is reduced and, no income results (unless the amount exceeds the basis of the asset involved).
- Recoveries of ***lost profits*** are taxable as ordinary income.
- Damages received as a result of a ***broken agreement*** to purchase property are taxable.
- Amounts received from ***business interruption insurance*** policies to compensate for lost profits are taxable ordinary income.

LEGAL EXPENSES

Business or Employment Related - Legal fees for defending and filing damage suits in a taxpayer's business or in employment are deductible. Examples are:

- Defending suit for wrongfully taking property.
- Corporation's defense of its position before the National Labor Relations Board related to liability for compensatory damages to employees.
- Settlement of damage suit in business that could help avoid adverse publicity and controversy.
- Getting a judgment for damages to rental real estate.
- Teacher's action of sex discrimination against a university.

***Damages for Personal Injury or Sickness* -** To the extent a taxpayer can't exclude from income a portion of an otherwise tax-free personal damage award--e.g. due to payment of interest accruing on the settlement funds-- the legal costs are deductible (but see next item).

WHERE TO DEDUCT LEGAL EXPENSES

- **Related to Individuals** - Depends upon when the expenses are incurred:
  - **2018 through 2025 Tier 2 Treatment**: As part of the TCJA, Tier 2 miscellaneous deductions are suspended for years 2018 through 2025. Therefore, any expenses incurred in obtaining a personal taxable award or settlement, including legal fees, will not be deductible for years 2018 through 2025 and the taxpayer will be liable for the tax on the entire taxable amount. On the bright side, the miscellaneous deduction often triggered the AMT – no longer the case now.
  - **Pre-2018 Tier 2 Treatment:** Generally, prior to 2018, legal expenses related to non-business awards or settlements are deducted on Schedule A as Tier 2 miscellaneous itemized deductions. The entire amount of the legal fees included in a taxable damages award or settlement must be included in the taxpayer's income, even if the taxpayer receives the award net of the attorney fees. This issue has been hashed out in court numerous times, all with the same unfavorable result for the taxpayer. The following are some citations:
    - When an attorney is paid under a contingent fee arrangement, the client must include in gross income the amount paid to the attorney as a contingent fee. (Campbell v. Commissioner, affirmed CA-11, 2011-2)
    - Under the assignment-of-income doctrine, a taxpayer may not avoid taxation by assigning income to another party. The amount paid to the attorney is includible in gross income regardless of whether the attorney-client contract or state law gives the attorney any special rights, such as a lien. (Commissioner v. Banks, 2005-1 USTC)

- **Related to business:** If related to the taxpayer's: (1) self-employed business, deduct expenses on Schedule C or Schedule F if a farm sole proprietorship; (2) real estate rental, deduct on Schedule E.
- **Related to capital items:** If the expenses must be added to basis, sale of the related property would be reported on Form 8949 (Schedule D) or Form 4797.
- **Above-the-line deduction for some discrimination awards -** An above-the-line deduction is allowed for attorneys' fees and costs paid by, or on behalf of, a taxpayer in connection with a claim of unlawful discrimination, certain claims against the federal government, or a private cause of action under the Medicare Secondary Payer statute. This provision applies to judgments or settlements occurring after October 22, 2004 and is unchanged by the TCJA. ***(Code Sec 62(a)(20))***

HUMAN TRAFFICKING RESTITUTION PAYMENTS NONTAXABLE

Under 18 U.S.C. § 1593 a defendant convicted of a human trafficking offense is required to make restitution payments to the victim. IRS issued guidance that these payments are excludable from gross income for federal income tax purposes. The payments may be to compensate the victim for costs of medical services, physical and occupational therapy or rehabilitation, transportation, temporary housing, child care expenses, lost income, attorneys' fees and other costs and losses the victim suffers as a result of the offense. ***(Notice 2012-12)***

CALIFORNIA DIFFERENCES

California conforms to federal law except for (1) elimination of the Tier 2 miscellaneous itemized deductions (for legal expenses related to taxable damage awards) and (2) the denial of a business deduction for sexual harassment settlements and related legal expenses.

With regard to claims for amounts previously included in income by wrongfully incarcerated individuals, if the normal CA statute of limitations has expired for the year the income was included, an amended return to claim a refund for CA income taxes paid on that income must be filed before January 1, 2019. (AB 454; FTB Tax News 2/1/18)

NOTES

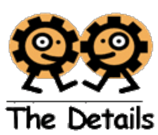
STATUTORY EMPLOYEE

- **Wages:**
  - FICA withholding required
  - Federal withholding not required but may occur
- **Statutory employees:**
  - Agent and commission drivers
  - Full-time life insurance sales agent
  - Home Workers
  - Full-time traveling or city salespeople
- **Reporting**
  - Income is reported on Schedule C (Do not combine with non-statutory income)
  - Do not include a Schedule SE for the statutory employee income (Software should handle if properly coded)

RAPID FINDER

Related IRC and IRS Publications and Forms

- **Forms W-2 and W-3** Instructions
- **Publication 15-A** -Employer's Supplemental Tax Guide (Supplement to Circular E, Employer's Tax Guide, Publication 15)
- **IRC Sec 3121**



DEFINITION: Statutory employees occupy a sort of middle ground between independent contractors and regular employees. They can be defined as workers in certain occupations who would not be considered employees under the usual rules, but who have been declared employees under the federal tax laws so that their employers must withhold FICA taxes on their income.

Thus a statutory employee is one whose earnings are subject to social security and Medicare taxes but **not** subject to Federal income tax withholding (although some employers may withhold income tax). These are workers who are independent contractors under the common-law rules but are treated by statute as employees. They are called statutory employees. The following are statutory employees:

1. **Agent and commission drivers** - Agent-drivers and commission-drivers who distribute meat, vegetable, fruit or bakery products, beverages other than milk, or laundry or dry-cleaning services for their principal *(Code Sec. 3121(d)(3)(A))* and who meet the requirements of Code Sec. 3121(d)(3) are employees for FICA purposes. *(Code Sec. 3121(d)(3)(A)).*

   For purposes of determining if someone is an agent-driver or commission-driver, it isn't relevant whether:

   - He operates his own truck or the truck of his principal;
   - He services customers designated by the principal or those solicited on his own;
   - His compensation is a commission or the difference between what he charges his customers and the price he pays the principal *(Reg § 31.3121(d)-1(d)(3)(i))*.

   A driver, who purchased his territory, set his own hours and established methods of conducting his business without supervision from his principal was an employee for FICA tax purposes *(Rev Rul 75-269, 1975-2 CB 401).*

2. **Full-time life insurance sales agent** - A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.

3. **Home Workers -** An individual who works at home on materials or goods that are supplied by the employer and must be returned to the employer, if the employer must also furnish specifications for the work to be done.

4. **Full-time traveling or city salespeople** - A full-time traveling or city salesperson who works on behalf of an employer and turns in orders to the employer from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the employer must be the salesperson's principal business activity.

   A person is a full-time traveling or city salesperson if he:

   - Is not an agent- or commission-driver;
   - Is engaged on a full time basis soliciting orders on behalf of his principal and transmitting those orders to that principal (but he may conduct side-line sales activities on behalf of other persons as well);
   - Obtains the orders from wholesalers, retailers, contractors, or operators of hotels, restaurants *(Code Sec. 3121(d)(3)(D))* or other businesses whose primary function is the furnishing of food and/or lodging (Social Security Handbook ('97));
   - Sells merchandise for resale or for use as supplies in his customers' business operations (Code Sec. 3121(d)(3)(D));
   - Is not a "direct seller."

   Salespersons who operate off the premises of their principals and who are generally compensated on a commission basis are included in this occupational group. Such individuals are generally not controlled as to the details of their services or the means by which they cover their territories, but they are generally expected to call on regular customers with a fair degree of regularity (Reg § 31.3121(d)-1(d)(3)(iv)(a)).

FILING & REPORTING:

Employer – The employer reports on Form W-2 and must check "statutory employee" in box #13. Both SS and Medicare must be withheld, but no income tax is required to be withheld.

Statutory employees - must use Schedule C or C–EZ to report their wages and expenses related to the statutory wage income. Because FICA taxes have already been paid the employee does not file a Schedule SE for this income. If the taxpayer has both statutory employee income and other income from their business, do not combine these two types of income on a single Schedule C. Instead file two Schedule Cs with only the income (net of expenses) from non-statutory-employee business activities flowing through to the Schedule SE.

MUST MEET TESTS: To be classified as a statutory employee, the employee must meet the following tests:

(a) The contract of service contemplates that the worker performs substantially all of the services himself;

(b) The worker doesn't have a substantial investment in facilities used for doing the work, other than transportation facilities;

(c) The services are part of a continuing relationship with the person for whom they are performed, i.e., they aren't in the nature of a single transaction *(Code Sec. 3121(d)(3)).* The fact that the services aren't provided on consecutive workdays doesn't disqualify a worker *(Reg § 31.3121(d)-1(d)(4)(iv))*.

STATUTORY WAGES & SEC 199A: For purposes of the Sec 199A 20% deduction of qualified business income (QBI), statutory wages paid by a business (i.e., where box 13 of the W-2 is marked) are not wages includible for the wage limitation computation.

The trade or business of performing services as an employee is not a trade or business for purposes of section 199A. Therefore, any amounts reported in box 1 of Form W-2, amounts reported in box 1 where the "Statutory Employee" box in box 13 is checked, are not QBI.

See Chapter 3.24 for details about the Sec 199A deduction.

NOTES

NATIVE AMERICAN INCOME

Overview

- **Federally Tax Exempt Income**
  - Income directly derived from restricted lands by enrolled members of the tribe
  - Examples
    - Farming and ranching
    - Sale of standing timber
    - Sale of allotted lands
  - Tribal programs benefits (general welfare exception)
  - Payments from Tribal Trust Funds
- **Federally Non-Exempt Income**
  - Income not directly derived from the restricted land
  - Investment income
  - Examples
    - Income from lodging
    - Retail businesses
    - Per-capita gaming income

RAPID FINDER

The Details

EXEMPT INCOME

Noncompetent Indians who are wards of the U.S. government are exempt from tax on all income directly derived from restricted lands allotted to them or to an ancestor and held in trust by the government for their benefit under the General Allotment Act of 1887.

Heirs - Where land held under a trust patent is transferred from an original allottee by devise or inheritance to a noncompetent heir, the income directly derived from that land by the heir continues to be exempt. The exemption is lost, however, if the heir later receives a fee simple title. *TR FR-051, 4/9/57.*

Exempt Income Tests - IRS will recognize the exempt status of income received by enrolled members of an Indian tribe where all of the following tests are met:

(1) The land is held in trust by the U.S. government;

(2) The land is restricted and allotted and is held for an individual noncompetent Indian, and not for a tribe;

(3) The income is "derived directly" from the land;

(4) The statute, treaty, or other authority involved evinces Congressional intent that the allotment be used as a means of protecting the Indian until such time as he becomes competent; and

(5) The statute in question contains language indicating clear Congressional intent that the land, until conveyed in fee simple to the allottee, is not subject to taxation.

Examples of Exempt Income - Income directly derived from the allotted lands held exempt under the rules described above includes:

- Rent (whether in crops or otherwise), royalties, and proceeds from the sale of natural resources or crops.
- Ground rent paid to Indians by their wholly-owned S corporation to lease their possessory interests in reservation land. Although the S corporations operated motels, the rent was for the bare land and the lease agreement was legitimate and provided for a fair rental value based on prior appraisals.
- Proceeds from the sale of standing timber.
- Proceeds from the sale of the allotted lands.
- Appreciation in value of the lands during the period of trust allotment, which is later realized on a sale.
- Farming income, grazing fees and oil lease bonuses.
- The proceeds of sale or exchange of livestock raised on the land.
- Income from farming and ranching.
- Government payments under agricultural conservation programs.

NONEXEMPT INCOME

The exemption doesn't apply to the following, which are taxable in the absence of a contrary statute or treaty:

- ***Investment income*** - Income not directly derived from the allotted lands and therefore taxable includes income realized on the reinvestment of the above-exempt income. *Squire v. Capoeman, Horton, (1956, S Ct) 49 AFTR 178*
- ***Income of a competent Indian from a tribal mineral trust****. Shelton, Jacqueline Est, (1977) 68 TC 15*
- ***Income of any kind derived from the allotted land after the Indian has been declared competent*** and has received a fee simple deed to the property from the government. Thus, a gain realized on the sale of the land after the deed has been received is taxable. *Rev Rul 58-341 , 1958-2 CB 400*
- ***Income from the operation of a motel, restaurant and gift shop, and from the rental of buildings***, although all their facilities were situated on tax-exempt reservation land. *Shelton, Jacqueline Est, (1977) 68 TC 15*
- ***Income from the sale of artifacts to tourists*** - although the sales took place on tribal trust lands. *Chief Counsel Advice 200111044*
- ***Per capita payments under the Indian Gaming Regulatory Act*** - see more below.
- ***Rental income from an apartment complex situated on exempt land*** - The income wasn't generated by the direct exploitation or use of the land itself as would be the case with farming, ranching, or timber value. Beck, George v. Com., (1995, CA4) 76 AFTR 2d 95-6139
- ***Income from a trust allotment rented from another Indian***. *Rev Rul 57-523, 1957-2 CB 51*
- ***Income of a noncompetent Indian, where the income was allocable to cattle grazing on other's trust land***. *U.S. v. Anderson, George, (1980, CA9) 46 AFTR 2d 80-5703*
- ***Dividends attributable to a noncompetent Indian's mineral lease*** of tribal or allotted land. *Wynecoop, Thomas, (1981) 76 TC 101*
- ***Income from land other than that held in trust*** for the Indian by the government*. TR FR-051, 4/9/57.*
- ***Income from operating a smokeshop*** - The income wasn't "directly derived" from the exploitation of trust land. *Cross, Silas, (1984) 83 TC 561*
- ***Income from operation of a smokeshop*** - *Dillon, Harry Sr. v. U.S., (1986, CA9) 58 AFTR 2d 86-5226 , 792 F2d 849 , 86-2 USTC ¶9492*
- ***Income from logging operations on unallotted tribal lands*** - *Kieffer, Joe T., (1998) TC Memo 1998-202*
- ***Income from shops, restaurants, a motel and a gas station -*** *Saunooke, Charles E. v. U.S., (1986, Cl Ct) 57 AFTR 2d 86-814*
- ***Income from the training and sale of horses on allotted land***, where taxpayer bought the horses and their feed off the reservation, and added to their value primarily through her labor and skill in training and showing them. *Arviso, Gloria, (1992) TC Memo 1992-685*
- ***Income from sale of gravel mined from tribal land -*** was not exempt to the taxpayers under the General Allotment Act, the Canandaigua Treaty, and the Treaty of 1842 because these documents do not apply to individual tribal members. *Alice Perkins and Fredrick Perkins v. Commissioner., U.S. Tax Court, Dkt. No. 28215-14, 150 TC —, No. 6, March 1, 2018*

INDIAN GAMING REGULATORY ACT

Under the terms of the Indian Gaming Regulatory Act, 25 United States Code Sections 2701 et seq. ("IGRA"), the tribe is limited in the uses to which it may put profits derived from gaming conducted on its reservation. The only purposes for which gaming revenues may be used are:

(i) To fund tribal government operations or programs;
(ii) To provide for the general welfare of the Indian tribe and its members;
(iii) To promote tribal economic development;
(iv) To donate to charitable organizations; or
(v) To help fund operations of local government agencies.

However, the IGRA permits per capita payments to members of a tribe. Tribes making such distributions are required to notify members that such per capita payments are subject to Federal tax. *(25 U.S.C. section 2710(b)(3)(D))* Tribes are also required to withhold Federal tax from such payments. *(IRC section 3402(r))*

PER CAPITA PAYMENTS:

Per capita payments—equal payments not based on the recipient's financial status, health, educational background, or employment status—made to tribal members under the Indian Gaming Regulatory Act (IGRA) are includible in gross income. *25 USCS 2710(b)(3)*

This result isn't affected by the fact that tribal members receiving per capita payments designated what portion of their payments they used for “qualified expenses” (not otherwise described) and each member designated a different amount. *IRS Letter Ruling 9717007*

Similarly, where the payments are paid into an irrevocable trust established by a tribe (as settlor) for the sole benefit of a tribal member who is a minor, the payments are includible in the income of the beneficiary (who is treated as the grantor of the trust). *Letter Ruling 199906015*

But where the trust was revocable, and an amendment to the tribe's plan removed the provision that prohibited the denial of payments or benefits to the minor beneficiaries, the payments paid into the trust weren't taxed to the minors. There was nothing to guarantee that the minors would ever receive payments from the trusts. *IRS Letter Ruling 200106007*

Similarly, where the agreement and amended plan for an irrevocable trust provided that the beneficiaries' rights to all principal and income of the trust would be subject to the claims of the tribe's general creditors in the event of insolvency, the beneficiaries weren't taxed on the accumulated per capita distributions that were placed into the trust, or on the income earned on those amounts, until actual receipt of distributions from the trust. *IRS Letter Ruling 200222003* See also ***Rev. Proc. 2011-56*** which provides a safe harbor under which the beneficiaries aren't taxed on the gaming revenue and income earned by the trust until actually or constructively received.

The tribe must notify its members of their tax liability when the payments are made. However, the payments are taxable whether or not the notice is given.

Kiddie Tax - Per capita payments made to children under the Indian Gaming Regulatory Act would be taxable to the child. Since the payments are not compensation for personal services, they would be unearned income for purposes of the kiddie tax rules.

TRIBAL TRUST FUNDS – Per Capita Payments

Under 25 U.S.C. § 117b(a) and 25 U.S.C. § 1407, per capita distributions made from funds the Secretary of the Interior holds in a Trust Account for the benefit of a tribe are generally excluded from the gross income of the members of the tribe receiving the per capita distributions. For example, if proceeds from timber sales, an agricultural lease, or a grazing permit are deposited into a tribe’s Trust Account and that tribe subsequently makes a per capita distribution using funds from the Trust Account, the per capita distributions are excluded from the tribal members’ gross income.

Exceptions to the excludable rule include distributions that (1) constitute compensation, (2) business profits and (3) gaming revenues. Further, distributions to tribal members from a tribal Trust Account are gross income to the members of the tribe receiving the distributions if a tribal Trust Account is used to mischaracterize what would otherwise be taxable income as nontaxable per capita distributions. For example, distributions from a tribal Trust Account constitute gross income if, based on the facts and circumstances, the distributions are mischaracterized compensation to tribal members for their services, mischaracterized distributions of business profits, or mischaracterized gaming revenues. (Notice 2015-67)

Tribal Trust Fund Settlements - Under 25 U.S.C. §117b(a), per capita payments made from the proceeds of an agreement between the United States and an Indian tribe settling the tribe's claims that the United States mismanaged monetary assets and natural resources held in trust for the benefit of the tribe by the Secretary of the Interior are excluded from the gross income of the tribal members receiving the per capita payments. Per capita payments that exceed the amount of the Tribal Trust case settlement proceeds and that are made from an Indian tribe's private bank account in which the tribe has deposited the settlement proceeds are included in the gross income of the members of the tribe receiving the per capita payments. For example, if an Indian tribe receives proceeds under a settlement agreement, invests the proceeds in a private bank account that earns interest, and subsequently distributes the *entire* amount of the bank account as per capita payments, then a tribal member excludes from gross income their portion of the per capita payment attributable to the settlement proceeds and must include the remaining portion of the per capita payment in gross income. (Notice 2013-1) The IRS has updated the list of the Indian tribes participating in the settlement; see Notice 2019-23, which can be found on page 941 of IRB 2019-15 at: https://www.irs.gov/pub/irs-irbs/irb19-15.pdf.

States - Personal Income Tax Regulation 17071(p) provides that income derived from allotted and restricted Indian land held by the United States as Trustee under Section 5 of the General Allotment Act of 1887 is exempt from taxation. Such exempt income includes rentals, royalties, proceeds of sale of cattle raised on or of crops grown upon the land and income from the use of the land for grazing purposes. *California FTB Legal Ruling 399, 01/19/1977*

BENEFITS FROM TRIBAL PROGRAMS

To qualify under the general welfare exclusion, which exempts certain government benefit payments from being taxed, the payments must (1) be made pursuant to a governmental program, (2) be for the promotion of the general welfare (that is, based on need), and (3) not represent compensation for services. Over the years, the IRS and Native American tribal governments have disagreed as to which programs provided by tribal governments qualify for the general welfare exception.

Rev Proc 2014-35 provides safe harbors under which the IRS will conclusively presume that the individual need requirement of the general welfare exclusion is met for benefits provided under certain Indian tribal governmental programs, making these benefits nontaxable to the recipient tribal members and "qualified nonmembers" (a spouse, former spouse, legally recognized domestic partner or former domestic partner, ancestor, descendant, or dependent of a member of an Indian tribe).

To be eligible the benefits cannot be lavish or extravagant. Rev Proc 2014-35 contains an extensive list of the types of benefits provided by tribes for housing, education, elder and disabled, cultural and religious, and other programs that qualify as safe harbor programs.

IRC Sec 139E – Subsequent to publication of Rev Proc 2014-35, the Tribal General Welfare Exclusion Act of 2014 was enacted on September 26, 2014. This Act created IRC Sec 139E, which codifies the general welfare exclusion for certain benefits provided under Indian tribal government programs. IRS has advised taxpayers in Notice 2015-34 that they may continue to rely on the safe harbors provided in Rev. Proc. 2014-35, which is broader than new Sec 139E.

The Act provides that certain Indian general welfare benefits that were reported as taxable are eligible for refund or credit. Use Form 1040X to apply for a refund (a one-year waiver of the statute of limitations provided in the Act has expired so only open years may be amended to claim a refund), and send it to:

Internal Revenue Service
1973 North Rulon White Blvd
M/S 1110 Attn: GECS
Ogden, UT 84404-7843

Write "Tribal General Welfare Exclusion Act" at the top of the form to ensure the claim is properly processed.

CALIFORNIA DIFFERENCES

California - The income derived from reservation sources by Native Americans living on a reservation is not subject to the California personal income tax. For this income to be excluded on 2017 and prior returns, the Native American must be a tribal member of the reservation on which he or she resides. The exemption of income with respect to reservation Indians does not apply to income earned outside the reservation (also see special rules relating to per capita gaming distributions).

New Law & Stuff

Residency Requirement Eased - The requirement that the Native American be a tribal member of the reservation where he or she resided was liberalized by SB 855, signed by the governor June 27, 2018, effective for tax years beginning on or after January 1, 2018. This provision allows American Indian tribal members living in Indian country in California, *whether their own or another tribe's reservation*, to exclude from California gross income their earned income that is derived from sources within *any* Indian country in California. Any per capita distributions received by an individual not residing on their tribe's reservation would remain includible in gross income.

PORTFOLIO INCOME

RAPID FINDER

Overview

- **Qualified Dividends**
  - Taxed at capital gains rates
  - From domestic & some foreign corporations
  - Excludes dividends from stock not held more than 60 days during the 121-day period beginning 60 days before the ex-dividend date
- **Capital Gain Dividends (Distributions)**
  - Currently treated the same as long-term capital gains
- **Other Dividends** - Taxed at regular rates
- **Interest Income**
  - **U.S. Government Obligations - Interest**
    - Not taxable to states (Examples):
      - Series E, EE, H, HH and I Bonds
      - Treasury bills, notes and bonds
    - Taxable to the states (Examples):
      - Fannie Mae Bonds
      - Ginnie Mae Bonds
      - FHLMC securities
  - **Tax-Exempt (Federal)**– State and municipal obligations
  - **Private Activity Bonds** – Exempt for regular tax but generally not for AMT
  - **Taxable** – Taxed at ordinary income rates

Pubs Forms

Related IRS Publications and Forms

- **Pub 17** – Your Income Tax
- **Pub 550** – Investment Income
- **Form 1040 Schedule B**

CAUTION – FOREIGN ACCOUNT REPORTING REQUIREMENTS

1. Individuals with a financial interest in or signature or other authority over any foreign financial accounts, including bank, securities, or other types of financial accounts, in a foreign country, if the <u>aggregate value</u> of these financial accounts exceeds $10,000 at any time during the calendar year, must file FinCEN Form 114 on or before April 15 of the succeeding year (automatic 6-month extension if April deadline missed).
2. Code Sec. 6038D requires an individual with an interest in a "specified foreign financial asset" during the year to attach a disclosure statement to their income tax return for any year when the aggregate value of all such assets exceeds $50,000 or other amount set by IRS. Form 8938 is used to make the disclosure.
3. See details of these reporting requirements in Chapter 1.13.

The Details

TCJA

DIVIDEND INCOME

"Qualified" dividends from domestic corporations and qualified foreign corporations received by noncorporate taxpayers are treated as net capital gain taxed at 0%, 15% or 20% determined according to the taxpayer's taxable income as shown in the following table. Prior to 2018, the rate breakpoints exactly matched the breakpoints for the ordinary income tax brackets: 0% capital gains rate for taxpayers in the two lowest tax brackets, 15% for those in the 25% through 35% brackets, and 20% to the extent a taxpayer's income exceeds the threshold for the 39.6% rate. While the TCJA kept the 0%/15%/20% capital gains rates, the breakpoints no longer exactly match the ordinary tax bracket breakpoints. The capital gains rates apply for both regular income tax and alternative minimum tax.

CAPITAL GAINS & QUALIFIED DIVIDENDS TAX RATES - 2019

Capital Gains Rate	Taxable Income 2019			
	Single	Head of Household	Married Joint*	Married Separate
0%	0 – 39,375	0 – 52,750	0 – 78,750	0 – 39,375
15%	39,376 – 434,550	52,751 – 461,700	78,751 – 488,850	39,376 – 244,425
20%	434,551 & up	461,701 & up	488,851 & up	244,426 & up

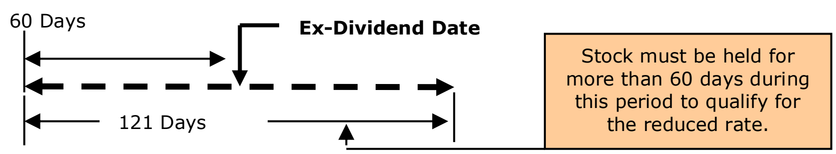
CAPITAL GAINS & QUALIFIED DIVIDENDS TAX RATES - 2018

Capital Gains Rate	Taxable Income 2018			
	Single	Head of Household	Married Joint*	Married Separate
0%	0 - 38,600	0 – 51,700	0 – 77,800	0 – 38,600
15%	38,601 – 425,800	51,701 – 452,400	77,801 – 479,000	38,601 – 239,500
20%	425,801 & up	452,400 & up	479,001 & up	239,501 & up

*also includes Qualifying Widow(er)

Qualified dividend income does NOT include:

- Dividends on stock ***not held for more than 60 days during the 121-day period*** beginning 60 days before the ex-dividend date (longer for preferred stock – see below). *Code Sec. 1(h)(11)(B)(iii)(I)*



  If a taxpayer receives dividends with respect to preferred stock which are attributable to a period or periods aggregating more than 366 days, the holding period is 90 days during the 181-day period beginning 90 days before the ex-dividend date.
- Dividends on any share of stock to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make ***related payments*** with respect to positions in substantially similar or related property *Code Sec. 1(h)(11)(B)(iii)(II)); see Payment in Lieu of Dividends below.*
- Any amount ***taken into account as investment income*** under Code Sec. 163(d)(4)(B) (which treats qualified dividend income as investment income only where taxpayer so elects) allowing the dividend to support a deduction for investment interest. *Code Sec. 1(h)(11)(D)(i))*
- Dividends from ***corporations that are exempt from tax*** under Code Sec. 501 (charitable, religious, scientific, etc., organizations) or Code Sec. 521 (farmers' cooperatives).
- Amounts allowed as a deduction under Code Sec. 591 (***dividends paid by mutual savings banks***).
- Dividends paid on employer securities held by an employee stock ownership plan (***ESOP***). *Code Sec. 1(h)(11)(B)(ii))*

What Is a Dividend? A dividend is defined in Code §316 as a distribution by a corporation to its shareholders out of its current or accumulated earnings and profits. The distribution, therefore, must be:

- Made by a corporation, not some other kind of entity,
- Must be received by shareholders, in their capacity as shareholders, not by lenders, employees or customers, and
- The corporation must have earnings and profits.

Types of Dividends and Do They Qualify? The following is a discussion of the various types of dividends and whether or not they qualify for the lower rates. Those noted as qualifying will qualify only if the holding period stated above is met.

- **Common Stock –** Common stock dividends will generally qualify for the lower rate.
- **Preferred Stock –** Generally, dividends paid on preferred stock should be eligible for the reduced dividend rate. However, some preferred stock is not preferred stock; it is debt masquerading as preferred stock. It has been developed and marketed to corporations to enable corporations to deduct the distributions as interest expense on the corporate tax return. If the corporation is entitled to an interest expense deduction, it is not preferred stock, and the distributions, with respect to that instrument, are not dividends.
- **Return of Capital** - A distribution to shareholders by a corporation without earnings and profits is a return of capital, not a dividend. Return of capital is not taxable, but reduces the basis of the investor's stock. Once basis is entirely recovered, the distribution gets capital gain treatment (long- or short-term depending on how long the stock is held).
- **Mutual Funds –** Mutual fund companies pass through earnings to fund holders in the form of ordinary dividends or capital gains. Short-term capital gain distributions from mutual funds are treated as ordinary dividends. Mutual fund ordinary dividends are classified into qualifying and nonqualifying dividends on Form 1099-DIV.
- **Money Market and Bond Funds -** Interest on money market and bond funds is taxable as dividend income but may not be qualifying dividends because the mutual fund may not hold the underlying financial instruments for the required time period. The 1099-DIV issued by the fund should identify the portion of the total dividends paid that can be treated as qualified dividends.
- **S Corporations -** S corporations are corporations that make distributions to shareholders, but those distributions will, in general, not qualify as dividends for the reduced tax rates. S corporations typically do not have earnings and profits because they are allocated to the shareholders each year for pass through taxation. It is possible for an S corporation to have accumulated earnings and profits from a prior life as a C corporation, and therefore it is possible for an S corporation to pay dividends with respect to those earnings and profits, but that would be the exception rather than the rule.
- **Real Estate Investment Trusts (REITs) -** REITs are corporations that make distributions to shareholders. However, they are required to distribute to their shareholders most of the REIT earnings for the year. If some portion of REIT earnings is retained in the REIT, it is taxed at the REIT level, and distributions with respect to those earnings would qualify for the reduced dividend tax rates. Also, if a REIT happened to be a shareholder in a corporation and passed dividends it received from the corporation through to its shareholders, that distribution would also qualify for favorable dividend treatment. These would be exceptions to the general rule; however, most REIT distributions would not qualify for the favorable dividend tax rates.

TCJA

Under TCJA, REIT dividends qualify for the Sec 199A deduction (the 20% deduction for pass-through income). See chapter 3.24 for details.

- **Payment in Lieu of Dividends -** Brokerage houses typically support the short sale industry by borrowing stock held by customers in brokerage accounts and using the borrowed stock to provide the stock needed by short sellers. If a dividend is paid while the stock is not part of the customer's account, it has customarily resulted in a payment in lieu of dividend to make sure that the customer received the equivalent of the dividend that would have been received had the stock actually remained in the account. Since these payments are not being made by a corporation with respect to its shareholders, these payments in lieu of dividends would not qualify for the favorable tax treatment accorded dividends. In fact, these payments are reported by the broker on Form 1099-MISC (box 8) and not on Form 1099-DIV. They are to be included on the miscellaneous income line of the customer's Form 1040 (2019 draft Schedule 1, line 8) and not on Schedule B.
- **Credit Union Dividends –** Dividends from credit unions are not paid from earnings and profits and therefore do not qualify for the lower rates. These payments are reported as interest income on the tax return.
- **Foreign Corporations -** The House and Senate had different views as to whether the favorable dividend rates should apply to dividends received from foreign corporations as well as domestic corporations. The result, as with most compromises, is complexity—some foreign corporate dividends meet the definition of qualified dividend income, while others do not. In general, for dividends from a foreign corporation to qualify for favorable treatment, the foreign corporation must be (1) incorporated in a U.S. possession, (2) traded on a U.S. exchange or (3) incorporated in a country covered by a comprehensive tax treaty with the United States (see Table 8-1 in IRS Pub 17 for a list of these foreign countries).

Dividends & Investment Income – Dividends qualifying for the reduced tax rates are not considered investment income for purposes of the investment interest deduction calculation unless the taxpayer elects to have them taxed at ordinary rates in the same manner as the election to treat capital gains as investment income. Dividends are treated as investment income for the 3.8% surtax on net investment income.

Exempt-Interest Dividends - Exempt-interest dividends received from a regulated investment company (mutual fund) are not included in taxable income. However, these payments must be reported on the return for information purposes and may affect the taxability of Social Security benefits. Payers include exempt-interest dividends on Form 1099-DIV, box 11. Exempt-interest dividends paid by the fund on private activity bonds will be shown in box 12 of the 1099-DIV. These dividends are generally subject to AMT in the same way as directly-paid private activity bond interest as explained in the "Interest Income" section below.

Dividends & AMT – Qualified dividends are taxed at the capital gains rate for both regular income tax and alternative minimum tax.

Retirement Accounts – There is no tax benefit associated with dividends qualifying for the lower rates that are earned within a qualified retirement account. Just as capital gains earned in retirement accounts do not qualify for favorable capital gain treatment when eventually distributed, dividends earned in those retirement accounts will not qualify for the favorable dividend rates when eventually distributed. Payers of dividends do not issue 1099-DIV forms for dividends paid to IRA or other retirement accounts.

INTEREST INCOME

- **Private Activity Bond Interest** - Tax-exempt interest on certain private activity bonds is a tax preference item. Private activity bonds include those which finance mass-transit facilities, sewage and solid waste disposal facilities and certain multi-family dwellings. Tax-exempt interest, and the portion of it that is private activity interest, is required to be included on Form 1099-INT, boxes 8 and 9, respectively. The tax preference amount is the private activity interest income reduced by the related expenses not allowed for regular tax purposes because the income is nontaxable.
- The Housing Assistance Act of 2008 exempts from the AMT three special classes of bonds issued after July 30, 2008:
  (1) Certain exempt facility bonds used at least 95% for qualifying residential rental projects;
  (2) Qualifying mortgage bonds; and
  (3) Qualifying veterans' mortgage bonds.

  Tax-exempt interest on specified private activity bonds issued in 2009 or 2010 is not an item of tax preference and therefore is not subject to the AMT. This provision also applies to a private activity bond issued in 2009 or 2010 to currently refund a private activity bond issued in 2004 through 2008. For bonds that refund bonds issued in 2009 or later years, the refunding bond is treated as being issued on the date of the issuance of the refunded bond or, in the case of a series of refundings, the original bond. *(IRC Sec. 57(a)(5(C)(vi), as added by ARRA of 2009)*
- **Interest on VA Dividends -** Interest on insurance dividends left on deposit with the Department of Veterans Affairs (VA) is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance and on National Service Life Insurance policies.
- **Dividends that are Actually Interest -** Certain distributions commonly called dividends are actually interest and should be reported as such. These include payments from:
  - Cooperative banks,
  - Credit unions,
  - Domestic building and loan associations,
  - Domestic savings and loan associations,
  - Federal savings and loan associations, and
  - Mutual savings banks.
- **Interest on Insurance Dividends -** Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable in the year it is credited to the account. However, if withdrawal can only be made on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.
- **Bonds Traded Flat -** If a bond is purchased when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if paid later. When payment of that interest is received, it is a return of capital that reduces the remaining cost basis. Interest that accrues after the date of purchase is taxable interest income for the year it is received or accrued.
- **Bond Premium –** Generally, bond premium occurs when the stated interest rate on the bond is higher than the market yield for the bond when it is purchased. The bond premium amount is the excess of the holder's basis in the bond immediately after its acquisition over the sum of all amounts payable on the bond after its purchase (other than payments of qualified stated interest) – in other words, face value of the bond. Special rules (not covered here) apply for convertible bonds, variable rate debt instruments and bonds subject to contingencies. The tax treatment of the premium depends on whether the bond pays tax-exempt or taxable interest.
  - **Tax Exempt Bonds –** Any premium on tax-exempt bonds cannot be deducted but must be amortized, and the basis of the bond must be reduced by the nondeductible amount. *(IRC Sec 171(a)(2); IRC Sec. 1016(a)(5))* As a result, even though no deduction is allowed of the amortized premium, no loss is available when a tax-exempt bond is acquired at a premium and held to maturity.
  - **Taxable Bonds –** At the bondholder's election, a premium may be amortized, and a deduction is allowed for the year's amortized amount. *(IRC Sec. 171(a)(1); Sec. 171(b)(3))* The bond premium is

computed under a constant-yield method based on yield to maturity. *(Sec. 171(b)(3)(A))* The deduction is an offset on Schedule B to the stated interest allocable to the same period. When the amortization election has been made, the basis of the bond is reduced by the offset amount. The amortization deduction amount in any one year cannot exceed the income reported from the bond during the year. However, excess premium amortization can be carried forward to the next accrual period to offset that period's interest income. *(Reg §1.171-2(a)(4))*

Making the election - The amortization election is made by (1) offsetting the interest income with the bond premium on a timely filed return for the first tax year to which the bond holder wishes the election to apply, and (2) attaching an election statement to the return. Unless revoked with IRS consent, the election, once made, is binding for the year made and all future years for all taxable bonds held by the taxpayer at the beginning of the election year and to all taxable bonds subsequently acquired by the taxpayer.

Example - Amortizing The Premium –During the year Jack purchased a bond maturing in 5 years for which he paid a $6,000 premium. The 1099-INT he received for the year reported $10,000 of taxable interest from the bond and in box 11 showed $600, which is the premium amortization allocable to the year's interest payments. He has not advised the payer that he doesn't want to amortize the bond premium. The $600 was figured by dividing the premium amount by the number of months to maturity and multiplying the result by 6 months, the period he owned the bond during the year ($6,000/60 x 6 = $600). See the 1099-INT instructions for Box 11.

Reporting the Amortization - Report the bond's interest on Schedule B (Form 1040), line 1. Under your last entry on line 1, put a subtotal of all interest listed on line 1. Below this subtotal, enter the amortizable bond premium allocable to the interest payments for the year and label this amount "ABP Adjustment". Subtract this amount from the subtotal, and enter the result on line 2. (Pub 550 (2018) Page 33)

No election - If the election is not made, the premium is recovered when the bond is redeemed or sold. Because the election provides a current offset to interest income, generally making the election is preferable to having a future capital loss deduction. But each taxpayer's situation needs to be analyzed before making an election.

CAUTION

Most debt instruments are considered covered securities either as of Jan. 1, 2014 or Jan. 1, 2016, so brokers are required to report on Form 1099-B (or substitute statement) not only the gross proceeds from sales or maturities of these bonds, but also the adjusted basis of the debt instrument (and whether any gain or loss is short-term, long-term, or ordinary). However, in certain circumstances, an adjusted basis different from the one reported by the broker will need to be used to arrive at the correct amount of gain or loss. This will be the case, for example, with market discount or premium amortization for taxable bonds if the taxpayer's and broker's treatments aren't the same. The regulations specify which elections the brokers are to assume for basis reporting purposes, but these elections can be overridden by the taxpayer if the broker is timely notified. Taxpayers need to inform their broker in writing (an email is acceptable) by no later than December 31 of the year for which they want the broker to begin to apply or cease to apply the applicable election. See also IRS FAQs at: http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Cost-Basis-Reporting-FAQs

- **Bonds Traded Between Interest Dates**
  - **Bond Sold -** If a bond is sold between interest payment dates, part of the sales price represents interest accrued to the date of sale. The part of the sales price that represents interest must be reported as interest income for the year of sale.
  - **Bond Purchased** - If a bond is purchased between interest payment dates, part of the purchase price represents interest accrued before the date of purchase; this interest belongs to the seller of the bond. At the next interest payment date after the purchase, the buyer will receive interest from the bond issuer that includes both the accrued interest at purchase and post-purchase interest. Only the interest in excess of the amount paid to the seller for the accrued interest is taxable. The buyer purchased the interest that had accrued up to the purchase date, so the interest payment equal to that amount is a return of capital. There is no effect on the cost basis of the bond since the purchase of the interest was not included in the basis of the bond. On Schedule B, report the full amount of interest received for the year (so as to match the 1099-INT), subtotal all interest income, enter the accrued interest paid as a negative amount on the next line, and then enter the net total of line 1 on line 2. If the first interest payment after purchasing the bond does not occur until the following tax year, deduct the accrued interest paid on the following year's return, not on the return for the year the bond was purchased.

Example *– On May 25, in the secondary market, Chuck purchased a bond with a face value of $10,000 for $9,810. The coupon rate on the bond is 5%, which is payable semi-annually on April 15 and October 15. At the time of the purchase, interest of $58.91 had accrued, which Chuck paid the seller, thus making his total cost for the purchase $9,868.91. On October 15 he receives an interest payment of $250, which he offsets with the $58.91 of accrued interest he purchased, leaving $191.09 as taxable interest and a zero basis in the purchased interest (original basis $58.91 – return of principal 58.91 = 0). His basis in the bond is $9,810.*

- **Original Issue Discount (OID) -** A debt instrument generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. OID is the difference between the stated redemption price at maturity and the issue price. All instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments.

Original issue discount (OID) is a form of interest and is generally included in income as it accrues over the term of the debt instrument, whether or not the taxpayer receives any payments from the issuer. The discount or OID is treated as zero ("de minimis" OID) if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity.

- **State or Local Government Obligations -** Generally, interest on obligations used to finance government operations is not taxable if the obligations are issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions. This includes interest on certain obligations issued after 1982 by an Indian tribal government treated as a state. Interest on arbitrage bonds issued by state or local governments and interest on private activity bonds generally is taxable.

CAUTION:

If a taxpayer is required to file a tax return, they are required to show any tax-exempt interest and exempt-interest dividends received during the year (line 2a of draft 2019 Form 1040).

Bond and Acquisition Premium Broker Reporting Final Regs Issued – These regulations relate to information reporting by brokers for bond premium and acquisition premium, as well as final and temporary regulations relating to brokers' information reporting for transactions involving debt instruments and options. The regulations address the reporting of original issue discount (OID) on tax-exempt obligations, the treatment of certain holder elections for reporting a taxpayer's adjusted basis in a debt instrument, and transfer reporting for Code Sec. 1256 options and debt instruments. These regulations adopt, with certain clarifications and one change, the 2013 proposed interest reporting regulations (NPRM REG-154563-12, I.R.B. 2013-20, 1097). The text of the temporary regulations also serves as the text of the proposed regulations (NPRM REG-143040-14). The regulations are effective on March 13, 2015.

U.S. GOVERNMENT OBLIGATIONS

Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States is taxable for Federal income tax purposes.

- **Treasury Bills** generally have a 4-week, 13-week, or 26-week maturity period, although shorter and longer periods (a few days to up to 52 weeks) are possible. They are issued at a discount in the amount of $1,000 and multiples of $1,000. The difference between the discounted price paid for the bills and the face value received at maturity is interest income. Generally, this interest income is taxable when the bill is paid at maturity.
- **Treasury Notes** are currently issued with maturity periods of 2, 3, 5, 7 or 10 years. Generally, interest (fixed-rate) is paid every 6 months and taxable in the year paid.
- **Treasury Bonds** are currently sold only with 30-year terms, although they used to be sold with shorter maturity periods. Treasury bonds pay interest every 6 months. The interest income is reported in the year paid.
- **Series HH Bonds** were issued at face value. Interest is paid twice a year by direct deposit to the bond owner's bank account. Cash method taxpayers must report interest on these bonds as income in the year it is received. Series HH bonds mature in 20 years. They were available prior to Sept. 1, 2004 in exchange for Series EE/E bonds or upon reinvestment of matured H bonds; they are no longer issued.
- **Series H Bonds** were issued before 1980 and had the same tax treatment as series HH bonds. The income was reported as received. Series H bonds had a maturity period of 30 years. The last Series H bond matured in 2009.
- **Series EE and Series I Bonds** have interest payable when the bonds are redeemed. The difference between the purchase price and the redemption value is taxable interest.

1. ***Series I Bonds*** - These are inflation-indexed bonds, first offered in 1998, issued at their face amount with a maturity period of 30 years. The face value plus accrued interest is payable at maturity. If they are redeemed within the first 5 years, the bond owner forfeits the most recent 3-months' interest.
2. ***Series EE Bonds*** – First offered in July 1980, Series EE Bonds issued before May 1997 earn various rates for semi-annual earnings periods beginning between May 1 and October 1, 2005, depending on

dates of issue. Series EE bonds issued from May 1997 through April 2005 earn market-based interest rates set at 90% of the average 5-year Treasury securities yields for the preceding six months. A fixed rate of 3.50% applies for Series EE savings bonds issued from May 1 through October 31, 2005. Fixed rates for future issues are set each May 1 and November 1. Interest accrues monthly and compounds semi-annually. Bonds held less than five years are subject to a three-month interest penalty. EE bonds have an original maturity of 20 years, and an interest-bearing life of 30 years. If purchased electronically from the U.S. Treasury, the bonds are sold at face value; if purchased before 2012 in paper form from a bank, they were sold at 50% of face value but are not worth face value until redeemed.

3. ***Series E Bonds –*** Issued at discount with face value payable at maturity, these bonds originally had a 10-year maturity period. The maturity period was extended as follows:

Issued	Maturity
By Nov 1965	40 Years
After Nov 1965 thru July 1980	30 Years

Reporting Series E, EE and I Interest - If the cash method of reporting income is used, the taxpayer can report the interest on series EE, series E, and series I bonds in either of the following ways:

Method 1 Postpone reporting the interest until the earlier of:

- The year the bonds are redeemed, or
- The year they mature.

Method 2 Choose to report the increase in redemption value as interest each year. The same method must be used for all series EE, series E and series I bonds owned.

Change of Method

- ***Change from Method 1 -*** The method of reporting interest can be changed from Method 1 to Method 2 without permission from the IRS. In the year of change, the taxpayer must report all interest accrued to date and not previously reported for all bonds.
- ***Change from Method 2*** - Permission to switch from Method 2 to Method 1 is required, but is automatic if the taxpayer submits the required information (see Pub 17). As part of that agreement, the taxpayer must agree to:

  a) Report all interest on any bonds acquired during or after the year of change, when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, and

  b) Report all interest on the bonds acquired before the year of change, when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of the interest reported in prior tax years.

Choice to Report Interest in Year of Trade – A taxpayer could have chosen to treat all of the previously unreported accrued interest on the series EE or series E bonds traded for series HH bonds as income in the year of the trade.

SAVINGS BONDS – ELECTRONIC PURCHASES ONLY

Effective 1/1/12, U.S. savings bonds are no longer sold in paper form at financial institutions. U.S. savings bonds and other Treasury securities are available for purchase at www.treasurydirect.gov. Paper bonds continue to be redeemable at some, but no longer all, financial institutions.

SURTAX ON NET INVESTMENT INCOME

Beginning in 2013 a surtax referred to as the Net Investment Income Tax (NIIT) is imposed on individuals, estates, and trusts. For individuals, the surtax is 3.8% of the lesser of: (1) The taxpayer's **net** investment income or (2) The excess of modified adjusted gross income over the threshold amount ($250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all others). These amounts are **not** adjusted for inflation. See Chapter 12.05 for additional details.

CALIFORNIA DIFFERENCES

Ordinary Dividends – California does not provide reduced tax rates for dividends. Generally, there is no difference between the amount of dividends reported for Federal purposes and the amount reported using California law.

Exempt-Interest Dividends - California taxes interest derived from obligations of other states and their municipalities, but interest from U.S. obligations and California obligations is not taxed by California. When a mutual fund holds state and municipal bonds, the interest income from these obligations that the fund passes through to the shareholders is considered dividend income that is termed an "exempt-interest dividend" and is not taxable for federal purposes. If the mutual fund has at least 50% of its assets invested in tax-exempt U.S. obligations and/or in California obligations or those of its municipalities, that portion of the dividend derived from tax-exempt U.S. obligations and/or California or its municipalities' obligations is exempt from California income. If the exempt percentage is less than 50%, the entire amount is taxable. (R&TC Sec 17145)

Muni-Interest Taxability; 50% Rule

A lawsuit was filed in July 2016 in the Los Angeles Superior Court challenging the California law discussed above that U.S. obligations and California muni-interest is taxable to California where the interest is passed through from mutual funds and the mutual fund is invested less than 50% in the tax-exempt bonds. *(Ronald & Pamela Mass v. FTB (July 2016) Case #BC627648, Los Angeles Superior Court)* The tax amount in dispute on the taxpayer's 2010 return is $7,384. After hearing the case in September 2017, on October 30, 2017, the court issued judgment in favor of FTB, holding that the Legislature's enactment of Revenue and Taxation Code section 17145 was appropriate and does not violate Article XIII section 26(b) of the California Constitution.

The taxpayers appealed, but in August 2019 the Court of Appeal's ruling confirmed the lower court's decision that R&TC section 17145 does not directly tax the municipal bond interest income, and therefore does not conflict with Article XIII of the state Constitution that prohibits taxing interest from California municipal bonds, based on the premise that the distributions from the mutual funds do not retain their status as tax-exempt interest.

Interest from U.S. Obligations

- **Direct Obligations** - Interest from the following obligations is not taxable to CA:
  - U.S. Savings Bonds;
  - U.S. Treasury bills, notes, and bonds; or
  - Any other bonds or obligations of the United States and its territories. Territories include Puerto Rico (U.S. Code Title 48, Chapter 4, Sec 745). By federal law interest on Tennessee Valley Authority (TVA) Power Bonds is exempt from taxation by any state (16 U.S.C. Sec 831n-4(d)).
- **Indirect Obligations –** The following are indirect obligations that are fully taxable to CA:
  - Federal National Mortgage Association (Fannie Mae) Bonds;
  - Government National Mortgage Association (Ginnie Mae) Bonds; and
  - Federal Home Loan Mortgage Corporations (FHLMC) securities.

Tax-Exempt Interest – Generally, California only treats as tax-exempt interest from California state bonds or municipal bonds issued by a county, city, town, or other local government unit within California. Therefore, interest from the following obligations that are tax-exempt for Federal purposes are fully taxable in California:
- Non-California state bonds;
- Non-California municipal bonds issued by a county, city, town, or other local government unit;
- Obligations of the District of Columbia issued after December 27, 1973; and
- Non-California bonds, if the interest was passed through from S corporations, trusts, partnerships, or Limited Liability Company (LLCs).

Interest from Loans Made in an Enterprise Zone (EZ) – Through 2013 California law allowed a deduction from income for the amount of net interest received from loans made to a trade or business located within an enterprise zone. Federal law has no comparable deduction. This provision expired January 1, 2014.

NOTES

LIFE INSURANCE AND TAXES

Life Settlements

- Policy Holder
  - Surrender Policy – Gain in Excess of basis is ordinary Income
  - Sale of Policy with Cash Value - "Inside buildup" = ordinary income
    Balance is capital gain
  - Sale of Policy without cash value – gain is capital gain
- Policy Purchaser
  - Death Proceeds – gain is ordinary income
  - Contract Resold – gain is capital gain

Viatical Settlements

- Terminally Ill – All benefits excludable
- Chronically Ill – Benefits excludable to extent used for qualified long-term care

Death Benefits – Generally income excludable

RAPID FINDER

The TCJA of 2017 added new IRC Section 6050Y, information return reporting rules for "reportable policy sales" of life insurance contracts and "reportable death benefits" paid after December 31, 2017. Implementation is delayed until proposed regulations are issued. See page 02.14.04 for more information.

LIFE SETTLEMENTS

In times past, an individual who no longer needed a life insurance policy had few options. In general, he could surrender the policy to the issuing insurance company for its cash surrender value or he could stop paying the premiums and let the policy lapse. For a term insurance or other policy without cash surrender value, the only choice was to let the policy lapse. Now, for some individuals, there is a secondary insurance market in which they may be able to sell a policy for more than its cash surrender value or even sell a policy without cash surrender value, such as a term policy. These transactions are called life settlements.

CAUTION

When counseling your clients, be aware there is little transparency with respect to this market, as well as a significant amount of confusion and variation among state and federal authorities as to the appropriate regulatory approach to the transactions involved. On the seller side of the transaction, there is potential for seniors to have unexpected tax liability, loss of insurability, undisclosed commissions or even bid-rigging by brokers, and possible legal liability to their insurance companies in certain circumstances.

Reasons for considering a life settlement - include:

- Funds are needed to pay medical or long-term care expenses;
- The insured can no longer afford the premiums;
- The primary beneficiary has died and the policy is no longer needed;
- The insured got divorced;
- Business circumstances have changed and the coverage is no longer needed to fund a buy-sell agreement; and
- Expected death tax costs have been reduced or eliminated and the coverage is no longer needed to pay death taxes.

Factors bearing on the settlement amount - The settlement amount will depend on the unique circumstances of the specific case. Some reports say that the average payout is 24% of the face amount of the policy but they can vary widely. Factors bearing on the amount that may be realized include the insured's age, gender, health, life expectancy, type of policy, its face amount, and any cash value. Obviously, individuals with a shorter life expectancy can expect to realize more than those with a higher life expectancy in otherwise equivalent situations. There may be fees and commissions and state law may impose a cap on the amount that may be realized.

Disposition of a Contract by the Policy Holder - Rev Ruling 2009-13 explains the tax treatment of policyholder surrenders and sales of life insurance contracts with and without cash value. The ruling initially explains the tax treatment of a surrender and then modifies the facts slightly to explain a sale.

Surrender of policy – The Rev Ruling provides the following example: In Year-1, John enters into a "life insurance contract" with cash value. John is the insured and a member of John's family was the beneficiary. John had the right to change beneficiaries or surrender the contract for its cash value. In Year-8 John surrenders the contract for its cash value of $78,000 which reflects the subtraction of $10,000 for the "cost of insurance." John paid total premiums on the policy of $64,000. John was not terminally or chronically ill at the time of the surrender. John's resulting gain from the sale would be:

Surrender Cash Value:	$78,000 (this figure is net of insurance costs)
Paid Premiums:	<64,000>
Ordinary Income:	$14,000

Since the surrender of a life insurance contract does not produce capital gain, the income was ordinary income.

Sale of policy with cash value - The facts are the same, except that John sells the insurance contract for $80,000 to George who is unrelated to John and who would suffer no economic loss upon John's death. Here, John's resulting gain from the sale would be determined as follows:

Contract Sales Price:		$80,000
Paid Premiums:	64,000	
Cost of Insurance	<10,000>	
Contract Basis		<54,000>
Total Profit:		$26,000
Ordinary Income		$14,000 (Difference between cash value & paid premiums)
Capital Gains		$12,000 (Balance of gain)

To determine the character of the income, the IRS applied the "substitute for ordinary income" doctrine. Application of the substitute for ordinary income doctrine is limited to the amount that would be recognized as ordinary income on surrender of the policy, and income received on sale of a life insurance policy may qualify as gain from the sale of a capital asset to the extent that it exceeds the cash surrender value minus the premiums paid (that is, the "inside build-up" under the contract). Thus, of the income received, the amount equaling the inside buildup on the contract was taxed as ordinary income. The excess was taxed as long-term capital gain.

Sale of policy without cash value - The facts are the same, except: the contract is a level premium term life insurance contract without cash surrender value; monthly premiums were $500 per month and through the date of sale John had paid premiums of $45,000; John sold the contract on June 15th (89.5 months into the contract) to Dave (unrelated and who will suffer no economic hardship upon John's death) for $20,000.

John's adjusted basis in the contract is equal to the total premiums paid, less charges for the provision of insurance before the sale. Thus, there generally would be no tax basis in a term policy except in this example provided by the IRS, John technically had insurance coverage for 89.5 months, and so he received the benefits from $44,750 ($500 x 89.5) of premium coverage but paid $45,000 in premiums, thereby creating a basis of $250.

Contract Sales Price:	$20,000
Contract Basis	< 250>
Capital Gain:	$19,750

In this case since the term life insurance contract had no cash surrender value, no inside build-up to which the substitute for ordinary income doctrine could apply. Thus, the entire gain is a long-term capital gain.

Disposition of a Contract by the Purchaser - Rev Ruling 2009-14 explains the tax treatment of the death benefits paid to a purchaser of a life settlement insurance contract or the resale of a contract.

Death Benefits – Dave purchased a term insurance contract from the policy holder John for $20,000. Dave continued to make the $500 per month premium payments on the contract. Dave had no insurable interest in John's life and, except for the purchase of the contract, Dave had no relationship to John and would suffer no economic loss upon John's death and purchased the contract with a view to profit.

Dave continued to make the $500 monthly payments (totaling $9,000) on the contract up to the time of John's death and received $100,000 in death benefits.

Death Benefits:		$100,000
Contract Purchase Price:	$20,000	
Additional Premiums Paid:	9,000	
Contract Basis		<29,000>
Total Profit (ordinary income):		$71,000

Neither the surrender of a life insurance or annuity contract nor the receipt of a death benefit from the issuer under the terms of the contract produces a capital gain. Accordingly, the $71,000 income recognized by Dave upon the receipt of death benefits under the contract is ordinary income.

Resells the Contract – The facts are the same as the receipt of death benefits (above), except that John did not die and Dave sold the contract to Alan (a person unrelated to John or Dave) for $30,000.

Contract Sales Price:		$30,000
Contract Purchase Price:	$20,000	
Additional Premiums Paid:	9,000	
Contract Basis		<29,000>
Total Profit (capital gain):		$1,000

Since the contract represented a capital asset in Dave's hands, the character of income recognized is a capital gain.

VIATICAL SETTLEMENTS

Any amounts received under a life insurance contract on the life of a **terminally ill** individual are excluded from gross income. Amounts received under a life insurance contract by **chronically ill** individuals are also excluded from gross income if certain requirements are satisfied. Similar exclusions apply when the amounts are received as a result of a sale or assignment of the life insurance contract to a viatical settlement provider.

Special Requirements for Chronically Ill Individuals – The nontaxable part of any amounts received under a life insurance contract on the life of an individual who is chronically ill is limited to the cost of qualified long-term care services.

Definitions:

Terminally Ill Individual - the term "terminally ill individual" means a person who has been certified by a physician as having an illness or physical condition that reasonably can be expected to result in death within 24 months of the date of certification.

Chronically Ill Individual – a "chronically ill" individual is one who has been certified within the previous 12 months by a licensed health care practitioner as:

(A) being unable to perform, without "substantial assistance" from another individual, at least two activities of daily living for at least 90 days due to a loss of functional capacity,

(B) having a similar level of disability as determined under IRS regs prescribed in consultation with the Dept of Health and Human Services, or

(C) requiring "substantial supervision" to protect the individual from threats to health and safety due to "severe cognitive impairment," even if the individual is physically able.

DEATH SETTLEMENTS

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

Payments made under life insurance or endowment contracts before the death of the insured (e.g., loans, refunds, dividends) generally are treated as amounts "not received" under an annuity contract and are fully taxable if received *on or after* the annuity starting date. "Non-annuity" amounts received *before* the annuity starting date are:

(1) *Not taxable,* to the extent that, as of the date of distribution, they don't exceed the cost of the contract (i.e., accumulated net premiums paid) and

(2) *taxable,* to the extent allocable to income (i.e., excess of the contract's cash value over the owner's investment) at that time.

Veteran's insurance dividends are tax-free, regardless of the policy's cost.

INFORMATION REPORTING RULES

The TCJA of 2017 added new IRC Section 6050Y information reporting rules for "reportable policy sales" of life insurance contracts and "reportable death benefits" paid after December 31, 2017. The IRS issued proposed regulations, NPRM REG-103083-18, in late March 2019 that include transitional guidance delaying any reporting until final regulations are issued. A reportable policy sale is the direct or indirect acquisition of an interest in a life insurance contract, if the acquirer has no substantial family, business, or financial relationship with the insured other than the acquirer's interest in the life insurance contract. A reportable death benefit is any amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

Under new Sec 6050Y(a)(1), any person who acquires a life insurance contract or any interest in a life insurance contract in a reportable policy sale during a tax year must file a return for the tax year (at the time and in the manner as the Secretary of the Treasury shall prescribe) that includes the:

- Name, address, and TIN of the reporting person and of each recipient of payment in the reportable policy sale;
- Date of the sale;
- Name of the issuer of the life insurance contract sold and the policy number of the contract, and
- Amount of each payment (defined in Sec 6050Y(d)(1) as the amount of cash and the fair market value of any consideration transferred in any reportable policy sale).

In addition, the person required to file the return must furnish to each person named in the return a written statement showing (1) the name, address, and phone number of the information contact of the person required to make the return, and (2) the information required to be shown on the return with respect to such person (except that in the case of an issuer of a life insurance contract, the statement is not required to include the amount of each payment). (Code Sec 6050Y(a)(2))

There is also a requirement that the life insurance company, upon receipt of the statement described above or upon notice of a transfer of a life insurance contract to a foreign person, must file an information return that reports the name, address and TIN of the seller who transfers an interest in the contract, the seller's investment in the contract and the policy number of the contract. (Code Sec 6050Y(b)(1))

Every person required to file a return reporting the seller's basis must furnish to each person whose name is required to be reported in the return a written statement showing (1) the name, address, and phone number of the information contact of the person required to file the return, and (2) the information required to be shown on the return with respect to each seller whose name is required to be set forth in the return. (Code Sec 6050Y(b)(2))

The IRS has developed two new forms, 2019 version shown below, for these Sec 6050Y filing requirements: 1099-SL, Reportable Life Insurance Sale, and 1099-SB, Seller's Investment in Life Insurance Contract..

☐ CORRECTED (if checked)

ACQUIRER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	1 Amount paid to payment recipient $ 2 Date of sale	OMB No. 1545-2281 2019 Form 1099-LS	Reportable Life Insurance Sale
ACQUIRER'S TIN / PAYMENT RECIPIENT'S TIN	Issuer's name		Copy B For Payment Recipient This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.
PAYMENT RECIPIENT'S name Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code Policy number	Acquirer's information contact name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. (if different from ACQUIRER)		

Form **1099-LS** (keep for your records) www.irs.gov/Form1099LS Department of the Treasury - Internal Revenue Service

☐ CORRECTED (if checked)

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ISSUER'S TIN / SELLER'S TIN	ISSUER'S information contact name		Copy B For Seller This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.
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CALIFORNIA DIFFERENCES

California follows Federal taxation rules.

INTEREST TRACING RULES

How to treat interest expense for tax purposes is sometimes complicated. The simple answer is that it depends on the character of the interest. That is, we know personal interest is not deductible while business interest is. The character of the interest depends on the character of the loan and the character of the loan depends on what the loan proceeds were spent on. In other words the use of the loan funds must be "traced". If the loan was used for personal purposes, like funding a cruise, the character of the loan is personal and may not be deducted (Section 163(h)(1)). If the funds were used for purchase of a business car (assume 100%) or for funding working capital in a business, the interest is business and is deductible (Section 163(a) & Section 162).

In the same way, if a taxpayer borrows money secured by rental #1 and uses the loan proceeds to purchase rental #2, then the character of the interest would be related to and deductible on the Schedule E of rental #2. If loan proceeds are used to buy stocks and bonds, then the interest paid is allocable to purchase of the securities and therefore becomes investment interest.

Related IRS Publications and Other References

- Reg. Sec. 1.163-8T (the IRS has never issued final regulations)
- Big Book of Taxes Chapter 6.02 – Higher Education Interest
- Big Book of Taxes Chapter 7.05 – Home Mortgage Interest
- Big Book of Taxes Chapter 7.07 – Investment Interest

One of the more complicated, misunderstood and often overlooked tax issues is this concept of interest tracing. The income tax regulations refer to it as "allocation" of debt and interest. Though the concept is straightforward, it can get complicated. The tracing rules are generally summed up as follows:

> *In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. This section prescribes rules for tracing debt proceeds to specific expenditures. (Reg Section 1.163-8T(a)(3))*

Interest expenses generally fall into commonly understood categories, and the treatment of the interest for tax purposes depends upon which category it falls into:

1. **Personal interest** – Not deductible says Section 163(h)(1);
2. **Trade or business interest -** Generally deductible under Section 163(a) and Section 162**;**
3. **Investment interest –** Generally deductible under Section 163(a) and Section 212(1) and/or (2) but investment interest is limited, however, by Section 163(d) to net investment income;
4. **Interest related to a passive activity**, which is taken into account under Section 469 in computing income or loss from a passive activity.
5. **Qualified residence interest** within the meaning of Section 163(h)(3);
6. **Educational loans. –** Any interest paid on educational loans and allowable as a deduction under Section 221. (Note that educational loans are personal and would not be deductible because of Section 163(h)(1) were it not for Section 221.)

Home Equity Debt – Interest on home equity debt is suspended for years 2018-2025. But there is an opportunity to trace the use of the home equity debt to another deductible purpose such as investment or business. How this is accomplished was changed by TCJA. The following explains how it was handled pre-TCJA (and supposedly after 2025 when the suspension of the home equity debt interest deduction expires) and during the years 2018 through 2025 while the suspension is in place.

- Pre-TCJA - Under the pre-TCJA law the interest on the first $100,000 of equity debt secured by a taxpayer's home had to be deducted as "qualified residence interest" (home mortgage interest) regardless of how the funds were used **unless** the election to unsecure the debt under regulation Section 1.163-10T9(o)(5) was made.

> ***CAUTION:*** *If before the passage of TCJA (before 2018) a taxpayer had utilized the unsecured election, that election is irrevocable without IRS consent and thus the loan continues to be treated as unsecured, and since home acquisition mortgage debt is defined as being secured by the home, none of the interest allocated to home acquisition mortgage debt is deductible on Schedule A or anywhere else.*

- *2018 through 2025* - For 2018 through 2025, the interest tracing rules can be applied to **ALL** debt secured by the home – both home acquisition debt and equity debt – since home equity interest is suspended during that period. That means there is no need to use the unsecured election, since all the interest on a refinanced loan (secured by the home), both home acquisition and excess debt, can be traced to the use of the loan proceeds.

  Example – 2018 through 2025: A home has an existing home acquisition debt balance of $40,000 and the taxpayer refinances the home for $200,000. The $40,000 portion of the refinanced debt continues to be home acquisition debt and thus 20% ($40,000/$200,000) x 100)) of the interest on that portion of the refinanced mortgage is deductible on Schedule A. The deductibility of the balance of the interest (80%) depends (is traceable) to the use of the $160,000 proceeds from the refinance.

Special Issues:

- *Home Equity Line of Credit (HELOC)* – Just because banks refer to them as equity debt does not mean the interest on a HELOC loan is not traceable to purposes other than non-deductible personal interest. Like any other debt the use of the loan proceeds determines if the interest on the loan is deductible and where it is deducted. Thus, it is possible for the interest on a HELOC loan to be home acquisition interest, business interest, investment interest, personal interest, etc.
- *Debts Traced to the Purchase of Tax Exempt Securities* – The interest on loan proceeds used to acquire tax exempt securities is non-deductible investment interest. This rule also applies to any interest paid on a loan to produce any tax-exempt income (Sec 265).
- *Higher Education Loans* - If a student loan is not subsidized, guaranteed, financed, or is not otherwise treated as a student loan under a program of the Federal, state, or local government or an eligible educational institution, a payee (lender) must request a certification from the payor (borrower) that the loan will be used solely to pay for qualified higher education expenses (Reg.1.6050S-3(e)(2)). Form W-9S, Request for Student's or Borrower's Social Security Number and Certification, is used for this purpose. See chapter 6.02 for more on higher education loan interest.

Examples: The best way to understand the tracing rules is by example. The following are a variety of situations to help understand the application of the tracing rules.

- **Example 1:** A taxpayer takes out a loan secured by his rental property and uses the proceeds to finance a European vacation. The use of the funds was to pay for a vacation and thus the interest on the loan is non-deductible personal interest expense.
- **Example 2:** A taxpayer refinances an existing loan ($150,000 amortized balance) secured by his rental property for $200,000 and uses the excess proceeds to buy for $50,000 a car for personal use. The taxpayer must trace the use of the refinanced loan proceeds ("allocate the proceeds") to the portion used to pay off the existing amortized rental loan of $150,000 and the $50,000 portion, used to purchase the car. The loan interest expense is then proportionally allocated between rental interest ($150,000/$200,000) and personal interest ($50,000/$200,000) for the purchase of the car. So 75% ($150,000/$200,000) is related to the rental property and is deductible on Schedule E and 25% ($50,000/$200,000) is non-deductible personal interest. **Note:** it does not matter that the new loan is secured by the business property; the interest allocated to the personal use of the loan proceeds is not deductible.
- **Example 3:** The taxpayer borrows $50,000 secured by his home to be used as working capital in his consulting business. He has no other debt on his home. He deposits the $50,000 into a checking account that's devoted to his business, and he uses the money in that account only for his business.
  - *For years before 2018 and after 2025* – He must deduct the interest as home equity debt interest on his Schedule A since the debt is secured by his home and the debt is less than the $100,000 limit for equity indebtedness. However, the election to unsecure the debt from the home could have been used, in which case the interest on the debt would have been traceable to the use of the loan proceeds.
  - *For 2018 through 2025*– He must trace the use of the funds and since the loan proceeds were used in his business, the interest is an expense of the business.
- **Example 4:** The taxpayer wants to acquire an additional rental so she refinances one of her existing rentals to obtain the down payment. Here the tracing rules are used to trace the use of the funds. The interest on the refinanced loan must be allocated between the portion of the refinanced debt used to refinance the existing rental loan and the portion of the debt used to acquire the new rental. Thus, the interest is proportionally allocated between the two rentals

- **Example 5:** The taxpayer owns a rental property and wants to purchase a personal residence. So he obtains a loan on the rental to refinance the existing amortized acquisition debt of $40,000 and to purchase the personal residence for $160,000. Under the tracing rules the taxpayer must trace the use of the refinance proceeds to its uses. Since $40,000 of the new debt was used to pay off the debt related to the rental property, the character of $40,000 of the new debt takes on the same character as the old debt. The $160,000 balance of the refinance proceeds is traced to the purchase of the taxpayer's home. However, the definition of home acquisition loan debt requires the debt to be secured by the home, which it is not. Thus the interest on the $160,000 portion of the refinanced debt is not deductible.

- **Example 6:** The taxpayer wants to purchase a lot and build a rental on it. He plans to purchase the lot with cash savings and then build the house with a construction loan. Once the construction is complete he intends to refinance the construction loan with a take-out loan and use part of the debt to restore the savings account for the funds used to purchase the lot. Under the tracing rules he must trace the interest based upon the use of the refinanced loan proceeds. The portion of the loan used to refinance the construction loan can be traced to the rental, and thus is deductible as rental interest. The portion reimbursing the taxpayer for the cost of the lot must be traced to the use of those funds, and assuming the taxpayer banked those proceeds, that portion of the interest would be treated as investment interest.

- **Example 7:** The taxpayer borrows $20,000 on a margin account held by his broker. He uses the $20,000 to buy additional securities. The interest he pays on the margin account is treated as investment interest.

- **Example 8:** Taxpayer purchases a property he intends to use as a rental. The property is in such bad condition that he cannot obtain a loan. So, he purchases it with cash from his savings and fixes up the property, also using cash from his savings. When the work is complete, and the property is available for rent, he finances the rental and deposits the proceeds in his savings account. Following the tracing rules, we trace the use of funds to determine if the interest is deductible and where. In this case funds were deposited in the taxpayer's savings account and as a result the interest on the loan becomes investment interest.

  But that is not the end of the story. Since the proceeds of the loan are now in the taxpayer's savings account, if he subsequently uses some of those proceeds (takes money out of the savings account) and uses it for another purpose, we again have to trace the use of the savings withdrawal to follow the money. If used for a personal purpose the interest on that portion of the loan is not deductible. If used for a business purpose then the interest on that part of the original loan would become business interest.

  As you can imagine, this would become a tracing recordkeeping nightmare.

- **Example 9 - Special rule that only applies to first and second homes:** The taxpayer has an opportunity to purchase a home in a quick sale and does not have time to obtain financing and make the purchase with cash. Then after escrow has closed, he obtains financing for the home. Notice 88-74 states that where a taxpayer is purchasing a residence the debt may be treated as incurred to acquire the residence ("acquisition debt") to the extent of expenditures to acquire the residence made within 90 days before or after the date that the debt is incurred.

See chapter 7.05 for additional examples where debt secured by the home is used for other purposes.

CALIFORNIA DIFFERENCES

California conforms to the interest tracing rules. However, California has not conformed to the TCJA provision that home equity debt interest is not deductible as mortgage interest for 2018-2025.

NOTES

TCJA

QUALIFIED OPPORTUNITY FUNDS

Overview

The TCJA created new code Sections 1400Z-1 and 1400Z-2 related to qualified opportunity zones (QOZ), which are intended to promote investments in certain economically distressed communities through qualified opportunity funds (QOF). Tax incentives were included in the legislation to encourage investment in these funds.

Pubs Forms

Related IRC and IRS Publications and Forms

- IRC Sec 1400Z-1
- IRC Sec 1400Z-2
- Notice 2018-48 - List of QOZs
- Notice 2019-42 - List of QOZs
- Opportunity Zone Resources: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
- Form 8996 - Qualified Opportunity Fund
- Form 8949 – Sales and Other Dispositions of Capital Assets

The Details

Reinvesting Gain – Starting in 2018, a taxpayer who has a capital gain on the sale or exchange of any property to an unrelated party may elect to defer, and potentially partially exclude, the gain from gross income if the gain is reinvested in a QOF within 180 days of the sale or exchange. Only one election may be made with respect to a sale or exchange. If less than the full amount of the gain is reinvested in the QOF, the part not reinvested is taxable as usual in the sale year. Unlike Sec 1031 deferrals, the amount of the gain, not the amount of the proceeds of sale, is what needs to be reinvested in order to defer the gain.

Making the Election – According to the instructions of the 2018 Form 8949, when electing to defer the gain on an eligible asset, report the sale as usual on Form 8949, and then report the deferral of the eligible gain on its own row of Form 8949 (Part I with box C checked if short-term gain or Part II, box F, if long-term gain). If multiple investments were made in different QOFs or in the same QOF on different dates, a separate row needs to be used for each investment. If eligible gains of the same character (i.e., ST or LT) but from different transactions on the same date were invested in the same QOF, these can be grouped on the same row. In column (a), enter only the EIN of the QOF into which the investment was made and in column (b), enter the date of the investment. Leave columns (c), (d) and (e) blank, and enter code Z in column (f) and put the amount of the gain being deferred as a negative number in column (g).

There is no need to trace or allocate the funds invested in a QOF to the specific gain being deferred, but the QOF investment must have occurred within the 180-day period beginning on the date the deferred gain was realized. If both short-term and long-term gains were realized during the 180-day period the taxpayer can choose how much of each gain to defer by reporting the deferral in Part I or Part II, as applicable. The character of the eligible gain transfers to the investment in the QOF so that when the eligible gain is recognized, the gain recognized will be the same character as the gain deferred.

Deferral Period - The gain income is deferred until the earlier of the date the investment in the QOF is sold or December 31, 2026. If the taxpayer continues to hold the investment after December 31, 2026, the taxpayer still has to include the deferred gain in the 2026 tax return. If that is the case, the gain reported in 2026 adds to the basis of the QOF.

Qualified Opportunity Fund Basis - To the extent the QOF is purchased with the deferred gain, the basis in the QOF is zero. Then when the QOF is sold, the deferred gain subject to tax is the excess of the lesser of (a) or (b), below, over the QOF's basis (or enhanced basis (explained next), if applicable):

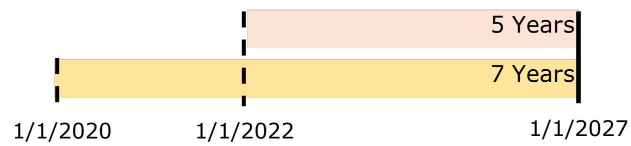
(a) The deferred gain, or

(b) The fair market value of the investment as determined at the end of the deferral period.

Enhanced Basis – If the taxpayer holds the QOF for 5 years, the basis of the QOF investment is increased by 10% of the deferred gain, and if held for 7 years, the basis is increased by an additional 5%, for a cumulative increase of 15%. In other words, if held at least 5 years, 10% of the original gain is excluded, or if held 7 years, 15% of the original gain is excluded. When the deferred gain is included in income – either as of 12/31/2026 or when sold, if before 12/31/2026 –the amount of the deferral that is taxable also increases basis. (IRC Sec.1400Z-2(b)(2)(B)(ii))

Example 1: Phil sold a rental apartment building June 30, 2018 for $3 million, which resulted in a gain of $1 million. He invests the $1 million within the statutory 180-day window into a QOF and elects the temporary gain deferral exclusion. On July 1, 2026 the QOF is sold for $1.5 million. Since Phil had held the investment over seven years, his basis is enhanced by $150,000 (15% of $1 Million). The deferral period ends on the date of sale since the investment is sold before 12/31/2026. The deferred gain that will be included in Phil's 2026 income is $850,000 ($1,000,000, which is the lesser of the deferred gain or the FMV of the QOF on the sale date, less basis of $150,000). The $850,000 reportable deferred gain then increases his basis back to $1 million, and so the difference between the sales price of $1.5 million and $1 million, or $500,000, is a long-term capital gain. Thus, the total gain that's taxable is $1.35 million.

CAUTION: Because only gains incurred before 2027 can be deferred, the clock is ticking on the extra 5% basis increase, since the gain must be incurred before 1/1/2020 (see adjacent diagram). That means gains incurred after 2019 will not qualify for the 5%. In addition, to qualify for 10% basis adjustment the gain must be incurred before 2022 meaning gains after 2021 will not qualify for the 10% basis adjustment.



10 Year Election - If the QOF is held for 10 years or longer before it is sold, the taxpayer can elect to increase the basis to the fair market value amount. The effect of this adjustment is that none of the appreciation since the QOF was purchased is taxable when it is sold. This provision applies only to the investment in the QOF that was made with deferred capital gains. (Prop. Reg. 1.1400Z-2(c)-1(a))

All qualified opportunity zones now in existence will expire on December 31, 2028. So after the relevant qualified opportunity zone loses its designation, will investors still be able to make a basis step-up election for QOF investments from 2019 and later? Yes, according to proposed regulations. Although the statute doesn't so specify, the proposed regulations would permit taxpayers to make the basis step-up election under section 1400Z-2(c) after a qualified opportunity zone designation expires for dispositions of QOFs up to December 31, 2047. (Prop. Reg. 1.1400Z-2(c)-1(b))

Example 2: Same facts as Example 1, except Phil didn't sell the QOF until 2030, having held it nearly 12 years. Since he had the investment on December 31, 2026, he was required to include $850,000 ($1 million – ($1 mil x 15%)) of deferred gain on his 2026 return, and his basis in the QOF was increased from zero to $850,000. The QOF's sale price was $1.5 million. Phil elects to permanently exclude the gain by increasing his basis to $1.5 million, the fair market value at the date of sale. Thus, there is no gain ($1.5 mil – $1.5 mil).

Mixed Investments – Investment in a QOF isn't limited to deferred capital gain from the sale of another asset; a taxpayer can purchase an interest in a QOF with other funds. Where a taxpayer's investment in a QOF consists of both deferred gain and additional investment funds, the investment is treated as two separate investments with the tax benefits of both the gain deferral election and the 10-year gain exclusion election applying only to the deferred gain portion.

Qualified Opportunity Funds (QOF) – To take advantage of the tax deferral of gains available from the TCJA-enacted opportunity zone program, taxpayers must invest in a QOF, which is any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) acquired after December 31, 2017. The fund must hold at least 90% of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held in the fund on the last day of the first 6-month period of the fund's tax year and on the last day of the fund's tax year. Taxpayers may not invest directly in QOZ property.

Partnerships – Because the basis of the QOF purchased with deferred capital gains is zero, taxpayers that invest in QOFs organized as a partnership may be limited in deducting losses that may be generated by these partnerships.

Qualified Opportunity Zones (QOZ) – These are population census tracts that are low-income communities that are specifically designated as QOZs after being nominated by the governor of the state or territory in which the community is located. After the governor notifies the Treasury Secretary in writing of the selected QOZs, the Treasury Secretary must certify the community as a QOZ. Qualified opportunity zones retain this designation for 10 years. More information about QOZs and a link to a list of designated opportunity zones is available at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

More Details to Come - The Treasury Department and the IRS will be providing further details, including additional legal guidance on this new incentive in the coming months. See also: https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

The following are selected and sometimes reworded excerpts from the IRS Q&As modified for the current year:

Question: I sold stock for a gain in 2019 and during the 180-day period beginning with the date of the sale, I invested the amount the of the gain in a QOF. Can I defer paying tax on that gain?

Answer: Yes, you may elect to defer the tax on the amount of the gain invested in a Qualified Opportunity Fund. Therefore, if you only invest part of your gain in a Qualified Opportunity Fund(s), you can elect to defer tax on only the part of the gain which was invested.

Question: How do I elect to defer my gain on the 2019 sale of stock?

Answer: You may make an election to defer the gain, in whole or in part, when filing your 2019 Federal Income Tax return. That is, you may make the election on the return on which the tax on that gain would be due if you do not defer it. For additional information, see How to Report an Election to Defer Tax on Eligible Gain Invested in a QO Fund in the Form 8949 instructions.

Question: Can I elect to defer tax on gain if I already filed my tax return?

Answer: Yes, but you will need to file an amended return, using Form 1040-X and attaching Form 8949.

Question: I deferred gain into a QOF and now the QOF has dissolved before the end of my deferral period. What happens to my deferred gain?

Answer: When the QOF dissolved, the deferral period ended, and you must include the deferred gain when you file your return, reporting the gain on Form 8949.

Question: I deferred a gain into a QOF and then gave the investment to my children before the end of the deferral period. Is there anything I need to do?

Answer: Yes, the deferral period ended when you gave away the QOF investment. You must include the deferred gain when you file your return for the year of the gift, reporting the gain on Form 8949.

> **Note**: Inheritance by a surviving spouse is not a taxable transfer, nor is a transfer, upon death, of an ownership interest in a QO Fund to an estate or a revocable trust that becomes irrevocable upon death.

Question: Can I defer section 1231 capital gains net income for a taxable year into a QOF

Answer: Yes, if a taxpayer's section 1231 gains for any taxable year exceed the section 1231 losses for that year, the net gain is long-term capital gain. A taxpayer can elect to defer some or all of this capital gain under section 1400Z-2 by making an investment of a corresponding amount in a Qualified Opportunity Fund (QOF) during the 180-day period that begins on the last day of the taxpayer's taxable year.

Question: Can I transfer property other than cash as an investment in a QOF?

Answer: Yes. A taxpayer can transfer property other than cash as an investment to a QOF. However, a transfer of non-cash property may result in only part of the investment being eligible for opportunity zone tax benefits, so that not all of the taxpayer's capital gain is able to be deferred. See proposed regulations §1400Z2(a)-1(b)(9) & (10).

Question: When I transfer property to a QOF, does my holding period of the property also transfer to the QOF?

Answer: No. The opportunity zones tax incentives provisions determine a taxpayer's holding period in a qualifying investment in a QOF without regard to the holding period of the cash or other property transferred to the QOF.

Question: I made an investment in a QOF. After holding it for at least 10 years, I sell or exchange it. Can I adjust the basis to fair market value?

Answer: Yes, but only if you made the investment in connection with a proper deferral election. Also, the election must have remained in effect until that post-10-year sale or exchange. The election didn't cease to be in effect solely because – on December 31, 2026 – the law requires you to include in your income the gain that you had deferred under that election.

Question: I had ordinary gain from the sale of property in 2018. During the 180-day period beginning on the date of the sale, I invested the amount of that gain in a QOF. In 2029, I sell my interest in the QOF. Can I adjust my basis to fair market value?

Answer: No. Because the gain wasn't capital gain, you can't elect to defer it. So, your investment in the QOF wasn't made in connection with a proper deferral election. For this reason, the basis adjustment to FMV isn't available for that investment.

Question: What is a Qualified Opportunity Fund?

Answer: A Qualified Opportunity Fund is an investment vehicle that files either a partnership or corporation federal income tax return and is organized for the purpose of investing in Qualified Opportunity Zone property.

Question: How does a corporation or partnership become certified as a Qualified Opportunity Fund?

Answer: To become a Qualified Opportunity Fund, an eligible corporation or partnership self-certifies by filing Form 8996, Qualified Opportunity Fund, with its federal income tax return. For additional information, see Form 8996 and its instructions. The return with Form 8996 must be filed timely, taking extensions into account.

Question: Can a limited liability company (LLC) be an Opportunity Fund?

Answer: Yes, a LLC that chooses to be treated either as a partnership or corporation for federal tax purposes can organize as a Qualified Opportunity Fund.

Question: When is tangible property "original use" tangible property?

Answer: Tangible property is original use on the date first placed in service in the qualified opportunity zone for purposes of depreciation or amortization. Used tangible property satisfies the original use requirement if the property has not been previously placed in service in the qualified opportunity zone.

Question: Can inventory in transit be "Qualified Opportunity Zone business property"?

Answer: Yes, inventory of a QOF, including raw materials, does not fail to be "used in a Qualified Opportunity Zone" solely because the inventory is in transit from a vendor to the QOF or from the QOF to a customer.

Question: What is the 50-percent-of-gross-income test?

Answer: A Qualified Opportunity Zone business must earn at least 50 percent of its gross income from business activities within a QOZ. It must do so for each taxable year. The proposed regulations provide three safe harbors that a business may use to meet this test. These safe harbors are the:

- Hours-of-services-received test.
- Amounts-paid-for-services test.
- Necessary-tangible-property-and-business-functions test.

Question: Must a Qualified Opportunity Zone business meet all three safe harbors to satisfy the 50-percent-of-gross income test?

Answer: No. It's enough for a QOZ business to satisfy just one safe harbor.

For example, 50 percent or more of all the hours of services that a business receives and uses were performed in one or more QOZs. This business satisfies the hours test and, therefore, the 50-percent-of-gross-income test.

Second example, a QOF owns a business that operates in multiple QOZs. The business received and used 100,000 hours of services during the year. Of those:

- Employees spent 25,000 hours in QOZ 1.
- Independent contractors spent 20,000 hours in QOZ 2.
- Employees of independent contractors spent 10,000 hours in QOZ 3.
- The remaining 45,000 hours were outside of a QOZ.

This business satisfies the hours test and therefore the 50-percent-of-gross-income-test. The aggregate hours of services in QOZs during the tax year were at least 50 percent of all hours of services obtained by the business in all locations.

At publication the states that have not yet conformed to the OZ program, include: California, Arizona, Hawaii, Massachusetts, Minnesota, North Carolina and Pennsylvania.

CALIFORNIA DIFFERENCES

Sec 1400Z-1 allows each Governor to designate up to 25% of census tracts that either have poverty rates of at least 20% or median family incomes of no more than 80% of statewide or metropolitan area family income. There are 3,516 census tracts in 54 California counties that would qualify under one or both of the mandatory criteria, which allowed Governor Brown to designate up to 879 tracts. After he did so the U.S. Department of the Treasury certified those 879 tracts as qualified opportunity zones.
http://dof.ca.gov/Forecasting/Demographics/opportunity_zones/

California has not conformed to the tax benefits of QOZs, so any deferred gains reinvested under this program will be taxable in the sale year for California, and the basis of the investment in a QOF will be different for federal and state.

SELF-EMPLOYMENT ISSUES

This chapter is devoted to several issues that apply to self-employed individuals. However, there are many other issues pertaining to self-employed taxpayers that are covered elsewhere in this text; they are listed below and cross-referenced to the applicable chapter:

Related IRS Publications and Forms

- **Pub 15-A** - Employer's Tax Guide
- **Pub 334** – Guide for Small Business
- **Pub 463** - Travel, Gift & Car Expenses
- **Pub 535** – Business Expenses
- **Pub 537** – Installment Sales
- **Pub 544** – Sales & Other Dispositions of Assets
- **Pub 583** - Starting a Business and Keeping Records
- **Pub 587** – Business Use of Your Home
- **Pub 925** – Passive Activity and At-Risk Rules
- **Schedule C**
- **Schedule SE**
- **Schedule SE Instructions**
- **Form 8300** & Instructions – Reporting Cash Payments over $10K
- **Form 8594** – Asset Acquisition Statement

RAPID FINDER

UBER DRIVER TAX TREATMENT

This analysis does not address the potential employee/independent contractor issue related to Uber divers; it only deals with the tax treatment of drivers who are independent contractors.

How Uber Works – Each fare (customer) establishes an account with Uber using a credit card, Paypal, or other method. The fare uses the Uber app to request a ride, and an Uber driver picks up that person and takes him or her to the destination. Generally, no cash money changes hands, as Uber charges the fare's credit card (CC), deducts both its fee and the credit card processing fee and deposits the net amount into the driver's bank account.

Uber Reporting – Uber issues each driver a Form 1099-K reflecting the total amount charged for the driver's fares. Because the IRS will treat the 1099-K as gross business income, it must be included on line 1 (gross income) of the driver's Schedule C before adjusting for the CC and Uber fees. The net amount that Uber deposits into the driver's bank account reflects the fares minus the CC charges and the Uber fee. Thus, the sum of the year's deposits from Uber can be subtracted from the 1099-K amount, and the difference can be taken as an expense or as a cost of goods sold. Currently, a third party operates the billing, coordinates the drivers' fares and issues the drivers' 1099-Ks.

Uber also provides an online statement to its drivers detailing the miles driven with fares, and the dollar amount for both the fares and the bank deposits.

Automobile Deductions – Although the Uber statement mentioned above includes the miles driven for each fare, this figure only represents the miles between a fare's pickup point and delivery point. It does not reflect the additional miles driven between fares. Drivers should maintain a mileage log to track their total miles and substantiate their business mileage.

Luxury Auto Rules – *Regulation 1.280F-6(c)(3)(ii) exempts from the luxury auto rules any vehicle used by a taxpayer directly in the trade or business of transporting persons or property for compensation or hire.*

Tips – As originally designed, tips were supposedly included in the fare charged by Uber, but it was not uncommon for a driver to receive additional cash tips. These should be included in Schedule C gross income. Beginning in July 2017, fares may add a tip via the Uber app or they may continue to pay tips by cash. Presumably the on-app tips will be included in the gross income on the 1099-K issued by Uber. Care should be taken that tip amounts are properly reported – neither double-counted nor omitted on Schedule C.

Business Use of the Home – When deciding whether an Uber or Lyft driver qualifies for a home office deduction, remember the home office must be used **exclusively** in a taxpayer's trade or business on a **regular**, continuing basis. A taxpayer must be able to provide sufficient evidence to show the use is regular. Exclusive use means there can be no personal use (other than de minimis) at any time during the tax year. Use of only a portion of a room is acceptable as long as the taxpayer shows that section is totally for business. The office must also be the driver's **principal place of business.**

Both Uber and Lyft provide their drivers with detailed accounting information (see Uber reporting above). The only additional record keeping required is the miles traveled between fares and that is accomplished while in the vehicle. So justifying a home office is problematic. Without a qualified home office, the distance to pick up the first fare and the distance to return home at the end of the shift would be considered nondeductible commuting.

Some would contend that a portion of the garage where the vehicle is parked could be used toward a business use of the home deduction. Remember, the use must be exclusive, which means the vehicle must be used 100% for business. Since the distance between home and the first and last fares is commuting, it is not realistic to believe that the vehicle is never used for personal purposes and justifying business use of the home for garage parking is also challenging.

Neither the courts nor the IRS have provided any specific guidance on this subject related to Uber drivers, so it is up to the tax practitioner to make the determination on a case-by-case basis.

Deductions Other Than the Vehicle – Possible other deductions might include:

- Cell phone service, prorated if the phone isn't used 100% for Uber activity
- Liability insurance
- Water for the fares

Lyft is a competitor to Uber, and they operate in a manner similar to Uber.

PAYMENT CARD AND THIRD-PARTY PAYMENT TRANSACTIONS (Code Sec 6050W)

Payment settlement entities (e.g., a bank) have to make an annual information report in settlement of reportable payment transactions (e.g., a credit or debit card transaction) and transactions settled through third-party payment networks, such as third-party organizations (e.g., PayPal or Google Pay (previously Google Wallet)) that settle online transactions to the merchant **and** the IRS stating the gross amount paid to the merchant during the previous calendar year. Form 1099-K is used for this reporting.

We can probably expect IRS to develop statistics for various types of businesses related to the ratio of cash payments to credit payments as a means of imputing cash payments for merchants that do not report a reasonable amount of income over and above that reported by the payment processors.

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TIGTA Report: IRS is Underutilizing Form 1099-K Data to Identify Tax Returns for Audit
According to a September 2017 report from the Treasury Inspector General for Tax Administration (TIGTA), an IRS pilot program that used merchant card third-party reporting for the assignment of productive audits failed to detect the more obvious examples of noncompliance, and the IRS missed opportunities to audit tax returns with large discrepancies between payments reported on Forms 1099-K and the income reported on taxpayers' tax returns. The IRS generally agreed with recommendations made by TIGTA that the IRS consider implementing compliance projects to test the use of Form 1099-K data to identify certain types of tax returns for audit. TIGTA also recommended that the Service identify and address the reasons tax returns with large discrepancies between income reported on tax returns and the amounts reported on Forms 1099-K were not selected for audit or other treatment. The IRS disagreed with TIGTA as to the magnitude of the issues. (TIGTA Reference Number: 2017-30-083)

Currently, there is no requirement to separate the 1099-K amounts from cash receipts when entering gross income on Schedule C, E or F.

Payment Card - A payment card, as defined under the regulations, includes, but is not limited to, credit cards, debit cards, and stored-value cards (e.g., gift cards or similar cards with a prepaid value). A payment card also includes the acceptance as payment of any account number or other indicia associated with a payment card. A payment card issued in connection with a flexible spending arrangement or a health reimbursement arrangement is not exempted from the reporting requirements. The final regulations also clarify that the withdrawal of cash from an automated teller machine and the use of a payment card to obtain a loan or cash advance do not constitute payment card transactions. (Reg. 1.6050W-1(b))

Backup Withholding – If a merchant fails to provide his correct tax ID number and other required information for reporting, the merchant may be subject to a 24% (28% before 2018) backup withholding on any payments forwarded to the merchant. The backup-withholding requirement began after 12/31/2012. The lower 24% rate is a result of the revised tax brackets in the TCJA of 2017. (Notices 2011-88 and 2011-89) The lower 24% rate is a result of the revised tax brackets in the TCJA of 2017. Backup withholding that was made is reported in box 4 of the 1099-K.

On-line Business Transactions – If clients sell their merchandise through eBay accounts or other on-line businesses, they can expect transactions for those accounts to be reported.

Exception: No reporting is required by a third-party settlement organization with regard to a specific business unless the aggregate payments to the business from third-party network transactions exceed $20,000 and the aggregate number of transactions is 200 or more in the calendar year. This exception does not apply to payments in settlement of payment card transactions.

REPORTING CASH PAYMENTS OF OVER $10,000

As part of the Financial Crimes Enforcement Network (FinCEN) efforts to combat money laundering and to detect tax evasion, terrorist financing and drug dealings, business transactions of over $10,000 require the filing of Form 8300.

Who must file Form 8300? **-** Any persons who receive more than $10,000 while conducting their trade or business must file a Form 8300. The $10,000 may occur in a single transaction, or a series of related transactions.

What payments must be reported? **-** A business must file Form 8300 to report cash (U.S. or foreign coin and currency) paid to it if the cash payment is:

- Over $10,000,
- Received as:
  1. One lump sum of over $10,000,
  2. Two or more related payments that total in excess of $10,000, or
  3. Payments received as part of a single transaction (or two or more related transactions) that cause the total cash received within a 12-month period to total more than $10,000.
- Received in the course of trade or business,
- Received from the same buyer (or agent), and
- Received in a single transaction or in two or more related transactions.

What is and isn't cash? **–** U.S. and foreign coins and currency are cash, but a personal check is not considered cash for purposes of filing Form 8300. A cashier's check, money order, bank draft or traveler's check with a face amount of over $10,000 is **not** treated as cash (because the issuer of these instruments was required to file a separate Currency Transaction Report). However, certain payments of $10,000 or less made by cashier's check, money order, bank draft or traveler's check must be reported for retail sales of consumer durable goods, a collectible, a travel or entertainment activity *(Reg. § 1.6050I-1(c)(iii))* or if the recipient knows the payer is trying to avoid the transaction being reported on Form 8300.

What is the definition of a transaction? A transaction is the underlying event resulting in the transfer of cash. Examples include:

- Sale of goods, services or real or intangible property
- Rental of goods or real or personal property
- Cash exchanged for other cash
- Establishment, maintenance of or contribution to a trust or escrow account
- A loan repayment
- Conversion of cash to a negotiable instrument such as a check or a bond

What is a related transaction? Transactions between a buyer, or agent of the buyer, and a seller that occur within a 24-hour period are related transactions.

When and where to file? – Form 8300 must be filed by the 15th day after the date the cash was received (or the next business day if that date is a Saturday, Sunday, or legal holiday). The form is filed with the Internal Revenue Service, Detroit Computing Center, P O Box 32621, Detroit, MI 48232. Alternatively Form 8300 may be electronically filed using FinCEN's Bank Secrecy Act (BSA) Electronic Filing (E-Filing) System. More information is available at http://bsaefiling.fincen.treas.gov/main.html. In addition, a written or electronic statement must be given to each person named on a required Form 8300 by January 31 of the year following the calendar year in which the cash was received. The statement must show the business name and contact information, aggregate amount of reportable cash received, and that the information was furnished to the IRS.

FAILED BUSINESS EXPENSES

Rev Rul 67-12, 1967-1 CB 29 Jan. 1, 1967 allows ordinary and necessary expenses incurred in a trade or business in prior years and paid in the current year by a cash-basis individual to be deducted under section 162 even though the trade or business has been discontinued. Unfortunately, those expenses must be deducted on a Schedule C, which provides a very poor audit profile. Some practitioners attempt to hide these expenses on other forms and could run afoul of Cir 230 Sec 10.51(4), providing false or misleading information.

Voluntary payments of another's business expenses, where there is no legal obligation to pay them, are not deductible. This is true even though the payments are made to preserve the individual's reputation, credit or professional standing.

SPOUSES MAY ELECT OUT OF PARTNERSHIP RULES

A husband and wife who file a joint return may elect out of the partnership rules. Thus, when the election is made, a joint venture between them is not treated as a partnership for tax purposes.

All items of income, gain, loss, deduction, and credit are divided between the spouses according to their respective interests in the venture, and each spouse takes into account his or her respective share of these items as if they were attributable to a trade or business conducted by the spouse as a sole proprietor. Accordingly, each electing spouse will report his or her shares on the appropriate form, such as Schedule C.

Limited Scope - This rule does not apply to spouses who operate in the name of a state law entity (including a general or limited partnership or a limited liability company). The election can be made only for a business operated by spouses as co-owners that is, or should otherwise be, taxed as a partnership (whether or not there is a formal partnership).

A qualified joint venture means any joint venture involving the conduct of a trade or business if:

(1) The only members of the joint venture are a husband and wife,
(2) Both spouses materially participate in the trade or business, and
(3) Both spouses elect the application of this rule.

Notwithstanding other self-employment rules, each spouse's share of income or loss from a qualified joint venture is taken into account under the above rules in determining the spouse's net earnings from self-employment.

Similarly, each spouse's share of income or loss from a qualified joint venture is taken into account under the above rules in determining the spouse's net earnings from self-employment for purposes of the Social Security benefits rules. Thus, each spouse will receive credit for his or her self-employment tax contributions for purposes of receiving Social Security benefits. However, this rule is not intended to prevent allocations or reallocations, to the extent permitted under pre-2007 law, by courts or by the Social Security Administration of net earnings from self-employment for purposes of determining Social Security benefits of an individual.

Material Participation - Generally to qualify as materially participating in the activity, and therefore avoid loss limitations under § 469, 500 hours of participation are required during the year, or if participation is less than 500 hours, the taxpayers must provide substantially all of the participation.

Code § 761(f)(2)(B) says one of the requirements is that both spouses materially participate "within the meaning of § 469(h) without regard to paragraph (5) thereof". Paragraph (5) of 469(h) says "in determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account." So for this purpose, the spouse's participation is NOT taken into account. You would look at each spouse separately, i.e., as if each was operating a separate activity, and disregard the other spouse's involvement.

DEDUCTING START-UP AND ORGANIZATIONAL COSTS

Start-up costs include amounts paid or incurred to create an active trade or business or to investigate the creation or acquisition of an active trade or business. Organizational costs include the costs of creating a corporation or a partnership. These costs are generally capital expenses, but by election, can be deducted or amortized, starting with the month the active trade or business begins. The discussion in this section deals primarily with business start-up costs.

Election to Deduct Start-Up Costs **-** Taxpayers can elect to deduct up to $5,000 of start-up and $5,000 of organizational expenses in the first year of a business. Each of the $5,000 amounts is reduced by the amount by which the total start-up expense or organizational expense exceeds $50,000. Expenses not deductible in the first year of the business must be amortized over 15 years. *(IRC § 195)* If a taxpayer who incurred start-up expenses does not make the election, the start-up costs must be capitalized, meaning that the expenses can only be recovered upon the termination or disposition of the business. (Under prior law, start-up costs were capitalized unless an election was made to amortize them over no less than 60 months.)

All start-up and organizational costs related to a particular business, regardless of when incurred are to be considered in determining whether the cumulative cost of the start-up or organizational expenditures exceeds $50,000.

How to Make the Election to Deduct Start-Up Costs – The election to deduct start-up costs is made by claiming the deduction on the return for the year in which the active trade or business begins. The return must be filed by the extended due date. On Schedule C, the deduction is taken as part of the "Other Expenses" in Part V. If the entire amount of start-up costs isn't deductible in the business's first year, use Form 4562 to amortize the excess amount over 180 months.

Qualifying Start-Up Costs – A qualifying start-up cost is one that would be deductible if it was paid or incurred to operate an existing active business in the same field as the new business, and the cost is paid or incurred before the day the active trade or business begins. Examples of qualified start-up costs include:

- Surveys/analyses of potential markets, labor supply, products, transportation facilities, etc.;
- Wages paid to employees, and their instructors, while they are being trained;
- Advertisements related to opening the business;
- Fees and salaries paid to consultants or others for professional services; and
- Travel and related costs to secure prospective customers, distributors and suppliers.

Start-up costs don't include interest, taxes, or research and experimental costs. Depreciable items aren't included in start-up expenses either--begin depreciation when the business actually begins (i.e., when the assets are "placed in service").

For a purchase of an active trade or business, only investigative costs incurred while conducting a general search for or preliminary investigation of the business (i.e., costs that help the taxpayer decide whether to purchase a new business and which one to purchase) are qualified start-up costs. Costs incurred attempting to buy a specific business are capital expenses that aren't treated as start-up costs.

If a business closes operations before start-up costs are fully amortized, deduct remaining costs as an ordinary loss (Form 4797).

EMPLOYING A FAMILY MEMBER

One way of reducing the overall family tax bite is to employ family members in your business. This will allow you to shift income to them and possibly provide them with employment benefits.

Strategy - Employing a Child **-** By employing a child, the income tax advantages include obtaining a business deduction for a reasonable salary paid to that child and reducing the self-employment income and tax of the parents (business owners) by shifting income to the child. Since the salary paid to a child is considered earned income, it is not subject to the "Kiddie Tax" rules that apply to children through age 18 and full-time students ages 19 through 23. The Kiddie Tax won't apply at all to the 19- through 23-year-old student if his or her earned income exceeds one-half of total support, another incentive to employ a child in some situations.

The maximum standard deduction available to the child in 2019 is $12,200 (up from $12,000 in 2018). Therefore, the standard deduction eliminates all tax on that amount of income if the child is paid $12,200 in compensation. * If the business is unincorporated, wages paid to the child under age 18 are not subject to social security taxes. Not only are there significant income tax advantages to employing the child, but the parent-employer may provide him or her with fringe benefits, such as group-term life insurance and qualified pension plan contributions.

The child may also make deductible contributions to an IRA for 2019 of the lesser of earned income or $6,000. By combining the standard deduction and the maximum deductible IRA contribution, a child could earn $18,200 of wages and pay no income tax. If the child balks at contributing his or her hard-earned money to an IRA, the parent might consider giving the child part or all of the IRA contribution as a gift.

Strategy - Employing a Spouse **-** Reasonable wages paid to a spouse entitles the employer-spouse to a business deduction. The wages are subject to FICA taxes, and the spouse may qualify for Social Security benefits to which he or she might not otherwise be entitled. In addition, the spouse may also be eligible to receive coverage under the business' qualified retirement plan, and the employer-spouse may obtain a business deduction for health insurance premium payments made on behalf of the employed spouse. While maintaining the same family coverage, the business deductions could be increased by providing the spouse with family health insurance coverage as an employee. These wages are subject to income tax.

Please keep in mind that when a family member is employed in a family business, the wages should be reasonable for the work performed and that the services performed are necessary to the business.

*Actually, only $11,850 of wages would need to be paid since the Kiddie Tax rules allow as the standard deduction for 2019 the lesser of $12,200 or the sum of $350 plus earned income, with a minimum standard deduction of $1,100. Thus $12,200 - $350 = $11,850.

ADVERTISING EXPENSES

The Tax Court's view is that advertising and promotional expenses cannot be charged to future years as deferred charges nor amortized over future years where the taxpayer fails to show that "the future benefits can be determined precisely and are not of indefinite duration *(Finkenberg's Sons Inc, A., (1951) 17 TC 973)*

Where the period over which the benefit will be derived is definitely ascertainable, the expenditure must be capitalized and amortized over the period. Thus, IRS ruled that advertising expenses incurred in connection with a fair which operated for six months in each of two years must be spread over the periods during which the fair was in operation *(Rev Rul 68-283, 1968-1 CB 63)*. Tax Court held that signs and clocks which a Coke company placed on its dealers' premises, and scoreboards which it placed at high school ball fields, were capital expenses amortizable over a five-year useful life *(Alabama Coca-Cola Bottling Co, (1969) TC Memo 1969-123)*.

But expenses incurred by business or professional people to build up their reputations are capital expenditures to develop or enhance goodwill, unless the expenses can be tied directly to the production of added income.

Website costs – Although the IRS has not issued guidance on when Internet website costs can be deducted, the costs should generally be treated under the same principles as other business expenses. Generally, website costs will be either a software expense or an advertising expense, but if they are paid or incurred before a business begins, they would be treated as start-up expenses.

Website designs such as the part of a website's design produced from sophisticated programming languages (example: C++) will be treated as software. However, whether a design produced from HTML (hypertext markup language) will qualify as software is questionable.

Purchased software - If the business owner starting the website purchases the design from another individual or company that would be at economic risk if the software doesn't perform, the design costs are amortized over 3 years, starting with the month the website is put into service. If the software is off-the-shelf computer software placed in service in a tax year beginning in 2003 or later, it qualifies as Sec. 179 property.

In-house developed software – If the website design is developed by the proprietor who is launching the website (or his or her employee or an independent contractor who isn't at risk for lack of performance of the software), the costs may be:

- Deducted in the year paid or accrued (depending on the proprietor's accounting method), or
- Amortized over three years (as if the design had been purchased).

Non-software design costs – The portions of the website design costs that aren't software generally must be amortized over the number of years that the non-software portions of the design are expected to be used in the business. If the expected use is one year or less, the costs are currently deductible.

Website content - Costs of the website content that is advertising are deductible currently as an advertising expense. Non-advertising content may be deductible or amortized, depending on its useful life. Also treated as advertising expenses are website monthly fees paid for a generic customized site.

Domain name purchased on secondary market – In IRS CCA 201543014, the Chief Counsel opined that:

(1) Costs incurred by a taxpayer to acquire either a generic or a non-generic domain name from the secondary market for use in the taxpayer's trade or business must be capitalized under § 263(a) as an intangible asset. A non-generic domain name is usually a company or product name. A generic domain name is not a company or product name, but typically describes a product or service using generic terms people associate with the topic.

(2) If a non-generic domain name is registered as a trademark or functions as a trademark, the capitalized costs of acquiring the name from the secondary market for use in the taxpayer's trade or business meets the definition of a trademark in Sec 1.197-2(b)(10) and would be an amortizable Sec 197 intangible. Alternatively, if the name does not meet the definition of a trademark but will be used by the acquiring taxpayer in its trade or business to

provide goods or services through an already constructed website and will be maintained by the taxpayer, the capitalized costs of acquiring the name meets the definition of a customer-based intangible and will be an amortizable Sec 197 intangible.

(3) If a generic domain name is associated with a website that is already constructed and will be maintained by the acquiring taxpayer who acquired the generic domain name for use in its trade or business either to generate advertising revenue by selling space on the website or to increase its market share by providing goods or services through the website, the capitalized costs of acquiring the generic domain name from the secondary market for use in the taxpayer's trade or business meets the definition of a customer-based intangible and is an amortizable Sec 197 intangible.

Intangibles are amortizable over 15 years. See Chapter 3.08 for more information on Intangibles.

AUTO LOAN INTEREST

A self-employed individual may deduct on Schedule C interest paid on a loan to acquire a business vehicle even if the loan is consumer debt. This is so even if the standard mileage rate method is used because the standard rate does not include an allowance for interest to purchase the vehicle. If the vehicle is part for business and part personal, the interest must be allocated between the personal (nondeductible) part and the business part *(§ 163).* In addition, the business portion of any taxes paid on the vehicle during the year is also deductible on Schedule C. *(Rev Proc 2002-61, Sec. 5.04, 2002-39 IRB 616)*

> ***Example – Auto Loan Interest –*** *Assume the self-employed individual paid $600 interest on a car loan and used the car 60% for business and 40% for personal purposes. The taxpayer can deduct $360 (60% × $600) on Schedule C. The remaining interest of $240 is a nondeductible personal expense.*

LEASE PAYMENTS – RENTAL EXPENSE OR PURCHASE COST?

A payment made in connection with the taxpayer's trade or business is deductible as a rental expense if it is an ordinary and necessary expense, but only if the lessee (taxpayer) has not taken or is not going to take title to the property and has no equity interest in it. *(IRC Sec. 162(a)(3))* Therefore, payments made under conditional sales contracts are not deductible as rent. No deductions for rental payments are allowed for a transaction that is structured to look like a lease but is in fact a disguised purchase.

A lease with an option that allows the lessee to buy the property may be construed as a sale, in which case, none of the payments are deductible as rent. For example, lease expenses for a business-use vehicle that are in fact payments toward the vehicle's purchase price are not deductible, but the cost may be recovered through depreciation. The intent of the parties, as shown in the agreement and based on the facts and circumstances when the agreement was made, will determine whether the lease is considered a sale. Factors indicating a sale instead of a lease include a nominal option price, designating part of the payment as interest, excessive rent, application of rent payments to the lessee's equity in the property, and rental plus option price equal to the property's value plus interest.

CHARITABLE CONTRIBUTION VS. BUSINESS EXPENSE

Generally, for a self-employed individual, charitable contributions are not deductible on Schedule C and can only be deducted on Schedule A. However, transfers to a charity that are directly related to a taxpayer's business and are made with a "reasonable expectation of financial return commensurate with" the amount transferred may be deductible as business expenses, and not as charitable contributions. But no business expense deduction is allowed for the transfer if *any* part of it is deductible as a charitable contribution. (Reg § 1.162-15(a)(2))

EDUCATION EXPENSES - A self-employed individual has optional tax benefit strategies for education expenses:

- Take as a business expense and thereby offset both SE and income tax, or
- Take as an education credit (if qualified) where that benefit outweighs the other options.
- When deciding which option to use, be sure to consider the overall tax reduction.
  - Schedule C – Generally SE rate plus Tax Bracket rate.
  - Education credit – American Opportunity up to 100% of first $2,000 plus 25% of next $2,000, Lifetime at 20%.

TRAVEL INSURANCE

The deductible travel expenses, for a business trip, would include the cost of travel insurance, visa fees, customs fees, and books about the destination (TC Memo 1998-272), and would be deductible on Schedule C as a travel expense for a self-employed individual or, in years other than 2018 through 2025, as a Schedule A, miscellaneous itemized deduction for an employee.

Although there are no specific citations to reference, it would seem that the medical portion of the travel insurance premium–if it is separately stated–for a self-employed individual and more-than-2% S-Corporation stockholders (corporate wages count as SE income for purposes of the net income limitation) would qualify for the above-the-line SE medical deduction (see next topic) whether or not the trip was for business (Sec 162(I)(1)(B)).

It would also seem, where the above-the-line SE medical deduction does not apply, the medical portion of the travel insurance would qualify as a Schedule A medical deduction–again, only if the medical portion of the premium is listed separately from other coverage such as for trip delays, lost or damaged luggage, or trip cancelation.

HEALTH INSURANCE DEDUCTION

A self-employed individual (or a partner or a more-than-2%-shareholder of an S corporation) can deduct as an above-the-line expense 100% of the amount paid during the tax year for medical insurance on behalf of himself, his spouse and his dependents subject to the following requirements (Code Sec. 162(l)(1)(B)):

- The deduction cannot exceed the individual's net earnings from self-employment derived from the trade or business for which the plan providing the coverage is established.
- For a more-than-2% S corporation shareholder, that shareholder's wages from the S corporation are treated as his earned income.
- No deduction is available for any month in which the self-employed individual is eligible to participate in a "**subsidized**" health plan maintained by an employer of the taxpayer, the taxpayer's spouse, or any dependent, or any child of the taxpayer who hasn't attained age 27 as of the end of the tax year. This rule is applied separately to (1) plans that provide coverage for qualified long-term care services or are qualified long-term care insurance contracts and (2) plans which don't include such coverage and aren't such contracts (Code Sec. 162(l)(2)(B)). Thus, an individual eligible for employer-subsidized health insurance may still be able to deduct long-term care insurance premiums, so long as he isn't eligible for employer-subsidized long-term care insurance.

  Definition of Subsidized - The term "subsidized" means at least 50% of the cost of the coverage is paid by the employer (Sec 35(f)(1)).

When adding the amounts that qualify as insurance premiums for either the self-employed health insurance deduction or the Schedule A deduction, don't overlook:

- Long-term care insurance premiums (up to the age-based maximum)
- ACA marketplace premiums net of the advance premium tax credit (APTC)
- Payback of any portions of the APTC in the year of the APTC
- Employee costs for employer group coverage
- Medicare parts B, C and D premiums
- Medicare supplemental plan premiums
- Dental insurance premiums
- Vision insurance premiums
- Lost or damaged contact lens premiums
- Travel Medical Insurance (see "Travel Insurance" previously)

If the taxpayer is self-employed and the premiums cannot be used for the above-the-line self-employed health insurance deduction because of the net SE earnings limitation, the excess can be taken as a Schedule A deduction.

Medical expenses paid by an HRA or FSA are not deductible health insurance premiums because they are paid for by pretax dollars. The same goes for medical expenses paid for or reimbursed by an HSA.

Medicare B and the SE Health Insurance Deduction **-** A Chief Counsel Advice (CCA 201228037, July 16, 2012) addresses the question of whether Medicare premiums can be deducted under section 162(l) for the coverage of a self-employed individual's spouse. The answer: **YES**. The Counsel's analysis of the law is as follows (emphasis added):

> *"Medicare is insurance that constitutes medical care under section 162(l). Therefore,* ***all Medicare premiums*** *are similar to other health insurance premiums and can be used to compute the deduction under section 162(l).* ***This rule also extends to Medicare premiums for coverage of a self-employed individual's spouse****, dependent, or child (as defined in section 152(f)(1)) who as of the end of the taxable year has not attained age 27."*

So, in addition to stating that a spouse's Medicare premiums are eligible for the SE health insurance deduction (if all other requirements are met), the CCA also clarifies that all Medicare premiums (B, C and D) are eligible.

Children Under the Age of 27 - As part of the health care reform law medical insurance premiums paid for a self-employed individual's child who is under the age of 27 as of the end of the year can be covered under the SE individual's plan and deducted as part of the self-employed individual's health insurance deduction. (Notice 2010-38) The definition of "child" for this purpose includes:

- The individual's child,
- The individual's stepchild,
- A legally-adopted individual,
- A person lawfully placed with the individual for legal adoption, and
- An eligible foster child.

The child does not have to qualify as a dependent. No other requirements apply so long as the individual meets the definition of a child and has not reached age 27 by the last day of the year. Even a married child is included by this definition! (But the married child's spouse and/or children are not covered.) A child attains age 27 on the 27th anniversary of the date the child was born (for example, a child born on April 10, 1992 attained age 27 on April 10, 2019).

If the self-employed individual utilizes a group policy provided by an association, be aware that although group policies offered by insurers are also required to cover older children, they are only required for children under the age of 26.

Receiving Premium Assistance Credit - The SE health insurance deduction is normally a straight forward above-the-line deduction that is based upon qualified health insurance premiums paid by a self-employed individual and limited to the profit from the business less one-half of the SE tax paid (i.e., the 50% of SE tax deduction that reduces gross income).

However, the ACA adds a whole level of complexity when computing the deduction of SE taxpayers who purchased their insurance through a government exchange (marketplace), since, for the deduction, the insurance premiums paid must be reduced by the premium assistance credit received, and the credit received is based upon the taxpayer's MAGI. Thus, the credit and MAGI are interdependent upon one another. The IRS solution to the problem is to recalculate the credit and MAGI over and over again until the difference is within $1 (Rev Proc 2014-41). The Rev Proc also provides an alternative calculation. Either way it produces a complicated calculation that is best left up to your software.

Partner's Guaranteed Payments - A self-employed individual qualifying for the deduction includes a general partner or a limited partner receiving guaranteed payments (Rev Rul 91-26, 1991-1 CB 184).

Where Taken – The deduction is not taken on Schedule C since the medical expense cannot offset SE taxes. Instead it is taken as an adjustment to gross income.

Annual Limitation – 100% of medical insurance premiums paid.

Net Income Limitation - No deduction is allowed for self-employed individuals to the extent that the deduction exceeds the individual's net earnings from self-employment *(Code Sec. 401(c))* derived from the trade or business with respect to which the plan providing the medical care coverage was established. Does this mean that a health insurance policy purchased by a sole proprietor must be issued in the name of the trade or business? No, according to the IRS' Chief Counsel's Office, the policy may be in the individual's name. However, the sole proprietor may not net the earnings of multiple businesses for the net income limitation unless separate policies are involved. For example, if the self-employed individual purchases a medical plan under Business #1 and a dental plan under Business #2, the earned income from each business may be considered together. *(CCM 200524001)*

Employer Plan Limitation - The deduction isn't available to any taxpayer for any calendar month for which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of the taxpayer *(Code Sec. 162(l)(2)(B))*. Thus, if the taxpayer were only covered for one month under the employer's subsidized plan, the SE health insurance deduction is still available for the other 11 months of the year. A former employer generally does not pay part of continuation or COBRA medical insurance premiums, so unless the employer picks up 50% or more of the cost, the COBRA premiums of a self-employed individual will be eligible for the SE health insurance deduction, if other requirements are met.

Additional Medicare Tax - As part of the Affordable Care Act, an additional 0.9% Medicare tax applies to combined wage and self-employment income in excess of $200,000. For married taxpayers, the threshold is instead $250,000 for taxpayers filing jointly and $125,000 for taxpayers filing separately. See Chapter 8.03 for information on self-employment tax and Chapter 12.06 for details on the additional Medicare tax.

PREPAID EXPENSES

Generally, prepaid expenses are not deductible. This rule applies to any expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year.

> ***Example – Prepaid Expense -****The taxpayer signs a 3-year insurance contract. Even though he paid the premiums for 2017, 2018 and 2019 when he signed the contract, he can only deduct the premium for 2017 on his 2017 tax return. He can deduct in 2018 and 2019 the premium allocable to those years.*

WHO MAY ESTABLISH A SELF-EMPLOYMENT RETIREMENT PLAN (aka Keogh)

Even though a qualified plan can only be established by an employer *(§ 401(a)),* a sole proprietor *can* establish a Keogh plan, and so can a partnership. Only a sole proprietor or a partnership can set up a Keogh plan. A common law employee cannot and neither can a partner *(Reg § 1.401-10(e)(1)).*

For purposes of establishing a Keogh plan, an individual who owns the entire interest in an unincorporated trade or business is treated as his own employer. And a partnership is treated as the employer of each partner who is considered to be an employee under *§ 401(c)(1), § 401(c)(4).* Therefore, a sole proprietor is considered to be his own employer, and the partnership is considered to be the employer of each of the partners. *(Reg § 1.401-10(e)(1))*

Directors' fees are self-employment income - Since directors' fees are self-employment income *(Rev Rul 72-86),* a taxpayer who is both an officer and director of the same corporation, and is covered as an employee under the corporation's pension plan, may set up a Keogh plan for the separate fees he receives for acting as director *(Letter Ruling 7839059)*.

CREDIT CARD MIXED INTEREST

When it comes to credit card debt where a portion of the debt is for personal purchases and part for business, can any part of the interest charged on the debt be deducted as business interest?

IRC Section 163(h)(2) clearly bars a deduction for personal (consumer) interest but does not mention dealing with mixed charges. IRS Section 163(h)(2)(A) specifically excludes interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee) from the definition of personal interest. As such, the interest associated with a credit card used solely for business purposes is plainly deductible as business interest.

An example of allocating interest between personal and business is a vehicle used partially for business and partially for personal purposes. The business use percentage is determined by the miles driven for business as compared to the total miles driven for the entire year. Thus, in this situation, it is easy to determine the percentage of the car's consumer loan on which business interest is deductible.

However, when it comes to allocating the interest on a credit card that is used both personally and for business (mixed use), how does one allocate the interest among all of the ongoing charges and monthly installment payments? Although some part of the interest is deductible business interest, it is difficult to determine a proper allocation and, in an examination, a tough thing to prove.

Moral of the story? Taxpayers should use separate credit cards whenever possible for business and personal purchases. Doing so will make proving the deductibility of the business interest much easier in an examination.

PARTNER EXPENSES

A frequent question that arises is how to handle the deductible business expenses of individuals in a partnership. Generally, the partnership should reimburse each partner for any allowable expenses; those expenses would then be deducted on the partnership's 1065 return.

If the partnership does not reimburse these expenses, the following instructions from Part II of Form 1040, Schedule E apply: "You can deduct unreimbursed ordinary and necessary expenses you paid on behalf of the partnership **if you were required to pay these expenses under the partnership agreement.**"

The inference here is that, if the partnership agreement does not require the partner to pay expenses, those expenses are not deductible.

If they are deductible, the expenses are claimed on Part II of Schedule E. See line 27 (page E-10) of the 2018 Schedule E instructions to learn how to fill in the entry on line 28 based on whether the activity is passive or active. Be sure to check the "yes" box on line 27 to indicate that there are unreimbursed partnership expenses. Refer to your software's instructions on how to achieve the desired result.

Whatever you do, do not adjust the K-1. That is the incorrect place to do so; in addition, not using the numbers from the filed K-1 necessitates that Form 8082 (Notice of Inconsistent Treatment) also be filed.

FARM LOSSES LIMITED

Prior to 2018, the farming loss of a taxpayer, other than a C corporation, is limited for any tax year in which any applicable subsidies are received. The losses are limited to the greater of (a) $300,000 ($150,000 for a married person filing separately), or (b) the taxpayer's total net farm income for the prior five tax years.

Applicable subsidies are (1) any direct or counter-cyclical payments under title I of the Food, Conservation, and Energy Act of 2008 (or any payment elected in lieu of any such payment), or (2) any Commodity Credit Corporation (CCC) loan.

Total net farm income is an aggregation of all income and loss from farming businesses for the prior five tax years. Any loss that is disallowed under this rule in a particular year is carried forward to the next tax year and treated as a deduction attributable to farming businesses in that year. Farming losses arising because of fire, storm, or other casualty, or by reason of disease or drought, are disregarded for purposes of calculating the limitation. (Code Sec. 461(j), as amended by the Heartland, Habitat, Harvest, and Horticulture Act of 2008, § 15351)

TCJA

Under TCJA the IRC Sec 461(j) limitation on "excess farm loss" for non-corporate taxpayers no longer applies after 2017 and through 2025, although an excess farm loss from 2017 will carry over to 2018. For 2018-2025 all non-corporate taxpayers' business loss deductions are limited to a threshold amount *(IRC Sec. 461(l) as modified by TCJA Sec. 11012(a)).* *See chapter 3.25.*

EQUIPMENT RENTAL – SCHEDULE E OR C?

Generally, equipment rental is income for SE tax purposes and cannot be reported on Schedule E. Instead, it should be reported on Schedule C where it will be subject to SE tax. In a Tax Court case, a taxpayer reported rental income for his vehicles and equipment used in the performance of self-employed services. The tax court ruled that the equipment rental in reality was self-employment income reportable on Schedule C (Walker, Charles, (1993) 101 TC 537).

Frequently, 1099-MISCs are issued from the entertainment industry reporting "rents." An example is off-duty police officers who are paid rents for their motorcycles and other equipment. The so-called rents are actually SE income paid as rents to avoid the employer's share of the FICA withholding.

JOINT & SEVERAL LIABILITY

If self-employment income is reported on a joint return, both spouses are jointly and severally liable for the self-employment tax (Reg § 1.6017-1(b)(2)).

OUTSOURCING PAYROLL TASKS – BE ALERT FOR SCAMS

Many employers use a third-party payroll service to prepare their payroll checks and handle related tax duties, including withholding, reporting, and paying social security, Medicare, and income taxes. Third-party payroll service providers can help assure filing deadlines and deposit requirements are met and greatly streamline business operations. If the payroll service fails to perform its tax collection and depositing duties, the employer will still be responsible for the deposit and payment of federal tax liabilities, even though the employer may have forwarded the tax amounts to the third-party to make the tax deposits. The employer is the responsible party, and if the third-party fails to make the federal tax payments, the IRS may assess penalties and interest on the employer's account, and the employer will be liable for all taxes, penalties and interest due. The employer may also be held personally liable for certain unpaid federal taxes, i.e., the "trust fund" taxes.

As a precaution, employers should not change their address of record with the IRS to be that of the payroll service provider because the employer will then not be informed of tax matters involving their business, and if there is any nefarious activity by the payroll service, the business will be in the dark about it until it is too late. The IRS suggests that employers – even those not required to make electronic payroll payments – should ensure their payroll service providers are using EFTPS (Electronic Federal Tax Payment System) so the employers can confirm that payments are being made on their behalf. Employers should register on the EFTPS system to get their own PIN and use this PIN to periodically verify payments. A red flag should go up the first time a service provider misses or makes a late payment. When an employer registers on EFTPS they will have on-line access to their payment history for 16 months. In addition, EFTPS allows employers to make any additional tax payments that their third-party provider is not making on their behalf such as estimated tax payments.

IS CLAIMING EXPENSES ON SCHEDULE C OPTIONAL?

May a taxpayer disregard depreciation and other allowable deductions in computing net earnings from self-employment for self-employment tax purposes? Some taxpayers might like to do this to boost their Social Security contributions and eventually their SS benefits. In some circumstances it could also increase their earned income credit. But is this allowed? The short answer is NO. Here's the explanation why:

IRC Sec 1402(a) defines net earnings from self-employment as "the gross income derived from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business." Gross income from a trade or business does not itself constitute net earnings from self-employment; allowable deductions must be taken for expenses in order to arrive at net SE earnings. Rev. Rul. 56-407 held that under Sec 1402(a), every taxpayer (with the exception of certain farm operators) must claim all allowable deductions in computing net earnings from self-employment for self-employment tax purposes. Since net SE earnings are included in earned income for EITC purposes as defined by cross-reference to the definition of net-earnings from self-employment under I.R.C. §1402(a), the rule that claiming allowable deductions is mandatory applies equally to the EITC. Deliberately not claiming expenses to increase the amount of EITC would be fraud. (Chief Counsel Advice 200022051)

CALIFORNIA DIFFERENCES

E-file Requirement for Businesses - Beginning January 1, 2015, for taxable years beginning on or after January 1, 2014, any business entity that files an original or amended tax return prepared using tax preparation software is required to electronically file (e-file) their return with the FTB unless a waiver is obtained for one of the following reasons:

- Technology constraints – the inability of the tax preparation software used by a taxpayer to electronically file the return due to the inadequacy of the software or the complex nature of the return,

- Where compliance would result in undue financial burden, or
- Circumstances that constitute reasonable cause and not willful neglect.

Waiver requests may be submitted directly to the FTB by an online fillable form on the FTB's website: https://www.ftb.ca.gov/professionals/busefile/Business_eFile_Waiver_Request.asp

For this purpose, "business entity" means a corporation, including an "S" corporation, an organization exempt from tax pursuant to Chapter 4 (commencing with Section 23701) of Part 11, a partnership, or a limited liability company.

A penalty for failing to file electronically will be assessed against the taxpayer (not the preparer) for returns filed for taxable years beginning on or after January 1, 2017. The penalty is $100 for an initial failure and $500 for each subsequent failure unless the failure is due to reasonable cause, and not willful neglect.

E-Pay Requirement - California Assembly Bill (AB 1245) (Chapter 222, Statutes of 2015) requires all employers to electronically submit employment tax returns, wage reports, and payroll tax deposits to the EDD. This law became effective for employers with 10 or more employees January 1, 2017 and for all employers January 1, 2018.

Penalties - Filing paper returns instead of electronically filing when required will result in the following penalties:

- Quarterly Contribution Return and Report of Wages (DE 9) - $50 per return
- Quarterly Contribution Return (DE 3D) - $50 per return
- Quarterly Contribution Return and Report of Wages (Continuation) (DE 9C) *-$20 per wage item*
- Payroll Tax Deposit (DE 88) – 15% of the amount due.

Waiver - Employers may request a waiver from the electronic filing mandate due to:

- Lack of automation,
- Severe economic hardship,
- Current exemption from the federal government, or
- Other good cause.

The E-file and E-pay Mandate Waiver Request (DE 1245W) can be downloaded at: www.edd.ca.gov/pdf_pub_ctr/de1245w.pdf

Waiver requests, which cannot be filed retroactively, must be received by the final filing date of the quarter for which the taxpayer is requesting that the waiver begin. Requests received after the due date for the quarter requested will be processed for the subsequent quarter. An approved waiver will be valid for four consecutive quarters beginning with the effective quarter, and to avoid a non-compliance penalty when the waiver expires, an employer must start to electronically file and pay, or submit a new waiver request.

Above-the-line Health Insurance Deduction - The amount of above-the-line health insurance premiums deductible for California income tax purposes is the same as the amount deductible for federal income tax purposes, so no California adjustment is required. (R&TC Section 17201.1)

Education Expenses - Since California does not allow an education credit, a sole proprietor's business-related education expenses would be deductible only on Sch. C for CA.

Family Employment - No California Unemployment Insurance, Education Training Tax or State Disability Insurance (SDI) is required for wages paid to children under age 18 employed by a parent (or partnership of parents only), a spouse employed by a spouse, or a parent employed by a son or daughter. They are subject to personal income tax withholding and may apply for elective SDI coverage.

NOTES

ACCOUNTING METHODS

Overview

A taxpayer **filing its first return** may adopt any permissible method of accounting in computing taxable income for such year (Reg. Sec. 1.446-1(e)(1)). Permissible methods generally include Cash and Accrual, but the **accounting system used must clearly reflect income** (Reg. Sec. 1.446-1(2)).

- But you generally can't use the cash method if there is inventory unless an exception discussed in the following dialog applies.
- Generally C-corporations and partnerships with a C-corporate partner could not establish the cash method of accounting in their first year if their gross receipts exceeded $10 Million (Sec 448(a) and Rev. Proc. 2002-28) prior to 2018 (TCJA) and cannot use the cash method if their gross receipts exceed $25 Million after 2017 ($26 million for tax years beginning in 2019) (TCJA).

Thus, where inventory is not a material factor a taxpayer can generally use the cash method regardless of the amount of gross receipts (except for C-corporations and partnerships with a C-corporate partner as discussed above).

However, the accrual method of accounting is mandatory where the production, purchase or sale of merchandise is a significant income producing factor (Reg. Sec. 1.446-1(a)(4)(i)). Thus where there is inventory, the accrual method of accounting would be mandatory unless a gross income exception applies.

RAPID FINDER

Pubs Forms

Related IRS Publications and Forms

- **Pub 538** – Accounting Periods
- **Form 3115 & Instructions** – Application for Change in Accounting Method

EXCEPTIONS

There are exceptions to the above rules for mandatory use of the accrual method of accouting.

TCJA

TCJA Post-2017 Exception - TCJA (effective beginning in 2018) allows businesses (termed "small business taxpayers") to use the cash method of accounting if they have average annual gross receipts of $25 million (indexed for inflation after 2018) or less during the preceding three years. The amount is $26 million for tax years beginning in 2019. In addition the taxpayer's method of accounting for inventory won't be treated as failing to clearly reflect income if the method: (Code Sec. 471(c)(1)(B))

(1) Treats inventory as non-incidental materials and supplies (Code Sec. 471(c)(1)(B)(i)), or
(2) Conforms to the taxpayer's method of accounting reflected in an "applicable financial statement" (i.e., an AFS, defined below) of the taxpayer for that tax year or, if the taxpayer doesn't have any AFSs for the tax year, the taxpayer's books and records prepared in accordance with the taxpayer's accounting procedures (Code Sec. 471(c)(1)(B)(ii)).

Sole Proprietorship - In the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship is a corporation or partnership. (Code Sec 471(c)(3))

Exceptions - The provision retains the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities are allowed to use the cash method without regard to whether they meet the $25 million gross receipts test, **so long as the use of such method clearly reflects income** (Committee report).

Consistent with present law, the cash method generally may not be used by taxpayers, other than those small business taxpayers, i.e, those that meet the $25 million gross receipts test, if the purchase, production, or sale of merchandise is an income-producing factor. In addition, the cash method may not be used by a tax shelter (Committee report).

Change In Accounting Method – The cash basis accounting exceptions to accrual accounting are permissive and a taxpayer wishing to switch to cash accounting under these TCJA provisions can change accounting methods by using Form 3115 – Application for Change in Accounting Method. Per Rev Proc 2018-40, the IRS will provide automatic consent to a small business taxpayer's application to change to the cash method of accounting.

Applicable Financial Statement (AFS) – For purposes of this exception, an AFS is defined by reference to Code Sec 451(b)(3), and is a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is:

- A 10–K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the U.S. Securities and Exchange Commission (SEC) (Code Sec 451(b)(3)(A)(i)),
- An audited financial statement of the taxpayer which is used for credit purposes, reporting to shareholders, partners or other proprietors, or to beneficiaries (Code Sec 451(b)(3)(A)(ii)), or any other substantial nontax purpose (but only if the taxpayer doesn't have a statement described in the bullet just above), or
- Filed by the taxpayer with any other Federal agency for nontax purposes, but only if there's no statement as described in the two bullets above (Code Sec 451(b)(3)(A)(iii)).
- A financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government which is equivalent to the U.S. SEC and which has reporting standards not less stringent than the standards required by the SEC, but only if there is no statement of the taxpayer described in the three bullets above (Code Sec 451(b)(3)(B)), or
- A financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Treasury Secretary, but only if there is no statement of the taxpayer described in the bullets above (Code Sec 451(b)(3)(C)).

Pre-2018 Exceptions - There are two exceptions to the accrual method:

$1 Million or Less Average Gross Receipts - Taxpayers (other than tax shelters) with 3-year average annual gross receipts of $1 million or less do not have to account for inventories or use an accrual method of accounting. Businesses permitted to use the cash method under this exception that **do not want to account for inventories** (Rev. Proc. 2001-10) must treat all inventoriable items (e.g., items purchased for resale and raw materials purchased for use in producing finished goods) in the same manner as non-incidental materials and supplies, deductible in the year in which they are first used or consumed in the taxpayer's operations (Reg. § 1.162-3(a)(1)).

Taxpayers qualifying for the exception and that do not want to use inventories must treat merchandise inventory in the same way that cash method taxpayers are required to treat materials or supplies (other than incidental costs) under Reg. 1.162-3. Thus, taxpayers using the cash method under Rev. Proc. 2001-10 may not deduct merchandise costs until the year in which the merchandise is consumed, used, or sold. The procedure says that taxpayers may use any reasonable method of estimating the amount of raw materials and finished goods inventory to determine the amount of raw materials used to produce finished goods during the year, provided that method is used consistently. Apart from the simplified bookkeeping this procedure allows, the main advantage of IRS's liberalized allowance of the cash method is deferral of income until payment is received, rather than accounting for the income when billed

Over $1 Million and Up To $10 Million Average Gross Receipts – Another pre-2018 exception applies to taxpayers (other than tax shelters) with 3-year average annual gross receipts of over $1 million and up to $10 Million (Rev. Proc. 2002-28) that also do not wish to account for inventories or use an accrual method of accounting, provided they are **NOT** any one of the following North American Industry Classification System (NAICS) businesses:

- Retailing (NAICS codes 44 – 45);
- Wholesaling (NAICS code 42);
- Manufacturing (NAICS codes 31 – 33);
- Mining (NAICS codes 211, 212);
- Publishing (NAICS code 5111); or
- Sound recording (NAICS code 5112).

Rev. Proc. 2002-28 does not apply to a farming business of a qualifying small business taxpayer. However, farmers generally are allowed to use the cash method for their farming business anyway.

The Details

A taxpayer ***adopts an accounting method*** when he uses it to file his/her first return (a change later requires IRS consent). The method chosen must:

- Clearly reflect income, and
- Be consistent on a year-by-year basis.

The three most commonly used accounting methods are: **Cash - Accrual - Hybrid**

CASH RECEIPT AND DISBURSEMENT METHOD

Under this accounting method, amounts received are included in gross income in the year of actual or constructive receipt, regardless of whether the income is earned in that year. Expenses are usually deducted in the year paid. All that is needed for income recognition is that the amounts have a FMV (i.e., a cash equivalent). So if a cash method taxpayer receives a note in payment of services, there is income in the year of receipt of the note equal to its **FMV**. **Note:** A creditor's promise to pay (without a formal note) is not considered to have a FMV--thus, no income is received.

Example - Cash Basis Gross Receipts: *Rich, a CPA, reports income using the cash method. In 2019, he did an audit for T Corporation for which he billed $5,000. He collected this amount in 2019. He had also performed an audit in 2018 for D, Inc. Unfortunately, D, Inc. was in poor financial condition, and Rich took a secured note for $8,000 from the company for the audit fee. This occurred in 2018. The FMV of the note is $6,000. Rich actually collected $8,000 on the note in 2019. His gross incomes for 2018 and 2019 are:*

	2018	***2019***
FMV of note from D, Inc.	*$6,000*	
Cash received - T Corp's payment		*$5,000*
D, Inc.'s payments		*8,000*
Less: *Recovery of capital*		*<6,000>*
Total gross income	*$6,000*	*$7,000*

Receipt of a check is considered a cash equivalent. For this reason, a cash basis taxpayer recognizes income when a check is received--even if the check is received after banking hours.

Exception to "normal" cash basis rules - constructive receipt: Income that hasn't actually been received by a taxpayer is taxed as though it had been, if the following are true:

- The amount is readily available to the taxpayer.
- The taxpayer's actual receipt isn't subject to substantial restrictions.

The rationale behind constructive receipt is that if income is available, the taxpayer shouldn't be allowed to postpone income recognition. Many times, constructive receipt determination is simply a judgment call--based on the facts and circumstances.

Example 1 - Constructive Receipt: *Randy was a member of a barter club. In 2019, he performed services for several club members and earned 1,500 points. Each point meant that he was entitled to $1 in goods and services sold by others in the club. The points could be used at any time. In 2020, Randy exchanged his points for a big screen TV. He must recognize $1,500 in income in '19 when the points were credited to him.*

Example 2 - Constructive Receipt: *On 12/31/18 Linda's employer gave her a bonus check, but asked her to hold it until 01/19 so that the employer could deposit funds to cover the check. The check amount is income to Linda in 2019 when it became cashable.*

Example 3 - Constructive Receipt: *Ken is a key employee of ABC Company. The company gave stock valued at $12,000 to Ken. However, the stock couldn't be sold for 5 years. Ken isn't required to recognize income for the stock until the restrictions on the stock lapse. (IRC §83)*

Example 4 - Constructive Receipt: *Landlord Lionel received a security deposit from a new tenant to pay for apartment damage during the tenant's period of occupancy. If no damage occurs, Lionel is required to return the deposit to the tenant. The deposit is not income to Lionel in this case. He will recognize income to the extent of the deposit amount he doesn't return to the tenant in the year he returns the deposit to the tenant. If the deposit had been a prepayment of rent, it would be income in the year received.*

Actual Cases:

Patch, TC Memo 1995-449. *A bank robber was required to report stolen cash as income in spite of the fact that he paid it back the next year. The court stated, "a taxpayer who unlawfully acquires cash has possession and receives gross income in the taxable year that he unlawfully acquires the cash, even though he makes restitution in a later year."*

TAM 9519002. *Advances to a life insurance agent after life insurance policies were sold were considered taxable income in the year they were received. These advances were not loans, but compensation for past services.*

Childs, Richard A., 103 TC No. 36 (1994). *Partners in a law firm had fees paid under a structured format; they only reported the cash received. The IRS sought to tax them on the FMV of an arrangement in the year a tentative settlement was made. The Tax Court held, however, that the attorneys never had the right to receive full payment, because they didn't have ownership until actual settlement was received.*

ACCRUAL METHOD

With the accrual method, include amounts in gross income when they are earned, even though payment may be received in another year. Income is earned when:

- All events have occurred that fix the right to receive the income, and
- The amount to be received can be determined with reasonable accuracy.

Generally, a taxpayer's right to income accrues when title to property passes to the buyer or services are performed for customers. If there is potential for refund, the income is reported in the year of sale and a deduction is allowed in subsequent years when actual claims accrue.

When a taxpayer's right to income is contested, the year of income inclusion depends on whether payment has been received. If payment hasn't been received, no income is recognized until the claim is settled. However, if the payment is received prior to settlement of the dispute, the claim-of-right doctrine requires the taxpayer to recognize the income in the year of receipt.

Measurement of the income on accrual basis*:* The amount of income to report is the amount the taxpayer has a right to receive (contrast this with the cash method above).

Expenses: Expenses are claimed when a taxpayer becomes liable for them, whether or not they are actually paid in the same year.

Accrual method must be used for businesses maintaining inventory, except as noted below. The following must use the accrual method:

- Corporations (not S corps);
- Partnerships with a corporate partner;
- Tax Shelters.

The accrual requirement has these exceptions: (a) Family farming corporations; (b) Qualified personal service corporations and partnerships with a qualified personal service corporation as a partner; (c) C corps and partnerships (not tax shelters) with average annual gross receipts for the most recent 3-year period of $5 million or less. **Note:** See above for rules added by Revenue Procedures 2001-10 and 2002-28 for small businesses prior to 2018 and TCJA of 2017 for years after 2017. Situations where accrual method isn't applied even with an accrual basis taxpayer:

- **Prepaid income**: When it comes to financial reporting, advance payments are reflected as prepaid income and liabilities of the seller. For tax purposes, though, prepaid income is often taxed in the year of receipt. When the income should be reported often becomes a sore point between the IRS and taxpayers.
- **Advance payments for goods:** Generally, a taxpayer can elect to defer income recognition for advances paid for goods if the method of accounting for the sale is the same for both tax and financial reporting purposes.

> ***Example - Advance Payment for Goods:*** *Vance & Co. ships goods only after payment for them is received. In December 2019, Vance got $8,000 for goods not shipped until January 2020. Vance can elect to report the income for tax purposes in 2019, assuming they report the income the same way on their 2019 books.*

- **Advance payment for services: *Rev. Proc. 71-21*** allows accrual basis taxpayers to defer recognition of income for services to be performed by the end of the tax year following the year of receipt. No deferral is allowed, however, if the taxpayer might be required to perform any services, under the agreement, after the tax year following the year of receipt of the advance payment.

Example - Advance Payment for Services: *Z Corp, an accrual basis taxpayer, services office equipment under 12-month, 18-month, and 24-month contracts. The services are provided to customers on a monthly basis. In April 2018, Z Corp sold the following contracts:*

Term of Contract	*Advance Payment*
1 Year	*$6,000*
1-1/2 Years	*3,600*
2 Years	*2,400*

- *$1,500 of the $6,000 payment may be deferred to '19 (3/12 x $6,000).*
- *$1,800 of the $3,600 may be deferred (9/18 x $3,600), since those amounts won't be earned until 2019.*
- *The whole $2,400 received on the 2-year contract is taxable in 2018. This is due to the fact that part of the income will still be unearned by the end of the tax year following year of receipt.*

Rev Proc 71-21 doesn't apply to prepaid rent, or prepaid interest.

TCJA change re advance payments for accrual method taxpayers: For tax years beginning after 2017, an advance payment or other prepaid income received during the tax year must either be included in gross income for the tax year of receipt or the taxpayer must make an election to defer the inclusion of the payment in gross income with respect to the category of advance payments to which it belongs. (Code Sec. 451(c)). When the deferral election is made, the part of the advance payment that must be included in gross income in the year payment is actually or constructively received is the portion of the advance payment required to be included as gross income in the taxpayer's AFS. The remainder is included in gross income in the following year. See IRS Notice 2018-35 for further information.

HYBRID METHOD

The most common hybrid accounting method is a combination of cash and accrual. Generally, this combination is used when inventory is an income-producing factor. To simplify recordkeeping, a taxpayer accounts for inventory using accrual and uses the cash method for all other income and expense items.

The hybrid method is primarily used by small businesses - Income that hasn't actually been received is taxed as though received (constructive receipt). Accrual is allowed for sales and purchases, cash for operating expenses. However, if the cash method is used for sales and purchases, then it must also be used for expenses.

ONE TAXPAYER WITH SEVERAL BUSINESSES

Different accounting methods can be used for each business as long as the methods clearly reflect income. Separate books and records must be kept for each business, and a taxpayer can't create or shift income or losses between businesses.

CHANGE OF ACCOUNTING METHOD

A taxpayer's choice of accounting method on his/her first tax return controls the accounting method to be used in future years. To change an accounting method, IRS consent is needed. File Form 3115, Application for Change in Accounting Method, to obtain consent. Unless the change is "automatic" (see below), as of Februar 1, 2019, a user fee of $10,800 applies. A reduced fee of $7,600 applies to taxpayers with a personal or business-related tax issue whose gross income is less than $1 million but over $250,000 or a fee of $2,800 for taxpayers with a personal or business tax issue whose gross income is less than $250,000 (see Rev. Proc. 2019-1, Appendix A). These fees are subject to change annually.

Starting August 16, 2017, when requesting an accounting method change for which a user fee is required, taxpayers will only be able to make the user fee payment through the federal government's Pay.gov system. Since Pay.gov is used only to accept payments, the original, signed request and any supporting materials must still be submitted to the IRS. This electronic payment requirement also applies to requests for letter rulings and certain other rulings. (IR 2017-102) Pay.gov accepts payments using a credit card, debit card, or via direct debit or electronic funds withdrawal from a checking or savings account.

The following are some considered accounting method changes that require IRS approval:

- A change from accrual to cash if not an eligible small business taxpayer;
- A change in the method of basis used to value inventory;
- A change in the method of figuring depreciation (other than permitted changes to straight-line for property placed in service before 1981).

On the other hand, these changes don't require any approval:

- A change from cash to accrual, or for eligible small business taxpayers, from accrual to cash;
- Corrections of math or posting;
- Corrections of errors in computing tax liability;
- Adjustments to income or deductions that involve timing of inclusion or deduction;
- Adjustments to the useful life (not the recovery period of ACRS or MACRS assets) of depreciable property.

NOTE:
Accounting changes related to tangibe property capitalization and repairs are covered in chapter 3.27

Automatic Change Procedures: The automatic change procedures were instigated to simplify and encourage compliance to IRS guidelines. The automatic change procedures may apply to changes in the following:

- Trade and business expenses;
- Depreciation or amortization (including changing impermissible depreciation methods);
- Research and experimental expenses;
- Capital expenses;
- UNICAP rules;
- Plan contributions and deferred compensation under Code Section 404;
- Method of accounting;
- Discount obligations (bonds, etc.);

- Prepaid subscription income;
- Inventories;
- LIFO issues.

For a complete list of accounting method changes to which the automatic change procedures apply see Rev. Proc. 2018-31, modified by Rev. Proc. 2018-35 (related to certain costs for replanting citrus plants after the loss or damage of citrus plants), Rev. Proc. 2018-40 (relates to small business taxpayers changing to overall cash method), Rev. Proc. 2018-44 (concerns the Sec 481(a) adjustment), Rev. Proc. 2018-49 (modifies Rev Procs 2018-31 and 2018-29), Rev. Proc. 2018-56 (modifies Rev. Proc. 2018-31 to provide additional automatic method changes under §1.263A-1, -2, and -3 to assist taxpayers in complying with the final regulations), and Rev. Proc. 2018-60 (modifies Rev Proc 2018-61 related to the timing of income recognition under §451(b) for a taxpayer with an applicable financial statement (AFS)).

Filing Form 3115: Individuals, partnerships, corporations (C and S), personal service corporations, cooperatives, insurance companies, controlled foreign corporations, estates and trusts, and tax-exempt organizations use this form to request an accounting method change. If the change is one for which automatic consent is granted, the completed Form 3115 must be filed in duplicate, and by the due date (including extensions) for the return for the year of the change. The original 3115 is attached to the taxpayer's return, and a signed copy of the application must be filed with the IRS in Ogden, UT no earlier than the first day of the year of the change (and no later than the filing of the original with the return). The mailing address is included in the 3115 instructions, available at: https://www.irs.gov/pub/irs-pdf/i3115.pdf. The IRS does not send acknowledgements of receipt for automatic change requests.

For non-automatic change requests Form 3115 must be filed during the tax year for which the change is requested, unless otherwise provided by published guidance. (See Rev. Proc. 2015-13, section 6.03(2)). Form 3115 is filed with the IRS National Office at the address listed in the address chart in the 3115 instructions. The Form 3115 should be filed as early as possible during the year of change to provide adequate time for the IRS to respond prior to the due date of the taxpayer's return for the year of change. The IRS normally sends an acknowledgment of receipt within 60 days after receiving a Form 3115 filed under the non-automatic change procedures.

No extensions for filing Form 3115 are granted unless for very unusual circumstances and an additional fee may apply. However, a taxpayer filing for an **automatic change** is granted an **automatic extension of six months** from the unextended due date of the return for the year of change if the taxpayer: (1) timely filed (including extensions) its federal income tax return for the year of change, (2) files an amended return within the six-month extension period in a manner consistent with the new accounting method, (3) attaches the original application to the amended return, (4) files a copy of the application with the Ogden office no later than when the original is filed with the amended return, and (5) attaches a statement to the application that the application is being filed pursuant to Reg. §301.9100-2. (Rev. Proc. 2015-13, 6.03(4)(a)).

Income Adjustments: When changing an accounting method under the various revenue procedures noted above, an income adjustment is required under ***§481***. This adjustment must be made to account for changes in taxable income due to the change. The adjustment is made over 4 tax years beginning with the year of the change. However, a taxpayer can elect to account for an adjustment in one year if the total is less than $50,000 (Rev Proc 2015-13). It is probably best for taxpayers to accelerate negative adjustments of less than $50,000 into one year and use the 4-year period for positive adjustments. There are no different adjustment periods for different categories of accounting method changes.

Example - A Change from Cash to Accrual: *Moran got permission from the IRS to change its accounting method from cash to accrual for reporting cost of goods sold. The firm's* ***accrual basis gross profit*** *for 2019 is computed as follows:*

Sales		*$100,000*
Beginning inventory	*$ 15,000*	
Purchases	*60,000*	
Less: Ending inventory	*<10,000>*	
Cost of goods sold		*<65,000>*
Gross profit		*$ 35,000*

- ***Adjustments to above calculation:*** *At the end of 2018, Moran had accounts receivable of $25,000 and accounts payable for merchandise of $34,000.*
- ***Handling the Receivables:*** *The receivables of $25,000 were never included in income since Moran was on the cash basis in 2018. In 2019, the $25,000 wasn't included in the accrual basis sales since the sales were made in the prior year. Thus, a $25,000 adjustment to income is required to prevent the receivables from being left out altogether.*
- ***Handling the Payables:*** *In addition, the $34,000 in payables must be considered. They weren't included in 2019 purchases shown above nor were they taken as deductions in 2018.*

- ***Inventory:*** *Another adjustment is needed to correctly reflect the $15,000 beginning inventory that Moran had deducted in the previous year due to the cash method. The cost of goods sold shown above for 2019 was increased by the beginning inventory and resulted in a double deduction.*
- ***Net Adjustment:*** *The net adjustment due to the accounting method change, then, is:*

Beginning inventory (deducted in both 2018 and 2019)	*$15,000*
Beginning accounts receivable (never included in income)	*25,000*
Beginning accounts payable (not deducted)	*<34,000>*
Net increase in taxable income	*$ 6,000*

INVENTORY

Inventory is a frequent audit target. This audit issue will likely lessen for most small businesses, since for tax years beginning after 2017, a business is not required to use inventories or account for them using the accrual method if it meets the $25 million gross receipts test explained above for using the cash method of accounting. Therefore, the information below will now generally apply only to larger businesses that don't meet the gross receipts test.

Rules for inventory when inventories are required:

- Inventories are necessary for a business to clearly reflect income when there is sale of goods. They must conform to the best accounting practice in a trade or business.
- Inventories include all finished goods, goods in process, and raw materials and supplies that will become part of the product (including containers).
- Physical possession of merchandise is not required for it to be part of inventory.
- Methods used to handle and value inventory must be followed consistently.
- Inventory must be valued at either (1) cost, or (2) lower of cost or market value.

Determining inventory cost:

- **Cost:** Use actual cost of merchandise, less discounts plus freight and other handling charges.
- **Uniform capitalization (UNICAP):** ***§263A*** significantly affects inventory rules. For inventory and property produced by a taxpayer, (a) the direct cost of such property, and (b) such property's share of those indirect costs (including taxes) part or all of which are allocable to such property must be capitalized. To value inventory under UNICAP, a producer must:
    1. Classify all costs into these categories: (a) production, (b) general administration, and (c) mixed services.
    2. Allocate mixed service costs (on a reasonable basis, e.g., according to number of employees, or using an elective method) to production and general administration expenses.
    3. Allocate production costs between the cost of goods sold and ending inventory.
- **Lower of Cost or Market:** This valuation method is available for most taxpayers except those who use the Last-In-First-Out Method (LIFO) method. LIFO users must value inventory at cost. Write-down of damaged merchandise is not considered an application of the lower of cost or market method. To use this method, each item in inventory must be valued at lower of cost or market.

Estimating inventory shrinkage: A taxpayer's inventory must be maintained under a method that clearly reflects income. Normally inventory is valued at cost. Under former law, it was uncertain as to whether a taxpayer was in compliance with allowable inventory valuation rules when the taxpayer made adjustments to year-end inventory for estimated "shrinkage"--i.e., inventory decrease due to items such as undetected theft, breakage, bookkeeping errors, etc.

Under current law, the adjustment for estimated inventory shrinkage may only be claimed by the taxpayer (business) if:

- The taxpayer normally does a physical count of inventories at each location on a regular, consistent basis, and
- The taxpayer makes proper adjustment to those inventories and to estimating methods if those estimates are greater than or less than the actual shrinkage.

CALIFORNIA DIFFERENCES

New Law & Stuff

AB 91 (signed by the governor 6/27/2019) generally brings California into conformity with the accounting method simplifications made by the TCJA. The legislation is effective for tax years beginning on or after January 1, 2019. This is one year later than the Federal effective date of 2018 which creates a disparity for the 2018 tax year between federal and CA law.

Retroactive Elections - However, AB 91 also included a provision allowing taxpayers to make a retroactive election to have the new rules apply to tax year 2018. While CA develops final procedures a taxpayer can retroactively adopt the new Federal small business accounting rules on either an original or amended paper-filed 2018 CA return by doing the following:

- Include a statemenrt stating the taxpayer is electing the Federal TCJA small business accounting for a year beginning on or after January 1, 2018. Specify in the statement which election(s) is/are being adopted.
- Add “AB 91 – Small Business Accounting Election” in blue ink on the top of the first page.
- Mail the return to: Franchise Tax Board, PO Box 942857, Sacramento, CA 94257-0500

NOTES

PROFIT MOTIVE

RAPID FINDER	
Court Cases	3.02.03
Delay Determination	3.02.02
Factors – Profit Motive	3.02.01
Form 5213	3.02.02
Hobby Loss	3.02.01
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Presumption, Profit	3.02.02
Profit Presumption	3.02.02
SE Tax	3.02.03
Trade or Business	3.02.01

- Profit Presumption
  - Breeding, training, showing or racing horses if a profit in 2 of 7 consecutive years
  - Other businesses if a profit in 3 of 5 consecutive years
- Limit on deductions and losses – order of use
  - Home mortgage interest, taxes, casualty losses
  - Deductions that don't reduce basis
  - Deductions that do reduce basis (i.e., deprecation)

HOBBY LOSS RULES

Although this chapter's title is Profit Motive, these rules are also commonly referred to as the hobby loss rules. Under the hobby loss rules, where an activity of the taxpayer is deemed to be a hobby (not for profit) the income is reported on line 8 (other income), Schedule 1, of the 2019 draft of Form 1040 (Schedule C Instructions, Page 1) and any deductions, to the extent of the income, are reported as an itemized deduction on Schedule A. Since such an activity generally has no profit there are no SE tax issues.

However under TCJA, tier 2 miscellaneous deductions are suspended for years 2018 through 2025. Therefore for those years, hobby expenses will not be deductible, making the entire income from a hobby taxable.

Sporadic or one-shot deals, hobbies, or diversions are not a trade or business and therefore not subject to SE tax (Commissioner v. Groetzinger, SCt, 87-1 and Langford v. Commissioner, Dec. 44,891(M), TC Memo. 1988-300, aff'd, CA-6,). Thus a hobby is taxable for income tax purposes but not for self-employment tax.

DETERMINING IF AN ACTIVITY IS REALLY A BUSINESS

The tax law doesn't really give a definition of the term ***"trade or business,"*** probably because no single definition will apply in all cases. But certainly to be considered a trade or business, an activity must be motivated by the taxpayer's profit motive (even if that motivation is unrealistic!) ***(Reg. §1.183-2(a)***. Along with profit motive, the taxpayer must carry on some kind of economic activity.

In ***Gajewski, R v. Comm., 723 F2d 1062 (USCA 2, 12-15-83)***, the court held that a taxpayer who didn't hold himself out to others as offering goods or services, wasn't in a trade or business. **Note:** Taxpayer was a professional gambler who bet solely for his own account. Denial of his business deductions "above the line" turned the expenses into Schedule A deductions. The result was that minimum tax kicked in for the taxpayer.

In ***Ditunno v. Comm., 80 TC 363 (1983)***, the court ruled that the proper test of whether an individual was carrying on a trade or business required examination of ***all facts involved***. Here a full-time gambler was determined to be in a trade or business of gambling and his gambling losses were business expenses, even though they weren't related to offering goods and services. The taxpayer had no other gainful employment.

In ***Groetzinger (1987, S Ct) 82 TC 792 (1984),*** the Supreme Court held that a full-time gambler who bet solely on his own account was engaged in a trade or business of gambling. This prevented his gambling losses from being tax preference items for the purpose of computing minimum tax.

FACTORS USED TO DETERMINE IF AN ACTIVITY IS ENGAGED IN FOR PROFIT

No one factor is decisive, but all must be considered together in making a determination of whether an activity is for profit. The factors are:

(1) **Is the activity carried on in a businesslike manner?** Maintenance of complete and accurate records for the activity is a definite plus for a taxpayer, as is a business plan that formally lays out the taxpayer's goals and describes how the taxpayer realistically expects to meet those expectations.

(2) **How much time and effort does the taxpayer spend on the activity?** The IRS looks favorably at substantial amounts of time spent in the activity, especially if the activity has no great recreational aspects. Full-time work in another activity is not always a detriment if a taxpayer can show the activity is regular; time spent by a qualified person hired by the taxpayer can also count in the taxpayer's favor.

(3) **Does the taxpayer depend on the activity for a source of income?** This test is easiest to meet when a taxpayer has little income or capital from other sources (i.e., the taxpayer could not afford to have this operation fail).

(4) **Are losses from the activity the result of sources beyond the taxpayer's control?** Losses from unforeseen circumstances like drought, disease, fire, etc., are legitimate reasons for not making a profit. The extent of losses in a start-up phase of a business also needs to be looked at in the context of the kind of activity involved.

(5) **Has the taxpayer changed business methods in attempts to improve profitability?** Document efforts of the taxpayer to turn the activity into a profit-making venture.

(6) **What is the taxpayer's expertise in the field?** Extensive study of this field's accepted business, economic, and scientific practices by the taxpayer before entrance into the activity is a good sign that profit intent exists.

(7) **What success has the taxpayer had in similar operations?** Document how the taxpayer turned a similar operation to a profit-making venture in the past.

(8) **What is the possibility of profit?** Even though losses might be shown for several years, the taxpayer should try to show that there is <u>realistic</u> hope of a good profit.

(9) **Will there be a possibility of profit from asset appreciation?** Although profit may not be derived from current operations of an activity, asset appreciation could mean the activity will realize a large profit when assets are disposed of in the future. However, the appreciation argument may mean nothing without the taxpayer's positive action to make the activity profitable in the present.

PRESUMPTION OF PROFIT MOTIVE

There is a *presumption that a taxpayer has a profit motive* if an activity shows a profit for any **three or more years during a period of five consecutive years**. However, if the activity involves breeding, training, showing or racing horses, the period is two out of seven consecutive years. (Reg Sec 1.183-1)

Election To Delay Determination of Profit Intent - A taxpayer may elect to get an IRS determination of whether an activity is for profit if he/she does so before the end of the fourth tax year (sixth year for horse activities) following the year he/she first engages in the activity. In effect, the election suspends the application of the presumption until the taxpayer has a chance to prove himself/herself in the activity. The election can be made within three years of the unextended due date of the return for the year the taxpayer first engaged in the activity. However, it can't be made later than 60 days after the taxpayer receives a written notice from the IRS that proposes to disallow deductions attributable to a not-for-profit activity.

To make the election, file ***Form 5213, Election to Postpone Determination as To Whether the Presumption That an Activity is Engaged in for Profit Applies.*** This form is not filed with a taxpayer's tax return, but is filed separately with the IRS Service Center where the taxpayer normally files a return or with the office that sent a disallowance of deductions notice if applicable. The election automatically extends the statute of limitations until two years after the date for filing the return for the last year of the presumption period. This extension applies only to the activity for which the taxpayer has made the election.

HOBBY LOSS OR NOT FOR PROFIT LOSS

The question sometimes arises what is the difference between a "hobby loss" and "not for profit determination"? In actuality, they end up being treated the same for income tax purposes. The hobbyist does what he does because he enjoys doing it, didn't do it with the goal of making a profit and maybe gets a little income from it. Someone who thinks they are in a trade or business but doesn't conduct the activity in a businesslike way and ends up with a loss may find the IRS making the determination the taxpayer wasn't in it to make a profit after all.

LIMIT ON DEDUCTIONS AND LOSSES

If an activity is not carried on for profit, deductions are used only in the following order, are limited to three categories, and are allowed ***only if a taxpayer itemizes***.

Category 1. This category includes deductions for home mortgage interest, taxes, and casualty losses. Report them on the appropriate lines of Schedule A.

Category 2. Deductions that don't result in an adjustment to the basis of property are allowed next, **but only to the extent gross income from the activity is more than the deductions under Category 1**. Most business deductions, such as those for advertising, insurance premiums, interest, utilities, wages, etc., belong in this category.

Category 3. Business deductions that decrease the basis of property are allowed last, **but only to the extent the gross income from the activity is more than deductions under the first two categories**. The deductions for depreciation and amortization belong in this category.

Additional limit PRIOR to 2018 - Individuals must claim the amounts in categories (2) and (3) as miscellaneous deductions on Schedule A, subject to the 2% of AGI reduction, **and as a result**, they are not deductible for alternative minimum tax.

Additional limit AFTER 2017 – Due to the itemized deduction limitations imposed by TCJA the ability to deduct not-for-profit activity expenses other than home mortgage interest and taxes has been suspended for the years 2018 through 2025. That is because casualty losses (other than disaster losses) and miscellaneous deductions subject to the 2% of AGI reduction (tier 2 deductions) are suspended and therefore not allowed at all for 2018 through 2025. This includes depreciation which for a not-for-profit activity would be a tier 2 miscellaneous deduction. As result, the calculation illustrated below will not apply for years 2018 through 2025.

EXAMPLE - Not-For-Profit Computation – Allocation of Category 1 through 3 deductions for years other than 2018 through 2025 - *Ray is engaged in a not-for-profit activity. The income and expenses of the activity are as follows:*

Gross income		*$3,200*
Less expenses:		
Real estate taxes	*$700*	
Home mortgage interest	*900*	
Insurance	*400*	
Utilities	*700*	
Maintenance	*200*	
Depreciation on car	*600*	
Depreciation on machine	*200*	
Total expenses		*3,700*
Loss		*$ 500*
Limit on deductions		*$3,200*
Taxes and interest	*1,600*	
Insurance, utilities and maintenance	*1,300*	*2,900*
Available for depreciation		*$ 300*

The $300 for depreciation is divided between the car and machine (and the basis reduced accordingly), as follows:

$600/$800 x $300 = $225 depreciation for car

$200/$800 x $300 = $75 depreciation for machine

The $1,600 for Category (1) items is deductible as part of the taxes and interest expense on the appropriate lines on Schedule A. The remaining $1,600 (the total of Categories (2) and (3)) is added to Ray's other miscellaneous deductions on Schedule A (Form 1040) that are subject to the 2% limit.

Self-Employment Tax – A trade or business for purposes of determining whether an individual has self-employment income, subject to the self-employment (SE) tax, has the same meaning as when used for federal income tax purposes in allowing trade or business expenditures under Code Sec. 162 (i.e., a continuous, regular activity engaged in with a profit motive) (Code Sec. 1402(c); Reg § 1.1402(c)-1).

However, since the gross income from a not-for-profit activity (hobby) is reported on (1040 Schedule 1, line 8, 2019 draft), make sure your software does not assess SE tax on it since the activity isn't a trade or business. Use Schedule C when the activity is a trade or business of a sole proprietor.

SELECTED CASES INVOLVING PROFIT MOTIVE

Anthony Ranciato v. Com., (1995, CA2) and Ranciato, TC Memo 1996-97 - This case points out that the hobby-loss limits can apply to retail businesses and other traditionally for-profit enterprises. Taxpayers engaging in all activities, not just hobby-type activities, need to operate in a businesslike manner and take steps to demonstrate a profit-making intent. The Second Circuit had questioned whether a retail business can be an activity not engaged in for profit and the Tax Court, on review, countered with an emphatic, "Yes, it can."

Three other cases found that taxpayers lacked a profit objective with respect to businesses typically run for profit: ***Houston, TC Memo 1995-159*** (retail gun store); ***Ypsilantis, TC Memo 1992-644*** (import/export commodities business); and ***Hutchinson, TC Memo 1988-568*** (retail cosmetics business).

Lamb, TC Memo 1996-166, shows that a taxpayer whose business suffers hard times won't necessarily be challenged when he or she claims losses. IRS denied losses to a fisherman, but the Tax Court ruled against the Service. It ruled that the taxpayer's failing health, rather than lack of profit motive, business acumen or effort, accounted for the losses.

Drummond v. Comm., TC Memo, 1997 involved a psychologist's horse and cattle activities. The activities were both determined to be not-for-profit. The taxpayer didn't show that the cattle were kept for horse pasture management and animals weren't kept on the same land. The taxpayer didn't keep adequate books or carry on horse activities in a businesslike manner. He didn't show that he expected the horses to appreciate in value or prove the horses' alleged unforeseen injuries affected the profitability.

In ***Phillips et ux. v. Comm., TC Memo, 1997,*** a nurse anesthetist and wife were engaged in Arabian horse breeding for profit, in spite of initial losses. Taxpayers carried on activities in a businesslike manner where they have a valid business expansion plan, kept accurate records and calculated income necessary to produce profit. Expansion delays resulted from the wife's poor health, the death of a champion mare's 1st foal and the taxpayers' bankruptcy. The taxpayers tried to cut costs by constructing small barns and attempting to sell some horses.

In a review of a tax court decision, ***Courville v. Comm., CA 9, 79 AFTR 2d 97-1636,*** a golfing activity was found to be not-for-profit. Taxpayer's golfing activity was denied in spite of the time and effort the taxpayer put into the activity. The taxpayer didn't keep complete and accurate records and made no profit in 4 years after beginning the activity. The activity also had recreational and personal elements.

In Kelly v. Comm., TC Memo 1997-185, the court denied deductions for state and local taxes and unreimbursed employee business expenses in excess of the amount the IRS allowed. The taxpayer didn't prove the claim that her car was used 95% for business. She didn't show that she made payments on or business use of a leased computer and she didn't support tax deductions.

Lucid, et ux. v. Comm., TC Memo 1997-247 involved a full-time plastic surgeon and psychotherapist. They couldn't deduct their S corporation losses from yacht and boating equipment sales due to lack of profit motive. Despite their advertising in boating magazines and their attendance at boat shows, their activities weren't carried on in a businesslike manner.

CALIFORNIA DIFFERENCES

California follows the federal profit motive rules and that a hobby loss is not deductible. However, unlike federal in years 2018-2025, California allows miscellaneous itemized deductions that are subject to the 2% of AGI reduction. Therefore, a hobbyist who itemizes his or her deductions for California will be allowed to deduct hobby-related expenses within the limits described above in the "Limit on Deductions and Losses" section and the "additional limit prior to 2018" provision, which continues to apply for California post-2018.

NOTES

AT-RISK RULES

Overview

- **At Risk** – To take a deduction, a taxpayer must have:
  - Paid the expenses, OR
  - Be responsible for paying them.
- **Applies to:**
  - Individuals
  - Estates and Trusts
  - Closely held C-corporations
- **At-Risk Activities:**
  - Holding, producing and distributing motion picture films/videotapes
  - Farming
  - Leasing Section 1245 property
  - Oil and gas exploration/exploitation:
    - As a trade or business, or
    - For production of income.
  - Any activity where a taxpayer carries on a trade or business or engages in income production.
  - Real property placed in service after 1986
    - Exception for real estate activities subject to non-recourse financing

RAPID FINDER

Pubs Forms

- **Related IRC and IRS Forms and Publications**
  - **Publication 925 –** Passive Activity and At-Risk Rules
  - **Form 6198 –** At-Risk Limitations
  - **IRC Sec 465**

New Law & Stuff

In Chief Counsel Advice 201805013, the IRS has determined that a taxpayer couldn't treat business activities, conducted through three S corporations and a limited liability company (LLC) in which he was a minority owner, as a single activity for purposes of the at-risk rules. Accordingly, the taxpayer, who had personally guaranteed a line of credit that had been utilized by only the LLC, couldn't deduct losses for all four entities on the basis of the personal guaranty.

The Details

AT RISK - Losses from certain activities are limited to the amount a taxpayer has "at risk" in the activities. The at-risk rules apply to individuals, estates and trusts, and certain closely held C corporations. Form 6198, At-Risk Limitations, must be filed by taxpayers who have a loss from an at-risk activity in which they have invested amounts for which they are not at risk.

What Does It Mean To Be "At Risk"? To take a deduction for an item on a tax return, a taxpayer must have either actually paid for the item or be responsible for paying it. Good intentions aren't enough to put a taxpayer at risk. He/she must have either expended cash for something or become liable to pay for it through a credit purchase. A mere promise to pay is not enough.

Example - The Meaning of At Risk - *John, a self-employed engineer using the cash method of accounting, has subscribed to The Journal of Mechanical Engineers for many years. His subscription expired in November 2018, but he didn't actually renew until January 2019, because he was short on cash. He'd like to take a business expense deduction in 2018 based on his intention to renew. However, since he didn't follow through with the intention in 2018, he gets no deduction on his 2018 return. He would claim the expense on his 2019 return. If John had renewed the subscription by December 31 by charging the cost to his credit card, he would have been at risk even though he had not paid any cash out of pocket, and he then could have deducted the expense on his 2018 return.*

At-Risk Activities - The at-risk rules apply to the following types of activities:

(1) Holding, producing and distributing motion picture films and/or videotapes.

(2) Farming.

(3) Leasing Section 1245 property.

(4) Oil and gas exploration/exploitation as a trade or business or for production of income; Geothermal exploration/exploitation for percentage depletion purposes.

(5) Any other activity where a taxpayer carries on a trade or business or engages in income production. Real property placed in service after 1986 is part of this category. However, there is an exception for real estate activities subject to nonrecourse financing (see additional information below).

Computing the At-Risk Amount - To compute the amount a person has at risk in an activity, add the following amounts:

(a) Cash contributed to the activity;

(b) Adjusted basis of property contributed to the activity;

(c) Amounts borrowed for use in the activity (in the case of investors in a partnership, a partner must generally be personally liable for the repayment or must have pledged property to secure the loan).

The amount at risk [(a) + (b) + (c)] is then either reduced by losses/distributions from the activity or increased by its net profits.

Losses and Recapture - Losses from an activity that are not allowed because of the at-risk limits are treated as deductions from that activity in the following year; the loss carried over can be used as a deduction against the following year's income from the same activity (subject to the amount at risk in the following year). If losses can't be used in the following year, they can be carried over indefinitely to later years until they are able to be used.

Application of at-risk merely limits the amount of losses which can be deducted; it doesn't affect the basis of a taxpayer's asset. Thus, for example, a partner's basis in a partnership interest is generally unaffected by at-risk disallowances.

There is recapture of previously allowed losses when the at-risk amount goes below zero. The application of this rule means that if the amount at risk is reduced below zero (whether by distributions to the taxpayer, changes of liabilities from recourse to nonrecourse, etc.), a taxpayer recognizes income to the extent of the negative amount. This amount is limited to the excess of losses previously allowed in an activity over any amounts previously recaptured. The amount added to income is treated as a deduction allocable to the activity in the first succeeding year and is allowed if and when the taxpayer's at-risk amount increases.

Recapture income isn't treated as income from an activity for purposes of determining whether current or suspended losses are allowed under the passive loss rules. This rule prohibits using losses to offset at-risk recapture income.

Special At-Risk Rules for Real Estate - Generally, taxpayers are not at risk for nonrecourse loans (loans for which they are not personally liable). However, there is an exception to the at-risk limitations for nonrecourse loans on real property when the loans are transacted in arms' length transactions. To qualify for this exception, the lender must not be:

(a) Related to the taxpayer, as defined in ***§267(b)*** (unless the loan provides for commercially reasonable interest and terms);

(b) The seller of the property (or a person related to the seller);

(c) A party who is paid a fee, because of the taxpayer's investment in the property (e.g., a realtor).

At-Risk and Partnership Interests - A partner's at-risk amount is determined using the following information:

(1) The type of activity the partnership is involved in (e.g., real estate, etc.),
(2) Analysis of the partner's capital account on Schedule K-1 (Form 1065), and
(3) The partner's share of partnership liabilities (shown on the K-1 in Part II, item K).

Example - Computing a Partner's At-Risk Amount - *On January 15, Megan invested $20,000 in Rhys Key Business, a limited real estate partnership; she was a 12% owner. Her K-1 from the partnership showed the following information:*

Rental loss	*$26,000*
Share of liabilities:	
Qualified nonrecourse *(First Bank)*	*14,000*
Nonrecourse *(loan on real property owned by partnership & payable to property seller)*	*57,600*
Capital account:	
Capital account 01/01	*0*
Capital contributed	*20,000*
Megan's share of loss	*<26,000>*
Capital account 12/31	*<6,000>*

Megan's amount at risk is $34,000 ($20,000 investment plus her share of qualified nonrecourse liabilities). The nonrecourse liability of $57,600 can't be considered as part of her at-risk amount because it is payable to the seller of the underlying property. Megan will be able to deduct a loss of $26,000 on Schedule E of her tax return (subject, of course, to the passive limitations).

Form 6198 - Form 6198, At-Risk Limitations, is a highly misunderstood form. It serves two purposes in a tax return.

(1) It makes certain that the taxpayer doesn't get a deduction once he/she reaches the limit of risk; and
(2) It tracks disallowed deductions so that they may be used in the future when the at-risk position changes.

The at-risk limit goes down when a taxpayer is able to deduct items on his/her tax return, or when he/she gets distributions from the venture. At-risk limit goes up when a taxpayer has income from the activity or makes a capital contribution to it.

The instructions to Form 6198 say that ***if there is any nonrecourse financing*** in an activity, the form must be filed.

Using Form 6198: Assume Dan invested $20,000 in a limited partnership in January Year #1. He received the following K-1s in Years 1-3.

TAX YEAR	ORDINARY INCOME	PORTFOLIO INCOME
Year #1	<$ 9,000>	$200
Year #2	<$10,000>	$100
Year #3	<$ 8,000>	$ 50

The K-1s do not indicate any recourse or nonrecourse liabilities.

- **Part I:** Part I of Form 6198 reports the income (loss) for the current year. Ordinary income is separated from gains and losses and from other income and other deductions.
- **Parts II and III:** Parts II and III allow for two different ways of finding at-risk amounts. Either can be chosen. The bottom line answer is the amount at risk just before preparing the current-year tax return. If Part II is used, the taxpayer's real basis in the partnership must be known from year to year. Part III is designed to be used if the current basis is not known.
- **Part IV:** Part IV compares the income or loss from Part I with the limit from Part II or III.

Dan's Year #1-#3 6198 Data

Form 6198, Part I	**Year #1**	**Year #2**	**Year #3**
LINE 1: Enter the entire amount of income or loss, even if there is a limit.	($9,000)	($10,000)	($8,000)
LINE 3: Enter the portfolio income	$200	$100	$ 50
LINE 5: The total of ordinary loss and portfolio income	($8,800)	($9,900)	($7,950)

Form 6198, Part II - The income items from Part I should not be included here. This section will show any entries that are reflected on the tax return which affect the at-risk limit.

LINE 6: Balance of Investment			
The amount invested	$20,000		
Year #1 C/O ($20,000 less $8,800).		$11,200	
Year #2 C/O ($20,000 less $8,800 less $9,900).			$1,300
LINE 7 & 9	0	0	
LINE 10(b) Net amount at risk prior to preparation	$20,000	$11,200	$1,300

Form 6198, Part IV

LINE 20: The at-risk amount prior to preparation	$20,000	$11,200	$1,300
LINE 21: Allowed Loss (if passive allowed)	($8,800)	($9,900)	($1,300)

Bottom line for Year #1: *The taxpayer can write off a net loss of $8,800, since the basis in the partnership is $20,000. Note that Line 5 plus Line 10 gives the taxpayer's at-risk limit at the end of Year #1. This number will be used to begin the next year's computation.*

Bottom line for Year #2: *The taxpayer started the year with an at-risk limit of $11,200 and had a net loss of $9,900 passed through from the partnership. The loss can be written off, but now the taxpayer's at-risk limit as of the end of Year #2 is just $1,300. (Line 5 plus Line 10).*

Bottom line for Year #3: *The taxpayer started the year with an at-risk limit of $1,300 and had a net loss of $7,950 passed through from the partnership. The Year #3 loss that can be written off is limited to $1,300 due to the at-risk rules. The remaining $6,650 is disallowed. For Year #4, the at-risk limitation is ($6,650), the amount of the disallowed loss (Line 5 plus Line 10). This disallowed loss can be carried to later tax years if not absorbed by profits or additional investment amounts in Year #4 or later years.*

Several other tax limitations may disallow the losses, which are allowed to pass through due to Form 6198 computations. Always compute the at-risk limit first and use the amount allowed on Form 6198 as the basis for computing the other limits on the tax return--passive limits, capital loss limits, etc.

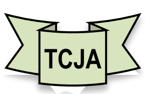
NOTES

MACRS/ADS PROPERTY

MAJOR SUBJECT MATTER INCLUDED IN CHAPTER

RAPID FINDER

- **Bonus Depreciation**



  - Acquired & Placed In Service After 9/27/17
    - 100% through 2022
    - Phase-out 2023 through 2026
  - Acquired Before 9/28/17 and Placed In Service After 9/27/17
    - In Service 2017: 50%
    - In Service 2018: 40%
    - In Service 2019: 30%

Recovery Periods

- **Cost Segregation Depreciation –** See details starting on page 3.04.11.
- **3 Year Property** – Examples: tractor units for over-the-road use, race horses over two years old when placed in service (all race horses regardless of age 2009 through 2017), other horses over twelve years old when placed in service. **5 Year Property** – Examples: computers, typewriters, copiers, duplicating equipment, heavy trucks, trailers, cargo containers, autos, motorcycles, light-duty trucks, certain technological and research equipment.
- **7 Year Property** – Examples: office furnishings, fixtures and equipment, railroad track and theme park structures
- **10 Year Property** - Example: water transportation equipment.
- **15 Year Property** – Examples: municipal sewage treatment plants, telephone distribution plants, two-way communication equipment, parking lots, sidewalks, roads, landscaping and fences.
- **20 Year Property** – Examples: municipal sewers and farm buildings.
- **27.5 Year Property** – Examples: residential rental property and mobile homes.
- **31.5 Year Property** - Any real property which is not residential rental property and which was acquired before 05/13/93.
- **39 Year Property** - Nonresidential real property placed in service after 05/12/93.

Repair & Improvement Regulations

The IRS issued temporary and identical proposed regulations (**T.D. 9564; REG-168745-03**) regarding the treatment of amounts paid to acquire, produce, or improve tangible property, including rules on determining whether costs related to tangible property are deductible repairs or capital improvements. These regulations, which are generally effective for tax years beginning on or after **January 1, 2014** (Notice 2012-73), affect all taxpayers that acquire, produce or improve tangible property. These regulations are discussed in chapter 3.27.

Related IRC and IRS Publications and Forms

- **Pub 946** – Depreciation
- **Form 3115** - Change of Accounting Method
- **Form 4562** – Depreciation & Amortization
- **Instructions Form 4562** – Depreciation & Amortization
- **IRC Sec 168**

MODIFIED COST RECOVERY SYSTEM (MACRS)

Form 4562, Depreciation and Amortization, is used to report depreciation and amortization deductions.

MACRS Recovery Period

- **Three-year property:** Generally, this includes property with an Asset Depreciation Range (ADR) class life of four years or less. Examples are tractor units for over-the-road use, race horses over two years old (all racehorses regardless of age 2009 through 2017*) when placed in service, other horses over twelve years old when placed in service.
- **Five-year property:** Includes property with an ADR class life of more than four but less than ten years. Examples are computers, typewriters, copiers, duplicating equipment, heavy trucks, trailers, cargo containers, autos, motorcycles, light-duty trucks, certain technological and research equipment. Also, appliances, carpets, furniture, etc., if used in a rental real estate activity.
- **Seven-year property:** Includes property with an ADR class life of ten years or more, but less than sixteen years. This category is also the "catch-all" for assets with no ADR assignment. Examples are office furnishings, fixtures and equipment, railroad track and theme park structures.
- **Ten-year property:** Includes property with an ADR class life of sixteen or more years, but less than twenty years. An example is water transportation equipment.
- **Fifteen-year property:** Includes property with an ADR class life of twenty or more, but less than twenty-five years. Examples are municipal sewage treatment plants, telephone distribution plants, two-way communication equipment, parking lots, sidewalks, roads, landscaping and fences.
- **Twenty-year property:** Includes property with an ADR class life of twenty-five years or more, other than 1250 real property (residential and nonresidential). Examples are municipal sewers and farm buildings.
- **Twenty-seven-and-one-half-year property:** Includes real property (Section 1250) that is residential rental property and mobile homes. To qualify as residential, the property must derive 80% or more of its rental income from its dwelling units. A hotel or motel with more than half of the units used on a transitory basis IS NOT a part of this class, notwithstanding percent of income derived from rental. Buildings used to provide housing to seniors in communities that offer a range of services (e.g., from independent to assisted living to nursing care) as well as housing are properly classified as residential rental property for depreciation purposes according to an IRS Internal Legal Memorandum (ILM 201147025). Thus, the buildings may be depreciated over a 27.5-year recovery period, rather than the 39-year period that applies to nonresidential rental property.
- **Thirty-one-and-one-half-year property:** Includes any real property which is not residential rental property and which was acquired before 05/13/93.
- **Thirty-nine-year property:** For nonresidential real property placed in service after 05/12/93, the depreciation period is 39 years. The old rules continue to apply to property placed in service before 01/01/94, if the taxpayer had a binding contract before 05/13/93, or construction of a property by or for the taxpayer or a "qualified person" began before 05/13/93. A "qualified person" is anyone who transfers his/her rights in a contract or the property itself to the taxpayer before the property is placed in service.
- **Indian reservation property:** "Qualified Indian reservation property" is that which is used predominantly in a trade or business within an Indian reservation and benefits from shortened depreciation periods. The shortened depreciation periods are as follows:

Indian Reservation Property	
Class	**Recovery Period (Yrs)**
3-year	2
5-year	3
7-year	4
10-year	6
15-year	9
20-year	12
Nonresidential rental	22 (31.5 prior to 1993)
Residential	27.5 (Same as non-reservation)

The same shortened lives apply under the AMT system; thus, there is no adjustment for such property under AMT. These rules are effective for property placed in service after 12/31/93 and before 01/01/18*. *(IRC § 168(j)(8))*

**Extended through 2017 by the Bipartisan Budget Act of 2018, signed into law Feb. 9, 2018*

For tax years beginning after December 31, 2015, a taxpayer is permitted to make an election out of the special recovery periods. If the election is made for any class of property for any tax year, the special recovery periods do not apply to all property in that class placed in service during that year for which the election out is made. *(Code Sec. 168(j)(8) as added by the PATH Act of 2015).*

"Qualified Rent-to-Own Property" - Qualified rent-to-own property is that held by a rent-to-own dealer under a rent-to-own contract. A **"rent-to-own dealer"** is a person in the business of entering arrangements like "Lease with Ownership Option," and a substantial portion of the contracts end with the property being returned to the dealer before receipt of all payments needed to transfer ownership of the property. Generally, rent-to-own property placed in service after Aug. 5, 1997 is assigned to the 3-year property class.

Class Life Guidelines - IRS Revenue Procedures give guidelines for class lives - Rev Proc 87-56, Rev Proc 87-57 and Rev Proc 88-22. These Rev Procs are generally effective for property placed in service after 12/31/86. To use the tables shown in Rev Proc 87-57, first determine the asset category by looking for its description in the left-hand column. The Class Life and MACRS recovery period are found to the right of the description. A recovery period labeled "ADS" (Alternative Depreciation System) is to be used to determine life for alternative minimum tax purposes or if ADS is elected for regular tax purposes.

General MACRS Methods – The following table outlines available MACRS methods:

Method	Type of Property	Possible Advantage
200% Declining Balance (DB) using the general depreciation system (GDS)	Nonfarm 3-, 5-, 7-, and 10-year property	Gives greater deduction during earlier years. Changes to SL when that method gives greater deduction.
150% DB using GDS	a. All farm property (except real property) b. All 15- and 20-year property♦ c. Nonfarm 3-, 5-, 7- and 10-year property*	Gives greater deduction in earlier years. Switches to SL when that method gives greater deduction.
SL using GDS	a. Nonresidential real property b. Residential real property c. Fruit or nut trees or vines d. All 3-, 5-, 7-, 10-, 15- and 20-year property*	Provides equal yearly deductions (except for 1st and last years)
SL using ADS	a. Property used outside U.S. b. Tax-exempt property c. Tax-exempt bond-financed property d. Imported property** e. Any property as t/p elects*	Provides equal yearly deductions

♦ From 10/23/04-onward, method is S/L for qualified leasehold improvements and restaurant property.
** Elective method*
*** See Section 168(g)(6) of IRC.*

Mid-Month Convention (applies to nonresidential real and residential rental property) - Consider all property placed in service or disposed of during any month as placed in service or disposed of in the middle of that month.

Example - Mid-Month Convention - *Bill purchased and placed in service a commercial building on 03/08, at a cost of $100,000 (excluding land). A full year's cost recovery on the building is $2,564 ($100,000/39). However, using the mid-month convention, Bill is considered to have placed his new property in service in the middle of March. He gets a MACRS deduction for 9.5 months [this is 79.17% (9.5/12) of the year]. Bill's MACRS deduction is $2,030 ($2,564 x .7917). Note that by using the IRS table for 39-year property, multiplying $100,000 by the percentage for Year 1, Month 3, the result is nearly the same ($100,000 x .02033 = $2,033).*

Half-Year Convention - Under the half-year convention, property gets only a half year of cost recovery in the first recovery year, regardless of what month the property is placed in service. The remaining half is deducted in the year following the last year of the recovery period. Thus, a property placed in service in January gets the same MACRS deduction as it would if it had been placed in service in December (assuming the mid-quarter convention doesn't apply). Property subject to the half-year convention gets half the yearly MACRS deduction in both the year placed in service and the year of disposition.

Example - Half-Year Convention *- Tom placed 7-year property in service on 8/10/13. The cost of the property was $10,000. He did not claim first-year bonus depreciation. Full year recovery deduction is $2,857 ($10,000/7 x 2). This amount must be modified using the half-year convention. Tom's first-year recovery deduction is $1,429 ($2,857/2).*

In 2014, Tom's recovery deduction is figured using the property's adjusted basis on 01/01/14 ($10,000 less $1,429 recovery deduction from 2013 = $8,571). Divide the adjusted basis by 7 and multiply the result by 2 in order to arrive at the 2014 deduction ($8,571/7 x 2 = $2,449).

Deductions for the following years: 2015 $1,749 [($8,571 less $2,449)/7 x 2]
2016 $1,249 [($6,122 less $1,749)/7 x 2]

After 2016, the straight-line method is more favorable. The remaining life of 3.5 years is used to compute Tom's deduction in 2017 and after.
2017-2019 $893 ($3,124/3.5)
2020 $445 remaining basis
IRS tables for 7-year property may be used to produce the same result with a much simpler computation. Multiply the cost of the property by the applicable percentage from the table for each year. Do not reduce the cost by the prior depreciation – use the original cost amount each year.

To use the half-year convention for taxpayers who have a short taxable year, treat an asset as acquired at the midpoint of the short year.

Mid-Quarter Convention - This convention treats property as placed in service (or disposed of) at the midpoint of the quarter in which it is placed in service (or disposed of). It applies when the basis of property placed in service during the last three months of the year is more than 40% of the basis of ALL property placed in service during the year. For assets placed in service when the bonus depreciation allowance applies, do not reduce basis by the bonus allowance for purpose of this test. If the 40% limit is exceeded, then the mid-quarter convention (RATHER THAN THE HALF-YEAR CONVENTION) applies to ALL property placed in service during the year. Disregard the basis of nonresidential real property, residential rental property, and Section 179 deductions, as well as the personal-use portion of the basis, when making the computation to determine whether the mid-quarter convention applies. Property placed in service and disposed of during the tax year is also not included in applying the 40% test.

To compute the deduction using the mid-quarter convention, figure the deduction for the full year, then apply the following percentages, depending on the quarter the property is placed in service:

QUARTER	PERCENTAGE
First	87.5
Second	62.5
Third	37.5
Fourth	12.5

Example - Mid-Quarter Convention *- Jackie purchased the following depreciable assets during the tax year:*

Date	*Asset Description*	*Cost*
02/10	*Office furniture (used)*	*$ 1,000*
10/01	*Computer (used)*	*5,500*
11/08	*Residential rental*	*$ 100,000*

The mid-quarter convention applies to the office furniture and the computer, because more than 40% of the total was purchased in the last three months of the year ($5,500/6,500 = 84.6%). For purposes of determining the 40% limit, disregard the rental property. The office furniture is 7-year property. 1st yr. deduction is figured: [$1,000/7 x 2].875 = $250. The computer is 5-year property. The 1st yr. deduction is figured: [$5,500/5 x 2].125 = $275.

Cost recovery on the residential rental is computed in the usual way, using the mid-month convention. The IRS has published tables that incorporate the mid-quarter convention. The complete tables are published in IRS Publication 946.

BONUS DEPRECIATION

Bonus depreciation was substantially changed under TCJA with one set of rules for property acquired and placed in service after 9/27/17 (the more common occurrence) and another set of rules for property acquired before 9/28/17 and placed in service after 9/27/17.

Although touted as unlimited expensing by the GOP and the press leading up to passage of the TCJA, this change is really the return of the 100% bonus deprecation, but with some differences.

Property Acquired Before 9/28/17 but Placed in Service After 9/27/17 – The old rules continue to apply. Thus depending upon which year the property is placed in service, the allowable bonus depreciation will be:

- 2017: 50%
- 2018: 40%
- 2019: 30%
- After 2019: None

Qualifying property includes that for which the **first use began with the taxpayer**:

- Most tangible personal property with a MACRS life of 20 years or less,
- Qualified improvement property, and
- Computer software (excluding software being amortized under Code Section 197).

Qualified improvement property means "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service," except expenditures attributable to the enlargement of the building, any elevator or escalator, and the internal structural framework of the building do not qualify.

***Commentary*:** Bonus depreciation prior to September 28, 2017 only applied to new property while bonus depreciation after September 27, 2017 applies both to new and used property.

Property Acquired and Placed in Service After 9/27/17 - The Act allows 100% expensing of tangible business assets (except structures) acquired after September 27, 2017 and through 2022, at which point it begins to phase out *(IRC Sec. 168(k) amended by TCJA Sec. 13201(a).* The bonus percentage will be:

- 100% After September 27, 2017 and through 2022.
- 80% After Dec. 31, 2022 and before Jan. 1, 2024
- 60% After Dec. 31, 2023 and before Jan. 1, 2025
- 40% After Dec. 31, 2024 and before Jan. 1, 2026
- 20% After Dec. 31, 2025 and before Jan. 1, 2027
- Sunsets after 2026.

A special phase out applies to aircraft and certain long-production period property; see summary table below.

IMPORTANT DIFFERENCE

Note the differences in qualifying property under TCJA as opposed to the old law.

Old Law: first use must begin with the taxpayer
New Law: New or Used

Qualifying property can be **new or used** and the bonus rate applies to:

- All tangible assets except structures, with a MACRS life of 20 years or less,
- Qualified film productions.
- Qualified television productions.
- Qualified live theatrical productions.
- Certain fruit and nut trees grafted or planted after September 27, 2017.

Specifically excluded from qualified property is public utility property and vehicle dealer property.

Bonus Depreciation Percentage Phase-out Summary

Date Placed In Service	Qualified Property	Long-Production Period Property & Aircraft
1/1/17 Through 9/27/17	50%	50%
9/28/17 through 2022	100%	100%
2023	80%	100%
2024	60%	80%
2025	40%	60%
2026	20%	40%
2027	None	20%
Post- 2027	None	None

Commentary: Both the bonus depreciation and the Sec 179 expensing provide means of substantially reducing business profits. However, TCJA has added some new issues that need to be considered before utilizing these provisions.

1. The new Sec 199A deduction is based on qualified business income (QBI). QBI is generally net profits for Schedule Cs and Fs, real estate rentals (Schedule E), and flow-through income from partnerships and S-Corporations. Writing off large capital purchases reduces an entity's profit and in turn will generally reduce the amount of the Sec 199A deduction.
2. On the flip side, lowering a taxpayer's taxable income may be helpful in avoiding certain 199A phase-outs and limitations.

Revoking the Bonus Depreciation Election **-** Generally, the election out of bonus depreciation can only be revoked with IRS consent, except that if made on a timely filed return, the election-out can be revoked on an amended return filed within six months of the original return's due date (excluding extensions). (Reg § 1.168(k)-1(e)(7))

> *Reg § 1.168(k)-1(e)(7)(ii) - Automatic 6-month extension* - If a taxpayer made an election specified in paragraph (e)(1) of this section for a class of property, an automatic extension of 6 months from the due date of the taxpayer's Federal tax return (excluding extensions) for the placed-in-service year of the class of property is granted to revoke that election, provided the taxpayer timely filed the taxpayer's Federal tax return for the placed-in-service year of the class of property and, within this 6-month extension period, the taxpayer (and all taxpayers whose tax liability would be affected by the election) files an amended Federal tax return for the placed-in-service year of the class of property in a manner that is consistent with the revocation of the election.

Qualified Leasehold Improvement, Restaurant and Retail Improvement Property - Qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property **DO NOT QUALIFY** for bonus depreciation. The final regs issued September 16, 2019 make it clear that TCJA Sec. 13204 amended Code Sec 168(k) to eliminate the 15-year MACRS classification for these properties and therefore they revert to 39-year property. Since bonus deprecation only apples to property with a recovery period of 20 years or less, these properties no longer qualify for the bonus depreciation.

The preamble to the final regulations acknowledges there was confusion related to this issue and it was widely reported that these Act changes were in error. However, they go on to say that a legislative change must be enacted to provide for a recovery period of 20 years or less for qualified improvement property placed in service after 2017 in order for it to be qualified property. As a result, qualified improvement property has a MACRS life of 39 years and is not eligible for the bonus depreciation.

AMT Depreciation Relief – Property for which the bonus depreciation is claimed is exempt from the alternative minimum tax (AMT) depreciation adjustment, which requires that certain property depreciated on the 200% declining balance method for regular income tax purposes must be depreciated on the 150% declining balance method for AMT purposes. Under a change made by the PATH Act of 2015, if a taxpayer elects not to take the bonus depreciation allowance for qualified property, the property will not be subject to an AMT adjustment for depreciation if placed in service after 2015. In other words, AMT depreciation on property eligible for the bonus depreciation is computed the same way as for regular tax purpose with no AMT adjustment, even if the taxpayer elects out of bonus depreciation. (Code Sec. 168(k)(2)(G), as amended by the PATH Act)

Business autos – The so-called "luxury auto" rules impose a maximum annual deduction for depreciation. These limits are included in the table below. In years after 2007 when the bonus depreciation is allowed, the first-year luxury auto limits were increased by $8,000 if the taxpayer elected bonus depreciation. Under the TCJA of 2017 the bonus depreciation element of the luxury auto continues to be $8,000 for years 2015 through 2022, with the following exceptions: In the case of a passenger automobile acquired by the taxpayer before September 28, 2017, and placed in service by the taxpayer:

- September 28, 2017 through 2018, the limit is increased by $8,000.
- During 2019, the limit is increased by $4,800.

Other rules that apply:

- Related party rules.
- Section 179 is applied first and the basis adjusted prior to computing any bonus allowed.
- The bonus depreciation on "qualified property" under Code Sec. 168(k) is not taken into account as a cost in applying the percentage of completion method.

SPECIAL DEPRECIATION ALLOWANCES

Racehorses – All racehorses placed in service after 2008 and before 2018 are assigned a three-year recovery period under MACRS, regardless of their age. However, for racehorses placed in service after 2017, only those animals that are more than two years old when placed in service by the purchaser are in the three-year recovery period (Code Sec. 168(e)(3)(A)).

Computer Software

Purchased Software **-** Generally the costs of acquiring computer software must be capitalized, including the costs of acquiring readily available software, and amortized over 3 years (Reg. Sec. 1.263(a)-4(c)).

Software Acquired with Business - Software that is acquired in connection with the acquisition of a trade or business is generally an amortizable intangible under Sec 197 and as such is amortized over 15 years.

Special Rule for Off-the-Shelf Software – Taxpayers have the option of expensing off-the-shelf software under Sec 179.

Bonus Depreciation – Software amortized over 3-years qualifies for bonus depreciation (Sec 168(k)(2)(A)).

Bundled Software – Software included in the cost of hardware or other tangible property is treated as part of the cost of the hardware or other tangible property and depreciated under the rules applying to that hardware or other property, generally 5-year MACRS.

Self-Developed Software – The costs of developing computer software (other than Sec 197 Intangibles) can be recovered in one of the following ways:

(1) Consistently expensed currently (Sec 174(a)), or

(2) Consistently treated as capital expenditures amortized for 60 months from the date of completion of the development (Sec 174(b)), or

(3) Amortized over 36 months from the date the software is placed in service (Sec 167(f)(1)).

Costs of developing software may also qualify as research and experimental expenditures under Code Sec. 174.

Farm Equipment - For property placed in service after Dec. 31, 2017, in tax years ending after that date, the cost recovery period is shortened from seven to five years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business, the original use of which commences with the taxpayer. *IRC Sec. 168(e)(3)(B)(vii) as amended by TCJA Sec. 13203(a)*

The required use of the 150% declining balance depreciation method for property used in a farming business (i.e., for 3-, 5-, 7-, and 10-year property) is repealed. Thus the 200% declining balance method can be used.

The 150% declining balance method continues to apply to any 15-year, or 20-year property used in the farming business to which the straight-line method does not apply, and to property for which the taxpayer elects the use of the 150% declining balance method. *IRC Sec. 168(b)(2) as amended by TCJA Sec. 13203(b)*

Trailer Depreciation - A trailer that includes kitchen, bathroom and sleeping facilities is rented long term to an unrelated party for use as their primary residence. What is the depreciable life of that trailer? Is it 5 years or 27.5 years?

A 27.5-year class is assigned to residential rental property (Sec 168(c)). Residential rental property is defined as a building or structure of which 80% or more of the gross rental income is from dwelling units. A dwelling unit is a house or apartment that provides living accommodations in a building or structure, but doesn't include a unit in a hotel, motel, or other establishment more than half of the units in which are used on a transient basis (Sec 168(e)(2)(A)). Otherwise-qualifying residential rental property can include manufactured homes, and, if permanently anchored, mobile homes.

The five-year MACRS class includes depreciable personal property with a class life of more than four years and less than ten years (Code Sec. 168(e)(1)), such as information systems (computers); heavy general purpose trucks; trailers and trailer-mounted containers; breeding or dairy cattle; and certain assets used in the drilling of oil and gas wells, construction, the manufacture of textile yarns, apparel, and other finished goods and the cutting of timber.

Whether a trailer is 1245 or 1250 property was also addressed in Rev Ruling 77-291. In that Revenue Ruling, the determination depended on the way the trailers are attached to the land and on how permanently the property is designed to remain in place; i.e., whether they are buildings. Where the property isn't affixed to the land and remains at all times movable, it is considered 1245 property.

So, whether the property is 5-year-life property or 27.5-year-life property seems to hinge on whether the trailer is permanently anchored in place (27.5-year life) or remains mobile (5-year life).

SPECIAL MACRS RULES*: MACRS* can't be used for the following property:

(1) Intangible property;
(2) Automobiles, where the taxpayer deducts expenses using the standard mileage rate.
(3) Most personal property if:
   (a) either the taxpayer or a party ***related*** to the taxpayer (according to Code Section 267(b)) owned or used the property prior to 1987, or
   (b) the same person who used the property in 1986 also uses it after the taxpayer acquires it,
   (c) it is leased to a person (or someone ***related*** to that person) who owned or used the property in 1986, or
   (d) the property was acquired in a transaction in which:
      - the user of the property didn't change, and
      - the property wasn't MACRS property in the hands of the person from whom it was acquired because of (b) or (c)
(4) Real property (other than nonresidential real and residential rentals) if:
   (a) either the taxpayer or someone ***related*** to the taxpayer owned the property prior to 1987, or
   (b) the taxpayer leases the property back to the person who owned it in 1986, or
   (c) the taxpayer acquires the property in a transaction where gain or loss isn't recognized with respect to property the taxpayer or a relative owned in 1986 (MACRS doesn't apply to the "carryover" basis). MACRS applies only to that portion of the basis in the acquired property that represents cash paid or unlike property given up. It doesn't apply to the substituted portion of the basis.
(5) Any motion picture film, video tape or sound recording.

If the rules described above allow for a bigger deduction under ACRS than is available under MACRS, then MACRS must be used.

Who Are Related Parties? For this purpose, related parties are the taxpayer and:
   (1) Spouse, children, parents, sisters and brothers (including half-brothers and sisters), grandparents;
   (2) A corporation or partnership in which the taxpayer owns more than 10% of the stock or capital.

THE ALTERNATIVE DEPRECIATION SYSTEM: Under certain circumstances, the alternative depreciation system MUST be used for computing depreciation. In other instances, it is an optional method of recovering the cost of property.

The alternative system must be used:
(1) To compute the portion of depreciation which will be treated as a tax-preference item for alternative minimum tax purposes;
(2) In figuring depreciation for tangible property used outside the U.S.;
(3) For property that is leased or otherwise used by a tax-exempt organization or is financed with tax-exempt bond proceeds;
(4) For property imported from foreign countries with discriminatory trade practices;
(5) For luxury automobiles and other listed property used 50% or more for *personal* use;
(6) For certain pre-production costs of farming property not covered by the inventory-capitalization rules of Code Section 263A.

OPTIONAL (ADS) METHOD FOR PERSONAL AND REAL PROPERTY: Taxpayers who place in service personal property after 12/31/86 may elect to use the alternative depreciation system on a class-by-class basis, but the election is only available on a property-by-property basis for residential rental and nonresidential real property. The election is irrevocable and must be made by the extended due date of the tax return for the year the property is placed in service. ADS generally uses the straight-line method of computation and no salvage value.

Exception: For alternative minimum tax purposes, use 150% declining balance for personal property being depreciated under regular MACRS 200% or 150% declining-balance method.

Like MACRS, ADS uses the half-year, mid-month and mid-quarter conventions. Examples of recovery periods under ADS include:

Nonresidential rentals	40 years
Residential rentals (placed in service before 2018)	40 years
Residential rentals (placed in service after 2017)	30 years
Cars, light trucks	5 years
Personal property not assigned a class life	12 years
Fruit or nut trees/vines	20 years
Other property assigned a class life	The class life
Single-purpose agricultural/horticultural structures	15 years

HOW TO DEPRECIATE PROPERTY WHEN USE CHANGES (Reg. § 1.168(i)-4)

Personal-use property converted to business or income-producing use (e.g., personal residence converted to rental property) would be:

- Treated as placed in service on the conversion date;
- Subject to the MACRS (Code Sec. 168) depreciation method;
- Subject to recovery period and placed-in-service convention applicable to the property beginning in the tax year of the conversion.

The property's depreciable basis in the change year would be the lesser of:

1. Its fair market value, or
2. Adjusted depreciable basis when it is converted.

These rules don't apply when another section of the Code prescribes a specific depreciation treatment for a change to business use, such as under the rules for listed property.

Business use property converted to personal or investment use - The conversion of MACRS property from business or income-producing use to personal use would be treated as a disposition, with depreciation for the conversion year computed by applying the applicable convention. However, the conversion wouldn't result in gain, loss or depreciation recapture (except for recapture under § 280F(b)(2) of excess depreciation upon conversion of listed property to personal use). *(Reg § 1.168(i)-4(c))*

Use changes in MACRS property after placed-in-service year – e.g., a taxpayer may change commercial rental property to residential rental property or vice versa.

- **Generally,** MACRS depreciation for the change year would be determined as though the change occurred on the first day of that year. *(Reg § 1.168(i)-4(d)(2)(iii))*
- **Shorter Recovery Period** – For changes resulting in a shorter recovery period or a faster depreciation method, the property's adjusted depreciable basis as of the beginning of the change year would be depreciated over the shorter recovery period and/or by the faster depreciation method beginning with the year of change as though the property were first placed in service in that year. *(Reg § 1.168(i)-4(d)(3)(i)(A))*

  Where the change results in a shorter recovery period, this rule would require a taxpayer to depreciate the property over the new shorter recovery period even if the remaining portion of the original longer recovery period is less than the new shorter recovery period. To avoid this adverse effect, taxpayers could elect on timely filed returns (including extensions) to continue to depreciate the property as though the change in use had not occurred. The election is made by claiming the depreciation deduction as though no change of use had occurred. *(Reg § 1.168(i)-4(d)(3)(ii))*
- **Longer Recovery Period** - If a longer recovery period and/or slower depreciation results from a use change, the property's adjusted depreciable basis as of the beginning of the change year is depreciated over the remaining portion of the new, longer recovery period as of the beginning of the year of change. *(Reg § 1.168(i)-4(d)(4))*
- **Using Optional MACRS Tables** - A taxpayer that had been using the optional MACRS depreciation tables from the time the property was first placed in service would be allowed (but not required) to continue using the tables after the change in use. The regs provide guidance on how to modify the calculations. *(Reg § 1.168(i)-4(d)(5))*

Use changes during placed-in-service year - The depreciation allowance will generally be determined by the primary use of the property during that tax year, determined in any reasonable manner that is consistently applied to the taxpayer's MACRS property. *(Reg § 1.168(i)-4(e))*

CONVERTING A PERSONAL RESIDENCE TO RENTAL USE: When a personal residence is converted to rental use determine the depreciation using MACRS.

> ***Example - Converting a Residence to Rental Use -*** *Bill bought a personal residence in 1990 for $100,000. In 2019, when the residence had a FMV of $250,000, he purchased a new home and converted the old residence to rental use. Bill will depreciate the rental using MACRS, using $100,000 (the lower of cost or FMV), reduced by the land portion, and a 27.5-year life to compute his cost recovery.*

When converting personal use property to business use, the FMV of the property can be a very important factor. If challenged, the IRS will want to know how the FMV was determined and will require more than a guess. They often require a certified appraisal. Taking short cuts can lead to problems in the future.

Issues When Converting a Home to a Rental **-** When a taxpayer converts their home to a rental, there are a number of tax issues that come into play, see chapter 3.17.

IMPROVEMENTS TO PROPERTY: Figure the MACRS deduction for an improvement made to property based on the date the improvement is placed in service, not the date the original property was placed in service.

Leasehold Improvements – Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period is longer than the lease term. For example, if a tenant makes an improvement to a nonresidential building, the improvement is depreciated over 39 years (except as noted below for qualified leasehold improvement property), straight-line, even if the tenant's lease is only for 10 years.

Qualified Leasehold Improvements – "Qualified leasehold improvement property" placed in service after October 22, 2004, and before January 1, 2018, is 15-year property instead of being depreciable over 39 years. This provision was made permanent by the PATH Act of 2015, but subsequently repealed as part of the TCJA for property placed in service after 2017*. Generally, for the pre-2018 definition, a qualified leasehold improvement is any improvement to an interior part of a building that is nonresidential real property, if all of the following conditions are met:

- The improvement is made under a lease by the lessee, or any sublessee, or the lessor of that part of the building, which is occupied exclusively by the lessee (or sublessee) of that part;
- The improvement is made more than 3 years after the building was first put into service by any person; and
- The improvement is Sec 1250 property.

*Through apparently a drafting error, the TCJA did not include leasehold improvements as 15-year property as intended by Congress and explained on page 3.04.06. Until corrected by Congress, these costs have a MACRS recovery period of 39 years. Improvements that enlarge the building, relate to escalators or elevators, benefit a common area structural component, or are for the building's internal structural framework don't qualify.

In CCA Letter Ruling 201310028, the IRS Office of Chief Counsel determined that the installation of a heating, ventilation, and air conditioning (HVAC) unit, either located on the roof of a building or located on a concrete pad adjacent to the building, was not qualified leasehold improvement property because the installation of an exterior HVAC unit was not an improvement to an interior portion of a building.

DISPOSITIONS:

Special rules apply when MACRS property is disposed of prior to the end of a recovery period. Under MACRS, a deduction is allowed in the year of disposition, even for Section 1245 property. Use the following rules in the year of disposition:

(1) **Residential and nonresidential real property:** Always consider the property disposed of at the middle of the month. Thus, a residential rental disposed of on March 3 by a calendar year taxpayer is depreciated for 2.5 months in the disposition year. Prorate the full-year's deduction by 2.5/12.

(2) **Property using the half-year convention:** The deduction in the year of disposition is half the depreciation allowed for a full year.

(3) **Mid-quarter convention property:** Determine the depreciation for a full year first. Multiply the result by 12.5%, if the disposition occurs in the first quarter; 37.5%, if in the second quarter; 62.5%, if in the third quarter; 87.5%, if in the fourth quarter.

> ***Example - Disposition of MACRS Mid-Quarter Convention Property -*** *John placed used 5-year property in service on 12/01/17 at a cost of $10,000. He did not claim any bonus depreciation. The mid-quarter convention applied to the property, because no other property was placed in service that year. In 2017 and 2018, and using the IRS mid-quarter table for assets placed in service in the 4th quarter, John's depreciation deductions were $500 (.05 x $10,000) and $3,800 (.38 x $10,000), respectively. On 04/06/19, John disposed of the property. His 2019 depreciation deduction is $855 [($10,000 x .228).375].*

(4) **Short tax year:** Multiply the basis of the property by the depreciation rate for the year. Prorate the result by the fraction, the number of months the property is in service during the year divided by 12 months.

COST SEGREGATION DEPRECIATION

It is common for taxpayers to engage tax professionals, often working with architects, builders or engineers, to (1) distinguish the items of property treated as structural components of a building for tax purposes from items of property (personal property) closely associated with the building and (2) allocate costs between the building components and personal property (and among the various classes of personal property). This process is referred to, by both tax professionals and IRS, as cost segregation. Cost segregation studies are not binding on the IRS.

Retroactive Change – It is possible, where the cost of appraisals, accounting, and tax preparation fees warrant, to retroactively segregate a building's property into its Sec 1250 and Sec 1245 components, thus allowing a shorter depreciable life (generally 7 years for commercial property and 5 years for residential rental property) for the Sec 1245 components. Amending prior returns is not required if the automatic IRS consent to a change in accounting for depreciation is used. However, retroactive change should be approached with caution.

Rental Activities - IRS stated that appliances, carpets, furniture, etc., used in a rental real estate activity are 5-year MACRS class property (Ann 99-82). The IRS has also indicated that such property used in a residential rental real estate activity is 5-year MACRS class property (IRS Pub 527, (2018), page 9). As with most things in taxes there is no all-encompassing list of items than can or cannot be treated as Sec 1245 property. Each item must be looked at on a one-by-one basis. Consider for example kitchen cabinets; most are easily removable and replaceable and might be considered Sec 1245 property. But here are some issues to consider:

- If the structure is purchased as a whole then an appropriate appraisal is required to segregate the costs of the building components.
- Sec 1245 depreciation will recapture as ordinary income on sale.
- The new Sec 199A deduction is based on qualified business income (QBI). QBI is generally net profits for Schedule Cs and Fs, real estate rentals (Schedule E), and flow-through income from partnerships and S-Corporations. Using shorter depreciable lives for assets identified as Sec 1245 property in a segregation study will increase the depreciation deduction and reduce an entity's profit, which in turn will generally reduce the amount of the Sec 199A deduction. On the other hand, lowering a taxpayer's taxable income may be helpful in avoiding certain 199A phase-outs and limitations.
- Under the TCJA of 2017, only real property (i.e., land and Sec 1250 buildings) will be eligible for Sec 1031 tax-deferred exchanges. Unclear at the time this material was updated is whether property identified as Sec 1245 property in a cost segregation study will also qualify for nonrecognition of gain. Some tax commentators argue that 1245 treatment is only for depreciation purposes and shouldn't disqualify such property from 1031 tax deferral. We hope that the IRS will include this issue as one of the numerous TCJA clarifications that they make in the near future. Otherwise, it will be up to the courts to decide down the road.

Most recent cases and rulings related to cost segregation refer to *HCA v. Commissioner* discussed below.

Apartment Building Cost Segregation Study Too Aggressive – The Tax Court found that a taxpayer's cost segregation study that broke down the cost of a residential apartment complex into over 1,000 parts was overly aggressive, and agreed with the IRS that most of the components were structural components, integral to the buildings' operations and maintenance, and were depreciable over 27.5 years rather than the 5 to 15 years used by the taxpayer. Only the following components were re-classified as personal property depreciable at lesser lives: clothes dryer vents; outlets and timers related to watering of the grounds; surveillance components (TV and camera); gate components; outlets for refrigerators, stoves, and washer/dryer machines; and cable, telephone and data outlets. *(AmeriSouth XXXII, Ltd., T.C. Memo 2012-67)*

Post-Purchase Cost Segregation Study Can't Change Purchase Price Allocations – The Tax Court ruled that a taxpayer could not modify purchase price allocations that had been agreed to when two processing plants were acquired. After the purchase, the taxpayer had a cost segregation study done which separated the assets into various subcomponents and reclassified them for depreciation purposes as 7-year or 15-year property instead of the 39-year class applicable to commercial buildings and their structural components. The taxpayer applied for a change in accounting method and claimed a Sec. 481(a) adjustment. The IRS took the position that the taxpayer could not modify the purchase price allocations under Sec. 1060, which provides that in connection with an applicable asset acquisition, the parties to a written agreement as to purchase price allocation are bound by the agreement. The Court agreed with the IRS. *(Peco Foods Inc. et al., T.C. Memo 2012-18)*

Therefore, taxpayers who anticipate purchasing the assets of a business should consider having a cost segregation analysis completed **before** the purchase agreement is written.

Hospital Corporation of America (HCA) – The court ruled that the enactment of ACRS did not redefine § 1250 property to include property that had been § 1245 property for purposes of ITC (investment tax credit). Accordingly, the court determined that §168(f)(1), prohibiting component depreciation, applied only to §1250 property. The HCA ruling effectively reinstated a form of component depreciation for certain building support systems, such as the electrical and plumbing systems that directly serve tangible personal property. Therefore, cost segregation methodologies previously used to allocate the cost of a building between structural components and ITC property can now be used for § 1250 and § 1245 property.

In an Action on Decision (AOD CC-1999-008), the Service acquiesced to the validity of the method approved by the court (i.e., pre-1981 ITC tests remained applicable for determining tangible personal property under both ACRS and MACRS). However, the Service non-acquiesced to the court's findings as to which specific assets qualified as tangible personal property. Two cases, *LaPetite Academy* and *Boddie-Noell*, were specifically referenced in the AOD with respect to the determination of structural components and tangible personal property.

- In *LaPetite Academy*, wall panels, kitchen plumbing, bathroom accessories and a portion of the electrical system were held to be structural components under the regulations.
- In *Boddie-Noell*, the court held that acoustical tile ceilings, a portion of an electrical system and a plumbing system were structural components under the regulations.

Bottom Line

Cost segregation is a valid and acceptable depreciation technique. However, bona fide appraisals or other determinations are necessary when assigning cost to the various components, and keep in mind the IRS acquiesced to the technique but can still argue what is and is not a structural component of a building.

Additional Resources – Additional information related to the IRS' view related to cost segregation can be obtained from the IRS' Audit Technique Guide on Cost Segregation. On the IRS web site put "cost segregation" in the search box to link to the Audit Technique Guide. There are a few industry specific tables that break down (at least in IRS' view) what is 1245 and 1250 property.

CORRECTING PAST DEPRECIATION

When it is discovered that a taxpayer has not been taking the correct amount of depreciation in a prior year, the prior years must be corrected because of the "allowed or allowable" rule. There are two possible procedures for making the correction: filing an amended return or filing for a change of accounting method. The limitations, pros and cons for each are discussed.

Amended Return – A taxpayer that claimed incorrect depreciation on a return may use a 1040X to correct the error **ONLY IF**:

- The statute of limitations is open for the year of the error,
- The taxpayer is **NOT** changing from one permissible method of accounting to another permissible method of accounting.
- The taxpayer has **NOT** adopted a method of accounting for the property.

  Note: *A taxpayer has adopted a method of accounting if an incorrect depreciation amount was deducted on the taxpayer's return in two or more consecutive tax years for reasons other than a mathematical or posting error.*
- The taxpayer is correcting math or posting errors that are not a change in accounting method. However the corrections can only be made for open years.

  Note: *Generally math or posting errors are not possible when using computer-processed returns.*

Disadvantages of Using an Amended Return:

- If the depreciation was overstated, any additional tax liability would be immediately due (if a Form 3115 was used to make the change the tax can be spread over 4 years).
- If there is a tax due, interest will be assessed.
- You must file a separate 1040X for each year (while a Form 3115 corrects all years at issue).

Form 3115 – Generally the Form 3115 is used when a 1040X can't be used or the statute of limitations has expired on the tax year to be changed. Form 3115 rather than Form 1040X is used in the following situations to make depreciation corrections (Pub 946):

- A change from an impermissible method of determining depreciation for depreciable property, if the impermissible method was used in two or more consecutively filed tax returns.
- A change in the treatment of an asset from nondepreciable to depreciable or vice versa.
- A change in the depreciation method, period of recovery, or convention of a depreciable asset. However, a 1040X can be used to change the placed-in-service date of a depreciable asset.

- A change from not claiming to claiming the special allowance (bonus) depreciation if the election to not claim any special allowance hadn't been made.
- A change from claiming 50% bonus depreciation to claiming a 100% bonus allowance for qualified property acquired and placed in service after September 27, 2017 (if the election under section 168(k)(10) to claim 50% bonus depreciation wasn't made).

Changes of accounting method are only allowed if approved in advance by the IRS or if the change is one that IRS will approve automatically. Most changes of depreciation qualify for an automatic approval by the IRS if the required approval procedures are followed, e.g., Form 3115 is properly completed and filed. See Rev Proc 2018-31 for a complete list of current automatic accounting method changes and the specific procedures for each type. There is no user fee charged for automatic accounting method changes, but user fees do apply for those changes not granted automatically by the IRS.

Benefits of Using the Form 3115:

- Multiple years are corrected on one return for the year of adjustment. (Rev. Proc. 97-27, Rev. Proc. 2002-19 and Rev. Proc. 2007-67)
- Eliminates the statute of limitations issues for past returns (changes can be made without regard to the statute of limitations).
- If there is a negative Sec 481(a) adjustment it reduces the business' income in the year of the adjustment which could result in a tax refund in the adjustment year.
- If there is a positive adjustment it increases the business' income and results in an increase in tax for the year of adjustment.
  - If the adjustment is less than $50,000 (was $25,000 prior to 2015), the taxpayer can elect to pay the tax in the year of the adjustment (de minimis election – Rev Proc 2015-13, Sec 7.03(3)(c)).
  - Otherwise add ¼ of the adjustment to the current year's return and ¼ in each of the next three years, thus spreading the additional tax over four years.

Potential Problem – If the taxpayer did not make the election to apply the new cap and repair regulations retroactively for tax years beginning on or after January 1, 2012, then the accounting method change (Form 3115) cannot be used to correct **new-regs-related** depreciation occurring prior to 2014. However, apparently a correction to pre-2014 depreciation could be made if the correction is unrelated to the changes in the repair regulations. Pub 946 does not make any mention of restricting pre-2014 corrections unrelated to the new regulations.

Note: Some seminars strongly advocated filing the Form 3115 to adopt the new cap and repair regulations retroactively. If you did so, then all corrections to prior years related to the new regulations should have been made at that time and a Form 3115 cannot now be used to make a new-repair-regs correction for years prior to 2014. If you did not, then you automatically adopted the regulations prospectively and the chance to adopt the new regulations for years before 2014 has passed (Rev. Proc. 2015-20). ***Bottom Line****:*

1. If the taxpayer **did not retroactively** adopt the new regulations the taxpayer can still use the 3115 to correct pre-2014 depreciation unrelated to the new regulations.
2. If the taxpayer **did retroactively** adopt the regulations then the taxpayer cannot use the 3115 to correct pre-2014 depreciation errors.

Special Issues

- **Taxpayer out of business** – the Sec 481(a) adjustment must be taken in the final year of the business or if a rental, the year of sale.
- **Taxpayer under audit** – Generally a taxpayer will not qualify for an *automatic* accounting method change while the taxpayer is under audit.
- **Previous 3115 filings** – The *automatic* accounting method change cannot be used if Form 3115 was used in the prior five years for the same type of change.

Completing Form 3115 – When making an automatic change the instructions for the 3115 provide us with the following information:

- For automatic changes only Parts I, II, and IV need to be completed (skip Part III).
- For a depreciation change, only Schedule E of the 3115 (not to be confused with the 1040 Schedule E) must be completed; skip the other Form 3115 schedules.

Thus, when making depreciation or amortization corrections only Parts I, II, and IV and Schedule E need to be completed.

Designated Change Number (DCN) – The instructions for the Form 3115 include a great number of DCNs since the form has multiple uses. DCNs are entered at Part I, line 1a. For correcting depreciation for small businesses the DCNs to use are:

- **DCN 7** – Is used when changing from an impermissible method to a permissible method; commonly encountered impermissible methods include:
    - Depreciation not claimed
    - Incorrect asset life used
    - Inheritance FMV basis adjustments not made
    - No land value adjustment made to basis when determining depreciable basis
- **DCN 107** – Same as DCN 7 except used when the property has already been disposed.
- **DCN 8** – Is used when changing from one permissible method to another permissible method. Not normally encountered for small business. Used when switching from individual item accounting to multiple asset accounting.

Part I – in addition to entering the DCN number (see above), lines 2 and 3 must be completed.

- **Line 2** – Generally check NO. Check YES if under audit.
- **Line 3** – Check YES; you will be attaching a statement specifying the changes.

Part II –

- **Line 4** - asks if the business entity ceased doing business in the adjustment year. Check YES if ceased doing business (should have entered DCN 107 on line 1a). Otherwise check NO (should have entered DCN 7 on line 1a). If this question is checked YES a statement must be added and "see statement" entered on the line.

STATEMENT
Rev. Proc. 2015-14, Sec. 6.01 provides that the eligibility rule of Rev. Proc. 2015-13, Sec. 5.01(1)(d) does not apply to depreciation adjustments under DCN 7 or DCN 107.

- **Line 5** – deals with corporate acquisition; check NO.
- **Line 6a** – asks if an affected return is under audit. Generally check NO, but if under audit see the instructions for line 6a and complete 6b and 6c.
- **Line 7a** – generally, the answer to this question is YES, but if in doubt see the 3115 instructions for line 7a and 7b.
- **Line 7b** – if 7a was answered yes, check the appropriate box. Generally check the box "not under exam;" otherwise see the 3115 instructions for line 7b.
- **Lines - 8a and 10,** check NO.
- **Line 11a –** generally check NO. But if the answer is yes, follow the instructions on lines 11b and 11c.
- **Lines 12 and 13** – check NO.
- **Lines 14 and 15** – enter "see attached statement".
- **Line 16** – skip.
- **Lines 17 and 18** – check YES.
- **Line 19a** – enter N/A for not applicable.
- **Line 19b** – skip.

Part IV –

- **Line 25** - check NO unless property disposed of (DCN 107 on line 1a) in which case check YES.
- **Line 26** – enter the amount of the adjustment, either + or –. Note: an increase in the amount of depreciation would be a minus and a decrease would be a plus.
- The adjustment is the difference between the total depreciation actually deducted for the property and the total amount allowable prior to the year of change. If no depreciation was deducted, the adjustment is the total depreciation allowable prior to the year of change. A negative section 481(a) adjustment results in a decrease in taxable income. It is taken into account in the year of change and is reported on your business tax returns as "other expenses." A positive section 481(a) adjustment results in an increase in taxable income.
- **Line 27** – this is where you make the election to take the entire positive adjustment in the year of the adjustment as opposed to spreading it over 4 years. If the adjustment on line 26 is negative (i.e., more depreciation is allowed than was previously deducted), it will reduce the business' income and could result in a refund. In this case, check the NO box. If the

- adjustment on line 26 is positive, the business' income is increased and the taxpayer has the option, where the adjustment is an increase of less than $50,000, to report the entire amount in the year of the adjustment. To make that election check the YES box and check the $50,000 de minimis election. Otherwise check NO and the income will be spread over 4 years.
- **Line 28** – generally check NO.

Schedule E –

- **Line 1** – check NO
- **Line 2** – is asking if the depreciation adjustment needs to be capitalized. Generally check NO.
- **Line 3** – generally check NO for real estate property. The YES box would be checked for elections under Sec 179, or electing out of bonus depreciation (Sec 168(k)).
- **Line 4b** – check YES or NO based upon whether the property was previously used as a primary residence.
- **Line 4c** - check NO.
- **Lines 5, 6, 7** – prepare and include the appropriate statement.

CALIFORNIA DIFFERENCES

California generally conforms to Federal MACRS rules for individuals. CA does **NOT** conform to:

- Bonus Depreciation (none allowed)
- The shortened recovery periods for Indian reservation property,
- The 15-year recovery period, straight-line method, for qualified leasehold improvements, qualified retail property, and qualified restaurant property (CA is 39 years) or treating these types of property as Sec 179 property,
- Inclusion of off-the-shelf computer software as Sec. 179 property., and
- The higher first-year luxury auto depreciation limit when federal bonus depreciation is claimed

Effective January 1, 2010 and through 2017, California conforms to the 3-year recovery period for race horses of any age (personal income tax only).

For California disease-infested vineyards, the recovery period for replacement vines is reduced from 10 years to 5 years for CA purposes (for post-1991 replacements due to phylloxera infestations and post-1996 replantings due to Pierce's disease). A written certification from an independent state-certified integrated pest management adviser, or a state agricultural commissioner or adviser, that specifies that the replanting was necessary to restore a vineyard infested with phylloxera or Pierce's disease is required. The taxpayer must retain the certification for future audit purposes.

NOTES

FREQUENTLY USED MACRS TABLES

3-YEAR PERSONAL PROPERTY

YR	ACCELERATED					STRAIGHT LINE				
	HALF YEAR	MID-QUARTER				HALF YEAR	MID-QUARTER			
		1	2	3	4		1	2	3	4
1	33.33	58.33	41.67	25.00	8.33	16.67	29.17	20.83	12.50	4.17
2	**44.45**	**27.78**	**38.89**	**50.00**	**61.11**	**33.33**	**33.33**	**33.33**	**33.33**	**33.33**
3	**14.81**	**12.35**	**14.14**	**16.67**	**20.37**	**33.33**	**33.33**	**33.34**	**33.34**	**33.33**
4	7.41	1.54	5.30	8.33	10.19	16.67	4.17	12.50	20.83	29.17

5-YEAR PERSONAL PROPERTY

YR	ACCELERATED					STRAIGHT LINE				
	HALF YEAR	MID-QUARTER				HALF YEAR	MID-QUARTER			
		1	2	3	4		1	2	3	4
1	20.00	35.00	25.00	15.00	5.00	10.00	17.50	12.50	7.50	2.50
2	32.00	26.00	30.00	34.00	38.00	20.00	20.00	20.00	20.00	20.00
3	**19.20**	**15.60**	**18.00**	**20.40**	**22.80**	**20.00**	**20.00**	**20.00**	**20.00**	**20.00**
4	**11.52**	**11.01**	**11.37**	**12.24**	**13.68**	**20.00**	**20.00**	**20.00**	**20.00**	**20.00**
5	11.52	11.01	11.37	11.30	10.94	20.00	20.00	20.00	20.00	20.00
6	5.76	1.38	4.26	7.06	9.58	10.00	2.50	7.50	12.50	17.50

7-YEAR PERSONAL PROPERTY

YR	ACCELERATED					STRAIGHT LINE				
	HALF YEAR	MID-QUARTER				HALF YEAR	MID-QUARTER			
		1	2	3	4		1	2	3	4
1	14.29	25.00	17.85	10.71	3.57	7.14	12.50	8.93	5.36	1.79
2	24.49	21.43	23.47	25.51	27.55	14.29	14.29	14.29	14.29	14.29
3	17.49	15.31	16.76	18.22	19.68	14.29	14.28	14.28	14.28	14.28
4	**12.49**	**10.93**	**11.97**	**13.02**	**14.06**	**14.28**	**14.29**	**14.29**	**14.29**	**14.29**
5	**8.93**	**8.75**	**8.87**	**9.30**	**10.04**	**14.29**	**14.28**	**14.28**	**14.28**	**14.28**
6	**8.92**	**8.74**	**8.87**	**8.85**	**8.73**	**14.28**	**14.29**	**14.29**	**14.29**	**14.29**
7	8.93	8.75	8.87	8.86	8.73	14.29	14.28	14.28	14.28	14.28
8	4.46	1.09	3.33	5.53	7.64	7.14	1.79	5.36	8.93	12.50

10-YEAR PERSONAL PROPERTY

YR	ACCELERATED					STRAIGHT LINE				
	HALF YEAR	MID-QUARTER				HALF YEAR	MID-QUARTER			
		1	2	3	4		1	2	3	4
1	10.00	17.50	12.50	7.50	2.50	5.0	8.75	6.25	3.75	1.25
2	18.00	16.50	17.50	18.50	19.50	10.00	10.00	10.00	10.00	10.00
3	14.40	13.20	14.00	14.80	15.60	10.00	10.00	10.00	10.00	10.00
4	**11.52**	**10.56**	**11.20**	**11.84**	**12.48**	**10.00**	**10.00**	**10.00**	**10.00**	**10.00**
5	**9.22**	**8.45**	**8.96**	**9.47**	**9.98**	**10.00**	**10.00**	**10.00**	**10.00**	**10.00**
6	**7.37**	**6.76**	**7.17**	**7.58**	**7.99**	**10.00**	**10.00**	**10.00**	**10.00**	**10.00**
7	6.55	6.55	6.55	6.55	6.55	10.00	10.00	10.00	10.00	10.00
8	6.55	6.55	6.55	6.55	6.55	10.00	10.00	10.00	10.00	10.00
9	6.56	6.56	6.56	6.56	6.56	10.00	10.00	10.00	10.00	10.00
10	**6.55**	**6.55**	**6.55**	**6.55**	**6.55**	**10.00**	**10.00**	**10.00**	**10.00**	**10.00**
11	**3.28**	**.82**	**2.46**	**4.10**	**5.74**	**5.00**	**1.25**	**3.75**	**6.25**	**8.75**

RESIDENTIAL RENTAL PROPERTY - 27.5 YEAR
Straight Line – Mid-Month

Effective after 1986

Recovery Year	Month Placed In Service In First Year: 1	2	3	4	5	6	7	8	9	10	11	12
1	3.485	3.182	2.879	2.576	2.273	1.970	1.667	1.364	1.061	0.758	0.455	0.152
2	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
3	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
4	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
5	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
6	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
7	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
8	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
9	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
10	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
11	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
12	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
13	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
14	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
15	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
16	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
17	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637	3.637
18	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636	3.636
19	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637	3.637
20	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
21	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
22	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
23	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
24	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
25	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
26	3.637	3.637	3.637	3.637	3.637	3.637	3.636	3.636	3.636	3.636	3.636	3.636
27	3.636	3.636	3.636	3.636	3.636	3.636	3.637	3.637	3.637	3.637	3.637	3.637
28	1.970	2.273	2.576	2.879	3.182	3.485	3.636	3.636	3.636	3.636	3.636	3.636
29	0.000	0.000	0.000	0.000	0.000	0.000	0.152	0.455	0.758	1.061	1.364	1.667

NONRESIDENTIAL RENTAL PROPERTY - 31.5 YEAR
Straight Line – Mid-Month

Effective 1987 through 05/12/93

Recovery Year	Month Placed In Service In First Year 1	2	3	4	5	6	7	8	9	10	11	12
1	3.042	2.778	2.513	2.249	1.984	1.720	1.455	1.190	0.926	0.661	0.397	0.132
2	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
3	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
4	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
5	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
6	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
7	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
8	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.175	3.175	3.175	3.175	3.175
9	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
10	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.175	3.175	3.175	3.175	3.175
11	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
12	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
13	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
14	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
15	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
16	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
17	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
18	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
19	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
20	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
21	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
22	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
23	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
24	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
25	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
26	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
27	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
28	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
29	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
30	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174
31	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175	3.174	3.175
32	1.720	1.984	2.249	2.513	2.778	3.042	3.175	3.174	3.175	3.174	3.175	3.174
33	0.000	0.000	0.000	0.000	0.000	0.000	0.132	0.397	0.661	0.926	1.190	1.455

NONRESIDENTIAL RENTAL PROPERTY - 39.0 YEAR
Effective after 05/12/93

Recovery Year	Month Placed In Service In First Year 1	2	3	4	5	6	7	8	9	10	11	12
1	2.461	2.247	2.033	1.819	1.605	1.391	1.177	0.963	0.749	0.535	0.321	0.107
2-39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

MACRS - ALTERNATIVE MINIMUM TAX

3-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	25.00	43.75	31.25	18.75	6.25
2	37.50	28.13	34.38	40.63	46.88
3	25.00	25.00	25.00	25.00	25.00
4	**12.50**	**3.12**	**9.37**	**15.62**	**21.87**

5-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	15.00	26.25	18.75	11.25	3.75
2	25.50	22.13	24.38	26.63	28.88
3	17.85	16.52	17.06	18.64	20.21
4	**16.66**	**16.52**	**16.76**	**16.56**	**16.40**
5	**16.66**	**16.52**	**16.76**	**16.57**	**16.41**
6	**8.33**	**2.06**	**6.29**	**10.35**	**14.35**

6-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	12.50	21.88	15.63	9.38	3.13
2	21.88	19.53	21.09	22.66	24.22
3	16.41	14.65	15.82	16.99	18.16
4	**14.06**	**14.06**	**14.06**	**14.06**	**14.06**
5	**14.06**	**14.06**	**14.06**	**14.06**	**14.06**
6	**14.06**	**14.06**	**14.07**	**14.06**	**14.06**
7	7.03	1.76	5.27	8.79	12.31

7-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	10.71	18.75	13.39	8.04	2.68
2	19.13	17.41	18.56	19.71	20.85
3	15.03	13.68	14.58	15.48	16.39
4	**12.25**	**12.16**	**12.22**	**12.27**	**12.87**
5	**12.25**	**12.16**	**12.22**	**12.28**	**12.18**
6	**12.25**	**12.16**	**12.22**	**12.27**	**12.18**
7	12.25	12.16	12.23	12.28	12.19
8	6.13	1.52	4.58	7.67	10.66

9-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	8.33	14.58	10.42	6.25	2.08
2	15.28	14.24	14.93	15.63	16.32
3	12.73	11.86	12.44	13.02	13.60
4	**10.61**	**9.89**	**10.37**	**10.85**	**11.33**
5	**9.65**	**9.64**	**9.64**	**9.64**	**9.65**
6	**9.64**	**9.65**	**9.65**	**9.65**	**9.65**
7	9.65	9.64	9.64	9.64	9.64
8	9.64	9.65	9.65	9.65	9.65
9	9.65	9.64	9.64	9.64	9.64
10	**4.82**	**1.21**	**3.62**	**6.03**	**8.44**

10-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	7.50	13.13	9.38	5.63	1.88
2	13.88	13.03	13.59	14.16	14.72
3	11.79	11.08	11.55	12.03	12.51
4	**10.02**	**9.41**	**9.82**	**10.23**	**10.63**
5	**8.74**	**8.71**	**8.73**	**8.75**	**9.04**
6	**8.74**	**8.71**	**8.73**	**8.75**	**8.72**
7	8.74	8.71	8.73	8.75	8.72
8	8.74	8.71	8.73	8.74	8.72
9	8.74	8.71	8.73	8.75	8.72
10	**8.74**	**8.71**	**8.73**	**8.74**	**8.71**
11	**4.37**	**1.09**	**3.28**	**5.47**	**7.63**

12-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	6.25	10.94	7.81	4.69	1.56
2	11.72	11.13	11.52	11.91	12.31
3	10.25	9.74	10.08	10.43	10.77
4	**8.97**	**8.52**	**8.82**	**9.12**	**9.42**
5	**7.85**	**7.46**	**7.72**	**7.98**	**8.24**
6	**7.33**	**7.33**	**7.33**	**7.33**	**7.33**
7	7.33	7.33	7.33	7.33	7.33
8	7.33	7.33	7.33	7.33	7.33
9	7.33	7.33	7.33	7.33	7.33
10	**7.33**	**7.32**	**7.33**	**7.32**	**7.32**
11	**7.32**	**7.33**	**7.33**	**7.33**	**7.33**
12	**7.33**	**7.32**	**7.32**	**7.32**	**7.32**
13	3.66	.92	2.75	4.58	6.41

15-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	5.00	8.75	6.25	3.75	1.25
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	**7.70**	**7.39**	**7.59**	**7.80**	**8.00**
5	**6.93**	**6.65**	**6.83**	**7.02**	**7.20**
6	**6.23**	**5.99**	**6.15**	**6.31**	**6.48**
7	5.90	5.90	5.91	5.90	5.90
8	5.90	5.91	5.90	5.90	5.90
9	5.91	5.90	5.91	5.91	5.90
10	**5.90**	**5.91**	**5.90**	**5.90**	**5.91**
11	**5.91**	**5.90**	**5.91**	**5.91**	**5.90**
12	**5.90**	**5.91**	**5.90**	**5.90**	**5.91**
13	5.91	5.90	5.91	5.91	5.90
14	5.90	5.91	5.90	5.90	5.91
15	5.91	5.90	5.91	5.91	5.90
16	**2.95**	**.74**	**2.21**	**3.69**	**5.17**

20-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	3.750	6.563	4.688	2.813	.938
2	7.219	7.008	7.148	7.289	7.430
3	6.677	6.482	6.612	6.742	6.872
4	**6.177**	**5.996**	**6.116**	**6.237**	**6.357**
5	**5.713**	**5.546**	**5.658**	**5.769**	**5.880**
6	**5.285**	**5.130**	**5.233**	**5.336**	**5.439**
7	4.888	4.746	4.841	4.936	5.031
8	4.522	4.459	4.478	4.566	4.654
9	4.462	4.459	4.463	4.460	4.458
10	**4.461**	**4.459**	**4.463**	**4.460**	**4.458**
11	**4.462**	**4.459**	**4.463**	**4.460**	**4.458**
12	**4.461**	**4.460**	**4.463**	**4.460**	**4.458**
13	4.462	4.459	4.463	4.461	4.458
14	4.461	4.460	4.463	4.460	4.458
15	4.462	4.459	4.462	4.461	4.458
16	**4.461**	**4.460**	**4.463**	**4.460**	**4.458**
17	**4.462**	**4.459**	**4.462**	**4.461**	**4.458**
18	**4.461**	**4.460**	**4.463**	**4.460**	**4.459**
19	4.462	4.459	4.462	4.461	4.458
20	4.461	4.460	4.463	4.460	4.459
21	2.231	.557	1.673	2.788	3.901

25-YEAR - 150% DB

YR	HALF YEAR	MID-QUARTER 1	2	3	4
1	3.000	5.250	3.750	2.250	.750
2	5.820	5.685	5.775	5.865	5.955
3	5.471	5.344	5.429	5.513	5.598
4	**5.143**	**5.023**	**5.103**	**5.182**	**5.262**
5	**4.834**	**4.722**	**4.797**	**4.871**	**4.946**
6	**4.544**	**4.439**	**4.509**	**4.579**	**4.649**
7	4.271	4.172	4.238	4.304	4.370
8	4.015	3.922	3.984	4.046	4.108
9	3.774	3.687	3.745	3.803	3.862
10	**3.584**	**3.582**	**3.583**	**3.584**	**3.630**
11	**3.583**	**3.582**	**3.583**	**3.584**	**3.582**
12	**3.584**	**3.582**	**3.583**	**3.584**	**3.582**
13	3.583	3.582	3.583	3.584	3.582
14	3.584	3.582	3.583	3.584	3.582
15	3.583	3.582	3.583	3.584	3.582
16	**3.584**	**3.582**	**3.583**	**3.584**	**3.583**
17	**3.583**	**3.582**	**3.583**	**3.584**	**3.582**
18	**3.584**	**3.582**	**3.583**	**3.584**	**3.583**
19	3.583	3.581	3.583	3.584	3.582
20	3.584	3.582	3.583	3.584	3.583
21	3.583	3.581	3.583	3.585	3.582
22	**3.584**	**3.582**	**3.583**	**3.584**	**3.583**
23	**3.583**	**3.581**	**3.583**	**3.585**	**3.582**
24	**3.584**	**3.582**	**3.582**	**3.584**	**3.583**
25	3.583	3.581	3.583	3.585	3.582
26	1.792	0.448	1.343	2.240	3.135

LIMITED LIABILITY COMPANIES

NOTE - This chapter does not include information for foreign or multi-state LLCS

Overview

A Limited Liability Company (LLC) is a form of **state** business entity. The IRS did not create a new tax classification for the LLC when LLCs were created by the states; instead IRS uses existing tax entity classifications: corporation, partnership, or sole proprietor. An LLC is always classified by the IRS as one of these types of entities.

RAPID FINDER

LLCs have advantages over both the corporation and the partnership forms of operating a business. The LLC's main advantage over a general partnership is that, like the owners (shareholders) of a corporation, the owners (members) of an LLC are generally not responsible financially for the debts and obligations incurred in the course of the LLC's business. In addition, an LLC has the flexibility to be taxed as a partnership, sole proprietorship, or corporation.

- **Default** Forms of Taxation (Disregarded Entity)
  - Single Member LLC – Sole Proprietorship (Schedule C, E, or F)
  - Multiple Member LLC– Partnership (Form 1065)
- **Elective** Form of Taxation
  - Corporation - Must file IRS Form 8832

Pubs Forms

Related IRS Publications and Forms

- **Form 8832** – Entity Classification Election
- **Form 2553** – Election by a Small Business Corporation
- **Pub 3402** - Tax Issues for Limited Liability Companies
- **Pub 1635** – Understanding Your EIN Number

The Details

LIABILITY PROTECTION

The primary purpose of an LLC is to provide liability protection to the members. An LLC protects the members of the LLC from liability but not the LLC itself. Since the LLC itself is not protected, it can be sued, and the LLC's assets can be seized to pay court ordered judgments.

Example – LLC Liability Protection - *Dave and Lee acquire a rental and hold it in an LLC. The tenant claims she got sick from mold in the building and sues. If the tenant wins the suit, then the only asset in jeopardy is the rental property itself and no other assets owned by Dave and Lee can be seized to pay the judgment.*

Members, agents and managers are not personally responsible for LLC debts and obligations. However, depending upon state law they may be held liable for:

1. Debts they personally guaranteed.
2. Wrongful acts committed as a member.
3. Promised, but not made, contributions to the LLC.
4. Wrongful distributions (under state law) from the LLC.
5. Improper personal benefits from the LLC.
6. Unremitted sales taxes.
7. Unremitted employment taxes.
8. Criminal acts.
9. Malpractice claims against professionals in states that permit professional LLCs.
10. In some states to the extent the LLC is under-capitalized or under-insured.

Using Multiple LLCs – Property held within an LLC provides protection to its members against claims unrelated to the business. However, property held in that LLC is subject to claims. Liability can be further limited by forming multiple LLCs; thus, only assets within each LLC are subject to claims associated with that LLC.

***Example – Multiple LLCs –** Dave and Lee in the prior example have two rental properties held within a single LLC. Thus, both properties' equity would be in jeopardy to the tenant's mold sickness claims. On the other hand, if each property was held in a separate LLC, the tenant's claims would only be against the assets of the LLC holding the property subject to the mold claim.*

Some states allow the creation of what is referred to as Series LLCs. These are structured to provide separate protection by separating the LLC in separate cells holding different assets and eliminating the need to create multiple entities. States allowing Series LLCs include: AL, DE, DC, IA, IL, KS, MN*, MO, MT, NV, ND*, OK, TN, TX, UT, and WI*. *State allows series LLCs but doesn't specifically provide a liability shield between the different series

LLC ARTICLES OF ORGANIZATION AND OPERATING AGREEMENTS

Articles of Organization – This document starts the process of becoming an LLC and is required by all states (after first naming the business and registering it with the state). The form includes basic business information, including name, address, member names (if a partnership), and details of the registered agent, such as an attorney, who has been authorized to accept legal documents on behalf of the LLC. Sample Articles of Organization can be found on most state web sites. Once filed and approved by the state, the articles of organization legally create the LLC as a registered business entity within the state. The taxpayer can prepare the articles or consult an experienced business attorney for assistance.

Operating Agreements – An LLC's operations are governed by its Operating Agreement, which structures the LLC's financial and functional decisions, and defines each member's duties, powers, and responsibilities. An LLC can alter their Operating Agreement to fit business and member needs as frequently as necessary. This document is not required by most states, but it is recommended that one be created to protect the owner(s) and the interests of the business.

CAUTION - Don't practice law unless you are also an attorney. Best practice is to refer your client to a competent attorney to prepare the Operating Agreement. Circular 230 Sec 10.32 states that nothing in Cir 230 may be construed as authorizing persons not members of the bar to practice law.

LLC FEES

LLCs are available in all 50 states and the District of Columbia. These states all charge a fee for having the LLC. Some look upon the fee as an additional tax. The fee is in addition to the tax on the income paid by the members. If clients squirm when paying the fees remind them that they are essentially buying a form of personal liability insurance.

LIMITED LIABILITY JURISDICTION

The liability protection of an LLC is **limited to the state in which the LLC is established**. This is a routinely misunderstood issue. For example a business establishes a Nevada LLC but the business is in California. The Nevada LLC provides no liability protection for the business in California.

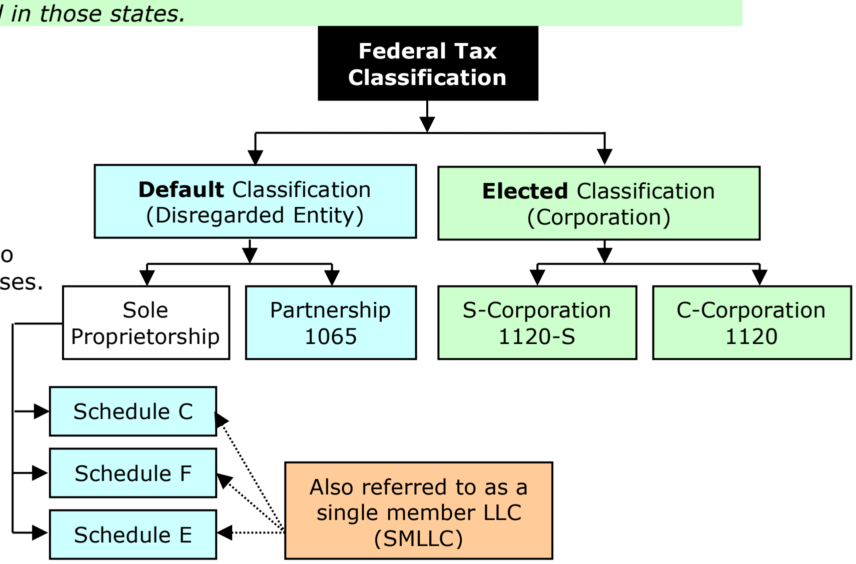
***Example – LLC Operating in Multiple States -** Roy and Louis own a trucking company that is organized as a New York LLC. Their trucks also service customers in New Jersey and Connecticut. Their LLC status in New York affords them **no protection** in New Jersey or Connecticut. On the other hand, if they establish LLCs in both the other states, they would be protected in those states.*

FEDERAL TAX CLASSIFICATION

LLCs are organized under state law and are not recognized as an entity for Federal tax purposes. Therefore for Federal purposes a state LLC is classified as a sole proprietorship, partnership or corporation.

An LLC can opt for a default classification or elect to be classified as a corporation for Federal tax purposes. (Reg §301.7701-3)

Single Member Limited Liability Companies A single member LLC (SMLLC) defaults to be a "disregarded entity" (sole proprietor – Schedule C, E or F) or can file Form 8832 – "Entity Classification Election" – to elect to be taxed as a corporation.



Default Classification – An LLC is classified for federal tax purposes under the default rules unless it files Form 8832 or Form 2553, Election by a Small Business Corporation, to be classified as a corporation. The default classifications are:

- **Sole proprietorship** for one member LLCs (C, E of F)
- **Partnership** for multi-member LLCc (1065)

An eligible entity uses Form 8832 to elect how it will be classified for federal tax purposes: as a corporation, a partnership, or an entity disregarded as separate from its owner.

Making The Election to be Taxed As a Corporation

- **When To File -** An election specifying an eligible entity's classification cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed.
- **Late Election Relief -** A newly formed entity may be eligible for late election relief under Rev. Proc. 2002-59, 2002-39 I.R.B. 615 if:
  - The entity failed to obtain its desired classification solely because Form 8832 was not timely filed,
  - The due date for the entity's desired classification tax return (excluding extensions) for the tax year beginning with the entity's formation date has not passed, and
  - The entity has reasonable cause for its failure to make a timely election.

To obtain relief, a newly formed entity must file Form 8832 on or before the due date of the first federal tax return (excluding extensions) of the entity's desired classification. The entity must also write "FILED PURSUANT TO REV. PROC. 2002-59" at the top of the form. The entity must attach a statement to the form explaining why it failed to file a timely election. If Rev. Proc. 2002-59 does not apply, an entity may seek relief for a late entity election by requesting a private letter ruling and paying a user fee in accordance with Rev. Proc. 2006-1, 2006-1 I.R.B. 1 (or its successor).

Form 8832 – The IRS Form 8832 has several uses. The following is an overview of those uses.

- If the LLC initially is to be a default entity (1065, C, E or F) the Form 8832 does not need to be filed.
- If the LLC initially is to be a corporation the 8832 (or the 2553 in the case of an S-Corporation) is used to elect to be taxed as a corporation.
- If the LLC wants to change its previous election.

CAUTION – 60 Month Rule

The entity generally cannot change its classification by election again during the 60 months after the effective date of the election. However, the IRS may (by private letter ruling) permit the entity to change its classification by election within the 60-month period if more than 50% of the ownership interests in the entity, as of the effective date of the election, are owned by persons that did not own any interests in the entity on the effective date or the filing date of the entity's prior election.

DEFAULT ENTITY RULES

Existing entity default rule - If an existing entity decides to change its classification, it may do so subject to the 60-month limitation rule. See Regulations sections 301.7701-3(b)(3) and 301.7701-3(h)(2) for more details.

Domestic default rule - Unless an election is made on Form 8832, a domestic eligible entity is:

1. A partnership if it has two or more members.
2. Disregarded as an entity separate from its owner if it has a single owner.

Automatic Classification as a Corporation – The following business entities are automatically classified by regulation as corporations for federal tax purposes (Reg §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8)):

- A business entity organized under federal or state law if the statute describes or refers to the entity as incorporated, a corporation, body corporate, or a body politic;
- An association;
- A business entity organized under state law if the statute describes or refers to the entity as a joint-stock company or a joint-stock association;
- An insurance company;
- A federally insured state-chartered bank;
- A business entity wholly owned by a state or any political subdivision of a state;
- A publicly traded business entity taxable as a corporation under IRC Section 7704; and
- Certain foreign business entities.

Change in Number of Members - A change in the number of members:
- Corporation – Does not affect the entity's classification.
- Partnership - Will become a disregarded entity when the entity's membership is reduced to one member.
- Disregarded Entity - Will be classified as a partnership when the entity has more than one member.

EMPLOYMENT TAXES

Filing Employment & Excise Tax Returns- Final regulations (T.D. 9356) require single member LLCs (SMLLCs) to be treated as the taxpayer for employment tax and excise tax obligations. The SMLLC will continue to be disregarded for other federal tax purposes. The SMLLC will be responsible for collecting, reporting and paying over employment tax obligations using the name and EIN assigned to the LLC.

Employment tax requirements apply to LLCs in much the same way as other types of businesses.

For wages paid, the disregarded entity is required to use its name and EIN for reporting and payment of employment taxes. A disregarded entity is also required to use its name and EIN to register for excise tax activities on Form 637, pay and report excise taxes reported on Forms 720, 730, 2290, and 11-C, and claim any refunds, credits, and payments on Form 8849. The Form SS-4 includes more specific details regarding EINs for LLCs. Once you have downloaded the PDF file from IRS.gov, use the PDF search tool and search the form instructions under "disregarded".

SE TAX & LIMITED PARTNERS

In computing net earnings from self-employment, the distributive share of an item of income or loss of a limited partner (other than certain guaranteed payments, discussed below) is excluded (Code Sec. 1402(a)(13)).

Under proposed regulations (Prop Reg § 1.1402(a)-2(h)(2)), an individual would be treated as a limited partner unless he:
(1) Has personal liability for the debts of or claims against the partnership by reason of being a partner;
(2) Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or
(3) Participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.

> ***Code Sec 1402(a)(13) -*** *there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services;*

Thus LLC Members who are passive investors and do not participate in the management of the business are not subject to SE Tax. Guaranteed payments are always subject to SE tax.

INFORMATION REPORTING

- Employees of all LLCs are subject to withholding taxes.
- Forms W-2 and Forms 1099 must be filed when required.
- As a member, an individual's liability for LLC debts is limited by state law. However, a member may be held personally liable in situations involving unpaid employee withholdings if the member is found to be the person responsible for making the payments. (IRC Section 6671 and 6672)

CONVERTING AN EXISTING BUSINESS INTO AN LLC

Pitfalls - There are two common situations where unintentional errors may occur:

1. When an existing business, such as a corporation, is converted into an LLC there may be tax implications, such as:
   - The conversion may result in a taxable gain;
   - Employment tax wage bases may be affected.
2. Special rules may apply when the LLC has an operating loss:
   - The amount of loss a member can deduct may be limited because of the member's limited liability for LLC debts. (IRC Sec 465)
   - Passive Activity Loss limitation may restrict the amount of loss a member can deduct. (IRC Sec 469)

This chapter does not deal with the complicated issues related to business entity conversions and practitioners are advised to carefully review the laws and procedures relating to entity conversions.

MATERIAL PARTICIPATION

In *Garnett v. Commissioner, Dec. 57,875, 132 TC 19* the IRS contended that because the taxpayers had limited liability with respect to their ownership interests in limited liability companies and limited liability partnerships they should be deemed to have a limited partnership interest, and the losses they incurred from these activities should automatically be considered passive losses under Code Sec. 469(h)(2).

The court disagreed with the IRS that simply being a member of an LLC or an LLP and having limited liability automatically makes losses from an LLC or LLP passive. Instead, all of the facts and circumstances of a taxpayer's participation in the entity must be considered in determining whether the material participation requirements are met.

This is not the only case on this topic that the IRS lost; another is *Thompson v United States 87 Fed Cl 728 (July 20, 2009)* to which the IRS acquiesced "in result only."

It should be noted that Code Sec. 469 and related regulations were enacted prior to the existence of LLPs and the widespread availability of LLCs. Recognizing that litigation wasn't working, the IRS issued Prop. Reg. §1.469-5, which will become effective after being finalized. It clarifies when a member of a partnership or multi-member LLC is a limited partner for determining material participation under the passive activity rules: whether an individual is a limited partner in an LLC depends upon the individual's right to participate in management of the entity, and not on the extent to which the individual has limited liability. An individual's interest in an LLC will be treated as a limited partnership interest if:

1. For federal tax purposes, the entity is classified as a partnership under the check-the-box regulations, and
2. Under state law or the operating agreement of the entity the holder of the interest does not have any rights to manage the entity at any time during the entity's tax year. ***(Prop. Reg. 1.469-5(e)(3)(i))***

The general partnership exception continues to apply under the proposed regs. That is, an individual is not treated as holding a limited partnership interest in a limited partnership if he or she also holds a general partnership interest at all times during the partnership's tax year ending with or within the individual's tax year. ***(Prop. Reg. 1.469-5(e)(3)(ii))***.

<u>DISREGARDED ENTITY AND "OUTSIDE BASIS"</u>

Tracking outside basis is critical to properly taxing a partner on partnership distributions or on the disposition of its partnership interest, because in each case the partner's federal tax consequences derive directly from its outside basis in its partnership interest. Not so for the owner of a disregarded entity said the IRS Associate Chief Counsel in ***AM-2012-001 (2/20/12)***. Tracking outside basis in a disregarded entity is irrelevant to the owner's taxation, and therefore, no authority provides for such tracking.

The legal ruling cites Rev Rul 99-5, 1999-1 CB 434, which explains the taxation of an owner who sells part of its interest in a disregarded entity and doesn't mention a taxpayer's outside basis in the disregarded entity. Therefore, taxpayers owning 100% interest in LLCs that are disregarded entities cannot split their interests into separate classes of membership interests and then allocate income, loss, deduction, credit and basis among those classes for federal tax purposes in an attempt to manipulate the outside basis of the interests.

<u>POWER OF ATTORNEY</u>

A legal opinion from the IRS' Office of Chief Counsel says that a general partner or in the case of an LLC, a member-manager, may sign a power of attorney (POA) for purposes of a TEFRA partnership-level examination or for other tax purposes of the partnership. A POA can also be secured from a limited partner or LLC member for the purposes of securing partnership item information and disclosing partnership information to the POA. In the case of an LLC that has no member who is also a manager, the non-member manager may sign the POA for purposes of establishing that it would be appropriate and helpful to secure partnership item information including securing documents and discussing the information with the designated individual. This advice may not be used or cited as precedent. (Chief Counsel Advice Memorandum 2015-004, 4/3/15)

<u>CALIFORNIA LLC ANNUAL FILING REQUIREMENTS</u>

A California LLC must file its initial report, called the Statement of Information, with the California Secretary of State (SOS) within 90 days of the company's formation. The report is then due to the state biennially by the company's anniversary date. Form LLC-1 accompanied by the LLC's Operating Agreement is used for that purpose. The form is available on the Secretary of State's website at www.sos.gov.org. In addition, the LLC will be required to biennially file Form LLC-12 with the Secretary of State. However, Form LLC-12NC (Statement of No Change) may be used in lieu of Form LLC-12 if a previous complete LLC-12 has been filed with the SOS and if there has been no change in any of the information contained in the previous LLC-12. Changes to information contained in a previously filed LLC-12 can be made by filing a new Form LLC-12, completed in its entirety.

<u>REAL PROPERTY HELD FOR SALE TO CUSTOMERS</u>

The Franchise Tax Board, in Legal Ruling 2016-01 has held the adjusted basis of real property held for sale to customers in the ordinary course of business is included in the cost of goods sold. As a result, the sales price of the real property must be included in the LLC's gross income (adjusted basis added back) to determine the LLC fee. This will have a direct impact on taxpayers who are buying, improving and subsequently selling real property, commonly referred to as flipping.

Where property is held for investment purposes only, the property's adjusted basis is not added back to the taxpayer's gross income for purposes of calculating the fee.

NONRESIDENT MULTI-MEMBER LLCs' FILING REQUIREMENTS

The Franchise Tax Board, in Legal Ruling 14-01, has held that for tax purposes, the business of a partnership is the business of each partner. For this reason, wherever a partnership does business, the activities of the partnership are attributed to each partner, with the consequence that in geographic locations where the partnership is "doing business," the partners are also "doing business."

If an LLC is treated as a partnership for tax purposes, both the LLC and its members, are subject to the same legal principles applicable to any partnership. Thus, if an LLC classified as a partnership for tax purposes is "doing business" in California under Section 23101, the members of the LLC are themselves "doing business" in California. According to the FTB, this is true even in the case of "manager-managed" LLCs. If an LLC is classified as a partnership for tax purposes, the members, who are considered general partners for tax purposes, are "doing business" where the LLC, i.e., a general partnership for tax purposes, is "doing business," even though the members have limited liability protection and are not California residents. Therefore, if the member is deemed to be doing business in California, the member is subject to the LLC filing requirements and taxes.

However, in November 2014, a California Superior Court disagreed with the FTB's position. The court ruled that an Iowa corporation whose only connection with California was its 0.2% ownership interest in a fund organized as a California LLC was not "doing business" in California. Under California law, the fund was organized as a "manager-managed LLC" rather than a "member-managed LLC"; thus, the out-of-state corporation had no control over the management of the fund and did not have a sufficient percentage interest to indirectly control its management. The court said the corporation was entitled to a refund of the annual franchise tax, interest, and penalties previously collected by the FTB. (Swart Enterprises, Inc. v. California Franchise Tax Board, Fresno Superior Court, No. 13CECG02171, Order on Cross-Motions for Summary Judgment, November 14, 2014)

The FTB appealed this case to the 5th Circuit Court of Appeals and lost the appeal. (Swart Enterprises, Inc. v. California Franchise Tax Board (January 12, 2016) California Court of Appeal, Fifth District, Case No. F070922). The Appeals Court opined that California's expansive interpretation of doing business "defies a commonsense understanding of what it means to be 'doing business'. This is a precedent-setting case that other taxpayers can rely on. The FTB provided guidance in FTB Notice 2017-01 that any taxpayers who file a claim for refund and who believe their situation has the same facts as in *Swart*, should cite the holding in *Swart* and explain how their factual situation is the same as the facts in *Swart*. So it appears that to meet the same fact pattern as in *Swart*, a taxpayer's interest in an LLC that meets the other facts of *Swart* can't be more the 0.2%. The FTB has said that it is not going to withdraw Legal Ruling 14-01.

WITHHOLDING TAXES ON LLC MEMBERS – CA CONFORMS TO FEDERAL

Legislation enacted in 2014 (SB 1131) conforms treatment of LLCs to federal law by excluding members of an LLC that is taxed as a partnership from the definition of employee as it relates to personal income tax (PIT) withholding requirements. Thus, the LLC is not required to withhold state PIT from its members. Legislation in 2010 had exempted LLCs taxed as a partnership from unemployment tax and disability insurance withholding. With the passage of SB 1131, California now fully conforms to federal regarding compensation of LLC members.

LLCs AND PROFESSIONAL SERVICES

An LLC may not render professional services. (Corp. Code § 17375) "Professional services" are defined in California Corporations Code sections 13401(a) and 13401.3 as any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Business and Professions Code, the Chiropractic Act, the Osteopathic Act or the Yacht and Ship Brokers Act.

If the business is required to be licensed, registered or certified, the owner should contact the appropriate licensing authority before registering as an LLC with the California Secretary of State's (SOS) office in order to determine whether the services are considered professional.

Information on legally establishing an LLC can be found on the Small Business Administration's web site, www.SBA.gov, or on the California Secretary of State's web site, www.sos.ca.gov.

HUSBAND & WIFE MEMBERS

A husband and wife who each have a separate interest in the LLC will be treated as separate members. The LLC must file a partnership return and issue a separate Schedule K-1 (FTB Form 568) to each member. A husband and wife who hold a membership interest together are treated as a single member. The LLC must file a return as a disregarded entity if they are the sole owners, and issue them a single K-1 (FTB Form 568).

TAX CREDIT LIMITATIONS
A taxpayer that owns an interest in a single-member LLC that is disregarded for tax purposes may only claim credits or credit carryforwards from the LLC to the extent the member's tax liability is attributable to the LLC. Disallowed credits may be carried forward to future years.

ANNUAL TAX & LLC FEE - LLCs are responsible for a flat **franchise tax of $800.00** assessed by the California Franchise Tax Board. The initial franchise tax is due by the 15th day of the fourth month after the company's formation, and annual franchise taxes must be prepaid by the 15th day of the fourth month of each tax year. California LLCs are also assessed **a fee** (also known as the gross receipts tax) **on annual income exceeding $250,000.00**.

An LLC required to file Form 568 (all entities except corporations) pays an annual tax of $800, and also may be subject to a fee based on the LLC's total California source income (not worldwide income). The annual tax is due by the 15th day of the fourth month of the taxable year, and is paid using CA Form 3522. The fee, based upon total California income, is determined from the chart below:

If Total California Income is. . .		
Equal to or over –	But not over –	Fee
$ 250,000	$ 499,999	$ 900
$ 500,000	$ 999,999	$ 2,500
$ 1,000,000	$ 4,999,999	$ 6,000
$ 5,000,000 and over		$11,790

Estimated Fee Payment Required - The LLC fee must be estimated and paid by the 15th day of the 6th month of the current taxable year. *(R&TC 17942(d)(1))* For calendar year filers that means the payment for tax year 2019 was due June 17, 2019. A penalty of 10% of the underpayment of the estimated fee will apply if the estimated fee is underpaid, although no penalty will be imposed if the timely paid estimated fee is equal to or greater than the total of the preceding year's annual fee. *(R&TC 17942(d)(2))* Form FTB 3536 must be used to pay the estimated fee.

Deducting the LLC tax and fee – For federal purposes both the $800 tax and the income-based fee are deductible on the LLC's tax return, but for California purposes, only the fee paid is deductible.

- In addition, an LLC filing Form 568 that has members that are not residents of California must file the agreements of those non-resident members acknowledging that California may tax them and may collect tax from them, agreeing to file a California return and pay tax on the members' share of California source income of the LLC. For any non-residents that do not sign an agreement, the LLC must pay tax on the nonresidents' share of LLC income.

***Commencing and Dissolving LLCs* -** Commencing and dissolving LLCs are exempt from tax during the year of organization or dissolution if the tax year is 15 days or less and the LLC does no business in California during the tax year. For example, a calendar year LLC that is formed between December 17 and December 31 is exempt from tax during the first tax year if it does no business in California during that period. A calendar year LLC that dissolves by January 15 is exempt from tax during the last tax year if it does no business in California during that period.

Related FTB Publications and Forms

- **Form 100 –** Corporate Return
- **Form 568** – Limited Liability Company Return of Income
- **Form 568 Booklet**
- **FTB 3522 -** LLC Tax Voucher
- **FTB 3536 –** Estimated Fee for LLCs
- **FTB 3537 -** Payment for Automatic Extension for LLCs
- **FTB 3832 -** Limited Liability Company Nonresident Members' Consent
- **Form LLC-1** - Limited Liability Company Articles of Organization
- **Form LLC-12** – Statement of Information (Limited Liability Company)
- **Form LLC-12NC** –Statement of No Change (Limited Liability Company)

KEY LLC FEATURES

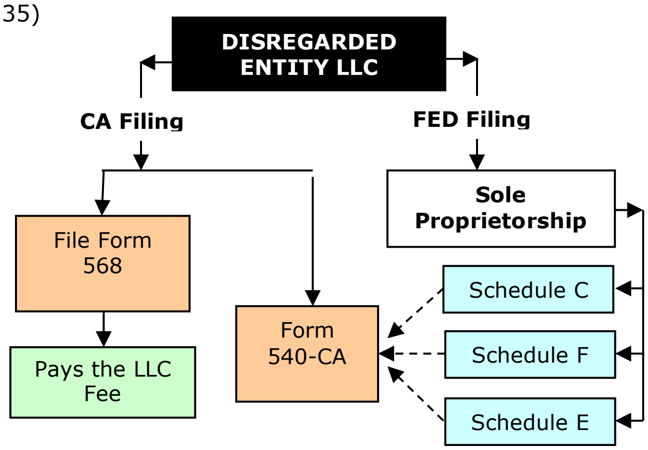
- An LLC may have one or more owners, and may have different classes of owners. In addition, an LLC may be owned by any combination of individuals or business entities. An LLC, therefore, is more flexible than an S-corporation with regards to types and numbers of owners.
- An LLC is treated as a legal entity separate from its owners, similar to how a corporation is treated, regardless of how the LLC is classified for tax purposes.
- In general, the owners (members) are shielded from individual liability for debts and obligations of the LLC.
- An LLC is formed by filing "articles of organization" with the California Secretary of State prior to conducting business.
- Forming an LLC is simpler and faster than forming and maintaining a corporation.

- LLCs do not issue stock, and are not required to hold annual meetings or keep written minutes, which a corporation must do in order to preserve the liability shield for its owners.
- Either before or after filing its articles of organization, the LLC members must enter into a verbal or written operating agreement. A formal, written agreement is advisable.
- An LLC is typically managed by its members, unless the members agree to have a manager manage the LLC's business affairs.
- Generally, members of an LLC that are taxed as a partnership may agree to share the profits and losses in any manner. Members of an LLC classified as a corporation receive profits and losses in the same manner as shareholders of a corporation legally organized as such.
- An LLC's life is perpetual in nature. However, the members may agree in the articles of organization or the operating agreement to a date or event that will cause the LLC to terminate. In addition, members of the LLC may vote at any time to end the business operations of the LLC.

<u>CA PENALTY – LLC FAILURE TO FILE</u>

Effective January 1, 2013, the FTB will assess a $2,000 penalty against an LLC (domestic/foreign) that is doing business within California while not registered to do business within the state or while suspended or forfeited and fails to file its required tax return upon notice and demand. (RTC §19135)

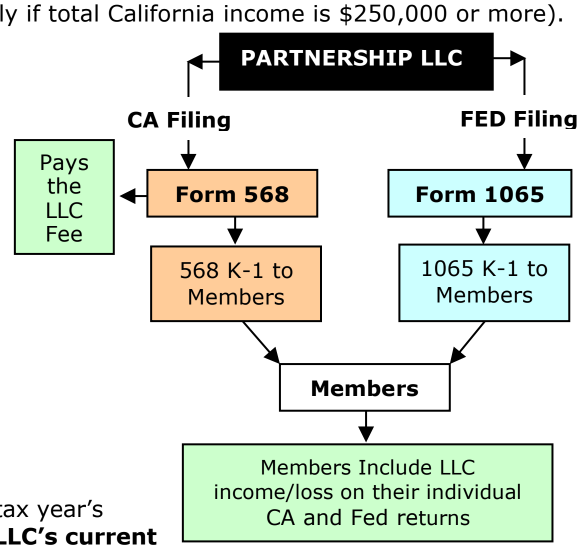
<u>CA & FEDERAL FILING REQUIREMENTS - OVERVIEW</u>



Single Member LLCs (SMLLC)

- <u>Federal Return</u> – Complete **Schedule C, E, or F as appropriate**.
- <u>California Returns</u> -
  - **Form 568** - Complete the following pages of the CA Form 568 LLC Return of Income using income, deductions, credits, etc., from the member's 1040 Schedule C, E or F:
    - Side 1,
    - Side 2,
    - Side 3,
    - Side 7, Sch IW (Income Worksheet)
    - Schedule B (only if income or loss amount reported on line 1 or line 3 through line 11 is $3 million or more),
    - Schedule K (only if total distributable income/payment items on line 21a is greater than or equal to $3,000,000 or less than or equal to <$3,000,000>), and
    - Pay the annual tax and LLC fee.
    - Due April 15th of the following year (calendar year taxpayers)
  - **Form 3522** – Complete the voucher and pay the $800 minimum annual LLC tax. For calendar year taxpayers the tax is due on or before April 15th **of the LLC's tax year** (not the following year).
  - **Form 3536** – Complete the voucher and pay the current tax year's estimated LLC fee by the 15th day of the 6th month of the **LLC's current tax year** (applies only if total California income is $250,000 or more).

Multi-Member LLC



- <u>Federal Return</u> – Prepare a **Form 1065 Partnership Return**
- <u>California Returns</u> -
  - **Form 568** - Complete the CA Form 568 LLC Return of Income using the income, deductions, credits, etc., from the corresponding Federal Form 1065, adjusted for California law differences:
    - Pay the annual tax and LLC fee.
    - Issue the K-1s to the members
    - Due the 15th day of the fourth month after the close of the LLC tax year.
  - **Form 3522** – Complete the voucher and pay the $800 minimum annual LLC tax. For calendar year taxpayers the tax is due on or before the 15th day of the fourth month **of the LLC's tax year** (not the following year).
  - **Form 3536** – Complete the voucher and pay the current tax year's estimated LLC fee by the 15th day of the 6th month of the **LLC's current tax year** (applies only if total California income is $250,000 or more).

Classified as a Corporation –

- Federal Return – Prepare a **Form 1120 or 1120S**
- California Returns -
  - **Prepare California Form 100**
    - Due 15th day of the 4th month after the close of the LLC's taxable year.
    - Taxed at the corporate tax rate of 8.84 percent and subject to a minimum tax of $800.

  - **Form 3522** – Complete the voucher and pay the $800 minimum annual LLC tax. For calendar year taxpayers the tax is due on or before the 15th day of the fourth month **of the LLC's tax year** (not the following year).

E-file Requirement - For taxable years beginning on or after January 1, 2014, California law requires any business entity that files an original or amended tax return that is prepared using tax preparation software to electronically file (e-file) their tax return with the FTB. Thus an LLC must file their Form 568 or Form 100 electronically. For more information, see the California Differences section in Chapter 3.00 or go to ftb.ca.gov and search for "business efile."

Short Form Cancellations for LLCs

California Code provisions allow limited liability companies (LLCs) to cancel and not be required to pay the first year annual tax if they meet certain conditions (Corporations Code Section 17350.5 and California Revenue and Taxation Code (R&TC) Section 17941(e)).

A domestic limited liability company (LLC) may use the Secretary of State's form SOS Form LLC-4/8, Limited Liability Company Short Form Certificate of Cancellation, to cancel (ceasing the LLC's rights, powers, and privileges) if it is filed within twelve months from the date the Articles of Organization were filed with the SOS, and it meets the following requirements:

- Owe no debts or liabilities, except for its final state income tax.
- Filed or will file a timely final tax return.
- Conducted no business since filing its articles of organization.
- Distributed all remaining assets to the entitled persons after providing for payment of all debts and liabilities.
- Voted to dissolve the LLC from a majority of the managers, members, or persons that signed the articles of organization.
- Returned all payments received for interests to the investors.

The short form cancellation is operative for LLC's that filed articles of organization.

The LLC annual tax is not required for the first taxable year if an LLC filed the short form cancellation with SOS and is classified as a partnership or disregarded entity.

If an LLC files SOS Form LLC-4/7, Limited Liability Company Certificate of Cancellation, or is involved in a merger or conversion, it does not qualify for LLC short form cancellation even if it meets all of the requirements.

Currently, the minimum tax is not required for the first taxable year only if the LLC is classified as a corporation.

The FTB can only refund the annual tax or fee that was paid on or after the date the LLC filed the SOS Form LLC-4/8, Limited Liability Company Short Form Certificate of Cancellation, with the SOS.

Example - Annual Tax Unpaid *- Needs Capital, LLC, filed articles of organization on August 1, 2019, with the SOS. The LLC later determined that it was unable to obtain sufficient funding to begin business operations. The LLC filed a short form cancellation (SOS Form LLC-4/8) with the SOS on December 14, 2019. It used a calendar tax year and did not pay any tax or fee. The LLC would file a final 2019 Form 568 without self-assessing the annual tax*

Example - Payment Received Prior to the Cancellation Date *- Use the same facts as in the prior Example, except that the LLC made an annual tax payment on November 16, 2019. The LLC would file a final 2019 Form 568 and self-assess the annual tax. The FTB cannot refund annual tax payments received before the date the LLC filed the short form cancellation with the SOS.*

Example - Payment Received On or After the Cancellation Date *- Use the same facts as in the first example, except that the LLC made an annual tax payment on January 15, 2020. The LLC files a final 2019 Form 568 without self-assessing the annual tax. The FTB will refund the annual tax payment since it was paid on or after the date the LLC filed the short form cancellation with the SOS.*

For additional information related to closing a CA business entity visit:

https://www.ftb.ca.gov/about-ftb/newsroom/tax-news/may-2018/how-to-close-a-california-business-entity.html

https://www.ftb.ca.gov/help/business/index.html

LLC Elects to Be Taxed as a Corporation - If the LLC elects to be taxed as a corporation for federal tax purposes, the LLC must file Form 100-ES and enter the California corporation number, federal employer identification number (FEIN), and California Secretary of State file number (CA SOS), if applicable, in the space provided. The FTB will assign an identification number upon receipt of the first estimated tax payment, tax payment, or the first tax return. The LLC will be subject to the applicable provisions of the Corporation Tax Law and should be considered a corporation for purpose of all instructions unless otherwise indicated.

NOTES

SECTION 179 DEDUCTION

RAPID FINDER

Overview

- An **election** to expense instead of depreciate
- **2019 Annual limit:** $1,020,000 ($510,000 MS)
- **Investment limit:** $2,550,000 (2019). The annual limit is reduced by $1 for every $1 over the investment limit.
- Limited to taxable income from all of the taxpayer's ***active*** trades or businesses.
- SUV (14K pounds or less) Limitation is: $25,500 (2019)
- **Qualifying Property**
  - Tangible personal property
  - Used in an active trade or business
  - Property eligible for MACRS
  - Off-the-shelf software
  - Qualified real property
  - Certain air conditioning and heating units after 2015
  - Roofs, HVAC, fire protection systems, alarm systems and security systems (nonresidential real property only)
- Furnishings used in the living quarters of a lodging facility after 2017
- Not available to estates and trusts
- Not allowed for buildings & structural components - unless "qualified real property"
- Partially recaptured (excess of Sec. 179 over MACRS) if taken out of service early.
- Taxpayers allowed to make, change, or revoke a Sec 179 election on a timely filed amended return. However, once a change has been made it becomes irrevocable.

TCJA

Increased Limits - For property placed in service after 2017, the TCJA increases the annual Sec 179 expensing limit from $510,000 to $1,000,000, and the annual investment limit threshold is upped from $2,030,000 to $2,500,000, with both amounts subject to future inflation indexing. *(Sec. 179(b) as amended by TCJA Sec. 13101)*

Expanded Definition of Sec 179 Property - TCJA expanded the definition of Sec 179 property placed in service after 2017 to include certain furnishings used in the living quarters of a lodging facility. See details on page 3.06.02.

***Post Construction Improvements To Non-residential Real Property* -** As qualified real property, certain improvements to nonresidential real property placed in service after the date such property was first placed in service are qualified Sec 179 property after 2017. Details on page 3.06.02.

***Commentary*:** The Sec 179 deduction was originally created as a small business expensing election allowing up to $25,000 of annual expensing. The higher limits now give larger companies that tend to purchase more and costlier qualifying property the ability to use Sec 179 expensing, a benefit especially in future years as the 100% bonus depreciation phases out.

Pubs Forms

Related IRC and IRS Publications and Forms

- **IRS Publication 946** – How to Depreciate Property
- **Form 4562** – Depreciation and Amortization
- **Section 179**

The Details

Taxpayers, **except trusts, estates and certain noncorporate lessors**, can **elect** (on Form 4562) to expense the cost of qualifying property used in the active conduct of a trade or business. The portion of the cost not expensed under Sec 179 is depreciable. If the taxpayer's use of the property drops to 50% or less in a subsequent year, recapture of some of the deduction benefit is required.

EXPENSE LIMITS

2017	2018	2019	2020
$510,000	$1,000,000	$1,020,000	1,040,000

QUALIFYING PROPERTY

Generally, qualifying property is purchased tangible personal property, either new or used, purchased for use in the active conduct of a trade or business eligible for ACRS or MACRS depreciation. However, buildings and their structural components, **other than** "qualified real property," **do not qualify**. The following are eligible property:

- Tangible personal property, either new or used,
- Off-the-self software
- Portable heating and air conditioning (AC) units (after 2015)
- Vines and fruit bearing trees (once in production stage)
- Qualified Real Property, generally includes:
  - Qualified leasehold improvement property
  - Qualified restaurant property
  - Qualified retail Improvement property
- Non-residential Real Property – certain post construction improvements (listed below)

Examples of Qualifying Property:

Personal Tangible Property **-** Grocery counters, refrigerators, display racks, shelves, neon signs, machinery, equipment, gas pumps, gas storage tanks, grain storage bins, autos, trucks, elevators, escalators, certain livestock, greenhouses, single-purpose livestock structures, and coin-operated vending machines.

Off-the-Shelf Computer Software – Off-the-shelf computer software (made permanent by the PATH Act of 2015).

Air Conditioning and Heating Units - Beginning after 2015, AC and heating units qualify for Sec 179 expensing, but only if they are Sec 1245 property, such as portable units – for example a window air conditioner and portable plug-in unit heaters. An example of an air conditioning or heating unit that will not qualify as Sec. 179 property is any component of a central air conditioning or heating system of a building, including motors, compressors, pipes, and ducts, whether the component is in, on, or adjacent to a building. However, AC and heating units that meet the definition of qualified real property (see below), placed in service after 2015 (Rev. Proc. 2017-33), and HVAC equipment put in service after 2017 in nonresidential real estate (see below), may qualify if the taxpayer so elects.

TCJA

Furnishings – Beginning after 2017 furnishings, e.g., beds and other furniture, refrigerators, ranges, and other equipment – used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) used predominantly to furnish lodging or in connection with furnishing lodging.

Commentary: Previously Sec. 179 could only be used for a *transient* lodging activity, such as hotels and motels.

TCJA

Post-Construction Improvements to Non-residential Real Property **-** As qualified real property, any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service and after 2017: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

SUV Limitations - The 2019 Sec 179 deduction for SUVs is limited to $25,500 (up from $25,000 in 2018), and applies to sport utility vehicles rated at 14,000 pounds gross vehicle weight or less. **Excluded from this limitation** is any vehicle that:

- is designed for more than nine individuals in seating rearward of the driver's seat;
- is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length, **or**
- has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

The $25,000 limitation is adjusted for inflation in $100 increments for tax years beginning after 2018. (IRC Sec 179(b)(6)(B), as added by the TCJA)

Vineyards **-** In Chief Counsel Advice (CCA201234024), IRS has concluded that vineyards are eligible for the Code Sec. 179 expensing deduction.

Fruit bearing trees and vines aren't considered placed in service until they have reached an income-producing stage. (Reg. § 1.46-3 (d)(2)(iii)) To utilize the Sec 179 deduction, the cost of a newly planted vineyard must be capitalized until such time as the vines reach the income producing stage (placed in service) and then capitalized costs may be expensed under Sec 179.

Qualified Real Property – Includes the following property. (Under TCJA the property in the first 3 bullets below were combined into the single definition of qualified real property.):

- Qualified leasehold improvement property,
- Qualified restaurant property, and

- Qualified retail improvement property.
- Effective for property placed in service after 2017, any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Qualified improvement property generally means an internal improvement to nonresidential real property if the improvement is placed in service after the date the building was first placed in service but does not include any improvement that enlarges the building, any elevator or escalator, or the internal structural framework of the building. (Code Sec. 168(e)(6)).

For this purpose, the term "**qualified real property**" means property acquired by purchase for use in the active conduct of a trade or business (Sec. 179(d)(1)), is property that is normally depreciated (Sec. 179(d)(1)) and **is not:**

- (prior to 2018) property used for lodging, except for property used by a hotel or motel in which the predominant portion of the accommodations is used by transients;
- property used outside the U.S; and
- property used by governmental units, foreign persons or entities, and certain tax-exempt organizations, and
- (prior to 2016) air conditioning or heating units.

> ***Example:*** *A small business owner with a retail clothing store can expense under Sec 179 improvements that were made inside the store, such as built-in cabinets to better stock clothing or lights to brighten the fitting rooms.*

Special Dollar Limitation: Prior to 2016 no more than $250,000 of the Sec 179 deduction limitation applicable can be used for Qualified Real Property.

NON-QUALIFYING PROPERTY

Examples of Non-qualifying Property include: Buildings, central heating and air conditioning units (unless eligible as qualified real property), swimming pools, paved parking lots, wharves, docks, bridges, fences, horses, property used outside the U.S. and property used 50% or less for business in the year placed in service.

RENTAL PROPERTY

The definition of Sec 179 property specifically states that buildings and their structural components do not qualify for the Sec 179 expense deduction. However, a question that is frequently asked is whether Sec 179 applies to Sec 1245 (personal tangible property), such as a washer or dryer, purchased and installed in a rental. Section 179 property is further defined as property used in an active trade or business. Since a rental generally does not meet the requirement of being an active trade or business the ***Sec 179 expense deduction will not apply to Sec 1245 property used in a rental activity.*** The term "trade or business" has the same meaning as in Sec 162 and the regulations thereunder. (Reg. 1-179-2(c)(6)(i))

Reg. 1-179-2(c)(6)(ii) – active conduct: "For purposes of this section, the determination of whether a trade or business is actively conducted by the taxpayer is to be made from all the facts and circumstances and is to be applied in light of the purpose of the active conduct requirement of section 179(b)(3)(A). In the context of section 179, the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income derived from that trade or business. Consistent with this purpose, a taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business. Generally, a partner is considered to actively conduct a trade or business of the partnership if the partner meaningfully participates in the management or operations of the trade or business. A mere passive investor in a trade or business does not actively conduct the trade or business."

FIRST YEAR PLACED IN SERVICE

Section 179 election is ***available only in the first year a property is placed in service.*** If a property is a nonqualifying property in its first year in service, a 179 deduction is not allowed in a later year if the property becomes qualifying. A property becomes a nonqualifying property if it is used for other than a qualifying purpose prior to being placed in service.

CARRYOVER

Any amount which can't be deducted in one tax year because of the taxable income limit (see next item) may be carried over to the next year and added to the cost of qualifying property in that year. Apply carryover amounts on a FIFO basis. The carryover amount is subject to the taxable income limitation and maximum dollar limitation in effect for the carryover year. No carryover is available for deductions lost due to the investment limit or the maximum deduction limit.

TAXABLE INCOME LIMIT

The amount of deduction is further limited to the amount of taxable income from any of a taxpayer's active trades or businesses. Taxable income, for this purpose, is computed without regard to:

1. The cost of any qualified expense property,
2. The above-the-line deduction for a portion of self-employment tax,
3. Any net operating loss carryback or carryforward, and
4. Any deductions suspended under the passive activity rules.

Employees are considered to be engaged in the active conduct of the trade or business of their employment. Thus, **wages, salaries, tips and other compensation** (not reduced by unreimbursed employee business expenses) derived by an employee are included for purposes of the taxable income limit (Reg § 1.179-2(c)(6)(iv)).

Example - Computing Taxable Income Limits for Section 179: *Joe purchased and placed in service office equipment at a cost of $12,000. In the year he purchased the equipment, Joe's taxable income from his business was $7,000 (without regard to any Section 179 deduction for the equipment). Joe has a W-2 for $2,000 from a part-time job. His Section 179 deduction is limited to $9,000, but he may carry $3,000 forward to future years.*

INVESTMENT LIMIT

When the total cost of qualifying property placed in service in any given year exceeds the investment limit, decrease the expense cap amount for the year by one dollar for each dollar over the investment limit. The investment limit is annually inflation adjusted, rounded to the nearest $10,000, after 2015.

Year	2017	2018	2019	2020
Investment Limit	2,030,000	2,500,000	2,550,000	2,590,000

If an amount is not shown, it was not available at publication date

Example – Computing Section 179 Under Investment Limit: *Jack placed business machinery costing $2,600,000 in service during 2019 when the investment limit was $2,550,000 and Sec 179 deduction cap was $1,020,000. Jack's net profit from his business is $2,950,000 before his Section 179 expense deduction. His maximum 179 expense deduction for the placed-in-service year is $970,000, ($1,020,000 reduced by $50,000, the machinery's cost exceeding $2,550,000).*

RECAPTURE

If property is removed from business service (or not used more than 50% for business) AT ANY TIME before the end of its recovery life, recapture is necessary. Add back the excess of the Section 179 amount over the MACRS deduction that would have been allowed. Recapture amount is initially entered on Form 4797, Part IV, and is then reported as income on the same form or schedule where the deduction was originally taken.

Example 1 - Recapture of Section 179 Deductions: *Fran bought a copier on 02/15/18 for $700. The property was used 100% in her secretarial business, and she elected a Section 179 deduction of $700 on her 2018 tax return. In 2019, she closed her business and the copier was used only for personal use. She must recapture $560 [the difference between the Section 179 deduction and the MACRS deduction (five-year property, 20% of $700 = $140), which would have been allowed in 2018 if Sec 179 had not been elected]. The recapture would add to Fran's 2019 net income, if any, on Schedule C and thus could increase her self-employment tax.*

Example 2 - Recapture of Section 179 Deduction When Decrease in Business Use: *Sam bought and placed in service on 10/31/17 three-year property, which cost $10,000. He elected a 179 deduction of $5,000 on his 2017 tax return. He did not claim any bonus depreciation. The property was not listed property and was used 100% in Sam's business in '17 and '18, but in 2019 his business use was only 40%. Since his business use of the property fell to 50% or less in 2019, he is not entitled to the Section 179 deduction. Sam's recapture in 2019 is $816, figured as follows:*

Year	*Deduction*	*Redetermined*
2017	*$6,667* [1]	*$3,333* [4]
2018	*2,223* [2]	*4,445* [5]
2019	*296* [3]	*592* [6]
Total	*$9,186*	*$8,370*
	<8,370>	
Recapture	***816***	

[1] *$5,000 179 deduction + MACRS on remaining basis ($5,000 x .3333 = $1,667)*
[2] *$5,000 x .4445*
[3] *$5,000 x .1481 x .40*
[4] *$10,000 x .3333*
[5] *$10,000 x .4445*
[6] *$10,000 x .1481 x .40*

OTHER ISSUES

Prorating the Expense - A taxpayer can pick and choose the qualifying items to which the Sec 179 expense deduction is to apply. The taxpayer may also expense any portion of a qualifying item, leaving the remaining basis to be depreciated (Reg. 1.179-1(b)).

The full amount of the expense deduction is allowed regardless of when during the year the item was purchased and placed in service. Therefore, even qualified property purchased and place in service on the last day of the tax year will qualify for the full Sec 179 deduction (Reg. 1.179-1(c)).

Listed Property - If a section 179 election is made for "listed property" and there is personal use of the property, the Section 179 deduction may be limited by the listed property rules of section 280F(d)(1), which provides rules that coordinate section 179 with the section 280F limitation on the amount of depreciation that may apply (Reg. 1.179-1(d)(3)).

Basis Adjustment - Reduce the depreciable basis of the section 179 property by the amount of the section 179 expense deductions (Reg. 1.179-1(f)).

The basis of a partnership or S corporation's Section 179 property must be reduced to reflect the amount of section 179 expense elected by the partnership or S Corporation. This reduction must be made in the basis of partnership or S corporation property even if the limitations of section 179(b) and § 1.179-2 prevent a partner in a partnership or a shareholder in an S corporation from deducting all or a portion of the amount of the section 179 expense allocated by the partnership or S corporation. See §1.179-3 for rules on applying the basis provisions when a person has a carryover of disallowed deduction (Reg. 1.179-1(f)).

Alternative Minimum Tax - The Section 179 deduction **is not** an adjustment or preference item for AMT purposes.

Marital Status:

- **Married separate taxpayers** - Treated as one taxpayer for determining the Section 179 limit. Divide the limit equally between the taxpayers, unless they elect an unequal split. Determine the taxable income limitations separately as well.
- **Joint taxpayers** - For purposes of the expense election, a husband and wife filing a joint return are also treated as one taxpayer in applying the dollar limitations, regardless of which spouse purchased the Section 179 property. In applying the taxable income limitation of joint taxpayers, use the aggregate taxable income from active trades or businesses of both taxpayers (Reg. 1.179-2(c)(7)).

Bonus Depreciation - For property eligible for the bonus depreciation and Sec 179 is also being claimed, figure the Section 179 deduction before figuring the bonus allowance and MACRS deduction. Subtract the 179 deduction, as well as the bonus allowance if applicable, from the basis of the property and compute the MACRS deduction on the remainder.

> **NOTE**: Wherever possible, it is best practice to use bonus deprecation and avoid Sec 179 expensing, thus eliminating or minimizing any potential Sec 179 recapture and its ramifications.

Making the Election - The election to expense under Section 179 is made on the return for the year the property is placed in service. Specify the items to which the election applies. Use Form 4562 to make the election. For any taxable year beginning after 2014, a taxpayer may make a Section 179 election with respect to any eligible 179 property without the consent of the IRS on an amended Federal tax return for the taxable year in which the taxpayer places in service the Sec 179 property (Rev. Proc. 2017-33, section 3.02) The Treasury Department and the IRS intend to amend Reg. 1.179-5(c) to incorporate this provision and until that is done, taxpayers can rely on the guidance in Rev. Proc. 2017-33.

Revoking the Election - Taxpayers may make or revoke an expensing election on amended returns without IRS consent if filed within the time prescribed by law for filing an amended return for the tax year for which the election was made, Reg § 1.179-5(c), as verified by Rev. Proc. 2017-33. An amended return must be filed within 3 years (including extensions) after the date the return was filed or within 2 years after the date the tax was paid, whichever is later (1040-X Instructions, Pg. 3 for 2018).

CALIFORNIA DIFFERENCES

The CA Section 179 expense limit is $25,000 with an investment limit of $200,000. Where there is a difference from the Federal, the Section 179 adjustment is made on the Schedule CA. In general, for taxable years starting on or after January 1, 2015, the state conforms – with many exceptions – to the Internal Revenue Code as of January 1, 2015. Exceptions and differences related to Sec 179 expensing, in addition to the dollar limits noted above, include the following:

- Computer software cannot be expensed but must be depreciated or amortized.
- The state does not permit revocation of Section 179 without permission.
- Sec 179 expensing of "qualified real property" is not allowed.
- The state has not adopted the post-2015 inclusion of portable heating and air conditioning units as qualified Sec 179 property.
- The state has not adopted as qualified Sec 179 property the post-2018 inclusion of beds and other furniture, refrigerators, ranges, and other equipment – used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) used predominantly to furnish lodging or in connection with furnishing lodging.
- The state has not has not adopted as qualified Sec 179 property the post-2018 inclusion of improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

NOTES

LISTED PROPERTY

Listed Property:

- Passenger vehicles
- Other property used as means of transportation
- Property used for entertainment, recreation, or amusement:
  - photographic,
  - phonographic,
  - video recording.
- Pre-2018: Computer or peripheral equipment – except when used exclusively at the taxpayer's regular business establishment
- **Limitations**:
  - If business use is 50% or less:
    - No Sec 179 allowed
    - Use straight line depreciation
    - Employees – deduction not allowed unless a condition of employment (no deduction 2018-2025 due to TCJA suspension of tier 2 miscellaneous deductions).
  - Subsequent year if use is 50% or less:
    - Switch to straight line method
    - Sec 179 recapture

Related IRC and IRS Publications and Forms

- **Pub 946 –** How to Depreciate Property
- **Pub 463 –** Travel, Gift and Car Expenses
- **Form 4562 –** Depreciation and Amortization
- **IRC Sec 280F**

TCJA removes computers and peripheral equipment from the definition of listed property, effective for property placed in service after 12/31/2017. Thus they are no longer subject to the listed property substantiation requirements and special depreciation rules. IRC Sec. 280F(d) as amended by TCJA Sec. 13202(b)

Congress imposes strict limitations on the deductions allowed for so-called "listed" property and provided guidelines (Code Sec. 280F(b)) for determining what property is included in the "listed" category.

WHAT IS "LISTED PROPERTY"?

In general, the following property is considered "listed property":

(1) Any ***passenger automobile*** that is a four-wheeled vehicle for use on public roads and has an unloaded gross vehicle weight (or, for trucks and vans, gross vehicle weight) of 6,000 pounds or less (thus the luxury auto rules). The Section 280F regs specifically exclude vehicles used for hire or commuter highway vehicles from the definition of a passenger auto.

(2) Other property used as means of transportation such as trucks, buses, trains, boats, airplanes, motorcycles, or other vehicles used for transporting persons or goods.

(3) Property used for entertainment, recreation, or amusement (unless used in connection with a taxpayer's trade or business or exclusively at the taxpayer's place of business), e.g., ***photographic, phonographic, and video recording*** equipment.

(4) If placed in service **before 2018**, ***computer or peripheral equipment*** except those owned or leased by the taxpayer, and used exclusively at the taxpayer's regular business establishment (which may include a home office only if the conditions of Sec. 280A(c)(1) are met, i.e., exclusive and regular use as a principal business location, etc.).

(5) Any other property as specified in regulations.

CELL PHONES EXCLUDED FROM THE "LISTED PROPERTY" RULES:

Effective for years beginning after Dec 31, 2009, cellular telephones (cell phones) and other similar telecommunications equipment are not part of the categories of "listed property" under Code Sec. 280F(d)(4). Thus, the heightened substantiation requirements and special depreciation rules that apply to listed property don't apply to cell phones. That is, a taxpayer using his or her own cell phone for business purposes isn't limited to using straight-line depreciation under the ADS system when business use is 50% or less. Further, an employee's use of his own cell phone does not have to be "for the convenience of the employer" and "as a condition of employment" for business-related costs of the phone to be deductible.

Employers may deduct the cost of providing cell phones to their employees for employment-related business use, without having to satisfy the strict substantiation requirements for listed property. To support a deduction for the cell phones, the employer need only substantiate their cost, in much the same way as the employer supports the deduction for other types of business equipment.

Cell Phones as an Excludable Fringe Benefit – IRS Notice 2011-72 provides guidance on the treatment of employer-provided cell phones as an excludable fringe benefit.

Employer Provided Phone **-** When an employer provides an employee with a cell phone primarily for noncompensatory business reasons, the business and personal use of the cell phone is generally nontaxable to the employee (as a working condition fringe benefit for the business portion and a *de minimis* fringe for the personal use). The IRS will not require recordkeeping of business use in order to receive this tax-free treatment.

An employer will be considered to have provided an employee with a cell phone primarily for noncompensatory business purposes if there are substantial reasons relating to the employer's business, other than providing compensation to the employee, for providing the employee with a cell phone. Examples of possible substantial noncompensatory business reasons include:

- The employer's need to contact the employee at all times for work-related emergencies,
- The employer's requirement that the employee be available to speak with clients at times when the employee is away from the office, and
- The employee's need to speak with clients located in other time zones at times outside of the employee's normal work day.

A cell phone provided for the following reasons will **not** be considered as provided primarily for noncompensatory business purposes:

- To promote the morale or good will of an employee,
- To attract a prospective employee, or
- As a means of furnishing additional compensation to an employee.

Employer Reimbursement for Cell Phone Expenses – Although Notice 2011-72 does not cover the situation where an employer reimburses the employee for cell phone expenses, the IRS did issue a memo on September 14, 2011 to all field examination operations bringing this issue and Notice 2011-72 to the attention of the audit staff (Control Number SBSE-04-0911-083).

Where employers reimburse employees for business use of their personal cell phones, tax-free treatment is available without burdensome recordkeeping requirements. However, the employee must maintain the type of cell phone coverage that is reasonably related to the employer's business needs, and the reimbursement must not exceed the employee's actual cell phone expenses. Additionally, the reimbursement for business use of the employee's personal cell phone must not be a substitute for a portion of the employee's regular wages. IRS examiners are directed to closely scrutinize arrangements that replace a portion of an employee's previous wages with a reimbursement for business use of the employee's personal cell phone and arrangements that allow for the reimbursement of unusual or excessive expenses.

The guidance does not apply to the provision of cell phones or reimbursement for cell-phone use that is not primarily business related, as such arrangements are generally taxable.

SOME VEHICLES ARE EXCLUDED FROM THE "LISTED PROPERTY" RULES: *For the rules pertaining to the luxury auto rules, refer to chapter 3.11.*

Some vehicles are generally not thought of as being for personal use. Therefore, they are termed "qualified, nonpersonal-use vehicles" and are not subject to the listed property rules. The regulations §1.274-5(k) define these vehicles in great detail, indicating the features necessary to exempt them from the listed rules. Such vehicles are:

- Clearly-marked police, fire and public safety officer vehicles. A clearly marked public safety officer vehicle is a vehicle owned or leased by a governmental unit or any agency or instrumentality thereof, that is required to be used for commuting by a public safety officer who, when not on a regular shift, is on call at all times. (Reg Sec 1.274-5(k)(3))

  To qualify, any personal use (other than commuting) of the vehicle outside the limit of the public safety officer's obligation to respond to an emergency must be prohibited by the governmental unit. To be "clearly marked" the vehicle's painted insignia or words must make it readily apparent that the vehicle is a public safety officer vehicle. Thus, emergency responders who are not employed by either the fire department or police department receive the same treatment as those who work for the police or fire departments;

- Delivery trucks with seating only for the driver (or driver plus a folding jump seat);

- Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds. Trucks and vans are exempt if the weight requirement is met or if they have been modified so that little personal use is likely. For example, a van that has only a front bench for seating, permanent shelving filling most of the cargo area, carries merchandise or equipment on a constant basis, and is painted with the company name will be considered a nonpersonal use vehicle;

- Passenger buses used as such with a capacity of at least 20 passengers;
- Ambulances and hearses, used as such;
- Bucket trucks (cherry pickers) and flatbed trucks;
- Cranes, derricks, forklifts and cement mixers;
- Dump trucks, including garbage trucks;
- Tractors, combines, and other special purpose farm vehicles;
- Refrigerated trucks;
- School buses;
- Qualified moving vans;
- Qualified specialized utility repair trucks; and
- Unmarked law enforcement vehicles if the use is officially authorized.

Qualified Non-Personal Use Vehicles - A **truck or van that is a qualified non-personal use vehicle** is also a vehicle exempt from the luxury auto rules. The truck or van must have been specially modified with the result that it is not likely to be used more than a *de minimis* amount for personal purposes. The regulations' example of a qualifying nonpersonal use vehicle is a van with only a front bench for seating, in which permanent shelving that fills most of the cargo area has been installed, that constantly carries merchandise or equipment, and that has been specially painted with advertising or the company's name. These specially manufactured or modified vehicles do not provide significant elements of personal benefit, and a taxpayer is not likely to purchase this type of truck or van unless there was a valid business purpose that could not be met with a less expensive vehicle. (Reg. 1.280F-6)

THE LIMITATIONS FOR LISTED PROPERTY

If listed property is not used more than 50% in "qualified business use" during the year, then no Section 179 deduction is allowed, and the property must be depreciated using the straight-line method. If the listed property is a so-called "luxury" vehicle, specific dollar limitations (see chapter 3.11) apply to MACRS deductions.

Although a "heavy" truck or van may not be a "passenger automobile," it is still used as a means of transportation and falls within the definition of listed property. Therefore, if business use is not more than 50%, the heavy truck or van may be depreciated using the straight-line method only and no Sec. 179 deduction is allowed. It would escape the annual depreciation caps, however, because it is not a passenger auto.

QUALIFIED BUSINESS USE

(1) Use for the production-of-income is not considered qualified business use.

Example - Production-of-Income Use of Listed Property - *During 2019 a taxpayer uses a camera for 300 hours during the year. Of that time, 147 hours are for use in the taxpayer's business and 6 hours are used to take pictures of potential investments. The remainder of the time is personal. Though the camera is used over 50% of the time for business/investment purposes, the actual business-use time is only 49% (147/300). The listed property limitations must be applied to the camera; i.e., no Section 179 deduction is allowed and straight-line depreciation over the earnings and profits (ADS) life must be used. On the other hand, when an asset is used for both business and investment purposes and the qualified business-use percentage is over 50%, then both the business and investment use count towards allowable MACRS deductions for the property.*

Example - Computing Business Use of Listed Property *– During 2019 an asset is used 60% for business, 20% for investment, and 20% for personal purposes. The cost recovery deduction will be based on 80% business/investment use. For 2018 through 2025, the investment use portion of the depreciation is not deductible because the TCJA suspended the miscellaneous deduction for items subject to the 2% of AGI reduction, which includes investment expenses. Likewise, if the business use is by an employee, none of the depreciation or related expenses will be deductible.*

(2) Commuting is not a qualified business use.

(3) Leasing of property to a 5% owner (or person related to the owner, as defined in Code Section 267(b)) of the taxed entity is not qualified business use.

(4) The use of listed property which is provided as compensation for services of a 5% owner (or person related to the owner) is not qualified.

> ***Example - Listed Property Limits for Business Owners -*** *Robert owns a clothing store and employs his brother, Jim, in the business. Part of Jim's compensation includes use of a company car for personal purposes. The value of the use of the car is included in Jim's gross income and Robert withholds taxes on it. This use of the property is not considered "qualified business use."*
>
> *However, assume the same facts as above except Jim uses the car 75% for use in the clothing store and 25% for personal use. The personal use portion is included on Jim's W-2 and taxes are withheld. In this case, the company's qualified business use is 75% (and total business use is 100%).*

(5) Use of listed property by any person (other than 5% owner or owner's relative), which is provided as part of that person's compensation, is not qualified business use. However, if the value of the use is added to the user's income (e.g., if the value is treated as wages, subjected to withholding and included on the employee's W-2), then this will be considered qualified business use.

> ***Example - Listed Property Treated as Compensation*** *- India, Inc. owns several automobiles which are used by employees in the course of India's business. The employees also commute back and forth to their homes in these vehicles. The value of the commuting is included in the W-2s of the employees and taxes are withheld. Under these circumstances, the use of the cars by the employees (even the personal use) is qualified business use for India, Inc.*

<u>EMPLOYEES AND THE LISTED PROPERTY RULES</u>

TCJA

Computers and peripheral equipment are removed from the ranks of listed property, effective for property put into service in 2018 and later. Effective 2018 through 2025, the TCJA suspends miscellaneous itemized deductions that are subject to the 2% of AGI reduction. Thus, employee business expenses are not deductible during this period.

When an employee uses his/her own listed property in the course of his/her employment, special rules apply. Such property must be used FOR THE CONVENIENCE OF THE EMPLOYER and must be ***<u>REQUIRED AS A CONDITION OF EMPLOYMENT</u>***. The use of the property must actually be necessary for the employee to properly perform the duties of the job.

Rev Rul 86-129 - Addressed the issue in the use of a computer by an employee. The employee was allowed no deduction (not even straight-line depreciation) for the job-related use of his own computer, even though he had a statement from his employer stating the computer was required.

The IRS ruled that the computer was not necessary for the proper performance of the employee's duties. Though the ruling only addressed the issue of employee use of a computer, it would seem that other types of listed property (i.e., autos, etc.) might have a similar fate under the same circumstances.

> ***Example - Qualified Employee Use of Listed Property -*** *David works as a delivery person for D-Best Courier Service, where he uses his own car in delivering packages for D-Best. The courier service actually requires all its delivery people to own a car for use in their delivery responsibilities and reimburses these employees for their car expenses. Under these circumstances, the "convenience of the employer" test has been met.*

> ***Example – Nonqualified Employee Use of Listed Property -*** *Faith is an inspector for Fieldstone Construction in Fontana. Fieldstone requires Faith to visit their various construction sites in the area. She uses her own vehicle, even though the company has a car available for her to use. Faith does receive reimbursement for the use of her own car. Faith's use of her automobile is not considered for the convenience of the employer and is not required as a condition of employment.*

Cadwallader, TC Memo 1989-356 - This case offers some good news to employees hoping to deduct the cost of home computers used for business use. Mr. Cadwallader was a professor at a university in the Midwest and his job required a large amount of research at home. He didn't have access to a computer at the college. Mrs. Cadwallader also used a computer for extensive number crunching in her job as a transportation planner for the state. However, her employer didn't have a computer nor require her to purchase one in order to keep her job. The Court concluded that the condition of employment test was met by both taxpayers:

(1) The computer enhanced Mr. Cadwallader's job capability by giving him the ability to gather and store his vast research data.
(2) Mrs. Cadwallader's employer had budget restrictions, which prevented the state from providing her with the computer required for her to properly perform her duties.

In addition, the convenience of employer test was met by both taxpayers because the employer was spared the cost of providing computer equipment for their employees.

FIGURING THE DEDUCTION:

To figure the deduction for any listed property, divide the property into segments according to use, i.e., business portion, investment portion, personal portion. Then determine what kind of use is "predominant" (i.e., over 50% of the total). If the "qualified business use" is over 50%, figure the deduction using MACRS (accelerated) or Section 179 (if elected in the

year placed in service). The predominant-use test must be met each year during the recovery period. If that test is not met, the taxpayer must change to the straight-line method and possibly a longer recovery life. Use the alternative depreciation method (ADS) and the lives assigned under it. In the year the property changes to straight-line, excess depreciation and any Section 179 previously deducted must be recaptured. The recapture amount is the excess depreciation and 179 expense deducted in previous years over the depreciation which would have been allowed under the straight-line method.

Example - Recapture of Listed Property Deductions - *On January 1, 2018, Mike purchased and placed in service camera equipment which cost $12,000; he used the equipment exclusively in his trade or business. In 2019, Mike used the camera equipment 50% for business and 50% for personal purposes.*

2018 Section 179 deduction $12,000
2018 MACRS deduction...0
Total 179 and MACRS deductions 12,000
Actual allowable 2018 depreciation...1,200
(5-year life, straight-line, .10 x $12,000)
Total excess--add to 2019 income.. 10,800
2019 Basis ($12,000 x 50%)...6,000
Depreciation allowed in 2019...1,200
(Straight-line, 20% x $6,000)

ADJUSTED BASIS OF LISTED PROPERTY – When listed property is partly used for personal purposes, for determining future depreciation, the basis of the asset must be reduced as though 100% of the depreciation allowable had been claimed. Basis for computing gain or loss will be the actual adjusted basis.

Example – Unrecovered Basis of Listed Property: *Dan purchased a computer in 2013 for $3,000 that was listed property according to the law at that time. In 2013 and the next five years, his qualified business use ranged from 55% to 80%. In total, he deducted $2,144 of depreciation over the recovery period. At the end of that time, his actual adjusted basis was $856 ($3,000 - $2,144). In 2019, Dan uses the computer 100% for business, but since his remaining basis for depreciation is zero, he can't claim a depreciation deduction. His depreciable basis is zero because he has to include the personal portion of each year's depreciation amount when figuring his adjusted basis for computing future depreciation – thus, the full amount of the original cost is deemed depreciated. If Dan were to sell the computer after 2018, his basis for figuring gain or loss would be $856.*

REQUIRED RECORDS

No depreciation or Sec. 179 deduction for the use of listed property (including passenger autos) may be claimed unless the taxpayer can prove business/investment use with "adequate records" or sufficient evidence to support his or her own statements. Records related to listed property must be kept as long as any excess depreciation can be recaptured.

The adequate records requirement will be met if the taxpayer maintains an account book, diary, log, statement of expense, trip sheet, or similar record that, together with a receipt, is sufficient to establish each element of an expenditure or use. If the information is already shown on the receipt, it is not necessary to record the information in an account book, diary, or similar record. However, the records should back up the receipts in an orderly manner. The records or other documentary evidence must support:

- The amount of each separate expenditure, such as the cost of the item, maintenance and repair costs, capital improvement costs, lease payments, and any other expenses;
- The amount of each business and investment use (based on mileage for vehicles and time for other listed property), and the total use of the property for the tax year;
- The date of the expenditure or use; and
- The business or investment purpose for the expenditure or use.

Written documents of expenditure or use are generally better evidence than oral statements alone. A written record prepared at or near the time of the expenditure or use has greater value as proof of the expenditure or use, although a daily log is not required. However, some type of record containing the elements of expenditure or the business or investment use of listed property made at or near the time and backed up by other documents is preferable to a statement prepared later.

CALIFORNIA DIFFERENCES

California generally conforms to the listed property rules as of 1/1/15. California has conformed to the delisting of cell phones from listed property (AB 154 – 2015). However, without conforming legislation, California will continue to treat computers and peripheral equipment as listed property.

NOTES

TAX TREATMENT OF INTANGIBLES

IRC §197 allows acquired intangibles like goodwill, going concern value, etc., to be **amortized ratably over 15 years.**

RAPID FINDER	
12-month Rule	3.08.04
Acquired	3.08.03
Allocation, Purchase Price	3.08.02
Anti-Churning Rules	3.08.03
Created	3.08.03
Definitions	3.08.02
Form 8594	3.08.02
Going Concern Value	3.08.02
Goodwill	3.08.04
Intangibles, Amortizable	3.08.01
Liquor License	3.08.01
Losses, Disposition	3.08.02
Nonrecognition	3.08.02
Regulations	3.08.03
Residual Method-Goodwill	3.08.02
Sec 197 Intangible	3.08.01
Taxi-Cab Medallion	3.08.01
Transaction Costs	3.08.03
Workforce In Place	3.08.01

Related IRS Publications and Forms

- **Pub 535** – Business Expenses
- **Pub 551** – Basis of Assets
- **Pub 946** – How To Depreciate Property
- **Form 8594** – Asset Acquisition Statement

Different rules apply for self-created intangible assets (e.g., goodwill created through advertising) than for intangibles that are acquired. Self-created intangible assets are either deductible (but see "Regulations" at the end of this chapter) or their capitalized costs are amortized, provided they are of use to the business for only a limited period of time that can be reasonably estimated. Examples are patents and copyrights. If the self-created intangible asset's useful life is not limited or determinable, its cost is not amortizable.

AMORTIZABLE SEC 197 INTANGIBLE ASSETS: Amortizable Section 197 intangible assets are those ***acquired in a trade or business or for the production of income***. They include:

(1) Goodwill and going concern value,
(2) Workforce in place,
(3) Information in place,
(4) Know-how,
(5) Customer and supplier-based intangibles,
(6) Government licenses and permits. These include
   - Liquor License
   - Taxi-cab Medallion (or license)
(7) Franchises, trademarks, and trade names,
(8) Insurance policy expirations, and
(9) Bank deposit base.

The following assets are treated as Section 197 assets, if they are ***acquired in connection with the acquisition of a business:***

- Covenants not to compete,
- Computer software,
- Films,
- Sound recordings,
- Video tapes and books,
- Copyrights and patents,
- Rights to receive tangible property or services,
- Interest in patents and copyrights,
- Mortgage servicing rights secured by residential real property, and
- Contract rights good for less than 15 years or fixed in amount.

The following assets are never Section 197 assets, regardless of how acquired: interests in corporations, partnerships and estates, computer software that is readily available for purchase by the general public, futures, foreign currency contracts, and notional principal contracts, land, leases of tangible property, debt instruments, tax-free transaction costs, accounts receivable.

DEFINITIONS

Going concern value is the value attached to the ability of a business to continue to function and collect income without interruption, even after an ownership change.

Workforce in place refers to the portion of a purchase price attributed to a trained, experienced workforce in place as of the date of acquisition.

LOSSES ON DISPOSITION OF SECTION 197 ASSETS:

A loss deduction is not allowed on disposition, abandonment, or worthlessness of an intangible if any other Section 197 intangible was acquired in the same transaction and a taxpayer still has the other intangible. If the latter is true, the unallowed loss is reallocated to the retained intangible. Thus, the cost of many Section 197 assets must continue to be amortized, although they become worthless for one reason or another.

RESIDUAL METHOD TO ALLOCATE BUSINESS PURCHASE PRICE TO GOODWILL:

When a taxpayer sells a trade or business for a lump sum, and the character of the business is such that goodwill or going concern value could be attached to the assets that make up the business, the seller and purchaser who don't otherwise have a binding written agreement as to how the purchase price is to be allocated among the assets must use a residual allocation method. The result of this method is to determine the purchaser's bases in the acquired assets and the seller's gain or loss, capital or ordinary, on the assets sold. ***The allocation is reported on Form 8594, Asset Acquisition Statement (applicable to both buyer and seller).***

The residual method requires that all assets of an acquired business be divided into seven classes:

(1) **Class I:** Cash and cash equivalents;

(2) **Class II:** Certificates of deposit, U.S. government securities, readily marketable securities, foreign currency;

(3) **Class III:** Assets the taxpayer marks to market at least annually for tax purposes, including accounts receivable.

(4) **Class IV:** Stock in trade or other property that would be included in inventory if on hand at the close of the tax year, property held primarily for sale to customers;

(5) **Class V:** All assets other than Class I, II, III, IV, VI and VII assets (generally including furniture and fixtures, buildings, land, vehicles, and equipment, which constitute all or part of a trade or business);

(6) **Class VI:** Code Sec. 197 intangibles, except goodwill and going concern value;

(7) **Class VII:** Assets in the nature of goodwill and going concern value.

The purchase price (reduced by Class I amounts) is allocated successively to the assets in Classes II through VI based on their fair market value. The excess (residual) of the purchase price over the values of Class I through VI assets is goodwill and going concern value.

Example - Purchase of Goodwill - *Gary bought a business from Ginny for $400,000. The following Class II, III and V assets were included as part of the purchase price: equipment, furniture, land, building, marketable securities, and accounts receivable. These assets had a value of $350,000. Also included in Gary's acquisition are goodwill and a customer list claimed to be worth $26,000. The customer list is a Class VI asset, leaving the residual amount of $24,000 to be goodwill as a Class VII asset. Although both the customer list and goodwill are Sec. 197 assets amortizable over 15 years, they are classed separately for the asset acquisition computation on Form 8594*

Example – Insurance Agent Termination Payments - There was no sale or exchange where assets used by an insurance agent in the conduct of his business, including a computer, customer lists, and books and records, were returned to the insurance company. The assets weren't the agent's to sell because his agreement with the insurance company specified that the assets were the insurance company's property. And while the agent developed goodwill during his tenure (the sale of which would generally produce capital gain), the goodwill, too, belonged to the company and wasn't the agent's to sell. So, termination payments received by the agent were ordinary income. (Baker, Warren L. Jr. v. Com., (2003, CA7)).

NONRECOGNITION TRANSACTIONS:

Prior to 2018 - If any Section 197 intangible is transferred in certain transactions that qualify for nonrecognition of gain, the transferee "steps into the shoes of the transferor" with respect to the portion of the adjusted basis of the transferee that isn't more than the adjusted basis of the transferor. The following nonrecognition transactions fall under this rule: subsidiary liquidations (Section 332), incorporation transfers (Section 351), reorganization transfers (Section 361), partnership contributions (Section 731), like-kind exchanges (Section 1031), involuntary conversions (Section 1033).

Post 2017 - Generally, for exchanges completed after December 31, 2017, Section 1031 applies only to real property exchanges.

REGULATIONS

IRS has issued comprehensive regulations explaining how the Code Sec. 263(a) rule barring deductions for capital expenses applies to amounts paid to acquire, create, or enhance intangible assets.

The regulations generally would require taxpayers to capitalize an amount paid to acquire, create, or enhance an intangible asset, a term that includes the following assets: *Reg § 1.263(a)-4(c)*

Acquired intangibles - amounts paid to another party to acquire an intangible asset from that party in a purchase or similar transaction. Generally, they include:

- An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other similar entity;
- A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes;
- A financial instrument, such as a notional principal contract; a foreign currency contract; a futures contract; a forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property)); an option (including an agreement under which the taxpayer has a right to provide or to acquire property (or to be compensated for such property), regardless of whether the taxpayer provides or acquires the property)); any other financial derivative.
- An endowment contract, annuity contract, or insurance contract.
- Non-functional currency.
- A lease.
- A patent or copyright;
- A franchise, trademark or trade name (as defined in §1.197-2(b)(10)).
- An assembled workforce (as defined in §1.197-2(b)(3)).
- Goodwill (as defined in §1.197-2(b)(1)) or going concern value (as defined in §1.197-2(b)(2)).
- A customer list.
- A servicing right (for example, a mortgage servicing right that is not treated for Federal income tax purposes as a stripped coupon).
- A customer-based intangible (as defined in §1.197-2(b)(6)) or supplier-based intangible (as defined in §1.197-2(b)(7)).
- Computer software.
- An agreement providing either party the right to use, possess or sell an intangible described in paragraphs (c)(1)(i) through (v) of this section.
- *Readily available software.*
- *Intangibles acquired from an employee.* However, if the amount paid to acquire the intangible is includible in the employee's income for performing services under § 61 or 83, the amount paid is not required to be capitalized.

Created intangibles - This broad class of intangibles would include:

- Amounts paid to another party to create or originate with that party any of a number of enumerated financial interests; (*Reg § 1.263(a)-4(d)(2))*
- Prepaid expenses (for example, prepaying a 3-year insurance policy premium or prepaying the rent on a 2-year lease); *Reg § 1.263(a)-4(d)(3))*

- Amounts paid to an organization to obtain or renew a membership or privilege; *(Reg § 1.263(a)-4(d)(4))*
- Amounts paid to a governmental agency to obtain or renew a trademark, trade name, copyright, license, permit, franchise, or other similar right; (*Reg § 1.263(a)-4(d)(5))*
- Amounts paid to another party to induce that party to enter into, renew, or renegotiate an agreement giving the taxpayer the right to (a) use tangible or intangible property or be compensated for the use of such property; (b) provide or acquire services (or be compensated for such services), but not if the amount is allocable to services that the taxpayer must provide or acquire before the end of the tax year in which the payment is made; (c) a covenant not to compete; (d) an agreement not to acquire additional ownership interest in the taxpayer; or (e) an agreement providing the taxpayer with an annuity, endowment or insurance coverage; *(Reg § 1.263(a)-4(d)(6))*
- Certain contract terminations; *(Reg § 1.263(a)-4(d)(7))*
- Amounts paid for realty relinquished to another, or amounts paid to produce or improve realty owned by another, if the realty can reasonably be expected to produce significant economic benefits for the taxpayer; and *(Reg § 1.263(a)-4(d)(8))*
- Amounts paid to another party to defend or perfect title to intangible property where the other party challenges the taxpayer's title to the intangible property. *(Reg § 1.263(a)-4(d)(9)*

Goodwill - Goodwill can be purchased or created. If purchased, it can be amortized over 15 years as a Sec 197 intangible. If created, it has no basis.

<u>Gain from Sale</u> – While no deduction for depreciation is allowable with respect to goodwill, the sale of goodwill is a section 1231 transaction because goodwill, under Section 197(f)(7), is treated as if it was a depreciable asset for all purposes under "chapter 1". Thus a sale of goodwill is reported on Form 4797, and if held for longer than one year, becomes a long-term capital gain.

<u>Loss from Sale or Abandonment</u> - Loss on the sale or abandonment of goodwill is not allowed *unless* goodwill is the only intangible the business owns. (Reg Sec 1.197-2(g)(1)(ii)). If the business owns other intangibles the loss is added to their bases using a pro rata allocation. (Reg Sec 1.197-2(g)(1)(i)(A)(2)). If a loss is allowed, it is a Sec 1231 ordinary loss reported on Form 4797.

<u>CAUTION</u> – Form 8594 must be filed by both the buyer and the seller showing the allocation to the various assets of the business (Sec 1060). See IRS Publication 544 for instructions regarding this allocation process. Goodwill is the last item to be allocated and therefore becomes the residual after all other assets are allocated.
For additional study related to goodwill, Letter Ruling 200243002 includes an extensive analysis.

Capitalization of Transaction Costs - Under Regulation § 1.263(a)-4(b)(1), taxpayers are required to capitalize an amount paid to "facilitate" (a) the acquisition, creation, or enhancement of an intangible asset, (b) a restructuring or reorganization of a business entity, or (c) a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.

12-Month Rule - The regulations don't require a taxpayer to capitalize under Code Sec. 263(a) amounts paid to create or enhance an intangible asset (see discussion above), or the related transaction costs, if the amounts do not create or enhance any right or benefit for the taxpayer that extends beyond the earlier of:

(1) 12 months after the first date on which the taxpayer realizes the right or benefit, or

(2) The end of the tax year following the tax year in which the payment is made. *(Regulation § 1.263(a)-4(f))*

The 12-month rule does not apply to amounts paid to create or enhance financial interests or amortizable Code Sec. 197 intangibles.

CALIFORNIA DIFFERENCES

California conforms to Federal treatment of intangibles except with regard to intangibles transferred in Sec 1031 exchanges, where only exchanges of real property qualify for 1031 treatment for federal for years after 2017 while California adopted the TCJA provision that limits Sec 1031 treatment only to exchanges of real property only for exchanges completed after January 10, 2019 and only for taxpayers with AGI of $500,000 or more ($250,000 for those filing single or married separate). (AB 91 (6/27/19))

EMPLOYEE OR INDEPENDENT CONTRACTOR

READ FIRST: The distinction between an employee and an independent contractor is governed by both federal law and state law. Because of the significant payroll tax revenues involved the states are the most aggressive in classifying workers as employees. The first part of this chapter covers the federal issues and the second part covers classification under California Assembly Bill AB5. California preparers should skip to the California section.

Other Related Text References

Subject	**Chapter**
Non-Resident & Resident Aliens	1.09
1099-MISC Reporting	1.16
Virtual Currency	1.18
Employees Misclassified as Independent Contractors	2.01
Statutory Employee	2.11
Rental of Office Space to Employer	3.15
Sec. 199A (Flow-through) Deduction	3.25
Self-employment Tax	8.03

RAPID FINDER

1099-NEC	3.09.06
20 Factor Control Test	3.09.01
ABC Test	3.09.06
Court Cases	3.09.04
Direct Sellers	3.09.03
Dynamex	3.09.06
Employer Liability	3.09.04
Form 8919	3.09.03
Form SS-8	3.09.02
GrubHub	3.09.06
Home Workers	3.09.03
Misclassified	3.09.02
Payroll Withholding Adj.	3.09.05
Qualified RE Agent	3.09.03
Section 530 Relief	3.09.04
Settlement Program	3.09.05
Statutory Indep. Contrs.	3.09.03

Frequently, the Internal Revenue Service and taxpayers disagree about the classification of workers as independent contractors or employees. At stake is the collection of employment taxes, as well as eligibility to participate in the employer's retirement plan. The IRS has developed audit programs that focus on employers who "misclassify" workers as independent contractors. These IRS programs can be expensive for employers and particularly painful for small businesses that may not be able to withstand the "economic strain" of additional employment taxes. And a worker who was misclassified as an independent contractor could also put the business's retirement and benefit plans in jeopardy for failing to cover all employees. This chapter contains guidelines that can be used to help determine the status of workers--whether independent or employee.

Related IRC and IRS Publications and Forms

- **Form SS-8** - Determination of Employee Work Status
- **Form 8919** – Uncollected Social Security and Medicare Taxes on Wages
- **Form 8952** – Application for Voluntary Classification Settlement Program
- **Pub 15 –** Employer's Tax Guide
- **Pub 15-A** – Employer's Supplemental Tax Guide
- **Pub 334** – Tax Guide for Small Business
- **Pub 533** – Self-Employment Tax
- **IRC 3509** - Determination of Employer's Liability for Certain Employment Taxes
- **IRC 7436** - Proceedings for Determination of Employment Status
- **Chapter 2.11** – Statutory Employee

THE 20-FACTOR CONTROL TEST

A worker's status as an employee or independent contractor depends on the amount of control the employer has over the worker. The IRS has developed 20 factors to help determine the extent of this control. The importance of each factor varies depending on the kind of work being done. Lack of control isn't necessarily shown if an employer allows a worker freedom of action. The 20 factors are:

(1) **Instructions:** A worker who must comply with instructions about when, where and how to work is considered an employee. An employer has control in this area if he/she has the right to require compliance with instructions.

(2) **Training:** Independent contractors ordinarily use their own methods and receive no training from their customers about how to do the job. On the other hand, training given the worker by the employer usually shows employee status.

(3) **Integration:** Employee status is often shown when a worker's services are integrated into the business' operations and the success of the business depends on the performance of those services. This factor may be one that works against supporting independent contractor status in nearly every situation--it's very difficult to establish whether or not success of a business would depend on the worker's contribution to an overall effort.

(4) **Services rendered personally:** A business which requires the worker to personally perform the services shows that the business is interested in the methods used to accomplish the tasks. This, then, shows control by the employer.

(5) **Hiring assistants:** If a worker hires, pays and supervises assistants to complete a contract that requires the worker to supply materials and labor and be responsible for the result, then the worker is independent. When the employer hires, supervises and pays assistants to help the worker, employee status is indicated for the worker.

(6) **Continuing relationship:** An employer-employee relationship is indicated if there is an on-going relationship between the employer and worker. This kind of relationship often exists where work is performed at frequently recurring (although irregular) intervals.

(7) **Set hours of work:** While employees normally have set hours of work, independents set their own hours.

(8) **Full-time work:** Independents work when and for whom they choose, while employees must work full-time for a business, with restrictions on the worker being able to work elsewhere.

(9) **Work done on the premises:** Work required to be done on the employer's premises often indicates control, especially if the work could be done elsewhere. However, control may even be present when a worker performs services in his/her own office(s). To pinpoint the importance of this factor, look at the nature of the services being performed. Control over the place of work may be indicated when the business has the right to compel the worker to travel a certain route or work at specific places. The worker should be required to work from his/her own office.

(10) **Order of sequence set:** When the employer sets the order of an employee's duties, it shows control by the employer.

(11) **Reports:** If a worker must submit reports (oral or written) to the employer to account for his/her actions, control is also shown.

(12) **Payments:** Employee status is shown if a worker is paid by the hour, week, etc. The worker should not be guaranteed a minimum salary nor be offered any fringe benefits. If a drawing account is set up for the worker, the worker should be required to repay any excess drawn from the account over commissions earned. In effect, the job should be paid on a straight-commission basis.

(13) **Payments of expenses:** If the employer pays business or travel expenses of the worker, the worker is likely to be classed as an employee.

(14) **Tools and materials:** An employer furnishing all the tools and materials to do the job usually shows that an employer-employee relationship is operative.

(15) **Significant investment:** An independent has significant investment in facilities or equipment used to perform services for someone else.

(16) **Profit or loss:** An independent contractor can realize a profit or loss as a result of services performed. For example, a worker who has invested in expensive equipment to do a job runs the risk of incurring a heavy loss from the job. This indicates that the worker is an independent contractor. However, the risk that a worker will not be paid is not sufficient risk to categorically show independent status.

(17) **Working for more than one business at a time:** When a worker performs services for multiple firms at the same time, independent status is indicated.

(18) **Offers service to the general public:** When a worker who regularly and consistently makes his/her services available to the general public, he/she is an independent contractor.

(19) **Right to fire:** Whereas an independent can't be fired as long as he/she produces a result that meets the specifications of the contract, an employee can be fired.

(20) **Right to quit:** The reverse of (19) is true here: an employee can quit a job at any time without incurring liability. However, an independent is responsible to meet the terms of a contract.

MISCLASSIFIED AS AN INDEPENDENT CONTRACTOR

It is not uncommon to encounter a client with 1099-MISC income from an employer that is treating him or her as an independent contractor when your client is actually an employee.

The general distinction, of course, is that an employee is an individual who works under the direction and control of their employer while an independent contractor is a business owner or contractor who provides services to other businesses.

To determine whether a worker is an independent contractor or an employee, IRS examines the relationship between the worker and the business, and considers all evidence of control and independence. The facts that provide this evidence fall into the following three categories:

(1) Behavioral control covers facts that show whether the business has a right to direct and control how the work is done through instructions, training, or other means. Employees are generally given instructions on when and where to work, what tools to use, where to purchase supplies, what order to follow, etc.

(2) Financial control covers facts that show whether the business has a right to control the financial and business aspects of the worker's job. This includes the extent to which the worker has unreimbursed business expenses; the extent of his investment in the facilities being used; the extent to which he makes his services available to the relevant market; how he's paid; and the extent to which he can realize a profit or incur a loss.

(3) Type of relationship includes written contracts describing the relationship the parties intended to create; the extent to which the worker is available to perform services for other, similar businesses; whether the

business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay; the permanency of the relationship; and the extent to which services performed by the worker are a key aspect of the company's regular business.

The above three categories condense IRS' 20-factor test used to help determine if the employer has direction and control over an individual.

Form SS-8 – Where the status is in doubt, Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding, can be used. The form may be completed by an employer or a worker and asks the IRS to determine whether a worker is an employee or independent contractor for federal tax matters. Form SS-8 is to be filed separately from the requestor's tax return. The IRS does not issue determinations for proposed employment arrangements or hypothetical situations, and will only issue a determination if the statute of limitations for the year at issue hasn't expired.

Form 8919 – For an employee to avoid having to pay SE tax on the 1099-MISC income when he or she has already been determined to be an employee or when the worker has filed an SS-8 and has not received a response, the individual files Form 8919 (Uncollected Social Security and Medicare Tax on Wages), which only requires payment of what would have been withheld if the worker were treated as an employee. By using Form 8919, the employee's Social Security and Medicare taxes will be credited to the employee's social security record. Form 8919 requires the employee to check one of these boxes:

Code A. I filed Form SS-8 and received a determination letter stating that I am an employee of this firm.

Code C. I received other correspondence from the IRS that states I am an employee.

Code G. I filed Form SS-8 with the IRS and have not received a reply.

Code H. I received a Form W-2 and a Form 1099-MISC from this firm [for the same tax year]. The amount on Form 1099-MISC should have been included as wages on Form W-2.

If code H is used, do not file an SS-8. Examples of amounts that are sometimes erroneously included, but not necessarily deliberately misclassified, on Form 1099-MISC that should be reported as wages on Form W-2 include employee bonuses, awards, travel expense reimbursements not paid under an accountable plan, scholarships, and signing bonuses.

If reason code G is used, the employee or the firm that paid the employee may be contacted for additional information. Use of this reason code is not a guarantee that the IRS will agree with the worker's opinion as to his/her status. If the IRS does not agree that the worker is an employee, the worker may be billed for the additional tax, penalties, and interest resulting from the change to the worker's status.

Where the IRS determination is for multiple open years, the employee can amend open years to recover a portion of the SE tax paid. Amend the open year by deleting the SE tax form and adding the Form 8919.

HOME WORKERS

Just because an individual works at home does not necessarily make that individual an independent contractor for self-employment tax purposes. Many will fall under the category of statutory employee. Here is a court case (LaVerne VanZant, TC Summary Opinion 2007-195) dealing with the issue. Note: Tax Court summary opinion cases cannot be treated as precedent for any other case.

The Tax Court has held that an educational consultant who collected data on schools and collated the data at home using a template provided by the firm who engaged her services qualified as a home worker for statutory employee purposes. Thus, she was exempt from self-employment tax.

Several classes of workers are employees for FICA purposes even if they are not subject to an employer's direction and control (i.e., even if they would not be treated as workers under the common-law rules). These workers, who are commonly referred to as statutory employees because they are specifically classified as employees by the Code, include home workers. (Code § 3121(d)(3)(C)) See chapter 2.11 for more on statutory employees.

A home worker is a person who:

- Performs work in accordance with specifications provided by the person for whom the work is performed;
- Works on materials or goods furnished by that person; and
- Must return the finished product to that person or to someone designated by that person. (Code § 3121(d)(3)(C))

An individual will not be a statutory employee, however, if the services are performed as a single transaction rather than part of a continuing relationship, or if the individual has a substantial investment in the facilities used in connection with the performance of the services.

Statutory employees are allowed to deduct trade and business expenses in arriving at AGI (above-the-line deductions) while common law employees may only deduct their business expenses as part of miscellaneous itemized deductions, subject to the 2% of AGI limitation (Tier 2 deductions). However, for years 2018 through 2025, Tier 2 deductions are not allowed, having been suspended by the Tax Cuts and Jobs Act. Therefore, employee business expenses of common law employees will not be deductible during those years.

STATUTORY INDEPENDENT CONTRACTORS

Certain workers are automatically treated as independents by law. These are qualified real estate agents and direct sellers.

A **qualified real estate agent** is a licensed real estate sales person. Substantially all the income earned as an agent must be directly related to sales or other output, not hours worked. There must be a written contract between the agent and the principal; the contract should provide that the agent won't be treated as an employee for tax purposes.

Direct sellers are those in the business of selling consumer products to buyers at other than a permanent retail establishment. The sales must be made on a buy-sell basis, deposit-commission basis, or similar arrangement. Like the real estate agent, payment for the direct seller's services must be on a commission basis, not according to hours worked and there should be a written contract stating nonemployee status for tax purposes.

SECTION 530 RELIEF

Section 530 of the Revenue Act of 1978 lets employers treat certain employees as independent contractors, sometimes even when the employer has classified workers as independents in error. Section 530 gives relief from employment taxes to an employer who treats a worker as an independent (has never treated the worker as an employee) and has consistently filed all Federal returns (including 1099s) required AND has a "reasonable basis" for not treating the worker as an employee.
Reasonable basis is present if any of the following can be shown:

(1) There is judicial precedent (published rulings, IRS technical advice, etc.) to back the way the employer has handled the workers' status.
(2) An IRS audit of the employer did not change the status of the workers (or similar workers).
(3) Recognized practice in the employer's line of business shows that the workers would normally be classed as independents. The practice need not be uniform through the entire industry--it can be a local area practice.

Even when an employer fails to meet one of these tests, he/she can still get Section 530 relief by showing reasonable basis in some other reasonable manner. The section indicates that this reasonable basis is to be construed liberally in favor of the taxpayer.

Boles Trucking, Inc., (CA8 02/22/96): The Eighth Circuit ruled that a taxpayer qualifies for Section 530 relief only if it can be shown by a preponderance of evidence that there was reasonable basis for not treating workers as employees. Boles Trucking leased truck tractors to interstate trucking carriers and supplied drivers with each leased tractor. The lease agreements stated that the drivers were to be employees of Boles, but they were treated as independent contractors by the company. No withholding was done, nor was FUTA paid; Forms 1099 were issued to the workers. The District Court had previously found that Boles had a reasonable basis for treating the workers as independents and was entitled to Section 530 relief. However, the Circuit Court was not so sure--they remanded the case back to the District Court for further review.

Cable TV installers are independent contractors - KM Systems, Inc. v. U.S., (DC NJ, 5/10/2004) 93 AFTR 2d 2004-2458: A district court has granted summary judgment relief to a business that treated the people it engaged to install cable television services in subscribers' homes as independent contractors rather than employees. The company was entitled to relief under the Section 530 safe harbor because it was standard industry practice to treat these workers as independent contractors.

MISCELLANEOUS CASES

Mortgage Loan Officer was Independent Contractor – In ***Cibotti, TC Summary Opinion 2012-21***, the Tax Court held that a mortgage loan officer was an independent contractor even though he was issued a W-2 form for his work, owned part of the company's stock and was its president (albeit in name only). The court weighed the various factors and found the scales tipped to the independent contractor status. The factors that indicated independent status were: (1) degree of control – the company did not have control over or dictate the taxpayer's business or total hours, office location, methods of obtaining clients or route; (2) employee benefits – the taxpayer did not get benefits such as health or life insurance and there was no company retirement plan; (3) investment in work facilities – the company did not provide an office, so he maintained one at his home; (4) opportunity for profit or loss – the taxpayer was paid a commission based on a percentage of the proceeds from mortgage loans he closed and was not guaranteed any compensation. Other factors were either neutral or indicated employee status.

Project-by-Project Construction Workers were Employees - In ***Kurek, TC Memo 2013-64***, the Tax Court found that workers hired on a project-by-project basis by a construction company to work on various residential projects were employees and the company was liable for employment taxes for the year in dispute. The owner of the company was a sole proprietor of a home improvement company. The factors that indicated employee status were: (1) degree of control (the "crucial test" according to the court) – the proprietor set the deadlines, monitored the work done, made site visits to the projects, instructed the workers on the work to be done and had the right to approve its quality. He paid the workers weekly and was ultimately responsible for the success or failure of the project; (2) investment in work tools – while the workers used their own small tools, the company supplied all heavy tools and purchased all materials used by the workers; (3) opportunity for profit or loss – the workers were paid a negotiated flat fee, and so were shielded from suffering a loss or realizing a profit or being able to increase their earnings through their efforts; (4) right to fire – the proprietor could and did replace workers who missed deadlines or performed unsatisfactorily. Other factors were either neutral or indicated contractor status.

THE EMPLOYER'S LIABILITY WHEN A WORKER IS MISCLASSIFIED

When a worker is unintentionally misclassified as an independent by an employer, the employer is assessed as follows: 1.5% of the wages paid to the employee and 20% of the employee's share of FICA that should have been imposed (IRC Sec. 3509). If no 1099s were filed for the worker, the penalty is 3% of wages and 40% of employee's FICA. The employer isn't entitled to recover these amounts from the employee. Of course, the employer is still liable for his/her own share of the FICA and for FUTA taxes.

Penalties and interest for failure to deduct and withhold may also be assessed. The penalties are based on the amount of the employer's liability determined under Code Section 3509. If an employer misclassifies an independent contractor without reasonable cause, the following could apply:

- The employer can be held liable for employment taxes. However, the employer's FICA tax liability can be reduced by the amount of SE tax paid by the employees. This relief does not affect the employer's liability for penalties and additional tax (CCA 201808016)
- The late tax deposit penalty could apply. The penalty is 2% of the underpayment if the deposit is not more than 5 days late; 5% if more than 5 but not more than 15 days late; 10% if more than 15 days late.
- If a deposit is made within 10 days of the taxpayer receiving a demand notice, the penalty is 15% of the underpayment.
- A 100% penalty (plus interest) can be imposed on persons responsible for withholding, accounting for or depositing withholding taxes. This penalty is often referred to as the Trust Fund Recovery Penalty.

In addition to penalties and additional tax liability for employment taxes, employer-maintained retirement and benefit plans (e.g., group health insurance, cafeteria, educational assistance plans, etc.) may be adversely affected when a worker has been misclassified. In the extreme case, the IRS could disqualify a retirement plan for failing to properly cover all workers in accordance with the terms of the plan if a worker who had been treated as an independent contractor is found really to be an employee. Or the plan could fail certain non-discrimination and participation tests when the reclassified worker's compensation is included. Disqualification of such plans would impact both the employer (who would not be allowed to deduct the costs associated with the retirement or benefit plans) and other employees who were participants in the plans.

Interest Free Payroll Withholding Adjustment - In a Chief Counsel Advice (CCA-201109025) dealing with the issue of worker misclassification, IRS has provided guidance on the time frame for paying prior period federal income tax withholding and FICA taxes without incurring any interest charges.

Generally, interest must be paid to IRS on any underpayment of tax. However, Reg. § 31.6205-1(a) allows certain FICA or withholding tax underpayments from previous periods to be corrected on an interest-free basis if the employer files an amended return in the 94X series (e.g., 941-X, 944-X) to report the error, and the taxes are paid in full by the last day for filing the employment tax return for the quarter in which the error is "ascertained." The employer is required to enter the date the error was "discovered" on the "94X" form, and to provide in detail the grounds and facts relied on to support the correction.

The date the error was "discovered" is also provided on Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. Employers and workers may submit Form SS-8 to IRS to receive a determination regarding an employee's worker status (i.e., employee or independent contractor).

In the CCA, IRS notes that the SS-8 determination letter will provide the date that the error was "discovered," but the standard used in Reg. § 31.6205-1(a) for interest-free adjustments is the date when the error was "ascertained." IRS says that an error is "ascertained" when the employer has sufficient information to correct it. The SS-8 determination letter will not always control the "ascertained" date (e.g., the employer may need to determine which employees are similarly situated and/or go through its records to obtain information to fill out Form 941-X), though some employers may have sufficient information at that point to determine the "ascertained" date. IRS notes that, in all cases, the employer must be able to prove when the error was ascertained for purposes of making an interest-free adjustment.

Note: No interest-free adjustments may be made for an underpayment after the employer has received a statement of notice and demand for payment of the underpayment based on an assessment (Reg. §31.6205-1(a)(6)). Interest-free adjustments also are not allowed after the employer receives from the IRS a Notice of Determination Concerning Worker Classification under Code Sec. 7436.

VOLUNTARY WORKER CLASSIFICATION SETTLEMENT PROGRAM

The Internal Revenue Service has a program that enables many employers to resolve past worker classification issues and achieve certainty under the tax law at a low cost by voluntarily reclassifying their workers. This program allows employers the opportunity to get into compliance by making a minimal payment covering past payroll tax obligations rather than waiting for an IRS audit. To be eligible, an applicant must:

- Consistently have treated the workers in the past as nonemployees,
- Have filed all required Forms 1099 for the workers for the previous three years, and
- Not currently be under an employment tax audit by the IRS, or a worker classification audit by the Department of Labor or a state agency.

Interested employers can apply for the program by filing Form 8952, Application for Voluntary Classification Settlement Program, at least 60 days before they want to begin treating the workers as employees.

Employers accepted into the program will pay an amount effectively equaling just over one percent of the wages paid to the reclassified workers for the past year. No interest or penalties will be due, and the employers will not be audited on payroll taxes related to these workers for prior years. For additional information see the instructions for Form 8952 and the frequently asked questions portion of the IRS web site:

https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-Settlement-Program-VCSP-Frequently-Asked-Questions

FORM 1099-NEC RESURRECTED

The Internal Revenue Service has resurrected a form that hasn't been used since the early 1980s, Form 1099-NEC, Nonemployee Compensation. Draft version is shown below. Since 1983, the IRS has required businesses to instead file Form 1099-MISC for contract workers and freelancers. The revival of Form 1099-NEC is part of an effort mandated by Congress in the PATH Act of 2015 to require businesses to file information returns about any non-employee compensation by Jan. 31 of each year. However, there were problems with the IRS's processing systems because there was still a March 31 due date for any Form 1099-MISC that didn't contain non-employee compensation. The draft form is dated 2020, so it would be used for reporting nonemployee compensation paid in 2020, not for 2019.

VOID CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

OMB No. 1545-xxxx

2020

Form **1099-NEC**

Nonemployee Compensation

1 Nonemployee compensation
$

Copy 1
For State Tax Department

PAYER'S TIN

RECIPIENT'S TIN

2 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale . . . . ▶

RECIPIENT'S name

3

Street address (including apt. no.)

4 Federal income tax withheld
$

City or town, state or province, country, and ZIP or foreign postal code

FATCA filing requirement

Account number (see instructions)

5 State tax withheld
$
$

6 State/Payer's state no.

7 State income
$
$

Form **1099-NEC** www.irs.gov/Form1099NEC Department of the Treasury - Internal Revenue Service

DRAFT AS OF July 24, 2019 DO NOT FILE

CALIFORNIA EMPLOYEE OR INDEPENDENT CONTRACTOR

CALIFORNIA DIFFERENCES

New Law & Stuff

Although the federal tax laws have guidelines for determining whether an individual is an employee or an independent contractor, generally the states are the most aggressive in this area because they have significant payroll tax revenues at stake in the classification decision.

This is especially true in California where there have been a rash of court cases dealing with the issue, and now we have California legislation signed by the Governor September 18, 2019. The legislation, AB5, passed both houses of the legislature by large majorities, and adopts the strict ABC test imposed by the California Supreme Court in the Dynamex case.

Dynamex Operations West - In this case the CA Supreme Court confirmed a Los Angeles County Superior Court finding against Dynamex, a trucking company that was treating its drivers as independent contractors. In arriving at a decision, the court adopted the so-called "ABC" Rule being used by other states. In doing so the court has made it tougher for an employer to treat a worker as an independent contractor.

CA Assembly Bill 5 – AB5 was passed by the state Assembly by a margin of 61 to 16 and by the Senate by 29 to 11, mostly along party lines. In general, this is what the legislation provides:

- It codifies the Dynamex decision for using the "ABC" test.
- Where a court rules the ABC test cannot be applied, then contractor status will be determined under the tests adopted in S.G. Borello & Sons, Inc. vs the Dept. of Industrial Relations (1989) 48 Cal.3d 341 (Borello).
- Exempts certain occupations from the provisions.

> **CAUTION:** Be aware that AB5 does not provide a bright line simplified definition for either an employee or independent contractor and is filled with exceptions that should make labor attorneys elated with its passage.

"ABC" Test - Several states, including Massachusetts and New Jersey, have also adopted this so-called "ABC" test. The test is a broad means of determining a worker's status as either an employee or a contractor by considering the following criteria (CA Labor Code 2750.3(a)(1)):

(A) That the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact;

(B) That the worker performs work that is outside the usual course of the hiring entity's business; **and**

(C) That the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

"A" follows the federal direction and control criteria, but "B" and "C" apply criteria not specifically included in the federal definition.

The objective of the ABC test is to create a simpler, clearer test for determining whether the worker is an employee or an independent contractor and *presumes a worker hired by an entity is an employee* and places the burden on the hirer to establish that the worker is an independent contractor.

Examples: A plumber temporarily hired by a store to repair a leak or an electrician to install a line would be an independent contractor. But a seamstress who works at home to make dresses for a clothing manufacturer from cloth and patterns supplied by the company, or a cake decorator who works on a regular basis on custom-designed cakes, would be employees.

Borello Application – AB5 provides the determination of employment status will be based upon the criteria set forth in the Borello case instead of the ABC tests where:

- A court of law rules the ABC test cannot be applied to a particular case (CA Labor Code 2750.3(a)(3)), or
- Certain occupations that AB5 exempts from the application of the ABC tests. Those occupations generally include (CA Labor Code 2750.3(a)(1)):

(1) A person or organization who is licensed by the Department of Insurance.

(2) A physician and surgeon, dentist, podiatrist, psychologist, or veterinarian licensed by the State of California.

(3) An individual who holds an active license from the State of California and is practicing one of the following recognized professions: lawyer, architect, engineer, private investigator, or accountant.

(4) A securities broker-dealer or investment adviser or their agents and representatives that are registered with the Securities and Exchange Commission or the Financial Industry Regulatory Authority or licensed by the State of California.

(5) A direct sales salesperson as described in Section 650 of the Unemployment Insurance Code.

(6) A commercial fisherman working on an American vessel – **but only until January 1, 2023** unless extended by the legislature

PROFESSIONS SPECIFICALLY SUBJECT TO BORELLO
(CA Labor Code *2750.3(a)(1)*

- Insurance Agents
- Physician and surgeon
- Dentist
- Podiatrist
- Psychologist
- Veterinarian
- Lawyer
- Architect
- Engineer
- Private investigator
- Accountant
- Securities broker-dealer
- Investment adviser
- Direct sales salesperson
- Commercial fisherman

Professional Services (CA Labor Code *2750.3(c)* – AB5 specifies that certain professional services are not subject to the ABC test and instead are also subject to the Borello criteria if **ALL** of the following are conditions are satisfied:

(A) The individual maintains a business location, which may include the individual's residence, that is separate from the hiring entity. Nothing in this subdivision prohibits an individual from choosing to perform services at the location of the hiring entity.

(B) If work is performed more than six months after the effective date of this section, the individual has a business license, in addition to any required professional licenses or permits for the individual to practice in their profession.

(C) The individual has the ability to set or negotiate their own rates for the services performed.

(D) Outside of project completion dates and reasonable business hours, the individual has the ability to set the individual's own hours.

(E) The individual is customarily engaged in the same type of work performed under contract with another hiring entity or holds themselves out to other potential customers as available to perform the same type of work.

(F) The individual customarily and regularly exercises discretion and independent judgment in the performance of the services.

Professional services mean services provided by an individual providing services through a sole proprietorship, or other business entity that meet any of the following:

PROFESSIONAL SERVICES
(CA Labor Code *2750.3(c)*

- Marketing
- Human Resources Admin.
- Travel Agent
- Graphic Design
- Grant Writer
- Fine Artist
- Enrolled Agent
- Payment Processing Agent
- Still Photographer
- Photojournalist
- Freelance writer
- Editor
- Newspaper Cartoonist
- Esthetician*
- Electrologist*
- Manicurist*
- Barber*
- Cosmetologist*

**See special qualifications; no longer applies to manicurists on 1/1/2022.*

Are ALL of the conditions (A) through (F) satisfied?

NO → Use the **ABC Test**

YES → Use the **Borello** Factors

(i) *Marketing*, provided that the contracted work is original and creative in character and the result of which depends primarily on the invention, imagination, or talent of the employee or work that is an essential part of or necessarily incident to any of the contracted work.

(ii) *Administrator of human resources*, provided that the contracted work is predominantly intellectual and varied in character and is of such character that the output produced or the result accomplished cannot be standardized in relation to a given period of time.

(iii) *Travel agent services* (See CA Labor Code 2750.3(c)(2)(B)(iii) for additional limitations).

(iv) *Graphic design*

(v) *Grant writer*

(vi) *Fine artist*

(vii) *Enrolled agent*

(viii) *Payment processing agent* through an independent sales organization.

(ix) *Still photographer or photojournalist* who do not license content submissions to the putative employer more than 35 times per year. This clause is not applicable to an individual who works on motion pictures. (See CA Labor Code 2750.3(c)(2)(B)(ix) for additional limitations).

(x) *Freelance writer, editor, or newspaper cartoonist* who does not provide content submissions to the putative employer more than 35 times per year. (See CA Labor Code 2750.3(c)(2)(B)(ix) for additional limitations).

(xi) *Licensed esthetician, licensed electrologist, licensed manicurist, licensed barber, or licensed cosmetologist* provided that the individual:

- Sets their own rates, processes their own payments, and is paid directly by clients.
- Sets their own hours of work and has sole discretion to decide the number of clients and which clients for whom they will provide services.
- Has their own book of business and schedules their own appointments.
- Maintains their own business license for the services offered to clients.
- If the individual is performing services at the location of the hiring entity, then the individual issues a Form 1099 to the salon or business owner from which they rent their business space.

This subdivision shall become inoperative, with respect to licensed manicurists, on January 1, 2022.

> This will definitely put a crimp in the way many beauty and barber shops currently function.

Determined by Business and Professions Code *(*CA Labor Code *2750.3(d)* – The following categories are not subject to the holding in Dynamex and instead the status of employee or independent contractor are governed by the Business and Professions code.

- *Real estate Licensees* – Determined by subdivision (b) of Section 10032 of the Business and Professions Code.
- *A licensed repossession agency* – provided repossession agency is free from the control and direction of the hiring person.

Business-to-business Contracting Relationships *(*CA Labor Code *2750.3(e)* – are not subject to the Dynamex holding if the business entity is formed as a sole proprietorship, partnership, LLC, or corporation that contracts to provide services to another business. The determination of employee or independent contractor status of the business services provider shall be governed by Borello, if the contracting business demonstrates that all of the following criteria are satisfied:

(A) The business service provider is free from the control and direction of the contracting business entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.

(B) The business service provider is providing services directly to the contracting business rather than to customers of the contracting business.

(C) The contract with the business service provider is in writing.

(D) If the work is performed in a jurisdiction that requires the business service provider to have a business license or business tax registration, the business service provider has the required business license or business tax registration.

(E) The business service provider maintains a business location that is separate from the business or work location of the contracting business.

(F) The business service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed.

(G) The business service provider actually contracts with other businesses to provide the same or similar services and maintains a clientele without restrictions from the hiring entity.

(H) The business service provider advertises and holds itself out to the public as available to provide the same or similar services.

(I) The business service provider provides its own tools, vehicles, and equipment to perform the services.

(J) The business service provider can negotiate its own rates.

(K) Consistent with the nature of the work, the business service provider can set its own hours and location of work.

(L) The business service provider is not performing the type of work for which a license from the Contractor's State License Board is required, pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code

This foregoing does not apply to an individual worker, as opposed to a business entity, who performs labor or services for a contracting business.

The determination of whether an individual working for a business service provider is an employee or independent contractor of the business service provider is governed by the ABC test unless a court of law applies Borello.

The following applies to construction workers and construction truckers

Contractor and Individual Contracting Relationships (CA Labor Code *2750.3(f)* - the holding in Dynamex does not apply to the relationship between a contractor and an individual performing work pursuant to a subcontract in the construction industry, and instead the determination of whether the individual is an employee of the contractor shall be governed by Section 2750.5 and by Borello, if the contractor demonstrates that all the following criteria are satisfied:

(1) The subcontract is in writing.

(2) The subcontractor is licensed by the Contractors State License Board and the work is within the scope of that license.

(3) If the subcontractor is domiciled in a jurisdiction that requires the subcontractor to have a business license or business tax registration, the subcontractor has the required business license or business tax registration.

(4) The subcontractor maintains a business location that is separate from the business or work location of the contractor.

(5) The subcontractor has the authority to hire and to fire other persons to provide or to assist in providing the services.

(6) The subcontractor assumes financial responsibility for errors or omissions in labor or services as evidenced by insurance, legally authorized indemnity obligations, performance bonds, or warranties relating to the labor or services being provided.

(7) The subcontractor is customarily engaged in an independently established business of the same nature as that involved in the work performed.

(8) (A) Paragraph (2) shall not apply to a subcontractor providing construction trucking services for which a contractor's license is not required provided that all of the following criteria are satisfied:

(i) The subcontractor is a business entity formed as a sole proprietorship, partnership, limited liability company, limited liability partnership, or corporation.

(ii) For work performed after January 1, 2020, the subcontractor is registered with the Department of Industrial Relations as a public works contractor pursuant to Section 1725.5, regardless of whether the subcontract involves public work.

(iii) The subcontractor utilizes its own employees to perform the construction trucking services, unless the subcontractor is a sole proprietor who operates their own truck to perform the entire subcontract and holds a valid motor carrier permit issued by the Department of Motor Vehicles.

(iv) The subcontractor negotiates and contracts with, and is compensated directly by, the licensed contractor.

(B) For work performed after January 1, 2020, any business entity that provides construction trucking services to a licensed contractor utilizing more than one truck shall be deemed the employer for all drivers of those trucks.

(C) For purposes of this paragraph, "construction trucking services" mean hauling and trucking services provided in the construction industry pursuant to a contract with a licensed contractor utilizing vehicles that require a commercial driver's license to operate or have a gross vehicle weight rating of 26,001 or more pounds.

(D) **This paragraph shall only apply to work performed before January 1, 2022.**

(E) Nothing in this paragraph prohibits an individual who owns their truck from working as an employee of a trucking company and utilizing that truck in the scope of that employment. An individual employee providing their own truck for use by an employer trucking company shall be reimbursed by the trucking company for the reasonable expense incurred for the use of the employee owned truck.

Relationships Between Referral Agencies and Service Provider (CA Labor Code *2750.3(g))* – If a business entity formed as a sole proprietor, partnership, limited liability company, limited liability partnership, or corporation ("service provider") provides services to clients through a referral agency, the determination whether the service provider is an employee of the referral agency shall be governed by Borello, if the referral agency demonstrates that all of the following criteria are satisfied:

(A) The service provider is free from the control and direction of the referral agency in connection with the performance of the work for the client, both as a matter of contract and in fact.

(B) If the work for the client is performed in a jurisdiction that requires the service provider to have a business license or business tax registration, the service provider has the required business license or business tax registration.

(C) If the work for the client requires the service provider to hold a state contractor's license pursuant to Chapter 9 (commencing with Section 7000) of Division 3 of the Business and Professions Code, the service provider has the required contractor's license.

(D) The service provider delivers services to the client under service provider's name, rather than under the name of the referral agency.

(E) The service provider provides its own tools and supplies to perform the services.

(F) The service provider is customarily engaged in an independently established business of the same nature as that involved in the work performed for the client.

(G) The service provider maintains a clientele without any restrictions from the referral agency and the service provider is free to seek work elsewhere, including through a competing agency.

(H) The service provider sets its own hours and terms of work and is free to accept or reject clients and contracts.

(I) The service provider sets its own rates for services performed, without deduction by the referral agency.

(J) The service provider is not penalized in any form for rejecting clients or contracts. This subparagraph does not apply if the service provider accepts a client or contract and then fails to fulfill any of its contractual obligations.

The foregoing does not apply to an individual worker, as opposed to a business entity, who performs labor or services for a contracting business.

The determination of whether an individual working for a business service provider is an employee or independent contractor of the business service provider is governed by the ABC test unless a court of law applies Borello.

Retroactive Application (CA Labor Code *2750.3(i))* - Insofar as the application of CA Labor Code *2750.3(b)* through (h) of this section would relieve an employer from liability, those subdivisions shall apply retroactively to existing claims and actions to the maximum extent permitted by law.

Effective Date (CA Labor Code *2750.3(i)* - Except as provided these provisions of the Labor Code shall apply to work performed on or after January 1, 2020.

Injunctive Relief (CA Labor Code *2750.3(i)*- In addition to any other remedies available, an action for injunctive relief to prevent the continued misclassification of employees as independent contractors may be prosecuted against the putative employer in a court of competent jurisdiction.

Borello Test Factors - The *Borello* test involves the principal factor of 'whether the person to whom services is rendered has the right to control the manner and means of accomplishing the result desired' as well as the following nine additional factors.

(1) right to discharge at will, without cause;

(2) whether the one performing the services is engaged in a distinct occupation or business;

(3) the kind of occupation, with reference to whether in the locality the work is usually done under the direction of the principal or by a specialist without supervision;

(4) the skill required in the particular occupation;

(5) whether the principal or the worker supplies the instrumentalities, tools, and the place of work for the person doing the work;

(6) the length of time for which the services are to be performed;

(7) method of payment, whether by the time or by the job;

(8) whether or not the work is part of the regular business of the principal; and

(9) whether or not the parties believe they are creating the relationship of employer-employee."

These individual factors cannot be applied mechanically as separate tests; they are intertwined, and their weight depends often on particular combinations making the outcome subjective.

CIVIL PENALTIES FOR WILLFUL MISCLASSIFICATION

California Senate Bill 459 (Ch 11-706), signed into law by the governor October 9, 2011 and effective January 1, 2012, makes the willful misclassification of employees as independent contractors unlawful and allows California's Labor and Workforce Development Agency, or a court, to impose a civil penalty of $5,000 to $15,000 ($10,000 to $25,000 if there is a pattern and practice of misclassifications) for each violation found to be "willful." Each misclassified individual is one violation. These civil penalties are in addition to other assessments and penalties that may be imposed under other laws. ***(Labor Code Sec. 226.8)***

In addition, any violator will be required, for one year, to post a notice signed by an officer (owner if sole proprietor) on its Internet website (or otherwise prominently display the notice if the violator does not have a website) that explains the violation in detail. The notice must contain the following:

(1) That the Labor and Workforce Development Agency or a court, as applicable, has found that the person or employer has committed a serious violation of the law by engaging in the willful misclassification of employees.

(2) That the person or employer has changed its business practices in order to avoid committing further violations of this section.

(3) That any employee who believes that he or she is being misclassified as an independent contractor may contact the Labor and Workforce Development Agency. (The notice must include the mailing address, e-mail address, and telephone number of the Agency.)

(4) That the notice is being posted pursuant to a state order.

If the violator is a licensed contractor, the Labor Agency is required to notify the Contractors' State License Board, which must initiate an action against the licensee within 30 days.

"Willful Misclassification" - is defined as "avoiding employee status for an individual by voluntarily and knowingly misclassifying that individual as an independent contractor."

Paid Advisors Also Subject to Penalty - Under this law, paid advisors (excluding attorneys and employees of the company) who "knowingly advise" employers to treat an individual as an independent contractor to avoid employee status for that individual **are jointly and severally liable for any penalties** imposed on the employer if the individual is found not to be an independent contractor. (***Labor Code Section 2753)***

CAUTION: Given the advisor liability provision, consultants, Enrolled Agents, CPAs, return preparers and others who might otherwise advise their clients on how to classify workers should instead refer the client to an employment attorney.

NOTES

MEALS AND ENTERTAINMENT

- **Meal Allowance %**
  - Regular: 50%
  - Transportation Workers: 80%
- **Standard Meal Allowance** (Meals & Incidental Expenses)
  - Regular (depending on location):
    - 2019 (effective 10/1/18): $60 - $71
    - 2020 (effective 10/1/19): $60 - $71
  - Find per diems by location at www.gsa.gov/perdiem
  - Transportation Workers:
  - 2019 - $66 CONUS, $71 outside CONUS
  - 2020 - $66 CONUS, $71 outside CONUS
- **Simplified Per Diem Rates** – High-Low Method – Employer reimbursement per diem for substantiation purposes:
  - Low CONUS:
    - 2019, effective 10/1/18 - $195 of which $60 is meals
    - 2020, effective 10/1/19 - $200 of which $60 is meals
  - High CONUS:
    - 2019, effective 10/1/18 - $287 of which $71 is meals
    - 2020, effective 10/1/19 - $297 of which $71 is meals
- **Employees (pre-2018 and post-2025) and Self-Employed**:
  - May use Standard Meal Allowance for business meals
  - May NOT use lodging per diem (actual expense and documentation required)

RAPID FINDER

50% Limit	3.10.02
80% Limit	3.10.03
Associated with	3.10.04
Business Meals	3.10.01
Club dues	3.10.05
Consistency	3.10.07
Directly related	3.10.03
Employer Meals	3.10.01
Employer provided	3.10.03
Firefighters	3.10.05
Fishermen	3.10.05
High-low	3.10.07
Hours of Service	3.10.03
Incidental	3.10.06
Lavish	3.10.04
Lodging	3.10.06
Meal Allowance	3.10.06
Meals, Business	3.10.01
Meals, Employer	3.10.01
Meetings	3.10.03
Option	3.10.06
Per Diem	3.10.05
Per Diem	3.10.07
Recreational	3.10.02
Reimbursed	3.10.02
Sports events	3.10.05
Substantiation	3.10.05
Theatrical events	3.10.05
Transportation Workers	3.10.07

Related IRC and IRS Publications and Forms

- **Domestic Per Diem Rates** (General Services Administration) http://www.gsa.gov/perdiem
- **Foreign Per Diem Rates** (State Department)- http://aoprals.state.gov/content.asp?content_id=184&menu_id=89
- **Pub 535** – Business Expenses
- **IRC Sec 274**
-

Business Entertainment No Longer Deductible - Under the TCJA, after December 31, 2017, no deduction is allowed with respect to:

(1) An activity generally considered to be entertainment, amusement or recreation,

(2) Membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or

(3) A facility or portion thereof used in connection with any of the above items. (IRC Sec. 274(a) as amended by TCJA Sec. 13304(a))

So this means that deductions are no longer allowed for the cost of such activities as golf outings, fishing trips, sporting events, concerts, etc., with clients or business associates, even if business is discussed.

Business Meals – In a very business friendly transitional guidance (Notice 2018-76) on the deductibility of business meals, the IRS has announced that taxpayers generally may continue to deduct the food and beverage expenses associated with operating their trade or business. Under this notice, taxpayers may deduct 50 percent of an otherwise allowable business meal expense if:

1. The expense is an ordinary and necessary expense paid or incurred during the taxable year in carrying on any trade or business;
2. The expense is not lavish or extravagant under the circumstances;
3. The taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;
4. The food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and
5. In the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.

Example *– (This example was taken from Notice 2018-76) Taxpayer invites a business contact to a baseball game. The tickets to the game fall into the entertainment category and are not deductible. However, the taxpayer also purchased hot dogs and a beverage for himself and the business contact. Because food and drinks are purchased separately, they are not disallowed as entertainment and are deductible if they otherwise qualify as an ordinary and necessary business expense. Had the ticket price included the hot dogs and beverages, they would be treated as non-deductible entertainment. If the ticket price separately stated the ticket price and the food and beverage price, then the food and beverage portion would not be disallowed as entertainment*

Employer-Provided Meals - The 50% rule will apply to employers providing meals through an in-house cafeteria effective for 2018 through 2025. (IRC Sec. 274(n)(2) as amended by TCJA Sec. 13304(b)(1)) Previously the employer could deduct 100% of these costs. And as of January 1, 2026 an employer's deduction for meals for the convenience of the employer, including in-house cafeterias, is disallowed. (IRC Sec. 274(o) as amended by TCJA Sec. 13304(d)(2))

NOTE: We have retained the pre-TCJA (pre-2018) rules within the following text. They are pointed out by the notation "**prior to 2018**" throughout.

The Details

<u>50% LIMIT</u>: Deductions for business meal (and **prior to 2018** entertainment) expenses are limited to 50% of their cost. The 50% rule also covers the cost of meals during away-from-home business travel. In addition, deductions for expenses related to the meals (e.g., taxes, tips and cover charges) are also limited to 50% of cost; however, this is not true for costs of transportation to and from the meal or entertainment location. In the case of pre-2018 entertainment, the cost of parking and room rentals is subject to the 50% rule. Because they are not business related, the 50% limitation does not apply to the deduction of meals associated with medical or charitable travel.

The 50% limit doesn't apply to:

- *<u>Expenses Treated as Compensation</u>* - Expenses treated as compensation paid to an employee or otherwise included in the gross income of the recipient of the meal (or entertainment prior to 2018) are fully deductible. (Code Sec. 274(n)(2)(A))
- *<u>Reimbursed Expenses</u>* - Meal (and prior to 2018 entertainment) expenses that are reimbursed are fully deductible, and instead the percentage limit applies to the person making the reimbursement. (Code Sec. 274(n)(2)(A))
- *<u>Recreational, etc., Expenses for Employees</u>* **-** Expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees (other than employees who are highly compensated employees (within the meaning of section 414(q))) are fully deductible. For purposes of this paragraph, an individual owning less than a 10-percent interest in the taxpayer's trade or business shall not be considered a shareholder or other owner, and for such purposes an individual shall be treated as owning any interest owned by a member of his family (within the meaning of section 267(c)(4)). A highly compensated employee is an employee who (1) was a 5% owner at any time during the determination year or the preceding year, or (2) for the preceding year, received more than 125,000 in compensation from the employer and, if the employer elects, also was in the "top-paid group" (top 20%) of employees for that year. The compensation figure for years 2015 through 2018 is $120,000.
- *<u>Services and Facilities for General Public</u>* – Expenses for goods, services and facilities made available by the taxpayer to the general public are fully deductible. (Code Sec. 274(n)(2)(A))
- *<u>Entertainment Sold</u>* - Expenses of goods, services, or use of facilities, sold by the taxpayer in a bona fide transaction (entertainment sold to customers) are fully deductible. (Code Sec. 274(n)(2)(A))

- *Employer-provided Food and Beverages* - Expenses for food and beverages (and facilities used in connection therewith) furnished on the business premises of the taxpayer primarily for his employees are fully deductible. (Code Sec 274(e)(1)) Prior to the TCJA, the code said that food or beverage expenses that are excludable from the gross income of the recipient under the de minimis fringe benefit rules are allowed in full. (Code Sec. 274(n)(2)(B) prior to being stricken by TCJA) The term "de minimis fringe" (Code Sec 132(e)) means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.
- *Employee, Stockholder, etc., Business Meetings* – Expenses incurred by a taxpayer which are directly related to business meetings of his employees, stockholders, agents, or directors are not limited by the 50% rule. (Code sec 274(e)(5))
- For years prior to 2018, the operation by an employer of any eating facility for employees shall be treated as a de minimis fringe, and therefore the costs are fully deductible, if:
    - Such facility is located on or near the business premises of the employer, and
    - Revenue derived from such facility normally equals or exceeds the direct operating costs of such facility.

  The preceding shall apply with respect to any highly compensated employee only if access to the facility is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees.

  Effective in 2018, the 50% rule applies to these expenses, and after 2025, none of these expenses will be deductible.
- For years prior to 2018, an expense that is part of a package that includes a ticket to attend certain charitable sporting events. (Code Sec. 274(n)(2)(C) prior to being stricken by TCJA) The event must: (1) be organized for the primary purpose of benefiting a tax-exempt charitable organization, (2) contribute 100% of the net proceeds to the charity, and (3) use volunteers for substantially all work performed in carrying out the event. The TCJA disallows any portion of the expense, effective with 2018.
- Food or beverage expenses of crews of certain drilling rigs and crews of certain commercial vessels (Code Sec. 274(n)(2)(C) as amended by the TCJA), but not fishing vessels, are fully deductible.

80% LIMIT - "HOURS OF SERVICE" BUSINESS MEAL DEDUCTIONS

TCJA

For years 2018 through 2025, the TCJA suspends the deduction of miscellaneous itemized deductions that are subject to the 2% of AGI reduction. This category includes employee business expenses, so although the 80% deduction for transportation workers' meal expenses was unchanged by the TCJA, employees who would otherwise benefit by the higher deductible percentage will get no deduction for the cost of their meals during the suspension period.

The law allows an increased, deductible percentage of 80% for away-from-home food and beverage costs ***for individuals subject to the hours of service limitations of the Department of Transportation***. Evidently, these individuals must often eat meals away from home in circumstances where choice is limited, prices comparatively high and the opportunity for lavish meals remote.

Individuals subject to the hours of service limitations of the Department of Transportation include:

- Air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators under Federal Aviation Administration regulations.
- Interstate truck operators and interstate bus drivers under Department of Transportation regulations.
- Railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel under Federal Railroad Administration regulations, and
- Merchant mariners under Coast Guard regulations.

GENERAL DEDUCTION REQUIREMENTS*:*

As with travel expenses, meal (and prior to 2018 entertainment) expenses must be "ordinary" and "necessary" in carrying on a trade or business *(Code Sec 162),* and prior to 2018 must be "directly related to" or "associated with" the active conduct of business *(Code Sec 274(a)(1) prior to amendment by the TCJA)****.*** Under the TCJA, no deduction is allowed for the expense of any food or beverages unless the expense "is not lavish or extravagant under the circumstances and the taxpayer (or an employee of the taxpayer) is present at the furnishing of such food or beverages." (Code Sections 274(k)(1)(A) and (B))

Pre-2018 Directly-related Test - In order to meet the prior code's directly-related test, the meal expense must be incurred in the active conduct of business and be for the taxpayer, business guest(s) and spouse(s). Under this test, actual business discussions are required during the meal, and the taxpayer must show that there was anticipation of a specific business benefit from the meal (even if the benefit does not materialize). (Code Sec. 274(a)(1)(A) before amendment by the TCJA)

Pre-2018 Associated-with Test - The associated-with test is somewhat more liberal, because it allows deductions for expenses incurred either preceding or following a bona fide business discussion (Reg. § 1.274-2(d)(3)(i)(A)). Goodwill-generating quiet business meals "in an atmosphere conducive to business" are not deductible.

> ***Example - Associated with business (pre-2018)*** *- Pete treats many of his clients to an expensive lunch or dinner during 2017. He usually doesn't talk business—the treats are intended to promote goodwill and "keep in touch." These goodwill-building meals aren't deductible because they aren't "directly related" to the active conduct of Pete's trade or business. However, he can salvage deductions by scheduling the meals for those days when he makes business calls on the client. This way, the meals can qualify as "associated with business" entertainment.*
>
> ***Example – Associated with business (pre-2018)*** *- Susan Albertson, president of Media Corp. has successfully recruited Dan Baker to be the company's CFO starting July 1, 2017. To celebrate, Albertson and her husband take Baker and his wife for an evening on the town—a night at the theater followed by dinner. Media Corp. foots the bill, and Albertson substantiates the expense under the accountable plan rules. The cost of the entertainment is tax-free to Albertson, and Media Corp. can deduct 50% of the cost because this is entertainment "associated with" its business.*

***Pre-2018** - Directly preceding or following requirement* - Generally, entertainment is considered to have directly preceded or followed a business discussion if both events occur on the same day. However, entertainment can still pass muster, even if it doesn't occur on the same day as the business meeting, if the facts and circumstances warranted a delay. (Reg. § 1.274-2(d)(3)(ii)) **Caution:** Effective after 2017, entertainment expenses are not deductible for federal tax purposes.

> ***Example - Directly preceding or following requirement (pre-2018)*** *- If the taxpayer's client or business associate comes from out of town to hold a substantial business meeting, the entertainment of the business guests and their spouses held the day before or after the meeting would generally be regarded as qualifying under the "associated with business" test. (Reg. § 1.274-2(d)(3)(ii)) Similarly, there may be situations where a client or business associate has a scheduling conflict and asks that the entertainment be put off a day.*
>
> ***Example - Directly preceding or following requirement (pre-2018)*** *– In 2017 Mr. Salter is negotiating a major deal with Mr. Smith, who flew into town with his wife for the occasion. The day after their meetings conclude, Salter invites the Smiths to a catered dinner at his home. Result: 50% of the home-entertainment cost is deductible. What is more, Salter can even invite a few non-business guests (although the portion of the expense allocable to their presence is not deductible – see allocations below).*

***Pre-2018** - When an allocation may be required* **-** If non-business guests are invited to an otherwise allowable "associated with business" entertainment event, the expenses must be allocated between the business and nonbusiness guests. The expenses related to the non-business guests are nondeductible. However, note that the spouse of the taxpayer and his or her business guests or associates are considered business guests for this purpose. (Reg. § 1.274-2(d)(2))

> ***Example (pre-2018) –*** *On April 1, 2017 ABC Corp. concluded negotiations on a major contract with XYZ Corp. ABC celebrates by throwing a party after the papers are signed. Of the 60 guests, 40 are officers, counsel, and accountants of both companies and their spouses. The remaining 20 are friends and well-wishers. Two-thirds of the expense qualifies as "associated with business" entertainment. The remaining one-third, representing the non-business guests, is nondeductible.*

Lavish - Meal (and pre-2018 entertainment) expenses are deductible up to an amount not considered "lavish" (i.e., reasonable under the circumstances). The taxpayer (or a representative of the taxpayer) must be present. The representative could be, for example, the taxpayer's employee, an attorney or an independent contractor who performs significant services for the taxpayer.

Away-From-Home Meals - When taxpayers travel away from home on business, they may deduct 50% of the cost of their own meals. A business traveler who pays for meals consumed with out-of-town clients or associates may deduct the cost of the clients' or associates' meals. However, if the taxpayer is an employee, for 2018 through 2025, unreimbursed employee business expenses are not deductible as part of itemized deductions. For years before 2018, the business traveler was required to meet the directly related or associated with tests in order for the meal costs to be deductible.

> ***Example** - **Away-From-Home Meals -*** *Margaret's employer sent her on a five-day business trip to Minneapolis to make a sales presentation to MM&M, Inc. Margaret received no reimbursement for her meals during the trip. Margaret ate alone in her hotel on the first three nights away, at a total cost of $100. On the fourth night, she met one of her friends from another company for dinner. Margaret paid the tab of $80. The next day, she invited Martie, a purchase representative for MM&M, Inc., to dinner. Their dinner followed a full day of discussion on MM&M's latest order from Margaret. Margaret paid for dinner that night too, a total of $100. Margaret's deductible meal expense is $120 for the trip (50% x ($100, meals alone + $40, her portion of dinner with friend + $100, meal with Martie)).*

Business Meal Recordkeeping - Meal (and pre-2018 entertainment) expenses are deductible only if substantiation requirements are met. Code Section 274(d) requires substantiation of the following:

- The amount
- Date, time and place
- Business purpose
- Names of guests & business relationship

Reimbursed Expenses - If a taxpayer is reimbursed for business meal costs (or pre-2018 entertainment expenses) and makes an adequate accounting, the 50% rule applies to the one who makes the reimbursement, not the taxpayer.

Using Per Diem Rate to Substantiate Employee's Expenses for Lodging, Meals and Incidentals (Rev Proc 2011-47 & Notice 2011-81) – Rev Proc 2011-47 details the rules, effective October 1, 2011, for using a per diem rate to substantiate the amount of an employee's expenses for lodging, meals and incidentals that an employer (or third party) reimburses, and explains how an employee or self-employed individual may use the "standard meal allowance." This revenue procedure will only be updated as necessary in the future.

Rev Proc 2011-47 also clarifies that partners and volunteers who receive reimbursements from payors may use the methods allowed in the procedure to substantiate their expenses.

Instead of an annual revenue procedure, the IRS issues a shorter, annual notice providing the special per diem rates effective as of October 1 of the year issued. The 2019-2020 rates are included in Notice 2019-55; 2018-2019 rates are included in Notice 2018-77; 2017-2018 rates are included in Notice 2017-54; and 2016-2017 rates were published in Notice 2016-58.

Letter Ruling 9414040 states that a real estate broker who provided dinner to prospective purchasers before making a sales presentation, could take a full deduction for the cost of the meal. None of the broker's owners or employees received a dinner.

Pre-2018 Entertainment at Sports or Theatrical Events - The deduction available for years before 2018 for tickets to entertainment events generally is limited to 50% of the face value of the ticket.

> ***Example*** *-* ***Sports/Theater Entertainment (pre-2018) -*** *Allen paid a ticket scalper $300 for two tickets to a popular musical in June 2017 and used them for qualifying business entertainment. The tickets cost $50 each when purchased at the theater box office. Allen's tax deduction for the entertainment is $50 (50% of the face value of the two tickets).*

Club Dues Deductions - No deduction is allowed for amounts paid or incurred for membership in any club organized for business, pleasure, recreation or other special purpose. (Code Sec 274(a)(3)) For years before 2018 specific business expenses incurred at a club are deductible only to the extent they otherwise qualify as business deductions. Effective with 2018, this specific business expense exception does not apply.

Exceptions – According to IRS Pub 535 (page 46, 2018 edition) the following organizations aren't treated as clubs organized for business, pleasure, recreation, or other social purpose unless one of the main purposes is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities.

- Boards of trade
- Business leagues
- Chambers of commerce
- Civic or public service organizations
- Professional organizations such as bar associations and medical associations
- Real estate boards
- Trade associations

Meals & Commercial Fishermen - Affirming the Tax Court, the Eleventh Circuit Court of Appeals has ruled that a seaman's deduction for meals while aboard a fishing vessel is subject to the 50% deduction limit. The Court held that the exception to the deduction limit for commercial vessel crews doesn't apply to fishing vessel crews.

Meals and Lodging of Firefighters – This issue has been to tax court more than once. One of the most significant cases began in the late 1970s and eventually was decided at the appellate level. As a part of a desegregation plan implemented in the late 1950s, Los Angeles firefighters were required to participate in and contribute to a common mess. The meals were organized and prepared by the firemen in kitchen facilities furnished by the employer-fire department. A firefighter by the name of Sibla excluded the contribution to the common mess from his income and ended up in court. The Ninth Circuit held that because firefighters were required to contribute, they never had "complete dominion" over the funds which were contributed. Thus, in substance, the meals were furnished in kind by the employer, rather than paid for by the employees and reimbursed in cash. (Sibla, Richard v. Com., (1980, CA9) 45 AFTR 2d 80-955)

Since that time courts have taken the position that in such cases as outlined above the contribution to the common mess is not an adjustment to income, but, instead, an employee business expense.

It is a common practice for firefighters to eat meals on the premises of their station houses. Ordinarily, the cost of these meals is considered a personal expense and isn't deductible, even where a firefighter is required to remain at the firehouse overnight and cannot leave the premises for meals. (Rev Rul 56-49, 1956-1 CB 152).

An exception to this rule has been applied to permit a firefighter to deduct the payments as a business expense if the following conditions are met:

1. The contribution to the common mess is required by the fire department.
2. The meals are served at the firehouse.
3. The firefighter had to pay for the meals whether he or she was at the firehouse to eat them or away from the firehouse on fire department business. (Sibla, Richard, (1977) 68 TC 422, nonacq 1978-2 CB 4)

Thus, where the above strict conditions apply, the common mess expense is treated as employee business meals (50% deductible) and deducted as a miscellaneous itemized deduction subject to the 2% of AGI reduction.

TCJA

However, **for years 2018 through 2025**, the TCJA suspends the deduction of miscellaneous itemized deductions that are subject to the 2% of AGI reduction. This category includes employee business expenses, so firefighters who would otherwise benefit from deducting their meal costs will get no deduction for them during the suspension period.

Optional Method for Deducting Away-From-Home Meals – Under several revenue procedures meal deductions are allowed using optional meal rates equal to the Federal meal and incidental expenses (M&IE) per diem rate for the location to which the taxpayer is traveling on business (but not for medical or charitable purposes). The optional rate method, also called the **standard meal allowance**, is elective and can be used by employees (in years before 2018 and after 2025) and self-employed individuals. The optional meal allowance must be prorated for both the days of departure on and return from the trip (IRS allows either 75% of the daily rate for each of the first and last days of the trip or any consistently applied method that is in accordance with reasonable business practices).

Under the optional rate method, the same rate is used no matter how long the stay away from home. For travel in 2019 the standard meal allowance is $60 ($51 in 2016, 2017 and from January through September 2018, $60 for October through December 2018) for most small localities in the U.S. The 2020 standard meal allowance is $60. The rate is generally higher for major cities, resort areas and other locations in the U.S., with the highest being $76 for 2019 ($74 for 2016, 2017 and 2018). The applicable rate can be found at the following web site: www.gsa.gov/perdiem

The standard meal allowance rates noted above do not apply to travel in Alaska, Hawaii or other locations outside the continental United States (CONUS). The foreign location rates are normally published by the various tax services in conjunction with explanations of Code Section 274. Or they can be found on the Internet at:

> Non-foreign areas outside CONUS (e.g., Hawaii, Alaska, Puerto Rico):
> *http://www.defensetravel.dod.mil/site/perdiemCalc.cfm*
>
> Foreign per diem rates:
> https://aoprals.state.gov/web920/per_diem.asp

New federal CONUS rates are published each year, effective from October 1 of that year through September 30 of the following year (coinciding with the federal government's fiscal year). However, there may be mid-year changes to some of the high-low rates, which will be reflected on the web site referenced above. For 2019, in lieu of the updated rates that will be effective October 1, 2019, a taxpayer claiming the standard meal allowance may continue to use the CONUS rates in effect for the first 9 months of 2019 for all of calendar 2019. However, the taxpayer must consistently use either the rates for the first 9 months of 2019 or the updated rates for the period October 1, 2019 through December 31, 2019.

Substantiation of time, place and business purpose is still required when claiming the standard meal allowance, and the 50% limit applies if the business traveler is not reimbursed or is reimbursed under a nonaccountable plan. If reimbursement under an accountable plan is less than the optional meal allowance, only 50% of the excess amount is deductible.

CAUTION – LODGING PER DIEM

Although per diem rates may be used to substantiate deductions for lodging, meals, and incidental expenses, or for meal expenses and/or incidental expenses only, they may not be used to substantiate deductions for lodging expenses only. Self-employed individuals are not entitled to use the federal per diem rates to substantiate lodging expenses under any circumstances (*Starr v. Commissioner,* TC Memo. 2000-305). There is no optional standard lodging amount similar to the standard meal allowance. The allowable lodging expense deduction is the taxpayer's actual cost (2018 Pub 17, page 141)

No Double Dipping Allowed – A business traveler who elects to use the standard meal allowance, and who also has a qualified meal expense during the trip, cannot deduct his own meal expense incurred at that event.

Example: *Arnold is a computer software salesperson who traveled away from home for several days to meet with potential clients. He opts to use the standard meal allowance method for his meal expense deduction. He meets with two prospective clients for dinner to discuss the benefits of his company's products and pays for the meals – his guests' meals cost $70 and his was $30. He can deduct the $70 expense plus the full daily standard meal allowance amount, with both amounts subject to the 50% reduction, but he can't also include the $30 he spent for his meal.*

Incidental Expenses - The optional meal allowance is intended to cover both daily meals and incidental expenses while traveling away from home on business. Incidental expenses are defined the same as the definition of incidental expenses in the Federal Travel Regulations, which the General Services Administration says include only fees and tips to:

- Porters,
- Baggage carriers,
- Hotel staff, and
- Staff on ships.

Mailing costs of filing travel vouchers and paying employer-sponsored credit card billings, and transportation between lodging or business sites and places where meals are taken, are not included as incidental expenses. Instead, taxpayers using the per diem rates may separately deduct or be reimbursed for transportation and mailing expenses. Also **not** included as incidental expenses, and therefore separately deductible in addition, are the costs for:

- Laundry
- Clothes cleaning and pressing
- Lodging taxes
- Telephone calls and telegrams

If no meal expenses were paid or incurred, a business traveler may elect to use an optional method for incidental expenses only. The deductible amount for years 2010 through 2020 is $5 per day for incidental expenses paid or incurred during away-from-home business travel. This method cannot be used for any day that the standard meal allowance method is used.

Transportation Workers Meals & Incidentals Standard Daily Allowance					
Calendar Year	**2016 -2017**	**1/1/18-9/30/18**	**10/1/18-12/31/18**	**2019**	**2020**
CONUS (Meals & Incidentals)	$ 63	$63	$66	$66	$66
Outside CONUS (Meals & Incidentals)	$ 68	$68	$71	$71	$71

If amount is not shown it is not available at publication date

Transportation Workers - A special method applies for determining expenses of employees in the transportation industry. **Note:** Unless indicated otherwise, rates for a given calendar year are based on the fiscal year rates effective on October 1 of the prior year.

TCJA

However, for years 2018 through 2025, the TCJA suspends the deduction of miscellaneous itemized deductions that are subject to the 2% of AGI reduction. This category includes employee business expenses, so employees in the transportation industry who would otherwise benefit from deducting the special standard meal allowance will get no deduction for meal expenses during the suspension period.

Per Diem Reimbursement – In lieu of an employer reimbursing the actual substantiated expenses incurred while an employee travels on business, the employer may pay a per diem amount to the employee. This concept is unchanged by the TCJA. The per diem amount generally is intended to cover costs of away-from-home lodging, meals and incidental expenses (M&IE). As long as the rate paid is not more than the maximum amount approved by the IRS, and the employee provides appropriate substantiation (time, place and business purpose), the reimbursement is considered made under an accountable plan. Thus, it is not included in the employee's W-2 wages and is free of income tax and FICA tax withholding. Generally, the per diem maximum allowed by the IRS is equal to the highest per diem rate paid by the federal government to its employees on travel status. This rate varies from locality to locality, sometimes changes seasonally, and is updated periodically (see the web sites noted above). The standard meal allowance is derived from the M&IE component of these government per diem rates. The rates generally are updated as of October 1 each year (to match the federal government's fiscal year). The rates in effect for the first nine months of the year may continue to be used for the balance of the calendar year provided it is done consistently for all travel.

Employers may choose instead to use a simplified per diem method – referred to as the **high-low per diem** – rather than using actual per diems. Under this method there is one rate for designated high-cost areas within the continental United States (CONUS) and another per diem rate for all other areas within CONUS. For example, effective October 1, 2018 (apply to 2019 calendar year taxpayers), the optional high-low per diem for high cost areas is $287; it is $195 for other areas. These rates have two components, lodging (set at $216 in high-cost areas, $135 for other localities) and meals and incidental expenses $71 in high-cost areas and $60 elsewhere). As of October 1, 2019 (for 2020 calendar year taxpayers), the high-low per diem rate for high-cost areas is $297 ($226 lodging, $71 meals) and for low-cost areas $200 ($140 lodging, $60 meals).

Consistency Required - An employer who used the actual per-diem method for an employee for the first nine months of 2019 can't switch to the high-low per-diem method for that employee until Jan. 1, 2020. If the high-low substantiation method was used for an employee during the first 9 months of calendar year 2019, the employer must continue to use the high-low method for the rest of 2019 for that employee, although for travel on or after October 1, 2019, and before January 1, 2020, the employer may continue to use the rates and high-cost localities as of 10/1/18 in lieu of the updated rates and high-cost localities effective 10/1/19, if those rates and localities are used consistently during the last 3 months of the calendar year for all employees reimbursed under the high-low method.

CAUTION

There is no optional standard lodging amount similar to the standard meal allowance. IRS allows the per diem rates for lodging to be used as a way to satisfy adequate accounting and substantiation requirements. They are for the purpose of reimbursing employees who travel away from home for their employers, **not for use by the employee or a self-employed person to claim a tax deduction. The allowable lodging expense deduction is the actual cost and must be substantiated by receipts.** The **standard meal allowance amount is determined from the meals and incidental expenses component of the federal government's per diem allowance for its workers on travel status, based on location of the travel, not from the meals and incidentals portion of the per diem rates for the high-low method.**

CALIFORNIA DIFFERENCES

California has not adopted the TCJA changes discussed in this chapter, including elimination of the deduction for business entertainment expenses and allowance of only 50% of the cost of meals provided by employers for the employer's convenience. Thus, unless conforming legislation is enacted by the state, 50% of entertainment expenses and 100% of employer-provided meals will be deductible on California returns. Employees continue to be able to deduct employee business expenses as a miscellaneous itemized deduction subject to a 2% of federal AGI reduction on their California returns.

NOTES

VEHICLE EXPENSES

Overview

Methods:

- *Actual expense* – must continue in subsequent years if selected in 1st year
- *Standard mileage* – can later switch to actual w/SL Dep.
  - 2019 rate: **58.0**
  - Up to **four vehicles**
  - Leased vehicles ok if std used entire term
  - Interest not included – deduct separately if SE
  - Taxes not included – deduct separately

2019 First Year Luxury Vehicle Limits (6,000# or less, acquired after 9/27/17 & placed in service in 2019):

- $10,100
- $18,100 with bonus depreciation

Sport Utility Vehicles:

- 14,000 pounds gross vehicle weight or less
- Sec 179 limited to $25,500 (2019)

New Law & Stuff

Bonus Depreciation Phase-Out – Included in the PATH Act of 2015 was a provision that extends but phases out bonus depreciation, and correspondingly, the added $8,000 increase to the luxury auto limit.

TCJA

The TCJA further modified the effective dates, as follows: the first-year luxury auto is increased by $6,400 (total limit $16,400) for vehicles acquired before September 28, 2017 but not put in service until 2018 or by $8,000 for post-September 27, 2017 acquisitions of passenger autos put in service in 2018 (total limit $18,000) or 2019 (total limit $18,100).

Heavy SUVs are vehicles with a gross vehicle weight (GVW) rating of more than 6,000 pounds and are exempt from the luxury auto dollar caps and qualify for bonus depreciation.

RAPID FINDER

Actual Expenses	03.11.03
Actual or Optional	03.11.01
Capital Improvements	03.11.04
Deemed Depreciation	03.11.06
Depreciation	03.11.04
Disposition	03.11.05
Exempt Vehicles	03.11.04
Interest, Car Loan	03.11.02
Interest, Vehicle	03.11.02
Lease Inclusion Tables	Pub 463
Leased Vehicles	03.11.02
Leased Vehicles	03.11.06
Luxury Limits	03.11.03
Luxury Vehicle	03.11.03
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Switching Methods	03.11.01
Trade-in	03.11.07
Truck or Van	03.11.04
Uber/Lyft	03.11.06
Unrecovered Basis	03.11.05

Pubs Forms

Related IRS Publications and Forms

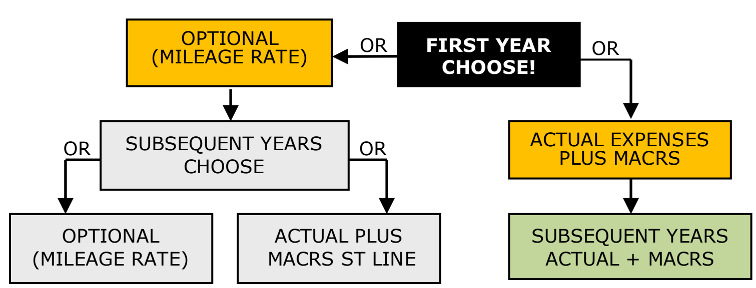
- **IRS Publication 463** – Travel and Entertainment
- **Lease Inclusion Tables** – Pub 463
- **IRS Publication 946** – How to Depreciate Property
- **Form 2106** – Employee Business Expenses
- **Form 4562** – Depreciation and Amortization
- **IRC Sec 280F** – Luxury Automobiles

OPTIONAL OR ACTUAL AUTO EXPENSE METHOD

The Details

Taxpayers may choose to deduct automobile expenses using the actual operating expenses of an automobile plus depreciation (or lease payments if leased) or they can use the "optional standard mileage rate" to compute business auto deductions.

If the taxpayer chooses the actual method, which includes MACRS depreciation, in the first business-use year, then the optional method may not be used in any future year. However if the optional mileage rate method is chosen in the first year, the taxpayer can switch back and forth to the actual expense method in subsequent years for that vehicle but is limited to MACRS straight-line depreciation in years they opt for the actual method.



Strategies

Switching Methods - More expensive cars are generally the ones most limited by the luxury auto rules. Choosing the optional mileage rate method the first year of business use may be the better choice for these vehicles, since in subsequent years when the actual method may be elected the use of straight-line depreciation will produce only a small reduction in depreciation, leaving the taxpayer the option to switch methods at will in subsequent years.

Generally, the longer (more years) a vehicle is kept, the more beneficial it becomes to select the optional mileage method in the first year. There are two primary reasons: (1) older vehicles tend to have more substantial maintenance expenses, and (2) the luxury auto limit reaches its lowest level in the fourth and subsequent years. Therefore, the taxpayer would be able to switch to the actual method in years of high-maintenance costs and use the optional mileage rate during the earlier years where the vehicle warranty usually covers most repairs. Besides, once the vehicle is traded or sold, the reduced depreciation will reduce the gain or increase the loss if the vehicle is sold or increase the basis of the replacement vehicle if it is traded in.

TCJA

NOTE: Prior to 2018 a business vehicle trade qualified as a Sec 1031 tax-deferred exchange. Effective for exchanges completed after 2017, for federal tax purposes, only real property used in a trade or business or held for investment is eligible for 1031 treatment. Therefore, when a business vehicle is traded-in for another vehicle in 2018 or later, the transaction will have to be reported as a sale.

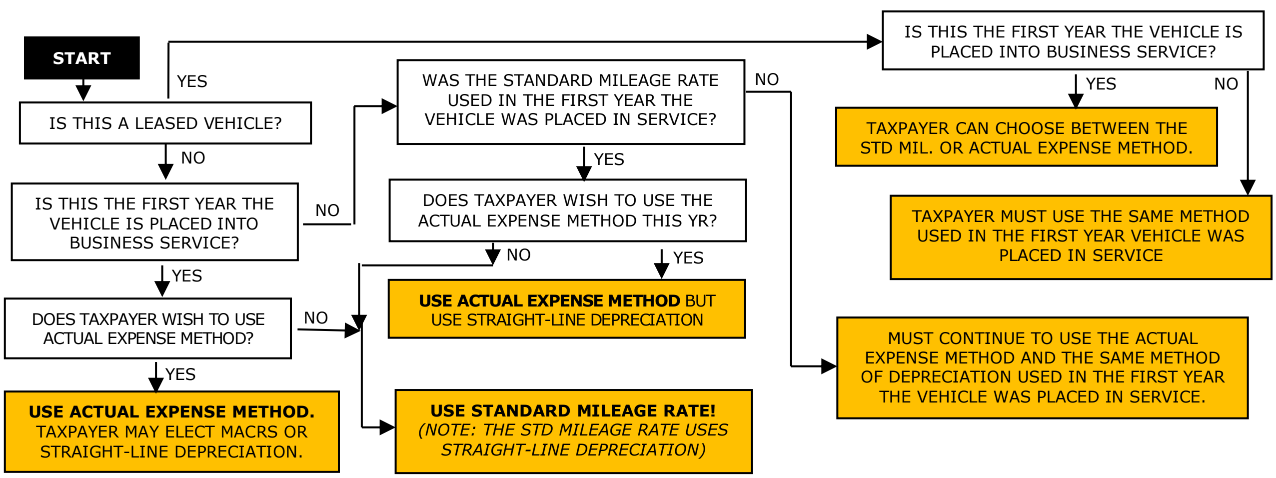
DEDUCTING CAR EXPENSES USING THE OPTIONAL MILEAGE RATE

As an alternative to deducting actual operating expenses of an automobile (and depreciation as described later in this chapter), taxpayers can use the "optional standard mileage rate" to compute business auto deductions for owned and leased vehicles. See the table on page 3.11.03 for current and historical mileage rates.

Motorcycles – The IRS has never established an optional mileage rate for motorcycles; thus the actual expenses method must be used. In Office of Chief Counsel Info letter (INFO 2009-0255) this subject was addressed and indicated that to date no standard mileage rate is available for motorcycles.

Leased vehicles – The optional mileage method may be used for a leased as well as a purchased auto used for business provided the mileage method is used for the entire lease period. (Rev Proc. 97-58, 1997-52 IRB 24)

Method Chart for Vehicles (Chart assumes vehicle is not limited by the fleet operation rules).



Multiple vehicles - Whether the taxpayer is an owner or lessee, the mileage allowance method can't be used to claim business auto deductions for vehicles used for hire or for fleet operations. Fleet operations (after 2003) are defined as 5 or more vehicles used simultaneously. Thus taxpayers who use no more than four vehicles at the same time for business purposes may use the standard mileage rate.

Expenses included in the optional standard mileage rate – The standard mileage rate is determined annually by the IRS using data from a study conducted by an independent contractor of vehicle-operating expenses based on the prior year's costs (Rev Proc 2002-61). The rate covers gas, oil, lubrication, maintenance and repairs, vehicle registration fees, insurance and straight-line depreciation. Parking and tolls, as well as state and local property taxes attributable to business use, may be deducted in addition to the optional rate. This, however, does not include sales tax, which must be capitalized into the business basis of the vehicle.

Car loan interest – Regardless of whether the standard mileage rate or actual expense method is used, a self-employed taxpayer may also deduct the business-use portion of interest paid on an auto loan (claimed as an interest expense on Sch. C). For years 2018 – 2025 employee business expenses aren't deductible for federal purposes because the Tier 2 miscellaneous deduction is suspended. Employees may **not** deduct interest paid on a car loan. (Note: in years before 2018 and after 2025, if a home equity loan is used to buy a vehicle, the employee may be able to deduct the interest as home mortgage interest.)

Employers' reimbursement - Employers may reimburse employees for business-related car expenses using the mileage allowance method for each substantiated employment-connected business mile. The reimbursement is tax-free if the employee substantiates to the employer the time, place, mileage and purpose of employment-connected business travel.

Employees' expenses exceed employer's mileage reimbursement (years before 2018 and after 2025) – Employees whose actual employment-related business mileage expenses exceed the employer's reimbursement can deduct the difference as a miscellaneous itemized deduction subject to the 2%-of-AGI floor on their federal returns. However, an employee who leases an auto and is reimbursed using the mileage allowance method can't claim a deduction based on actual expenses unless he does so consistently beginning with the first business use of the auto.

ACTUAL EXPENSES

The actual expense method includes deducting the cost of gas, oil, lubrication, maintenance and repairs, vehicle registration fees, insurance, interest, state and local property taxes and depreciation (or lease payments if the vehicle is leased – see "Leased Vehicles" later in this chapter for possible limitation on lease deduction). However, these expenses must be allocated between deductible business use and non-deductible personal use where the vehicle is also used personally making it necessary to also keep records of business miles and total miles in order to document the allocation between business and personal.

TCJA

Depreciation – The so-called "luxury auto" rules of IRC Sec 280F(a) impose a maximum annual deduction for depreciation. These limits are included in the table below. In years after 2007 when the bonus depreciation is allowed, the first year luxury auto limits were increased by $8,000 if the taxpayer elected bonus depreciation. Under the TCJA of 2017 the bonus depreciation element of the luxury auto continues to be $8,000 for years 2015 through 2022, with the following exceptions: In the case of a passenger automobile acquired by the taxpayer before September 28, 2017, and placed in service by the taxpayer:

- September 28, 2017 through 2018, the limit is increased by $6,400.
- During 2019, the limit is increased by $4,800.

Definition of a Luxury Auto - Vehicles subject to the luxury auto rules include any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways, and having an unloaded gross vehicle weight of 6,000 pounds or less. This definition may also include smaller trucks and vans, which meet the weight limitation.

HISTORICAL MILEAGE RATES & LUXURY VEHICLE DEPRECIATION LIMITS

Year	2014	2015	2016	2017	2018	2019	2020
Business Mileage Rate	56.0	57.5	54.0	53.5	54.5	58.0	
Depreciation Component	22.0	24.0	24.0	25.0	25.0	26.0	
Luxury Vehicle Limits							
Automobiles:							
First Year	3,160	3,160	3,160	3,160	10,000	10,100	
First Year w/Bonus	11,160	11,160	11,160	11,160	18,000*	18,100	
Second Year	5,100	5,100	5,100	5,100	16,000	16,100	
Third Year	3,050	3,050	3,050	3,050	9,600	9,700	
Thereafter	1,875	1,875	1,875	1,875	5,760	5,760	
Qualified Trucks & Vans:							
First Year	3,460	3,460	3,560	3,560	Same as autos **		
First Year w/Bonus	11,460	11,460	11,560	11,560			
Second Year	5,500	5,600	5,700	5,700			
Third Year	3,350	3,350	3,350	3,450			
Thereafter	1,975	1,975	1,975	2,075			

Note: Mileage rates are published late in the year for the subsequent year. The luxury auto rates are generally not published until the 2nd quarter of the year to which they apply.

* Per Sec 168(k)(10)(A): In general.—In the case of qualified property placed in service by the taxpayer during the first taxable year ending after September 27, 2017, if the taxpayer elects to have this paragraph apply for such taxable year, paragraphs (1)(A) and (5)(A)(i) shall be applied by substituting "50 percent" for "the applicable percentage".

**The 2018 and 2019 caps for autos and for trucks and vans are identical because the TCJA upped the caps for both to the same amounts.

CAUTION – Luxury auto limits are just as the title implies, a top limit for depreciation, and as example, for that limit to kick in for 2019 the cost of the vehicle will have to be $58,500 or more. Thus, if a vehicle costs less than that, then the deduction for the year will be less than the luxury limit, which is $18,100 for vehicles purchased and put into service in 2019 when bonus depreciation is claimed.

Example: Car was purchased 7/1/19 for $34,000; used 100% in business:

Purchase price:	$34,000
Less max bonus:	< 8,000>
Balance:	26,000
Regular Depreciation ($26,000 x 20%):	5,200
Total ($8,000 + $5,200):	$13,200

Delayed Placement In Service – For vehicles acquired before 9/28/17 and not placed in placed until 2018, the first year depreciation when claiming 100% bonus depreciation will be $16,400 ($10,000 plus $6,400) or if not put into service until 2019, the first year depreciation limit will be $14,900 ($10,100 plus $4,800).

Exempt Vehicles - The luxury auto limitations do not apply to any vehicle used directly in a taxpayer's trade or business of transporting persons or property for compensation or hire (qualified non-personal use vehicle), such as an:

- Ambulance,
- Hearse,
- Taxi, Uber, Lyft (or similar)
- Clean fuel vehicles,
- Bus,
- Qualified non-personal use vehicles (see definition in "Truck or Van" below), and
- Commuter highway vehicles (may still be subject to the listed property rules).

Truck or Van **–** To be a Qualified Non-personal Use Vehicle a truck or van must have been specially modified with the result that it is not likely to be used more than a *de minimis* amount for personal purposes. The regulations' example of a qualifying non-personal use vehicle is a van with only a front bench for seating in which permanent shelving that fills most of the cargo area has been installed, that constantly carries merchandise or equipment, and that has been specially painted with advertising or the company's name. These specially manufactured or modified vehicles do not provide significant elements of personal benefit, and a taxpayer is not likely to purchase this type of truck or van unless there was a valid business purpose that could not be met with a less expensive vehicle.

Public safety officer vehicles - IRS final regulations § 1.274-5 add clearly marked public safety officer vehicles as a type of qualified non-personal use vehicle under Code Sec. 274(i). As such, they are excepted from the strict substantiation requirements of Code Sec. 274(d)(4) that apply to listed property. They also qualify as a working condition fringe benefit so that the value of their use is excluded from income.

DEPRECIATION RATES

Automobiles and small trucks are depreciated using a five-year life. As with other MACRS property, the half-year and mid-quarter conventions apply. Where the business use of a luxury auto is less than 50%, the listed property rules limit the depreciation method to straight line MACRS and prohibit a Sec 179 deduction. See page 3.04.12 for depreciation tables.

First-Year Calculation - When calculating the first-year depreciation, and using 100% of the cost basis, figure the Sec. 179 deduction first (if being claimed), then reduce the vehicle's basis by the amount of the Sec 179 deduction before determining any bonus depreciation. Reduce the basis again by the amount of bonus depreciation claimed and then figure the otherwise allowable depreciation on the remaining basis – keeping in mind at each step the luxury auto first-year depreciation limit if applicable. Prorate the result by the business use percentage (business miles/total miles) if less than 100%.

Calculation after the first year - Beginning with the second year of business use, and for each year thereafter, both the listed property rules and the luxury auto limitations must be applied each year. If the luxury auto was used more than 50% for business in the current year and all prior years, then the listed property restrictions do not apply; depreciation can continue to be calculated using whatever method was used the first year. However, if the business use is less than in any prior year, recapture rules may apply. If the auto was used 50% or less for business in the current year or in any prior year during the earnings and profits (ADS) life of the car, then the listed property limitations do apply; depreciation must be calculated using the straight-line method over the earnings and profits (ADS) life. Under MACRS, the earnings and profits (ADS) life for luxury autos is five years. If the auto was used 50% or less for business in the current year and more than 50% for business in all prior years, then the listed property rules regarding Section 280F recapture must be applied.

CAPITAL IMPROVEMENTS TO LUXURY CARS

A capital improvement to a luxury car (e.g., a new engine) is generally treated as a new depreciable asset placed in service the year the improvement is made. The improvement is also subject to the luxury auto limits. Therefore, the deduction limit for a given year is figured based on both the car and the improvement made to it. However, the de minimis safe harbor rule (see chapter 3.27) of the capitalization and repair regulations would allow such capital improvements to be treated as an expense if the cost is within the safe harbor cost limits.

FASTER WRITE-OFFS FOR HEAVY SPORT UTILITY VEHICLES (SUVs)

Sport Utility Vehicles (SUV) with weight in excess of 6,000 pounds are not subject to the luxury auto depreciation limit rules and can utilize the §179 expense deduction up to a limit of $25,000*. This applies to sport utility vehicles rated at **14,000 pounds** gross vehicle weight or less.

Excluded from the $25,000* limitation is any vehicle that:

- Is designed for more than nine individuals in seating rearward of the driver's seat;
- is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or
  has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

*Per the TCJA, the $25,000 amount is adjusted for inflation after 2018, and the 2019 amount is $25,500 (Rev Proc 2018-57).

CAUTION!

Business autos are 5-year class life property. If the taxpayer subsequently disposes of the vehicle early, as many do, a portion of the §179 expense deduction will be recaptured and must be added back to income (SE income for self-employed individuals). The future ramifications of deducting the entire or a significant portion of the vehicle's cost using §179 should be considered.

TIP: As an alternative, by definition, a heavy SUV is over 6,000 pounds and therefore qualifies for bonus depreciation. Thus, the entire business portion of the vehicle can be expensed using 100% bonus deprecation in the first year.

UNRECOVERED BASIS

If the depreciation deductions for a vehicle have been limited due to the luxury auto rules, then at the end of the normal recovery period, the luxury auto will have a remaining (unused) basis. This "unrecovered basis" can be deducted in the subsequent years, subject to the annual limitations for luxury autos. The unrecovered basis is calculated as if the vehicle was used 100% for business in every prior year.

Under a safe-harbor provision (Rev Proc 2019-13), for a vehicle on which the 100% bonus depreciation was claimed, depreciation of the vehicle may continue during each year of the vehicle's recovery period. In this situation the depreciation during the remaining years of the recovery period is the lesser of the cap for that year or an amount computed by multiplying the depreciation table percentage for the year times the vehicle's cost reduced by the first-year cap.

Example – Facts: In June of 2018 Warren purchased and placed in service for his business a new passenger auto that cost $60,000. He uses the auto 100% in his business. He does not claim a Sec 179 deduction. The vehicle is depreciated using the 200% declining balance method, a 5 year recovery period and the half-year convention.

No safe harbor election – If Warren does not adopt the safe harbor method of Rev Proc 2019-13, his 2018 depreciation deduction is limited to $18,000, leaving an excess amount of $42,000 that would be recovered starting in tax year 2024 (i.e., the first year after the recovery period is finished). IRC Sec. 280F(a)(1)(B)(ii) limits the post-recovery period yearly recovery amount to $5,760 so it would take Warren another 8 years to fully recover his purchase cost. The result would be the same if Warren elected to claim $18,000 of the auto's cost as a Sec 179 expense deduction or if he elected not to claim the 100% bonus depreciation.

With safe harbor election – if Warren adopts the safe harbor method of Rev Proc 2019-13, he must determine his depreciation using the depreciation table for the 200% declining balance method, 5-year recovery period and half-year convention. For 2018 this would result in a depreciation amount of $18,400 ($8,000 bonus amount + ((60,000 – 8,000) x .2)). However, the deductible amount is limited by the Sec 280F(a) rules, which for 2018 is $18,000 per Rev Proc 2018-25. This leaves a remaining adjusted depreciable basis of $42,000 ($60,000 – 18,000) as of January 1, 2019 and this amount multiplied by the applicable table amount will be the allowable depreciation for years 2019 through 2023, as shown in the following table:

Year	Depreciation Limit	Depreciation Using Safe Harbor	
2018	18,000	$18,000	
2019	16,000	13,440	(42,000 x .32)
2020	9,600	8,064	(42,000 x .192)
2021	5,760	4,838	(42,000 x .1152)
2022	5,760	4,838	(42,000 x .1152)
2023	5,760	2,419	(42,000 x .0576)
Depreciation 2018 – 2023…………51,599			

As of January 1, 2024 (the first tax year succeeding the recovery period), Warren's adjusted basis of the auto is $8,401 ($60,000 – 51,599), and his 2024 depreciation is $5,760, the lesser of his adjusted basis of $8,401 or the 280F(a)(1)(B)(ii) limitation of $5,760. His adjusted basis as of January 1, 2025 will be $2,641, and since it is less than the code-imposed limit of $5,760, his depreciation deduction for the auto for 2025 will be $2,641.

Making the election is done simply by using the safe harbor to deduct depreciation on the vehicle for the first taxable year succeeding the placed-in-service year of the vehicle.

RURAL MAIL CARRIERS

An employee of the U.S. Postal Service who uses his or her personal vehicle to collect and deliver mail on a rural route may receive an "equipment maintenance allowance" (EMA). This reimbursement is considered paid under an accountable plan so that neither the reimbursement received, nor the expense incurred is reportable on the postal employee's tax return. For years before 2018 and after 2025, the actual expenses that exceed the EMA are deductible as a miscellaneous itemized deduction, subject to the 2% floor.

UBER & LYFT DRIVERS

Regulation 1.280F-6(c)(3)(ii) exempts from the luxury auto rules any vehicle used by a taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

LEASED VEHICLES

A taxpayer who leases a luxury auto, and does not claim the standard mileage rate, is allowed to deduct the business part of actual expenses such as fuel, maintenance, repairs, etc., plus the full business portion of the lease/rental payments. However, the listed property and luxury auto limitations are indirectly imposed by requiring the lessee to add "phantom" amounts, called "inclusion amounts," to income over a period of years. In actuality, the inclusion amounts reduce the deductible lease payments claimed. Self-employed persons make an adjustment to car expense on Schedule C. For years before 2018 and after 20205, employees make a subtraction of the inclusion amounts on Form 2106.

Lease inclusion amounts - "Income inclusion" amounts represent the luxury auto limitations and are based on the fair market value of a vehicle at the beginning of the lease term. Depending on the FMV of the car, there may be an inclusion amount every year, or just for the first few years; if FMV is low enough, there will never be an inclusion amount.

The IRS annually issues tables and formulas for calculating the inclusion amounts. The tables are generally built into your tax software, but can be accessed in IRS Pub 463.

DISPOSITION OF AN AUTOMOBILE USED IN BUSINESS – SALE AND TRADE-IN

TCJA

The tax treatment for the disposition of a vehicle used in business is the same as the disposition of any other Sec 1245 business asset. Prior to TCJA (prior to 2018) a business could trade in a business vehicle when the disposition resulted in a gain and defer the gain into the replacement vehicle. On the flip side they could sell the vehicle and recognize the loss. This is no longer true; for federal tax purposes, every post-2017 business vehicle disposition will now be a Form 4797 reportable transaction regardless of gain or loss.

DEEMED DEPRECIATION

When a vehicle is depreciated, the amount of depreciation taken over the life of the vehicle is generally tracked by your tax software even if it is limited by the luxury auto rules. On the other hand, if the standard mileage rate was used, the depreciation is included in the standard mileage rate. The amounts differ from year to year. See "Depreciation Component" in the Historical Auto Mileage Rates & Luxury Limits table earlier in this chapter (2014 and forward) or IRS Pub 463 for earlier years for deemed depreciation amounts.

Example - Computing the deemed depreciation *– Jack placed a business vehicle into service in December of 2015 and sold the vehicle in 2019. He used the standard mileage rate for all years. His business miles were: 980 in '15, 11,960 in '16, 10,440 in '17, 12,790 in '18 and 5,440 in '19. The deemed depreciation is computed as follows.*

Year	***Miles***	***Rate***	***Deprec.***
2015	*980*	*.24*	*235*
2016	*11,960*	*.24*	*2,870*
2017	*10,440*	*.25*	*2,610*
2018	*12,790*	*.25*	*3,198*
2019	*5,440*	*.26*	*1,414*
Deemed Depreciation……			***10,327***

SALE OF A BUSINESS AUTO

Continue to worksheet on page 3.11.06

WORKSHEET – SALE OF BUSINESS AUTO

1. Odometer when sold.. ___________
2. Odometer when acquired.. ___________
3. Total miles driven - line 1 minus line 2.......................... ___________
4. Total business miles (entire period owned) .... ___________
5. Overall business use factor (line 4 divided by line 3)........... ___________

	Total - 100%	Business Use (Total x line 5)
6. Sales price................................	___________	___________
7. Purchase price..........................	___________	<___________>
8. Purchase costs..........................	___________	<___________>
9. Improvements............................	___________	<___________>
10. Cost of sale...............................	___________	<___________>
11. Depreciation (Actual or deemed)...............................		___________
12. **BUSINESS PROFIT (LOSS)** - sum of business use		___________

Example – Sale of a business auto – Standard mileage rate – Dave purchased a new car in 2016 that he used partially for business. He paid $24,000 for the vehicle, added a $1,500 stereo system and sold it in 2019 for $10,000. The odometer reading on the car when he sold it was 54,940 miles. He used it for business; 5,900 miles in 2016, 16,400 miles in 2017, 14,800 miles in 2018 and 8,500 in 2019. He used the standard mileage rate method in all years.

Year	Business Miles	Rate	Deemed Depreciation
2016	5,900	.24	1,416
2017	16,400	.25	4,100
2018	14,800	.25	3,700
2019	8,500	.26	2,210
Total	**45,600**		**11,426**

1. Odometer when sold.. 54,940
2. Odometer when acquired.. 5 (new car)
3. Total miles driven - line 1 minus line 2.......................... 54,935
4. Total business miles (entire period owned) 45,600
5. Overall business use factor (line 4 divided by line 3)........... 0.83

	Total - 100%	Business Use (Total x line 5)
6. Sales price................................	10,000	8,300
7. Purchase price..........................	24,000	<19,920>
8. Purchase costs..........................	0	<0>
9. Improvements............................	1,500	<1,245>
10. Cost of sale..............................	0	0
11. Depreciation (Actual or deemed)..................................		**11,426**
12. **BUSINESS PROFIT <LOSS>**		<1,439>

The loss in this example is a Form 4797 ordinary loss.

TRADE-IN OF A BUSINESS AUTO

Prior to 2018, when a business vehicle was traded-in for a new business vehicle, the transaction was actually a Section 1031 exchange, reported on IRS Form 8824. After 2017, Sec 1031 only applies to real estate property, and as a result, no longer applies to the trade-in of a vehicle. Thus, whether sold or traded in, the transaction is treated as a sale.

TIP: Since all trade-ins are treated as sales (Sec 1031 no longer applies after 2017), all things being equal, one would want to negotiate a lower trade-in value and higher purchase price as opposed to a higher trade-in value and a lower purchase price to minimize gain or maximize the loss from the disposition of the trade-in.

CALIFORNIA DIFFERENCES

California generally conforms to pre-TCJA Federal provisions related to vehicle expenses. However, there are a number of differences, particularly with the passage of the TCJA, including the following:

- CA has not adopted the first year Bonus Depreciation. Since there is no bonus depreciation conformity, CA does not go along with the higher luxury auto limits for the years when the bonus depreciation applies. Since CA's general conformity is based on the IRC as of January 1, 2015, and without legislation to change the conformity date, the increased luxury auto depreciation limits included in the TCJA will not apply for CA. Therefore, the CA limits for autos placed in service in 2018 are (2019 amounts won't be available until the latter part of 2019):

	Autos	Trucks/vans
Year 1	$3,160	$3,560
Year 2	5,000	5,700
Year 3	2,950	3,350
Year 4 & subsequent yrs	1,775	2,075

California also does not conform to the changes made by the TCJA to the auto lease inclusion amounts. For CA lease inclusion amounts, go to ftb.ca.gov and search for lease inclusion.

New Law & Stuff

CAUTION: California conformity has created a complicated issue for vehicle trade-ins. Read the following very carefully.

- For most individuals, California also has not conformed to the TCJA change limiting Sec 1031 to real property. Therefore, most taxpayers who trade in a business-use vehicle must treat that transaction as a Sec 1031 exchange for CA purposes. However, CA conforms to the Federal treatment for high income taxpayers for exchanges completed after January 10, 2019. High income taxpayers are taxpayers with AGI of $500,000 or more ($250,000 for those filing single or married separate).

CAUTION: Where a trade-in is treated as a 1031 exchange in CA and not for Federal it creates a different basis for each.

- CA continues to allow Tier 2 miscellaneous deductions, including employee business deductions such as employment-related use of a personal auto.

NOTES

TRAVEL EXPENSES

Taxpayers who travel away from their ***"tax home"*** for business purposes can deduct their "ordinary and necessary" expenses of doing so, provided the expenses are not "lavish or extravagant."

RAPID FINDER

Definite	3.12.02
Extravagant	3.12.02
Home Office	3.12.02
Lavish	3.12.02
Local Transportation	3.12.02
Lodging	3.12.02
Necessary	3.12.01
Ordinary & Necessary	3.12.01
Reimbursement	3.12.03
Reservist	3.12.01
Sole Proprietors	3.12.03
Spouse	3.12.01
Tax home	3.12.01
Temporary	3.12.02
Transportation, Local	3.12.02
U.S. Travel	3.12.03

Self-employed taxpayers: deduct these expenses on Schedule C.

Employees:

- 2018 through 2025 - Tier 2 miscellaneous deductions are suspended by the TCJA, so an employee with unreimbursed travel expenses gets no deduction for these expenses.
- Prior to 2018 and after 2025 - Employees' unreimbursed, away-from-home expenses are deductible only if they itemize deductions. Employees' expenses are generally claimed on Form 2106 and are carried to Schedule A as Tier 2 miscellaneous deductions, subject to the 2% floor and not deductible to the extent the taxpayer is taxed by the AMT.

Temporary work locations less than one year: Expenses deductible

Local travel deductible only if:

- The taxpayer has one or more regular work locations away from his/her home; or
- The taxpayer's home is his/her principal place of business (as defined under the home office rules).

Reservist travel (above-the-line deduction): >100 miles and overnight

Spouse, Dependent or Employee's Expenses – generally not deductible unless

1. The spouse, etc., is an employee of the taxpayer, and
2. The travel of the spouse, etc., is for a bona fide business purpose, and
3. The expenses would otherwise be deductible by the spouse, etc.

Related IRC and IRS Publications and Forms

- **Form 2106** – Employee Business Expenses
- **Form 1040 Schedule C** – Profit and Loss from Business
- **Form 1040 Schedule F** - Profit and Loss from Farming
- **Pub 463** – Travel, Gift and Car Expenses
- **Pub 535** – Business Expenses
- **IRC Sec 162**

Strategy - Reservists & Travel Expenses - Armed Forces reservists who travel more than 100 miles away from home and stay overnight in connection with service as a member of a reserve component can deduct travel expenses as an adjustment to gross income (IRC Sec 62(a)(2)(E)). This is in lieu of deducting those expenses as a miscellaneous itemized deduction (subject to the 2% of AGI limitation). Thus, this deduction can be taken even if the taxpayer does not itemize their deductions. The TCJA of 2017 did not change how these expenses are treated.

Limit on Expenses – Unreimbursed expenses for transportation, meals (subject to the 50% limit) and lodging qualify, but the deduction is limited to the amount the federal government pays its employees for travel expenses, i.e., the general federal government per diem rate for lodging, meals and incidental expenses applicable to the locale and the standard mileage rate for car expenses plus parking and ferry fees and tolls.

Member of Reserve Component – A member of a reserve component of the Armed Forces is an individual who is in the:

- Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve;
- Army National Guard of the United States;
- Air National Guard of the United States; or
- Reserve Corps of the Public Health Service.

Strategy – Spousal Travel Expenses (IRC Sec 274(m)(3))- Generally deductions are denied to a business for travel expenses paid or incurred for a spouse, dependent or employee accompanying the business owner on a business trip unless the:

(1) Spouse, etc., is an employee of the taxpayer, **and**
(2) Travel of the spouse, etc., is for a bona fide business purpose, **and**
(3) Expenses would otherwise be deductible by the spouse, etc.

Strategy - The law allows a deduction for the single rate for lodging and frequently there is no rate difference between one or two occupants. Thus, virtually the entire lodging expense for an accompanying spouse will be deductible. When traveling by car the law does not require any allocation because the spouse is also traveling in the vehicle. Thus, if traveling by vehicle the entire cost of the transportation would be deductible. That would generally also apply to taxis at the destination. The only substantial cost that is not allowed is the cost of the spouse's meals which even if they were deductible would be reduced by the 50% rule.

DEFINITIONS:

***"Ordinary and necessary" expense* -** An expense is "ordinary" if it is customary and conventional for the taxpayer's line of business. A "necessary" expense is helpful in the taxpayer's business; but it need not be indispensable.

"Lavish or extravagant" - is not defined in the Code or Regulations, although IRS indicates an expense that is "unreasonable" (also not defined) may be considered extravagant. Facts and circumstances determine.

"Tax home" - is generally the location of a taxpayer's main place of business (not necessarily the place he/she lives). If taxpayers work regularly in more than one area, the main work location controls--look at such factors as total time, amount of work, and relative income at each location to determine main business place (amount of income is first in order of importance).

For a taxpayer with no main business location, residence may be considered tax home if a taxpayer:

(1) Does some business in the area of his/her residence and actually uses it for lodging while doing business;
(2) Duplicates living expenses at his/her residence because the job requires being away from home;
(3) Has not left the area of his/her traditional home, close family resides there, or taxpayer often uses the home for lodging.

If all three factors apply to the taxpayer, tax home is where the taxpayer's home is. If only two factors apply, facts and circumstances determine. If only one factor applies, the taxpayer is an itinerant and no away-from-home expenses are deductible.

> ***Example* - *Determining Tax Home -*** *Tom, an outside salesperson whose territory covers the western U.S., is employed by a firm whose main office is in Denver. Tom spends about one month a year in Denver for both business and nonbusiness purposes, but the majority of the time he is on the road for his sales job. He owns a home in Denver where his wife, Tina, lived all year; the home has been the couple's residence for a number of years. Tom's tax home is Denver, because he meets all three factors listed above.*

GUIDELINES FOR DEFINITE, TEMPORARY ASSIGNMENT

> **TCJA CAUTION:** For 2018 through 2025, employees are not able to deduct their job-related travel expenses because the TCJA of 2017 suspended the Schedule A miscellaneous deductions that are subject to the 2% of AGI reduction, including employee business expenses. Employees should consider negotiating with their employers to be covered by an accountable plan that would provide tax-free reimbursement to them for their employee business expenses.

During employment of short and fixed duration away from a taxpayer's regular business location, tax home does not change. The advantage of this is that a taxpayer on a temporary assignment may deduct the necessary travel expenses in first getting to the temporary place of work and in returning to the tax home after the assignment is completed. Reasonable expenses for meals, lodging, and other ordinary and necessary business expenses are deductible while at the temporary location (even for days off).

A taxpayer is deemed not on a temporary assignment if the stay away from home exceeds one year. This means that for stays away from home of over one year, no travel or living cost deductions at the assignment location are allowed, even though the taxpayer's family remains at the old job location. See chapter 3.14 for details and examples related to "Temporary Work Locations".

Local Transportation Within Tax Home - Transportation between a taxpayer's home and a temporary work location in the same trade or business WITHIN the metropolitan area where the taxpayer lives and normally works is deductible business transportation only if one of the following two conditions is met:

Multiple locations: The taxpayer has one or more regular work locations away from his/her home; or

Home office: The taxpayer's home is his/her principal place of business (as defined under the home office rules).

Lodging Per Diem - Although per diem rates may be used to substantiate deductions for lodging, meals, and incidental expenses, or for meal expenses and/or incidental expenses only, they may not be used to substantiate deductions for lodging expenses only. Self-employed individuals are not entitled to use the federal per diem rates to substantiate lodging expenses under any circumstances (Starr v. Commissioner, TC Memo. 2000-305). From 2018 Pub 17, page 141: There is no optional standard lodging amount similar to the standard meal allowance. Your allowable lodging expense deduction is your actual cost.

Local (Within Tax Home) Lodging - IRS has issued final regulations permitting certain non-away-from-home lodging expenses to be treated as deductible business expenses by the employer and tax-free working condition fringe benefits or accountable-plan reimbursements to the employee. The regulations provide a safe harbor; local lodging expenses are treated as ordinary and necessary business expenses if all these conditions are met (Reg § 1.162-32(b)):

(1) The lodging is necessary for the individual to participate fully in or be available for a bona fide business meeting, conference, training activity, or other business function.

(2) The lodging is for a period that does not exceed five calendar days and does not recur more frequently than once per calendar quarter.

(3) If the individual is an employee, his employer requires him to remain at the activity or function overnight.

(4) The lodging is not lavish or extravagant under the circumstances and does not provide any significant element of personal pleasure, recreation, or benefit.

The final regulations added a provision that, even if the safe harbor conditions aren't met, "facts and circumstances" may still allow favorable treatment of the expenses. According to Reg § 1.162-32(a), "whether local lodging expenses are paid or incurred in carrying on a taxpayer's trade or business is **determined under all the facts and circumstances**. One factor is whether the taxpayer incurs an expense because of a bona fide condition or requirement of employment imposed by the taxpayer's employer. Expenses paid or incurred for local lodging that is lavish or extravagant under the circumstances or that primarily provides an individual with a social or personal benefit are not incurred in carrying on a taxpayer's trade or business."

Example – Safe Harbor: *A business conducts a 2-day business-related sales training program at a hotel and conference center near its main office. The employer requires both its field and in-house sales force to attend the training and stay at the hotel overnight between Day 1 and Day 2 for the bona fide purpose of facilitating the training. If the company pays the lodging costs directly to the hotel, the stay is a working condition fringe benefit to all attendees (even to employees who live in the area who are not on travel status), and the company may deduct the cost as an ordinary and necessary business expense. If the employees pay for the lodging costs and are reimbursed by the company, the reimbursement is of the accountable plan variety and is tax-free to the employees and deductible by the company as an ordinary and necessary business expense.*

Example – Self-Employed: *Continuing the example above. . .If a locally based self-employed consultant who does business with the company was required by the company to attend the sessions and to stay at the hotel, he could deduct the lodging expense if he paid for it himself, or exclude the expense if he were reimbursed by the company after accounting to it in full for his costs.*

Example – Facts and Circumstances*: Able Company conducts a seven-day training session for its employees at a hotel near the company's main office. The training is directly connected with Able's trade or business. Some employees attending the training are traveling away from home and some employees are from the local area. Able requires all employees attending the training to remain at the hotel overnight for the bona fide purpose of facilitating the training. The company pays the costs of the lodging at the hotel directly to the hotel and does not treat the value as compensation to the employees.*

Because the training is longer than five calendar days, the safe harbor does not apply. However, the value of the lodging is excluded from income since the facts and circumstances test is satisfied: The training is a bona fide condition or requirement of employment and Able has a noncompensatory business purpose for paying the lodging expenses and is not paying the expenses primarily to provide a social or personal benefit to the employees. The lodging Able provides is not lavish or extravagant. If the employees who are not traveling away from home had paid for their own lodging, the employee could have deducted the expenses under section 162(a) as ordinary and necessary business expenses. Therefore, the value of the lodging is excluded from the employees' income as a working condition fringe under section 132(a) and (d), and the company may deduct the lodging expenses of all the employees as ordinary and necessary business expenses under section 162(a). (Based on example 1 from final regs)

Effect on Sole Proprietors – Part of paragraph (a) of the final regulations says, "Under certain circumstances, however, local lodging expenses may be deductible under section 162(a) as ordinary and necessary expenses paid or incurred in connection with carrying on a taxpayer's trade or business, including a trade or business as an employee." Therefore, deducting local lodging could apply to a sole proprietor. However, the self-employed individual would still have to meet the "no personal benefit" and "bona fide activity" tests. For example, if a self-employed tax return preparer attends the ClientWhys Fall Seminar in the same city where his office is located, it would be hard to qualify to deduct overnight hotel costs at the meeting location unless there was an evening session, too.

TRAVEL REIMBURSEMENT: Employers often use per diem arrangements to reimburse their employees for away-from-home travel expenses. The per diem rates include both a lodging and meal/incidental expense allowance. However, taxpayers who travel away from home should keep in mind that business travelers can't use per diems in computing their own travel expense deductions. While there are standard meal allowances for meal deductions, lodging expenses MUST BE receipted if they are to be deductible.

TRAVEL IN THE UNITED STATES: IRS Regulation §1.274-4 defines "within the United States" as follows:

(1) The term "United States" includes only the fifty states and the District of Columbia. (§1.274-4(a))

(2) Travel by automobile within the United States is travel between points within the U.S., even though en route to a destination outside the U.S. (§1.274-4(e)(2)(ii))

(3) If a taxpayer travels by private airplane, any trip or portion of a trip in which both the take-off and landing are in the U.S. is travel within the U.S. (even if part of the trip is over a foreign country). (§1.274-4(e)(2)(iii))

(4) If the travel is by bus, train, airline, or other public transportation, any place in the U.S. where that vehicle makes a scheduled stop to take on or discharge passengers is a point within the U.S. (§1.274-4(e)(2)(i))

Deductible U.S. travel expenses (Reg. 1.162-2) include:

(1) All ordinary and necessary travel expenses if a trip is entirely for business.

(2) If the travel is primarily for personal purposes, none of the expenses incurred in traveling to and from the business destination are deductible.

(3) If the trip is primarily for business and the taxpayer engages in some nonbusiness activity, travel expenses to and from the business destination are deductible in full. Regardless of whether the primary purpose of the trip is business or pleasure, expenses incurred at the destination that are directly attributable to a trade or business are deductible.

Expenses of traveling to and from a business destination may include airfare, bus and taxi fare, auto expenses, meals, lodging, and other expenses incidental to these. The deduction for meals is limited to 50% of their cost *(See chapter 3.10 for Meals and Entertainment).*

Example - Travel in the U.S. - *Nancy, a self-employed computer specialist from New York, made a trip to Nashville regarding the installation of a computer system at Nellis Air Conditioners, Inc. Nancy's expenses were: round-trip airport shuttle, $20; round-trip airfare, $740; taxi fares between airport and Nellis, $30; three nights in motel, $240; three days' meals in Nashville, $150; porter, $3; suit cleaning, $6; car rental, $100. On the trip home, Nancy stopped in North Carolina to spend the weekend with a friend. Meals, entertainment and local transportation in North Carolina were $225 (this stop required no additional airfare). Nancy's deduction is $1,214, i.e., $20 + $740 + $30 + $240 + (50% x $150) + $3 + $6 + $100. The expenses in North Carolina are nondeductible.*

CALIFORNIA DIFFERENCES

California conforms to federal law related to job-related travel expenses prior to the TCJA changes. Thus, California still allows employees to deduct unreimbursed job-related travel expenses as part of miscellaneous itemized deductions subject to a 2% of *federal* AGI reduction.

NOTES

TRAVEL OUTSIDE THE UNITED STATES

- **Foreign Travel**
  - Entire time devoted to business – ordinary and necessary expenses are deductible.
  - Primarily vacation – none of the expenses are deductible
  - Business trip with some amount of personal activities – allocate
- **Foreign Conventions (Outside North America)**
  - Qualifications
  - Must be directly related trade or business
  - It is "as reasonable" for the meeting to be held outside the North American area as within
- **Convention on Cruise Ships**
  - Must be directly related to trade or business
  - U.S. Flagship
  - All ports of call in U.S. or possessions
  - Written documentation attached to return
  - Taxpayer statement
  - Cruise sponsor statement
  - Maximum deduction: $2,000 each taxpayer
- **Luxury water travel –** travel instead of auto, train, air
  - Limited to twice the highest per diem rate within the U.S.
  - Meals must be separately stated
  - Meals subject to 50% limitation

RAPID FINDER

Related IRS Publications and Forms

- **Pub 463** – Travel, Gift and Car Expenses
- **Form 2106** – Employee Business Expenses

Tier 2 miscellaneous itemized deductions are suspended by the TCJA for 2018 through 2025, so employees with unreimbursed foreign travel expenses get no deduction for these expenses. These employees should consider negotiating with their employers to be covered by an accountable plan that would provide tax-free reimbursement to them for their employee business expenses.

§274 states: "In the case of any individual who travels outside the United States away from home in pursuit of a trade or business or in pursuit of an activity described in Section 212, no deduction shall be allowed under ***§162*** or ***§212*** for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary, is not allocable to such trade or business or to such activity."

GENERAL RULES FOR FOREIGN TRAVEL INCLUDE:

(1) If the entire time is devoted to business, all ordinary and necessary travel expenses are deductible.

(2) If the travel is primarily for vacation and only a few hours are spent attending professional seminars or meeting with clients, vendors, or business colleagues in the foreign locale, none of the expenses incurred in traveling to and from the business location are deductible.

(3) If, during a business trip, personal activities take place at, near, or beyond the business destination, then the expenses incurred in traveling to and from the business location have to be allocated between the business and nonbusiness expense.

(4) If the travel outside the U.S. meets certain conditions (see below), the expenses incurred in traveling to and from the business destination are deductible in full as long as the primary purpose of the trip is for business (same as for travel within the U.S.).

Travel Outside the U.S. **ClientWhys™**

Travel, otherwise deductible under ***§162*** or ***§212,*** that is outside the U.S., comes under the same rules that apply to travel within the U.S. if a taxpayer meets **any one** of the following conditions:

(1) The travel outside the U.S. is for a period of one week or less (seven consecutive days, excluding the departure day, but including the day of return).

(2) Less than 25% of the total time outside the U.S. is spent in non-business activities. (If 25% or more of the total time is spent on non-business activities, a day-by-day allocation between personal and business activities is necessary.)

(3) The individual incurring the travel expenses can establish that a personal vacation or holiday was not a major consideration.

(4) The taxpayer did not have "substantial control" over arranging the trip.

Business days are:

(a) Days en route to or from the business destination by a reasonably direct route without interruption;

(b) Days when actual business is transacted;

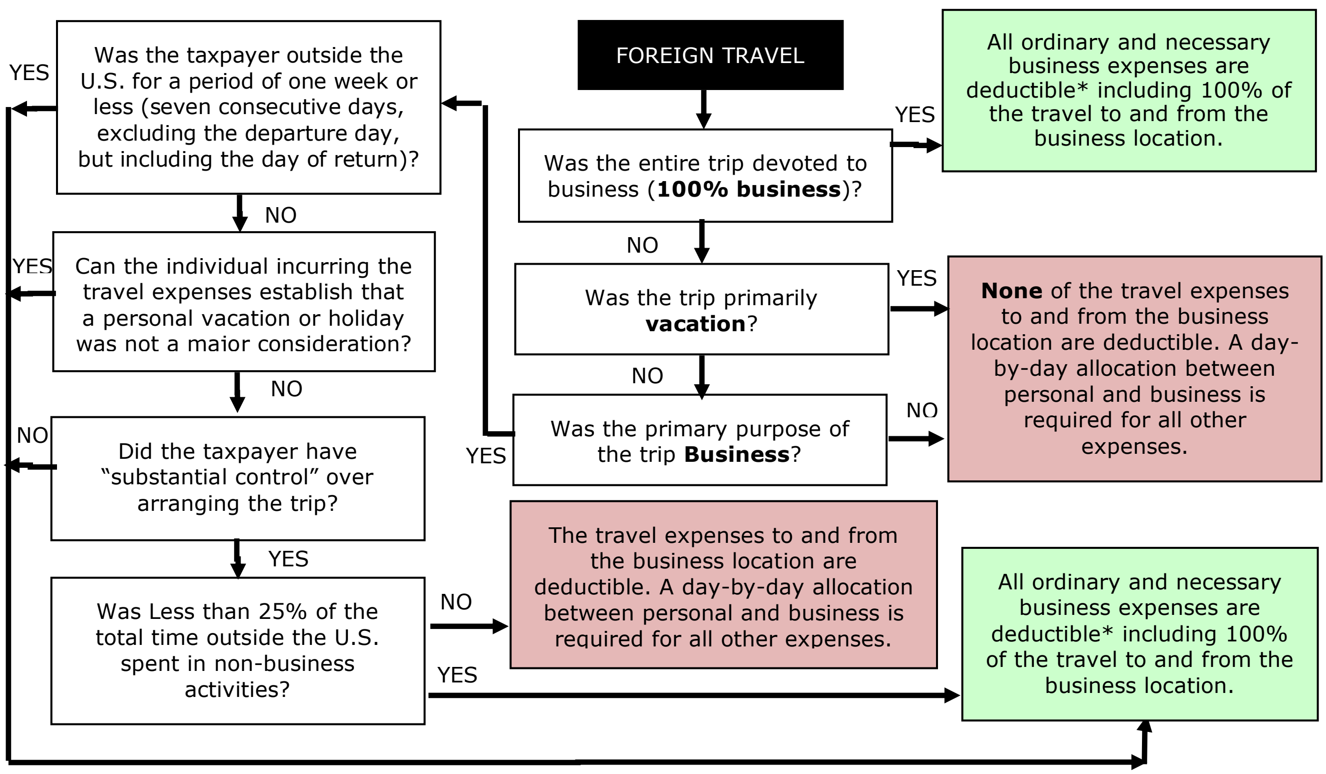
(c) Weekends or standby days which fall between business days;

(d) Days when business was to have been transacted but was canceled due to unforeseen circumstances.

Nonbusiness days are:

(1) Days spent on nonbusiness activities, and

(2) Weekends, holidays, and other standby days that fall at the end of the business activity, if the taxpayer remains at the business destination for personal reasons.



NOTE: **No federal deduction for employees in years 2018-2025 due to TCJA's suspension of Tier 2 miscellaneous itemized* deductions

"Substantial control"

(1) An employee traveling outside the U.S. on behalf of his employer under a reimbursement allowance is not considered to have substantial control over arranging his trip and is subject to the same rules that apply to U.S. travel.

(2) Managing executives (i.e., employees who have authority and responsibility to decide on the need for the business travel, without any effective veto procedures) are presumed to have control. An employee owning over 10% of the employer's stock is in this category.

(3) Being able to control the time of the trip does not indicate substantial control.

(4) A self-employed person is usually regarded as having substantial control.

Reg. 1.274-4(f) requires an allocation of business and nonbusiness expenses, unless one of the exceptions applies. The expenses which have to be allocated depend on where the nonbusiness activity takes place. The allocation is done on a day-by-day basis, unless the taxpayer establishes that some other method more clearly reflects expenses attributable to nonbusiness activity.

Personal Activities at, Near, or Beyond Business Destination - If the personal activities take place at, near or beyond the business destination, travel expenses (including meals and lodging) from the place where travel outside the U.S. began to the place of business activity and return to the U.S. must be allocated between business and personal amounts. The portion allocated to nonbusiness activities is not deductible.

The formula for computing the nondeductible expense when personal activities take place at, near or beyond the business destination is:

Total nonbusiness days/Total business and nonbusiness days

TIMES

Roundtrip transportation + In-transit meals and lodging from a point in U.S. to the business location outside U.S.

Example *-* ***Allocation of Expenses for Travel Outside the U.S. -*** *If an individual travels from New York to London on business, and then takes a vacation in Paris before returning to New York, the amount of the travel expense subject to allocation is the expense which would have been incurred in traveling from New York to London and returning* ***[Reg. 1.274-4(f)(2)].***

Personal Activities En Route to or from Business Destination - If the nonbusiness destination is on the route to or from the business destination, allocate the cost of traveling from the point of departure from the U.S. to the nonbusiness destination and returning to the U.S., including meals and lodging. The expenses incurred on nonbusiness days and the cost of travel to and from nonbusiness locations (except "en route") are nondeductible. The formula for the nondeductible travel when the nonbusiness destination is en route to the business destination is:

Total nonbusiness days/Total business and nonbusiness days

TIMES

Roundtrip transportation + In-transit meals and lodging from a point in U.S. to en route nonbusiness destination outside U.S.

FOREIGN CONVENTIONS, SEMINARS OR MEETINGS: No deduction is allowed for expenses allocable to a convention, seminar, or similar meeting which is held outside the North American area unless the taxpayer establishes:

(1) The meeting is directly related to the active conduct of the taxpayer's trade or business, and

(2) It is "as reasonable" for the meeting to be held outside the North American area as within ***[Code Sec. 274(h)(1)].***

Code Sec. 274(h)(3)(A) - defines the term "North American area" to be the U.S., its possessions (Puerto Rico is considered a possession for this purpose), the Trust Territory of the Pacific Islands, Canada and Mexico. ***Rev Rul 82-151, 1982-2 CB 75*** says that U.S. Virgin Islands, Guam, and American Samoa are also part of the "North American area."

The Jamaica Treaty, Article 25, permits a deduction for expenses of attending a convention in Jamaica. The expenses must be ordinary and necessary in order to be deductible. The "as reasonable" test does not apply to Jamaican conventions or seminars beginning after 1/01/82.

In 1983, legislation expanded the definition of "North American area" to include some Caribbean basin countries and Bermuda (designated "beneficiary countries" by presidential proclamation). To be eligible, the "beneficiary" country must have an agreement with the United States to exchange tax information. The agreement must be in effect at the time the convention begins. The "beneficiary" country cannot discriminate in its tax laws against conventions and similar meetings held in the United States or U.S. possessions.

Rev. Rul. 2011-26, I.R.B. 2011-48, as modified and superseded by Rev. Rul. 2016-16 lists the following geographical areas as "North American area":

(1) The 50 United States and the District of Columbia
(2) Possessions of American Samoa, Baker Island, Puerto Rico, Northern Mariana Islands, Guam, Howland Island, Jarvis Island, Johnston Island, Kingman Reef, Midway Islands, Palmyra Atoll, U.S. Virgin Islands, Wake Island, and "other U.S. islands, cays and reefs not part of the fifty states or District of Columbia"
(3) Canada
(4) Mexico
(5) Republic of the Marshall Islands
(6) Federated States of Micronesia
(7) Republic of Palau
(8) Antigua (after 2/9/03)
(9) Aruba (after 9/12/2004)
(10) Bahamas (after 12/31/2005)
(11) Barbados (after 11/2/84)
(12) Barbuda (after 2/9/03)
(13) Bermuda (after 12/1/88)
(14) Costa Rica (after 2/11/91)
(15) Curacao (after 12/22/13)
(16) Dominica (after 5/7/88)
(17) Dominican Republic (after 10/11/87)
(18) Grenada (after 7/12/87)
(19) Guyana (after 8/6/92)
(20) Honduras (after 10/10/91)
(21) Jamaica (after 12/17/86)
(22)Panama (after 4/18/2011)
(23) St Lucia (after May 5, 2014)
(24) Trinidad (after 2/8/90)
(25) Tobago (after 2/8/90)

The Rev Rul states that expenses for conventions in these areas may be deducted as provided in ***§274(h).*** The factors to be taken into account in determining whether the foreign convention meets the "as reasonable" test are:

(1) the purpose of and the activities taking place at the meeting;
(2) the purposes and activities of the sponsoring organization;
(3) the residences of the active members of the sponsoring organization and the places at which other meetings of the sponsoring organization or groups have been held or will be held; and
(4) other relevant factors that the taxpayer may present.

The Senate Finance Committee explained: "The bill makes clear that the foreign convention provisions do not apply to normal business meetings for employees of a company" [Committee Report (P.L. 96-608, 12/28/86)]. If the seminar is a reward for an employee, it must be included in income on the employee's W-2 or Form 1099, even if less than $600.

CONVENTIONS ON CRUISE SHIPS: Cruise ship convention expenses may be deductible (subject to the $2,000 limitation) if the following requirements are met:

(1) The taxpayer must establish that the meeting is directly related to the active conduct of his/her trade or business.
(2) The cruise ship is a U.S. flagship;
(3) All ports of call on the cruise are located in the U.S. or its possessions; and
(4) The taxpayer claiming the deduction must attach two written statements to the tax return (one signed by the taxpayer and the other signed by an officer of the cruise sponsor group).

Substantiation Statements - The taxpayer's statement must spell out the total days of the trip, excluding days of transportation to and from the cruise ship port, and the number of hours each day of the trip which were devoted to scheduled business activities. A program of scheduled business activities needs to be included, as well as "such other information as may be required in regulations." The second written statement (from the group's officer) must include a meeting schedule, the number of hours the taxpayer attended meetings, and "such other information as required by regulations" ***[§274(h)].***

Maximum Deduction - The maximum deduction of $2,000 applies even in the case of a married individual filing separately. If two married individuals filing a joint return each attended otherwise deductible cruise ship conventions at a cost of $2,000 or more each during a taxable year, they could deduct cruise ship convention expenses of $4,000 on their return for that year. If a married individual attended an otherwise deductible cruise ship convention at a cost of $3,000 (while his spouse attended no such convention), however, only $2,000 would be deductible for that year, whether a joint return or a separate return was filed for that year.

In ***Holswade, M.D., P.C., (1984) 83 TC No. 53,*** the court used five factors to determine whether a cruise seminar was primarily business or pleasure:

- Comparison of the lecture time to the length of the cruise;
- The features of the ship;
- The nature of the ports visited and the sightseeing activities of the taxpayers;
- Availability of similar lectures at less cost in settings more conducive to learning; and
- Amount of study or lecture preparation involved

LUXURY WATER TRAVEL: Business travelers who use cruise ships as a mode of transportation in carrying on their trade or business activities may generally find their deductions limited. The per day deduction for this kind of travel can't be more than twice the highest per diem amount allowed to Federal government employees for travel within the U.S. That rate changes periodically. IRS includes the rates annually in Publication 463. If the expenses for luxury water travel include separately stated meals or entertainment, the meals are subject to the 50% rule (apply the 50% limitation before making the per diem limit), and per the TCJA of 2017, none of the entertainment costs is deductible. If meal and entertainment charges are not separately stated, or are not readily identifiable, the total charge for the travel does **not** need to be allocated.

Example - Luxury Water Travel – *Phyllis, a travel agent, traveled from New York to London via a luxury liner. Her 6-day trip was made for a qualified business purpose at a cost of $5,200. At the time of her travel, the highest per diem rate for government workers was $374 per day.*

Cost of water transportation	*$5,200*
Daily limit ((2 x $374) x 6 days)	*$4,488*
Deduction allowed	*$4,488*

CALIFORNIA DIFFERENCES

California conforms to Federal law related to job-related foreign travel expenses prior to the TCJA changes. Thus California still allows employees to deduct unreimbursed job-related travel expenses as part of miscellaneous itemized deductions subject to a 2% of *federal* AGI reduction.

NOTES

TEMPORARY WORKPLACE

Overview

- **Away from home travel –** Outside the metropolitan area where the taxpayer lives and normally works.
- **Travel within tax home –** only deductible between home and temporary workplace if:
  - Taxpayer has one or more regular work places or
  - Taxpayer's home is his principal place of business.
- **Workplace is temporary if:**
  - Expected to last and does last one year or less.
  - Expected to last one year or less and then the expectation changes to longer – the period up to the change in expectation is a temporary workplace.
- **Workplace is NOT temporary if:** Expected to last for over a year (regardless of the actual duration)

RAPID FINDER	
Away From Tax Home	3.14.01
Break, Assignments	3.14.02
Definition	3.14.02
Engineer	3.14.02
Itinerant Workers	3.14.02
Merchant Marine	3.14.02
Metropolitan Area	3.14.02
Professional Athlete	3.14.03
Ski Patrolman	3.14.03
Temporary Employee	3.14.03
Temporary Job Site	3.14.02
Temporary Workplace	3.14.01
Travel Within Tax Home	3.14.01

Pubs Forms

Related IRS Publications and Forms
- **Pub 463** – Travel, Gift, and Car Expenses
- **Form 2106** – Employee Business Expenses (not applicable 2018-2025)

TCJA

Employee business expenses, including local business transportation and away-from-home travel expenses, are not federally deductible in years 2018-2025 because the TCJA suspended miscellaneous itemized deductions subject to the 2% of AGI reduction. The rules explained in this chapter continue to apply to self-employed individuals.

The Details

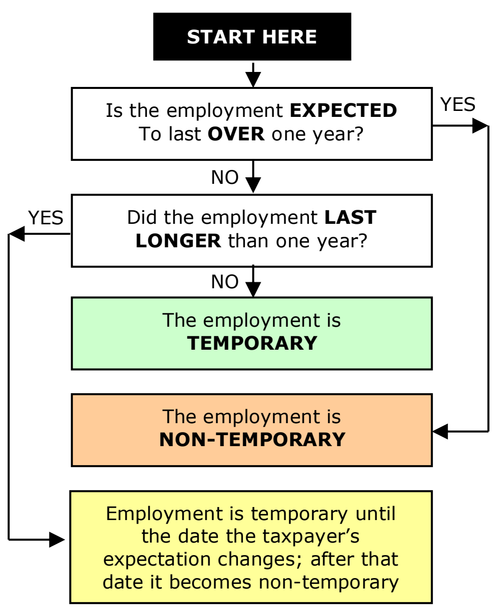
BUSINESS TRANSPORTATION RULES:

Away from tax home - Transportation between a taxpayer's home and a temporary work location OUTSIDE the metropolitan area where the taxpayer lives and normally works is deductible business transportation.

Within tax home - Transportation between a taxpayer's home and a temporary work location in the same trade or business WITHIN the metropolitan area where the taxpayer lives and normally works is deductible business transportation only if one of the following two conditions is met:

Multiple locations: The taxpayer has one or more regular work locations away from his/her home; or

Home office: The taxpayer's home is his/her principal place of business (as defined under the home office rules).



DEFINITION OF TEMPORARY WORKPLACE:

Rev Rul 99-7, 1999-5 IRB outlines the IRS's definition of "temporary workplace" for purposes of determining whether transportation between work and home is deductible.

1. Employment is temporary if it is realistically expected to last (and does last) for a year or less.
2. If employment at a location is expected to last for over a year, the employment isn't temporary, regardless of whether it actually exceeds one year.
3. If employment at a location initially is expected to last for one year or less, but later the expectation is for it to exceed a year, the employment is temporary until the date the taxpayer's expectation changes. After that date, it is non-temporary.

Example - Temporary Job - *Ina Hurry normally takes the train 5 miles to work in the city. However, due to output problems, the manager asked her to work for a few months at the company factory located 35 miles away. Ina drives from home to the factory each day; she is reimbursed for her expenses at the business mileage rate. The work at the factory lasts 3 months. Ina's assignment at the factory is temporary.*

BREAK BETWEEN TEMPORARY ASSIGNMENTS:

The Chief Counsel Advice (Chief Counsel Advice 200018052, Scenario 7) observes that there is no general IRS guidance on how significant a break must be, following a period of temporary employment, for a reassignment to a different work location to be treated as a separate period of work employment that will "restart the clock" on the 1-year limit. The Advice says, however, that a break exceeding 1-year is "clearly significant enough" to restart the clock when the taxpayer begins a 7-month reassignment.

TEMPORARY JOB SITE MUST BE DISTANT:

Courts have held that commuting expenses to a temporary work location are deductible only if the taxpayer's residence is distant from the temporary job site. ***Ellwein, Nester v. U.S., (1985, CA8) 57 AFTR 2d 86-389***

Thus, a taxpayer who lived and normally worked in Stockton, CA, could deduct the expenses of commuting to temporary job locations in Novato, Napa, and Yuba City, round trip distances of 171, 141, and 174 miles, respectively. Those locations were distant from her home in Stockton. ***(Daiz, Teresita T., (2002) TC Memo 2002-192)***

But commuting expenses from Seffner, FL, to New Wales and St. Petersburg, round trip distances of 44 and 30 miles, weren't deductible because the temporary job sites were within the general area of taxpayer's home. ***(Epperson, Jessie Elvin, (1985) TC Memo 1985-382)***

A union boilermaker who was required by the terms of his union membership to accept temporary assignments throughout his home state (Wisconsin) was permitted to deduct transportation expenses incurred in traveling to job sites that were over 35 miles from his home. He could also deduct motel and meal expenses incurred while working at more distant job sites, where it was impractical to drive home each day. In interpreting Rev. Rul. 99-7, the Tax Court found that there was no set definition of "metropolitan area" and that the taxpayer's use of a 35-mile radius as his metropolitan area was reasonable. **(Wheir, T.C. Summary 2004-117, 8/30/04)***

Metropolitan Area - The Tax Court noted that "because the term 'metropolitan area' is ill defined for the purpose of determining whether transportation expenses qualify for deduction under section 162, the Court considers all the facts and circumstances in deciding whether transportation expenses were incurred in traveling to a temporary worksite unusually distant from the area where the taxpayer lives and normally works." The Court would have allowed a heavy-equipment construction worker who lived in Roseville, CA (near Sacramento) to claim mileage from his home to temporary work sites 91 (Richmond), 92 (Modesto) and 293 (Bakersfield) miles from his home if he had had adequate records. But work sites 20 (Sacramento), 51 (Jackson) and 67 (Stockton) miles from his home were not outside the taxpayer's metropolitan area. **(*Tiller, J.B., T.C. Summary Opinion 2017-760)****

*Summary opinions cannot be cited as precedent for any other case

CAUTION

When considering what defines a particular taxpayer's "tax home" (or as frequently mentioned in the tax court cases the "metropolitan area") you must take into account the geographical scope of where the taxpayer resides. The definition of "tax home" or "metropolitan area" has a vastly different meaning for a taxpayer living in the Los Angeles metropolitan area as opposed to one living in Ely, Nevada. The IRS and the tax courts frequently focus on this issue.

ITINERANT WORKERS:

An individual's residence is his tax home if the individual has no principal place of business or employment but changes work locations continually, as happens with a traveling salesperson. If the individual has no regular place of abode in a real and substantial sense, that person has no home and cannot deduct travel expenses. However, in some tax court cases, the taxpayer was able to show that he had a tax home from which he was away so that he could deduct expenses at his temporary job site.

Merchant Marine Captain - The captain of a merchant ship sailed worldwide half the year, and lived at home with his family in Washington the rest of the time. Taxpayer had ownership and primary financial responsibility for the residence. But for the fact that his employer provided his meals and lodging while he was away on business, he would have incurred duplicate living expenses. Because taxpayer incurred substantial living expenses in maintaining his personal residence, that residence was his tax home. ***Johnson, Marin I., (2000) 115 TC 210***

Engineer - An engineer worked and lived in Chattanooga, TN, for eight months and Oak Ridge, TN, for five months. For several weeks between his employment in Chattanooga and Oak Ridge, the taxpayer resided at his wife's residence in Alabama, which he listed as his permanent address on a joint federal income tax return. The court found that the taxpayer's living expenses at his temporary job sites in part duplicated his living expenses at his permanent residence, and that his contacts and family ties in Alabama did not suggest that he was an itinerant worker with no home. ***Odle, Felix, (1985) TC Memo 1985-459***

Ski Patrolman - A ski patrolman worked in Sun Valley, ID, from January through May. He then traveled to Lake Tahoe, NV, where he worked in a casino from June to August of the same year. In September, he returned to Sun Valley and resumed his position in the ski patrol. During the months in Tahoe, taxpayer paid his Sun Valley landlord $100 to maintain his room and store his personal effects. Although the ski patrol position wasn't assured to him, it was assumed that he would return to the job in Sept. The Court held that taxpayer's tax home was in Sun Valley. ***Lanning, George, (1975) TC Memo 1975-313***

Temporary Employee - A taxpayer with temporary jobs was allowed an away from home deduction on the basis of a vacation type cabin. After his divorce, he lived in the cabin for six years. Then he worked at a series of temporary jobs, always returning to the cabin when possible. He spent about one month each year at the cabin. He also maintained his voting registration there and intended to retire to his cabin. He paid income and property taxes in Montana, where the cabin was located. His cabin in the woods was home for this purpose. ***Rambo, Charles, (1978) 69 TC 920***

Professional Athlete - Professional ice skaters employed by Ice Follies traveled with the show to various cities, except for a lay-off period of a few weeks each year. During the lay-off period they returned to their homes. They were allowed to treat their permanent personal residences as their tax home. ***Boyer, Lucien, (1977) TC Memo 1977-331***

CALIFORNIA DIFFERENCES

California follows Federal rules with regard to temporary workplaces. California has not adopted the TCJA provision suspending Tier 2 miscellaneous itemized deductions during 2018-2025. Therefore, employee business expenses continue to be included as part of miscellaneous itemized deductions that are subject to a 2% of federal AGI reduction.

NOTES

BUSINESS USE OF A HOME

Overview

- **Qualification Tests**: Used exclusively on a regular basis **AND** <u>one of the following must apply</u>:
    - **Storing inventory for a wholesale or retail business** for which the taxpayer's home is the only fixed location of the business
    - Used as a **licensed day care center**
    - A **separate structure (caution –** home sale gain exclusion will not apply to the separate structure)
    - Where the **taxpayer meets with customers, patients, or clients**
    - The **principal place of business**
- **Employees** –
    - Office must be for the convenience of the employer
    - Tier-2 Itemized – 2% of AGI Adjustment - not deductible for AMT
    - 2018 – 2025: employee business expense deductions suspended by the TCJA of 2017
- **Self-Employed** – Schedule C
- **Depreciation** - **MACRS straight-line** over **39 years**
- **Deduction Limit –** Limited to the income from the activity
- **Simplified (Safe Harbor) Deduction**
    - $5 per square foot with a maximum square footage of 300.
    - Maximum deduction $1,500
    - No other indirect expenses allowed
    - Interest & Taxes deductible as usual on Schedule A
- **Carryover** (not applicable if Simplified Method used)
    - **Never includes interest or taxes which are always currently deductible**
    - **In two parts –** Depreciation and other expenses (depreciation is used last)
- **Multiple Offices –** Reduced by **all** business expenses
- **Sale of Home with Office – Chapter 2.08**
- **Home Office Worksheet – See Pub 587**

RAPID FINDER

Related IRC and IRS Publications and Forms

Pubs

Forms

- **Pub 551** – Basis of Assets
- **Pub 587** – Business Use of Your Home
- **Pub 523** – Selling Your Home
- **Form 8829** – Expenses for Business Use of Your Home (use only with Sch C)
- **IRC Sec 280A -** Disallowance of Certain Expenses

TCJA

Employee business expenses, including the business use of a home, are not deductible in years 2018-2025 because the TCJA suspended miscellaneous itemized deductions subject to the 2% of AGI reduction. The rules explained in this chapter continue to apply to self-employed individuals.

The Details

According to ***§280A***, expenses related to a taxpayer's "dwelling unit" are normally not deductible (with the exception of qualified home mortgage interest, real estate taxes, and casualty losses, but for 2018-2025 only casualties occurring in federal disaster areas). The term "dwelling unit" can mean a house, apartment, condo, mobile home, or boat. ***When a home is used partially for business or as a rental, special rules apply as outlined below.***

<u>OFFICE-IN-HOME QUALIFICATION TESTS</u>

In order to deduct home office expenses, specific tests must be met:

1. The office area must be used **exclusively** in a taxpayer's trade or business on a **regular**, continuing basis. Taxpayer must be able to provide sufficient evidence to show the use is regular. Exclusive use means there can be no personal use (other than de minimis) at any time during the tax year. Use of only a portion of a room is acceptable as long as the taxpayer shows that section is totally for business.

2. ***One of the following must also apply***. The home office must be:

   a. Used for ***storing inventory for a wholesale or retail business*** for which the taxpayer's home is the only fixed location of the business. Use of the area need not be exclusive under this test, but it must be regularly used;

      i. Since the space is used to store inventory, cost of storage space for books, files or equipment can't be deducted unless the taxpayer qualifies under one of the other tests.

      ii. Storage of "product samples" can also produce a home office deduction.

   b. Used as a ***licensed day care center*** (another exception to the exclusive-use test);

   c. A ***separate structure*** not attached to the taxpayer's home but used for business;

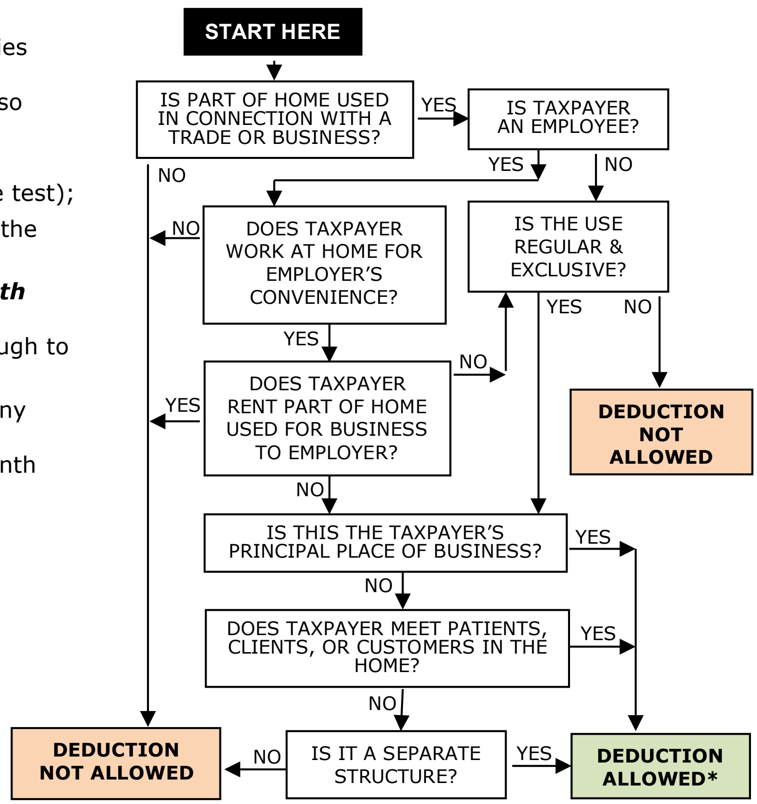
   d. A place where the ***taxpayer meets with customers, patients, or clients*** (just telephone contact with clients isn't enough to meet this test); or

   e. The ***<u>principal place of business</u>*** for any trade or business of the taxpayer (see definition below). Also see following Ninth Circuit ruling:

Musician's long hours of practice yield home office deductions - The Ninth Circuit has reversed the Tax Court and held that a professional musician could claim home office deductions under the Supreme Court's *Soliman* test.

The determining factor was her long hours of practice at home, because the "relative importance" test yielded no definitive answer to whether she used a room in her home as her principal place of business under Code Sec. 280A. *Popov, (CA9 4/17/2001) 87 AFTR 2d ¶2001-804*

Flowchart to Determine Home Office Deduction Qualification



No federal deduction allowed 2018-2025 for employees

- ***Application to current law*** - A home office is used as a principal place of business under Code *Sec. 280A(c)(1)* if a portion of the home is used for the administrative or management activities of any trade or business of the taxpayer, but only if there is no other fixed location where the taxpayer conducts substantial administrative or management activities of that trade or business. Examples of administrative or management activities include billing customers, keeping books and records, and setting up appointments.

  Under the Ninth Circuit's approach, musicians who may not be able to satisfy the statutory test (e.g., their agent handles all booking and billing details) may be able to use their long hours of practice at home to support a home office deduction under the ***Soliman*** principal-place-of-business test.

<u>HOME OFFICE FOR EMPLOYEES</u> – In years **before 2018 and after 2025**, employees are allowed home office deductions using the same criteria as cited above except that the home office use must also be for the ***convenience of the taxpayer's employer.***

Convenience of the employer means a business necessity—the use of the home must be a condition of employment. The employee needs a place to work, but the employer doesn't provide it (or the office provided by the employer is inadequate or unsafe). ***Usage by the employee for personal convenience is not enough.***

Example – Employee's Home Office – *In 2017 Melo Dee, a musician who worked as an employee, used her home for practice because her employer offered no facilities for practice. Melo's use of her home meets the convenience of the employer test and she will be able to deduct the expenses of her office (assuming she meets all the other tests). However, since an employee must deduct employee business expenses as a tier 2 miscellaneous deduction, Melo will be unable to deduct the home office expenses in 2018 through 2025 when tier 2 miscellaneous deductions are suspended.*

RENTAL OF HOME OFFICE SPACE TO EMPLOYER - Rental by an employee of a portion of his/her home to his/her employer doesn't qualify for a home office deduction if the employee uses the office to perform employee duties. The same rule applies to an independent contractor. The only deductions allowed are those which would be deductible regardless of business use—i.e., mortgage interest, real estate taxes, and casualty losses (disaster losses 2018-2025).

Example – Rental of Home to Employer - *Penny Prim owns a two-story building. She rents the ground floor to her solely-owned corporation and lives on the upper floor. Penny is an employee of the corporation.* ***Result:*** *According to LR 8819009, Penny should get no deduction for the portion of the building she rents to a corporation in which she is the sole shareholder. However, the corporation can deduct the rent it pays to Penny. Penny should be allowed to deduct the property taxes, interest and casualty losses, regardless of how the building is used.*

PRINCIPAL PLACE OF BUSINESS - A home office qualifies as a principal place of business if:

a. The office is used on an exclusive and regular basis for ***administrative or management activities of any trade or business of the taxpayer,*** and

b. There is ***no other fixed location*** of the business where the taxpayer conducts substantial administrative or management activities of the business.

If a taxpayer conducts administrative activities at a fixed location outside the home, he/she is still eligible to claim a deduction as long as the administrative activities conducted at the outside location aren't substantial (e.g., a taxpayer may do minimal paperwork at another fixed location of the business).

GROSS INCOME LIMITS - The deduction for the business use of a home is subject to the gross income limit from the business. However, home mortgage interest, property taxes and casualty losses (disaster losses 2018-2025) are always deductible, if the taxpayer itemizes deductions, whether or not the taxpayer claims a deduction for the business use of the home (Sec 280A(b)). Therefore, the prorated deduction for these expenses will always be allowed and is not subject to the gross income test. However, mortgage interest, taxes and casualty (disaster) losses are used in the computation to determine whether the other expenses of the home use and depreciation are deductible as illustrated in the four examples that follow.

Assume the taxpayer uses his home 20% for business.

		Ex #1	***Ex #2***	***Ex #3***	***Ex #4***
Gross income from the business		*$8,000*	*$10,000*	*11,000*	*13,000*
Home interest @ 20%	*2,400*				
Home taxes @ 20%	*1,000*				
Automobile expenses	*4,000*				
Computer depreciation	*1,200*				
Travel	*800*				
Supplies	*450*				
Total	*9,850*	*<$9,850>*	*<$9,850>*	*<$9,850>*	*<$9,850>*
Net		*<$1,850>*	*150*	*1,150*	*3,150*
Business use of home limitation		***0***	***150***	***1,150***	***3,150***
Home insurance @ 20%	*120*				
Home utilities @20%	*450*				
Home depreciation	*1,500*				
Total	*2,070*				
Allowed		***0***	***150***	***1,150***	***2,070***
Expenses carryover		***570***	***420***	***0***	***0***
Depreciation carryover		***1,500***	***1,500***	***920***	***0***

TCJA

CAUTION: *Under TCJA, all state and local taxes claimed as a Schedule A itemized deduction are limited to $10,000 for the years 2018 through 2025. The portion of the real property taxes used in the computation of the home office is unaffected by that limitation, i.e., the full amount of property taxes paid is used to determine the portion of the property taxes used in the home office deduction. However, the line on Form 8829 where the real property taxes are deducted will vary, thus affecting the gross income limitation computation and carryover of expenses.* *See "Forms" on page 3.15.08.*

GROSS INCOME - Gross income is defined as total income from the business less:

a. The business portion of expenses deductible even if the home was not used for business (e.g., mortgage interest, taxes, casualties), ***plus***

b. The business expenses relating to the business, but not to the use of the home (e.g., supplies, advertising, etc.).

CARRYOVER - Home mortgage interest, property taxes and casualty losses (limited to losses attributable to federally declared disasters for tax years beginning after 2017, and before 2026) are NEVER included in the carryover because they are allowed without regard to the gross income limitation (Sec 280A(b)). Therefore, the carryover consists of two elements which must be segregated for carryover purposes: (1) Other direct and prorated indirect expenses of the home office (including excess mortgage interest for self-employed taxpayers) that were not deductible because of the gross income limitation and (2) Home depreciation that was not deductible because of the gross income limitation. In subsequent years these two elements of the carryover are combined with like expenses for the subsequent year and then the gross income limitation for that year is applied. If there is any excess the carryover to the next subsequent year is determined and that process continues year to year until the carryover is used up.

Business Closes - Where a business closes with unused home office carryover, the carryover can only be used to reduce the business net profit to zero and cannot be used to create or increase a net loss from the business in any year. (S Rept No. 99-313 (PL 99-514) p. 84)) Thus any excess is lost and cannot be used against any other business.

Depreciation – The reason the carryover is divided into the two elements is because depreciation is always the last expense to be used in the computation for any year, and if not subsequently allowed before the home is sold, the depreciation that wasn't allowed is not subject to recapture (allowed or allowable rule).

Carryover application – The carryover can only be used for the same trade or business in the subsequent years and cannot be used against a positive income from another business.

Home Office and Sec 179 and/or Bonus Depreciation & Sec 199A Deduction

If the deductions for home office are being limited, and the business expenses include Sec. 179 expenses, and those Sec 179 expenses are impacting the home office limitation, it may be appropriate to forgo or reduce the elective Sec 179 expense. That would allow a larger home office deduction. However, this approach would not allow the business to show a negative result. For a year when first-year bonus depreciation is allowed, electing out of the bonus depreciation for eligible business assets should be considered if it results in a greater home office deduction. But remember that if the bonus depreciation is claimed for any asset of a particular class of property, it must be used for all qualifying property of that class; election out cannot be done on an asset-by-asset basis.

To further complicate matters, starting in 2018, the Sec 199A deduction also needs to be considered when deciding whether to claim the Sec 179 deduction and/or bonus depreciation. Higher depreciation or expensing deductions will reduce net profit and taxable income and result in a smaller 199A deduction. On the other hand, a lower taxable income may avoid certain 199A phase-outs and limitations.

MORTGAGE INTEREST - For purposes of the business use of the home, home mortgage interest is broken into two categories.

- Home Mortgage Interest – Which is the amount of the interest that would be allowed on Schedule A taking into consideration the acquisition debt (and prior to 2018, the equity debt) limitations. Do not include mortgage interest on a loan that did not benefit the home, such as an equity loan used to buy a car, pay tuition expenses, or pay off credit card debts.
- Excess Home Mortgage Interest **–**This is mortgage interest that is ***not*** deductible on Schedule A. Even though this interest is not deductible on Schedule A, for self-employed taxpayers, the home-use prorated amount is included with the other expenses attributable to business use of the home. Its deductibility is subject to the home office gross income limitation and unused amounts are included in the carryover. For **employees**, none of the excess home mortgage is deductible, and the business percentage of excess mortgage interest is not included as part of expenses when figuring the expense carryover.

RESIDENCE USED AS DAY CARE FACILITY - Day care facilities are not subject to the exclusive use requirement that applies to other home offices, but the exception to that requirement applies only if the owner or the operator:

(1) Has applied for (and the application has not been rejected) a license, certification, registration or approval as a day care center or as a family or group care home under the provisions of any applicable state law, or

(2) Has been granted (and the grant has not been revoked) a license, certification, registration or approval as a day care center or as a family or group day care home under the provisions of any applicable state law, or

(3) Is exempt from having a license, certification, registration or approval as a day care center or as a family or group day care home under the provisions of any applicable state law. (Code Sec. 280A(c)(4)(B))

The day care facility exception does not apply where the services performed are primarily educational or instructional in nature (e.g., musical instruction). However, the exception does apply if the services are primarily custodial, and the educational, development or enrichment activities are only incidental to the custodial services. The determination depends generally on the facts and circumstances of each particular case. (S Rept No. 3340 (PL 95-30) p. 7) The services must be provided for individuals age 65 or older, children, or individuals who are physically or mentally incapable of caring for themselves.

When calculating the percentage of business use of the home, both the space used to operate the day care business and the amount of time that the space is used to provide day care – including preparation and cleaning time – are factors. (Rev. Rul. 92-3; *Neilson v. Commissioner*, Dec 46,301, 94 TC 1)

***Example** – Edna uses her living room, kitchen, and bathroom ten hours a day, five days a week to provide licensed day care services. The home is 2400 square feet and the living room, kitchen and bathroom are a combined 1,400 square feet. Edna's percentage use of her home for business is determined as follows:*

$$\frac{1{,}400}{2{,}400} \times \frac{10}{24} \times \frac{5}{7} = .1736 \text{ or } \mathbf{17.36\%}$$

<u>SIMPLIFIED HOME OFFICE DEDUCTION</u> - Taxpayers can elect a simplified deduction for the business use of the taxpayer's home. The deduction is $5 per square foot with a maximum square footage of 300. Thus the maximum deduction is $1,500 per year. Here are the details of this simplified method:

<u>Annual Election</u> – A taxpayer may elect the simplified method or the regular Sec 280A method on an annual basis. Thus a taxpayer may freely switch between the methods each year. The election is made by choosing the method on a timely filed original return and is irrevocable for that year.

- *<u>No Form 8829</u>* - Instead of completing Form 8829, Expenses for Business Use of Your Home, a self-employed taxpayer using the simplified method enters their home's total square footage and the office square footage directly on Schedule C next to line 30. The Schedule C instructions include a worksheet for figuring the amount of the deduction using the simplified method
- *<u>Depreciation</u>* – When the taxpayer elects the simplified method, no depreciation deduction (including additional first year or Sec 179) for the home is allowed and the depreciation for the year is deemed to be zero.
- *<u>Additional Office Expenses</u>* – Additional office expenses such as utilities, insurance, office maintenance, etc., are not allowed when the simplified method is used.
- *<u>Home Mortgage Interest and Taxes</u>* – Prorated home mortgage interest and taxes are not allowed as an office expense when using the simplified method. Instead, 100% of the home mortgage interest and taxes are deductible as usual on Schedule A.
- *<u>Deduction Limited by Business Income</u>* – As is the case with the regular Sec 280A method, under the simplified method the home office deduction is limited by the business income. For the simplified method, the deduction cannot exceed the gross income derived from the qualified business use of the home for the taxable year reduced by the business deductions (deductions unrelated to the qualified business use of a home). However, unlike the regular method, any amount in excess of this gross income limitation is disallowed and may not be carried over and claimed as a deduction in any other taxable year.
- *<u>Sec 280A Home Office Carryover</u>* – Cannot be used in a year the simplified method is used. The carryover continues to future years and can only be used when the regular method is used.

  ***Example** – Julie used the regular home office method on her 2016 return and due to the business income limitation was unable to claim $500 of her direct and prorated direct expenses and $800 of depreciation, so she had a carryover of $1,300. On her 2017 and 2018 returns Julie used the simplified method and none of the carryover expenses were deductible. For 2019 she is again using the regular method and will be able to include the $1,300 of carryover expenses in her computation.*
- *<u>Qualifications</u>* – A taxpayer must still meet the Sec 280A qualifications to use the simplified method.
- *<u>Reimbursed Employee</u>* – The simplified method cannot be used by an employee who receives advances, allowances or reimbursements for expenses related to qualified business use of his or her home under a reimbursement or other expense allowance arrangement with the employer.
- *<u>Determining Square Footage</u>* - To determine the average square footage of the business, use these guidelines:
  - **Square Feet Maximum** - Never use more than 300 square feet for any month, even if the taxpayer has multiple businesses. Where there are multiple businesses use a reasonable method to allocate between businesses.
  - **Determining Average Square Feet for the Year** - Use zero for months where there was no business use, or where the business was not for a full year.
  - **15-Day Minimum** – Don't count any month in which the business use is fewer than 15 days.

    ***Example** - A calendar-year taxpayer begins using 400 square feet of her home for business on July 20 and continues using the space as a home office through the end of the year. Her average monthly allowable square footage for the year is 125 square feet (300 x 5 months = 1500/12 = 125). 300 was used instead of 400 in figuring the average because 300 is the maximum square footage that can be used. Since usage in July was fewer than 15 days, only 5 months are counted (Aug. – Dec.).*

- **Multiple Businesses** - Where there are multiple businesses only one method may be used for the year, either the regular or safe-harbor.
- **Mixed Use Property** - A taxpayer who has a qualified business use of a home and a rental use for purposes of § 280A(c)(3) of the same home cannot use the simplified method for the rental use.
- **Move** – A taxpayer who conducts business from a home office and moves during the year and uses part of the new home for the same business may use the simplified method for business use of one home and the regular method for business use of the other home. (Sch. C instructions, 2018, page 12, Example 3) When there is a move during the year, the average allowable square footage for the simplified method will generally be less than the 300 maximum.
- **Taxpayers sharing a home** - Taxpayers sharing a home (for example, roommates or spouses, regardless of filing status), if otherwise eligible, may each use the simplified method, but not for a qualified business use of the same portion of the home.

Example *- A husband and wife, both otherwise eligible to claim a home office deduction and regardless of filing status, may each use the simplified method for a qualified business use of the same home for up to 300 square feet of different portions of the home.*

- **Depreciation Rate When Switching Methods** – When the simplified method is used, and subsequently the taxpayer switches back to the regular method, then use the depreciation factor from the appropriate optional depreciation table as if the property had been depreciated all along.

Example *- A property was placed in service in July of 2014. The simplified method is used in 2017 and 2018, and then in 2019 the taxpayer switched back to the regular method. For 2019 the depreciation factor from the table would be* 2.564 (see non-residential 39 year life table on page 3.04.18).

FACTORS TO CONSIDER WHEN CHOOSING BETWEEN METHODS

When choosing between the methods, the following factors should be considered:

Depreciation – When a home is sold and meets the 2 out of 5 year ownership and use requirements, gain of $250,000 ($500,000 where both spouses on a joint return qualify) can be excluded under Sec 121. However, gain to the extent of depreciation claimed on the home cannot be excluded. When using the simplified method, there is no deprecation claimed and therefore no reduction in basis; thus the entire home gain, if qualified, is subject to the Sec 121 gain exclusion. This is one reason to utilize the simplified as opposed to the regular method.

Home Mortgage Interest & Taxes – The home mortgage interest and taxes included in the regular home office computation is deductible on Schedule A whether or not a home office deduction is claimed. Thus the interest and taxes are generally deductible (as long as the taxpayer can itemize and the taxes paid are within the $10,000 SALT limitation) whether or not the regular home office deduction is claimed. So where the simplified method amount equals or exceeds the depreciation and utility expense portion of the regular method it may be beneficial to utilize the simplified method.

SE Tax – For self-employed individuals the home office deduction generally reduces income for purposes of computing the SE tax except where the individual's SE income is above the current year maximum ($132,900 for 2019) amount. In addition, the 2.9% Medicare element of the SE tax applies to all SE income, with no cap, and the home office deduction will reduce that tax even for higher income taxpayers. This situation generally favors the regular method over the simplified method.

HOME OFFICE AND A CLOSELY HELD CORPORATION OR S CORP

If the business operated out of a taxpayer's home is organized as a corporation, direct and indirect expenses of the home office are the entity's expenses, not the owner-employee's. From a tax standpoint, there are three ways to handle these expenses:

- **Payment of rent -** The Corporation can pay its shareholder-employee rent to offset home office expenses and supply him with an information return (1099). The rent will be deductible by the corporation, assuming it's a reasonable amount for the space and services actually provided, and will be taxable to the shareholder-employee. **Caution** – shareholder-employees need to avoid any appearance of trying to convert wages subject to Social Security tax to rental income not subject to Social Security tax. However, the shareholder-employee/homeowner won't be able to claim offsetting deductions. The rules allowing deductions for business use of a dwelling unit do *not* apply to any expense attributable to the rental of all or part of a taxpayer's dwelling unit to his employer during any period in which he uses the rented portion to perform services as an employee of the employer. For purposes of this rule, an independent contractor is treated as an employee, and the party for whom the independent contractor is performing services is treated as an employer. Where such a lease arrangement exists, the only deductions that are allowable are those that could be claimed in the absence of any business use, e.g., mortgage interest, real estate taxes and casualty losses (limited to losses attributable to federally declared disasters for 2018 through 2025).

- **Unreimbursed employee expenses (before 2018 and after 2025) -** The shareholder-employee can satisfy the convenience of the employer test if he is working in the only location of the business. Assuming that he meets the other home-office requirements, the shareholder-employee can claim home office deductions as if he were a qualifying employee of an unrelated corporation, namely treat them as unreimbursed employee expenses on Schedule A. To ward off a possible IRS attack on the grounds that the shareholder-employee is paying expenses for which he could have sought reimbursement, there should be a written agreement to the effect that the shareholder-employee is required to pay for expenses. Although this approach appears to be clean, neat and simple, there are a number of unattractive consequences:
  - The shareholder-employee can only deduct home office expenses to the extent the total of his miscellaneous deductions exceeds 2% of his AGI—this rule may bar home-office deductions altogether. In years 2018-2025 no deduction is allowed because of the TCJA's suspension of miscellaneous itemized deductions subject to the 2% of AGI reduction.
  - Claiming home office deductions may increase the taxpayer's chances of being audited.
  - The deduction is not allowed against the AMT, which could reduce or eliminate the deduction if the individual is subject to the AMT.
  - Depreciation deductions claimed for the business-use portion of the home reduce the owner's basis in it, and any home sale gain representing depreciation adjustments attributable to post-May 6, '97 periods isn't eligible for the $250,000/$500,000 home sale gain exclusion.
- **Reimbursed employee expenses -** The shareholder-employee can treat his home office expenses as if he were a regular employee, and then, by written pre-arrangement with the corporation, have it reimburse him for these and other employee business costs after he substantiates them in full (amount, time, place, and business purpose of each expense). The shareholder-employee should include on his or her monthly expense report a list of home office-related expenses – for example, homeowner's insurance, utilities (oil heat, gas and electric, water and sewer), alarm or security service, trash disposal, general repairs and maintenance, real estate taxes, and mortgage interest (obtainable from the monthly mortgage billing statement or a loan amortization statement). The total of the office-related expenses multiplied by the business use percentage of the home will be the reimbursable amount by the corporation.

  Results: Assuming the shareholder-employee could have claimed the expenses as business deductions the reimbursement for the expenses is fully deductible by the corporation and is a tax-free accountable-plan reimbursement to the employee. The shareholder-employee avoids having to claim attention-generating home-office deductions, and doesn't have to struggle with depreciation deductions and basis adjustments. However, the shareholder employee can't deduct the business-related portion of his mortgage interest and property tax if the corporation gives him a tax-free accountable-plan reimbursement for these items. Otherwise, he would be getting a double tax benefit—a deduction and tax-free reimbursement—from the same expense.

ADDITIONAL CONSIDERATIONS

- ***Management of a taxpayer's investments*** is never considered a trade or business for purposes of the home office rules.
- A taxpayer who files ***married separate***, can deduct 50% of the home office expenses for home office space shared with a spouse.

RECOVERY PERIOD - Generally, the portion of a single-family residence that is owned by the taxpayer and used as a home office, and the simplified method isn't chosen, is depreciated under ***MACRS straight-line*** over ***39 years*** (i.e., treated as if it were commercial property). In contrast, if a property is used as a residential rental (defined as a building or structure where at least 80% of its gross rental income is from dwelling units), the recovery period is 27-1/2 years.

In a ruling that can't be cited as precedent, the IRS determined that the owner of an 8-unit apartment building who lived in one of the units, which he used partly as a home-office for a single trade or business, which may or may not be the rental of residential property, could depreciate the home office portion over 27-1/2 years instead of 39 years. The IRS considered the building to be residential rental property, and thus depreciable over the shorter period, since over 80% of the building's gross rental income came from dwelling units. ***(Chief Counsel Advice 200526002)***

<u>FORMS</u> - Self-employed taxpayers using the regular method to compute their home office deduction use ***Form 8829***; self-employed taxpayers using the simplified method use a worksheet in the instructions to Schedule C (not Form 8829) and enter square footage information directly on Schedule C. In years when the miscellaneous itemized deductions aren't suspended, an employee reports deductions on ***Schedule A (Tier 2 miscellaneous deductions)*** and can figure the deduction using a worksheet found in IRS Publication 587. Schedule F filers also use the worksheet (not Form 8829). <u>Employees deduct both the business and nonbusiness parts of home mortgage interest, real property taxes and casualty (disaster) losses in their usual places on Schedule A and not as part of the home office deduction in miscellaneous deductions</u>.

When computing the home office deduction on Form 8829 for 2018 (and presumably through 2025), and the total of real property taxes and other state and local taxes exceeds the $10,000 SALT limit imposed by the TCJA of 2017, the "Line 11 Worksheet" in the Form 8829 instructions is used to determine the amount of real property tax eligible to be deducted as part of the home office deduction and in which section of the form it is entered. In some situations, instead of entering the amount on line 11, column b (real estate taxes – indirect expenses) of the 8829, the entry goes on line 17, column a (excess real estate taxes – direct expenses), and the entry is already factored by the home office percentage.

For taxpayers claiming the standard deduction and using the regular method for figuring a home office deduction, the mortgage interest and real property taxes are entered on lines 16 and 17, column b, and not on lines 10 and 11.

The IRS didn't release the Form 8829 and instructions for 2018 until very late in the filing season; some tax software companies may not have properly completed the forms. In most cases the bottom line probably came out correctly, but if the gross income limitation applied, there may have been miscalculations, so be sure to verify any carryovers from 2018 to 2019 are accurate.

<u>SALT LIMIT AND THE HOME OFFICE FORM 8829</u>

There has been some confusion and concern about how the home office taxes are figured on the Form 8829. At first glance most cry foul, and for 2018 returns some software was getting it wrong. We have cut the instruction verbiage down and rewrote it in clearer tax-professional lingo. The way the form works is to allow a prorated amount of the interest (without the $1M/$750K limitations) and the prorated full amount of property tax (before the SALT limitation). However, it goes about it in a very convoluted manner that is hard to follow. Hopefully this will help.

<u>Home Office Interest:</u>

- If not itemizing
  - **Line 10** is to be blank (zero)
  - **Line 16** includes **ALL** acquisition interest (including that which would otherwise be limited on Schedule A by the $1M/$750K).
- If itemizing
  - **Line 10** is the amount that would be allowed on Schedule A if none were allocated to the business use of the home
  - **Line 16** only includes the excess (difference between the total acquisition interest and the amount on Line 10)

<u>Home Office Taxes:</u>

- If not itemizing
  - **Line 11** is blank (zero)
  - **Line 17** enter ALL the home's property taxes.
- If itemizing
  - **Line 11**
    - If total state and local tax amount is $10,000 ($5,000 MFS) or less, enter the amount of the home's property taxes on Line 11
    - If total Sch A tax deduction would be limited because of the SALT limit, complete Line 11 worksheet and include WS Line 10 amount on Line 11
  - **Line 17**
    - If the Line 11 worksheet was completed enter the amount from line 11 of the worksheet.
    - If the Line 11 worksheet was not used leave line 17 blank (zero).

Form 8829 Line 11 Worksheet

1. State & local income taxes or sales taxes
2. **Home** real estate taxes
3. Other nonbusiness real estate taxes
4. Personal property tax
5. Add lines 1 through 4
6. Multiple LN5 times business use %
7. Subtract LN6 from LN2
8. Subtract LN6 from LN5
9. Subtract LN8 from $10K/$5K (zero if neg)
10. RE taxes to 8829 LN 11 – Smaller of LN6 or LN9
11. RE taxes to 8829 LN 17 – LN6 less LN10

CATEGORIZING HOME EXPENSES TO DETERMINE DEDUCTIBILITY - Certain expenses are deductible whether or not a taxpayer has a home business. These include:

- Real estate taxes;
- Deductible home mortgage interest, and
- Casualty losses (limited to losses attributable to federally declared disasters for 2018-2025) .

Other expenses are deductible only if a taxpayer uses the home for business and is using the regular method to figure the home office deduction. These expenses generally include items like:

- Depreciation,
- Excess home mortgage interest,
- Insurance, Rent,
- Repairs, Security system, and Utilities.

The IRS groups home-related expenses into 3 categories:

a. ***Direct expenses*** - are the expenses that benefit only the business part of the home. They are deductible in full (subject to the home office gross-income limit, but they are not prorated by the business-use percentage). **NOTE:** Don't confuse direct expenses with expenses ***directly related to the business***. Directly related expenses aren't subject to the limitation of §280A and are fully deductible as business expenses and include such items as office supplies, postage, advertising, etc.

   The basic charge of the first home ***telephone*** line in the home is nondeductible. However, toll calls on that line related to the taxpayer's business are deductible (without limitation)—i.e., they are directly-related expenses without limitation. The cost of a second telephone used only for the business is a directly related expense ***fully deductible*** without limitation.

b. ***Indirect expenses*** (i.e., the expenses of running the entire home such as general repairs, not directly traced to the business) must be pro-rated in computing the home office deduction. This is normally done on the basis of space in the home office versus total space in the home.

   Unrelated expenses (i.e., those incurred for purely personal purposes) are nondeductible. The IRS would say that ***lawn care and landscaping*** are not related to the use of the home for business purposes. However, cases vary on this view.

   i. ***Letter Ruling 8534021*** disallowed deductions for a landscape architect who claimed landscaping expenses, because he occasionally showed his home landscaping to clients as an example of his work.

   ii. ***Hefti, Charles (1988) TC Memo 1988-22*** allowed a deduction to a taxpayer who had clients regularly visiting his home. The outside appearance of the house was deemed important to taxpayer's audio-visual business operations.

CASUALTY LOSSES - A casualty loss may be considered a direct expense if the loss is confined to the part of the home used for the business. The loss is indirect if it involves both the business and nonbusiness portion of the house. However, if the loss is totally unrelated to a portion of the house used for business, it is nondeductible as a home office expense. (2017 IRS Pub 587, page 8) Note: Personal casualty losses aren't allowed for 2018 through 2025.

PARSONAGE ALLOWANCE - A taxpayer can't deduct expenses that are related to ***tax-exempt allowances***—e.g. a tax-exempt parsonage allowance of a minister. Nonetheless, a tax-exempt housing allowance would not prevent deductions for mortgage interest and real estate taxes. However, no deduction would be allowed for other expenses related to the tax-exempt allowance.

MULTIPLE OFFICES - Where gross income is derived both from the business use of a home office and from the business use of other facilities, a reasonable allocation, based on the facts and circumstances of each case, must be made to determine what portion of the gross income is derived from the business use of the home. (S Rept No. 94-938 (PL 94-455) p. 149) In making the allocation, the time spent at each business location, the business investment in each location, and any other relevant facts and circumstances, should be taken into account. (IRS Publication 587, 2018, pg. 10; Prop Reg § 1.280A-2(i)(2)(ii)) After determining the part of gross income attributable to the home office (as opposed to other business locations), the taxpayer must subtract from that amount the total expenses (other than those related to use of the home) that are ***allocable*** to the business in which the home is used. The result will be the home office deduction limitation. (Form 8829 (2018 Instructions, page 2).

Income attributable to the home office – When determining the income attributable to the home office, consider all business income including Schedule C, Form 8949/Schedule D and Form 4797.

Expenses allocable to the home office (for gross income limitation) – Prorate expenses such as business insurance, professional dues, and education expenses between the home office and the other business locations based upon the income attributable to each location. Other expenses such as utilities, taxes, supplies, salaries, equipment, and similar expenses should be allocated to the specific location where they are used or incurred.

Example: *Jerry is a self-employed attorney with offices in the downtown business district. He also has an office in his home that he uses exclusively and on a regular basis to meet with clients whose work schedules prevent them from seeing him during regular business hours at his downtown office. The office occupies 20% of the space in Jerry's home. His gross income from the practice is $175,000, of which $20,000 is attributable to his home office. Jerry's Schedule C business expenses include the following items that are allocable by business income:*

E&O Insurance	*$10,000*
Website	*2,500*
On-line Legal Research Service	*5,000*
Bar Association Dues	*800*
Continuing Legal Education	*1,400*
Total	*$19,700*

Of the $19,700 of expenses, ***$2,251*** *(19,700 x (20,000/175,000)) is allocable to the income derived from the home office.*

Jerry's expenses for the home office, including utilities, taxes, interest, and depreciation, after applying the 20% business use allocation, totaled $4,500. Jerry's gross income for the home office deduction limitation is $17,749 ($20,000 - $2,251). Since his gross income attributable to the home office is greater than his home office expenses, he can claim the full $4,500 as his home office deduction.

Note: *The $2,251 calculation is only for purposes of figuring the OIH gross income limitation – the expenses underlying the $2,251 aren't actually part of the OIH deduction (i.e., if he filed a Schedule C, those expenses would be included in the general expenses, not on the OIH expenses line).*

MOTOR HOME AS AN OFFICE - In Cartwright, TC Memo 2015-212, the Tax Court has found that an on-call physician and surgeon at a hospital, who was required to work a 24-hour period three days a month, was allowed a home office deduction for his motor home but during audit the IRS determined that his deductions were excessive given the facts and circumstances. The court agreed with the IRS and sustained the IRS determination of approximately 20%.

California conforms to Federal law as of January 1, 2015. Therefore, California does not conform to the changes resulting from the TCJA of 2017 and will continue to allow employees to deduct their unreimbursed job-related expenses, including qualified home-office expenses, as a miscellaneous itemized deduction subject to the 2% of federal AGI reduction. California does not limit the deduction of personal casualty losses after 2017 to just those incurred in federally declared disasters areas.

NOTES

NET OPERATING LOSS (NOL)

Overview

- **Losses incurred prior to 2018:**
  - **Carrybacks**
    - General: 2 years
    - Casualty or theft: 3 years
    - Qual. Small business in disaster area: 3 years
    - Farm & Go Zone: 5 years
    - Specified Liability: 10 years
  - **Waiver of 5-yr and 10-yr carryback:** Reverts to 2 or 3 year carryback
  - **Waiver of all carryback:** Losses carried forward only
  - **Carryforward:** Limited to 20 years
  - **Limitation:** Deduction limited to taxable income of deduction year
- **Losses incurred 2018 or later:**
  - **Carrybacks**
    - **General:** No carryback
    - **Farm:** 2 years
  - **Carryforward:** Until used up
  - **Limitation:** Deduction limited to 80% of taxable income in deduction year
- **Form:** Use Form 1045 to carry back if filed by end of year after NOL year; otherwise use 1040X

RAPID FINDER

Pubs Forms

Related IRC and IRS Publications and Forms

- **Form 1045** - Application for Tentative Refund
- **Form 1040X** – Amended Tax Return
- **Pub 536** – Net Operating Losses (NOLs) For Individuals
- **IRC Sec 172**

TCJA

Carryback Repealed; New 80% Rule - For NOLs arising in years beginning after 2017*, the Act generally repeals the 2-year carryback, except for certain farm losses, and provides that the carryover is no longer limited to 20 years and is indefinite until it is used up. **Note**: NOLS prior to this change are unaffected and are still allowed at 100% and only have a carryforward of 20 years. (IRC Sec. 172(b)(1)(A) amended by TCJA Sec. 13302(b)(1)) Effective for NOLs arising in years beginning after 2017, the NOL deduction is limited to the lesser of:

- The aggregate of the NOL carryovers to that year, plus the NOL carrybacks to that year, or
- 80% of the taxable income computed without regard to the NOL deduction for the year. (IRC Sec. 172(a) as amended by TCJA Sec. 13302(a)(1))

*The language in the TCJA that modifies the NOL deduction says it applies to NOLs arising in taxable years *ending* after 12/31/2017 when, according to a letter from the Senate Finance Committee to the IRS, it was Congress' intent for the changes to be effective for NOLs arising in taxable years *beginning* after 12/31/17. The Committee intends to introduce technical corrections legislation to fix the error. The dates in this chapter are premised on the passage of such legislation.

TCJA

Excess Business Loss Adds to NOL – The TCJA added a provision that non-corporate taxpayers' business loss deductions are limited to a threshold amount (IRC Sec. 461(I) as modified by TCJA Sec. 11012(a)). When there is a nondeductible excess business loss, this amount is carried forward and treated like a net operating loss carryover to the next tax year. See Chapter 3.25 for more about this new limitation.

NET OPERATING LOSS

A net operating loss results from a business loss or a personal casualty loss. In order to have an NOL, a taxpayer generally must have a NEGATIVE AGI, or a casualty loss as part of itemized deductions. However, a positive AGI, which consists of positive nonbusiness income and a business loss may also create a net operating loss, if there are nonbusiness deductions to offset the nonbusiness income.

The net operating loss deduction is an exception to the general rule that computation of income tax for a given year is based on that year's income and deductions only. The reason for this is that when a net operating loss occurs, the loss is computed in the year of occurrence, but that loss is carried to the returns of other years and is used as a deduction in those years, resulting in a reduction of income tax (but not self-employment tax) for the other years. Carrybacks/carryovers of NOLs are explained in more detail later in this chapter.

WHO CAN TAKE AN NOL DEDUCTION

Individuals and C corporations can claim net operating loss deductions, but partnerships may not. However, a partner's share of a partnership loss may generate an NOL on the partner's individual tax return (a similar rule applies to shareholders in S corporations). An estate or trust may take an NOL deduction. Beneficiaries can't take the deduction until termination of the estate or trust. A net operating loss of a decedent can't be carried over to his/her estate (except in the case of decedents dying in 2010 and the executor elected to not be subject to the estate tax and the modified carryover basis rule applies – see Chapter 1.05). This section outlines the net operating loss deduction rules for individuals only.

Computing an NOL **-** The steps in computing an NOL are briefly described below. More detailed instructions for the computations are found later in the chapter. After completing the current year's return:

(1) Calculate the NOL for the current year by determining the excess of allowable deductions over gross income (modified as explained below).

(2) Carry the NOL to another tax year (by amending the return of the other year if carrying back the loss).

- (a) Combine the current year loss computed in (1) with all NOLs being carried back or forward to a given year. For losses arising in 2018 or later, this amount is limited to 80% of the taxable income of the year to which the NOL is being deducted. This total is called the NOL deduction for the carryback/carryforward year.
- (b) Recompute the income tax liability in the carryback/carryover year. Credits that are limited by the amount of income tax and the alternative minimum tax also may have to be revised.

(3) Determine how much of the NOL was "used up" in computing steps (2)(a) and (2)(b) above.

(4) Carry any unused loss from (3) to the next available carryback/carryover year.

CARRYOVER OF NOLS ARISING IN 2018 OR LATER YEARS

General Rule – For losses arising in a year beginning after 2017, the TCJA generally repealed the carryback of net operating losses and removed the limit of 20 years for the carryforward period, making the carryforward indefinite until the NOL is used up. (IRC Sec. 172(b)(1)(A) as amended by TCJA Sec. 13302(b)(1))

Farming Exception - An exception to the repeal of carrybacks is a 2-year carryback period for certain farming losses. For this exception a farming loss is the lesser of:

1. The amount that would be the NOL for the tax year if only income and deductions attributable to farming businesses are taken into account, or
2. The amount of the NOL for the tax year.

80% Rule - The NOL deduction on the return for the year to which the NOL is carried is limited to the lesser of:

- The aggregate of the NOL carryovers to that year, plus the NOL carrybacks to that year, or
- 80% of the taxable income computed without regard to the NOL deduction for the year.

CAUTION

Since the 80% rule only applies to NOLs that occur after 2017, it will be necessary to track pre-2018 and post-2017 NOL carryovers separately in order to correctly apply the 80% limitation. Your tax software should be able to do this but you should verify that it is accurately doing so.

CARRYBACK/CARRYOVER OF NOLS ARISING IN YEARS BEFORE 2018:

- *Two Years* - Generally the **carryback period is 2 years**. There are exceptions to this rule for certain eligible losses as noted below.
- *Three Years* **-** A three-year carryback is allowed for an "eligible loss," including an individual's loss from casualty or theft and a farm or losses of a small business attributable to federally declared disasters.

  Eligible loss - An eligible loss is any part of an NOL that is:
  - From a **casualty or theft**, or
  - a loss attributable to **a federally declared disaster** for a **qualified small business or farming business**.

  Qualified small business - A qualified small business is a sole proprietorship or a partnership that has average annual gross receipts (reduced by returns and allowances) of $5 million or less during the 3-year period ending with the tax year of the NOL. If the business did not exist for this entire 3-year period, use the period the business was in existence
- *Ten Years* – The carryback period for a specified liability loss is 10 years. Only the specified liability loss portion of the NOL can be carried back 10 years.

  Specified Liability Loss - Generally, a specified liability loss is a loss arising from:
  - Product liability, or
  - An act (or failure to act) that occurred at least 3 years before the beginning of the loss year and resulted in a liability under a federal or state law requiring:
    1. Reclamation of land,
    2. Dismantling of a drilling platform,
    3. Remediation of environmental contamination, or
    4. Payment under any workers compensation act.

  Waiving the 10-year carryback – The taxpayer can choose to treat a specified liability loss as if it were not a specified liability loss. If this choice is made, the loss carryback period will be 2 years (3 years to the extent the loss is an eligible loss).

CARRYBACK & DIVORCE

Where one spouse incurs a net operating loss (NOL) in a year following a divorce, which carries back to a year in which a joint return was filed, both spouses are entitled to a share in a joint overpayment resulting from the NOL carryback (Rev Rul 86-57, 1986-1 CB 362; Field Service Advice 1999-881, Vaughn No. 400). In such cases, careful consideration should be given to filing the election to forego the carryback period. *Caution: This is a "timely filed" election!*

ELECTION TO FORGO CARRYBACK PERIOD (PRE-2018 NOLS)

An irrevocable election can be made to forgo the carryback period and carry the loss forward without first carrying it back. This election applies to losses arising in years before 2018 and must be made by the extended due date of the return for the loss year and is advantageous if deductions or credits in carryback years would be lost if the loss were carried back. Another reason to relinquish the carryback period is if the tax rates in the two previous years are lower than the rates expected in the upcoming years. Make the election by attaching a statement to the return for the year of the loss indicating: "Taxpayer elects to forgo the carryback period under IRC Sec 172(b)(3)."

Amended Return Election - If a return was filed timely but did not include the statement electing carryforward, an amended return can be filed for the NOL year through the extended due date of the return whether or not an extension was filed. Enter "Filed pursuant to section 301.9100-2" at the top of the statement.

Amended Return Creates An NOL – Where an amended return is filed, and the requirements for a late election discussed above cannot be met, the carryforward election cannot be made. (Chief Counsel Advice 2016-16009)

CARRYFORWARD SUBSTANTIATION:

Clients who carry forward NOLs should be cautioned not to dispose of records that establish the losses and how much of each NOL has been used up until the statute of limitations has expired for the return in which the last of the carryover has been claimed. Taxpayers were denied NOL carryforward deductions because they were not able to provide the IRS and the Tax Court with books, records, bills, or receipts to establish the income and expenses of the business that suffered the losses. To substantiate the claimed NOLs the taxpayers tried to rely exclusively on copies of tax returns, and the court noted that "it is well settled that tax returns alone do not establish that a taxpayer suffered a loss." (Power v Comm., TCM 2016-157)

FORMS TO FILE FOR REFUND

The carryback, when permitted, can be made by filing a 1040X or Form 1045, Application for Tentative Refund. However, the period during which the 1045 can be used is limited: **the 1045 can only be filed within 1 year after the end of the year in which the NOL arose** – for example, a calendar year individual would need to file Form 1045 by December 31, 2018 for an NOL occurring in 2017. Schedule A (Form 1045) is used to compute the NOL in the loss year. Schedule B (Form 1045) is used to compute the amount of carryback/carryover used up in the carryback/carryover year. See the 1045 instructions for a list of the copies of forms from the loss year return that must be attached. It is generally more expeditious to use Form 1045, but due to the short filing window, if the 1045 time limit is not met, Form 1040X may be used to file for a refund in the carryback year. Form 1040X may be filed within 3 years after the due date, including extensions, for filing the return for the NOL year. Even though the filing due date of the 1045 may have passed, complete and attach Schedule A, and Schedule B if applicable, of Form 1045 to Form 1040X.

STEPS TO FIGURING AN NOL

Figure taxable income in the usual manner for the year the loss occurs (loss year). Several modifications must be made to taxable income in order to determine the actual NOL.

STEP #1 **-** Begin by separating business income and deductions and nonbusiness income and deductions.

Business income includes - wages, tips, commissions, self-employment income (Schedule C or F), gains from sale of depreciable property used in business, rental income, small business stock gains.

> ***NOTE:*** *Whether or not partnerships or S corporations produce business income cannot be clearly stated. Under Rev Rule 66-327, 1966-2, CB 357, Sub S income was nonbusiness income for NOL purposes. According to comments from various research services, it is unclear if this Rev Rule still applies. Partnership income must be characterized at the partnership level (according to the Tax Court). A partnership loss was determined to be nonbusiness in Campbell, (1987-CA5) 59 AFTR 2d 87-917. The partnerships involved in Campbell were formed for investment purposes (real estate partnerships), and the partners failed to prove that the partnerships were in a trade or business. IRS Pub. 536 says to treat nonbusiness income from partnerships and S corporations as nonbusiness income but not to include the taxpayer's share of business income from partnerships and S corps as nonbusiness income. So the facts and circumstances of each situation need to be considered when categorizing the partnership or S corp income.*

Business deductions include - above-the-line educator expenses, Schedule C expenses, unrecovered investment in employee annuity contracts if the employee dies after annuity starting date, casualty losses (business and personal), moving expenses (other than years 2018-2025), losses on sale of business or rental property, small business stock losses, above-the-line deduction for SE tax, SE health insurance deduction, domestic production activities deduction (not applicable after 2017), employee business expenses included as part of itemized deductions (not applicable 2018-2025), state income tax on business profits. The new Sec 199A qualified business income deduction is not included as a deduction when figuring the NOL. (IRC Sec. 172(d)(8)).

Nonbusiness income includes dividends, annuities, interest, state tax refund, gains from sale of nonbusiness property (stocks, bonds, unimproved real estate, etc.), estate/trust income, partnership and S corp income if not classified as business income, taxable alimony received, pension and annuity income, traditional IRA income, and taxable social security.

Nonbusiness deductions include Keogh/IRA/SEP contributions, HSA contributions, medical and interest expenses, taxes (unless related to business), contributions, alimony paid that's deductible in computing AGI, nonbusiness bad debts, standard deduction of non-itemizers.

STEP #2 **-** Use Schedule A of Form 1045 to figure the NOL. The form allows modification of regular taxable income to determine the actual NOL amount. Using Schedule A, make the following modifications to regular taxable income of the loss year:

(a) For years other than 2018 through 2025, add back personal or dependent exemption deductions;
(b) Add back NOL deductions from other years (carryovers/carrybacks aren't part of the current year NOL);
(c) The excess of nonbusiness capital losses over nonbusiness capital gains may not be deducted;
(d) Add back the excess of nonbusiness deductions over nonbusiness income (include in nonbusiness income any nonbusiness capital gains that remain after deducting nonbusiness capital losses in (c));
(e) Subtract the total of nonbusiness capital losses, personal exemptions when applicable, and nonbusiness deductions from nonbusiness capital gains. If there are excess nonbusiness capital gains after this subtraction, add the excess to business capital gains. Compare business capital losses to the result of the previous computation. If the business capital losses are more, the excess can't be deducted.

Example - Capital Gain/Loss and the NOL Computation (2017) - *Marshall is single and has no dependents. His nonbusiness income is $7,600 (interest from bank savings accounts and income from an annuity). His itemized deductions are: $4,750, home mortgage interest; $1,200, taxes; $800, contributions (standard deduction for 2017 would be $6,350). Personal exemption: $4,050 (2017). Marshall also had the following capital gains and losses for the year:*

Nonbusiness capital gains	*$13,000*
Nonbusiness capital losses	*7,000*
Business capital losses	*5,000*

Computation:

Nonbusiness capital gains	*13,000*
Less nonbusiness capital losses	*7,000*
Net capital gain over capital loss	*6,000 (a)*
Nonbusiness deductions: $4,050 personal exemption + 6,750 itemized deductions	*10,800*
Less nonbusiness income	*7,600*
Excess nonbusiness deductions	*3,200(b)*
Subtract (b) from (a) - (remaining nonbusiness capital gain)	*2,800*
Offset against business capital loss	*5,000*
Excess business capital loss	*2,200*

The $2,200 excess can't be used as part of Marshall's NOL deduction.

Example - Computing the NOL *- Keith, a single taxpayer with no dependents, had the following data for 2017:*

Income:

Wages	*$1,225*
Bank of America interest	*425*
Net business long-term capital gains	*2,000*

Deductions:

Schedule C loss	*<$5,000>*
NOL carryover from 2016	*< 185>*
Short-term loss on sale of stock	*<1,000>*
Loss on small business stock	*<700>*
Small business investment co. stock loss	*<300>*

Keith's AGI for 2017 is ($3,535) [$1,225 + $425 + ($2,000 - $1,000) - $300 - $5,000 - $185 - $700]. He did not itemize in 2017. The following computation shows Keith's '17 NOL:

1) ADJUSTED GROSS INCOME OR LOSS(-)........................		*-3,535*	
2) a. Itemized Deductions or	*0*		
b. Standard Deduction...	*6,350*		
3) Personal Exemptions..	*4,050*		
4) Sub Total..		*10,400*	
5) STATUTORY LOSS..			*13,935*
ADJUSTMENTS (ADD BACKS) TO COMPUTE NET OPERATING LOSS			
6) Personal Exemption Deduction..		*4,050*	
7)Net Operating Loss From Other Years..			*185*
8) NONBUSINESS DEDUCTIONS COMPUTATION			
a. Total Deductions (Std or Itemized).........	*6,350*		
b. Add IRA & Keogh Deductions.............	*0*		
c. Less Casualty Losses..............................	*0*		
d. Less Sch. A Business expense...............	*0*		
e. NonBusiness Deductions.................................		*6,350*	
9) NONBUSINESS INCOME COMPUTATION			
a. NonBusiness Income...		*425*	
b. NonBusiness CG..		*0*	
c. NonBusiness Income.....................................		*-425*	
10) EXCESS NONBUSINESS DEDUCTIONS...................................			*5,925*
11) EXCESS OF CAPITAL LOSS OVER CAPITAL GAINS.....................			*0*
12) TOTAL ADJUSTMENTS...			*10,160*
NET OPERATING LOSS...			***3,775***

USING UP AN NOL:

Once the NOL for the current year has been computed, it may be carried back (only if the loss year is before 2018 or the loss is an eligible farm loss occurring in 2018 or later) or forward and used to offset income in other tax years until it is entirely used up. This is done by amending the returns of the carryback years or reporting the NOL deduction as "other income" in carryforward years. The key, of course, is figuring the amount of the NOL which is used in each carryback/carryforward year. The general rules are:

(1) If the NOL is less than or equal to taxable income in the first carryback/carryforward year, the entire NOL is used up in the one carryback/carryforward year.

(2) If the NOL amount is more than taxable income of the first year to which it is carried, certain modifications must be made to the taxable income of the carryback/carryforward year to determine the excess NOL to be carried to the succeeding tax year.

If NOLs from more than one year are being carried to the same year, figure the amount that has been used up for each NOL separately. Start with the NOL from the earliest NOL year.

Post-2017 80% Rule – The TCJA limits the deduction of a net operating loss arising in a year after 2017 to no more than 80% of the taxable income of the year to which the NOL is being carried.

MODIFICATIONS IN CARRYBACK/CARRYOVER YEARS:

The modifications to taxable income in the carryback/carryover years are used only to determine if there is any excess NOL to be carried to the next tax year. Don't use any of the adjustments to figure the NOL deduction or to redetermine the tax liability. Follow these steps to make the modifications:

(1) Start with the AGI of the carryback/carryover year.

(2) Add back the net capital loss deduction of the carryback/carryover year, if any. Also add back any gain excluded from the sale of qualified small business stock.

(3) The NOL being carried forward or back isn't allowed as a deduction at this point. However, allowed NOL carrybacks or carryovers from years before the year of the NOL currently being carried, can be deducted. When carrying two or more NOLs to a tax year, deduct them in the order they occurred. Deduct first the NOL from the earliest year, then the NOL from the next earliest year, and so on.

(4) Make adjustments for the following items:
- Special allowance for passive losses from rental real estate activities;
- Taxable Social Security and tier 1 Railroad Retirement benefits;
- IRA deduction;
- Student loan interest deduction;
- Tuition and fees deduction;
- Excludable savings bond interest; and
- Excludable employer-provided adoption benefits.

Refigure the items that apply in the order listed above. The adjustment for each one is the difference between the refigured amount and the amount actually included on the return. Add the adjustments for the previous items to the revised AGI before refiguring the next item.

(5) The computations of (1) through (4) result in "modified AGI." Then modified taxable income must be computed.
- **First**, use this modified AGI to figure percentage limits on deductions for medical expenses, charitable contributions, Tier 2 deductions (not applicable 2018-2025), and casualty losses.

  Reminder: The deduction for charitable contributions isn't changed because of an NOL carryback. This means that any NOL carrybacks deducted in figuring AGI must be added back to refigure the percentage limit for charitable contributions. (The deduction for charitable contributions will be revised when figuring the amount of NOL available to carry to another year.)
- **Second**, deduct from AGI total itemized deductions (as revised) or standard deduction and the Sec 199A deduction (applicable for years 2018 through 2025). No deduction is allowed, however, for personal or dependent exemptions (applicable for years 2018 through 2025). If these modifications result in a negative amount, treat modified taxable income as zero.

Example - Computing Amount of NOL Used in Carryback Year *- Susan, a single taxpayer under the age of 65, with no dependents, had an NOL of $16,000 in 2017; she is carrying the NOL back to 2015. AGI in 2015 was $29,000 ($30,000 in wages and a $1,000 capital loss deduction). In 2015, Susan gave $17,000 to a qualified charity. Her medical expenses were $3,450, and home mortgage interest was $2,775.*

Susan's 2015 charitable contributions are limited to $14,500 ($29,000 x 50%). Her medical deductions are limited to $550 ($3,450 - ($29,000 x 10%)). Total itemized deductions are $17,825 ($14,500 + $550 +

$2,775). So Susan's taxable income for 2015 is $7,175 ($29,000 - $17,825 - $4,000 (exemption amount)).

*Since the $16,000 net operating loss from 2017 is greater than Susan's 2015 taxable income, she must figure modified taxable income to determine how much of the NOL she will actually use in the carryback year. This is shown in the computation following. Susan's carryover to 2016 is **$4,225.***

CORRECTED 2015 AGI:		
AGI Per Return	*29,000*	
Net Operating Loss Deduction	*-16,000*	
CORRECTED AGI	*13,000*	
CORRECTED ITEMIZED DEDUCTIONS:		
Corrected Excess Itemized Deduction	*-19,425[(1)]*	
Personal Exemptions	*-4,000*	
CORRECTED TAXABLE INCOME		*0*
COMPUTATION OF REMAINING NOL TO ANOTHER YEAR		
Net Operating Loss Deduction		*16,000*
AGI Per Return	*29,000*	
Net Cap. Loss Deduction	*1,000*	
Interim AGI	*30,000*	
Adjustments to AGI		*0*
Medical (use interim AGI)	*450*	
Contributions (use interim AGI)	*15,000*	
Casualty Losses	*0*	
Misc. Tier 2 Deductions	*0*	
Other Itemized Deductions	*2,775*	
Total Itemized Deductions	*18,225*	
MODIFIED TAXABLE INCOME (Not Less Than Zero)	*11,775*	
BALANCE OF THE NOL TO ANOTHER YEAR	*4,225*	

[(1)] ($3,450– (13,000 x 10%)) + 14,500 + 2,775 = 19,425

CALIFORNIA DIFFERENCES

The California NOL is generally figured the same way as the Federal NOL, albeit in most cases with different numbers due to the numerous federal-California differences.

New Law & Stuff

<u>No TCJA Conformity for 2018</u> – For 2018 California still allowed carrybacks and limited the carryover to 20 years and generally conformed to the Pre-TCJA federal NOL rules.

<u>Some TCJA Conformity for Years After 2018</u> - For NOLs occurring in taxable years beginning after December 31, 2018, AB 91(signed by the governor 6/27/2019) repeals the 2-year carryback period. California continues to allow a 20-year carryover period and has not adopted the federal rule limiting the NOL deduction to 80% of the carryover year's taxable income. Thus, 100% of the unused CA NOL is carried over.

Impact of Suspensions on NOL Carryforward – In some years before 2015, because of the severe state revenue deficits, the NOL carryforwards were suspended for some taxpayers and only a percentage of a carryback was allowed. As a result, the carryforward period was extended by two years for losses incurred before January 1, 2002 and by one year for losses incurred in 2002. Although the carryforward period for all post-2007 NOLs remains 20 years, as a result of the NOL suspension during the 2008 through 2011 tax years, the carryforward period for NOLs suspended during this period is extended as follows:

- one year for losses incurred during the 2010 taxable year;
- two years for losses incurred during the 2009 taxable year;
- three years for losses incurred during the 2008 taxable year; and
- four years for pre-2008 taxable year losses incurred.

NOL Carrybacks - NOL carrybacks are only allowed for NOLs incurred after 2012. As a result, taxpayers were first able to claim an NOL carryback on an amended return for the 2011 tax year (a carryback of an NOL from 2013). The NOL carryback was phased in over a three-year period. Consequently, only a 50% NOL carryback is allowed for NOLs incurred in the 2013 taxable year, a 75% NOL carryback is allowed for NOLs incurred in the 2014 taxable year, and 100% of the NOL may be carried back for NOLs incurred after taxable year 2014 and through year 2018. For information related to NOL carryback and carryforward in years before 2015, see the table in the instructions for FTB Form 3805V.

Election to Waive NOL Carryback - Any taxpayer entitled to a carryback period pursuant to IRC Section 172(b)(3) could make an irrevocable election to relinquish/waive the entire carryback period with respect to an NOL incurred in taxable years 2013 through 2018. By making the election, the taxpayer elected to carry an NOL forward instead of carrying it back to the previous two years. The election to waive the carryback could be made separately for California and federal.

The last year for which this election applies for California is 2018, and to be valid the election had to be made by the due date (including extensions of time) for filing the taxpayer's tax return for 2018. If the individual, estate, or trust filed the tax return on time without making the election, the taxpayer can still make the election on the FTB 3805V and attach it to an amended tax return filed within six months of the due date of the tax return (excluding extensions). Thus, October 15, 2019 generally would be the last day for making the election. Once made, the election is **irrevocable**. To make the election to relinquish/waive the entire carryback period for California, check the box in Part I under Section C - Election to Waive Carryback, of California Form FTB 3805V, and attach FTB 3805V to the tax return.

NOTES

RENTAL ACTIVITIES AND PASSIVE LIMITATIONS

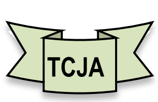
- **Passive Activity -** Any trade or business activity in which the taxpayer "DOES NOT MATERIALLY PARTICIPATE" in actual operations of the activity on a "regular, continuous, and substantial basis" is passive.
- **Rental Activity –** Is a passive activity (unless the rental isn't really a rental or the taxpayer qualifies as a real estate professional)
- **Limited Partnership Interest** – is presumed passive (unless material participation standards are met).

- **Material Participation (Generally)**
  - 500 hours or more;
  - Provides substantially all of the participation; or
  - 100 hours and no one spends more time
- **Active Participation**
  - Participates in management decisions
  - Generally must have 10% or more of ownership
  - Does not apply to limited partners
- **Special Rental Real Estate Rule**
  - $25,000 special loss allowance
  - Must show active participation
  - Allowance ratably phases out for AGI $100K to $150K
- **Reporting Schedules**
  - Real Property – Schedule E
  - Personal Property – Schedule C
  - Transient Property – Schedule C
- **Unallowed Losses**
  - Carry forward
  - Allowed in full for a total disposition (not a TFE)
  - Can offset other passive gains
- **Real Estate Professional –**See Chapter 3.26
- **Vacation Home Rental -** See Chapter 3.18
- **Section 199A Deduction** – See Chapter 3.24
- **TCJA Interest Limitation** – See Chapter 3.25

RAPID FINDER

Related IRC and IRS Publications and Forms

- **Pub 527** - Rental Activities
- **Pub 925** - Passive Activity & At Risk Rules
- **Pub 946** – How to Depreciate Property
- **Form 4562** – Depreciation & Amortization
- **Form 4797** – Sale of Business Assets
- **Form 4835** - Farm Rental Income & Expenses
- **Form 8582** – Passive Activity Loss Limitations
- **Form 8582-CR** – Passive Activity Credit Limitations
- **Schedule E** – Supplemental Income & Loss
- **Sec 469** – Passive Losses



Sec 199A Deduction – The TCJA added new code section 199A that gives a deduction, generally 20% of qualified business income, to most owners of pass-through entities, including rentals. See Chapter 3.24 for details.

The Details

Rental reporting usually is handled on Schedule E of Form 1040 and rentals generally are passive activities. When it comes to real estate rentals, this is generally no problem. Some taxpayers may be limited by the $25,000 loss rule (explained below). But certain "rentals" aren't passive. The goal in this section is to determine the various kinds of rentals, how they are reported on a taxpayer's return and what rentals are NOT covered by the passive rules. Some "rental activities" aren't classed as rentals and certain activities belong on Schedule C. Others are reported directly on Schedule 1 of Form 1040 and still others can be classed as non-passive (under rules for real estate professionals).

In general, passive losses can be offset only by passive income and excess losses are suspended. However, there are exceptions to this rule:

- Up to $25,000 in losses from certain rentals are allowed per year.
- Upon total disposition of a passive activity all losses can be recognized.

The passive rules apply to individuals, estates, trusts, and personal service corporations.

WHAT IS A PASSIVE ACTIVITY?

There must be an "activity," not just a simple holding of an investment. Any trade or business activity in which the taxpayer "DOES NOT MATERIALLY PARTICIPATE" in actual OPERATIONS of the activity on a "REGULAR, CONTINUOUS, AND SUBSTANTIAL BASIS" is passive. This includes any limited partnership interest, which is always presumed passive. However, a taxpayer may rebut the assumption by showing he/she meets the material participation standards (see following paragraph). A rental activity, whether or not the taxpayer materially participates in its operation, is a passive activity – but some "rentals" are not considered rentals for this purpose (see "Exceptions" below).

MATERIAL PARTICIPATION

This is not the same as the "ACTIVE PARTICIPATION" rule under which up to $25,000 of losses from REAL ESTATE RENTALS (more below) may be allowed. Instead, the following tests determine material participation (only one test needs to be met to qualify a taxpayer as a material participant):

Time Tests. A taxpayer is a material participant in an activity if the taxpayer:

(1) Participates **500 HOURS OR MORE** during the tax year;

(2) Provides "**SUBSTANTIALLY ALL THE PARTICIPATION"** in the activity;

(3) **SPENDS MORE THAN 100 HOURS** on the activity and nobody spends more time than this on the activity; or

(4) **SPENDS AGGREGATE TIME** over 500 hours on all "significant participation activities" (SPA's). A SPA is an activity in which the taxpayer spends over 100 hours during the year, but cannot meet one of the three other time tests.

Prior participation tests **-** A taxpayer may be a material participant based on prior participation rather than TIME. The taxpayer may meet either of these criteria:

(5) Participate in the activity "materially" **IN ANY 5 OF THE LAST 10 TAX YEARS**; or

(6) TAXPAYER is in a **PERSONAL SERVICE BUSINESS** and **WAS** a **MATERIAL PARTICIPANT IN ANY 3 PREVIOUS TAX YEARS**.

SPECIAL RULE FOR LIMITED PARTNERS

Limited partners are generally not treated as material participants. If a taxpayer wishes to rebut the presumption, only tests 1, 5, and 6 above may be used. The other tests are not available.

Proposed Regs on Limited Partner's Material Participation – In late 2011, the IRS issued Prop Reg. §1.469-5, which will apply to tax years beginning on or after the date the regulation is finalized, to clarify when a member of a partnership or multi-member LLC is a limited partner for determining material participation under the passive activity rules. Whether an individual is a limited partner will depend upon the individual's right to participate in management of the entity, and not on the extent to which the individual has limited liability. An individual's interest will be treated as a limited partnership interest if:

(1) For federal tax purposes, the entity is classified as a partnership under the check-the-box regulations, and

(2) Under state law or the operating agreement of the entity the holder of the interest does not have any rights to manage the entity at any time during the entity's tax year. ***(Prop. Reg. 1.469-5(e)(3)(i))***

The general partnership exception continues to apply under the proposed regs. That is, an individual is not treated as holding a limited partnership interest in a limited partnership if he or she also holds a general partnership interest at all times during the partnership's tax year ending with or within the individual's tax year. ***(Prop. Reg. 1.469-5(e)(3)(ii)***

RENTAL ACTIVITY EXCEPTIONS

The following are not considered rental activities and DO NOT qualify for the "up to $25,000" rental allowance.

- **Rental of a Dwelling** under §280A(c)(5). This covers home office, use of home for business storage, vacation homes, rental to related parties, and daycare centers. These are NOT PASSIVE ACTIVITIES for the year in question; use the rules of §280A.

  Where a dwelling unit is used by the taxpayer as a residence, and is rented out for less than 15 days during the tax year, then the rent isn't included in the taxpayer's gross income and no deduction due to the rental use of the dwelling unit is allowed, other than the normal interest and tax deductions on Schedule A. (Section 280A(g)) Thus this is not a passive activity and the "active participation" $25,000 loss allowance does not apply.
- **Activities with 7-day or less** periods of use are not considered rentals (See page 3.17.04);
- **Activities with 7-30 day periods** of rental are not considered rentals if significant (10% or more of attributable income) personal services are rendered (See page 3.17.04).
- **Activities where extraordinary personal services** are provided to make the rental incidental to a business activity.
- **Incidental income** is presumed if property is held for sale within the same year, or for use to house employees, and where annual rental income does not exceed 2% of the lesser of FMV or adjusted basis of property.
- **An activity that allows nonexclusive use** during business hours to customers.
- **Rental to self** or for non-rental activities of partnership, S-corp., or joint venture in which TAXPAYER owns an interest. These are allowed if in place on 02/18/88; agreements after this are not considered rentals. See "Recharacterization" below; these are passive if there is a net loss, non-passive if net income.

RECHARACTERIZATION OF PASSIVES

An activity can be either "passive" or "portfolio" depending upon income. (*Reg. 1.469-2T(f)*).

Significant participation activities **-** Losses are passive, but any income in excess of losses is non-passive! Remember that "significant participation" means 100+ hours of participation, but not enough participation to meet the material participation tests (above).

Self-rented property **-** Code Sec 469 includes a self-rental recharacterization rule that applies to taxpayers who rent property to a trade or business in which they materially participate, with the result that net rental income from an item of property is converted from passive to non-passive but net rental loss from an item of property remains passive. (*Reg. 1.469-2(f)(6)*)

> ***Example – Self-Rental Recharacterization:*** *Mike is the sole shareholder in a C corporation that operates a restaurant in which he materially participates and he, as an individual, owns the building in which the restaurant business is located. He had net rental income of $35,000 from the rental in the same year that he has losses of $15,000 from a limited partnership in which he doesn't materially participate. Because Mike materially participates in the restaurant business, the net rental income is recharacterized as not from a passive activity. As a result, he cannot offset the $15,000 loss from the partnership against this rental income.*

This rule recharacterizes rental income from an item of property, rather than from an activity, even where multiple properties are properly grouped as a single economic activity under Reg § 1.469-4(c)(1). *(Carlos, Tony R. (2004) 123 TC 275)*

> ***Example – Self-Rental, Multiple Properties:*** *Glenda owns Property A, which she rented at a profit to S corporation X, and Property B, which she rented at a loss to S corporation Y. Glenda materially participated in the activities of both S corporations. The rental income from Property A is recharacterized as non-passive under the self-rental rule, even though she properly grouped both properties as a single activity. The self-rental rule applies to the income from the rental of Property A (an item of property) and not to the net income from the grouped Properties A/B rental activity. Thus, the income from the rental of Property A (recharacterized as non-passive) cannot be used to absorb the loss from Property B (which is treated as a passive rental activity) or any other passive activity Glenda may have.*

Non-depreciable property rentals **-** Tangible property held for rental will be considered non-depreciable if less than 30% of its unadjusted basis is depreciable. There is no $25,000 allowance for losses.

Rental of property developed by taxpayer is not considered passive. Special rules apply to this, not covered here.

"$25,000 ALLOWANCE," SPECIAL RENTAL REAL ESTATE RULE

A special rule allows aggregate losses from rental real estate activities up to $25,000 per year (IRC Sec 469(i)). To qualify, a taxpayer must be an ACTIVE PARTICIPANT in the activity. This is a less stringent test than for material participation. It means that the taxpayer must participate in management decisions, and at least arrange for others to provide the necessary services such as repairs. DO NOT CONFUSE THESE RULES WITH EARLIER STANDARDS FOR MATERIAL PARTICIPATION. Moreover, keep the following in mind:

- **Less than 10% ownership** is presumed to not be active participation.
- **Limited partners** are not active participants, unless they meet the tougher material participation standards.
- **Different years:** TAXPAYER must be an active participant BOTH in the year of loss AND in the year the loss is allowed.
- **Phase out** of the allowance applies as AGI (without regard to passives) exceeds $100,000. The phase out is 50 cents for each $1 of income over $100,000. No allowance is allowed at gross income of $150,000 and over. Phase out applies to gross income without taking into account passives, taxable social security, or deductions for IRA. For married separate, taxpayers must live apart the entire year or they get no relief under this rule. If they lived apart all year, the allowance is $12,500, and phase out begins at income of $50,000.

REAL ESTATE PROFESSIONAL

The passive activity rules do not apply to the individuals who meet the definition of a "Real Estate Professional." See chapter 3.26 – Real Estate Professionals.

RENTAL OF PERSONAL PROPERTY

Most tax practitioners automatically think of Schedule E when considering rentals. IRS insists ONLY REAL ESTATE RENTALS belong on Schedule E. For rental of **PERSONAL PROPERTY**, IRS gives two different sets of instructions:

- **Trade or business.** If a taxpayer is in the trade or business of renting, the rental belongs on Schedule C. This would apply to most equipment rental operations (a similar rule applies to hotels and motels). The income from the activity is subject to SE tax and belongs on Schedule C. Whether the activity is passive or not depends upon the taxpayer's participation. If the taxpayer is a material participant, this is not a passive activity. If taxpayer is more of an investor, then it's passive.
- **NOT a trade/business.** It is possible for the activity to fit this category. Look at the taxpayer's level of services rendered, prior experience with such business activities, whether the taxpayer deals with the general public rather than a single client, and so on. With this type of rental activity, and provided it is done with a profit motive, IRS instructions say to claim the income on Form 1040, Schedule 1, line 21 as Other Income. The expenses should be detailed on a separate backup sheet and the total expense written on the dotted line next to line 36 of Form 1040, Schedule 1, which is the line where the total of all "adjustments to income" is entered. Identify the amount with the legend "PPR' ("Personal Property Rental") and include it in the line 36 total. IRS does not make it clear whether they consider this income passive. It is easy to argue this is less an activity than an investment. One unconfirmed view is that this is a "portfolio" item that eliminates the use of Form 8582 and classifies the income as "nonbusiness income" for purposes of calculating a Net Operating Loss.

SHORT-TERM RENTALS

Many taxpayers will rent their first or second homes using rental agents or online rental services that match property owners with prospective renters, such as Airbnb, VRBO and HomeAway. When a taxpayer rents property for a short period, special (and sometimes complex) taxation rules come into play, which can make the rents excludable from taxation; other situations may force the rental income and expenses to be reported on Schedule C (as opposed to Schedule E)**.** The following is a synopsis of the rules governing short-term rentals.

Rented for Fewer Than 15 Days During the Year: When a property is rented for fewer than 15 days during the tax year, the rental income is not reportable (*IRC Section 280A(g)*), and the expenses associated with that rental are not deductible. Interest and property taxes are not prorated, and the full amount of the qualified mortgage interest and property taxes, within the limits imposed by the TCJA, are reported on the taxpayer's Schedule A.

The 7-Day and 30-Day Rules: Rentals are generally passive activities. However, an activity is NOT a rental activity if (*Reg Sec 1.469-1T(e)(2)(ii)*):

A. The **average** customer use of the property is for 7 days or fewer—or for 30 days or fewer if the owner (or someone on the owner's behalf) provides significant personal services.

B. The owner (or someone on the owner's behalf) provides extraordinary personal services without regard to the property's average period of customer use. Extraordinary services are where the rental of the property is incidental to providing the services. Examples: Hospital's boarding facilities and a boarding school's dormitory room rental.

Since the activity is a trade or business that is not classified as a rental for Schedule E purposes, the only other option is to report the income and expenses on Schedule C. That opinion is shared by IRS Publication 527, which states: "If you provide substantial services that are primarily for your tenant's convenience, such as regular cleaning, changing linen, or maid service, you report your rental income and expenses on Schedule C." Substantial services do not include the furnishing of heat and light, the cleaning of public areas, trash collection, and such. Thus, the rental income and expenses, including interest and taxes, are included on Schedule C.

Exception to the 30-Day Rule – If the personal services provided are similar to those that generally are provided in connection with long-term rentals of high-grade commercial or residential real property (such as the cleaning of public areas and trash collection), and if the rental also includes maid and linen services, the cost of which is less than 10% of the rental fee, then the personal services are neither significant nor extraordinary for the purposes of the 30-day rule (*Reg. 1.469-1T(e)(3)(viii), Example 4*).

Profits & Losses on Schedule C **–** Profit from a rental activity that is reported on Schedule E is not subject to self-employment (SE) tax. But what about short-term rentals reported on Schedule C – are they subject to SE tax? Even though Pub 527, Page 12, indicates taxpayers "may" have to pay self-employment tax on short-term rental income, the "may" applies to real estate dealers. To quote Pub 334, "You are a real estate dealer if you are engaged in the business of selling real estate to customers with the purpose of making a profit from those sales. Rent you receive from real estate held for sale to customers is subject to SE tax. However, rent you receive from real estate held for speculation or investment is not subject to SE tax." (IRC Sec 1402(a)(1))

A loss from this type of activity is still treated as a passive activity loss and thus is limited under Sec 469 unless the taxpayer meets the material participation test or follows the real estate professional rules. Note that the special allowance for rental real estate activities with active participation, which permits a loss against nonpassive income of up to $25,000 (phasing out when modified adjusted gross income (MAGI) is between $100K and $150K), does **NOT** apply when the activity is reported on Schedule C (*Form 8582, Worksheet 3 and instructions*).

FORMER PASSIVE ACTIVITIES

Former passive activities are not too common but can cause confusion. There are several ways in which a tax return can include an item which is not passive on the current return, but which was passive at some time in the past. For example, tax-deferred exchanges can pass losses from one activity to another, transfers in a divorce, a change in business format and the conversion of a property from rental to personal use are a few possibilities that can cause this. When there are suspended losses from such activities, a taxpayer must wait for one of three events to claim the losses:

- **Income from the same activity.** When the same activity produces net income, this will trigger use of former losses from the same activity.
- **Income from another passive activity.** Form 8582 handles this automatically. Any excess net income from passive activities triggers the allowance of suspended losses from all other passives.
- **Disposition of the activity.** If the activity is disposed of in a fully taxable transaction, all suspended losses from that activity will be triggered.

Suspended Passive Losses – Former Principal Residence **-** In a taxpayer-friendly result in Chief Counsel Advice (*CCA 201428008*), IRS has determined that suspended passive activity losses from the passive rental of a home which was formerly used as the taxpayer's principal residence, did not offset gain excluded under Code Sec. 121 on the property's sale. This leaves suspended losses available to offset taxable passive income in the future. If IRS had reached a contrary result, the suspended losses would be wasted offsetting gain that wasn't taxable because it had already been excluded under the home sale exclusion.

VACATION HOMES; RENTAL TO RELATIVE

These activities are NOT PASSIVE and 280A TAKES PRECEDENCE! **The passive activity rules of *§469* don't even come into play in two** key cases where the prohibitions of §280A govern. (*See §469(j)(10)*)

- **Vacation home rules.** If the property is also used for personal purposes beyond the 14-day or 10% of total rental days standard, don't use passive activity rules (See chapter 3.18 for vacation home rental rules).
- **Rental to relative.** If the property is rented to a relative (either a "relative" in the sense of §267(c)(4))**,** or a co-owner) use the "not for profit" rules, unless it's established that there is fair market rent. If there is fair market rent, move back to the passive activity rules.

ROOM RENTAL – See Chapter 3.18 - Vacation Home Rentals

CATEGORIZING RENTALS

When a rental activity involves real estate, it's usual to automatically picture reporting on Schedule E and Form 8582, subject to the $25,000 loss rule. However, there are several activities that at first glance appear to be "rentals," but upon closer scrutiny are seen to fall under one of the exceptions. How must these be categorized?

(1) ***Golf course condo -*** John and Mary own a condo next to a golf course in Palm Springs. Their personal use never exceeds 14 days per year, and a leasing agent secures several dozen tenants during the year. The property generally shows losses in the $5,000 to $10,000 range. Is this an active participation rental? **ANSWER:** This activity is not likely to be an active participation rental real estate activity. Divide the days rented by the number of tenants. If the average rental period is less than 7 days, this is just a passive activity – much like a K-1. Report it on Schedule C. Suspend the loss if no other offsetting passive income.

(2) ***Vacation homes -*** Same as above – condo by a golf course, but John and Mary use the property for about 30 days each year. Their typical tenant stays for a month or so. Is this a passive activity? **ANSWER:** The vacation home rules take precedence over the passive loss rules. Any net loss MUST be suspended. The activity is NOT passive. The loss is suspended before Form 8582 ever comes into play!

(3) ***Rental to relative -*** Phil owns a residential property and rents it to his brother Bill. What pitfalls must be avoided? **ANSWER:** When a taxpayer rents a home to a relative for long-term use as a principal residence, the tax treatment of the rental depends upon whether the property is rented at fair rental value or rented at less than the fair rental value.

A fair rental is determined based upon facts and circumstances and by taking into account such factors as comparable rentals in the area.

Rented at Fair Rental Value – Where the home is rented to the relative at a fair rental value, it is treated as an ordinary rental reported on Schedule E, and losses are allowed subject to the normal passive loss limitations.

Rented at Less Than Fair Rental Value – When a home is rented at less than the fair rental value, it is treated as being used personally (*Reg Sec 1.280A-1(e)(2)*). Since it is rental property which the taxpayer is treated as using personally, the taxpayer would have to allocate the expenses between the personal and rental portions of the year.

However, since all the rental days (at a bargain rate to a relative) are treated as personal days, the rental portion is zero. So none of the expenses are deductible, other than property taxes and mortgage interest, assuming the interest would otherwise qualify as second home mortgage interest and the taxpayer itemizes.

Since it is not a rental, the income would be reported as "other income" (line 21, Schedule 1 of the 1040) and the mortgage interest and taxes deducted on Schedule A, assuming the landlord is itemizing deductions, and subject to the acquisition debt limitations and SALT cap, respectively, for years 2018 through 2025.

There also could be a gift tax issue depending upon the difference between the fair rental value and rent actually charged to the tenant-relative. Of course, that amount would be pro rated to each occupant of the home, so unless there was a large difference ($15,000 per each occupant, in 2018 and 2019) between the fair rental value and actual rent, or other gifting was involved, a gift tax return probably isn't needed in most cases.

(4) ***Commercial tenant -*** Joe owns a commercial property that he rents out. The tenant literally takes care of everything except the interest and taxes. How does Joe treat the property? **ANSWER:** This is probably NOT AN ACTIVE PARTICIPATION rental! If there is a loss on the property, the $25,000 loss rule will not apply. (This used to be called a "net lease" property. Under those old rules, a property was PRESUMED to be "investment" rather than "business" if expenses other than for interest, taxes and depreciation did not exceed 15% of gross rents.)

DISPOSITION RULES FOR PASSIVE ACTIVITIES

Any gain or loss from the disposition of a passive activity is generally also passive. However, special rules apply to dispositions.

Total disposition - presumes the disposition is a FULLY TAXABLE EVENT. Gains are taxed, and any previously suspended losses are allowed. A special rule accomplishes this.

- **Overall Gain.** If all aspects of the activity are aggregated (current year income/loss, previous suspended losses, gain/loss from disposition) and the aggregate is an overall gain, the overall gain is passive.
- **Overall loss.** If there is an overall loss, the loss shall be allowed. §469 accomplishes this by RECHARACTERIZING the activity as NONPASSIVE. This allows Form 8582 to be bypassed.

Partial dispositions - are more involved (See "Partial Disposition Election" in chapter 3.27.)

Partial recognitions - if only part of the total realized gain is recognized (as with INSTALLMENT SALES or some TAX-DEFERRED EXCHANGES), the gain/loss must be pro-rated. If, for instance, 20% of the total gain is currently recognized, then at least 20% of the overall losses will be allowed.

NON-RECOGNITION TRANSFERS: An exchange of the taxpayer's interest in an activity in a non-recognition transaction does not trigger suspended passive losses. Such transfers include:

- Transfer of property to a controlled corporation (Code Sec. 351),
- Contributions to partnerships (Code Sec. 721), or
- Like-kind exchanges (Code Sec. 1031) in which no gain or loss is recognized.

Following these types of exchanges, the taxpayer retains an interest in the activity and hence has not realized the ultimate economic gain or loss on his investment in the activity. In order for the excess suspended passive losses to be triggered, all gain or loss realized on a disposition must be recognized. *(IRS Letter Ruling 9739004)*

IRS gives as additional examples of transactions that are not fully taxable:

- A transfer to an ex-spouse on divorce, and
- A bankruptcy which has not been finalized *(IRS MSSP Reference Guide, Passive Activity Losses, (2/05), p. 5-2).*
- Suspended passive losses allocable to rental real estate that was sold by taxpayers to their son could not be deducted in the year the son sold the property (after using it as his residence) in a transaction that qualified for gain deferral under the pre-May 7, '97 home sale rollover rule. Instead, the losses remain suspended until the son disposes of the replacement property (his new principal residence) to an unrelated party in a fully taxable transaction (*IRS Letter Ruling 9739004).*

Partially Taxable Event - To the extent the taxpayer does recognize gain on the transaction (e.g., boot in an otherwise tax-free exchange), the gain is treated as passive activity income, against which the taxpayer may deduct passive losses (*S Rept No. 99-313 (PL 99-514) p. 727*).

Related parties **-** A taxpayer is not treated as having disposed of an interest if the disposition is to a related party within the meaning of ***§267(b)*** or ***§707(b)(1)***, including the applicable attribution rules. In the event of such a related-party transaction, suspended losses remain with the taxpayer and may be offset by income from the taxpayer's passive activities.

When a taxpayer's entire interest is transferred to a related transferee followed by a transfer to an unrelated party in a fully taxable disposition, the taxpayer may deduct the suspended losses attributable to his or her interest in the passive activity to the extent the transfer would otherwise qualify as a disposition triggering the suspended losses.

Divorce **-** Under ***§1041(b)*** and ***469(j)(6),*** if a taxpayer transfers property to a spouse incident to a divorce, the exchange is treated as though it were a gift. Therefore, any suspended losses attributable to the spouse giving up the interest in the passive activity are added to the basis of the property transferred to the other spouse. For the receiving spouse, the basis will be increased by the ex-spouse's suspended losses, but the receiving spouse's suspended losses on the same property will still be considered suspended losses, which are available currently to offset passive income.

Publicly traded partnerships - Publicly traded partnerships (PTP) are not passive! If a PTP shows net income for the year, it's portfolio. If a PTP shows a net loss, the loss is suspended, and can only be offset in future years by income from that same PTP. What is a PTP? It is a partnership which is traded on an established securities market, or readily tradable in a secondary market (or its substantial equivalent). FORM 8582 IS NOT USED for reporting PTP income/loss. However, the suspended loss from each PTP must be tracked – which most tax software used by tax professionals will do – so that the loss can be properly used when there is income from the PTP in the future or when the taxpayer's entire interest in the PTP is sold.

AGGREGATING (GROUPING) PASSIVE ACTIVITIES

A taxpayer can elect to treat one or more trade or business activities, or rental activities, as a single activity if those activities form an appropriate economic unit for measuring gain or loss under the passive activity rules.

Benefits of Grouping – If a taxpayer groups two (or more) activities into one larger activity, the taxpayer need only show material participation in the activity as a whole. For rental properties, grouping can be important in determining whether the 10% ownership requirement for active participation in rental real estate is achieved.

Drawbacks of Grouping – The main downside to grouping is that if only one of the activities in the group is disposed of, then the taxpayer has not disposed of his or her entire interest in the activity, and the suspended passive losses cannot be released at that time.

What Constitutes an Economic Unit? – The following factors have the greatest weight in determining whether activities form an appropriate economic unit:

- Similarities and differences in the types of trades or businesses,
- Extent of common control,
- Extent of common ownership,
- Geographical location, and

- Interdependencies between or among activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are generally provided together, have the same customers or employees, or are accounted for with a single set of books).

A rental activity and a trade or business activity cannot be grouped together unless either activity is insubstantial when compared to the other activity. Further, a rental of real property activity and an activity involving the rental of personal property generally cannot be treated as a single activity.

Aggregation Election & Disclosure Requirement – Once the election to aggregate activities is made, the taxpayer is not allowed to regroup the activities unless the original grouping was clearly inappropriate or the facts and circumstances have changed, making the original grouping inappropriate. The IRS may regroup the activities if the taxpayer's grouping fails to reflect economic reality and one of the primary purposes of the taxpayer's original grouping was to avoid the Sec. 469 rules.

Rev. Proc. 2010-13 requires taxpayers to disclose changes made to the grouping of activities by including a statement with the timely filed (including extensions) return for the year in which two or more activities are first grouped together, a new activity is added to an existing group, or an existing group is regrouped. The disclosure requirement is effective for tax years beginning after January 24, 2010. Failing to report these changes results in each activity being treated as a separate activity. Sample election and statement are included as the last page of this section.

Grouping Fresh Start Allowed for Taxpayers Subject to the 3.8% Surtax

Because of the enactment of Sec 1411, the 3.8% tax on net investment income (see chapter 12.05), proposed regulations include amendments to the Sec 469 regulations to permit taxpayers to elect to regroup their activities for passive activity loss purposes in the **first taxable year that they become subject to the 3.8% surtax**. Without permitting regroupings, taxpayers would be bound by their original grouping decisions – some of which may be two decades or more old. Any regrouping must comply with the disclosure and reporting requirements of Reg. 1.469-4(e) and Rev. Proc. 2010-13. A taxpayer may regroup activities only once under this provision, and the regrouping will apply to the taxable year for which the regrouping is done and all subsequent years.

RENTAL INCOME

The taxpayer must generally include in gross income all amounts received as rent during the year. The following are special situations related to payments received by the taxpayer from a tenant:

- **Advance rent** – Included in the year received regardless of the period covered.
- **Security deposits –** Generally not included in income where the landlord plans to return it at the end of the lease. Any amount of the deposit later retained by the landlord becomes income.
- **Expenses paid by tenant – If the tenant** pays any of the landlord's expenses, the payments are rental income. The expenses can be deducted or capitalized under the normal rules.
- **Lease with option to buy -** If the rental agreement gives the tenant the right to buy the rental property, the payments received under the agreement are generally rental income until the tenant exercises the option to buy the property. Payments received after the date of sale are considered part of the selling price.

RENTAL EXPENSES

Typical deductible rental expenses include amounts paid for advertising; janitorial/maintenance and gardening services; utilities; fire, earthquake, flood and liability insurance; taxes; management fees and commissions for collecting rent payments; travel and transportation expenses. An allocable portion of tax preparation fees paid is also deductible.

Equitable Ownership - a taxpayer may deduct, as home mortgage interest, interest he paid on a mortgage on real estate of which he is the legal or equitable owner, even though he is not directly liable on the debt secured by the mortgage. (Reg. § 1.163-1(b)) See chapter 7.05 for additional details.

Mortgage Interest – Mortgage interest paid on rental property is deductible. However, if the loan on a rental property is refinanced for more than the outstanding balance, the portion of the interest allocable to loan proceeds that are not related to rental use are not deductible as a rental expense. And when a personal residence is converted to rental property, the interest on the converted home's acquisition debt continues to be deductible as a rental expense but the interest on any equity debt is not deductible.

Business Interest Limitation – The TCJA added a provision that limits the deduction for business interest to 30% of the taxpayer's "adjusted taxable income," effective in 2018, with an exception for "small businesses" with average gross receipts of $25 million or less. Mortgage interest may be subject to this limitation if the rental activity is determined to be a "trade or business." See chapter 3.25 for additional details.

Deduction vs. Capitalization - Whether an expense is a capital improvement, or a repair has long been an arguable issue between the IRS and taxpayers. The IRS issued temporary regulations, that were to be effective January 1, 2012, but delayed to January 1, 2014, providing guidance with respect to whether costs to acquire, produce or improve tangible property should be currently deductible as repairs (or as materials or supplies) or capitalized. IRS finalized these regulations in 2013. Under these regulations, a qualifying taxpayer may, on an annual basis, elect a safe harbor provision to currently deduct improvements made to an eligible building property that would otherwise have to be capitalized. For details see Chapter 3.27.

Acquisition Costs - While quite complex, the final regs comprehensively restate many long-established concepts about which costs must be capitalized in connection with the acquisition or production of real or personal property. Generally, a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property, including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Amounts paid to acquire or produce a unit of real or personal property include the invoice price and transaction costs (discussed below). Costs for work performed before the date that the unit of property is placed in service by the taxpayer must be capitalized. (*Reg. § 1.263(a)-2(d)(1)*)

Amounts paid to facilitate the acquisition (or production) of real or personal property—i.e., paid in the process of investigating or otherwise pursuing the acquisition—must be capitalized and included in the basis of property acquired or produced. (*Reg. § 1.263(a)-2(f)(3)(i)*) Whether an amount is paid in the process of investigating or otherwise pursuing an acquisition is based on all of the facts and circumstances. The fact that the amount would (or would not) have been paid "but for" the acquisition is relevant but not determinative. (*Reg. § 1.263(a)-2(f)(2)(i)*) An amount is paid in the process of investigating or otherwise pursuing the acquisition of real or personal property if the amount is inherently facilitative. The amounts paid for the following are considered **inherently facilitative**:

1. Transporting the property (i.e., shipping fees and moving costs);
2. Appraisal or other fees for determining the value or price of property;
3. Negotiating terms of the acquisition and obtaining tax advice on the acquisition;
4. Application fees, bidding costs, or similar expenses;
5. Preparing and reviewing acquisition documents such as the bid, offer, sales contract or purchase agreement;
6. Examining and evaluation the title of the property;
7. Obtaining regulatory approval or securing permits, including application fees, related to the acquisition;
8. Conveying property between the parties, including sales and transfer taxes and title registration costs;
9. Finders' fees and brokers' commissions, including contingency fees;
10. Architectural, geological, survey, engineering, environmental, or inspection services pertaining to particular properties; or
11. Services of a qualified intermediary or other facilitator of a Sec 1031 exchange.

Costs relating to the process of determining whether to acquire real property and which real property to acquire generally aren't facilitative expenses (and therefore may be currently deductible), unless they are "inherently facilitative" expenses (e.g., the cost of an engineering study or a broker's fee). (*Reg. § 1.263(a)-2(f)(ii) and (iii)*)

The final regulations clarify the meaning of finders' fees and brokers' commissions and provide a definition of contingency fees. The final regulations provide that for purposes of §1.263(a)-2, a contingency fee is an amount paid that is contingent on the successful closing of the acquisition of real or personal property. The final regulations also clarify that contingency fees facilitate the acquisition of the property ultimately acquired and are not allocable to real or personal property not acquired. Therefore, if a real estate broker's commission is contingent on the successful closing of the acquisition of real property, the amount paid as the broker's commission inherently facilitates the acquisition of the property acquired and, therefore, must be capitalized as part of the basis of such property. However, no portion of the broker's contingency fee is allocable to real property that the taxpayer did not acquire. In addition, the final regulations retain the rule that inherently facilitative amounts allocable to real or personal property are capital expenditures related to such property, even if such property is not eventually acquired or produced.

1099 REPORTING REQUIREMENTS

Two questions to be answered on Schedule E, Part I (rental real estate and royalties section) are: "(A) Did you make any payments in [tax year] that would require you to file Form(s) 1099? and (B) If "Yes," did you or will you file all required Forms 1099?" Does this mean that landlords are responsible for issuing Forms 1099-MISC to their non-employee service providers such as gardeners, plumbers, and other maintenance workers? The instructions to Form 1099-MISC emphatically says to report on Form 1099-MISC only when payments are made in the course of a trade or business, and that "you are engaged in a trade or business if you operate for gain or profit." So, the issue boils down to the question of whether a rental real estate activity is a trade or business.

Unfortunately, there is no bright line definition of a trade or business in the over 70,000 pages of the tax code. There are only case histories and administrative rulings to go on. The determination can be subjective, and the regulations generally leave the determination to the taxpayer (or his preparer) to get it right. Many in the tax profession take the position that renting out even a single property can be a trade or business (*Hazard v. Commissioner*, Dec. 15,273, 7 TC 372, acq., 1946-2 CB3), and surely it is a trade or business if several properties are offered for rental and the property owner's property management activities are considerable, continuous and regular. And, therefore, if the activity is a rental trade or business, it will be subject to the 1099 reporting rules.

However, the 2012 instructions to Form 1099-MISC say the following (this language is absent in the 2013 and later years' instructions):

> Repeal of reporting requirements for certain rental property expenses. The requirement described in the 2011 instructions for persons receiving rental income from real estate to report payments for certain rental property expenses on Form 1099-MISC was repealed by Congress. You do not have to report those payments on Form 1099-MISC.

Given the language of the 2012 instructions, the likelihood that the IRS would assess a landlord a penalty for failing to file a 1099-MISC now seems slim. However, it may be best practice to advise rental owners who are operating a rental trade or business to issue 1099s.

Another consideration is the Sec 199A deduction created by the TCJA that applies to a trade or business, including most rentals. Included in the final 199A regulations is the following under "(e) Taxpayer Consistency" (prologue to final regs page 21) which includes the following caution for taxpayers treating rentals as a trade or business: "taxpayers should consider the appropriateness of treating a rental activity as a trade or business for purposes of section 199A where the taxpayer does not comply with the information return filing requirements under section 6041". In other words, it is not "consistent" for a taxpayer to claim the rental activity is a trade or business for section 199A and not for section 6041 Form 1099 reporting. See chapter 3.24 for more information about the Sec 199A deduction.

PORTFOLIO INCOME

Portfolio income includes interest, dividends, annuities, or royalties not from trade or business. It also results from the disposition gain/loss from investment property never used in a passive activity, or from property that normally yields interest, dividend, annuity, or royalty income.

GIFT/INHERITANCE AND SUSPENDED LOSSES

Passive activities disposed of by gift or inheritance have special rules to deal with suspended losses:

Inheritance **-** Suspended losses may be deducted on the final return of the decedent (as a miscellaneous itemized deduction not subject to a 2% floor) to the extent they exceed any step-up in basis at death *(IRC §469(g)(2))*.

Inherited Property Basis Adjustment
Don't overlook the requirement to adjust the basis of inherited property and start the depreciation anew on the inherited portion. Currently, use FMV at date of death, or alternate valuation date if so used in Form 706, Estate Tax Return (step-up or step-down)

Gift of Passives **-** Suspended losses are used to adjust basis of gifted property upward just before the transfer *(IRC §469(j)(6))*. Two bases are possible: When the losses are added to the donor's basis, there may be a basis that exceeds FMV. In this case, there are two bases. The basis as calculated is used to measure a gain, but FMV at the date of the gift is always used as the basis for loss (*Reg. 1.1015-1(a)(2)*). See the following example.

***Example** - **Gift/Inheritance of Passives –** Taxpayer owns a rental property with a basis of $120,000 and FMV of $150,000. There is $40,000 of previously suspended losses in connection with the property.*

*If taxpayer dies, the beneficiary receives the property with basis of $150,000 (FMV). This represents a step-up of $30,000. $30,000 of the suspended losses is deemed used to produce the step-up, and the remaining $10,000 suspended loss is deductible in full on decedent's final return as a Tier 1 miscellaneous itemized deduction. If the losses had not raised the basis above FMV, there would be no deduction available to the decedent. (**CAUTION:** The example may not apply to inheritances from someone who died in 2010.)*

If the taxpayer gifted the property while alive, the basis of the gift is normally $120,000. But here, the $40,000 of suspended losses is added to bring the basis to $160,000. No deductions are allowed to the donor.

***NOTE:** In this case, the new basis of $160,000 is greater than the FMV of the property, so this is a "dual basis" property. To realize a gain, the property must sell for more than $160,000. To realize a loss, the property must sell for less than $150,000. A sale for a price BETWEEN $150,000 and $160,000 results in neither gain nor loss.*

OTHER ITEMS

Passive credits **-** Convert credits into a "deduction equivalent," then this figure is subject to the same general rule as the losses themselves.

Casualties and passives **-** A casualty loss to a passive activity will be "recharacterized" as non-passive, and thus, it is fully deductible.

Mold Removal **-** IRS has privately ruled that the business cost a taxpayer incurred on a project to remove mold from a building it owned and leased out was deductible as an ordinary and necessary expense under Code Sec. 162. (*PLR 200607003*) Note: Presumably the mold removal would have had to be capitalized if it was done as part of an overall rehabilitation or renovation plan.

Generally, repairs are deductible as an ordinary and necessary trade or business expense under Code Sec. 162 if they merely keep the property in an ordinary, efficient operating condition. But expenses must be capitalized if they're needed to place the property in an ordinarily efficient operating condition (as in the case of expenses to remedy a condition that existed when the property was acquired), or if they add to the property's value, substantially prolong its useful life, or adapt it to a new or different use. See also Chapter 3.27.

Local Transportation - A taxpayer who owns rental property may be able to deduct ordinary and necessary local transportation expenses if the expenses are incurred to collect rental income or to manage, conserve, or maintain the rental property. However, transportation expenses incurred to travel between the property owner's home and a rental property generally constitute nondeductible commuting costs unless the landlord's home is used as his or her principal place of business. (Pub 17, 2018, page 67) For eligible expenses either the standard mileage rate or the actual expenses method can be used.

Converting a Home to a Rental **-** It is not uncommon to have a client convert a personal residence to a rental property. Some even think if they convert to rental use a home that has declined in value, they can then deduct a loss when they sell the property, which is not the case.

When a residence or other nonbusiness property is converted from personal use to business or income-producing use, for purposes of calculating losses or depreciation (but not gain), the basis for the property on the date of its conversion is the lower of its adjusted basis or fair market value on that date (*Regulation Sec 1.167(g)-1*).

However, for purposes of computing gain, the basis continues to be the adjusted basis at the time of the conversion (*Reg § 1.165-7(a)(5); Reg § 1.165-9(b); Reg § 1.167(g)-1*). Thus for property converted from personal use to business use the conversion has created a **dual basis** for the property:

- For computing a **loss:** if the sale results in a loss, the basis is the lower of the FMV or the adjusted basis at the time of conversion.
- For computing a **gain**: if the sale results in a gain, the basis is the adjusted basis at the time of conversion.

A sale of converted property where the sales price is more than the basis for loss but less than the basis for gain results in no gain or loss.

When converting personal use property to business use, the FMV of the property can be a very important factor. If challenged, the IRS will want to know how the FMV was determined and will require more than a guess. They often require a certified appraisal. Taking short cuts can lead to problems in the future.

Sale of Converted Residence – What is the treatment when a residence is converted to a rental and then sold at a loss? When property that was purchased for and used for residential purposes is converted to rental or business use, it loses its character as a residence and becomes business property. When a personal residence is converted to a rental, the property's basis at the time of conversion for computing loss or depreciation is the lesser of the property's adjusted basis or its fair market value. As a result, a taxpayer cannot rent out what was his personal residence for a time before selling it and expect to claim a loss that would otherwise not have been deductible if he'd continued to use the home as his personal residence. To deduct a loss on the sale of a residence, a taxpayer must actually rent the property at a fair rental price before it is sold. (*Newcombe v. Commissioner, Dec. 30,178, 54 TC 1298*)

> ***Example*** *– Lisa purchased a residence for $140,000, lived in it for a few years and then converted it to a rental. At that time the FMV was $115,000. If she had sold it instead of turning it into a rental, the loss would not have been deductible. After conversion, Lisa claimed $7,800 of deprecation during the time it was used as a rental. She sold it after a few years for $95,000. Her depreciable basis at the time of the sale was $107,200 ($115,000 – 7,800). Her loss is not $45,000 ($140,000 - 95,000), but $12,200 ($107,200 – 95,000). Effectively the loss sustained while Lisa used the property as her personal residence is excluded. Further, because the loss is limited by the FMV at the time of the conversion, if Lisa fails to prove the value at that date, any loss deduction is barred.*

*Easement*s – Easements can be permanent or for a period of time. Where they are for a specific period of time, the payments for easements are generally rental income (Wineberg, William, (1961) TC Memo 1961-336), but see GCM 35492 (9/73) for a different outcome). For the tax treatment of permanent easements see chapter 11.07.

CALIFORNIA DIFFERENCES

Generally, California law is the same as federal law concerning PAL limitations. However, for California purposes, all rental activities are passive activities, and California does not conform to federal treatment of Real Estate Professionals' passive losses (*IRC Sec 469(c)(7)*). Therefore, for purposes of California personal income tax, taxpayers should group rental activities without regard to IRC section 469(c)(7). (Real Estate Professionals are covered in chapter 3.26).

California has not conformed to the Sec 199A deduction with respect to rentals or other trade or business activities.

Withholding on Rents Paid to Nonresidents **–** 7% withholding is required from rents paid to nonresidents on real or personal property located in California if the rent is paid in the course of the withholding agent's business (e.g., a property management company). Withholding is not required if the withholding agent's total payments to the payee are $1,500 or less for the calendar year. The FTB issues a determination letter for each waiver request. A withholding agent must have received the determination letter authorizing a waiver of withholding before eliminating withholding on payments made to nonresidents. The withholding agent retains the determination letter and waiver for a minimum of four years and must furnish the form to the FTB upon request. Use FTB Form 588 to request a waiver of withholding and for additional details related to this requirement. Note: No withholding is required to be made by tenants of residential property who make their payments directly to nonresident owners.

Withholding for Real Estate Sales - Withholding on real estate sales includes all individuals, both resident and nonresident. In addition, the FTB will not grant individuals a waiver or reduced rate of withholding for sales with small taxable gains. There are some exceptions in the law. Withholding is not required if:

- The total sales price is $100,000 or less,
- The property sold was a principal residence (including a decedent's residence if being sold by the decedent's estate),
- Sale results in a taxable loss,
- The sale is a tax-free exchange, or
- For some involuntary conversions.

Also exempted are sales where the seller is a tax-exempt entity, a California corporation with a permanent place of business in California, or partnership or LLC (but an LLC treated as a disregarded entity is subject to withholding).

Withholding on Foreclosures and Short Sales – If the total sales price is over $100,000, withholding for real estate foreclosures and short sale transactions is required unless:

- Any of the exemptions certified on Form 593-C apply, or
- The seller is a bank acting as a trustee (other than a trustee of a deed of trust), or
- The buyer is acquiring the property as part of a foreclosure under one of the following conditions:
    - A power of sale required under a mortgage or deed of trust.
    - A decree requiring foreclosure.
    - A deed in lieu of foreclosure.

For additional information see FTB Pub. 1016, Real Estate Withholding Guidelines.

CAUTION

State income tax withholding is not deductible for Federal AMT purposes and therefore can create a Federal AMT and unexpected tax results. Practitioners are cautioned to consider the Federal AMT implications associated with a sale for which CA withholds state income tax which in some cases can be substantially excessive. However, with the $10,000 limitation on the deduction of state and local taxes imposed by the TCJA for years 2018 through 2025, fewer individuals will be subject to the AMT because of their deduction for real property tax (and other reasons). But this doesn't mean that the CA withholding on real estate sales will be any less for these individuals, just that they may more likely be subject to the SALT limitation on their federal returns.

Sellers of California real property will be given the option to select a withholding rate of **3.33% of the sales price** or, one of the following applicable rates multiplied by the **reportable gain from the sale**:

- 8.84% (Corporate franchise rate)
- 10.84% (Bank and financial corporation tax rate)
- 15.8% (Financial S Corporation)
- 13.8% (S Corporation)
- 12.3% (Individuals and non-California partnerships)

Seller Certification - A seller making the election must certify the withholding amount in writing, under penalty of perjury, to the buyer or the real estate escrow person. The seller also must submit a copy of the written certificate and supporting documentation for the withholding amount to the California Franchise Tax Board (FTB) upon request. The written certification must be in a form prescribed by the FTB, currently Form 593-C. The FTB makes the form available on its Web site and provides electronic means for a seller to estimate the amount of gain required to be recognized on a transaction (Form 593-E, Real Estate Withholding – Computation of Estimated Gain or Loss).

Installment Sales – For dispositions subject to real estate withholding, buyers are required to withhold on the principal portion of **each installment payment** if the sale of California real property is structured as an installment sale.

*Withholding responsibility***:**

- **Real estate escrow person** - is responsible to compute the first installment payment, withhold the required amount in escrow, and remit to the FTB within 20 days along with Forms 593, 593-V, 593-I and a copy of the promissory note. Retain copies for 5 years.
- **Buyer** – For all subsequent payments, the buyer is required to withhold the required amount from the installment payment due the seller, and remit it to the FTB within 20 days accompanied by Forms 593 and 593-V.

The withholding amount:

- 3 1/3% of each principal payment (initial payment in escrow and each subsequent payment), OR by election,
- The seller's tax rate (12.3% for an individual regardless of what the individual's actual CA tax rate is) times the product of multiplying the principal payment (initial payment in escrow and each subsequent payment) by the gross profit percentage (called the "installment withholding percent" on the worksheet to Form FTB 593).

Buyer's Certification – The buyer is required to complete and sign Form FTB 593-I, acknowledging the installment sale withholding rules and agreeing to transmit to the FTB (with a copy to the seller) a completed Form 593 and the required amount of withholding by the 20th day of the month following the month of each installment payment. The escrow person is required to attach a copy of the signed promissory note and the seller's certification form (Form 593-C) to Form 593-I and submit them to the FTB along with the required withholding on the first installment payment. The buyer must advise the FTB if there are changes to the terms of the sale, promissory note or payment schedule. The buyer is subject to penalties for failing to withhold or submit the withholding timely to FTB or if a copy of the Form 593 is not timely provided to the seller. These penalties are:

- Buyer (after notification) does not withhold – penalty is the greater of $500 or 10% of the required withholding.
- Form 593 filed late – within 30 days of due date, penalty is $15 per Form 593; filed more than 30 days late, penalty is $50 per Form 593; if failure is due to an intentional disregard of the requirement, penalty is the greater of $100 or 10% of the required withholding.

These mandatory withholding rules don't apply for installment sale payments for sales agreements made prior to 2009.

Withholding When a Trust is the Seller – Oftentimes there is confusion as to what name and ID number should be used on Form 593 when real estate subject to withholding is sold by a trust. The FTB says that if the seller is a grantor trust, Form 593 should be completed using the grantor's individual name and taxpayer identification number. The name of the grantor trust should not be entered on Form 593 since the grantor trust is disregarded for tax purposes and the individual seller must report the sale and claim the withholding on their individual tax return. On the other hand, if the seller is a non-grantor trust, Form 593 should be completed using the name of the trust and the trust's FEIN. Trustee information should not be entered on the Form 593, because the withholding credit belongs to the trust.

NOTES

ELECTION TO GROUP ACTIVITIES PURSUANT TO REG. 1.469-4(c)
STATEMENT IN ACCORDANCE WITH REV PROC 2010-13

Taxpayer's name:____ Tax Year Ending:____________

Taxpayer ID Number:___________________________

The taxpayer hereby reports the following activity in accordance with Rev. Proc 2010-13:

NEW GROUPINGS: The following activities have been grouped as a single activity for the first time during the current tax year:

Name of Activity	Address	ID Number (If Applicable)	Type (Business or Rental)

ADDITION OF ACTIVITIES TO AN EXISTING GROUP: The following activities have been added to a previously existing group during the current tax year:

Name of Activity Existing Activities:	Address	ID Number (If Applicable)	Type (Business or Rental)
Activities Added:			

REGROUPING ACTIVITIES: The following activities have been regrouped due to error in original grouping or a change in circumstances during the current tax year:

Revised Grouping: Name of Activity	Address	ID Number (If Applicable)	Type (Business or Rental)

Reasons for regrouping:____

____

____

I, the above referenced taxpayer, hereby declare that any and all groupings created above constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC Sec. 469.

VACATION HOME RENTALS

Overview

- **Rented Fewer than 15 days**
  - Exclude rental income
  - Don't deduct expenses
  - Interest & taxes to Schedule A
- **Rented 15 days or more**
  - **Personal Use 10% or less of the rental days**
    - Allocate expenses between personal and rental
    - Loss is allowed (but loss amount cannot include depreciation)
  - **Personal Use greater than 10% of rental days**
    - Allocate expenses between personal and rental
    - Deduct allocated interest and taxes first
    - Deduct other expenses except depreciation
    - Then deduct depreciation
    - No loss allowed!
- **Room Rental** – Follows vacation home rental rules
- **Personal Use Days** – Do not include "fix-up" days
- **Not a passive activity** – If subject to §280A rules, not subject to §469 rules

RAPID FINDER

Pubs Forms

Related IRC and IRS Publications and Forms

- **Pub 527** – Residential Rental Property (including vacation homes)
- **Pub 551** – Basis of Assets
- **Pub 925** – Passive Activity and At-Risk Rules
- **Form 8582 -** Passive Activity Loss Limitations
- **Schedule E (Form 1040)** – Supplemental Income and Loss
- **IRC Sec 280A**

CAUTION: Special Rules Apply to Short-term Rentals

When a taxpayer rents property for a short period, special (and sometimes complex) taxation rules come into play, which may force the rental income and expenses to be reported on Schedule C (as opposed to Schedule E). Short-term rental situations also occur where taxpayers will rent their first or second homes using rental agents or online rental services, such as Airbnb, VRBO and HomeAway that match property owners with prospective renters. Short-term rentals are covered in the Rental Activities chapter on page 3.17.04.

CAUTION: Renting To Relative

The days when rented to a relative at less than fair market rent are treated as personal use days and result in some very unfavorable tax treatment. See Rental Activities chapter on page 3.17.05.

The Details

VACATION HOME RENTALS

Section **280A** limits property expense deductions for taxpayers who rent out their home part of the year and also use the same property for their own use. The rules apply to ***"dwelling units"*** including homes, apartments, condos, mobile homes, boats, motor homes, etc. For the same year that the rental of a dwelling unit is subject to the limits imposed by Sec. 280A, it is not subject to the Sec 469 loss limitation rules.

DEFINITION OF A "DWELLING UNIT"

For purposes of the vacation home rules, a dwelling unit is property that provides basic living accommodations, including sleeping space, toilet, and cooking facilities. A single structure may contain more than one dwelling unit.

If a taxpayer rents rooms or other space in a home and the rented portion does not have facilities that would make it a dwelling unit on its own, the taxpayer and the renter may be considered to be occupying one dwelling unit, and loss on the rental may be disallowed under §280A. This does not apply to hotel or motel units, etc., regularly available for occupancy by paying customers, but may apply to a portion of a home used to furnish lodging to tourists or to long-term boarders, such as students. See more about "Room Rental" on page 3.18.04.

WHERE REPORTED

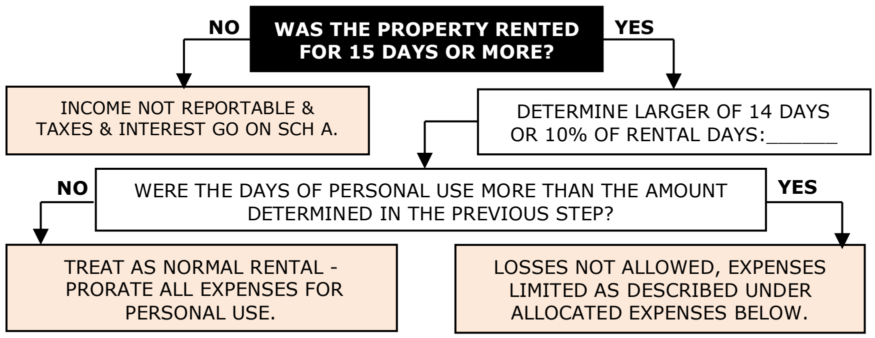
Report income and deductible expenses on Schedule E. Deduct interest, taxes, and personal casualty loss (only disaster losses in federally declared disaster areas for years 2018-2025) expenses attributable to personal use of the property on Schedule A. Worksheet 5-1, Worksheet for Figuring Rental Deductions for a Dwelling Unit Used as a Home, in IRS Pub 527 can be used to determine the allowable expenses and any carryovers of expenses.

APPLYING THE LIMITATIONS

If the "dwelling unit" is rented for fewer than 15 days - exclude the rental income. Claim no deductions (except qualified mortgage interest and taxes).

Strategies

Strategy – Rent 14 days or less – The rule excluding rental income where the home is rented for fewer than 15 days offers some opportunities for substantial tax free income, especially for more expensive homes. Here are some examples:



- **Rental as a film location –** typically film production companies will pay substantial amounts (thousands per day) for the short-term use of properties as a movie set. Individuals with unique properties can register with a local film location company.
- **Home in vacation locale –** individuals with homes in popular tourist or vacation locales can rent their home out while they are on vacation themselves.
- **Home in the area of a special event** – when a one-time or special event such as a major sports event (think the Super Bowl) or convention comes to town, hotel rooms may be scarce or even fill up. Homeowners in these locations may want to rent their homes short-term during the activity while getting out of town to avoid the crowds.

Definition of a day: This is generally "the 24-hour period" for which a day's rental would be paid. Thus, a person using a dwelling unit from Saturday afternoon through the following Saturday morning would generally be treated as having used the unit for seven days, even though the person was on the premises on eight calendar days.

If the unit is rented 15 days or more AND the taxpayer's personal use is for fewer than 15 days or 10% or less of the rental days - allocate expenses according to personal vs. rental days. No further limitation is necessary (except the usual "not-for-profit" rules must be considered). A loss can be claimed.

If taxpayer use is 15 days or more and over 10% of the rental days - first allocate expenses by personal vs. rental days, as in the previous paragraph. Deduct allocable taxes and interest first, then maintenance and other operating expenses, then depreciation until the net is ZERO. A loss cannot be claimed.

CARRYOVER

Any amount of rental expenses not allowable as a deduction because of the income limitations may be carried over to the next tax year, subject to the income limitations of the later year.

PERSONAL-USE DAYS

Include days used by an owner, co-owner or family member of the owner/co-owner or under a reciprocal arrangement as personal-use days. DO NOT include:

- "Fix-up" days (repairing and maintaining but not making improvements);
- Use by a co-owner in a "SHARED-EQUITY FINANCING" arrangement where the taxpayer and occupant both have an ownership interest in the property. The owner-occupant must use the property as a principal residence and PAY FAIR RENTAL VALUE, considering ownership interest. This is a common arrangement where parents wish to help their children buy a home; or
- The use of the property by a FAMILY MEMBER, if the property is the family member's principal residence and the family member pays fair rental value.

> ***Example 1:*** *Lotta Friends and her neighbor, Troodie, co-own a condo at the beach. They rent the unit to vacationers whenever possible. Neither Lotta nor Troodie uses the condo as a principal home; however, Troodie always spends two weeks at the condo during August. Troodie's use is considered personal use by both owners.*

Example 2: *Assume that Lotta and Troodie own the condo under a shared equity agreement. Troodie lives in the condo as her main home and pays fair rental to Lotta for her portion. Under this arrangement, personal use by Troodie is not attributed to Lotta as well. Lotta claims the rental income and expenses on Schedule E in the usual manner. Passive rules apply.*

Example 3: *Assume that Lotta owns the condo separately and rents it to Troodie. Troodie owns a home in the mountains, which she rents to Lotta. On the days Lotta rents the condo to Troodie, she is considered to be using it personally.* ***Reason:*** *She has a reciprocal arrangement with Troodie to rent the mountain cabin.*

ALLOCATING EXPENSES

For repairs, utilities, etc., the business percentage is rental days divided by total days used (i.e., personal plus rental). In ***Bolton v. Comm., 1982, CA9, 694 F2d 556,*** the Tax Court found that, for computing taxes and interest, the business percentage used is business days divided by 365. The portion of interest and taxes above the percentage are deducted as itemized deductions. This method "frees up" greater deductions for cash expenses or depreciation. The IRS, however, says these expenses should be allocated by using the same type of allocation percentage that's used for repairs, etc. (i.e., rental days/total days used).

Exception for principal residence: Personal vs. rental expenses must still be allocated. The overall limit (i.e., "no loss") does not apply if the rental period is at least 12 months, OR the rental period ends in the sale of the residence.

Example - IRS Method of Allocating Vacation Rental Expenses – *Jamie is single and owns a vacation home which she used personally during the month of July. She also rented the house during all of June and August. Rental income was $2,500. Her total expenses for the year were: interest, $1,300; taxes, $700; repairs, $800; utilities, $400; depreciation, $1,300. Because Jamie used the home personally for 31 days out of a total 93 days of use, she is subject to the limitations of §280A, meaning she cannot deduct a loss. Her rental schedule is figured as follows:*

Gross income	*$2,500*	
Taxes and interest (2/3 x $2,000)	*< 1,333>*	
Limit on other deductions		***1,167***
Repairs and utilities (2/3 x $1,200)	*< 800>*	
Subtotal		***367***
Depreciation (2/3 x $1,300)		
Subject to limit	*867*	
Deductible depreciation	*367*	
Carryover ($867 - $367)	*500*	

Example -Tax Court Method of Allocating Vacation Rental Expenses (Bolton) - *Assume the same facts as in the previous example. The Tax Court would figure Jamie's rental schedule like this:*

Gross income	*$2,500*	
Taxes and interest (61/365 x $2,000)	*< 334>*	
Limit on other deductions		***2,166***
Repairs and utilities (2/3 x $1,200)	*< 800>*	
Subtotal		***1,366***
Depreciation (2/3 x $1,300)		
Subject to limit	*867*	
Deductible depreciation	*867*	
Carryover	*0*	

The excess interest and taxes in both the above examples are deductible on Schedule A if Jamie itemizes her deductions.

Rental Days: Rental days are the days actually rented at fair rental value. They do not include days the property is just available for rent or the days it is rented under a reciprocal arrangement.

Fair rental by co-owners: According to ***Prop Regs Sec 1.280A-1(g),*** fair rental by co-owners is "an amount that is equal to the fair rental of the entire unit multiplied by that co-owner's fractional interest in the unit." But elsewhere in the Prop Regs, it is noted that "the totality of rights and obligations of all parties under the agreement is taken into account in determining fair rental." ***(Prop Regs Sec 1.280A-1(e)(3))***

Example - Determining Business vs. Personal Use - *Ted and Tabitha are owners of a fully-equipped recreational vehicle. During the month of July, the vehicle is used by three individuals; all of the usage listed below is deemed personal use by the owners.*

- *Ted used the vehicle on a seven-day trip;*
- *Terri, Tabitha's daughter, rented the vehicle at fair rental for ten days;*
- *Troy rented the vehicle at fair rental for 12 days under an arrangement whereby Tabitha gets to use for nine days, an apartment owned by Troy's friend, Tim.*

Example - Treatment of Maintenance Time - *Lionel owns a lake cottage which he rents during the summer. Lionel and his wife, Leanne, arrived late Thursday evening to prepare the cottage for the rental season. The couple made dinner, but did no work on the unit that evening. Lionel spent normal work days repairing the unit on Friday and Saturday. Leanne helped for a few hours each day, but spent most of the time relaxing. By Saturday evening, the necessary maintenance work was complete. Neither Lionel nor Leanne worked on the unit on Sunday; they departed shortly before noon. The principal purpose of the time spent at the unit from Thursday evening through Sunday morning was to perform maintenance work on the unit. Consequently, the use during this period was not considered personal use.*

ROOM RENTAL

Expenses allocable to a portion of a dwelling unit rented out are deductible under the vacation home rules. The amount of the deductible rental expenses would be the expenses attributable to that portion of the unit. And the days to be taken into account under that limitation rule would be the days on which the portion of the unit is rented at fair rental during the tax year and the days on which the portion of the unit is used for any purpose during the tax year.

Any reasonable method for dividing the expenses may be used. The two most common methods for allocating expenses, such as mortgage interest and heat for the entire house, are based on the number of rooms in the house and square footage of the home.

Example - *Taxpayer's home has 1,800 square feet. He rents out one room that is 180 square feet for the entire tax year. Taxpayer can deduct as a rental expense 10% of any expense that must be divided between rental use and personal use. Thus, if taxpayer's heating bill for the year for the entire house was $600, $60 ($600×10%) is a rental expense and the $540 balance is a nondeductible personal expense. If the home consisted of eight rooms, the taxpayer could presumably deduct 12.5% (one-eighth) of the expenses as rental expenses rather than the 10% that is based on square footage. The expenses that belong only to the rental part of the property, for example painting the room, don't have to be divided.*

If a taxpayer rents rooms or other space in a home and the rented portion does not have facilities (bathroom and kitchen) that would make it a dwelling unit on its own, the taxpayer and the renter may be considered to be occupying one dwelling unit, and any loss on the rental may be disallowed under §280A.

Where a loss is not allowed, the deductions are claimed in the following order. If the result is a loss, the expenses are only allowed until the income is reduced to zero.

1. Mortgage interest and taxes.
2. Operating expenses (examples: repairs, utilities, maintenance, insurance)
3. Depreciation.

Bottom Line: Under these rules if a taxpayer were to rent a bedroom in their home, the income would be reported on Schedule E and the result cannot be a loss. However, the deductions that are not allowable because of the rental income limitation may be carried over to the next tax year and used to offset that year's rental income, subject to the same limitations.

CALIFORNIA DIFFERENCES

California conforms to the Federal treatment.

INSTALLMENT SALES

Overview

- The installment method applies **automatically**
  - Taxpayer must elect out
  - **Election out is irrevocable** without IRS consent
- Depreciation & Sec 179
  - Is ordinary income that recaptures in year of sale
  - Regardless of principal received.
  - Recaptured amounts added to basis to reduce the gross profit %
- **Mortgage assumed** = a mortgage that exists both before and after the sale.
- **Contract Price** = Selling Price less mortgage(s) assumed by the buyer

RAPID FINDER	
Business	03.19.05
Contract Price	03.19.02
Death	03.19.05
Elect Out	03.19.01
Gross Profit %	03.19.02
Install Obligation	03.19.03
Multiple Assets	03.19.04
Recapture	03.19.03
Sec 179	03.19.03
Taken Subject To	03.19.01
Worksheet	03.19.06
Wraparound Mtg	03.19.03

- **Gross Profit Percentage** = $\dfrac{\textbf{Profit}}{\textbf{Contract price}}$

Pubs

Forms

IRC and Related IRS Publications and Forms

- **Pub 537** – Installment Sales
- **Pub 544** – Sales and Other Disposition of Assets
- **Pub 551** – Basis of Assets
- **Form 4797** – Sales of Business Property
- **Form 6252** – Installment Sale Income
- **Form 8949** – Sales and Other Dispositions of Capital Assets
- **IRC Sec 453**

The Details

Installment sales are those in which part or the entire selling price is paid to the seller after the year of the sale. The installment method may be used to report gains, but not losses. Generally, gains are reported as the payments are received. Part of each principal payment is return of the seller's capital and part is profit. The seller pays tax only on the profit portion. However, recognition of gain may be accelerated by the recapture of "excess" depreciation. In addition, installment sale contracts generally require that interest be paid by the buyer to the seller on the deferred payments. This interest is reported on the seller's Schedule B (1040) as payments are received. If the sale contract does not provide for adequate stated interest, part of the stated principal amount of the contract may be restated as interest. See IRS Pub 537 for additional information on unstated interest.

The installment method applies automatically, unless the taxpayer elects out of it by the (extended) due date of the return for the year of sale. The election is made by reporting the whole gain on the sale and, if applicable, showing the amount of a note reported at less than face value on Form 8949 or Form 4797. (Form 6252 is not used if electing out of the installment method.) ***The election out is irrevocable without showing "good cause" and getting IRS consent.***

Rev Rul 90-46 1990-1 CB 107 provides guidelines which taxpayers can use to justify a late election out of the installment method. Error on the part of a third party might be enough to show "good cause." For example, an accountant's mistake in failing to make the election may be good cause. The following, however, do not show good cause: (1) making the late election to simplify the taxpayer's recordkeeping and reporting requirements; (2) changes in the tax law or taxpayer's circumstances after the election due date.

Revocation Allowed - In a private letter ruling, taxpayers were allowed to revoke their election out of using the installment method, where their accountant had erroneously computed that the installment method would not be beneficial to them. The taxpayers were unaware of the accountant's actions, and the accountant only realized the error when he prepared their second-year return. (PLR 201503005)

Revolving credit plans, publicly-traded property & dealer dispositions - Revolving credit plan sales and sales of certain publicly-traded property (e.g., stock) cannot be reported on the installment basis. Also excluded from installment reporting are dealer dispositions of real or personal property. However, dispositions of property used in the business of farming and dispositions of residential lots or timeshares where the taxpayer elects to pay interest on the deferred tax arising from the use of the installment method are allowed.

Computation of the taxable amount: Form 6252 is used to compute the total gain and the gross profit percentage. Most of the information needed for computing the gain can be found on the closing statement. The taxable amount of the installment sale for the year transfers from Form 6252 to Schedule D – not Form 8949 – (for personal-use capital assets) or Form 4797 (for property used in a trade or business or that earns rent or royalty income).

Definitions:

- **Mortgage assumed or "taken subject to"** is a mortgage that exists both before and after the sale. It does not include the buyer's new mortgage or a second given by the seller, nor does it include the seller's mortgage paid off in escrow.

- **Principal received in the year of sale**:
  1. The down payment equals the selling price less amounts remaining to be paid, such as the assumed mortgage or note carried by the seller. This figure may not appear on the closing statement, but may have to be "backed into";
  2. Principal part of later payments;
  3. Payments received before the year of sale, e.g., in an option arrangement;
  4. Selling expenses paid by the buyer that relate to the property that was sold. These expenses are included in the selling and contract prices when figuring the gross profit percentage.
- **Contract price** is the selling price less any mortgage assumed (but not any amount of mortgage in excess of basis). In effect, this is the amount that will be paid to the seller.
- **Gross profit percentage** is equal to the profit divided by the contract price. The percentage is used to determine the part of each principal payment that will be taxable.

INSTALLMENT SALE COMPUTATIONS

In each of the sales for the following examples, adequate stated interest was included in the contract and will be reported by the seller in addition to the reportable gain.

Example (1)* - *The Basic Computation - *Agreement of sale is for $20,000 down, plus a note to seller for $80,000 = $100,000 total selling price. Adjusted basis of property sold is $70,000.*

Selling price	*$100,000*
Basis	*<70,000>*
Gain	*30,000*

Contract price *equals the selling price, because no mortgage was assumed.*
Gross profit percentage *= $30,000/$100,000 = 30%.*
Taxable in the year of sale*, if $1,000 principal is received in addition to the $20,000 down payment = $6,300 ($21,000 x 30%).*
Taxable in subsequent years *- As the seller gradually receives the remaining $79,000 in principal ($80,000 - $1,000), 30% of each payment is taxable.*
The total gain reported *will be $30,000 ($6,300 in the year of sale plus $79,000 x 30%).*

Example (2)* - *Installment Sale with Mortgage Assumed - *Agreement is for $65,000 down, $85,000 note to seller, plus $50,000 mortgage assumed = $200,000. Adjusted basis of the property sold is $80,000.*

Selling price	*$200,000*
Basis	*<80,000>*
Gain	*120,000*

Contract price *is $150,000 ($200,000 selling price, less $50,000 mortgage assumed).*
Gross profit percentage *= $120,000/$150,000 = 80%.*
Taxable in the year of sale, *if seller receives a $65,000 down payment and an additional $2,000 in installment principal payments = $53,600 ($67,000 x .80).*
Proof: *The seller receives a total of $150,000 (the other $50,000 goes to the lender, because of the assumed mortgage); $150,000 x .80 = $120,000 (the gain).*

Example (3)* - *Installment Sale with Mortgage Assumed Greater Than Basis - *Terms: $25,000 down + seller's $50,000 mortgage assumed by the buyer; $45,000 note to the seller = $120,000. Adjusted basis of the property sold is $40,000, so the mortgage assumed exceeds basis by $10,000.*

Selling price	*$120,000*
Basis	*<40,000>*
Gain	*80,000*

The $10,000 excess of mortgage over basis is treated as a PAYMENT IN THE YEAR OF SALE*. (The reasoning is that the seller realized a profit when the loan was received and must recognize it now at the time of the sale.)* ***The excess of mortgage over basis*** *is ADDED TO THE CONTRACT PRICE.*

Contract price:	*Selling price*	*$120,000*
	Less mortgage assumed	*<50,000>*
	Plus excess mortgage over basis	*10,000*
	Contract price	*80,000*

Gross profit percentage *= 100%.* ***Rule of thumb:*** *Profit % is always 100% when a mortgage assumed (or subject to) is equal to or greater than basis.*
Taxable first year*: $25,000 down payment; $1,000 principal payments; $10,000 excess mortgage over basis = $36,000 x 100% = $36,000 taxable.*
Proof*:* The seller will receive a total of only $70,000 ($25,000 down, plus $45,000 note), which is 100% taxable; taxing excess mortgage of $10,000 in year of sale means that the total $80,000 gain will be reported.

EXAMPLE (4)** - **Installment Sale with Expense of Sale and Excess Mortgage
Agreement for $30,000 down + $104,500 mortgage assumed + $15,500 note to seller = $150,000.
Adjusted basis of property sold is $90,000.

Selling price	*$150,000*
Basis	*<90,000>*
Expense of sale	*<7,500>*
Gain	*52,500*

Expenses of sale increase basis and reduce gain, profit percentage, and excess mortgage. They do not decrease the selling price or principal received.

***Contract price**:*	*Selling price*	*$150,000*
	Mortgage assumed	*<104,500>*
	Excess mortgage over basis	*7,000 (basis = $97,500 for this)*
	Contract price	*52,500*

***Gross profit percentage**: 100% ($52,500 gain/$52,500 contract price = 100%).*
***First year:** $30,000 + $1,500 principal payment + $7,000 excess mortgage over basis = $38,500.*
***PROOF:** The seller will receive a total of $45,500, 100% taxable. Add $7,000 (excess mortgage over basis) in the year of sale = $52,500 gain.*

WRAPAROUND MORTGAGES

A Tax Court decision from the Ninth Circuit (Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington) held invalid the treatment of wraparound calculations as outlined in Reg. 15A.453-1(b). [Professional Equities, Inc., (1987) 89 TC No. 15.] The regs treat the wraparound mortgage as a mortgage assumed and require two calculations of profit percentage--one in the year of sale and another in later years. In Professional Equities, the Court allowed computation of the installment sale (which included wrapped mortgages) according to the old method followed in Stonecrest v. Comm. 24 TC 659. In the Stonecrest case, the wrapped mortgage was not considered a mortgage assumed or taken subject to by the buyer. Vincent E. Webb, TC Memo 1987-451 also followed these decisions. The IRS has acquiesced to the findings in the Professional Equities case.

DEPRECIATION/SECTION 179 RECAPTURE UNDER THE INSTALLMENT METHOD

ALL ORDINARY INCOME DUE TO RECAPTURE IS RECOGNIZED IN THE YEAR OF SALE, regardless of the amount of principal received. Basis of the property is then increased by the amount of ordinary income reported, and a new, lower profit percentage is computed for later years.

***EXAMPLE** - **Installment Sale with Depreciation Recapture -** Bob sold a rental property. The adjusted basis of the property was $35,000 (sales price was $50,000). Bob used the installment method of reporting; his profit percentage would be 30% were it not for the depreciation recapture.*

Sales price	*$50,000*
Adjusted basis	*<35,000>*
Gain	*15,000*

$2,000 of the profit is ordinary income, representing "excess" depreciation; $13,000 is Section 1231 capital gain.

***Year of sale:** Ordinary income required to be reported*	*$2,000*	
Balance of gain	*13,000*	
Contract price	*50,000*	
Profit percentage ($13,000/$50,000)	*26 %*	
Principal received	*2,500*	
Taxable portion (26% of $2,500)	*650*	
Total taxable in year of sale ($2,000 ordinary, plus $650 Section 1231)	2,650	
Gain yet to be reported ($15,000 - $2,650)	$12,350	**(A)**
Later years:		
Principal yet to be received	*$47,500*	
Profit percentage	*26 %*	
Profit yet to be reported	*$12,350*	***(B)***

Since (A) = (B), the computation proves accurate. All gain reported in future years will be ***§1231*** (potentially capital) gain.

SEC 179 EXPENSE ELECTION AND INSTALLMENT REPORTING

The Sec 179 amount that was deducted (but not more than the total gain on the sale) is ordinary income in the year of sale, regardless of the date of the sale and regardless of the amount of principal actually received in that year. Add Section 179 deduction back to the adjusted basis in figuring profit percentage (§453(i)).

DISPOSITIONS OF INSTALLMENT OBLIGATIONS

When an installment obligation is disposed of before all gain from the underlying installment sale has been recognized, the seller must usually recognize gain/loss because of the disposition. A disposition can result from any of the following transactions: a sale, exchange, debt cancellation, or bequest, among other possibilities. The character of the gain or loss from the disposition of the obligation is the same as the character of the gain on the original installment sale.

If an installment obligation is sold or exchanged, or if the holder of the obligation accepts less than face value for it, the gain or loss on the transaction is the difference between the basis of the obligation and the amount realized on the disposition. If the obligation is disposed of in any other kind of transaction, the gain or loss is the difference between the holder's basis in the obligation and the FMV of the obligation.

Example* - *Installment Obligation Sale - *Chris sold an investment lot on the installment method. Original sales information is as follows (the only payment received in sale year is the down payment):*

Selling price	*$250,000*
Adjusted basis	*<100,000>*
Gain on sale	*150,000*
Down payment	*50,000*
Note held by Chris	*200,000*
Profit percentage ($150,000/$250,000)	*60%*
Gain recognized in sale year	*30,000*

Unrecovered Cost: *Chris had received no principal payments on the note when he sold it the next year for $180,000. His unrecovered cost in the note is:*

Face value of note	*$200,000*
Gain, if note pd in full ($200,000 X 60%)	*<120,000>*
Unrecovered cost	*80,000*

Gain on sale of note:

Sales price of note	*180,000*
Unrecovered cost	*< 80,000>*
Gain recognized	*100,000*

PROOF: *Total gain recognized was $130,000 ($30,000 in year of sale and $100,000 at sale of the note). In effect, the sale of the note resulted in a reduced selling price of $230,000 for the property; the gain on the property is now $130,000 ($230,000 - $100,000). The gain on the sale of the note is a capital gain, because the gain on the original sale was capital.*

INSTALLMENT SALES OF MULTIPLE ASSETS IN ONE TRANSACTION

The sale of unrelated assets of the same type in a single sale contract is reported as one transaction under the installment method. If any of the assets are sold at a loss, however, those items cannot be reported under the installment method and therefore must be reported separately; the remaining assets are reported together. In order to figure the gain/loss on each asset, the seller must allocate payments received among the various classes of assets sold. The allocation is computed using the ratio of each asset's FMV to the total selling price less mortgage assumed.

If the assets are mortgaged and the mortgage is assumed or the asset taken subject to it by the buyer, use the FMV of each asset, net of mortgages assumed or taken subject to, in order to make the allocation.

Example* - *Multiple Asset Installment Sale - *Ray sold three unrelated investment lots (Lots 1, 2, and 3) for a combined selling price of $130,000. The closing statement did not individually list the amount of the selling price which was to be allocated to each lot. However, an appraisal determined that the FMV of Lots 1 and 2 was $60,000 each. The FMV of Lot 3 was $10,000. Ray's basis in each lot was $15,000; he had owned the lots for five years.*

Under the terms of the sale, the buyer paid $20,000 in cash, assumed Ray's mortgage of $30,000 on Lot 2, and gave Ray a note for the remainder ($80,000).

Since Ray's sale of Lot 3 results in a loss ($15,000 basis less $10,000 sales price), it cannot be reported on the installment method. Ray will report a long-term capital loss of $5,000 on Form 8949 of his tax return. Ray reports the sale of the other two parcels using the installment method. However, he must allocate the portion of the down payment attributable to the sale of Lots 1 and 2 in order to compute the installment sale accurately. The computation is as follows:

	Lots 1 & 2	***Lot 3***	***Total***
1. FMV	*$120,000*	*$10,000*	*$130,000*
2. Less mortgage assumed	*30,000*	*0*	*30,000*
3. Total net FMV	*90,000*	*10,000*	*100,000*
4. % of total net FMV	*90 %*	*10 %*	*100 %*
Proportion of payments:			
5. $20,000 x 90%	*18,000 (a)*		*18,000 (a)*
6. $20,000 x 10%		*2,000 (a)*	*2,000 (a)*
7. Excess of mortgage over basis on Lot 2	*15,000 (b)*	*0 (b)*	*15,000 (b)*
8. Allocation of payments in year of sale (a + b)	*33,000*	*2,000*	*35,000*

INSTALLMENT SALE OF A BUSINESS

A sale of a sole proprietorship usually involves the sale of a number of assets. The transaction is not treated the same as the sale of multiple assets using a single contract. The business assets must be categorized by property type--i.e., inventory, Section 1245 property, Section 1250 property, goodwill, etc. Separate calculations may be required to determine the gain or loss for each asset sold. Certain kinds of property, such as inventory, do not qualify for installment method reporting. Thus, allocations are necessary.

Example - Business Installment Sale *- Glen sold for $220,000, a machine shop which he had operated for several years. He received a down payment of $100,000 from the buyer and the buyer's note for $120,000; no mortgage was assumed by the buyer. Note payments were $30,000. Selling expenses were $11,000. The following assets were included in the sale:*

Asset	***FMV***	***Depr Claimed***	***Adj. Basis***
Land	*$90,000*	*0*	*$51,000*
Inventory	*10,000*	*0*	*8,000*
Machine X	*71,000*	*$27,200*	*63,800*
Truck	*6,500*	*18,624*	*5,376*
Machine Y	*24,000*	*12,960*	*22,040*
Goodwill	*18,500*	*0*	*0*
Total	*$220,000*	*$58,784*	*$150,216*

Compute the gain/loss on each asset as shown in the following example. First, reduce the selling price of each asset by an allocable portion of the selling expenses. Since the selling expenses represent 5% of the selling price ($11,000/$220,000), the allocation of these expenses is calculated by multiplying the FMV of each asset by 5%.

Asset	***Sale Pr***	***Sale Exp***	***Adj Basis***	***Gain***
Land	*$90,000*	*$4,500*	*$51,000*	*$34,500*
Inventory	*10,000*	*500*	*8,000*	*1,500*
Machine X	*71,000*	*3,550*	*63,800*	*3,650*
Truck	*6,500*	*325*	*5,376*	*799*
Machine Y	*24,000*	*1,200*	*22,040*	*760*
Goodwill	*18,500*	*925*	*0*	*17,575*
Total	*$220,000*	*$11,000*	*$150,216*	*$58,784*

The machines and truck are Section 1245 property; all of the gain from these assets is due to depreciation recapture. The $5,209 gain ($3,650, $799, $760) will be reported on Form 4797, Part II as ordinary income. The 1245 property will not be included in the installment sale computation.

Because inventory cannot be sold on the installment method, the $10,000 received from the sale is shown as ordinary income on Schedule C. The expense of sale allocated to the inventory sale ($500) will be deducted as a business expense. The $8,000 basis of the inventory is accounted for automatically in the cost of goods sold on Schedule C (i.e., the ending inventory of the business is zero and the cost of goods sold deduction increases). The remaining items involved in the sale (land and goodwill) are reported on the installment basis. The gross profit percentage is computed for each of these assets by dividing its portion of the gross profit by $108,500, the total contract price attributable to the two assets ($90,000 + $18,500).

Land ($34,500/$108,500)	*31.7972 %*
Goodwill ($17,575/$108,500)	*16.1982 %*

The sales of these assets are reported on Forms 6252 and Schedule D of Glen's tax return.

Glen must report all ordinary income in the year of sale. The down payment must first be allocated to the inventory ($10,000). The remaining down payment ($90,000) will be allocated to the assets which generate ordinary income (2 machines and truck), since the total selling prices of these three items exceed $90,000 ($71,000 + $6,500 + $24,000 = $101,500). In addition, $11,500 of the $30,000 note payments received in the year of sale is allocated to these three assets ($90,000 + $11,500 = $101,500). The remaining $18,500 from the note payments ($30,000 - $11,500) is used to compute the installment sale income.

Land (31.7972% x $18,500)	*$5,883*
Goodwill (16.1982% x $18,500)	*2,997*
Total	*$8,880*

PROOF: *Total gain on the transaction is $58,784. In the first year, gain of $1,500 is reported from the sale of inventory, $5,209 ordinary income from the sale of the truck and the machines is reported on Form 4797, $8,880 from the sale of the land and goodwill is reported as capital gain (Forms 6252 and Schedule D). In subsequent years, the taxpayer will report $28,617 gain from the sale of the land ($90,000 remainder to be paid on the note x 31.7972%) and $14,578 from the sale of goodwill ($90,000 remainder to be paid on the note x 16.1982%). Total gain reported: $1,500 + $5,209 + $8,880 + $28,617 + $14,578 = $58,784.*

Transfer due to death - The transfer of an installment obligation (other than to a buyer) as a result of the death of the seller is not a disposition. Any unreported gain from the installment obligation is not treated as gross income to the decedent. No income is reported on the decedent's return due to the transfer. Whoever receives the installment obligation as a result of the seller's death is taxed on the installment payments the same as the seller would have been had the seller lived to receive the payments. (Reg. Sec. 1.1451-1(b)(2))

CALIFORNIA DIFFERENCES

Real property sold in California may be subject to income tax withholding - see Chapter 3.17. California conforms to the Federal installment sale computation, except that the basis may not be the same, because different depreciation methods were used or because of differences in Federal and California Sec. 179 limitations. In that situation, use two worksheets – one for federal and one for CA.

INSTALLMENT SALES WORKSHEET

(This Worksheet is not a substitute for Form 6252)

SPECIAL INSTRUCTIONS - Complete parts I through IV in the year of sale. Complete only line 16 and part IV in later years.

GENERAL:

1. Description of Property:____

2a. Date property acquired…………………………………………………………… ____/____/____

2b. Date of sale………………………………………………………………………… ____/____/____

3. ❑ ***Check if property on line 1 is a principal residence. (Be sure to complete line 11.)***

I. BASIS OF PROPERTY SOLD:

4. Cost or other basis of property sold……………………………………. __________

5. Depreciation allowed or allowable………………………………………. __________

6. Adjusted basis - line 4 less line 5, but not less than zero………………………………..__________

II. GROSS PROFIT COMPUTATION:

7. Sales price……………………………………………………………………………… __________

8. Expenses of sale………………………………………..…… __________

9. Income recapture……………………………………………... __________

10. Recalculated basis - sum of lines 6, 8, and 9……………………….… __________

11. If line 3 is checked, enter amount of Sec 121 excluded gain… __________

12. GROSS PROFIT - line 7 less total of lines 10 & 11…………………….………………….. __________

III. CONTRACT PRICE & GROSS PROFIT PERCENTAGE COMPUTATION:

13. Mortgage assumed or taken subject to on property sold……… __________

14. Mortgage over basis adjustment - line 13 less line 10
    - but not less than zero………………………………………..………. __________

15. CONTRACT PRICE - line 7 less sum of lines 13 & 14…………….. __________

16. GROSS PROFIT % - line 12 divided by line 15……………………………………………. __________

IV. REPORTABLE INCOME:

17. Principal payments received during the year……………………… __________

18. Total reportable income - sum of lines 14 and 17…………..…….. __________

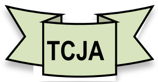
19a. Installment sale income - line 18 times line 16…………….……………………………….. __________

19b. Amount on line 19a that is ordinary income recapture (to 4797)................. __________

19c. Capital gain (to Schedule D or 4797) - line 19a less 19b...………................. __________

CAUTION - special rules apply to installment sales between related parties. Consult IRC 453A and Publication 537 for additional information about these rules.

TAX-DEFERRED EXCHANGES



Only Real Estate Qualifies for Years After 2017 – Prior to the TCJA both personal and real property used in a trade or business or for investment were eligible for the provisions of IRC Sec 1031. In light of the TCJA expanded expensing provisions for personal property and certain building improvements, Congress felt there was no need for Sec 1031 to apply to anything other than real property.

Thus after 2017, TCJA (except for a transition rule) limits the application of Sec 1031 to real property. The references in this chapter to property other than real estate apply only to transactions completed before 2018 or may continue to apply for some states.

Transition Rule - The provision generally applies to exchanges completed after December 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.

Code Section 1031 allows non-recognition of gain or loss when taxpayers trade properties of like-kind that are used for business or investment.

Qualifications:

- **Both** the property given and received must be **held for business or investment** purposes.
- The property **cannot be merchandise held for sale to customers** (i.e., inventory, raw materials and accounts receivable).
- The properties exchanged **must be like-kind** (similar in nature, but not necessarily of the same quality).
  - **Real estate must be exchanged for real estate** (improved or unimproved)
  - **Animals*** - exchanges of animals of different sexes don't qualify.
  - **Depreciable tangible personal property*** must be exchanged for property of "like-kind or class."
  - **Vehicles*** - Cars, Light Trucks, SUVs & Minivans are like kind (PLR 200912004)
  - **Mixed Use Property** – business portion can qualify (Rev. Proc. 2005-14)

  *Not eligible after 2017

Special Circumstances:

- **Vacation Home Rentals** may qualify
- **Water Rights Stock** – Not eligible beginning 2018

Mandatory if qualified: Section 1031 treatment is not elective. It is mandatory if qualified.

Delayed Exchange:

- Transaction must be completed through a **qualified intermediary**.
- Property to be received in the exchange must be **identified within 45 days**.
- Taxpayer is allowed to **designate a maximum of either**:
  - (a) **Three replacement properties** regardless of FMV; or
  - (b) **Any number** of properties, as long as the **total FMV isn't more than 200%** of the total FMV of all properties given up.
- Receipt of the new property must be completed before the **EARLIER** of:
  - (1) **180 days** after the transfer of the property given, OR
  - (2) The due date (including extensions) of the return for the year in which the property given was transferred.

Reverse Exchange

- Replacement Property is acquired by an exchange accommodation title holder (EAT)
- Property to be exchanged must be **identified within 45 days**.
  - Within 180 days of acquiring replacement properties and after identifying the relinquished property, the title to the replacement property must be transferred to the taxpayer.
  - Within 180 days of acquiring replacement properties, the relinquished property must be sold.

Related IRS Publications and Forms

- **Pub 544 -** Sales or Other Dispositions of Assets
- **Form 8824 –** Like-Kind Exchanges
- **IRC Sec 1031**

CONDITIONS NEEDED TO PRODUCE A TAX-DEFERRED EXCHANGE:

Business-Investment Property - Both the property given and the property received must be held for business or investment purposes.

No Inventory - The property cannot be merchandise held for sale to customers (i.e., inventory, raw materials and accounts receivable).

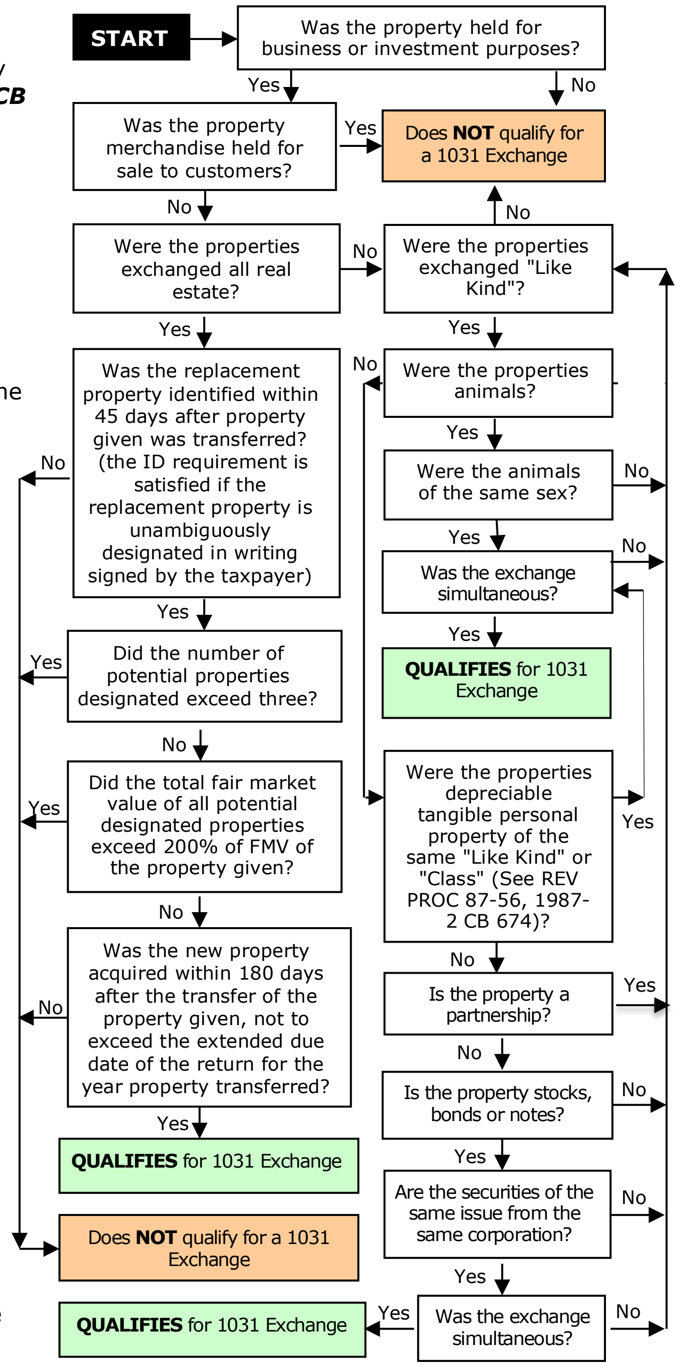
Like-Kind - The properties exchanged must be like-kind (similar in nature, but not necessarily of the same quality). Real estate must be exchanged for real estate. Real estate includes: residential, commercial, storage buildings, warehouses, land, manufacturing plants (improved or unimproved qualifies). For exchanges before 2018, exchanges of animals of different sexes don't qualify, and depreciable tangible personal property could only be exchanged for property of "like-kind or class" as outlined in ***Rev Proc 87-56, 1987-2 CB 674.***

Property NOT considered like-kind:

- Inventory
- Partnership Interests
- Stocks & Bonds
- Goodwill

Section 1031 Qualification Flow Chart

Note: Chart apples to real estate for all year and other property prior to 2018. Chart assumes that: (1) the property acquired is not solely acquired with the intent to exchange it for like-kind property, and (2) the property is exchanged with the sole intent to use the acquired property for business or investment purposes.



SIMULTANEOUS OR DELAYED:

Replacement Property Identified - An exchange can be simultaneous or delayed. If delayed, the property received in the exchange must be identified within **45 days** after the property given is transferred. The identification requirement is met if replacement property is unambiguously (clearly) designated in a written agreement or document signed by the taxpayer. Designation by street address or legal description of real property is considered unambiguous. The identification document must be hand delivered, mailed, faxed, etc., before the end of the identification period.

No matter how many properties are given up in an exchange, a taxpayer is allowed to designate a maximum of either:

- **Three replacement properties** regardless of FMV; or
- **Any number of replacement properties**, as long as the total **FMV isn't more than 200%** of the total FMV of all properties given up.

If a taxpayer identifies replacement properties over these limits, he/she is treated as if none were identified. A taxpayer can, however, revoke an identification at any time before the end of the 45-day time period.

The designated property does not need to exist at the time the relinquished property is transferred. However, the new property must still be unambiguously designated in writing to all involved parties and all time requirements must be met as to receipt of the new property (180-day requirement next).

Replacement Property Received - In a delayed exchange, the receipt of the replacement property must be completed before the **EARLIER** of:

- **180 days** after the transfer of the property given, OR
- **The return due date** (including extensions) of the return for the year in which the property given was transferred.

FOREIGN EXCHANGE LIMITATIONS:

- **Real Property –** Real property in the U.S. and real property located outside of the U.S. are not like-kind property. IRC § 1031(h)
- **Personal Property Predominant Use Requirement** (pre-2018) - Personal property used "predominantly" within the U.S. and personal property used "predominantly" outside the U.S. are not like-kind property (Sec 1031(h)(2)(A). To determine predominant use, a time-based test applies:
  - For the property given in the exchange, it's the two-year period ending on the date of giving up the old property (Sec 1031(h)(2)(B)(i)).
  - For property received in the exchange, it's the two-year period beginning on the date of acquiring the new property (Sec 1031(h)(2)(B)(ii)).

  Thus, to meet the "predominant" test, property received in the exchange must continue in the same use (i.e., foreign or domestic) for the 24 months immediately after the exchange. Alternatively, the property given in the exchange must have been in the same use (i.e., foreign or domestic) for the 24 months just before the exchange.

Except in the case of an exchange structured to avoid these rules, only the periods the property was held by the person giving up a property (or any related person) are used to figure predominant use of the property given. The same rule applies for the property acquired. Thus, the 24-month period is reduced to the actual time a taxpayer held (holds) the property, unless the shorter time is a result of a transaction structured to avoid this rule.

POSTPONEMENTS DUE TO WAR OR DISASTER:

Rev. Proc. 2007-56 provides the most current list of time-sensitive acts that may be postponed under Code Sections 7508 and 7508A for:

- Individuals serving in the armed forces in a combat zone,
- Individuals serving in support of combat zone armed forces, or
- For taxpayers affected by a presidentially declared disaster area.

Those time-sensitive acts include certain Code Sec. 1031 like-kind exchange requirements. With respect to Sec 1031, the postponements affect the:

- 45-day identification period.
- 180-day exchange period limitation.
- Last day of a period described under the QEAA requirements that fall on or after the date of a presidentially declared disaster.

Under these modifications, the respective acts are postponed by the later of:

- 120 days, or
- The last day of the general disaster extension period authorized by the IRS.

However, in no event may a postponement period extend beyond: (a) the due date (including extensions) of the taxpayer's tax return for the year of the transfer (See Treas. Reg. § 1.1031(k)-1(b)(2)); or (b) one year (See IRC § 7508A(a)).

Note: While Rev. Proc. 2007-56 lists the acts which may be postponed, actual postponement generally will be published as an IRS notice, news release or other guidance relating to a specific disaster. (Reg. §301.7501A-1(e)).

RELATED-PARTY EXCHANGES:

(1) When related parties exchange property, gain or loss must be recognized if either party disposes of the property acquired within **two years** of completion of the exchange.

(2) The related party rule does not apply if, within the two-year window, a post-exchange disposition occurs:
- After the death of either related party, **or**
- As a result of an involuntary conversion, **or**
- When income tax avoidance is not a factor.

MULTI-PARTY EXCHANGES:

Two-party exchanges are usually not feasible in reality. Seldom does Seller have the exact property Buyer wants, and vice versa. Complicated multi-party exchanges have become increasingly common.

In order to avoid pitfalls, structuring such exchanges generally requires assistance from experts (which can be expensive). Exchanges are often structured using one of a number of possible formats: e.g., escrow accounts, trusts, and qualified intermediaries. Safe harbor rules outline arrangements that are sanctioned under Section 1031.

The following examples illustrate possible structuring of multi-party exchange transactions, which qualify for Section 1031 treatment:

Example 1 - Multi-Party Exchange - *Tony wants to exchange an investment lot to avoid paying tax on the sizable gain he would have if he sold it. He hopes to replace the lot with a rental property owned by Teresa. Unfortunately, Teresa needs cash and prefers a sale to an exchange. In the meantime, Ted offers to buy Tony's lot for cash.* ***Possible solution:*** *Ted could buy the rental from Teresa and exchange it with Tony for the lot. This would satisfy all parties involved: Ted would have the lot, Tony would accomplish his exchange, and Teresa would have the cash from the sale of the rental.*

Example 2 - Exchange vs. Outright Sale - *Tony owns a duplex, which he wants to exchange for 5 lots owned by Clarence. Pete wants to buy the duplex. Bob acts as accommodator in the exchange transaction. To effect the exchange, Bob sets up a number of escrow agreements, providing for simultaneous transactions in which he:*

(1) Buys the 5 lots held by Clarence.
(2) Exchanges the lots with Tony for the duplex.
(3) Sells the duplex to Pete.

Each transaction is contingent on the successful closing of the others. The cash placed in escrow is earmarked for the acquisition of the 5 lots; and the agreements do not allow Tony access to the cash at any time.

Example 2 is based on Barker (1980) 74 TC 555 in which IRS claimed that Barker's transactions were simply a sale and repurchase and the gain on the sale was taxable. The Tax Court overruled, stating that the transfers of the lots for the duplex were mutually dependent transactions and could not be separated.

SAFE HARBOR RULES:

Four safe harbors have been created to prevent the disputes about actual/constructive receipt of cash and the use of qualified agents in tax-deferred exchange transactions (Preamble to TC 8346, 04/25/91). These safe harbors ensure that an exchange qualifies for nonrecognition.

(1) ***Security or guarantee arrangements -*** Taxpayers use guarantee/security arrangements in deferred exchanges to guard against a transferee's failure to transfer like-kind property. In such arrangements, taxpayers aren't treated as actually or constructively receiving cash or nonqualified property in an exchange when they secure the obligation of the transferee to provide replacement property with:

- A mortgage or similar security interest;
- A standby letter of credit which isn't treated as a "payment" under the installment sale rules and which can't be drawn on unless the obligation transferee fails to transfer the replacement property; or
- A third party's guarantee.

A security agreement that gives a taxpayer an ***unrestricted right*** to receive cash or other property does not qualify as a safe harbor.

(2) ***Qualified escrow accounts and trusts -*** Under this arrangement, a taxpayer isn't treated as actually or constructively receiving cash or property when the obligation of the transferee is (or may be) secured by cash (or equivalent) held in a qualified escrow or trust account. The escrow accountholder cannot be the taxpayer, and the agreement must limit the taxpayer's right to receive cash from the account (through borrowing or otherwise).

Example - Safe Harbor Escrow Account - *Larry and Laura agree to a deferred exchange, with Larry transferring his rental property with no mortgage to Laura. The FMV of the property is $110,000 and its adjusted basis is $50,000. The agreement requires Laura to purchase a replacement rental property and transfer it to Larry. On 6/15/19, Larry transfers his rental to Laura and identifies the property he wants as a replacement. Laura pays $10,000 to Larry at that time and deposits $100,000 in an escrow account as security for her obligation to purchase the replacement rental.*

The escrow provides that Larry can't have access to the escrow funds before 12/13/19 unless he:

a. Doesn't identify the replacement property within the 45-day period; or
b. Identifies and receives the replacement property before the end of the 180-day period.

Under these circumstances, Larry is not considered to have constructively received the funds at the time they are deposited in the escrow account. However, the $10,000, which he received from Laura in cash, is considered boot.

(3) ***Qualified intermediary -*** The law also provides a safe harbor when an exchange is set up using an intermediary to effect the transfer of property. The rules apply to both simultaneous and deferred exchanges. An <u>unqualified</u> intermediary can negate the exchange.

A "qualified intermediary" is one (can't be the taxpayer or a "disqualified party") who has a written agreement with the taxpayer, which calls for the intermediary to acquire and transfer both the property given and received in the exchange. Generally, the intermediary gets legal title to the property. A qualified intermediary can't be the taxpayer or a party related to the taxpayer (as defined in *§267(b)* or *§707(b),* but regarding controlling interests, substitute the words "more than 10%" wherever the words "more than 50%" appear).

Bankrupt Qualified Intermediary **-** A taxpayer who in good faith sought to complete a Sec 1031 exchange using a Qualified Intermediary (QI), but who failed to do so because the QI defaulted on the exchange agreement and became subject to a bankruptcy or receivership proceeding does not have to recognize gain from the failed exchange until the taxable year in which the taxpayer receives a payment attributable to the relinquished property. (Rev. Proc. 2010-4)

(4) ***Interest and growth factors -*** Taxpayers are often entitled to receive a growth factor (really another name for interest) on cash or property involved in a deferred exchange; the amount depends on the length of time between relinquishment of the old property and receipt of the new one. The growth factor amount must be included in income according to the taxpayer's method of accounting. The exchange agreement must limit a taxpayer's right to receive the growth amount.

BASIS OF THE NEW PROPERTY EQUALS

A. The adjusted basis of the old property **LESS** cash and/or unlike property received

B. **PLUS** cash and/or unlike property given, and any gain recognized (taxable).

HOLDING PERIOD

The holding period of the new property includes the holding period of the property given.

DEPRECIATING MACRS PROPERTY ACQUIRED IN A LIKE-KIND EXCHANGE

The replacement property, for depreciation purposes, is divided into the depreciable exchanged basis (i.e., remaining basis of the relinquished property carried over to the replacement property), and the depreciable excess basis (i.e., additional consideration to acquire the replacement property).

- **Where the exchanged properties share the same recovery class and depreciation method** - the depreciable exchanged basis is written off over what's left of the relinquished property's recovery period; and the depreciable excess basis is in effect treated as a separate property with a recovery period that begins anew. This is sometimes referred to as the split basis approach.

  Electing out of the split basis approach - A taxpayer may elect not to apply the "split basis" approach. If the election is made, the exchanged basis and excess basis, if any, in the replacement property are treated as placed in service at the time of replacement and the adjusted depreciable basis of the relinquished MACRS property is treated as being disposed. (Reg § 1.168(i)-6(i))

  The election is made by typing or printing "ELECTION MADE UNDER SECTION 1.168((i)-6(i)(1)" on Form 4562 and must be made by the extended due date of the return for the replacement year. (Reg § 1.168(i)-6(j))

Example: Property Given had a basis of $500,000 with $100,000 allocated to land. It was placed in service on 7/1/14. It was exchanged on 6/30/9. It was a residential rental and thus the depreciation allowance is 3.636% per year (1/27.5); mid-month convention applies so ***only a half-month of depreciation is allowed in the month put into service and in the disposal month***. The total depreciation taken up to the date of the exchange is $64,842 ((400,000 x .03636 x 5.5/12) + (400,000 x .03636 x 4)). The 2019 depreciation for the property given is $6,666 ($400,000 x .03636 x 5.5/12). Thus, the depreciation schedule for the property given would look like this for 2019:

Description	In Service	Basis	Accumulated Depreciation	Current Depreciation
Building	7/1/14	$400,000	$64,842	$6,666[1]
Land	7/1/14	$100,000	-0-	-0-

[1]$400,000 x .03636 x 5.5/12

Property Received, also a residential rental, has an exchange basis of $750,000, of which $300,000 is allocated to land. It was placed in service on 10/1/19. Because the exchange was delayed, there are a few months without depreciation. There are two options for establishing the depreciable basis for the replacement property based on whether or not the election is made:

Non-elective depreciation for the replacement property would look like:

Description	In Service	Basis	Accumulated Depreciation	Current Depreciation
Carryover Basis	7/1/14	$328,492		$3,030[2]
Excess 1031 Basis	10/1/19	$121,508		$ 920 [3]
Land	10/1/19	$300,000	-0-	-0-

[2]$328,492 x .04428 x 2.5/12 $328,492 = $400,000 – 64,842 – 6666 .04428 = 1/22.583 years (remaining life)
[3]$121,508 x .03636 x 2.5/12

Electing out of the split-basis approach, the depreciation would look like:

Description	In Service	Basis	Accumulated Depreciation	Current Depreciation
Building	10/1/19	$450,000	-0-	$3,409[4]
Land	10/1/19	$300,000	-0-	-0-

[4]$450,000 x .03636 x 2.5/12

***Caution – Improvements** - It is not uncommon for the depreciation schedule of the property being relinquished to include a line of depreciation for the original Sec 1250 purchase price and one or more additional lines of depreciation for subsequent Sec 1250 improvements to the property. Thus, when the carryover basis is figured (assuming the election wasn't made), there'll need to be separate entries for the improvement(s) and the original building (because their remaining lives will be different). This is a good reason to elect out of the split approach.*

- **Where the exchanged properties do not share the same recovery class and depreciation method** - complex rules apply. *Reg § 1.168(i)-6(c)(3)(ii)* See situations below.

Replacement property has a longer recovery period *Reg § 1.168(i)-6(c)(4)(i))*

- **Recovery period** = Period appropriate for replacement property less period property given had already been depreciated.
- **Depreciation method** = Appropriate convention for the replacement property.

***Example:** Rental exchanged for a commercial building. Rental has been in service for 10 years. Replacement (commercial building) would be depreciated over 29 (39 – 10) years (treated as if placed in service on the same date as rental property) using the 39-year mid-month convention table.*

Replacement property has a shorter recovery period *Reg § 1.168(i)-6(c)(4)(ii)*

- **Recovery period** = Remaining life of the property given up.
- **Depreciation method** = Same as the property given up.

***Example:** Commercial building exchanged for a Rental. Commercial building has been in service for 10 years. Replacement (rental) would be depreciated over 29 (39 – 10) years (treated as if placed in service on the same date as the commercial property) using the 39-year mid-month convention table.*

Replacement property uses a less accelerated depreciation method
Reg § 1.168(i)-6(c)(4)(iii)(A) and (B)

- **Recovery period** = Remaining life of the property given up.
- **Depreciation method** = Less accelerated method.

Replacement property uses a more accelerated depreciation method
Reg § 1.168(i)-6(c)(4)(iv)(A) and (B)

- **Recovery period** = Remaining life of the property given up.
- **Depreciation method** = Less accelerated method.

UNLIKE PROPERTY (BOOT) AND CASH

Note: It is rare in exchanges (especially real property exchanges) to have boot other than cash. Thus, boot generally represents cash given or received.

A. "Boot" is unlike property or cash given or received in an exchange.

B. When unlike property other than cash is given along with the exchanged like-kind property, gain or loss must be recognized on the "boot."

> ***Example – Unlike Property Given in an Exchange -*** *Tacksmie Knott exchanged investment real estate with a fair market value of $19,000 and an adjusted basis of $15,000 and STOCK (adjusted basis of $4,000, FMV of $1,000) for rental real estate worth $20,000. Knott recognized no gain on the exchange of the real property, but recognized a $3,000 loss on the stock.*

On the other hand, if unlike property or cash is received in an exchange, gain is recognized to the extent of the boot received, while loss is not recognized.

> ***Example – Cash Boot Received in TFE Transaction -*** *Rental real estate with an adjusted basis of $65,000 is exchanged for like-kind property valued at $75,000 AND cash of $25,000. The realized gain on the transaction is $35,000 ($75,000 + $25,000 less $65,000). Taxable gain is limited to the amount of cash boot, $25,000.*

When cash is both given and received, the amounts offset one another and only the net is boot received or given.

EXCHANGE EXPENSES

Rev Rul 72-456, 1972-2 CB 468 states that gain recognized in an exchange can be reduced by exchange expenses incurred in the transaction, but the reduction cannot create a loss.

> ***Example - Exchange Expenses Reduce Recognized Gain -*** *Hank exchanged a property with an adjusted basis of $10,000 for like-kind property worth $21,000 and cash of $11,000. His exchange expenses were $2,500. Hank's recognized gain on the transaction is $8,500 ($11,000 cash received less $2,500 exchange expense).*

ASSUMING LIABILITIES IN AN EXCHANGE

A. A taxpayer who ***assumes a liability*** or receives property subject to a liability gives boot.

B. A taxpayer who ***has a liability assumed*** or gives a property subject to liability receives boot.

C. Just as in a transaction where cash is both given and received***, mortgage boot given and received are netted*** and only the excess is treated as boot given or received.

D. Other ***boot netting rules***:

(1) Exchanger's liabilities assumed by exchangee are also offset by cash paid by exchanger;

(2) Cash or other boot received by exchanger IS NOT offset by exchanger's assumption of exchangee's liabilities.

Comm vs. North Shore Bus Co., Inc., 32 AFTR 931 states that where a taxpayer receives cash specifically for paying off a mortgage on a property involved in an exchange, the cash is not considered boot where the taxpayer is simply a conduit for the payment of the mortgage by the other party.

DETERMINING CASH GIVEN/RECEIVED:

A frequently encountered question is how to determine the cash given or received in a Section 1031 real estate exchange. Practitioners inexperienced in Sec 1031 exchanges may expect to find the answer in the exchange escrow statement; they will be disappointed. To grasp an understanding of the exchange process, you need understand that what is given is exactly equal to what is received. The transaction is a negotiation between a willing buyer and a willing seller who negotiate the exchange and mutually determine the FMV of the properties exchanged. In other words, an exchange is a balanced transaction.

Another issue is boot, which is the unlike property included in an exchange, which does not qualify as like property. Say you exchange a vacant parcel of land for a residential rental and a car. The car is unlike property, and the car's value cannot be included in the exchange computation. Cash is also unlike property. However, it is very rare that an exchange includes any unlike property except for cash, which makes up the differences in equity in virtually all exchange transactions.

Therefore, for exchanges that do not include boot other than cash, the cash given or received can easily be determined using the worksheet below. If, by some rare chance, unlike property other than cash is involved, its agreed upon value will reduce the cash given or received.

	A	B
Column…………………………………………………………	A	B
Property……………………………………………………...	Given	Received
1. FMV (Sales Price Col A & Purchase Price Col B).	_________	_________
2. Mortgage Balance (at time of transfer)..………...	_________	_________
3. Equity Exchanged (LN1 – LN2 Each Column)…..	_________	_________
4. **CASH GIVEN** (LNB3 – LNA3) but not < zero....	_________	
5. **CASH RECEIVED** (LNA3 – LNB3) but not <zero.		_________
6. Proof (LN3 + LN4 or LN5 EACH column)………… *Total of each column must be the same!*	_________	_________

Example: *A property with a FMV (sales price) of $400,000 and a mortgage of $100,000 is exchanged for another property with a FMV (cost) of $450,000 and new mortgage of $125,000.*

Column……………………………………………….	***A***	***B***
Property…………………………………………..	***Given***	***Received***
1. FMV (Sales Price Col A & Purchase Price Col B)……..	*400,000*	*450,000*
2. Mortgage Balance (at time of transfer)..………………...	*100,000*	*125,000*
3. Equity Exchanged (LN1 – LN2 Each Column) ………..	*300,000*	*325,000*
4. ***CASH GIVEN*** *(LNB3 – LNA3) but not < zero………..*	*25,000*	
5. ***CASH RECEIVED*** *(LNA3 – LNB3) but not < zero.*		*0*
6. Proof (LN3 + LN4 or LN5 EACH column)…………..……	*325,000*	*325,000*

WHEN TO AVOID AN EXCHANGE:

There are instances where a like-kind exchange is not appropriate.

- **Sale would result in a loss** – When the sale of the asset will result in a loss, that loss cannot be recognized in a like-kind exchange.
- **Sufficient Carryovers** – When a taxpayer has sufficient carryovers to offset all or a portion of the gain if the property is sold, an exchange may not be beneficial. These carryovers could include capital loss, investment interest (you can make the capital gains election), passive loss, and net operating losses.
- **Capital Gains Rates** – How long will the favorable CG rates be around? The taxpayer's circumstances may dictate taking the gain now as opposed to later.
- **Tax Bracket and Other Issues** – When a taxpayer anticipates that his or her tax bracket will be higher in future years, it may be appropriate to take the gain now as opposed to deferring it. The surtax on net investment income of upper-income taxpayers and the Sec 199A deduction for those with pass-through income should be taken into account. There are other income issues to be considered for elderly clients, including the taxation of Social Security, the income-based Medicare-B insurance premiums, and of course the required minimum distribution from retirement plans.

WHEN AN EXCHANGE MAY BE APPROPRIATE:

One of the most common uses of Section 1031, and for years after 2017 the only situation when Section 1031 applies, is to defer gain from real estate sales. Here are some examples of reasons an exchange should be considered:

- Taxpayer is a hands-on landlord and is relocating and wants his rental property close by where he can keep an eye on it.
- Taxpayer is a hands-on landlord but is getting tired of the day-to-day issues of residential real estate and wants to exchange into a less demanding type of property such as triple net commercial property.

- Taxpayer is approaching retirement and wants to get rid of the work associated with his rental properties, but does not want to pay the taxes currently that will result from a sale. He can exchange into what is commonly referred to as a tenant-in-common (TIC) arrangement where he can receive a guaranteed return without any responsibilities.
- Taxpayer feels his property is poorly located or has maxed out on appreciation and wishes to exchange to another area.
- Taxpayer has significant equity in his property which will allow him to leverage his equity and move up to a more costly property where he hopefully can better benefit from appreciation.

SELLING OR EXCHANGING A BUSINESS VEHICLE

When replacing a business vehicle prior to 2018, it made a difference for tax purposes if it was sold or traded-in for the replacement vehicle. If the vehicle was sold, the result was reported on a taxpayer's return as an above-the-line gain or loss. Since trade-ins were treated as a Section 1031 exchange, any gain or loss was absorbed into the replacement vehicle's depreciable basis. Thus, it was generally better to trade in a vehicle that would result in a gain if it were sold and sell a vehicle if the disposition of it would result in a loss. This is no longer true since Sec 1031 only applies to real estate after 2017; every business vehicle disposition will now be a Form 4797 reportable transaction regardless of gain or loss.

COMPREHENSIVE REAL PROPERTY 1031 EXCHANGE EXAMPLE

Step #1 – Make sure the transaction qualifies for Sec 1031 treatment.

Step #2 – Analyze the sale and purchase escrows determining FMVs, Mortgage Balances, and Exchange expenses.

ABC Escrow Company	**Debits**	**Credits**
Property: 12345 Main St.		
Sale Date: 6/16/19		
Consideration		148,500.00
Trust deed	50,125.00	
Interest (6/1 through 6/16)	82.40	
Property Taxes (6/16 – 7/01)		91.58
Document Transfer Fee	75.00	
Escrow Fee	550.00	
Real Estate Commission	8,800.00	
Security Deposits	2,500.00	
Rent Pro-ration	1,290.00	
1031 Accommodator fee	1,000.00	
Transfer to accommodator Account	84,169.18	
Totals	148,591.58	148,591.58

FMV Property Given

Mortgage Balance on Property Given

Exchange Expenses

FMV Property Received

Mortgage Balance on Property Received

Exchange Expenses Both escrows = $11,750

ABC Escrow Company	**Debits**	**Credits**
Property: 97 Park Place		
Purchase Date: 8/1/19		
Consideration	325,000.00	
Trust Deed		230,000.00
Property Taxes (7/01 – 8/01)		651.89
Title Insurance	775.00	
Escrow Fee	550.00	
Transfer ABC Escrow		84,169.18
Cash Due at Closing		11,503.93
Totals	326,325.00	326,325.00

Step #3 - Determine the cash given or received in the exchange. From the worksheet below, we determine that cash in the amount of $3,375 was received in the exchange. **Note:** Cash generally represents taxable gain, but that gain can be reduced by exchange expenses. Thus, without going any further, we are reasonably sure there is no taxable event in this exchange.

	A	B
Column………………………………………………………	**A**	**B**
Property…………………………………………………....	**Given**	**Received**
1. FMV (Sales Price Col A & Purchase Price Col B).	148,500.00	325,000.00
2. Mortgage Balance (at time of transfer)..………..	50,125.00	230,000.00
3. Equity Exchanged (LN1 – LN2 Each Column)…..	98,375.00	95,000.00
4. **CASH GIVEN** (LNB3 – LNA3) but not < zero....	________	
5. **CASH RECEIVED** (LNA3 – LNB3) but not <zero.		3,375
6. Proof (LN3 plus LN4 or LN5 EACH column)………	98,375.00	98,375.00

Step #4 – Complete the Schedule E and depreciation schedule for the property given which has been used as a residential rental. In this example, we had the following items from the sale escrow that flow over to the Schedule E.

- Income adjustment for prorated rents <1,290>
- Income adjustment security deposits (if originally treated as income) <2,500>
- Credit for property tax pro-ration in escrow <91.58>
- Mortgage Interest (if not already included on 1098 for the year) 82.40

Finish the depreciation schedule since the basis and accumulated depreciation will be needed to complete the Section 1031 computation.

Description	In Service	Basis	Accumulated Depreciation	Current Depreciation
Building	1/1/13	$50,000	$10,833 [2]	$833 [1]
Land	1/1/13	$25,000	-0-	-0-

[1] $50,000 x .03636 x 5.5/12 (Half month convention Jan – May = 5 + ½ for June)
[2] $50,000 x .03636 x 5.95833 = $10,833 5 yrs + 11.5 months = 5.95833

Thus, the:

- Original basis is $75,000 ($50,000 + $25,000).
- Accumulated depreciation to the date of the exchange is $11,666 ($10,833 + $833).
- Adjusted basis at exchange date $63,334 ($50,000 – 11,666 + $25,000), of which the remaining depreciable basis is $38,334 ($50,000 – 11,666).

Now you have accumulated all of the numbers required to complete the exchanges computation.

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Step #5 – Complete the 1031 Exchange Worksheet.

(II) BASIS OF PROPERTY CONVEYED:			
a. Cost or Other Basis of Property Conveyed	75,000		
b. Depreciation Allowed or Allowable	11,666		
c. Adjusted Basis of Property Conveyed (a minus b)		63,334	
(III) REALIZED GAIN:			
a. Fair Market Value of Property Received	325,000		
b. Cash Received	3,375		
c. Fair Market Value of Boot Received	-0-		
d. Mortgage Balance on Property Conveyed	50,125		
e. Total Consideration Received (Sum a. through d.)		378,500	
(LESS):			
f. Adjusted Basis of Property Conveyed	63,334		
g. Cash Given	-0-		
h. Adjusted Basis of Boot Conveyed	-0-		
i. Mortgage Assumed on Property Received	230,000		
j. Exchange Expenses	11,750		
k. Total Consideration Given (Sum f. through k.)		305,084	
l. Gain Realized on the Exchange (e. minus k. - but not less than zero)			73,416
(IV) RECOGNIZED GAIN:			
a. Cash or Boot Received	3,375		
b. Cash or Boot Given	-0-		
c. Exchange Expenses	11,750		
d. Net Cash or Boot Received (a-b-c, can be negative)		-8,375	
e. Mortgage on the Property Conveyed	50,125		
f. Mortgage Assumed on Property Received	230,000		
g. Net Mortgage Relief (e. less f. – but not less than zero)		-0-	
h. **GAIN RECOGNIZED (**d. plus g. but not less than zero)			-0-
(V) BASIS OF NEW PROPERTY			
a. Adjusted Basis of Property Conveyed	63,334		
b. Cash or Boot Conveyed	-0-		
c. Mortgage Assumed on Property Received	230,000		
d. Total (Sum a. through c.)		293,334	
e. Cash & Boot Received	3,375		
f. Mortgage on Property Conveyed	50,125		
g. Total (e. plus f.)		53,500	
h. Net Amount (d. less g.)		239,834	
i. Gain Recognized on the Exchange		-0-	
j. Exchange Expenses		11,750	
k. **BASIS OF NEW PROPERTY** (Sum h. through j)			251,584

Step #6 - The hardest part of an exchange is to get the information into your tax preparation software and have the software compute the exchange correctly. Seems they all do it a little differently. But you have the answer and know what the results should be.

Step #7 – Set up the depreciation for the replacement (acquired) property, which is also going to be used as a residential rental. Assuming a land allocation of $100,000, the depreciation options for this property would be:

Non-elective depreciation for the replacement property would look like:

Description	In Service	Basis	Accumulated Depreciation	Current Depreciation
Carryover Basis	1/1/13	$38,334		$833[2]
Excess 1031 Basis	8/1/19	$113,250		$1,544[3]
Land	8/1/19	$100,000	-0-	-0-

[2]$38,334 x .04743 x 4.5/12 = 682 $38,334 = 50,000 – 10,833 – 833 .04743 = 1/21.083 years (remaining life)
[3]$113,250 x .03636 x 4.5/12

Electing out of the split-basis approach, the depreciation would look like:

Description	In Service	Basis	Accumulated Depreciation	Current Depreciation
Building	8/1/19	$151,584	-0-	$2,067[4]
Land	8/1/19	$100,000	-0-	-0-

[4]$151,584 x .03636 x 4.5/12

MIXED CLASS (UNLIKE) PROPERTY OF THE EXCHANGE

More often than not exchanges of rental real estate (Sec 1250 property) will include items of personal property (Sec 1245 property) such as appliances. It is unlikely that the replacement property will be allocated between 1250 and 1245 property and since acquired real property can no longer be depreciated under the component method, the replacement property will generally always be treated as entirely 1250 property. Thus, there is generally no way to accomplish a 1031 exchange for the 1245 property being depreciated with the rental. Furthermore, under the 2017 tax reform, beginning with 2018 exchanges, Sec 1245 property is not eligible for Sec 1031 exchange treatment.

Generally, when mixed assets are sold, the assets must be allocated by class and identified as such in the sales agreement or by using IRS Form 8883. If the allocation has been made and a portion of the sales price allocated to the Sec 1245 property, it can be properly reported on Form 4797 as a sale and the resulting gain or loss carried over to the 1040. The remaining portion of the sales price is used in computing the Sec 1250 like-kind exchange.

If the 1245 property was not identified in the transaction, there is no standard method to subsequently deal with the Sec 1245 element. Here are approaches to the problem that others have taken:

- Assumed the transaction included only 1250 property, i.e., that 1245 property was *de minimis* and simply passed on to the buyer at zero value. However, if the 1245 property is not fully depreciated, the disposition for no value will result in a 4797-ordinary loss, which is really not the case.
- Assumed the Sec 1245 property to be a *de minimis* portion of the sale and reported the sale of the Sec 1245 property on the 4797 at the same price as the depreciated basis, resulting in no gain or loss.

TAX-DEFERRED EXCHANGES AND INSTALLMENT SALE RULES

The installment sale rules allow for "deferral" of gain when an installment note is carried back on a property disposed of in an exchange *(§453(f)(6)).* Regular installment sale rules contain the following two definitions:

1. **Gross profit percentage:** This equals the gross profit divided by the contract price.
2. **Payment received at time of sale:** This equals the contract price minus the face value of the installment note.

When a tax-deferred exchange is structured as an installment sale, 1 and 2 above are redefined.

1. **Gross profit** equals ***recognized gain***; the maximum deferral under ***§453*** will be the gain recognized under ***§1031.***
2. **Contract price** is redefined as ***the greater of***: (a) the recognized gain, or (b) the decline in FMV of the like-kind properties. Compare the FMV of like-kind property relinquished with the FMV of like-kind property received.

Reporting the Installment Sale - To report an installment sale in conjunction with an exchange, use Form 8824; however, the gain goes to Form 6252 rather than to Form 4797 directly. Although Form 6252 instructions don't indicate this, it's probably best to mark "From Form 8824" on Form 6252 when listing the "gross profit" and the "contract price". It may also be a good idea to attach a backup statement showing the computation.

QUICK ANALYSIS CONSIDERATION

Analyzing exchanges can be easier than you think! You need to know three things:

- **Fair market value of the property given and received**
- **Existing mortgages**
- **The equity given vs. equity received**

For an exchange to be 100% TAX-DEFERRED, make sure the following are true:

- ❑ **The taxpayer traded even or up in value.**
- ❑ **The taxpayer traded even or up in equity.***
- ❑ **The taxpayer transferred no other property.**

* Equity is the difference between the FMV and the existing mortgage on the property.

Example: *Taxpayer exchanged a rental with a FMV of $100,000 and a loan of $50,000 for another rental with a FMV of $125,000 and a mortgage of $25,000. Is it 100% tax-free?*

YES! The taxpayer traded up in value from $100,000 to $125,000. He also traded up in equity, from $50,000 to $100,000 and transferred no other property.

MIXED USE PROPERTY - HOME WITH BUSINESS USE

The exchange of a home can qualify for both the §121 home sale exclusion and §1031 like-kind exchange deferral treatment. This can occur where the property was used as a principal residence and a business consecutively (e.g., use as a principal residence followed by rental of the property) or concurrently (a portion of the home used as a principal residence and a portion used as a home office). (Rev. Proc. 2005-14)

> **Caution:** Coupling the tax benefits of the Sec 121 home sale gain exclusion with the Sec 1031 deferral for excess gain will only work if the transaction is an ***exchange***. A non-simultaneous sale of one home and a purchase of another or failure to meet the rules for a deferred exchange means the transaction won't qualify for the 1031 deferral. Unfortunately, most taxpayers don't structure sales of their homes in a way that would qualify to be an exchange.

Consecutive Use – This would occur when a taxpayer's home is converted to a rental property and is still being used as a rental property at the time of the sale AND still meets the two-out-of-five-years ownership and use qualifications. Thus, the §121 home sale exclusion would apply and since the property is in business use, it also would qualify for §1031 like-kind exchange deferral treatment.

Example *– Jack buys a house for $210,000 that he uses as his principal residence from 2013 to 2017. From 2017 until 2019, he rents the house to tenants and claims depreciation deductions of $20,000. In 2019, Jack, who is single, exchanges the house for $10,000 of cash and a townhouse with a fair market value of $460,000. Jack intends to use the townhouse as rental property. This is the way the transaction plays out:*

The Exchange	***GIVEN***	***RECEIVED***
Fair Market Value	*470,000*	*460,000*
Cash		*10,000*
Total	*470,000*	*470,000*
***Gain Computation**:*		
FMV of Property Given		*$470,000 (1)*
Less cost		*<210,000>*
Depreciation		*20,000*
Gain		*$280,000*
§121 Exclusion		*<250,000>*
Profit		*$ 30,000*
§1031 Deferral		*< 30,000> (2)*
Taxable Gain		*0*

(1) Townhouse worth $460,000 plus $10,000 in cash.
(2) Jack may defer the remaining gain of $30,000, including the $20,000 gain attributable to depreciation, under Code Sec. 1031. Moreover, although Jack received $10,000 of cash (boot) in the exchange, he is not required to recognize gain because the boot is taken into account for purposes of Code Sec. 1031(b) only to the extent the boot exceeds the amount of excluded gain.

Concurrent Use – This would occur when a taxpayer's home is used as a primary residence and for business purposes at the same time. A frequently encountered example would be a taxpayer with a home office.

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Example *- Charlie pays $210,000 for a house that constitutes a single dwelling unit (1). From 2014 until 2019, he uses 2/3 (by square footage) as his principal residence and 1/3 as an office in his business. In 2019, he exchanges the entire property for a residence and a separate property to be used as an office in his business. The total FMV of the replacement properties is $360,000. The FMV of the replacement residence is $240,000 and the FMV of the replacement business property is $120,000, which is equal to the FMV of the business portion of the relinquished property. From 2014 to 2019, Charlie claims depreciation deductions of $30,000 for the business use. Thus, he realizes gain of $180,000 on the exchange ($360,000 amount realized − $180,000 adjusted basis ($210,000 cost − $30,000 depreciation)). Charlie is single. He qualifies for both tax breaks as follows:*

	TOTAL	HOME	OFFICE
Sales Price	*360,000*	*240,000*	*120,000*
Home Cost	*<210,000>*	*<140,000>*	*<70,000>*
Depreciation	*30,000*	*---*	*30,000*
Realized Gain	*180,000*	*100,000*	*80,000*
§121 Exclusion	*<150,000> (2)*	*<100,000>*	*<50,000> (2)*
Tentative Taxable Gain	*30,000*	*0*	*30,000*
§1031 Deferral	*<30,000>(3)*	*---*	*<30,000> (3)*
Taxable Gain	*0*	*0*	*0*

(1) Under Code Sec. 1.121-1(e)(2) the sale of a home that is a single dwelling unit and is also used for business purposes is treated as one sale and the §121 exclusion applies to all gain except that gain attributable to depreciation taken after May 6, 1997.

(2) Under Reg. § 1.121-1(e), Charlie may exclude $50,000 of the gain allocable to the office because the office and residence are part of a single dwelling unit and any gain in excess of the depreciation taken after May 6, 1997 is subject to the §121 exclusion.

(3) Charlie may also defer paying tax on the office portion since he acquired a replacement. His basis in the separate replacement business property is $90,000 ($40,000 basis in the relinquished business property at the time of the exchange + $50,000 gain excluded under Code Sec. 121 attributable to the relinquished business property). (Code Sec. 1031. (Rev Proc 2005-14, Sec. 5, Ex. 3))

HOME SALES WITH BUSINESS USE – Section 121 exclusion applies first and then the Section 1031 deferral is applied.

Section 1031 is a valuable tax planning and strategizing tool that can be used for a variety of situations provided care is taken to make sure the qualification rules are carefully followed. However, in your planning, be sure you keep in mind that Section 1031 provides tax *deferral* and not tax *forgiveness*. The "tax-free" moniker frequently associated with Sec 1031 exchanges is misleading to taxpayers, and you, as a tax practitioner, must remind your clients of that fact.

VACATION HOME RENTALS MAY QUALIFY

One of the requirements for use of Sec. 1031 is that the exchanged properties be held for productive use in a trade or business or for investment. Thus, personal residences are ineligible. However, IRS recognized that many taxpayers hold dwelling units – commonly referred to as vacation rentals – primarily for the production of current rental income, but also use the properties occasionally for personal purposes.

Rev. Proc 2008-16 provides a safe harbor under which the IRS will not challenge whether a dwelling unit qualifies under Sec. 1031 even though the taxpayer uses it occasionally for personal purposes. All other requirements for a like-kind exchange under Sec. 1031 must still be met.

Safe Harbor – The standards that must be met for the dwelling unit to be considered to be held for productive use in a trade or business or for investment are as follows:

Relinquished property: The taxpayer owns the dwelling unit for at least 24 months immediately before the exchange, and within that period, in *each* of the two 12-month periods immediately preceding the exchange:

- The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and
- The taxpayer's personal use of the property does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

The first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day), and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

Replacement property: The taxpayer owns the dwelling unit for at least 24 months immediately after the exchange, and within that period, in *each* of the two 12-month periods immediately after the exchange:

- The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and
- The period of the taxpayer's personal use of the property does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

The first 12-month period immediately after the exchange ends on the day after the exchange takes place, and the second 12-month period begins on the day after the first 12-month period ends.

Filing Return Before Qualifying Use Period Ends – If a taxpayer files a federal income tax return and reports a transaction under Sec. 1031 based on the expectation that a replacement dwelling unit will meet the qualifying use standards noted above, and later determines that the dwelling unit does not qualify, the return should be amended to report the transaction other than as a Sec. 1031 exchange.

SPECIAL RULE FOR WATER RIGHTS STOCK (not applicable after 2017)

A provision of the 2008 Heartland, Habitat, Harvest, and Horticulture Act of 2008 amends Sec. 1031 to permit the exchange of water rights in the form of mutual ditch, reservoir and irrigation company stock, applicable to exchanges after the date of enactment. This is an exception to the general rule that stock is not qualified property for like-kind exchange treatment, but its application is limited to stock representing a holding of water rights that is recognized as real property under state law. Effective for exchanges after May 22, 2008 and before 2018.

REVERSE EXCHANGES

A reverse exchange is a transaction in which a taxpayer receives replacement property and subsequently transfers relinquished property. It is distinguished from a deferred exchange, which is a transaction in which a taxpayer transfers relinquished property and subsequently receives replacement property. Rev. Proc. 2000-37 offers guidance for taxpayers that engage in so-called "reverse" like-kind exchanges.

Until Rev. Proc. 2000-37 was published, there was no authority on which taxpayers could safely rely to structure reverse exchanges. In Rev. Proc. 2000-37, the Service took the position that a taxpayer may use a parking arrangement to effectuate the equivalent of a reverse exchange and thereby qualify for like-kind exchange treatment. The Procedure consists of three parts:

(1.) Safe harbor
(2.) Nine requirements
(3.) Several allowed agreements

Reverse exchanges require financial resources – To accomplish a reverse exchange requires the replacement property be acquired before the equity in the relinquished property is available. Thus, the taxpayer must have the ability to fund the purchase of the replacement property without the benefit of the capital from the relinquished property.

Safe harbor - The Rev. Proc. 2000-37 safe harbor is found in Section 4.01 of the Procedure and states: *The Service will not challenge the qualification of property as either "replacement property" or "relinquished property" (as defined in section 1.1031(k)-1(a)) for purposes of Section 1031 and the regulations thereunder, or the treatment of the **exchange accommodation titleholder [EAT]** as the beneficial owner of such property for Federal income tax purposes, if the property is held in a **QEAA [qualified exchange accommodation arrangement].***

Thus, if either the replacement property or the relinquished property is held in a QEAA, the Service will treat the EAT as the beneficial owner of the property so held. The effect of this rule is that the Service will ignore factors often used by courts in determining who owns property and treat the EAT as the owner of the property. To obtain this treatment, however, the property must be held in a QEAA. Property is treated as being held in a QEAA if all of the requirements listed in the Procedure (discussed below) are met.

1. ***The EAT must satisfy certain requirements.*** A person other than the taxpayer or a disqualified person must serve as the EAT. The Service does not define "disqualified person" in the Procedure. The definition of "disqualified person" found in Reg. 1.1031(k)-1(k) (i.e., the taxpayer's agent or a person related to the taxpayer), however, appears to apply in this context.
2. ***The EAT must be subject to U.S. income tax.***
3. ***The EAT must hold qualified indicia of ownership.*** The Procedure defines "qualified indicia of ownership" to mean "legal title to the property, other indicia of ownership of property that are treated as

beneficial ownership of the property under applicable principles of commercial law (e.g. a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for Federal income tax purposes (e.g., a single-member limited liability company) and that holds either legal title to the property or such other indicia of ownership."

4*. **The taxpayer must have a bona fide intent to do a Section 1031 exchange**.* At the time the EAT receives the qualified indicia of ownership, the taxpayer must have the bona fide intent that the property held by the EAT represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under Section 1031.

5. The agreement must be in writing. The taxpayer and the EAT must enter into a written agreement no later than five business days after the accommodation titleholder receives qualified indicia of ownership. The agreement must provide that:

- The EAT is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and Rev. Proc. 2000-37.
- The taxpayer and the EAT agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37.
- The EAT will be treated as the beneficial owner of the property for all Federal income tax purposes.

Furthermore, the taxpayer and the EAT must report the tax attributes of the property on their tax returns in a manner consistent with this agreement. This means that the taxpayer cannot deduct depreciation for property held by the EAT. The EAT must also recognize gain or loss on the disposition of any property it holds unless the gain or loss is otherwise specifically excluded from the EAT's income.

6. Relinquished property must be properly identified. The taxpayer must identify the relinquished property within 45 days after the EAT receives a qualified indicia of ownership of the replacement property. Identification must be made in accordance with Reg. 1.1031(k)-1(c), and the taxpayer may identify alternative and multiple properties, as described in Reg. 1.1031(k)-1(c)(4).

7. Holding period limitation: exchange-last arrangements. In an exchange-last arrangement, within 180 days after the EAT receives qualified indicia of ownership in the replacement property, the replacement property must be transferred either directly, or indirectly, through a qualified intermediary to the taxpayer.

8. Holding period limitation: exchange-first arrangement. If the transaction is an exchange-first arrangement, within 180 days after the EAT receives a qualified indicia of ownership in the relinquished property, the relinquished property must be transferred to a person who is not the taxpayer or a disqualified person.

9. Aggregate holding period limitations. The replacement property and relinquished property cannot be held in a qualified exchange accommodation arrangement for more than a combined total of 180 days.

Allowed agreements - The true benefit of Rev. Proc. 2000-37 is found in its Section 4.03, which states that the Service will allow taxpayers to enter into several agreements with an EAT without affecting the safe harbor. Discussed below are the allowed agreements.

- ***EAT as qualified intermediary -*** The EAT may enter into an exchange agreement with the taxpayer to serve as a qualified intermediary so long as the EAT otherwise qualifies as a qualified intermediary. Thus, if the EAT qualifies as a qualified intermediary, the EAT is not treated as the taxpayer's agent for purposes of determining whether the taxpayer is in constructive receipt of money or other property held by the EAT. Thus, the EAT may sell the taxpayer's relinquished property and use the proceeds from the sale to acquire other replacement property or make improvements on property held by the EAT without causing the transaction to fail to qualify for like-kind exchange treatment.

- ***Guarantee allowed -*** The taxpayer or a disqualified person may guarantee some or all of the obligations of the EAT, regardless of whether such obligations are secured or unsecured. Furthermore, the taxpayer may indemnify the EAT against costs and expenses incurred with respect to the transaction. This provision allows the EAT to protect itself against any unexpected costs that may arise with respect to the transaction. Thus, the EAT may immunize itself from a significant amount of risk to which an owner of property would otherwise be exposed.

- ***Other-than-market loans allowed -*** A taxpayer or a disqualified person is allowed to loan or advance funds to the EAT at other than an arm's-length rate of interest or guarantee a loan or advance to the EAT. This provision allows the EAT to use the taxpayer's money interest-free. As mentioned below, this may come with strings attached since Sections 7872 and 1272 may result in interest income being imputed to the taxpayer.

- ***Other-than-market leases allowed -*** The EAT may lease the property of which it holds a qualified indicia of ownership to the taxpayer or a disqualified person at other than an arm's-length rental amount. This provision allows the taxpayer to take possession of the property rent-free, while the EAT holds title to the property.
- ***Other-than-market services allowed -*** The taxpayer or a disqualified person may manage the property, supervise improvement of the property, act as contractor, or otherwise provide services to the EAT with respect to the property at other than an arm's-length charge during the period the EAT holds title to the property. Thus, a taxpayer may construct an improvement on the property while the EAT holds qualified indicia of ownership of the property, and the EAT may receive such services for a nominal amount. Furthermore, a taxpayer may transfer property to an EAT and continue to manage the property after it is transferred. Under such a situation, there will be no noticeable change in the ownership of the property. These allowances give the taxpayer great latitude in setting up parking arrangements.
- ***Option-type agreements allowed -***The taxpayer and the EAT may enter into option-type agreements or arrangements relating to the purchase or sale of the property. These types of agreements allow the taxpayer to obtain an option to purchase replacement property that the EAT holds and allows the EAT to obtain an option to sell replacement property to the taxpayer at the end of the 180-day holding period. By using this type of agreement, the contract between the taxpayer and the EAT can create a present obligation in the EAT to execute and deliver a deed to the taxpayer and can create a present obligation in the taxpayer to make payments to the EAT either in cash or in the form of relinquished property.
- ***Adjustments for economic risk allowed -*** The taxpayer and the EAT may agree or arrange for the taxpayer to advance additional funds or receive funds from the EAT if the value of the relinquished property fluctuates while held by the EAT. An agreement of this sort allows the parties to shift the economic risk of loss or damage to the property to the taxpayer without affecting whom the Service considers to be the beneficial owner of the property.

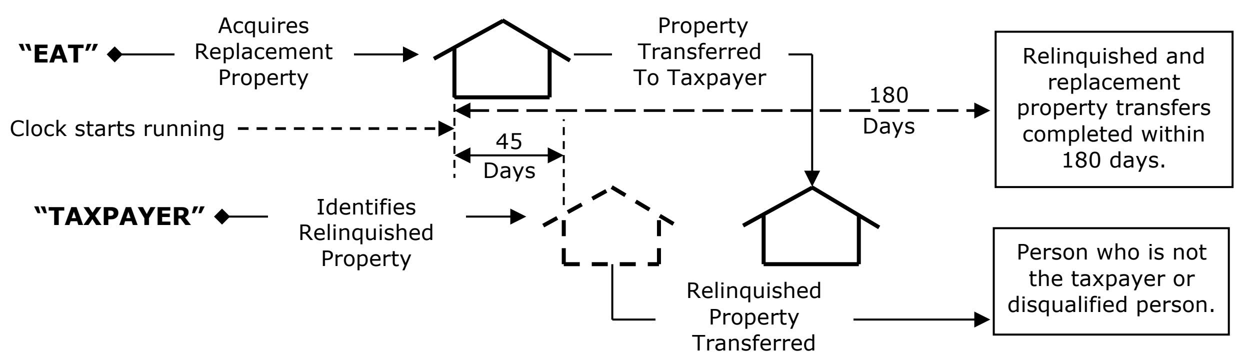


Illustration - Reverse Exchange Example

REAL ESTATE PARTNERSHIPS

Frequently, the question arises whether exchanging interests in a real estate partnership is allowed. Code Sec 1031(e) (see below) addresses this issue by saying if there is a valid Section 761(a) election in force the ownership interest will not be treated as a partnership. The following code excerpts are from Sec 1031 as amended by the TCJA.

1031 Exchange of real property held for productive use or investment.

(a)(1) In general - *No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such property is exchanged solely for real property of like-kind which is to be held either for productive use in a trade or business or for investment.*

(a)(2) Exception for real property held for sale. *This subsection shall not apply to any exchange of real property held primarily for sale.*

1031(e) Application to certain partnerships.

For purposes of this section, an interest in a partnership which has in effect a valid election under section

761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

The instructions for Form 1065 (2018) also say the same thing: *"A qualifying syndicate, pool, joint venture or similar organization may elect under Section 761(a) not to be treated as a partnership for Federal income tax purposes and will not be required to file Form 1065 except for the year of election. For details, see Section 761(a) and Regulations Section 1.761-2."*

Reg § 1.761-2.

(a) Exclusion of eligible unincorporated organizations.

(1) In general. Under conditions set forth in this section, an unincorporated organization described in subparagraph (2) or (3) of this paragraph may be excluded from the application of all or a part of the provisions of subchapter K of chapter 1 of the Code. Such organization must be availed of: (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions.

(2) Investing partnership. Where the participants in the joint purchase, retention, sale, or exchange of investment property—

(i) Own the property as co-owners,

(ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section.

FINAL REGS ADDRESS TAX TREATMENT OF INCOME FROM EXCHANGE FUNDS

The IRS released final regulations (**T.D. 9413, 73 FR 39614, July 10, 2008**) addressing (1) the taxation of income earned on escrow accounts, trusts, and other funds used during deferred like-kind exchanges, and (2) below-market loans to facilitators of these exchanges.

- If the exchange funds are treated as loaned by the taxpayer to the exchange facilitator, interest is generally imputed to the taxpayer under Code Sec. 7872, unless the exchange facilitator pays sufficient interest.
- A special applicable federal rate (AFR) that is the investment rate on a 13-week (generally 91-day) Treasury bill may be used when testing for sufficient interest under Code Sec. 7872. Because the normal short-term AFR may be lower than the 91-day rate, taxpayers may apply the lower of the two.
- The regulations provide an exemption from Code Sec. 7872 for an exchange facilitator loan if the amount of the exchange funds treated as loaned is $2 million or less and the loan's duration is six months or less.

CALIFORNIA DIFFERENCES

CA law conforms to Sec 1031 as it existed prior to TCJA, R&TC Sec. 18031 and 24941. Thus except as noted below, CA will not follow the TCJA change to Sec 1031 and vehicles and other non-real estate property would be eligible to receive tax-deferred exchange treatment for CA but not federal. California conforms to Federal computations. However, watch for differences in basis.

New Law & Stuff

The TCJA provision that limits Sec 1031 treatment only to exchanges of real property was adopted by California in AB 91 (signed by the governor 6/27/2019), with two significant differences:

- The provision only applies to taxpayers with AGI of $500,000 or more ($250,000 for those filing single or married separate) and
- Only applies to exchanges **completed** after January 10, 2019.

Exchange into Out-of-State Property - The replacement property in a qualified exchange may be located outside of California. If the out-of-state property is later sold in a taxable transaction at a time when the taxpayer is a California resident, any gain is taxable to California. Further, if the taxpayer who was a California resident when the exchange to out-of-state property took place sells the out-of-state property while a nonresident of California, the previously unrecognized gain is taxable to California.

California's Reporting Requirements for Certain 1031 Exchanges –Effective for exchanges on or after January 1, 2014 if a gain or loss from the exchange of property in California is deferred under IRC Section 1031, and the property acquired in that exchange is **located outside of California**, the taxpayer – whether a resident or nonresident – shall file an information return with the Franchise Tax Board for the taxable year of the exchange *and for each subsequent taxable year* - in which the gain or loss from that exchange has not been recognized. (AB 92 6/27/13; R&TC Sec 18032 and 24953) Taxpayers who exchange only personal property assets are not subject to this requirement. (2018 instructions to FTB 3840)

Form FTB 3840 is a comprehensive 2-page form used for this purpose and is attached to the taxpayer's CA return. However, a taxpayer not otherwise required to file a California return must complete the entire form FTB 3840, including the signature section, and file the form, by the due date for the type of return that they would have filed if one were required, at the following address: Franchise Tax Board, PO Box 1998, Rancho Cordova, Ca 95471-1998.

For taxpayers who fail to comply with the reporting requirement, FTB could make a return based on an estimate of the net income from the exchange and may issue an assessment including tax, interest, and penalties due in the same manner as assessments that are proposed for the failure to file a return.

See the instructions to FTB 3840 for additional information.

Transfer of Property to LLC in 1031 Exchange - In a unanimous and formal opinion, the State Board of Equalization granted the appeal of a group of taxpayers who had tenant-in-common interests in an apartment building that they exchanged for a shopping mall and surrounding property and ruled that there had been a qualified 1031 exchange even though, within a few months, the owners transferred the property to an LLC. "The foregoing record demonstrates that appellants conducted a valid exchange under IRC section 1031, notwithstanding the subsequent change in form of ownership, because the exchange was properly executed, the replacement property was held for investment purposes, and the step transaction doctrine does not apply to disregard appellants' acquisition of the replacement property." The taxpayer-favorable ruling made it clear that a plan to transfer property acquired in an exchange to a different form of holding does not disqualify the exchange as long as the taxpayer retains his or her investment in the property. (*Appeal of Rago Development Corp. et al. (June 23, 2015) 2015-SBE-001)*

CA Real Estate Withholding – Generally, no income tax withholding on a like-kind exchange is required with proper seller certification. However, if boot in excess of $1,500 is received by the seller, withholding is required. If the transaction fails to meet all of the IRC Sec. 1031 requirements (for example, the 45- or 180-day test is failed), then the intermediary or accommodator must withhold at 3 1/3% of the full sales price. *(2018 FTB Form 593-C/593-E Booklet)* See Chapter 3.17 for more information on California real estate withholding.

CONTINUE TO NEXT PAGE FOR WORKSHEET

NOTES

TAX-DEFERRED EXCHANGE OF PROPERTY*

(Code Section 1031)

*Only real property is eligible for federal deferral, effective 2018

Client: ________ Tax Year: ________
Property Given: ________ Date of Exchange: ________
Property Received: ________ Date Replacement Acquired: ________

(I) BALANCED EXCHANGE (CASH GIVEN OR RECEIVED):	GIVEN	RECEIVED
Fair Market Value of Property	________	________
Less Mortgages	________	________
Plus Boot (other than cash)	________	________
Cash (enter an amount in **one** column that makes both columns total the same)	________	________
Total of Each Column (Must be the same for a balanced exchange)	________	________

(II) BASIS OF PROPERTY CONVEYED:

a. Cost or Other Basis of Property Conveyed ________
b. Depreciation Allowed or Allowable ________
c. Adjusted Basis of Property Conveyed (a minus b) ________

(III) REALIZED GAIN:

a. Fair Market Value of Property Received ________
b. Cash Received ________
c. Fair Market Value of Boot Received ________
d. Mortgage Balance on Property Conveyed ________
e. Total Consideration Received (Sum a. through d.) ________

(LESS):

f. Adjusted Basis of Property Conveyed ________
g. Cash Given ________
h. Adjusted Basis of Boot Conveyed ________
i. Mortgage Assumed on Property Received ________
j. Exchange Expenses ________
k. Total Consideration Given (Sum f. through k.) ________
l. Gain Realized on the Exchange (e. minus k. - but not less than zero) ________

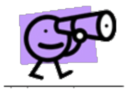
(IV) RECOGNIZED GAIN:

a. Cash or Boot Received ________
b. Cash or Boot Given ________
c. Exchange Expenses ________
d. Net Cash or Boot Received (a-b-c, can be negative) ________
e. Mortgage on the Property Conveyed ________
f. Mortgage Assumed on Property Received ________
g. Net Mortgage Relief (e. less f. – but not less than zero) ________
h. **GAIN RECOGNIZED (**d. plus g. but not less than zero) ________

(V) BASIS OF NEW PROPERTY

a. Adjusted Basis of Property Conveyed ________
b. Cash or Boot Conveyed ________
c. Mortgage Assumed on Property Received ________
d. Total (Sum a. through c.) ________
e. Cash & Boot Received ________
f. Mortgage on Property Conveyed ________
g. Total (e. plus f.) ________
h. Net Amount (d. less g.) ________
i. Gain Recognized on the Exchange ________
j. Exchange Expenses ________
k. **BASIS OF NEW PROPERTY** (Sum h. through j) ________

REPOSSESSIONS OF REAL PROPERTY

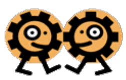


IRC Section 1038 outlines the general rules of real property repossessions. Under 1038, a seller's repossession of real property due to the buyer's default does not result in recognition of loss by the seller and gain is recognized only to a limited extent. The realty repossession rules basically treat all payments received from a sale before repossession as income. However, they limit the taxable gain to the profit the seller expected to receive from the original sale. Application of the realty repossession rules is <u>mandatory</u>, not elective.

Related IRS Forms & Publications

- **Pub 4681** - Canceled Debts, Foreclosures, Repossessions, and Abandonments

<u>THREE CRITERIA ARE NECESSARY FOR THE REALTY REPOSSESSION RULES TO APPLY</u>:



- The buyer's indebtedness to the seller must have originated from the sale of the seller's real property and be secured by that property.
- The seller must have reacquired the real property to either fully or partially satisfy that indebtedness.
- The seller cannot pay additional consideration to the buyer in order to get the property back unless the additional consideration was stipulated in the original sale, or the buyer has defaulted or is about to default on an obligation.

Unless all three of the above conditions are met, the repossession is treated as personal property repossession and reported accordingly. The repossession rules apply whether:

(A) The property is reacquired from the original buyer or a subsequent buyer (but the property must be acquired by the original seller, not a later holder of the loan);
(B) The seller provides additional consideration as provided in the third bullet above (e.g., taking property subject to a mortgage or back taxes);
(C) The sale was reported on the installment method or the gain was fully taxed;
(D) Title to the property has passed to the purchaser or not;
(E) The original sale showed a gain or a loss;
(F) The property has increased or decreased in value since the time of the original sale;
(G) The property is reacquired by voluntary conveyance or foreclosure.

<u>COMPUTING THE GAIN ON REPOSSESSIONS</u>:

The amount taxed on repossession is the <u>SMALLER OF:</u>

(1) The gain realized on the repossession. This equals:
Down payment
\+ Principal payments made by the buyer on the note
\+ Principal payments made by buyer on seller's loan "assumed"
\- Gain already reported

- OR -

(2) The gain recognized (no loss is recognized). This equals:
Gain on the sale
\- Gain already reported
\- Costs of repossession

<u>COSTS OF REPOSSESSION</u>:

These include attorney's fees, court and filing costs, clearing of liens (paying back taxes and interest), costs of obtaining title, and the BALANCE OF THE BUYER'S LOANS "ASSUMED" BY THE SELLER.

<u>HOLDING PERIOD AND BASIS OF THE REACQUIRED PROPERTY</u>:

The holding period of the property includes the time the property was held before the first sale plus the time it was held after the repossession. Holding period of improvements made by the buyer begins the day after repossession. The basis of the repossessed property is equal to the basis of the buyer's obligation to the seller (i.e., the remaining face value less the unreported gain) PLUS the gain recognized on the repossession PLUS the costs of repossession.

Example - Repossession of Real Property - *On 01/01/17, Don sold a parcel of land to Hank for $35,000. Don's adjusted basis in the property was $20,000 (purchased 03/15/11). Hank paid $7,000 down and gave Don a note for the remainder. Under the terms of the note, Hank agreed to make annual principal payments of $5,000 per year beginning 01/01/18. Don used the installment method when he reported the transaction on his 2017 tax return. Hank made the 2018 payment but on 01/01/19, he defaulted on the note and Don repossessed the property. Don paid $1,000 in legal fees to get the property back.*

Selling price	*$35,000.00*
Adjusted basis	*20,000.00*
Gross profit	*15,000.00*
Gross profit % ($15,000/$35,000)	*42.86 %*

TERMS OF ORIGINAL SALE:

1. Principal payments in year of sale.................................... 7,000
2. Profit percentage - enter as a decimal.............................. .4286
3. Reported gain - line 1 times line 2...3,000
4. Subsequent principal payments....................................... 5,000
5. Profit percentage - enter as a decimal.............................. .4286
6. Reported gain - line 4 times line 5... 2,143
7. Total payments received/gain reported - ln 3 plus ln 6.. 5,143

AMOUNTS RECEIVED WITH RESPECT TO THE SALE:

8 Total received directly by seller 12,000
9 Rec'd on sale of purchaser's indebtedness.. 0
10. Buyer's principal payments on mortgage assumed from seller.................. 0
11. Total amounts received - sum of lines 8, 9, and 10 12,000

GAIN BEFORE LIMITATION:

12. Gain reported as income - line 7 5,143
13. Gain reported on sale of notes.. 0
14. Total gain reported - sum of lines 12 and 13 5,143
15. Gain before limitation - line 11 less line 14.. 6,857

LIMITATION OF GAIN:

16. Original sales price. 35,000
17. Original selling expenses 0
18. Amount realized -line 16 less line 17 35,000
19. Original adjusted basis of the property 20,000
20. Total gain realized - line 18 less line 19 15,000

REPOSSESSION EXPENSES:

21. Seller's assumption of indebtedness 0
22. Seller's advances on indebtedness 0
23. Seller's payments on taxes and insurance 0
24. Foreclosure costs (legal fees, escrow, etc.) 1,000
25. Other costs... 0
26. Total - sum of lines 21 through 25 1,000
27. Limitation on gain - line 20 less lines 14 & 26....................................... 8,857
*28. **GAIN ON REPOSSESSION** - lesser of ln 15 or ln 27 ....6,857*

BASIS FOR REACQUIRED PROPERTY:

29. Original sales price - line 16 35,000
30. Mortgage assumed by the buyer 0
31. Original contract price - line 29 less line 30 35,000
32. Total amounts received - line 8 12,000
33. Unpaid (unsatisfied) debt - line 31 less line 32 23,000
34. Profit percentage of debt - enter as a decimal....................................... .... .4286
35. Unreported gain - line 33 times line 34 9,858
36. Basis of unpaid debt - line 33 less line 35 13,142
37. Gain on repossession - line 28.. 6,857
38. Cost of repossession - line 26... 1,000
39. Subtotal - sum of lines 37 and 38 7,857
*40. **BASIS OF THE REPOSSESSED PROPERTY** - sum of lines 36 and 39....... ....20,999*

REPOSSESSION OF PERSONAL RESIDENCE:

Disregard the repossession rules if the gain on the original sale was deferred because of buying another residence (under pre-May 7, 1997 Sec. 1034 rules) or the Sec. 121 exclusion was used AND the property was sold again within one year of the repossession. Treat the resale as part of the original sale, but with a NEW SELLING PRICE (equal to the selling price from the second sale plus the cash received on the first sale). (If gain was deferred under the old Sec. 1034 provisions, then there will be a new basis for the replacement property.) If there is any additional gain to be recognized because of the new higher "selling price," report it in the year of the second sale. IF THE RESALE DOES NOT TAKE PLACE WITHIN A YEAR OF THE REPOSSESSION, THE REGULAR SECTION 1038 REPOSSESSION RULES APPLY.

Example - Resale of Repossessed Residence - *In 2017, Harry, who is not married, sold his residence for $310,000 and excluded all of his $240,000 gain under Section 121. In 2018, he repossessed the home but resold it within one year (in 2019) for $295,000. The adjusted basis of the house was $70,000. Facts:*

Selling price, original sale	*$310,000*
Selling price, post-repossession sale	*295,000*
Adjusted basis	*70,000*
Down payment on original sale	*40,000*
Principal payments on note held from original sale	*4,000*

2019 Sale

Selling price	*$295,000*	
Cash received on 1st sale	*44,000*	
Redetermined selling price		*339,000*
Adjusted basis		*<70,000>*
Gain realized		*269,000*
Sec 121 Exclusion		*<250,000>*
Gain recognized (reported on 2019 return)		*19,000*

Example - Repossessed Home Converted To Rental - *If Harry (previous example) didn't resell the house but converted it to rental after his reacquisition, the regular repossession rules apply and he computes any gain under the regular repossession rules discussed earlier and the home sale gain exclusion would not apply to that computation.*

Taxpayer's reacquisition of principal residence triggers loss of Sec 121 exclusion - The Tax Court has concluded that, where a taxpayer sold his primary residence and excluded gain under Code Sec. 121, then reacquired the property after the buyers defaulted, but did not resell it within one year of reacquiring it, the taxpayer had to recognize long-term capital gain on the reacquisition, including amounts previously excluded under Code Sec. 121. The Court found that subjecting the taxpayer to the general gain recognition rules of Code Sec. 1038 was required under the statute and consistent with the economics of the transaction. (Debough, (2014) 142 TC No. 17)

EFFECTS OF REPOSSESSION ON THE BUYER:

See the section on Debt Cancellation for how repossessions affect a buyer.

CALIFORNIA DIFFERENCES

California conforms to Federal computations. However, watch for differences in basis and installment sale profit percentage for original sale.

NOTES

REPOSSESSION OF REAL PROPERTY WORKSHEET

General Rule (Sec 1038)

PROPERTY INFORMATION:

Property description:____

Date purchased...................... ____/____/____

Date sold............................ ____/____/____

Date reacquired.................... ____/____/____

TERMS OF ORIGINAL SALES:

1. Principal payments in year of sale.................................. ________
2. Profit percentage - enter as a decimal........................... ________
3. Reported gain - line 1 times line 2... ________
4. Subsequent principal payments...................................... ________
5. Profit percentage - enter as a decimal........................... ________
6. Reported gain - line 4 times line 5... ________
7. Total payments received/gain reported - line 3 plus line 6.............................. ________

AMOUNTS RECEIVED WITH RESPECT TO THE SALE:

8. Total received directly by seller.. ________
9. Rec'd on sale of purchaser's indebtedness...................................... ________
10. Buyer's principal pmts on mtg assumed from seller...................... ________
11. Total amounts received - sum of lines 8, 9, and 10.. ________

GAIN BEFORE LIMITATION:

12. Gain reported as income - line 7.................................... ________
13. Gain reported on sale of notes.. ________
14. Total gain reported - sum of lines 12 and 13.................................... ________
15. Gain before limitation - line 11 less line 14...................................... ________

LIMITATION OF GAIN:

16. Original sales price.. ________
17. Original selling expenses... ________
18. Amount realized -line 16 less line 17................................________
19. Original adjusted basis of the property.. ________
20. Total gain reported - line 14.. ________

REPOSSESSION EXPENSES:

21. Seller's assumption of indebtedness.................................________
22. Seller's advances on indebtedness....................................________
23. Seller's payments on taxes and insurance....................... ________
24. Foreclosure costs (legal fees, escrow, etc.) .... ________
25. Other costs... ________
26. Total - sum of lines 21 through 25..________
27. Limitation on gain - line 18 less line 26) .... ________
28. **GAIN ON REPOSSESSION** - lesser of line 15 or line 27................................... ________

BASIS FOR REACQUIRED PROPERTY:

29. Original sales price - line 16... ________
30. Mortgage assumed by the buyer.......................................________
31. Original contract price - line 29 less line 30..________
32. Total amounts received - line 8... ________
33. Unpaid (unsatisfied) debt - line 31 less line 32..................................________
34. Profit percentage of debt - enter as a decimal................................. ________
35. Unreported gain - line 33 times line 34... ________
36. Basis of unpaid debt - line 33 less line 35........................ ________
37. Gain on repossession - line 28...________
38. Cost of repossession - line 26.. ________
39. Subtotal - sum of lines 37 and 38...________
40. **BASIS OF THE REPOSSESSED PROPERTY** - sum of lines 36 and 39.......... ________

BUSINESS CODES

Accommodation, Food Services, & Drinking Places
Accommodation

721310	Rooming & boarding houses
721210	RV (recreational vehicle) parks & recreational camps
721100	Travel accommodation (including hotels, motels, & bed & breakfast inns)

Food Services & Drinking Places

722410	Drinking places (alcoholic beverages)
722110	Full-service restaurants
722210	Limited-service eating places
722300	Special food services (including food service contractors & caterers)

Administrative & Support and Waste Management & Remediation Services Administrative & Support Services

561430	Business service centers (including private mail centers & copy shops)
561740	Carpet & upholstery cleaning services
561440	Collection agencies
561450	Credit bureaus
561410	Document preparation services
561300	Employment services
561710	Exterminating & pest control services
561210	Facilities support (management) services
561600	Investigation & security services
561720	Janitorial services
561730	Landscaping services
561110	Office administrative services
561420	Telephone call centers (including telephone answering services & telemarketing bureaus)
561500	Travel arrangement & reservation services
561490	Other business support services (including repossession services, court reporting, & stenotype services)
561790	Other services to buildings & dwellings
561900	Other support services (including packaging & labeling services, & convention & trade show organizers)

Waste Management & Remediation Services

562000	Waste management & remediation services

Agriculture, Forestry, Hunting, & Fishing

112900	Animal production (including breeding of cats and dogs)
114110	Fishing
113000	Forestry & logging (including forest nurseries & timber tracts)
114210	Hunting & trapping

Support Activities for Agriculture & Forestry

115210	Support activities for animal production (including farriers)
115110	Support activities for crop production (including cotton ginning, soil preparation, planting, & cultivating)
115310	Support activities for forestry

Arts, Entertainment, & Recreation Amusement, Gambling, & Recreation Industries

713100	Amusement parks & arcades
713200	Gambling industries
713900	Other amusement & recreation services (including golf courses, skiing facilities, marinas, fitness centers, bowling centers, skating rinks, miniature golf courses)

Museums, Historical Sites, & Similar Institutions

712100	Museums, historical sites, & similar institutions

Performing Arts, Spectator Sports, & Related Industries

711410	Agents & managers for artists, athletes, entertainers, & other public figures
711510	Independent artists, writers, & performers
711100	Performing arts companies
711300	Promoters of performing arts, sports, & similar events
711210	Spectator sports (including professional sports clubs & racetrack operations)

Construction of Buildings

236200	Nonresidential building construction
236100	Residential building construction

Heavy and Civil Engineering Construction

237310	Highway, street, & bridge construction
237210	Land subdivision
237100	Utility system construction
237990	Other heavy & civil engineering construction

Specialty Trade Contractors

238310	Drywall & insulation contractors
238210	Electrical contractors
238350	Finish carpentry contractors
238330	Flooring contractors
238130	Framing carpentry contractors
238150	Glass & glazing contractors
238140	Masonry contractors
238320	Painting & wall covering contractors
238220	Plumbing, heating & airconditioning contractors
238110	Poured concrete foundation & structure contractors
238160	Roofing contractors
238170	Siding contractors
238910	Site preparation contractors
238120	Structural steel & precast concrete construction contractors
238340	Tile & terrazzo contractors
238290	Other building equipment contractors
238390	Other building finishing contractors
238190	Other foundation, structure, & building exterior contractors
238990	All other specialty trade contractors

Educational Services

611000	Educational services (including schools, colleges, & universities)

Finance & Insurance Credit Intermediation & Related Activities

522100	Depository credit intermediation (including commercial banking, savings institutions, & credit unions)
522200	Nondepository credit intermediation (including sales financing & consumer lending)
522300	Activities related to credit intermediation (including loan brokers)

Insurance Agents, Brokers, & Related Activities

524210	Insurance agencies & brokerages
524290	Other insurance related activities

Securities, Commodity Contracts, & Other Financial Investments & Related Activities

523140	Commodity contracts brokers
523130	Commodity contracts dealers
523110	Investment bankers & securities dealers
523210	Securities & commodity exchanges
523120	Securities brokers
523900	Other financial investment activities (including investment advice)

Health Care & Social Assistance Ambulatory Health Care Services

621610	Home health care services
621510	Medical & diagnostic laboratories
621310	Offices of chiropractors
621210	Offices of dentists
621330	Offices of mental health practitioners (except physicians)
621320	Offices of optometrists
621340	Offices of physical, occupational & speech therapists, & audiologists
621111	Offices of physicians (except mental health specialists)
621112	Offices of physicians, mental health specialists
621391	Offices of podiatrists
621399	Offices of all other miscellaneous health practitioners
621400	Outpatient care centers
621900	Other ambulatory health care services (including ambulance services, blood, & organ banks)

Hospitals

622000	Hospitals

Nursing & Residential Care Facilities

623000	Nursing & residential care facilities

Social Assistance

624410	Child day care services
624200	Community food & housing, & emergency & other relief services
624100	Individual & family services
624310	Vocational rehabilitation services

Information

511000	Publishing industries (except Internet)

Broadcasting (except Internet) & Telecommunications

515000	Broadcasting (except Internet)
517000	Telecommunications

I

Internet Publishing & Broadcasting

516110	Internet publishing & broadcasting

Internet Service Providers, Web Search Portals, & Data Processing Services

518210	Data processing, hosting, & related services
518111	Internet service providers
518112	Web search portals
519100	Other information services (including news syndicates and libraries)

Motion Picture & Sound Recording

512100	Motion picture & video industries (except video rental)
512200	Sound recording industries
512200	Sound recording industries

Manufacturing

315000	Apparel mfg.
312000	Beverage & tobacco product mfg.
334000	Computer & electronic product mfg.
335000	Electrical equipment, appliance, & component mfg.
332000	Fabricated metal product mfg.
337000	Furniture & related product mfg.
333000	Machinery mfg.
339110	Medical equipment & supplies mfg.
322000	Paper mfg.
324100	Petroleum & coal products mfg.
326000	Plastics & rubber products mfg.
331000	Primary metal mfg.
323100	Printing & related support activities
313000	Textile mills
314000	Textile product mills
336000	Transportation equipment mfg.
321000	Wood product mfg.
339900	Other miscellaneous mfg.

Chemical Manufacturing

325100	Basic chemical mfg.
325500	Paint, coating, & adhesive mfg.
325300	Pesticide, fertilizer, & other agricultural chemical mfg.
325410	Pharmaceutical & medicine mfg.
325200	Resin, synthetic rubber, & artificial & synthetic fibers & filaments mfg.
325600	Soap, cleaning compound, & toilet preparation mfg.
325900	Other chemical product & preparation mfg.

Food Manufacturing

311110	Animal food mfg.
311800	Bakeries & tortilla mfg.
311500	Dairy product mfg.
311400	Fruit & vegetable preserving & speciality food mfg.
311200	Grain & oilseed milling
311610	Animal slaughtering & processing
311710	Seafood product preparation & packaging
311300	Sugar & confectionery product mfg.
311900	Other food mfg. (including coffee, tea, flavorings, & seasonings)

Leather & Allied Product Manufacturing

316210	Footwear mfg. (including leather, rubber, & plastics)
316110	Leather & hide tanning & finishing
316990	Other leather & allied product mfg.

Nonmetallic Mineral Product Manufacturing

327300	Cement & concrete product mfg.
327100	Clay product & refractory mfg.
327210	Glass & glass product mfg.
327400	Lime & gypsum product mfg.
327900	Other nonmetallic mineral product mfg.

Mining

212110	Coal mining
212200	Metal ore mining
212300	Nonmetallic mineral mining & quarrying
211110	Oil & gas extraction
213110	Support activities for mining

Other Services Personal & Laundry Services

812111	Barber shops
812112	Beauty salons
812220	Cemeteries & crematories
812310	Coin-operated laundries & drycleaners
812320	Drycleaning & laundry services (except coin-operated) (including laundry & drycleaning dropoff & pickup sites)
812210	Funeral homes & funeral services
812330	Linen & uniform supply
812113	Nail salons
812930	Parking lots & garages
812910	Pet care (except veterinary) services
812920	Photofinishing
812190	Other personal care services (including diet & weight reducing centers)
812990	All other personal services

Repair & Maintenance

811120	Automotive body, paint, interior, & glass repair
811110	Automotive mechanical & electrical repair & maintenance
811190	Other automotive repair & maintenance (including oil change & lubrication shops & car washes)
811310	Commercial & industrial machinery & equipment (except automotive & electronic) repair & maintenance
811210	Electronic & precision equipment repair & maintenance
811430	Footwear & leather goods repair
811410	Home & garden equipment & appliance repair & maintenance
811420	Reupholstery & furniture repair
811490	Other personal & household goods repair & maintenance

Support Activities for Agriculture & Forestry

115210	Support activities for animal production (including farriers)
115110	Support activities for crop production (including cotton ginning, soil preparation, planting, & cultivating)
115310	Support activities for forestry

Arts, Entertainment, & Recreation Amusement, Gambling, & Recreation Industries

713100	Amusement parks & arcades
713200	Gambling industries
713900	Other amusement & recreation services (including golf courses, skiing facilities, marinas, fitness centers, bowling centers, skating rinks, miniature golf courses)

Museums, Historical Sites, & Similar Institutions

712100	Museums, historical sites, & similar institutions

Performing Arts, Spectator Sports, & Related Industries

711410	Agents & managers for artists, athletes, entertainers, & other public figures
711510	Independent artists, writers, & performers
711100	Performing arts companies
711300	Promoters of performing arts, sports, & similar events
711210	Spectator sports (including professional sports clubs & racetrack operations)

Construction of Buildings

236200	Nonresidential building construction
236100	Residential building construction

Heavy and Civil Engineering Construction

237310	Highway, street, & bridge construction
237210	Land subdivision
237100	Utility system construction
237990	Other heavy & civil engineering construction

Specialty Trade Contractors

238310	Drywall & insulation contractors
238210	Electrical contractors
238350	Finish carpentry contractors
238330	Flooring contractors
238130	Framing carpentry contractors
238150	Glass & glazing contractors
238140	Masonry contractors
238320	Painting & wall covering contractors
238220	Plumbing, heating & air-conditioning contractors
238110	Poured concrete foundation & structure contractors
238160	Roofing contractors
238170	Siding contractors
238910	Site preparation contractors
238120	Structural steel & precast concrete construction contractors
238340	Tile & terrazzo contractors
238290	Other building equipment contractors
238390	Other building finishing contractors
238190	Other foundation, structure, & building exterior contractors
238990	All other specialty trade contractors

Educational Services

611000	Educational services (including schools, colleges, & universities)

Finance & Insurance Credit Intermediation & Related Activities

522100	Depository credit intermediation (including commercial banking, savings institutions, & credit unions)
522200	Nondepository credit intermediation (including sales financing & consumer lending)
522300	Activities related to credit intermediation (including loan brokers)

Insurance Agents, Brokers, & Related Activities

524210	Insurance agencies & brokerages
524290	Other insurance related activities

Securities, Commodity Contracts, & Other Financial Investments & Related Activities

523140	Commodity contracts brokers
523130	Commodity contracts dealers
523110	Investment bankers & securities dealers
523210	Securities & commodityexchanges
523120	Securities brokers
523900	Other financial investment activities (including investment advice)

Health Care & Social Assistance Ambulatory Health Care Services

621610	Home health care services
621510	Medical & diagnostic laboratories
621310	Offices of chiropractors
621210	Offices of dentists
621330	Offices of mental health practitioners (except physicians)
621320	Offices of optometrists
621340	Offices of physical, occupational & speech therapists, & audiologists
621111	Offices of physicians (except mental health specialists)
621112	Offices of physicians, mental health specialists
621391	Offices of podiatrists
621399	Offices of all other miscellaneous health practitioners
621400	Outpatient care centers
621900	Other ambulatory health care services (including ambulance services, blood, & organ banks)

Hospitals

622000	Hospitals

Nursing & Residential Care Facilities

623000	Nursing & residential care facilities

Social Assistance

624410	Child day care services
624200	Community food & housing, & emergency & other relief services
624100	Individual & family services
624310	Vocational rehabilitation services

Information

511000	Publishing industries (except Internet)

Broadcasting (except Internet) & Telecommunications

515000	Broadcasting (except Internet)
517000	Telecommunications

Internet Publishing & Broadcasting

516110	Internet publishing & broadcasting

Internet Service Providers, Web Search Portals, & Data Processing Services

518210	Data processing, hosting, & related services
518111	Internet service providers
518112	Web search portals
519100	Other information services (including news syndicates and libraries)

Motion Picture & Sound Recording

512100	Motion picture & video industries (except video rental)
512200	Sound recording industries

Manufacturing

315000	Apparel mfg.
312000	Beverage & tobacco product mfg.
334000	Computer & electronic product mfg.
335000	Electrical equipment, appliance, & component mfg.
332000	Fabricated metal product mfg.
337000	Furniture & related product mfg.
333000	Machinery mfg.
339110	Medical equipment & supplies mfg.
322000	Paper mfg.
324100	Petroleum & coal products mfg.
326000	Plastics & rubber products mfg.
331000	Primary metal mfg.
323100	Printing & related support activities
313000	Textile mills
314000	Textile product mills
336000	Transportation equipment mfg.
321000	Wood product mfg.
339900	Other miscellaneous mfg.

Chemical Manufacturing

325100	Basic chemical mfg.
325500	Paint, coating, & adhesive mfg.
325300	Pesticide, fertilizer, & other agricultural chemical mfg.
325410	Pharmaceutical & medicine mfg.
325200	Resin, synthetic rubber, & artificial & synthetic fibers & filaments mfg.
325600	Soap, cleaning compound, & toilet preparation mfg.
325900	Other chemical product & preparation mfg.

Food Manufacturing

311110	Animal food mfg.
311800	Bakeries & tortilla mfg.
311500	Dairy product mfg.
311400	Fruit & vegetable preserving & speciality food mfg.
311200	Grain & oilseed milling
311610	Animal slaughtering & processing
311710	Seafood product preparation & packaging
311300	Sugar & confectionery product mfg.
311900	Other food mfg. (including coffee, tea, flavorings, & seasonings)

Leather & Allied Product Manufacturing

316210	Footwear mfg. (including leather, rubber, & plastics)
316110	Leather & hide tanning & finishing
316990	Other leather & allied product mfg.

Nonmetallic Mineral Product Manufacturing

327300	Cement & concrete product mfg.
327100	Clay product & refractory mfg.
327210	Glass & glass product mfg.
327400	Lime & gypsum product mfg.
327900	Other nonmetallic mineral product mfg.

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212110	Coal mining
212200	Metal ore mining
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211110	0il & gas extraction
213110	Support activities for mining

Other Services Personal & Laundry Services

812111	Barber shops
812112	Beauty salons
812220	Cemeteries & crematories
812310	Coin-operated laundries & drycleaners
812320	Drycleaning & laundry services (except coin-operated) (including laundry & drycleaning dropoff & pickup sites)
812210	Funeral homes & funeral services
812330	Linen & uniform supply
812113	Nail salons
812930	Parking lots & garages
812910	Pet care (except veterinary) services
812920	Photofinishing
812190	Other personal care services (including diet & weight reducing centers)
812990	All other personal services

Repair & Maintenance

811120	Automotive body, paint, interior, & glass repair
811110	Automotive mechanical & electrical repair & maintenance
811190	Other automotive repair & maintenance (including oil change & lubrication shops & car washes)
811310	Commercial & industrial machinery & equipment (except automotive & electronic) repair & aintenance
811210	Electronic & precision equipment repair & maintenance
811430	Footwear & leather goods repair
811410	Home & garden equipment & appliance repair & maintenance
811420	Reupholstery & furniture repair
811490	Other personal & household goods repair & maintenance

Professional, Scientific, & Technical Services

541100	Legal services
541211	Offices of certified public accountants
541214	Payroll services
541213	Tax preparation services
541219	Other accounting services

Architectural, Engineering, & Related Services

541310	Architectural services
541350	Building inspection services
541340	Drafting services
541330	Engineering services
541360	Geophysical surveying & mapping services
541320	Landscape architecture services
541370	Surveying & mapping (except geophysical) services
541380	Testing laboratories

Computer Systems Design & Related Services

541510	Computer systems design & related services

Specialized Design Services

541400	Specialized design services (including interior, industrial, graphic, & fashion design)

Other Professional, Scientific, & Technical Services

541800	Advertising & related services
541600	Management, scientific, & technical consulting services
541910	Market research & public opinion polling
541920	Photographic services
541700	Scientific research & development services
541930	Translation & interpretation services
541940	Veterinary services
541990	All other professional, scientific, & technical services

Real Estate & Rental & Leasing Real Estate

531100	Lessors of real estate (including miniwarehouses & self-storage units)
531210	Offices of real estate agents & brokers
531320	Offices of real estate appraisers
531310	Real estate property managers
531390	Other activities related to real estate

Rental & Leasing Services

532100	Automotive equipment rental & leasing
532400	Commercial & industrial machinery & equipment rental & leasing
532210	Consumer electronics & appliances rental
532220	Formal wear & costume rental
532310	General rental centers
532230	Video tape & disc rental
532290	Other consumer goods rental

Religious, Grantmaking, Civic, Professional, & Similar Organizations

813000	Religious, grantmaking, civic, professional, & similar organizations

Retail Trade Building Material & Garden Equipment & Supplies Dealers

444130	Hardware stores
444110	Home centers
444200	Lawn & garden equipment & supplies stores
444120	Paint & wallpaper stores
444190	Other building materials dealers

Clothing & Accessories Stores

448130	Children's & infants' clothing stores
448150	Clothing accessories stores
448140	Family clothing stores
448310	Jewelry stores
448320	Luggage & leather goods stores
448110	Men's clothing stores
448210	Shoe stores
448120	Women's clothing stores
448190	Other clothing stores

Electronic & Appliance Stores

443130	Camera & photographic supplies stores
443120	Computer & software stores
443111	Household appliance stores
443112	Radio, television, & other electronics stores

Food & Beverage Stores

445310	Beer, wine, & liquor stores
445220	Fish & seafood markets
445230	Fruit & vegetable markets
445100	Grocery stores (including supermarkets & convenience stores without gas)
445210	Meat markets
445290	Other specialty food stores

Furniture & Home Furnishing Stores

442110	Furniture stores
442200	Home furnishings stores

Gasoline Stations

447100	Gasoline stations (including convenience stores with gas)

General Merchandise Stores

452000	General merchandise stores

Health & Personal Care Stores

446120	Cosmetics, beauty supplies, & perfume stores
446130	Optical goods stores
446110	Pharmacies & drug stores
446190	Other health & personal care stores

Motor Vehicle & Parts Dealers

441300	Automotive parts, accessories, & tire stores
441222	Boat dealers
441221	Motorcycle dealers
441110	New car dealers
441210	Recreational vehicle dealers (including motor home & travel trailer dealers)
441120	Used car dealers
441229	All other motor vehicle dealers

Sporting Goods, Hobby, Book, & Music Stores

451211	Book stores
451120	Hobby, toy, & game stores
451140	Musical instrument & supplies stores
451212	News dealers & newsstands
451220	Prerecorded tape, compact disc, & record stores
451130	Sewing, needlework, & piece goods stores
451110	Sporting goods stores

Miscellaneous Store Retailers

453920	Art dealers
453110	Florists
453220	Gift, novelty, & souvenir stores
453930	Manufactured (mobile) home dealers
453210	Office supplies & stationery stores
453910	Pet & pet supplies stores
453310	Used merchandise stores
453990	All other miscellaneous store retailers (including tobacco, candle, & trophy shops)

Nonstore Retailers

454112	Electronic auctions
454111	Electronic shopping
454310	Fuel dealers
454113	Mail-order houses
454210	Vending machine operators
454390	Other direct selling establishments (including door-to-door retailing, frozen food plan providers, party plan merchandisers, & coffee-break service providers)

Transportation & Warehousing

481000	Air transportation
485510	Charter bus industry
484110	General freight trucking, local
484120	General freight trucking, long distance
485210	Interurban & rural bus transportation
486000	Pipeline transportation
482110	Rail transportation
487000	Scenic & sightseeingtransportation
485410	School & employee bus transportation
484200	Specialized freight trucking (including household moving vans)
485300	Taxi & limousine service
485110	Urban transit systems
483000	Water transportation
485990	Other transit & ground passenger transportation
488000	Support activities for transportation (including motor vehicle towing)

Couriers & Messengers

492000	Couriers & messengers

Warehousing & Storage Facilities

493100	Warehousing & storage (except leases of miniwarehouses & self-storage units)

Utilities

221000	Utilities

Wholesale Trade Merchant Wholesalers, Durable Goods

423600	Electrical & electronic goods
423200	Furniture & home furnishing
423700	Hardware, & plumbing & heating equipment & supplies
423940	Jewelry, watch, precious stone, & precious metals
423300	Lumber & other construction materials
423800	Machinery, equipment, & supplies
423500	Metal & mineral (except petroleum)
423100	Motor vehicle & motor vehicle parts & supplies
423400	Professional & commercial equipment & supplies
423930	Recyclable materials
423910	Sporting & recreational goods & supplies
423920	Toy & hobby goods & supplies
423990	Other miscellaneous durable goods

Merchant Wholesalers, Nondurable Goods

424300	Apparel, piece goods, & notions
424800	Beer, wine, & distilled alcoholic beverage
424920	Books, periodicals, & newspapers
424600	Chemical & allied products
424210	Drugs & druggists' sundries
424500	Farm product raw materials
424910	Farm supplies
424930	Flower, nursery stock, & florists' supplies
424400	Grocery & related products
424950	Paint, varnish, & supplies
424100	Paper & paper products
424700	Petroleum & petroleum products
424940	Tobacco & tobacco products
424990	Other miscellaneous nondurable goods

Wholesale Electronic Markets and Agents & Brokers

425110	Business to business electronic markets
425120	Wholesale trade agents & brokers

Unable to Classify

999999	Unclassified establishments (unable to classify)

SEC 199A PASS-THROUGH DEDUCTION

AKA: Pass-Through Entity Deduction - Tax Cuts & Jobs Act of 2017 (TCJA), as revised by the Consolidated Appropriations Act, 2018 (P.L. 115-141) and explained in Proposed Regulations Sec 1.199A (released 8/8/2018) and finalized in February 2019.

RAPID FINDER

Overview

As part of TCJA, Congress changed the tax-rate structure for C-corporations to a flat rate of 21% instead of the former graduated rates that topped out at 35%. Needing a way to equalize the rate reduction for all taxpayers with business income, Congress came up with a new deduction for businesses that are not organized as C-corporations. It replaces the Sec 199 Domestic Production Activities Deduction.

TCJA

As a result, TCJA has provided a new and substantial tax benefit for most non-C-corporation business owners in the form of a deduction that is generally equal to 20% of their qualified business income (QBI). This deduction is most commonly known as a pass-through income deduction because it applies to income from pass-through business activities where the income passes through to the individual's, partner's or stockholder's individual 1040 tax return. This category includes income from sole proprietorships, partnerships, S-corporations, rentals, farms, Real Estate Investment Trusts (REITs), and pass-through income from publicly traded partnerships. The shorthand term for this deduction is the Sec 199A deduction, as 199A is the Internal Revenue Code section number for this provision.

The deduction is figured for each individual business activity subject to certain limitations and then combined before being limited to 20% of the taxpayer's taxable income without capital gains.

Pubs Forms

Related IRC and IRS Publications and Forms

- IRS Pub 535
- Reasonable Compensation – BB Chapter 3.29
- IRC Sec 199A
- IRC Se 162 – Trade or Business

The Details

OVERVIEW – A Simplified View of the 199A Deduction

The 199A can be very simple or it can be very complex. In fact, it may be one of the most complex deductions ever to come out of Congress. So, before getting into the nitty-gritty of this deduction we will first look at it in its simplest form and work up to the more complex issues.

To begin, let's first get an understanding of some of the terminology and definitions used in computing the Sec 199A deduction:

1. Taxable Income – When figuring the deduction for each pass-through activity of an individual, the deduction may be limited based upon the individual's 1040 taxable income (before the deduction). Do not confuse the taxpayer's 1040 taxable income with a pass-through activity's taxable income.

2. Qualified Business Income (QBI) – Is generally the net profit from a Schedule C, E or F, a 1065 K-1, and 1120S K-1, a 1041 K-1, REITS (dividends) and pass-through income from publicly traded partnerships (PTP). But also see *QBI Reductions for AGI Adjustments* on page 3.24.17

3. The Deduction - The deduction is equal to 20% of the pass-through income (the qualified business income (QBI)) from various business activities. For purposes of the introduction we will only consider QBI from sole proprietorships (Schedule C net profit), partnership K-1s (but not including guaranteed payments) and S-corporation K-1s.

4. Business Categories - There are two categories of business entities when computing the deduction (note: there is actually a third category for farming cooperatives which is quite complicated that we discuss later in the course).

a. Qualified Trades or Businesses (QTB), and

b. Specified Service Trades or Businesses (SSTB) – Which are basically those businesses providing personal services, such as tax practitioners. More details later in the course.

Why are QTB and SSTB In Separate Categories?

If you recall, the purpose of the prior Sec 199 domestic production deduction was to promote manufacturing in the U.S. and only allowed the deduction for the production of goods and not services. Sec 199A replaces the prior Sec 199 and in doing so carried over some of its characteristics which leads us to believe that is why QTBs and SSTBs (which only provide services) have been put into separate categories.

5. Limitations – The major distinction between QTBs and SSTBs is that the 199A deduction phases out for SSTBs for taxpayers with 1040 taxable incomes between the threshold and the cap shown in the table below, while QTBs continue to qualify if they pay wages or have qualified property.

Filing Status	**Threshold**			(Excess over threshold)	**Cap**		
	2018	**2019**	**2020**		**2018**	**2019**	**2020**
Married Joint	315,000	321,400	326,600	100,000	415,000	421,400	426,600
Single & Hd of Hshld	157,500	160,700	163,300	50,000	207,500	210,700	213,300
Married Separate	157,500	160,725	163,300	50,000	207,500	210,725	213,300

Note: Using the inflation adjusted numbers tends to complicate the calculations for teaching purposes. So, **the examples throughout this course material continue to use the 2018 amounts**.

SEC 199A TABLE

The most difficult concept in understanding how the Sec 199A deduction works is the relationship of:

- Filing status
- The taxpayer's 1040 taxable income, and
- The type of trade or business.

To help with that we have developed the chart below that allows you to quickly determine whether a deduction is allowed, and if so, what limitations apply.

Example Assume you have a married couple filing jointly for 2018, they have a 1040 taxable income (before the 199A deduction) of $469,000, and the trade or business is a SSTB. First select the box with their filing status, then move to the right to the correct range of taxable income, and lastly go down in that column to align with the type of business. In this case the SSTB does not qualify for the 199A deduction.

Taxpayer's Filing Status	**1040 Taxable Income (2018)** (Before the 199A deduction)		
Married Filing a Joint Return	Less Than $315,000	Between $315,000 and $415,000	Greater than $415,000
Other filing Statuses	Less Than $157,500	Between $157,500 and $207,500	Greater than $207,500
Type of Business	**The 199A Deduction***		
Specified Service Trade or Business (SSTB)	20% of QBI	Deduction is phased out	No deduction allowed
Qualified Trade or Business	20% of QBI	Wage limitation phased in	Deduction is the lesser of 20% of QBI or the wage limitation

* This is the 199A deduction for a single trade or business activity and is only the first step in determining a taxpayer's overall 199A deduction, which may include multiple sources of 199A deductions that are combined and limited to 20% of the taxpayer's taxable income without capital gains.

Taxable Income Below the Thresholds – Note from the chart above, as long as the taxpayer's taxable income is below the threshold both QTB and SSTB have no limitations and the Sec 199A deduction is a simple 20% of QBI (before applying the 1040 taxable income limitation discussed next).

<u>*1040 Taxable Income Limitation*</u> – Another confusing issue related to this deduction is the fact that after computing the 199A deduction for each of a taxpayer's pass-through business activities and then summing them all up for the total Sec 199A deduction, that deduction is then limited to the lesser of the 199A sum or 20% of the taxpayer's taxable income, less net capital gain. For this purpose, net capital gain includes qualified dividends.

<u>*Specified Trade or Business (SSTB) Examples*</u> – Since those that are taking this course are for the most part tax preparers, Enrolled Agents, and CPAs and they are all SSTBs we will first look at the examples for SSTBs.

<u>SSTB COMPUTATION</u>

Probably the best way to understand this deduction is by doing a simple example:

> ***SSTB Example #1 – Taxable Income Below Threshold -*** *Gary, who files jointly with his spouse, is a CPA and his 2018 net profit (QBI) from his Schedule C sole proprietorship is $350,000. He had no capital gains. Gary's 1040 taxable income before the 199A deduction is $300,000.* ***Since his taxable income is below the $315,000 threshold*** *there are no limitations and Gary's preliminary Sec 199A deduction is $70,000 (20% of $350,000). However, his deduction will be limited by his taxable income to $60,000 (20% x $300,000).*
>
> ***Note 1:*** *If Gary's $350,000 of QBI had been from a partnership K-1 (not counting guaranteed payments) the result would have been the same. It could have also been from an S-corporation K-1 with the same result.*
>
> **Note 2**: To keep this example and those that follow as uncluttered as possible, we are ignoring that some of the pass-through income is subject SE Tax. However, if it is subject to SE tax, the taxpayer would be entitled to an adjustment to income for ½ of the SE tax which would reduce the taxable income and provide a different 20% of taxable income result. Further, before multiplying the QBI by 20%, the QBI must be reduced by the SE tax deduction, as well as any adjustment the taxpayer claimed for SE health insurance premiums and certain retirement plan contributions. Thus, the preliminary QBI deduction will also be less. Again, we are omitting this adjustment from the examples to minimize the clutter and concentrate on the concepts.

Commentary: It is important to note the taxpayer's 1040 taxable income is the decisive factor whether or not any limitations are triggered. In the prior example the QBI income was purposely made higher than the taxpayer's taxable income to illustrate that point.

So, what happens when the taxpayer's taxable income exceeds the threshold? This is where things get to be tricky. Remember SSTBs are treated differently than other qualified trades or businesses and are far less complicated.

> ***SSTB Example #2 – Taxable Income Above the Phaseout Cap -*** *If Gary's 2018 taxable income in Example #1 was above the cap of $415,000 (threshold of $315,000 plus $100,000), then Gary's 199A deduction for would be zero, completely phased out.*

Now this brings us to the complicated example, where Gary's taxable income is above the threshold ($315,000 for MFJ) and below the cap ($415,000). This is where the deduction is phased out.

> ***SSTB Example #3 – Taxable Income Between the Threshold and Phaseout Cap -*** *If Gary's taxable income in Example #1 had been $365,000 his 199A deduction would be partially phased out. For this computation we have developed a worksheet to do the phase-out calculation. We also need some additional information from Gary's Schedule C: the wages Gary paid his employees (for this example $50,000) and the unadjusted basis of his business equipment (we will use $20,000).*

We have developed a SSTB worksheet that includes the phase-out computation. The phase-out is an awkward calculation that takes into consideration the wages paid by the business and the qualified property of the business. **Both of these items will be explained later in the course**. As you can see from the worksheet, Gary's deduction has been partially phased out and his deduction is only $22,500.

Continue to worksheet – next page

199A SSTB Worksheet (2018)

For use **ONLY** with Specified Service Trades or Businesses)

Business Name: ____

☐ Schedule C ☐ Schedule E ☐ Schedule F ☐ 1065 ☐ 1120-S

1.	Qualified Business Income (QBI)	350,000
2.	Taxpayer's 1040 Taxable Income (before the 199A deduction)	365,000
3.	Threshold (enter $315,000 if MFJ; otherwise enter $157,500)	315,000
4.	Differential (enter $100,000 if MFJ; otherwise enter $50,000)	100,000
5.	Line 3 plus Line 4 (top of threshold range)	415,000
6.	If Line 2 equals or exceeds Line 5, **STOP** and enter zero on Line 22. Note: The 199A deduction for this business is zero. If Line 2 is less than Line 5, enter zero here and continue to Line 7.	0
7.	Tentative 199A deduction (20% of Line 1)	70,000
8.	If Line 2 is less than Line 3, **STOP** and enter the amount from Line 7 on Line 22. Note: The preliminary 199A deduction for this business is the full 20% of QBI. If line 2 is greater than Line 3, enter zero here and continue to Line 9.	0
9.	Wages paid by this business	50,000
10.	Assets (unadjusted basis of this business' eligible tangible property)	20,000
11.	50% of wages	25,000
12.	25% of Wages	12,500
13.	2.5% of Assets	500
14.	Line 12 plus line 13	13,000
15.	Wage Limit – Greater of line 11 or Line 14	25,000
16.	Subtract Line 3 from Line 2	50,000
17.	Divide Line 16 by Line 4	0.500
18.	If Line 7 is greater than Line 15, enter ((Line 7 – Line 15) x Line 17). Otherwise enter zero.	22,500
19.	Line 7 less Line 18	47,500
20.	1 minus Line 17	0.500
21.	Line 20 times Line 19	23,750
22.	**Preliminary Section 199A Deduction –** Lesser of Line 18 or Line 21	22,500

Instructions: This worksheet can only be used for specified service trades or businesses. It is designed to determine the preliminary 199A deduction for a single business. The results of this worksheet must be combined with the results from other businesses and flow-through income of the taxpayer to determine the combined preliminary Sec 199A deduction for the taxpayer. The combined preliminary Sec 199A deduction is further limited to 20% of the adjusted taxable income of the taxpayer.

ClientWhys has a separate worksheet for use with other qualified businesses. Although we believe the worksheets compute the deduction correctly, ultimately, the IRS worksheets or forms will take precedence.

Specified Service Trades or Businesses: Generally, includes any trade or business described in Sec 1202(e)(3)(A), but excluding engineering and architecture and trades or businesses that involve the performance of services that consist of investment-type activities. Specified service businesses include trades or businesses involving the performance of services in the fields of: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees, as defined in Reg. 1.199A-5(b)(2).

QUALIFIED TRADE OR BUSINESS

Now let's take a quick look at the results had Gary's business not been a SSTB and instead was a QTB.

> ***QTB Example #4 – Taxable Income Below Threshold*** *– Using the same situation as Example #1 the results would have been exactly the same since neither a QTB nor a SSTB has any limitations when the taxpayer's taxable income is below the threshold amount for the taxpayer's filing status. Thus, as with Example #1, Gary's preliminary 199A deduction would be $70,000 (20% of $350,000) but limited by his taxable income to $60,000 (20% x $300,000).*

> ***QTB Example #5 – Taxable Income Above the Threshold –*** *Unlike a SSTB whose 199A deduction is completely phased out when the taxpayer's taxable income exceeds the cap, a QTB can still have a deduction based on a so-called wage limitation. Although referred to as the wage limitation, it sometimes includes a percentage of the taxpayer's business assets.*

Wage Limitation - We will cover the wage limitation in more detail later in the course, but here is generally how it works:

When the taxpayer's 1040 taxable income exceeds the cap, in Gary's case $415,000 ($315,000 + $100,000), the deduction is limited to the **lesser** of:

1. 20% of QBI (net of adjustments, see page 3.24.16), or
2. The wage limitation

   The wage limitation is the greater of:

   - 50% of the W-2 wages paid by the business or
   - 25% of the W-2 wages paid by the business plus 2.5% of the unadjusted basis of the business's qualified property (abbreviated UBIA) More on UBIA later.

QTB Example #6 – Taxable Income Between the Threshold and Cap – As with a SSTB there is a complicated phaseout calculation. So rather than trying to explain how this works, we included the phaseout computation in the QTB worksheets that we have developed. There is also an example on page 3.24.12.

Ok, now that you understand the basic concepts of the Sec 199A deduction it is time to learn some definitions related to this deduction.

TAXABLE INCOME (TI)

There are actually two definitions for TI:

1. When figuring the preliminary 199A deduction for a specific qualified trade or business the taxpayer's 1040 taxable income before deducting the 199A deduction is used.

2. After the preliminary 199A deductions for each qualified trade or business are determined, combined with the 199A deductions from real estate investment trusts (REITs) and publicly traded partnerships (PTPs), that total is then limited to 20% of the taxpayer's taxable income. For purposes of this computation the term taxable income refers to the taxpayer's 1040 AGI minus standard or itemized deductions, but without regard to the Sec 199A deduction and without any net capital gain. Thus, the 199A deduction itself is not considered when determining the taxable income for this purpose.

THRESHOLD AMOUNT

For the 199A deduction the term "threshold" is used to both phase out and phase in limitations.

1. **Specified Service Trades or Businesses** – When used in conjunction with the 199A computation for SSTBs, the term threshold refers to the taxable income (TI) level at which the 199A deduction begins to phase out for higher income taxpayers.

2. **Qualified Trades or Businesses** - When used in conjunction with the 199A computation for qualified trades or businesses, the term threshold refers to the TI level at which the wage limitation begins to phase in for higher income taxpayers.

The 199A threshold is actually the same threshold as for the 32% tax bracket under TCJA for 2018 and is inflation adjusted annually. Thus for 2018 it is $315,000 for married taxpayers filing jointly or $157,500 for other filing statuses. The cap (top of the phase-out/phase-in range) is reached when the taxpayer has an additional $100,000 of taxable income for married filing joint taxpayers and $50,000 for others. Thus for 2018 the cap is $415,000 for married taxpayers filing jointly or $207,500 for other filing statuses. See page 3.34.02 for 2019 amounts.

Phaseout Cap – Although there is no official name assigned to this value, we will refer to it as the phaseout cap in this course. Some call it a ceiling. It is the sum of the threshold amount and the delta amount for a taxpayer's filing status. So, for 2018, for MFJ taxpayers it is $415,000 ($315,000 + $100,000) and for others it is $207,500 ($157,500 + $50,000).

TRADE OR BUSINESS

One of the more important issues related to the legislation is the definition of a "trade or business" since that describes the kind of activity that can create income for purposes of the 199A deduction.

The tax code does not provide a definitive "bright line" definition of a trade or business, and the regulations simply adopted an existing subjective definition that relies on the outcomes of past court cases and interpretive rules the IRS has issued under Code Sec. 162, which is the most familiar provision using the term "trade or business." This leaves some room for interpretation; most notably whether or not rental real estate income qualifies for the Sec. 199A deduction. Our research finds that except for totally passive rental real estate activities such as triple net leases, a rental real estate activity is a trade or business for purpose of Section 199A. But more on this later in the course.

The regulation also specifies a "qualified trade or business" means any trade or business other than a specified service trade or business, or the trade or business of performing services as an employee. This was done for the following reasons:

- Specified Service Trade or Business – A special computation was carved out for SSTBs; thus they are included in the term qualified trade or business.
- Performing Services as an Employee – Congress does not want employees claiming this deduction on the basis of their wage earnings. With the suspension of the deduction for employee business expenses from the Schedule A for 8 tax years, they specifically added this phrase to make it clear employees do not qualify for the deduction.

The rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a Section 162 trade or business is nevertheless treated as a trade or business for purposes of Section 199A, but only if the property is rented or licensed to a trade or business which is commonly controlled under §1.199A-4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under §1.199A-4(b)(1)).

PASS-THROUGH ENTITIES

The Sec 199A deduction applies to pass-through entities and certain other sources of pass-through income, subject to certain limitations. The following are entities to which the deduction may apply:

- Schedule C
- Schedule E
- Schedule F
- Partnership*
- S-Corporation*
- Real Estate Investment Trust*⬩
- Publicly Traded Partnership* ⬩

*Deduction is determined at the partner or shareholder level.

⬩This component of the Section 199A deduction is not limited by W-2 wages or UBIA of qualified property.

QUALIFIED BUSINESS INCOME (QBI)

QBI is generally the net amount of income, gain, deduction, and loss relating to any qualified trade or business of the taxpayer to the extent these items are effectively connected with the conduct of a trade or business within the U.S. and included or allowed in determining taxable income for the year.

- **QBI Adjustments:**
  - Ordinary gain attributable to the sale of partnership interest is included in QBI. (Sec 751)
  - Changes in accounting method adjustments, both positive and negative, are taken into account when figuring QBI. (Sec 481)
  - Puerto Rico - If all of an individual's QBI from sources within the Commonwealth of Puerto Rico are taxable to the U.S., then the QBI will qualify for the Section 199A deduction.
- **QBI does *not* include:**
  - Certain investment items;
    - Any short- or long-term capital gain or loss.
    - Any dividend, income equivalent, or payment in lieu of dividends.
    - Any interest income other than that which is allocable to the trade or business.

    - Any item of gain or loss from commodity transactions or foreign currency transactions (as described in Sec 954(c)(1) subparagraphs (C) and (D) by substituting qualified trade or business for controlled foreign corporation).
    - Annuity income that is not received in connection with a trade or business.
    - Any item of deduction or loss described in the prior clauses.
  - Reasonable compensation paid to the taxpayer;
  - Guaranteed payment to a partner for services;
  - Guaranteed payment to a partner for use of capital; or
  - Payment to a partner for services rendered with respect to the trade or business.

SPECIFIED SERVICE TRADES OR BUSINESSES (SSTB)

The deduction is limited as to how it applies to specified service trades or businesses described in Sec. 1202(e)(3)(A), but excluding engineering and architecture and trades or businesses that involve the performance of services that consist of investment-type activities.

Specified service trades or businesses are described by the IRS as being trades or businesses in the fields of:

- *Health* – The performances of services by physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals who provide medical services directly to a patient. Does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

- *Law* – The performance of services in the field of law means services provided by lawyers, paralegals, legal arbitrators, mediators, and similar professionals in their capacity as such. The performance of services in the field of law does not include providing services that do not require skills unique to the field of law – for example, services provided to a lawyer by printers, delivery services, or stenography services.

- *Accounting* - The performance of services in the field of accounting means services provided by accountants, enrolled agents, tax return preparers, financial auditors, and similar professionals in their capacity as such. Provision of services in the field of accounting is not limited to services requiring state licensure as a certified public accountant (CPA). The field of accounting does not include payment processing and billing analysis.

- *Actuarial Science* – The performance of services in the field of actuarial science means the services provided by actuaries and similar professionals in their capacity as such. It does not include the services provided by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

- *Performing Arts* - The performance of services in the field of the performing arts means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. It does not include providing services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, persons who broadcast or otherwise disseminate video or audio of performing arts to the public are not considered to be providing services in performing arts.

  Commentary*: The preamble of the final regulation used "****writers****" as an example of an occupation that may or may not be a SSTB. To quote the preamble: "To the extent that a writer is paid for written material, such as a song or screenplay, that is integral to the creation of the performing arts, the writer is performing services in the field of performing arts".*

  Applying that standard, it would seem the following professionals could fall into the definition of a SSTB: makeup artists, costume designers, set designers, lighting designer and director, sound and music directors, film editors, etc. However, remember Sec 199A does not apply to the earnings of those paid as employees. For example, a self-employed lighting director would be an SSTB while a lighting technician on payroll would not.

- *Athletics* - The performance of services in the field of athletics means the performances of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. It does not include providing services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. It also does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

- *Consulting* **-** The performance of services in the field of consulting means providing professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes lobbyists and other similar professionals performing services in their capacity as such. It does not include minor consulting that accompanies the sale of a product. A trade or businesses is not an SSTP if less than 10% of gross receipts are from consulting (5% where the gross receipts are greater than $25 Million).
- *Financial services* - The definition of financial services applies to services typically performed by financial advisors and investment bankers and provides that the field of financial services includes providing the following financial services to clients: managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 (bankruptcy) or similar cases), and raising financial capital by underwriting, or acting as the client's agent in the issuance of securities, and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals, but does not include banking services such as taking deposits or making loans.
- *Brokerage Services* **-** The field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities for a commission or fee. This includes services provided by stock brokers and other similar professionals but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

> **Commentary:** Final regulation §1.199A-5(b)(2)(x) confirms that this does not include services provided by **real estate agents and brokers, or insurance agents and brokers**. Thus, these activities are **not SSTBs**.

- *Reputation or Skill* - The original legislation included in its list of trades or businesses that were SSTBs, those where the principal asset of a trade or business is the reputation or skill of one or more of its employees or owners. Did this mean, for example, that a self-employed plumber who provided his skill for the business wouldn't be eligible for the 199A deduction? Luckily, in a taxpayer-friendly interpretation, the tax regulations have generally defined "reputation and skill" to mean:

(1) Receiving income for endorsing products or services for which the individual provides endorsement services;

(2) Licensing or receiving income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; or

(3) Receiving appearance fees or income (including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television, and other media hosts, and video game players).

> **Examples**: Alex Trebek endorsing Colonial Penn Insurance, Shaquille O'Neal – Celebrity Cruise Lines and the General Insurance

(4) Investing and investment management – see description in Reg. 1.199A5(b)(2)(xi)

(5) Trading – see description in Reg. 1.199A-5(b)(2)(xii)

(6) Dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)) – see description in Reg 1.199A-5(b)(2)(xiii)

$25 MILLION RULE

- *$25 Million or Less* - A trade or business (determined before aggregation) is not an SSTB if the trade or business has gross receipts of $25 million or less (in a taxable year) **and** less than 10% of the gross receipts of the trade or business is attributable to the performance of services in an SSTB.
- *More Than $25 million* - For trades or businesses with gross receipts greater than $25 million (in a taxable year), a trade or business is not an SSTB if less than 5% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB. (Reg. Sec.1.199A-5(c)(1))

DETERMINING W-2 WAGES

Although determining the wages for the purposes of computing the Sec 199A wage limit would seem to be a simple matter of just adding up the wages the business paid, unfortunately it is not. Wages for this purpose will only include wages paid during the calendar year. The wages include wages paid to employees, and if an S corporation, to the officers of the corporation. Reg 1.199A-2(b)(2)(iv) provides the following options in determining wages.

Step One – Determine the W-2 wages. The IRS provides 3 methods to determine the wage amounts with the unmodified box method being the simplest but the one that results in a lower wage number. These methods are the same three options IRS allowed for determining wages eligible for the now-repealed Sec 199 domestic production activities deduction.

- **Unmodified Box Method** – It is the lesser of:
  - Total entries in Box 1 of all Forms W-2 filed with SSA, or
  - Total entries in Box 5 (Medicare wages) of all Forms W-2 filed with SSA.

UNMODIFIED BOX METHOD	
1. Total amounts in Box 1 of W-2s filed for the business entity…	
2. Total amounts in Box 5 of W-2s filed for the business entity…	
TOTAL – UNMODIFIED BOX METHOD – Lesser of 1 or 2	

- **Modified Box 1 Method** – Determined as follows:
  - Total the entries in Box 1 of all Forms W-2 filed with SSA, then
  - Subtract the amounts in the Box 1 total that are not wages for FIT withholding, such as supplemental unemployment benefits, annuity payments and sick pay. (Sec 3402(o))
  - Finally add the total amounts reported in box 12 (excludable pension contributions) codes D, E, F, G, and S.

MODIFIED BOX 1 METHOD	
1. Total amounts in Box 1 of W-2s filed for the business entity…	
2. Amounts in Box 1 not subject to withholding (supplemental unemployment, annuity payments and sick pay)…	< >
3. Total pension plan exclusions included in Box 12 codes D, E, F, G, and S…	
4. TOTAL – MODIFIED BOX 1 METHOD (combine 1, 2 & 3)	

Example: *Modified Box 1 method for SL Lewis, Inc., an S Corporation with two shareholders, Susan Lewis who owns 80% of the stock and Jack Miller who owns 20% of the stock. The total Box 1 wages for the stockholders and employees for the year is $300,000. The $300,000 amount included $4,000 of supplemental unemployment compensation benefits. In addition, Box 12 included $35,000 code D amounts (employee 401(k) contributions). The Modified Box 1 amount is $331,000 ($300,000 – 4,000 + $35,000) which is allocated $264,800 to Susan (80% of $331,000) and $66,200 to Jack (20% of $331,000).*

- **Tracking Wages Method** – The taxpayer actually tracks total wages subject to Federal income tax withholding and makes appropriate modifications. W-2 wages using the tracking wages method are determined as follows:
  - Total of the entries in Box 1 of all Forms W-2 filed with SSA, **plus**
    The total amounts reported in forms W-2 box 12 of Forms W-2 that are coded:
  - D – Sec 401(k) elective deferrals
  - E – Sec 403(b) elective deferrals
  - F - Sec 408(k) salary reduction SEP
  - G – Sec 457(b) deferred compensation plan
  - S – Sec 408(p) salary reduction SIMPLE plan

TRACKING WAGES METHOD	
1. Total amounts in Box 1 of W-2s filed for the business entity…	
2. Total pension plan exclusions included in Box 12 codes D, E, F, G, and S.	
3. TOTAL (line 1 + line 2) – MODIFIED BOX 1 METHOD	

Compensation paid to statutory employees (Form W-2 box 13 is checked), is not includible in the calculation of W-2 wages under any of these methods. Wages paid by another employer, such as a staffing agency, are included, but both businesses can't claim the same wages.

Step Two – Properly allocate W-2 wages so only wages associated with QBI are included in the wage limitation calculation. A business entity could have non-U.S. source income, investment income, and capital gains income – none of which is QBI. An activity may have a concoction of business activities and perhaps not all of the activities produce QBI, and an adjustment may be required. (Sec 1.199A(b)(4))

QUALIFIED PROPERTY

Qualified property is defined as meaning tangible, depreciable property which is **held by** and **available for use** in the qualified trade or business at the close of the tax year, which is **used at any point** during the tax year **in the production of qualified business income**, and the depreciable period for which has not ended before the close of the tax year (Code Sec. 199A(b)(6)(A)). Qualifying **tangible depreciable** property would include, for example:

- Machinery
- Tools
- Vehicles
- Residential Buildings (but not land; land is not depreciable)
- Home office (if using the actual expense method, see below)
- Commercial Buildings (but not land; land is not depreciable)
- Office furnishings
- Computer systems
- Bundled software (sold with the computer)
- Over the counter software
- Qualifying property (leasehold improvements, restaurant property and retail improvement property)
- Race horses
- Certain fruit and nut trees and vines (once they reach production stage)
- Certain livestock (generally those purchased for draft, breeding or dairy)
- Farm buildings (but not land; land is not depreciable)
- See IRS Publication 225 for other depreciable farm property
- See IRS Publication 949 for other depreciable property

NOT included would be Sec. 197 intangibles such as:

- Goodwill and going concern value
- Workforce in place
- Know-how
- Customer and supplier-based intangibles
- Government licenses and permits
- Franchises, trademarks, trade names

Special Circumstances – Placed in Service Date

- MACRS property acquired in Sec 1031 Exchange or involuntary Conversion - Split Basis:
  - *Exchanged Basis - Date placed in service will be date the relinquished property was placed in service.*
  - *Excess Basis – Date the replacement property was placed in service.*
- Acquired in Sec 1031 Exchange or involuntary Conversion – Electing Out of Split Basis - Date the replacement property was placed in service.

Unadjusted Basis Immediately After Acquisition (UBIA) – Generally means cost or other depreciable basis on the date placed in service. (Code Sec. 199A(b)(6)(B)(3)).

- It is not reduced for depreciation.
- It is not adjusted for any tax credits allowed.
- Not reduced for bonus depreciation.
- Not reduced for Sec 179 expensing.
- It is reduced for any personal use during the year – such as personal use of a vehicle.
- In the case of real property it does not include land.
- Improvements are treated as separate qualified property.
- Property is not qualified property if acquired within the last 60 days of the year and disposed of within 120 days without being used for at least 45 days prior to disposition. However, ok if taxpayer can show the purposes was not to increase the 199A deduction.

Home Office - It appears, although generally trivial, that when using the home office actual expense method, the home office can be included in UBIA since per Reg 1.199A-2(a)(3) it is "determined and reported" on the tax return.

Allocating UBIA – Where a taxpayer is a partner or shareholder the partnership or S corporation must allocate the UBIA among the shareholders and partners in the same manner as depreciation is allocated to the shareholder or partner. If the qualified property does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended):

- In the case of a partnership, each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners if the qualified property were sold at fair market value in a hypothetical sale for cash.

- In the case of an S corporation, each shareholder's share of the UBIA of the qualified property is based on the ratio of shares in the S corporation held by the shareholder over the total shares of the S corporation.

NOTE: There are adjustments related to corporate and partnership dispositions not covered in this material.

Depreciable Period – For this purpose the term depreciable period means the period beginning on the date the taxpayer first puts the property in service and **ending on the later of:**

(a) 10 years after the placed-in-service date or

(b) The last day of the last full year of the applicable MACRS recovery period of the property (Code Sec. 199A(b)(6)(B)).

Item	***Property***	***Cost***	***Life***	***In Service***	***Method***	***Qualifying 199A Property***
1	*Displays cases*	*$4,500*	*7*	*2007*	*Depreciate*	*$ 0*
2	*Additional display cases*	*$2,500*	*7*	*2009*	*100% Bonus*	*$ 2,500*
3	*Storage racks*	*$1,200*	*7*	*2016*	*Sec 179*	*$ 1,200*
4	*Cash register*	*$900*	*5*	*2010*	*Depreciate*	*$ 900*
5	*Price labeling machine*	*$175*	*5*	*2010*	*Expense*	*$ 175*
6	*Computer system*	*$2,300*	*5*	*2015*	*Sec 179*	*$ 2,300*
7	*Delivery Truck (light)*	*$8,700*	*5*	*2012*	*Depreciate*	*$ 8,700*
	TOTAL					***$ 15,775***

Example #7 – Retail Store - *Gary has a retail store that he operates in rented retail space. His property that he used in his business* ***during 2018*** *is listed in the table above.*

When looking at the example, remember that the value we use for "qualifying 199A property" is the unadjusted basis. So, depreciation and expensing is ignored for this purpose. However, property counts as "qualifying property" within its depreciable life or 10 years, whichever is greater. Items 1, 4, 5 and 7 are past their useful lives but only 1 has been in service for a period greater than 10 years. So, all of Gary's property except item #1 counts as "qualifying 199A property". Thus, when the wage limitation is computed for Gary the qualifying property used in the computation will be $15,775.

UBIA Example #8: *Richard is a 25% shareholder in an S-Corporation that is not a specified service trade or business. During 2018 the S-corporation had $30,000 of qualified property it used during the year. Thus, when the wage limitation is computed for Richard, the qualifying property used in the computation will be $7,500 (25% of $30,000).*

UBIA Example #9: *Joyce owns a rental property. She originally purchased the property 12 years ago for $500,000 and the land value was $200,000. $300,000 ($500,000 - $200,000) would be the qualified property value for Joyce's rental property.*

Real Estate Investment Trust (REIT) – Sec 199A also includes qualified REIT dividends as pass-through income. However, for this purpose qualified REIT dividends do not include any portion of a dividend received from an REIT that is a capital gain dividend or qualified dividend.

Qualified Publicly Traded Partnership Income – The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of:

(A) The net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in Sec 199A(c)(3) and determined after the application of Sec 199A(c)(4) from a publicly traded partnership with pass-through income (Sec 7704(c)), and

(B) Any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under Sec 751(a) (unrealized receivables of the partnership).

REITS and Publicly Traded Partnerships - The regulations make it clear that the 199A computation for REITS and publicly traded partnerships (PTPs) is separate from that of the other 199A computations and has no effect on the other's computation. Thus, should the QBI from REITS and PTPs be negative, the result will be a separate loss carryover and will have no effect on the taxpayer's computation of the business entity 199A deduction.

Cooperative Dividends – Cooperatives are not eligible for the deduction. Instead, cooperatives must provide the necessary information to their patrons on Form 1099-PATR or an attachment to help eligible patrons figure their deduction. See the Instructions for Form 1120-C, U.S. Income Tax Return for Cooperative Associations, for rules applicable to agricultural and horticultural cooperatives

Qualified Trade or Businesses

Now we can continue our study of QTB and learn how to apply the wage limitation to QBI from QTBs.

So even though a taxpayer's 1040 taxable income is above the phaseout cap, they can still get a Sec 199A deduction for a QTB so long as the business entity paid wages and/or has UBIA from qualified property. Those are the elements that make up the wage limitation.

Wage Limitation: When a taxpayer's 1040 taxable income exceeds the phaseout cap the preliminary QBI deduction is limited to the lesser of 20% of QBI or the wage limitation. The wage limitation is the greater of:

- 50% of the W-2 wages that the business paid, or
- 25% of the W-2 wages from the business plus 2.5% of the unadjusted basis of the business's qualified property.

However, TCJA phased in this limitation for taxpayers whose taxable income is between the threshold and the cap, resulting in a rather complicated calculation. So, we will study the limitation as it applies to taxpayers whose taxable income exceeds the phaseout cap and rely on the worksheet for those with 1040 taxable incomes between the threshold and the phaseout cap. We start with a taxpayer that is an S corporation stockholder:

Example #10 – Taxable Income Above the Phaseout Cap - *Therese, who is married and filing a joint return, is an active shareholder (meaning she works in the business and is not simply an investor) in an S-corporation and owns 40% of the stock in the corporation. For 2018 she receives a W-2 in the amount of $250,000 as her compensation for working in the business and a K-1 that includes her flow-through income, QBI, of $150,000. Her taxable income (AGI less standard or itemized deductions) from her 1040 is $500,000, which is above the $415,000 cap, so she is subject to the wage limitation. The corporation paid $600,000 in wages during the year, which includes the $250,000 paid to her, and had $100,000 of qualified property. So, her 199A deduction is determined as follows:*

Summary:
QBI = $150,000
Her share of Wages = $240,000 (40% of $600,000)
Her share of qualified property = $40,000 (40% of $100,000)
20% of her QBI = $30,000
50% of her share of the wages = $120,000 (50% of $240,000)
25% of her share of the wages = $ 60,000 (25% of $240,000)
2.5% of the qualified property = $1,000 (2.5% of $40,000)

The preliminary 199A deduction is limited for this activity to the lesser of 20% of QBI ***($30,000)*** *or the greater of:*

- *50% of the W-2 wages from the business* ***($120,000)*** *or*
- *25% of the W-2 wages ($60,000) from the business plus 2.5% of the unadjusted basis of the business's qualified property ($1,000), which totals* ***$61,000****.*

$120,000 is greater than $61,000 so the preliminary 199A deduction for this entity is the lesser of the $120,000 W-2 limitation or $30,000; thus, ***the deduction is $30,000****.*

Example #11 – Wages Adjusted - *But what would have been the result if Therese had taken a W-2 salary of only $90,000 instead of $250,000 and the difference ($160,000) had been added to her QBI (flow-through income). Her QBI would be $310,000 ($160,000 + $150,000). The wages paid by the S-corporation would drop to $440,000 ($600,000 - $160,000). The qualified property would remain the same and we have a substantially different result.*

Summary:
QBI = $310,000.   Her share of Wages = $176,000 (40% of $440,000)
Her share of qualified property = $40,000 (40% of $100,000)
20% of her QBI = $62,000
50% of her share of the wages = $88,000 (50% of $176,000)
25% of her share of the wages = $44,000 (25% of $176,000)
2.5% of the qualified property = $1,000 (2.5% of $40,000)
So, the preliminary deduction is limited to the lesser of 20% of QBI ***($62,000)*** *or the greater of:*

- *50% of the W-2 wages from the business* ***($88,000)*** *or*
- *25% of the W-2 wages ($44,000) from the business plus 2.5% of the unadjusted basis of the business's qualified property ($1,000), which totals* ***$45,000****.*

$88,000 is greater than $45,000 so the preliminary 199A deduction for this entity is the lesser of the $88,000 W-2 limitation or $62,000; thus ***the preliminary deduction is $62,000****.*

SEE COMPLETED WORKSHEET ON PAGE 3.24.14

Example #12 – Different Results for Different Taxpayer - *Consider also that the S-corporation that Therese was a shareholder in had other shareholders that were drawing a W-2 wage. If they also shifted more of their wages to pass-through income, the S-corporation's wages could be reduced to the point that the wage limitation might become the limiting factor. Consider further if the shareholders were the only employees and they all took no W-2 salary, the W-2 limit would be the 2.5% of qualified property and the maximum 199A deduction would be $2,500 (2.5% of $100,000) split between them.*

Commentary: These two examples highlight the issue of "reasonable compensation" in the context of an S-corporation, since the Sec 199A deduction only applies to the K-1 pass-through income, not wages paid to the shareholder. See page 3.24.21 for further discussion on this topic.

Caution: Reasonable compensation is not an amount determined to suit the best tax advantages of the stockholder. It is based on the facts and circumstances of the situation such as what others are paid for doing the same job, cost of living in the area and a number of other factors. See page 3.24.21 for further discussion of reasonable compensation as it applies to the Sec 199A deduction. Also see chapter 3.29 in this text for a detailed discussion of reasonable compensation.

Continue to worksheet – next page

<u>K-1 Pass through Data</u> – Where a taxpayer has an interest in a pass-through activity, the K-1 from the activity will provide the necessary data to compute the 199A deduction for the activity.

If you are the tax preparer receiving a K-1, as opposed to the one who is preparing the K-1, you are not responsible for making the decision of whether the business entity is a qualified trade or business, or a specified service trade or business. Those determinations are made at the entity level, and you as the preparer simply use the information provided with the K-1. The K-1 or an attachment to the K-1 should show the owner's (stockholder, partner, or beneficiary) share of the information required to compute the 199A deduction for that particular entity.

If the K-1 or attachment doesn't include the owner's (taxpayer's) share of the required data, the owner's share will be presumed to be zero. (Reg. Sec. 1.199A-6(b)(iii))

The table below includes the boxes and code numbers for where the information was located on the 2018 K-1s. The data provided includes QBI, wages, UBIA, REIT dividends and publicly traded partnership income. Makes it easy for the 1040 preparer, but pretty gnarly for the preparer of the 1041, 1065 and 1120-S returns. The determination of whether an entity is a SSTB should be provided as a supplement to the K-1.

Sec 199A K-1 Box Codes			
Form	*1120-S*	*1065*	*1041*
Box	*17*	*20*	*14*
QBI	*V*	*Z*	*I*
Wages	*W*	*AA*	*
UBIA	*X*	*AB*	*
REIT	*Y*	*AC*	*
PTP	*Z*	*AD*	*

** This data provided on a supplemental statement*

ClientWhys®
Build your knowledge. Build your practice.

199A QTB Worksheet (2018)

(**NOT** For Use with Specified Service Trades or Businesses)

Business' Name: ______________________________

1	Qualified Business Income (QBI)	310,000
2	Taxpayer's 1040 Taxable Income (before the 199A deduction)	500,000
3	Threshold (enter $315,000 if MFJ; otherwise enter $157,500)	315,000
4	Differential (enter $100,000 if MFJ; otherwise enter $50,000)	100,000
5	Line 3 plus Line 4 (top of threshold range)	415,000
6	Tentative 199A deduction (20% of Line 1)	62,000
7	If Line 2 is equal to or less than Line 3, skip to line 21 and enter the amount from Line 6 on Line 21. If Line 2 is greater than line 3, continue to Line 8 (leave Line 7 blank).	
8	Taxpayer's share of the total wages paid by this business	176,000
9	Taxpayer's share of qualified business property for this business	40,000
	If Lines 8 and 9 are both zero, skip Lines 10 through 13 and enter zero on Line 14.	
10	50% of Line 8	88,000
11	25% of Line 8	44,000
12	2.5% of Line 9	1,000
13	Line 11 plus Line 12	45,000
14	Wage Limitation – **Greater** of Line 10 or Line 13	88,000
15	If Line 2 is equal to or greater than Line 5, skip to Line 21 and enter the **lesser** of Line 6 or Line 14. Otherwise continue to Line 16.	
16	If Line 14 is greater than Line 6, skip to Line 21 and enter the amount from Line 6. If Line 14 is equal to or less than Line 6, continue to Line 17.	
17	Subtract line 3 from Line 2	
18	Divide Line 17 by Line 4	
19	Subtract Line 14 from Line 6	
20	Multiply Line 18 by Line 19	
21	**Preliminary Sec. 199A Deduction** for this business (Line 6 minus Line 20)	62,000

Instructions: This worksheet is designed to determine the preliminary 199A deduction for a single business activity. However, it **cannot** be used for specified service trades or businesses. The results of this worksheet must be combined with the results from other businesses and flow-through income of the taxpayer to determine the combined preliminary Sec 199A deduction for the taxpayer. The combined preliminary Sec 199A deduction is further limited to 20% of the adjusted taxable income of the taxpayer.

ClientWhys has a separate worksheet for use with specified service trades or businesses. Although we believe the worksheets compute the deduction correctly, ultimately, the IRS worksheets or forms will take precedence.

Observations:

1. *For S-corporations, planning to maximize the 199A deduction becomes a balancing act between wages and QBI while walking a tightrope with the reasonable compensation issue.*
2. *Just as a reminder, the 199A deduction is figured at the individual, partner or stockholder level. The other stockholders, besides Therese in our examples above, might have taxable incomes below the threshold and would not be subject to the W-2 limitation.*
3. *If the business in the examples above had been a partnership the net profit would have flowed through to the individual partners as QBI. Where the partnership has no employees and no qualified property the W-2 limitation would be zero, and those partners with taxable income above the cap ($415,000 for MFJ and $207,500 for others) would have no 199A deduction (those between the threshold and cap would a get a partial 199A deduction). The same would apply to a sole proprietorship with no W-2 wages or qualified property.*
4. *That brings up another conflicting issue: employee or independent contractor? Before TCJA, many smaller employers wanted to treat workers as independent contractors as opposed to employees to avoid payroll taxes, reporting and ACA issues. But keep in mind payments to independent contractors don't count in the wage limitation and can have an effect on the 199A deduction.*
5. *On the other hand, there are individuals who are currently treated as employees who would like to be independent contractors for any number of reasons, some legitimate and some not. But the primary issues include:*
    a. *They have substantial employee business expenses and can no longer deduct them under TCJA.*
    b. *They would like to benefit from the 199A deduction.*

    Of course, there are negatives: Paying SE tax instead of only the employee share of the FICA and giving up whatever fringe benefits the employer might offer.

Qualified Trade or Businesses
Where you are computing the 199A deduction for **other** than a specified service trade or business when the taxpayer's 1040 taxable income is <u>between the threshold amount and the cap</u>.

Congress, rather than having a step function, established a gradual transition to the W-2 limitation between the threshold ($315,000 for MFJ and $157,500 or others) and the cap ($415,000 for MFJ and $207,500 for others).

In order to do this, they had to phase-out the 20% of QBI deduction and phase-in the W-2 limitation. This computation is best understood by example.

QTB-Example #13 - Taxable Income Between Threshold and Cap *- In this example we have a taxpayer filing a joint return.*

Taxable Income (TI): $385,000
Threshold: $315,000
Differential: $100,000
QBI: $190,000
Tentative 199A deduction: ***$38,000*** *(20% of $190,000)*
W-2 Wages paid by business: $10,000
Qualified Property: $200,000
a*. 50% of Wages: $5,000 (50% of $10,000)*
b. *25% of Wages: $2,500 (25% of $10,000)*
c*. 2.5% of Qualified Property: $5,000 (2.5% of $200,000)*
d*. Wage Limitation: Greater of a. or (b. + c.) = $7,500*
e*. Difference between TI and Threshold = $70,000*
f*. e. divided by the differential = .70 ($70,000/$100,000)*
g*. Tentative 199A deduction less Wage Limitation = $30,500 ($38,000 - $7,500)*
h*. Phase-out = f. times g. = $21,350 (.70 x $30,500)*
I. Preliminary Section 199A deduction:
Tentative 199A deduction less h. = ***$16,650*** *($38,000 – $21,350)*

SEE COMPLETED WORKSHEET ON PAGE 03.24.16

199A QTB Worksheet (2018)

(**NOT** For Use with Specified Service Trades or Businesses)

1	Qualified Business Income (QBI)	190,000
2	Taxpayer's 1040 Taxable Income (before the 199A deduction)	385,000
3	Threshold (enter $315,000 if MFJ; otherwise enter $157,500)	315,000
4	Differential (enter $100,000 if MFJ; otherwise enter $50,000)	100,000
5	Line 3 plus Line 4 (top of threshold range)	415,000
6	Tentative 199A deduction (20% of Line 1)	38,000
7	If Line 2 is equal to or less Line 3, skip to line 21 and enter the amount from Line 6 on Line 21. If Line 2 is greater than Line 3, continue to Line 8 (leave Line 7 blank).	
8	Taxpayer's share of the total wages paid by this business	10,000
9	Taxpayer's share of qualified business property for this business	200,000
	If Lines 8 and 9 are both zero, skip Lines 10 through 13 and enter zero on Line 14.	
10	50% of Line 8	5,000
11	25% of Line 8	2,500
12	2.5% of Line 9	5,000
13	Line 11 plus Line 12	7,500
14	Wage Limitation – **Greater** of Line 10 or Line 13	7,500
15	If Line 2 is equal to or greater than Line 5, skip to Line 21 and enter the **lesser** of Line 6 or Line 14. Otherwise continue to Line 16.	
16	If Line 14 is greater than Line 6, skip to Line 21 and enter the amount from Line 6. If Line 14 is equal to or less than Line 6, continue to Line 17.	
17	Subtract line 3 from Line 2	70,000
18	Divide Line 17 by Line 4	.7000
19	Subtract Line 14 from Line 6	30,500
20	Multiply Line 18 by Line 19	21,350
21	**Preliminary Section 199A Deduction** for this business (Line 6 minus Line 20)	16,650

Official IRS QTB Worksheet Can Be Found on Pages 55-56 of IRS Pub 535

QBI Adjustments

Seems the IRS decided that certain AGI adjustments were business deductions that must reduce QBI.

<u>*QBI Reductions for AGI Adjustments*</u> - The final regulation §1.199A-3(b)(1)(vi) (page 43-44 final regs) specifies that **solely for the determination of QBI** from a trade or business, the following are included as deductions from gross income when determining the activity's QBI.

- Self-employment tax deduction under Sec. 164(f),
- Self-employed health insurance deduction under Sec 162(l), and
- Deduction for qualified retirement plans under Sec 404.

- **Charitable contributions** under Sec 170 – Sec 199A(c)(1) defines QBI as the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer and Sec 199A(c)(3) defines the term "qualified items of income, gain, deduction, and loss" to mean items of income, gain, deduction, and loss to the extent such items are effectively connected with the conduct of a trade or business within the U.S. Thus, a charitable contribution made at the partnership level will reduce QBI even though the charitable contribution is passed through separately to the partners. This is because charitable contributions, although not a business expense, is deemed to be "effectively connected with" the related passthrough entity. So charitable contributions made by a passthrough entity reduces QBI,
- **Unreimbursed partnership expenses** under Sec 162 – There is a provision where partners may separately deduct unreimbursed partnership expenses on the Schedule E, line 28, column (g) and enter "UPE" in column (a) provided the partnership agreement requires the partner to pay the expenses. When a partner takes such a deduction, the partner must reduce the QBI from the partnership by the amount of the expenses deducted,
- **Interest expense on purchase debt financing -** Where a partner or S corp. stockholder financed the purchase the entity, the interest on that debt is deductible on separate line of Schedule E, column II labeled "business interest" and the name of the partnership or S corporation (Schedule E Instructions Line 28). These amounts reduce the QBI.
- **Business Interest Expense Limitation** under Sec 163(j) – Where a business does not meet the inflation income exception amount of $25M ($26M for 2019 and 2020) the amount of deductible interest is limited under Sec 163(j) (See chapter 3.25). Limiting the interest deduction has the effect of increasing the QBI leading one to question if entire amount of interest should be used when computing QBI for the 199A deduction. The regs and the IRS do not provide definitive guidance on this issue. This is a wait and see issue.

Where an individual has multiple activities with qualified business income (QBI) the foregoing adjustments to AGI are proportionately allocated among the business activities.

Example: A self-employed individual has a net profit of $130,000. His SE tax deduction for the tax year would be $9,184. He also has a self-employed health insurance deduction of $20,000 and contributed $5,000 to his SEP account.

QBI Before Adjustments:	$130,000
SE Tax Deduction:	< 9,184>
SE Health Insurance Deduction:	< 20,000>
SEP contribution:	< 5,000 >
QBI for 199A purposes:	**$ 95,816**

If the taxpayer had other business activities, these adjustments would have been proportionately applied to the QBI from each.

Observation – An IRA is not a qualified retirement plan under Sec 404. Thus, the taxpayer might have been able to make a deductible contribution of $5,000 to a traditional IRA instead of the SEP and would not have had to reduce his QBI by the $5,000.

Farming Activities and Horticultural Cooperatives

Cooperatives – As the law was originally written, some farmers would have been allowed an overly generous and unfair deduction of 20% of their qualified cooperative dividends, calculated on a *gross* basis. This was referred to as the "grain glitch" and was fixed by the Consolidated Appropriations Act, 2018. With the fix, the deduction for a specified agricultural cooperative is calculated and passed through to patrons under the rules for the domestic production activities deduction (DPAD) that existed before the repeal of Code Sec. 199. Thus, the cooperative's deduction is generally 9% of the lesser of its taxable income, or its qualified production activities income, but limited to 50% of the co-op's W-2 wages paid that are properly allocable to domestic production gross receipts. Some or all of the co-op's deduction may be passed through to its patrons (the farmers), which then reduces the patron's general QBI deduction. The cooperative must provide its patrons with the necessary information on Forms 1099-PATR or an attachment so each patrons can figure their deduction. Starting with 2019 this will be done on Schedule D of Form 8995-A. *Note:* the draft version of the 2020 Form 1099-PATR includes several new boxes that provide the needed information and that aren't on the 2019 version of the form.

Farming Activities – Other than co-op related, are treated the same as any other QTB when computing the 199A deduction.

What about multiple business activities with QBI?

The preliminary 199A deduction must be determined separately for each individual entity of a taxpayer and the various limitations and restrictions are applied at that level. Then all of the preliminary 199A deductions from the taxpayer's\ sources are combined and limited to 20% the taxpayer's taxable income reduced by net capital gains.

Example #15 – Multiple Activities - *The Morgans file a joint return. Their taxable income is $300,000, which includes $25,000 of net capital gains and REIT dividends of $500. They also have the following business activities for which you have computed the preliminary 199A deduction:*

Schedule C Business	*$42,000*
Schedule E Rental	*4,500*
1120-S K-1	*15,500*

First, sum up all the preliminary 199A deductions for all of the taxpayer's activities. That would include the following:

20% of the REIT Dividends	*$ 100*	
Schedule C Business	*42,000*	
Schedule E Rental	*4,500*	
1120-S K-1	*15,500*	
Total		***$62,100***

Next, compute the taxable income limit:

Taxable Income	*$ 300,000*	
Net Capital Gains	*<25,000>*	
Adjusted Taxable Income	*$ 275,000*	
20% of the Adjusted Taxable Income		***$55,000***

*The taxpayer's 199A deduction is the lesser of $62,100 or $55,000, so in this example the taxable income limited the deduction to **$55,000**.*

199A Summary Worksheet (2018)

1	REIT Dividends		500
2	Qualified Publicly Traded Partnership (PTP) Income		
3	Sum of Lines 1 & 2		500
4	199A Deduction for REITs and PTPs (20% of Line 3)		100
	INCOME FROM INDIVIDUAL FLOW-THROUGH BUSINESS ACTIVITIES		
	Description of Flow-Through Business Activities	**Preliminary 199A Deduction**	
5	Schedule C Business	42,000	
6	Schedule E Rental	4,500	
7	Form 1120-S K-1	15,500	
8	TOTAL lines 5, 6, and 7		62,000
9	Tentative 199A Deduction (Sum of lines 4 and 8)		62,100
	DETERMINATION OF TAXABLE INCOME LIMIT		
10	Enter the taxpayer's Taxable Income (Before the 199A deduction)		300,000
11	Enter the Taxpayer's Net Capital Gains		25,000
12	Adjusted Taxable Income (Line 10 less Line 11)		275,000
13	Taxable Income Limit (Line 12 times 20%)		55,000
14	**Section 199A Deduction for this taxpayer** (lesser of Line 9 or Line 13)		55,000

NUANCES AND SIDE ISSUES:

Not an Adjustment to Gross Income - The deduction is not allowed in computing AGI, but rather is allowed as a deduction reducing taxable income. (Code Sec. 62(a), as added by Act Sec. 11011(b)). Thus it will have no impact on AGI limitations. The IRS added line 9 to the 2018 Form 1040 (line 10 on 2019 draft) to accommodate the 199A deduction.

SE Tax - The deduction is only used to offset taxable income, so it does not reduce the net earnings for self-employment used to compute self-employment (SE) tax. Thus, it will not be used to reduce SE tax.

Reasonable Compensation - With the advent of the Sec 199A deduction the issue of "reasonable compensation" takes on a whole new meaning for S-Corporation shareholders. This has been an issue of contention in the past, with shareholders that are actually working in the business and not just being investors taking minimum or no salary and having all the income pass through via the K-1 as investment income, thus avoiding payroll taxes on the income that should have been treated as W-2 compensation.

As an advisor to your clients it is you who will normally provide guidance to your clients to minimize their tax liability. However, you also have to be concerned about the client's IRS jeopardy for not paying themselves an adequate amount for the services provided and instead treating all remuneration as return on investment.

For S-corporations, the Sec 199A deduction only applies to the K-1 pass-through income, not wages paid to the shareholder. The lure of this 20% deduction will only tempt more employee-shareholders to ignore the reasonable compensation requirements.

So, what is reasonable compensation? There currently is no bright line definition, but courts have consistently imposed reasonable compensation based on facts and circumstances. However, IRS Publication 536 provides the following factors to be considered when determining reasonableness:

- The duties performed by the employee.
- The volume of business handled.
- The character and amount of responsibility.
- The complexities of the business.
- The amount of time required.
- The cost of living in the locality.
- The ability and achievements of the individual employee performing the service.
- The pay compared with the gross and net income of the business, as well as with distributions to shareholders if the business is a corporation.
- The company policy regarding pay for all employees.
- The history of pay for each employee.

In the early stages of tax reform (TCJA) the bill included a safe harbor definition of reasonable compensation of 70% compensation and 30% flow-through income. It also allowed a larger (more taxpayer favorable) allocation to flow-through income where a taxpayer could prove investment in the business justified a larger allocation. Unfortunately, that provision did not make the cut.

As a result, this places an increased burden on tax practitioners, who will find themselves between a rock and a hard place (client and IRS) in determining what is reasonable compensation. Further guidance is needed from IRS; hopefully they will come up with safe harbor guidelines (but given the way they side-stepped the "trade or business" definition in the proposed and final 199A regulations, don't bank on it). Otherwise practitioners are exposed to potential preparer penalties and client litigation. **See BB Chapter 3.29 for additional details.**

Partners' or Shareholders' Allocations - For 2018 and subsequent years partnerships and S-corporations will have to provide, in addition to the usual information included on a K-1, the partner's or shareholder's share of qualified business income (QBI), qualified W-2 income paid by the entity and the partner's/shareholder's share of qualified business property. The 1065 and 1120-S K-1s for 2018 provide codes for boxes 20 (1065 K-1) and 17 (1120S K-1) for that information. The partnership or S-corporation is also required to indicate if the trade or business is a specified service trade or business; this is done on a separate statement.

Large Business Activities – At first impression one would think partners and shareholders of entities with large incomes would not qualify for the Sec 199A deduction. But that may not be true because the deduction is based on each partner's or shareholder's allocation of qualified income, wages and qualified property from the entity and each partner's or shareholder's individual taxable income.

LOSSES FROM QUALIFIED TRADE OR BUSINESS ACTIVITIES

- *Single Activity* – Where there is only a single activity qualifying for the 199A deduction and that activity has a loss, the QBI from that activity is zero, and the loss is carried over to the subsequent year's 199A computation.

- *Multiple Activities All Negative QBI* – Where there are multiple business activities and the QBI from each is negative, the QBI is zero and the negative QBI for each is separately carried over and is used to determine the QBI of each activity in the subsequent year.
- *Multiple Activities But Net QBI Is Positive* - When there are multiple activities involved and one or more have negative QBI, but the total QBI from all activities is positive, the QBI for the positive QBI activities is proportionally reduced by the negative QBI before computing the 199A deduction, and the ones that were negative will have no 199A deduction and no carryover.

The reason for the allocation is that some businesses in the group may be SSTBs and the 199A deduction may be subject to phase-out while other businesses may be subject to the wage limitation, which will limit the 199A differently for each activity.

Example #16 - Losses: *Jake has QBI from three qualified trades or businesses as illustrated in the table below. #1 and #2 show positive incomes while #3 shows negative income. Because the overall QBI is positive, the QBI for #1 and #2 must be proportionately reduced by the negative amount from #3 before the 199A deduction is determined for #1 or #2. The 199A deduction for #3 is zero and there is no negative QBI carryover because the QBI of #1 and #2 have been adjusted for the negative amount.*

Business	QBI	Percent	Adjustment	Adjusted QBI
#1	$20,000	20%	<2,000>	$18,000
#2	$80,000	80%	<8,000>	$72,000
#3	<$10,000>			
Total	$90,000			$90,000

The proposed regulations make it clear that these QBI carryovers and adjustment have no effect on the gain or loss computations or passive loss carryovers for the regular tax computation. They are figured separately without regard to the Sec 199A computations.

Previously suspended losses - Several sections of the Code, including:

- 465, At-Risk Limitation,
- 469, Passive Loss Limitations,
- 704(d), Partnership Losses In Excess of Basis, and
- 1366(d), Shareholder Losses In Excess of Basis

provide carryover losses to subsequent years. For purposes of the 199A deduction to the extent that any previously disallowed losses or deductions are allowed in the taxable year, they are treated as items attributable to the trade or business. These losses are to be used in order from the oldest to the most recent on a first-in, first-out (FIFO) basis. However, losses or deductions that were disallowed for taxable years beginning before January 1, 2018, are not taken into account for purposes of computing QBI in a later taxable year. (Reg. Sec 1.199A-3(b)(1)(iv))

Example #17 – Previously Suspended Losses - *John is preparing his 2018 tax return. He has a rental activity that qualifies for the 199A deduction. John also has a $17,000 passive loss carryover from 2017 for that rental. In 2018 John's rental shows a $12,000 loss.*

- ***Regular Tax Computation*** *- For regular tax purposes John's net passive loss for 2018 is $29,000 ($17,000 + $12,000). John's AGI for the year is less than $100,000, so he is entitled to claim a $25,000 rental loss and has a passive loss carryover of $4,000 to 2019.*
- ***199A Computation*** *– For the 199A computations we do not take into account (we disregard) any passive loss carryovers for any years beginning before January 1, 2018. Thus, we disregard the $17,000 passive carryover from 2017. So John's rental QBI for 2018 is a negative $12,000 and since his rental is his only qualified trade or business his 199A deduction for the year is zero. Now the $12,000 loss becomes a QBI carryover to 2019 and will be taken into account when figuring John's 199A deduction in 2019.*

Possible Unexpected Outcome

Since most rentals are qualified trades or businesses for purposes of Sec 199A, and because of substantial depreciation, many of these rentals will be producing negative QBI. Where a taxpayer has positive QBI from other qualified businesses, the negative QBI will reduce the 199A deduction for those other businesses, something the taxpayer may not have been expecting. Claiming the 199A deduction is not an option if the taxpayer qualifies. IRC Sec 199A(a): "Allowance of deduction - In the case of a taxpayer other than a corporation, there shall be allowed as a deduction…" and "shall" means the deduction is mandatory if qualified to claim it.

TRADE OR BUSINESS AGGREGATION

Aggregating (grouping) trades or businesses offers taxpayers a means of combining their trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations and potentially maximizing the deduction under Section 199A. If such aggregation were not permitted, taxpayers could be forced to incur costs to restructure their business activities solely for tax purposes. In addition, business and non-tax law requirements may not permit many taxpayers to restructure their operations. The IRS feels Sec 469 passive activity grouping is inappropriate relative to the 199A deduction, and therefore provides a separate from of grouping for 199A purposes, that permits the aggregation of separate trades or businesses, provided certain requirements are satisfied.

These grouping rules can become quite complicated because they may be made at the business entity level as well as the individual level. For purposes of this material, although we do include the rules applicable to entity aggregation, we will generally limit the discussion to aggregations at the individual level.

Who Should Consider Aggregation? Taxpayers whose taxable income exceeds the 199A deduction phaseout thresholds and who must rely on the wage limitation in order to qualify their QTB (not SSTB) for a deduction. Taxpayers with taxable income below the phaseout threshold amount do not benefit from aggregation. Aggregation is optional.

Before getting into an illustration, remember the 199A deduction figured at entity level is the **lesser** of:

1. 20% of QBI (net of the SE tax and SE health insurance premium adjustments), or
2. The wage limitation.

   The wage limitation is the **greater** of:

   - 50% of the W-2 wages paid by the business or
   - 25% of the W-2 wages paid by the business plus 2.5% of the unadjusted basis of the business's qualified property (abbreviated UBIA).

Illustrations – The illustrations below assume the taxpayer's taxable income is such that the wage limitation will apply in all cases. It also assumes that none of the businesses are SSTBs, which cannot be included in an aggregation. The 199A deduction determined in the illustrations is the amount determined before the final limitation that caps the combined 199A deductions from all sources to 20% of the taxpayer's taxable income before the 199A deduction and net of any capital gains.

Illustration #1 – To simplify the comparison, this illustration assumes the QTBs only have wages and no UBIA. The outcome is that aggregating these three QTBs results in a substantial increase in the 199A deduction.

Trade or Business (QTB)	QBI	A 20% of QBI	Wages	B 50% of Wages	199A Deduction Lesser of A or B
X	$900,000	$180,000	$500,000	$250,000	$180,000
Y	$800,000	$160,000	$80,000	$40,000	$40,000
Z	$2,000	$400	$400,000	$200,000	$400
The combined 199A Deductions for the trades or businesses figured separately:					**$220,400**
Aggregated Businesses	$1,702,000	$340,400	$980,000	$490,000	**$340,400**

Illustration #2 – This illustration assumes the QTBs only have UBIA and no wages. The results show that aggregating these three QTBs provides the taxpayer a substantial increase in the 199A deduction.

Trade or Business (QTB)	QBI	A 20% of QBI	UBIA	B 2.5% of UBIA	199A Deduction Lesser of A or B
L	$25,000	$5,000	$250,000	$6,250	$ 5,000
M	$40,000	$8,000	$80,000	$2,000	$2,000
N	$15,000	$3,000	$900,000	$22,500	$3,000
The combined 199A Deductions for the trade or businesses figured separately:					**$10,000**
Aggregated Businesses	$80,000	$16,000	$1,230,000	30,750	**$16,000**

QBI Losses – When making the aggregation analysis remember that losses from any QTB or SSTB entity proportionally reduce the QBI of the taxpayer's other entities (see page 3.24.19). So, an aggregation excluding an entity with a loss does not overcome the reduction of QBI for the profitable entities.

Next Step – The next step is to see if the proposed aggregation is permissible under the "aggregation qualification general rules" discussed next and whether the taxpayer is willing to abide by the "operating rules" and the "aggregation rules" also discussed later in this material. One important issue to consider is that once aggregated the eligible QTBs are generally aggregated for all future years.

Aggregation Worksheet

A worksheet taking into account both wages and UBIA is included on page 3.24.25.

(b)(1) - Aggregation Qualification General Rules

Under regulation §1.199A-4, Trades or businesses may be aggregated only if an individual or relevant passthrough entity (RPE) can demonstrate that:

A. The same person, or group of persons, directly or indirectly, own a majority interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income. In the case of trades or businesses owned by an S-Corp, own 50% or more the outstanding shares of stock and in the case of a partnership, have 50% or more of the capital or profits in the partnership.
B. The ownership exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income.
C. All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;
D. None of the aggregated trades or businesses can be an SSTB.
E. Individuals and trusts must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger, integrated trade or business. These factors are:
    1. The businesses provide products, property or services that are the same (for example, a restaurant and a food truck) or they provide products, property or services that are customarily provided together (for example, a gas station and a car wash);
    2. The businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or
    3. The businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies).
F. Consistent with other provisions in the proposed regulations, each trade or business must itself be a trade or business as defined in §1.199A-1(b)(13).

Operating Rules

(i) Individuals.

- An individual may aggregate trades or businesses operated directly or through an RPE to the extent an aggregation is not inconsistent with the aggregation of an RPE.
- If an individual aggregates multiple trades or businesses, QBI, W-2 wages, and UBIA of qualified property must be combined for the aggregated trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations of the wage limitation.
- An individual may not subtract from the trades or businesses aggregated by an RPE but may aggregate additional trades or businesses with the RPE's aggregation if the aggregation rules are otherwise satisfied.

(ii) RPEs.

- An RPE may aggregate trades or businesses operated directly or through a lower-tier RPE to the extent an aggregation is not inconsistent with the aggregation of a lower-tier RPE.
- If an RPE itself does not aggregate, multiple owners of an RPE need not aggregate in the same manner.
- If an RPE aggregates multiple trades or businesses, the RPE must compute and report QBI, W-2 wages, and UBIA of qualified property for the aggregated trade or business.
- An RPE may not subtract from the trades or businesses aggregated by a lower-tier RPE but may aggregate additional trades or businesses with a lower-tier RPE's aggregation if the rules of this section are otherwise satisfied.

An individual is permitted to aggregate trades or businesses operated directly and trades or businesses operated through relevant pass-through entities (RPEs.). Individual owners of the same RPEs are not required to aggregate in the same manner.

Aggregation Rules (Reg 1.199A-4(c)(1) and (2)

- Once aggregated must consistently report as such in all future years
- If failed to aggregate on an original return, can't aggregate on an amended return except for 2018 tax year.
- May add newly created or acquired (including by non-recognition transfers) trades or businesses.
- If in the future the aggregation no longer meets the aggregation qualification, then the aggregation ceases to apply, and the taxpayer may reapply qualifications to determine if a new aggregation is permissible.
- *In the case of an individual* – The individual must report aggregated trades or businesses of RPE in which the individual holds a direct or indirect interest.
- *In the case of an RPE* – The RPE must report aggregated trades or businesses of a lower-tier RPE in which the RPE holds a direct or indirect interest.

Disclosure - For each year, the individual or RPE must attach a statement to the return that includes:

- A description of each trade or business;
- The name and EIN of each entity in which a trade or business is operated;
- Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;
- Information identifying any aggregated trade or business of an RPE in which the individual holds an ownership interest.

Example #1 - Jack wholly owns and operates a catering business and a restaurant through separate disregarded entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. Jack maintains a website and print advertising materials that reference both the catering business and the restaurant. He uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

Because the restaurant and catering business are held in disregarded entities, Jack will be treated as operating each of these businesses directly and thereby satisfies paragraph (b)(1)(i) of the qualification. With regard to meeting 2 of the 3 requirements of (b)(1)(v), Jack satisfies the following factors:

(b)(1)(v)(A) is met as both businesses offer prepared food to customers; and

(b)(1)(v)(B) is met because the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting.

Thus, Jack may aggregate the catering and restaurant businesses. (Reg Ex #1)

Example #2 – Same facts as example #1 except the catering and restaurant businesses are owned in separate partnerships and Jack and three of his friends each own a 25% interest in each of the two partnerships.

Because under paragraph (b)(1)(i) of this section Jack and three of his friends together own more than 50% of each of the two partnerships, they **may** each aggregate the catering business and the restaurant as a single trade or business. (Reg Ex #2)

Example #3 - Phil owns a 60% interest in each of four partnerships (PRS1, PRS2, PRS3, and PRS4). Each partnership operates a hardware store. A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human resources and accounting are centralized for the four businesses.

Phil owns more than 50% of each partnership, thereby satisfying paragraph (b)(1)(i). With regard to meeting 2 of 3 of the requirements of (b)(1)(v), Phil satisfies the following factors:

(b)(1)(v)(A) because each partnership operates a hardware store.

(b)(1)(v)(B) because the businesses share accounting and human resource functions.

Phil decides to only aggregate PRS1, PRS3, and PRS4 and report PRS2, which generates a net taxable loss, as a separate trade or business. Phil's decision to aggregate only PRS1, PRS3, and PRS4 into a single trade or business is permissible. The loss from PRS2 will be netted against the aggregate profits of PRS1, PRS3, and PRS4 pursuant to Sec. 1.199A-1(d)(2)(iii). (Reg Ex#4)

Example #4 - George owns 80% of the stock in an S corporation (S1) and 80% of two partnerships organized as limited liability companies. Thus, George meets the ownership requirements of (b)(1)(i). LLC1 manufactures and supplies all of the widgets sold by LLC2. LLC2 operates a retail store that sells LLC1's widgets. S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store.

(b)(1)(v)(A) is met for LLC1 and LLC2 because they sell the same product.

(b)(1)(v)(B) is met for S1, LLC1 and LLC2 because they share significant centralized business elements and are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group.

(b)(1)(v)(C) S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store. Thus, S1 operated in coordination with, or reliance on, other businesses in the aggregated group.

Thus, each entity meets 2 of the 3 requirements of (b)(10(v) and they may be aggregated. (Reg Ex #8)

Example #5 – Same as example #4, except George owns 80% of the stock in S1 and only 20% each of LLC1 and LLC2. George's son owns a majority interest in LLC2, owns no stock in S1 and has no interest in LLC1. George's mother owns a majority interest in LLC1, owns no stock in S1 and has no interest in LLC2. Since the same group of persons, including George, own a majority interest in LLC1 and LLC2 George is considered to have met the ownership requirements of (b)(1)(i). (Reg Ex #9)

Example #6: Clive owns 60% of PRS1, a partnership, that sells non-food items to grocery stores. He also owns 55% of PRS2, a partnership, which owns and operates a distribution trucking business. The predominant portion of PRS2's business is transporting goods for PRS1. Clive meets the (b)(1)(i) ownership test. With regard to meeting 2 of the 3 requirements of (b)(1)(v), Clive only satisfies one of the factors:

(b)(1)(v)(C) - The businesses are operated in coordination with, or reliance on, other businesses in the aggregated group.

Clive does not meet either (b)(1)(v)(A) – provide the same products, property or services or (b)(1)(v)(B) – Share the same centralized business elements. Thus, Clive cannot aggregate the wholesaler and trucking company. (Reg Ex#12)

Example #7: PRS1, a partnership, owns 60% of a commercial rental office building in state A, and 80% of a commercial rental office building in state B. Both commercial rental office building operations share centralized accounting, legal, and human resource functions. PRS1 satisfies the ownership requirements. With regard to meeting 2 of the 3 requirements of (b)(1)(v), PRS1 satisfies the following factors:

(**b)(1)(v)(A) -** provide products, property and services that are the same.

(**b)(1)(v)(B) -** share significant centralized business elements (accounting, legal, and human resource functions).

Thus, PRS1 may aggregate its commercial rental office buildings. (Reg Ex #16)

Example #8: S, an S corporation owns 100% of the interests in a residential condominium building and 100% of the interests in a commercial rental office building. Both building operations share centralized accounting, legal, and human resource functions.

S satisfies the ownership requirements. With regard to meeting 2 of the 3 requirements of (b)(1)(v), S satisfies the following factor:

(b)(1)(v)(B) - share significant centralized business elements (accounting, legal, and human resource functions)

S does not meet either (b)(1)(v)(A) – provide the same products, property or services (commercial vs residential) or (b)(1)(v)(C) – operate in coordination with or reliance on the others. Thus, S cannot aggregate the commercial and residential businesses. (Reg Ex #17)

Precautionary Note: The regulations are taking the position that the commercial and residential activities do not provide the same products, property and services so cannot use (b)(1)(v)(A) for one of the two out of three requirements to group. So, they can only be aggregated together if they meet the requirements of (b)(1)(v)(B) and (b)(1)(v)(C).

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SECTION 199A AGGREGATION WORKSHEET

Use this worksheet to compare the sum of the 199A deductions for several QTBs figured separately to the results of aggregating them.

A	B	C	D	E	F	G	H	I	J	K
QTB	QBI	20% of B	Wages	UBIA	50% of D	20% of D	2.5% of E	G Plus H	Greater of F or I	199A Deduction (Lesser of C or J)
The combined 199A Deductions for the trade or businesses figured separately (Sum of Column K):										**Total** $__________
Aggregated QTBs	------------------ **Total entries from each column above** -------------------									
										Aggregation $__________

Instructions:

1. *Precautions:*
    a. *The taxpayer's taxable income is assumed to be such that without benefit of the wage limitation the 199A deduction would be zero.*
    b. *Do not include any SSTBs, as they are not allowed to be aggregated.*
    c. *If any entity is showing a loss, the allocation of the negative QBI among the positive QBIs must be completed before using this worksheet.*
2. *Enter the IDs of the QTBs to be aggregated in Column A, the QBIs from the businesses in column B, the wages in column D and the UBIAs in column E.*
3. *Next, complete the calculation indicated for columns C, F, G, H, I, J and K for each QTB and enter the results in the box for that QTB.*
4. *Next, total the amounts in column K and enter results in the "total" box.*
5. *Next, In the "Aggregated QTBs" row, total the amounts in columns B, D and E.*
6. *Next, for the "Aggregated QTBs" row, complete the calculations indicated for columns C, F, G, H, I, J and K.*
7. *The benefit from aggregation is the excess of the amount in the "Aggregation" box over the amount in the "Total" box.*
8. ***CAUTION:** Just because this worksheet indicates the aggregation provides a benefit does not mean the QTBs aggregated in this worksheet qualify to be aggregated. That is a separate determination. This worksheet does not take the place of Schedule B of Form 8995-A.*

TRUSTS, ESTATES, AND BENEFICIARIES

- **Grantor Trust** - Where the trust is a grantor trust, the owner will compute its QBI with respect to the owned portion of the trust as if that QBI had been received directly by the owner.
- **Non-grantor Trust** – In the case of a non-grantor trust or estate, the QBI and expenses properly allocable to the business, including the W-2 wages relevant to the computation of the wage limitation, and relevant UBIA of depreciable property must be allocated among the trust or estate and its various beneficiaries.

  Distributable Net Income (DNI) – A beneficiary's share of the DNI deemed to be distributed for the year is used to determine the beneficiary's share of QBI and W-2 wages from the trust for the year. Where part of the DNI is not deemed distributed, that amount shall be used to proportionally determine the QBI and W-2 wages for the trust or estate. Where there is no DNI for the year, all QBI and W-2 wages are allocated to the trust or estate. (Reg §1.199A-6(d)(3)(ii))

  UBIA - To the extent the trust's or estate's UBIA of qualified property is relevant to a trust or estate and any beneficiary, the trust's or estate's UBIA of qualified property will be allocated among the trust or estate and its beneficiaries in the same proportion as DNI of the trust or estate is allocated.

  Trust's TI Threshold - is determined at the trust level without taking into account any distribution deductions.

  Anti-Abuse Provisions - Trusts formed or funded with a significant purpose of receiving a deduction under Section 199A will not be respected for purposes of Section 199A.

  Multiple Trusts - In the case in which two or more trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of Federal income tax, then such trusts will be treated as a single trust for Federal income tax purposes. (Proposed §1.643(f)-1)

Now let's examine the issue of what rentals qualify for 199A

RENTAL PROPERTY AND SEC 199A

Regrettably, the most currently misunderstood issue for preparing taxes could be the most significant - the issue of when a rental activity is a trade or business qualified for the Sec 199A deduction. The final regulation (§1.199A-1(b)(14)) defines a trade or business as being the same as trade or business under Code Sec. 162. Whether a taxpayer is engaged in a trade or business under section 162 requires an examination of all the facts and circumstances. (*Higgins v. Commissioner, 312 U.S. 212 (1941)*)

The courts have laid out two conditions necessary for an activity to be a trade or business. The first requires the taxpayer to carry on the activity with the intent of making a profit. (See *Ferrell v. Commissioner, 90 T.C. 1154 (1988)* and *Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), aff'd without opinion 702 F.2d 1205 (D.C. Cir. 1983))* The second requires the scope and level of taxpayer activity to be considerable, regular, and continuous. (See *Groetzinger v. Commissioner (U.S. Supreme Court) 480 U.S. 23, at 32, 35 (1987)).*

Applying these two conditions to Rental Real Estate **-** The Treasury/IRS regulation writers received a number of requests for "bright line rules" to help taxpayers and tax preparers determine whether a rental real estate activity is a trade or business. In response Treasury/IRS issued Notice 2019-07 to address this issue.

Preparer Trap and Pitfall – To quote a close friend of mine, "dealing with rentals and Sec 199A for 2018 is like sitting in the front seat between Bonnie and Clyde." Making the ultimate decision that a rental activity is a trade or business solely on the basis of the Notice 2019-07 safe harbor can lead to big problems. The 199A deduction takes into account both positive (net profit) and negative (net loss) qualified business income (QBI) and negative QBI reduces the positive QBI from other activities, and in doing so, reduces the 199A deduction. Thus, if a **loss** activity qualifies under Sec. 162 and it is not treated as a trade or business because it did not meet the 250-hour safe harbor, that does not preclude the IRS from determining it is a trade or business based upon Sec 162. The best way to look at the safe harbor is the IRS will not challenge your position that the rental IS a trade or business, BUT it is not a safe harbor that a rental is NOT a trade or business.

Rental Property Safe Harbor - On January 18, 2019, the IRS issued Notice 2019-07 which provided the language of a proposed revenue procedure for "safe harbor" conditions under which a rental real estate activity will be treated as a trade or business for purposes of the 199A deduction.

TAKE NOTE - NOTICE 2019-07 IS ONLY A SAFE HARBOR
RENTALS GENERALLY STILL QUALIFY UNDER SEC 162

Failure of the taxpayer to satisfy the requirements of this safe harbor **does not preclude** a taxpayer from **otherwise** establishing that a "rental real estate enterprise" is a trade or business for purposes of section 199A.

The tax code itself does not provide a definition of a trade or business. Regulation Section 1.199A-1(b) (14) defines "trade or business as a trade or business under Section 162". This means that the taxpayer may rely on the large body of court cases involving the question of rental real estate being a trade or business or investment.

Our research finds that virtually all court cases, except in the 2nd Circuit, refer to real estate rental activities as a trade or business with one notable exception for triple net leases. Thus, it is our considered opinion that most rental activities will qualify as a trade or business even if they do not meet the safe harbor requirements of Notice 2019-07.

It's important to note that Notice 2019-07 prescribes three "safe harbor" conditions that if met for a rental real estate enterprise (enterprise is a tax term introduced by the IRS in this notice), the rental real estate enterprise will be deemed to be a trade or business and eligible for the section 199A 20% deduction. For purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties.

IMPORTANT: Do not mix up the grouping of rentals into a single rental enterprise to meet the 250-hour requirement with the Sec 199A aggregation rules (discussed on page 3.24.23) that allow taxpayers to aggregate business entities. They are two entirely different issues.

The following are the requirements that must be satisfied for the safe harbor:

1. Separate books and records must be maintained for each rental real estate enterprise;

Observation: It is our opinion that if the rentals are not combined into a single rental enterprise, then each requires its own books and records and bank account to meet the safe harbor requirements. If combined into a single rental enterprise, only a single set of books or bank account would be required.

   a. A real estate enterprise can consist of a single or multiple real estate rentals.
   b. Commercial and residential rentals **cannot** be combined in the same real estate enterprise.

Observation: The rules for aggregation of rental real estate trade or businesses under regulation section 1.199A-4 are similar but not the same as the rules for selecting a rental real estate enterprise under Notice 2019-07. **Both** aggregation under Reg Sec 1.199A-4 and rental real estate enterprise groupings under Notice 2019-07 are optional.

2. For years prior to 2023 at least 250 hours of rental services must be performed by the taxpayer and workers for the taxpayer for the year in question with reference to each rental real estate enterprise.

   A three-year lookback rule applies for taxable years 2023 and following. It specifies that the taxpayer must meet the 250-hour requirement for the rental enterprise for any three of the five prior consecutive taxable years; and

3. The taxpayer must maintain *contemporaneous* records, including time reports, logs, or similar documents, to document the following:
   a. hours of all services performed;
   b. description of all services performed;
   c. dates on which such services were performed; and
   d. who performed the services.

Observation: Contemporaneous is a difficult standard to meet, especially if the landlord is expecting his management company, gardener, pool person and other service providers to keep "contemporaneous records".

Special Relief: Because the safe harbor requirements were issued after the close of 2018, the requirement for contemporaneous records for 2018 does not apply.

Rental services – Rental services that may be counted toward the 250 hour requirement include: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in tenant applications; (iv) collecting rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials for operation such as repairs; and (viii) supervision of employees and independent contractors.

However, rental services do NOT include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; ***or*** *hours spent traveling to and from the real estate*.

Rental services counted toward the 250-hour requirement may be performed by owners or employees, agents, and/or independent contractors working for the owners.

Observation: Many landlords compensate their tenants for performing maintenance and repair services. It appears that rental services performed by a tenant will count towards the 250-hour requirement provided:

1. The tenant, **if compensated,** does so as an employee or independent contractor (if the qualification for independent contractor can be met). However, Notice 2019-07 includes no requirement that a tenant, or anyone for that matter, be compensated for the rental services provided.
2. A contemporaneous record of hours worked must be kept by the person responsible for keeping such records, in this case presumably the tenant. Records must be credible.
3. The services could be performed by the property owner's child, even if the child is not compensated for the work done.

*Triple net leases are not eligible for safe harbor***.** Notice 2019-07 specifies that real estate rented or leased under a triple net lease agreement is not eligible for this safe harbor. A triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, ***and*** to be responsible for maintenance activities for a property in addition to rent and utilities. Also ineligible for the safe harbor is a property leased under an agreement that requires the tenant or lessee to pay ***a portion*** of the taxes, fees, and insurance, **and** to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

Vacation rentals are not eligible for safe harbor **-** Real estate used as a residence by the taxpayer for **any** portion of the taxable year is not eligible for the safe harbor rules (see converted homes below).

Converted homes are not eligible for safe harbor - Real estate used by the taxpayer (including an owner or beneficiary of a relevant passthrough entity relying on this safe harbor) as a residence for any part of the year under section 280A is not eligible for this safe harbor.

Statement must be attached to the tax return **-** A statement signed by the taxpayer, or the person responsible for keeping the records with personal knowledge of them, must be attached to the return declaring that all of the safe harbor requirements have been met and must include the following language (second paragraph). You can expect your tax software to generate this statement:

STATEMENT

I(we) attest to the fact that the rental enterprise or enterprises for which the Sec 199A deduction has been claimed complies with Section 3.03 of the yet unnumbered proposed revenue procedure as articulated in Notice 2019-07.

Under penalties of perjury, I(we) declare that I(we) have examined the above statement, and, to the best of my(our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete.

Signatures

Year-to-year consistency required **-** The proposed revenue procedure states that taxpayers may not vary this treatment (i.e., treating each rental as a separate enterprise or grouping rentals as an enterprise) from year-to-year.

Double edged sword - The 199A deduction is 20% of a taxpayer's qualified business income from all of the taxpayer's trades or businesses subject to certain limitations. Many rentals do not show a profit and a rental that is treated as a trade of business that shows a deductible loss for the year will reduce the qualified business income of other trades or businesses of an individual, and as a result, reduces the 199A deduction of that individual.

This raises a serious due diligence question for tax preparers. Suppose a client does meet the safe harbor rules of Notice 2019-07 or qualifies as a trade or business under IRC Sec 162 and ends up with a deductible rental loss. Can this loss be omitted from the QBI calculation? The answer is obvious: if it meets the definition of a trade or business, of course it must be included in the computation of the Sec 199A deduction. To make matters more complicated, just because a rental does not meet the safe harbor rules does not mean it is not a trade or business under IRC Sec 162. The safe harbor criteria only means the IRS won't challenge the presumption that it is trade or business, nothing more.

CAUTION - Interest paid as part of a trade or business rental real estate activity is subject to the section 163(j) limitation on business interest UNLESS the rental real estate activity elects under section 163(j)(7)(B) to be an "electing real property trade or business". The effect of this election is that the rental activity though a trade or business, is not subject to the section 163(j) limitation. It's important to note, however, that there is a small business gross revenue exception from the section 163(j) limitation for any section 162 trade or business, whether or not it is a rental activity, where in the 3 prior years the gross annual revenues are less than $25M ($26M for 2019 and 2020). See chapter 3.25 for further details. The $26M (2019) section 163(j) interest limitation will not apply to most rentals.

Next let's look at Sec 162 which the final Sec 199A regulations say to follow when a rental is trade or business for purposes of the 199A deduction.

Rental Determination Using Sec 162 - The final regulation (§1.199A-1(b)(14)) defines a trade or business as being the same as a trade or business under Code Sec. 162. However, Code Sec. 162 is based on a myriad of court cases and IRS rulings that require the tax preparer to make a subjective determination which can be challenged by the Service. The catch-22 here is that IRS can determine a rental is a trade or business under Sec 162 even if it did not meet the safe harbor of Notice 2019-07. (You'll notice in the court cases we've cited that the IRS will sometimes argue that a rental is a trade or business, and in other cases will take the position that a rental is not a trade or business.) With regard to the Sec 199A deduction, a rental activity with a net profit benefits the taxpayer if it is a trade or business, but if the rental has a net loss it is a disadvantage since a net loss will offset any net profit from other business activities. You can't arbitrarily make those decisions to help a client; the decisions have to be based on facts and circumstances.

We see two problems facing tax practitioners:

- Explaining this very difficult determination to their client so the client (a) understands the determination is subjective, and can be challenged by the IRS, and (b) joins in the decision.
- Understanding the numerous tax court cases and how they might tie into their client's particular circumstances. For that we have developed a **checklist of facts and circumstances** that will help a practitioner determine if a rental is a trade or business under Sec 162 and have tied those facts and circumstance to particular court cases in a summary of **court cases and other guidance** that we have developed. The summary includes over 25 court cases related to rentals as trade or business.

COURT CASES & OTHER GUIDANCE - FOR USE IN DETERMINATION OF RENTAL REAL ESTATE TRADE OR BUSINESS

This is a compilation of court cases and other guidance, each concerning the rental real estate trade or business issue. This is to assist in determining whether a rental activity rises to the level of a trade or business. It may be appropriate to review the entire court case or other guidance if used in making a determination of trade or business. We suggest you use the checklist to gather information from your client to help you make an informed decision as to whether or not your client's rental real estate activity is a trade or business. You will notice that after the name of the case or other guidance there is a short description intended to capture the essence of the cited authority as to the rental real estate trade or business determination. We suggest you share your evaluation with your client and keep this evaluation in the client's file. Remember rental real estate trade or businesses with losses **reduce** QBI and the 20% Sec 199A deduction. Rental real estate trades or businesses with net profits increase QBI and the Section 199A deduction.

(I) THRESHOLD ISSUE - PROFIT MOTIVE REQUIRED & FACTS CONTROL

(1) **HIGGINS v. COMMISSIONER, 25 AFTR 1160 (61 S. Ct. 475), (S Ct), 02/03/1941**

Commentary – "whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case." 312 U.S. at 217. Taxpayer must have a profit motive. Most rental real estate activities are a for profit activity. Vacation rentals, rental for less than fair rental value and hobby properties are examples of not-for-profit activities.

(II) LEVEL OF ACTIVITY REQUIRED

[2] COMMISSIONER V. GROETZINGER, 480 U.S. 23 (1987)

Commentary – Activities must be "beyond the scope of mere ownership of property" **and** must be **considerable, regular, and continuous activity.** See generally Commissioner v. Groetzinger, 480 U.S. 23 (1987) for "regular and continuous" requirements.

[3] FINAL REGS SUMMARY OF COMMENTS & EXPLANATION OF REVISIONS – Sec 1.199A (Pg 22)

As discussed in part II.A.3.a. of this Summary of Comments and Explanation of Revisions, generally under Section 162, to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. Commissioner v. Groetzinger, 480 U.S. 23, 35 [59 AFTR 2d 87-532] (1987).

Commentary: Final regulations require a taxpayer to be involved in a rental activity with continuity and regularity and the primary purpose to be for income or profit.

[4] GENERAL COUNSEL MEMORANDUM (GCM) 38779

The memorandum says the Tax Court requires only a "*relatively small amount of activity"* for trade or business. The Tax Court has repeatedly ruled that one real estate rental activity managed by the owner, including an agent or manager, meets the Groetzinger standard of activities, which are "beyond the scope of mere ownership of property" and were deemed to be **considerable, regular, and continuous activity.**

(III) CASES INVOLVING A SINGLE RENTAL PROPERTY

[5] LELAND HAZARD, 7 TC 372, Code Sec(s) 23, 07/16/1946

Taxpayer occupied his property as a personal residence until such time as the TP relocated, at which point he rented the personal residence property and at the same time listed it for sale. The property was continuously rented for a period of about 3.5 years at which time it sold. The property was sold for $18,500 for which the taxpayer reported an ordinary trade or business loss of $6,844. No other activity was identified.

The IRS took the position that the home was a capital asset on the grounds that the rental was not a trade or business. The Tax Court found it to be a trade or business. The IRS subsequently acquiesced to this decision.

Commentary – A single rental, formerly a personal residence, was a trade or business – no specific other activity discussed.

[6] ANDERS I. LAGREIDE, 23 TC 508, 12/22/1954

"Taxpayer inherited a residence which she then rented out. The Commissioner there argued the rental of this single piece of residential property amounted to the operation of a trade or business regularly carried on by the taxpayer. The Tax Court agreed, saying: "It is clear from the facts that the real estate was devoted to rental purposes, and we repeatedly held that such use constitutes use of the property in trade or business, regardless of whether or not it is the only property so used. We add that the use of the property in trade or business was, upon the facts, an operation of the trade or business in which it was so used. It is clear, also, that the business was 'regularly' carried on, there having been no deviation, at any time, from the obviously planned use."

Commentary – A single residence was a trade or business – no specific other activity discussed as being required.

[7] CURPHEY 73 T. C. 766(1980)

TP managed 6 units, but the Tax Court made this remarkable statement regarding a single rental property being sufficient for trade or business. "This Court (Tax Court) has held repeatedly in cases subsequent to the Supreme Court decision in Higgins that the rental of even **a single piece of real property** for production of income constitutes a trade or business." See also *Fegan*, 71 T.C. 791, 814 (1979); *Elek*, 30 T.C. 731 (1958), acq. 1958-2 C.B. 5; *Noble*, 7 T.C. 960 (1946), acq. 1946-2 C.B. 4, supra; *Hazard*, 7 T.C. 372 (1946), acq. 1946-2 C.B. 3.

Commentary –Single rental is a trade or business & husband agent OK.

(IV) CASES WHERE TAXPAYER TRIED TO RENT BUT FAILED

(8) GEORGE S. JEPHSON., 37 BTA 1117, Code Sec(s) 23, 06/24/1938

A taxpayer, who purchased a house for renting, listed it for rent with a broker and showed it to prospective tenants but failed to rent it, was engaged in a business, and is entitled to deductions for care and maintenance expenses and depreciation on the property.

Commentary – Taxpayer attempted to rent but was not successful, ruled to be a **trade or business.**

(9) JACKSON V COMMISSIONER 34 T.C.M. 1139 (1975)

"But the record here, while shedding little light on what affirmative steps may have been taken to rent the property, makes clear those measures that were not pursued. Petitioner did not employ a rental agent nor advertise in newspapers his willingness to rent the El Cajon property despite the fact that at times, similar measures were among those used in efforts to sell the property. Moreover, although the property was no longer suitable for occupancy by the time he reluctantly expressed a willingness to accept a tenant, he did not undertake to make any of the repairs that were required to put the property in rentable condition. Such inaction certainly raises doubts about the earnestness with which petitioner tried to rent the property"

Commentary – Purchased for sale-Attempt to rent not serious enough – **Not Trade or Business**

(10) CAMPBELL v. COMMISSIONER 5 TC 272 (1945)

Facts from evidence indicated that TP's "only purpose in buying the property … was to rent it and that he tried to do so by listing it with a broker and showing it to prospective tenants, and that later he bought (another piece of property next door) …as a step in assembling property on which to build an apartment house".

Commentary – Attempt to rent was serious – **Trade or Business found**

(11) ESTATE OF MARIA ASSMANN, 16 T.C. 632 (1951)

Minimal unsuccessful efforts to rent not good enough. (See *Jackson* TCM 1965-275, to the same effect; also see *Redisch* TCM 2015-95, converted second home - unsuccessful attempt to rent - not a trade or business.)

Commentary: Minimal unsuccessful attempts to rent **NOT a trade or Business.**

(V) LEVEL OF ACTIVITY REQUIRED TO BE HIGHER IN 2ND CIRCUIT BUT AGENT ACTIVITY COUNTS

(12) 2ND CIRCUIT (covers the states of Connecticut, New York & Vermont)

Activities must be "beyond the scope of mere ownership and the receipt (collection) of income and these activities must be "continuous" rather than sporadic, "regular" rather than irregular, and "considerable" rather than minimal." (*Keefe* below; *See Alvary v. United States, 302 F.2d 790, 796-797 (2d Cir. 1962); Gilford v. Commissioner, 201 F.2d at 736; Pinchot v. Commissioner, - 17 - [*17] 113 F.2d 718, 719 (2d Cir. 1940); Balsamo v. Commissioner, T.C. Memo. 1987-477; Grier, 120 F. Supp. 395 at 398).* Courts found that minimal activities with respect to the house as compared to the length of ownership, the lack of activity to rent or re-rent, and the absence of employees hired to regularly maintain or repair the premises did not rise to a trade or business - lack of "regular and continuous activity of management" under a facts and circumstances analysis.

Commentary: 2nd circuit requires the taxpayer's rental activities to be "continuous" rather than sporadic, "regular" rather than irregular, and "considerable" rather than minimal. *Grier, 120 F. Supp.* ***395*** *at 398* is the seminal 2nd Circuit case)

(13) GILFORD v. COMMISSIONER, 43 AFTR 221 (201 F.2d 735), (CA2), 02/05/1953

Although it does not appear that the petitioner did anything herself in connection with the management of eight buildings, **an appreciable amount of time and work** was necessarily required on the part of the managing agent. And if such management was a "trade or business," the petitioner was so engaged although she acted only through an agent.

Commentary – Taxpayer's involvement in the rental was entirely through an agent, and the tax court ruled it to be a **trade or business**.

[14] DAVID KEEFE, ET UX., TC MEMO 2018-28

Maintenance and repairs supplied by the taxpayer or an agent of the taxpayer; the taxpayer's employment of labor to manage the property or provide services to tenants; the purchase of materials; the collection of rent; and the payment of expenses. *See also* Alvary v. United States, 302 F.2d 790, 796-797 [9 AFTR 2d 1633] (2d Cir. 1962); Gilford v. Commissioner, 201 F.2d at 736; Pinchot v. Commissioner, 113 F.2d 718, 719 [25 AFTR 447] (2d Cir. 1940); Grier, 120 F. Supp. 395 at 398. The totality of the facts and circumstances surrounding the use of the property must support a conclusion that the alleged rental activities were sufficient, continuous, and substantial enough to constitute a trade or business with respect to the rental of the property.

Commentary: More activity needed since this case was in the 2nd Circuit. "This Court will "follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone." Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971). Court determined the taxpayer's efforts were sufficient, continuous, and substantial enough to constitute a **trade or business**.

[15] FACKLER 45 BTA 708, (19) aff'd 133 F2d 509, 30 AFTR 932 (CA-6, 1943)

TP was responsible for expenses such as heat, light, water, insurance, real estate commissions, real estate taxes, miscellaneous expenses and repairs. **Trade or business found**. The sixth Circuit emphasized the importance of "rendering personal services to tenants" but did not elaborate on what those "personal services" were or are.

[16] PETER S. ELEK, 30 TC 731, 06/26/1958

The taxpayer, a Hungarian who relocated to the U.S., had his father take over managing his apartment building in Budapest. The court determined the rental and management of an apartment building or residential property amounted to a trade or business of the owner, and this is true where an agent, in this case his father, acts for the owner.

Commentary – Agent did the management - Taxpayer's involvement in the rental was entirely through an agent, his father, and the tax court ruled it to be a **trade or business**.

(VI) AGRICULTURAL LAND LEASE CASES

[17] BYRON K. ANDERSON, TC MEMO 1982-576, CODE SEC(S). 280A, 09/30/1982

Taxpayer owned 80 acres of farm land which he leased to tenant farmer. The court agreed if the taxpayer had personally farmed the 80 acres it undoubtedly could constitute a trade or business. However, he leased it to a tenant farmer, thereby relieving himself of virtually all of the day-to-day responsibilities of farming and thus was not a trade or business.

Commentary – Farm land leased to a tenant farmer who did all of the day-to-day work, court ruled **NOT a trade or business**

[18] GOOD V COMM 16 T.C. 906 (1951)

For several years' petitioner rented 20 acres of land to tenants who raised hay and grain, the rent being in the form of a quarter share of the profits. For the remainder of the time petitioner rented the property as pasture for $50 per year, and during two or three years a 2-acre portion of it was rented for the storage of lumber, also for $50 a year. When petitioner rented it for both pasture and as a lumber yard the total annual rental of $100 exceeded the property taxes."

Commentary – Farm land leased to a tenant farmer - partially crop share and partially land lease - ruled a **trade or business.**

(VII) MISCELLANEOUS ISSUES

[19] JACKIE H. ROBINSON, ET UX., TC MEMO 2014-120

The Robinsons claimed **losses** for 2007 and 2008 derived from rental real estate expenses and depreciation on their Magnolia house. Though the Robinsons rented out the Magnolia house from 1995 through 1999 and again in December 2009, they received no rents in 2007 or 2008. The property was not held out for rent from 1999 until 2009, a 10-year period, and the Robinsons made no effort to sell the property. The tax court determined the Robinsons did not engage in a real estate trade or business or hold the Magnolia house out for the production of income. They failed to make any significant attempt to sell the property during the years at issue, and the house went unrented for the 10-year period encompassing the tax years at issue.

Commentary – Treatment as a rental was inconsistent, rented for 4 years, unrented for 10 years, then sold. Court ruled **NOT a trade or business**.

[20] EDGAR PERRY, ET UX. V. COMMISSIONER, TC MEMO 2018-90 - RENTAL AT LESS THAN FRV

The court found that the taxpayers failed to carry their burden of establishing that they rented petitioners' second house to petitioners' relatives at fair rental.

Commentary – Taxpayer rented the home for less than fair market to relatives. Thus, **NOT a trade or business**.

[21] VICTORIA BALSAMO, TC MEMO 1987-477, 09/21/1987 - EVIDENCE NOT CREDIBLE & ACTIVITIES ALMOST NONEXISTENT

Petitioner's activities with respect to the premises as rental property were almost nonexistent. Petitioner testified that the lessee, Economopoulos, pointed out to her a dead rat, a bee's nest, and several leaks during her single visit, yet petitioner presented no evidence that she attempted to remedy these problems during her period of ownership.

Commentary: Testimony and other evidence not credible, records incomplete, taxpayer activity almost nonexistent - very short rental period. The court found it was **NOT a trade or business**.

[22] HAJOS 23 T.C.M. 2015 (1964) -PERSONAL RESIDENCE CONVERTED TO RENTAL

Private personal residence for about 1½ years converted to rental for 1 ½ years till sold. Court found it to be a trade or business.

Commentary: Personal residence converted and sold within 1½ years was a **trade or business**.

[23] STRATTON V. COMMISSIONER, T.C. MEMO 1962-218 - IRS ARGUED ONE RENTAL WAS A TRADE OR BUSINESS

IRS argued "the mere renting of the house for the (three-year period) constituted the carrying on of a trade or business." Court determined it was a trade or business.

Commentary: In this case the IRS argued in favor of a trade or business. House rented for three years was a **trade or business**. The sole issue was whether the loss realized when the house was sold in 1951 was an ordinary loss deductible only in the year of the loss or a capital loss which can be carried forward to the years in question.

[23.1] **James B. and Joan E. Murtaugh v. Commissioner (1997-319) - 25% interest in two timeshare units rented** in a resort lodging facility were trade or business even though they lost money for two years and then were sold.

(VIII) OTHER GUIDANCE

[24] NOTICE 2019-07

This notice provides for 250 hours of rental services to achieve a safe harbor designation that a rental real estate enterprise is a trade or business. To qualify for the safe harbor contemporaneous records must detail (i) the hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. It also requires the taxpayer to attach a statement, signed under penalty of perjury, that all the safe harbor requirements have been satisfied.

Commentary: Keep in mind the regulations specifically state that rentals can qualify under Sec 162, and the taxpayer need not meet Notice 2019-07's requirements to be a Trade or Business (see cases above).

[25] TRIPLE NET LEASES

Notice 2019-07 excludes triple net leases from qualifying under the safe harbor. In addition, triple net leases do not appear to qualify under Sec 162 either since the taxpayer provides no meaningful rental services.

SECTION 199A

RENTAL REAL ESTATE TRADE OR BUSINESS CHECKLIST:

This checklist is designed to help tax professionals determine the level of activity for the purpose of evaluating a rental activity's qualification for trade or business status under IRC section 162 for purposes of the pass-through deduction under IRC section 199A. The superscripted numbers refer to specific court cases or other guidance included in the "Court Cases & Other Guidance" to be used with this worksheet. This checklist does not provide a definitive determination, but rather assembles the information helpful to arrive at a decision based upon the facts and circumstances of the situation.

☐[24] Check this box if the activity meets the 250-hour safe harbor requirements of Notice 2019-07. (If you have checked this box and documented the safe-harbor requirements, the activity is deemed to be a trade or business for purposes of the Sec 199A, and you don't need to use the checklist.)

The level of activity need not rise to the 250-hour safe harbor level of Notice 2019-07 to qualify as a trade or business under IRC Section 162, but there must be some level of activity above that of a triple net lease, [25] which is specifically excluded from the definition of a trade or business under Sec 199A. (See prologue to the final Sec 199A regulations, page 17, section II.A.3.b. & Notice 2019-07, section 3.05). The courts (particularly the Tax Court confirmed by GCM 38779), have found that only "a relatively small amount of activity" is indicative of a trade or business. Use this worksheet to gather the facts and circumstances to help determine if the rental activity meets the Sec 162 definition of a trade or business.

A. Describe rental property
 ☐Commercial, ☐Residential, ☐Land lease, [17] [18] ☐Farm land [17]
 ☐Other (describe):____

B. How many other rental activities does the taxpayer own? ______

C. How long has this rental property been owned: ______

D. Has its use always been a rental? ☐Yes ☐No [2] [19] [22]

E. If no, explain: ____

F. Is it rented at less than FRV? ☐Yes ☐No [1] [20]

G. Did owner attempt to rent it but fail to do so? ☐Yes ☐No [8] [9] [10] [11]
 If yes, how long did owner attempt to rent? ____________________

H. Describe efforts to rent & conditions that hindered rental: ____

I. Has it been continuously rented or available for rent? ☐Yes ☐No [3] [10] [11] [12]
 If no, explain: ____

J. Check the boxes of the following expenses the owner or owner's property manager or other agent paid on behalf of the taxpayer: [6] [15] [16]
 ☐Mortgage P & I ☐Taxes ☐Insurance ☐Utilities ☐Fees
 ☐Homeowner assessments ☐Other (describe) ______________________

K. Was the taxpayer or the taxpayer's property manager or other agent responsible for the repairs and maintenance for the rental? ☐Yes ☐No [4] [13] [14] [15] [16]

L. Check the boxes and give cost for the repairs and maintenance actually completed by the taxpayer or the taxpayer's property manager or other agent during the year: [8] [14] [15] [16]
 ☐Gardening $_______ ☐Landscaping $_______ ☐Tree service $_______ ☐Pool maintenance $_______
 ☐Painting $_______ ☐Roof repairs $_______ ☐Appliance repair/replacement $_______ ☐Electrical $_______
 ☐ Plumbing $_______ ☐Other (description): ____ $_______

M. Management activities performed by the taxpayer, property manager, or taxpayer's other agent during the year: [9] [13] [16]
 ☐Showed property ☐ Prepared, negotiated and/or renewed leases ☐Presided over evictions ☐Maintained the books and records ☐ Supplying furnishings ☐ Cleaning & preparing unit(s)

*Rental activities that are specifically not trades or businesses:

- Triple net lease [25]
- Home rented to a related individual or entity at less than fair rental value [20]
- Vacation home rental [20]

Conclusion

It is our opinion that the determination of trade or business for rental activities should be based on Sec 162, and the safe harbor used sparingly and only where there is doubt under Sec 162, if at all. Our research of court cases upon which Sec 162 is based indicates most rental real estate activities are trades or businesses.

Consideration should be seriously given to the proper treatment of each activity under relevant case law with the conclusion that, except for exceptions outlined above, a rental real estate activity will be a trade or businesses. Consistency for both net profit and net loss activities is appropriate.

But of course, how you handle this mess is entirely up to you. Court rulings are certainly in our future but that will take a number of years to play out.

WORKSHEETS & NEW IRS FORMS

The following blank worksheets are provided for use by our students

CAUTION

SECTION 199A IS COMPLEX IN ITS WORDING AND ALTHOUGH WE USED OUR BEST EFFORTS TO DEVELOP WORKSHEETS TO COMPUTE THE DEDUCTION, THE ULTIMATE IRS INTERPRETATION MAY BE SOMEWHAT DIFFERENT THAN OURS. THEREFORE, IF YOU USE THESE WORKSHEETS, YOU DO SO AT YOUR OWN RISK**.**

For 2019 the IRS has developed two new forms that take the place of the worksheets that were available for 2018 in the 1040 instructions and Publication 535. According to drafts, these forms are:

- Form 8995 - Qualified Business Income Deduction Simplified Computation
- Form 8995-A - Qualified Business Income Deduction (plus a separate Sch A to handle SSTBs, a separate Sch B for aggregation of business operations, a separate Sch C for loss netting and carryforward, and a separate Sch D to deal with farming cooperatives)

At the time this chapter was updated, a draft of the instructions for Form 8995 (5 pages) was posted on the IRS web site, but those for the 8995-A and its schedules weren't available so we don't know how many pages they will be. The forms drafts are available on the IRS web site, https://apps.irs.gov/app/picklist/list/draftTaxForms.html - enter 8995 in the search box.

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2019 199A SSTB Worksheet

(For use **ONLY** with **Specified Service Trade or Businesses**)

Business Name: ______________________________

☐ Schedule C ☐ Schedule E ☐ Schedule F ☐ 1065 ☐ 1120-S

1.	Qualified Business Income (QBI)	
2.	Taxpayer's 1040 Taxable Income (before the 199A deduction)	
3.	Threshold (enter $321,400 if MFJ; $160,725 if MFS and $160,700 others)	
4.	Differential (enter $100,000 if MFJ; otherwise enter $50,000)	
5.	Line 3 plus Line 4 (top of threshold range)	
6.	If Line 2 equals or exceeds Line 5, **STOP** and enter zero on Line 22. Note: The 199A deduction for this business is zero. If Line 2 is less than Line 5, enter zero here and continue to Line 7.	
7.	Tentative 199A deduction (20% of Line 1)	
8.	If Line 2 is less than Line 3, **STOP** and enter the amount from Line 7 on Line 22. Note: The 199A deduction for this business is the full 20% of QBI. If line 2 is greater than Line 3, enter zero here and continue to Line 9.	
9.	Wages paid by this business	
10.	Assets (unadjusted basis of this business' eligible tangible property)	
11.	50% of wages	
12.	25% of Wages	
13.	2.5% of Assets	
14.	Line 12 plus line 13	
15.	Wage Limit – Greater of line 11 or Line 14	
16.	Subtract Line 3 from Line 2	
17.	Divide Line 16 by Line 4	
18.	If Line 7 is greater than Line 15, enter ((Line 7 – Line 15) x Line 17). Otherwise enter zero.	
19.	Line 7 less Line 18	
20.	1 minus Line 17	
21.	Line 20 times Line 19	
22.	**Preliminary Section 199A Deduction –** Lesser of Line 18 or Line 21	

Instructions: This worksheet can only be used for specified service trade or businesses. It is designed to determine the 199A deduction for a single business. The results of this worksheet must be combined with the results from other businesses and flow-through income of the taxpayer to determine the combined Sec 199A deduction for the taxpayer. The combined Sec 199A deduction is further limited to 20% of the adjusted taxable income of the taxpayer.

ClientWhys has a separate worksheet for use with other qualified businesses. Although we believe the worksheets compute the deduction correctly, ultimately, when the IRS worksheets become available, they will take precedence.

Specified Service Trade or Businesses: Generally, includes any trade or business described in Sec 1202(e)(3)(A), but excluding engineering and architecture and trades or businesses that involve the performance of services that consist of investment-type activities. Specified service businesses include trades or businesses involving the performance of services in the fields of: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees as defined in Prop Reg. 1.199A-5(b)(2)(xiv),

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2019 199A QTB Worksheet

(**NOT** For Use with Specified Service Trades or Businesses)

Business' Name: ____

☐ Schedule C ☐ Schedule E ☐ Schedule F ☐ 1065 ☐ 1120-S

1	Qualified Business Income (QBI)	
2	Taxpayer's 1040 Taxable Income (before the 199A deduction)	
3	Threshold (enter $321,400 if MFJ; $160,725 if MFS and $160,700 others)	
4	Differential (enter $100,000 if MFJ; otherwise enter $50,000)	
5	Line 3 plus Line 4 (top of threshold range)	
6	Tentative 199A deduction (20% of Line 1)	
7	If Line 2 is equal to or less Line 3, skip to line 21 and enter the amount from Line 6 on Line 21. If Line 2 is greater than line 3, continue to Line 8 (leave Line 7 blank).	
8	Taxpayer's share of the total wages paid by this business	
9	Taxpayer's share of qualified business property for this business	
	If Lines 8 and 9 are both zero, skip Lines 10 through 13 and enter zero on Line 14.	
10	50% of Line 8	
11	25% of Line 8	
12	2.5% of Line 9	
13	Line 11 plus Line 12	
14	Wage Limit – **Greater** of Line 10 or Line 13	
15	If Line 2 is equal to or greater than Line 5, skip to Line 21 and enter the **lesser** of Line 6 or Line 14. Otherwise continue to Line 16.	
16	If Line 14 is greater than Line 6, skip to Line 21 and enter the amount from Line 6. If Line 14 is equal to or less than Line 6, continue to Line 17.	
17	Subtract line 3 from Line 2	
18	Divide Line 17 by Line 4	
19	Subtract Line 14 from Line 6	
20	Multiply Line 18 by Line 19	
21	**Preliminary Section 199A Deduction** this business (Line 6 minus Line 20)	

Instructions: This worksheet is designed to determine the 199A deduction for a single business activity. However, it **cannot** be used for specified service trades or businesses. The results of this worksheet must be combined with the results from other businesses and flow-through income of the taxpayer to determine the combined Sec 199A deduction for the taxpayer. The combined Sec 199A deduction is further limited to 20% of the adjusted taxable income of the taxpayer.

ClientWhys has a separate worksheet for use with specified service trades or businesses. Although we believe the worksheets compute the deduction correctly, ultimately, when the IRS worksheets become available, they will take precedence.

199A Summary Worksheet

Caution: The Worksheet Does Not Accommodate Business Losses. Loss adjustments must be made at the QBI level for each trade or business activity.

1	REIT Dividends		
2	Qualified Publicly Traded Partnership (PTP) Income		
3	Sum of Lines 1 & 2		
4	199A Deduction for REITs and PTPs (20% of Line 3)		
	INCOME FROM INDIVIDUAL FLOW-THROUGH BUSINESS ACTIVITIES		
	Description of Flow-Through Business Activities	**Preliminary 199A Deduction**	
5			
6			
7			
8	*Total of lines 5, 6 and 7*		
9	Tentative 199A Deduction (Sum of lines 4 and 8)		
	DETERMINATION OF TAXABLE INCOME LIMIT		
10	Enter the taxpayer's Taxable Income (Before the 199A deduction)		
11	Enter the Taxpayer's Net Capital Gains		
12	Adjusted Taxable Income (Line 10 less Line 11)		
13	Taxable Income Limit (Line 12 times 20%)		
14	**Section 199A Deduction for this taxpayer** (lesser of Line 9 or Line 13)		

Instructions: This worksheet is designed to summarize all of the 199A deductions of the taxpayer and apply the final taxable income limit. It does not accommodate situations where one or more of the taxpayer's pass-through businesses has a negative QBI.

ClientWhys has three separate worksheets to develop the information needed for lines 7 thru 9. They include (1) Worksheet for most businesses, (2) Worksheet for specified services trades or businesses and (3) a worksheet for farming and cooperatives activities. Although we believe the worksheets compute the deduction correctly, ultimately, when the IRS worksheets become available they will take precedence.

EXCESS BUSINESS LOSSES & INTEREST DISALLOWANCE

Overview

Excess Business Losses

- Married Filing Joint – Applicable if losses are $510K (2019) or more
- Others - Applicable if losses are $255K (2019) or more

Interest Disallowance

- Applies to taxpayers (other than tax shelters) with average gross receipts for the three prior years of more than $26 million (2019)

Pubs

Forms

Related IRC and IRS Publications and Forms

- **IRC Sec. 461** – Excess Business Losses
- **IRC Sec 163** – Disallowance of Business Interest
- **Form 461** – Limitation on Business Losses
- **Form 8990** – Limitation on Business Interest Expense

RAPID FINDER

EXCESS BUSINESS LOSSES

The Details

Under pre-TCJA law (IRC Sec 461(j)), if a non-corporate taxpayer in the farming business received an applicable government subsidy, including a Commodity Credit loan, for the tax year, the taxpayer's "excess farm loss" for that year wasn't allowed. The amount of loss that could be claimed was limited to a threshold amount of $300,000 ($150,000 for MFS taxpayers).

TCJA

Under TCJA the IRC Sec 461(j) limitation on "excess farm loss" for non-corporate taxpayers no longer applies after 2017 and through 2025. Instead all non-corporate taxpayers' loss deductions are limited to a threshold amount *(IRC Sec. 461(I) as modified by TCJA Sec. 11012(a)).*

An "excess business loss" is the excess (if any) of the taxpayer's aggregate deductions for the tax year that are attributable to trades or businesses of the taxpayer (determined without regard to whether or not the deductions are disallowed for that tax year) over the sum of:

(i) the taxpayer's aggregate gross income or gain for the tax year, which is attributable to those trades or businesses, plus

(ii) $250,000 (200% of that amount for a joint return (i.e., $500,000)). This amount is adjusted for inflation after 2018, and for 2019, these amounts are $255,000 and $510,000, respectively.

APPLICABLE EXCESS BUSINESS LOSS			
Year	2018	2019	2020
Excess Business Loss			
MFJ	$500,000	$510,000	518,000
Others	$250,000	$255,000	259,000

Example: *A single taxpayer, in 2019, has deductions of $500,000 from a business. The taxpayer's gross income from the business is $200,000. The deductible loss would have been $300,000 prior to the TCJA change (provided the business was not a passive activity). The excess business loss under TCJA is $45,000 ($500,000 – ($200,000 + $255,000)). Thus, the taxpayer's deductible business loss for 2019 is $255,000 and the excess business loss of $45,000 is treated as an NOL carried forward to the next year.*

Coordination with Passive Loss Rules – Passive loss limitations apply before the excess business loss rules (Code Sec 461(l)(6)). Presumably, if a loss is disallowed under the passive activity loss rules, any deductions or income from that passive activity would not be considered in the determination of whether a taxpayer has an excess business loss.

Commentary: However, Code Sec. 461(l)(3)(A) language does not limit losses used in determining excess business losses to "active" trades or businesses, so some additional guidance is needed from the IRS.

***Commentary*:** TCJA also modified the NOL deduction for losses incurred after 2017 so there is no carryback and the carryforward is indefinite. But the deduction of post-2017 NOLs can only offset 80% of a taxpayer's income in any year. (See chapter 316 for more detail and an issue about effective date.)

DISALLOWANCE OF BUSINESS INTEREST

TCJA

Effective beginning in 2018, TCJA gets rid of the special and complicated "earnings strippings" rules that were put in place to prevent a U.S. corporation from borrowing money from a foreign subsidiary in a lower tax bracket and then deducting interest on the U.S. corporate return. We won't get into that big business tactic other than to provide a little understanding why this provision was passed. Regardless of business form, the interest expense is limited to the sum of:

1. The taxpayer's business interest income for the tax year;
2. 30% of the taxpayer's adjusted taxable income for the tax year; plus
3. The taxpayer's floor plan financing interest (certain interest paid by vehicle dealers) for the tax year.

The net interest expense disallowance is determined at the taxpayer level. *IRC Sec 163(j)(1) as amended by TCJA Sec. 13301(a)*

For purposes of this limitation, the following definitions and rules apply:

- **Adjusted Taxable Income** - For 2018 through 2021, adjusted taxable income is determined without regard to depreciation, amortization or depletion deductions. In addition, adjusted taxable income means taxable income computed without regard to:
  - Any item of income, gain, deduction, or loss which is not properly allocable to a trade or business;
  - Any business interest income or business interest expense;
  - The amount of any net operating loss deduction;
  - The amount of any qualified business income deduction allowed under section 199A; and
  - Adjustments described in published guidance.
- **Small Business Exemption** – An exemption from the rules applies to taxpayers (other than tax shelters) with average gross receipts for the three prior years of $25 million or less. This amount is inflation-adjusted for years after 2018, so for 2019 the exemption amount is $26 million or less.

SMALL BUSINESS EXCEPTION		
2018	2019	2020
$25 Million	$26 Million	$26 Million

***Commentary*:** Most small businesses are below the threshold so the interest deduction limitation generally will not apply.

- **Real Property Trades or Businesses** – Can elect out of this provision by using the alternative depreciation system (ADS) to depreciate the real property used in a trade or business. For this purpose a real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. (Form 8990 instructions)

Commentary: The ADS recovery period was reduced for residential real estate from 40 to 30 years by TCJA.

- **Farming Businesses** - Farming businesses and specified agricultural or horticultural cooperatives can elect out of this provision if they use ADS to depreciate any property used in the farming business with a recovery period of ten years or more. For this purpose a farming business includes livestock, dairy, poultry, fish (includes an area where fish and other marine animals are grown or raised and artificially fed, protected, etc., but not an area where they are merely caught or harvested), fruit, nuts, and truck farms. It also includes plantations, ranches, ranges, and orchards. A plant nursery is a farm for purposes of deducting soil and water conservation expenses. (Form 8990 instructions)

See Rev Proc 2019-08 for an explanation how electing real property trades or businesses or farming businesses change to the ADS for property placed in service before 2018. This revenue procedure provides that it is not a change in accounting method.

- **Automobile, Boat, Farm Machinery Dealers –** Interest on debt secured by the inventory is exempt from the limitation.
- **Partnerships and S Corporations** - There are special rules for partnerships and sub-S corporations not covered here, since this course is related to small business and the $25 million gross receipts should effectively provide an exemption for most small businesses. See Form 8990 and its instructions or proposed regulations for additional information.
- **Carryover** - Any business interest that isn't deductible because of the business interest limitation is treated as business interest paid or accrued in the following tax year, and may be carried forward indefinitely, subject to the restrictions applicable to partnerships. If a partnership or S corporation is subject to the business interest deduction limitation, the limitation is applied at the entity level and any disallowed business interest expense (excess business interest expense) is not carried over by the partnership but is allocated to the partners. In contrast, disallowed business interest expense is carried over by an S corporation and the S corporation treats it as business interest expense paid or accrued in the following year.
- **Application of Limitations** - Section 163(j) applies before the application of the at-risk rules (§ 465), passive activity loss provisions (§ 469), and the § 461(l) limitation on excess business losses of noncorporate taxpayers discussed above. (Prop Reg 1.163(j)-3)

<u>IRS Guidance</u> – In Notice 2018-28 (April 3, 2018) the IRS announced its intention to produce regulations addressing various issues related to this new provision, and that in the meantime, taxpayers could rely on the rules described in sections 3 through 7 of the notice. In late December 2018, the IRS issued the promised proposed regulations (NPRM REG-106089-18) that provide general rules and definitions and are organized into eleven sections, proposed §§1.163(j)-1 through 1.163(j)-11.

Excess Business Losses –

- CA does not conform to the IRC Sec 461(j) limitation on "excess farm loss."
- **2018** - CA does not conform to the limitation on excess business losses.
- **Post-2018** - In AB 91 (signed by the governor 6/27/2019), California adopted the TCJA change relating to the limitation on excess business losses of noncorporate taxpayers, with the following exceptions:
  - California law says that any loss which is disallowed under this provision is to "be treated as a carryover excess business loss for the following taxable year" instead of as a net operating loss carryover as it is for federal. This means the carryover amount is used in determining if there's an excess loss in the carryover year for California.
  - The federal provision applies only for years 2018 through 2025, while the California law is effective for taxable years beginning after December 31, 2018 and continues indefinitely.
  - California's, rather than the federal's, passive activity loss provisions are used in determining any excess loss.

Disallowance of Business Interest - CA has no similar provision, and it is unlikely the legislature will pass any conforming legislation.

NOTES

REAL ESTATE PROFESSIONALS

RAPID FINDER

- **Three Tests**
  - Material participation
  - Over half of personal services in RE trades or businesses
  - 750 hours of personal services in RE trades or businesses
- **Election to aggregate**

Related IRC and IRS Publications and Forms

- **Pub 925** – Passive Activity
- **Pub 527** – Rentals
- **IRC 469** – Passive Activity Losses Limited
- **Schedule E** – Instructions
- **Schedule E**
- **IRC Sec 199A**
- **IRC Sec 469(c)(7)**

The TCJA added new Sec 199A that for years 2018 through 2025 allows a deduction of 20% of qualified business income (or 20% of the individual's taxable income, if less) from pass-through activities, including Schedule E rentals. One of the many issues related to the Sec 199A deduction that was raised is whether the same grouping of activities will apply for the Sec 199A computation that is elected for purposes of exempting a qualified real estate professional from the automatic treatment of rentals as passive activities. The answer is NO. In final Reg. 1.199A-4, the IRS says that aggregation is permitted but not required and sets forth the requirements for establishing Sec 199A groupings. The preamble to the final regulations says "The Treasury Department and the IRS do not consider the grouping rules under section 469 an appropriate method for determining whether a taxpayer can aggregate trades or businesses for purposes of applying section 199A." See Chapter 3.24 for details on Sec 199A.

For any tax year in which the taxpayer is a "qualifying taxpayer" (a **real estate professional**), the rule treating all rental activities as passive activities doesn't apply to any **rental real estate** activity of the taxpayer. (Code Sec. 469(c)(7)(A)(i)) Instead, that activity is a passive activity unless the taxpayer materially participates. (Reg § 1.469-9(e)(1))

Thus, **real estate professionals** who materially participate in a **rental real estate** activity may use losses or credits from the activity to offset other, non-passive income. '

Usually Material Participation Test Doesn't Apply for Rental Activities

In general **rental activities are passive** activities regardless of whether the taxpayer materially participates in the activity. (IRC § 469(c)(2) and § 469(c)(4)) So, unless the "rental" really isn't a rental under the exceptions provided in Reg. Sec. 1.469-1T(e)(3), or this special rule for real estate professionals applies, the material participation tests can't be applied to the normal rental. For example, a taxpayer who owned an apartment house (but who doesn't qualify as a real estate professional) and who worked over 500 hours annually on the property would not be considered to have materially participated in the activity, and it would still be a passive activity (albeit eligible for the active participation loss allowance of up to $25,000 per year). Thus, qualifying as a real estate professional is the only way one would be able to deduct in full what would otherwise be a passive activity loss against non-passive income, and then only if material participation in the rental real estate activity can be proven.

REAL ESTATE PROFESSIONAL REQUIREMENTS

A taxpayer is a real estate professional (qualifying taxpayer) for a particular tax year if he meets BOTH of the qualifications below:

- **QUALIFICATION #1** - More than **half of the personal services** (see below) the taxpayer performs during that year **are performed in real property trades or businesses** (see below) in which the taxpayer **materially participates** (Code Sec. 469(c)(7)(B)(i)), **AND**
- **QUALIFICATION #2** - The taxpayer performs more than **750 hours of services** during that year **in real property trades or businesses** in which he **materially participates**. (Code Sec. 469(c)(7)(B)(ii))

A taxpayer who owns at least one interest in rental real estate **and** who meets the above tests is a real estate professional. (Reg § 1.469-9(b)(6))

Being a Full-Time Real Estate Professional Isn't Enough – The IRS audited two years of returns of a couple that filed joint returns and disallowed their rental losses, contending the losses were passive losses (taxpayers' incomes exceeded the cap for the $25,000 loss allowance so no amount of loss was allowed). The taxpayers' position was that the wife's full-time occupation as a real estate professional meant that all rental losses are automatically nonpassive and deductible, regardless of material participation. The key question before the court was whether the taxpayers must establish their material participation in their rental real estate activities separate and apart from the wife's undisputed material participation in her profession as a real estate agent. The Court concluded that they must, but had not, because she kept no records documenting the hours spent in her rental activities since she (erroneously) thought that as a real estate professional she didn't have to prove material participation in the rental activities. (*Gragg v Comm., U.S. Court of Appeals, Ninth Circuit; 14-16053, August 4, 2016, affirming DC Calif. decision)*

Closely-Held C-Corporation - A closely-held C corporation qualifies as a real estate professional if more than 50% of its gross receipts for the tax year are derived from real property trades or businesses in which it materially participates. (Code Sec. 469(c)(7)(D)(i))

PERSONAL SERVICES

"Personal services" means any work performed by an individual in connection with a trade or business, but not as an investor. (Reg § 1.469-9(b)(4)) Services performed as an employee don't count, unless the individual is a more-than-5%-owner of the employer. (Code Sec. 469(c)(7)(D))

REAL PROPERTY TRADE OR BUSINESS

A real property trade or business is: any real property **development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.** (Code Sec. 469(c)(7)(C)) The determination of a taxpayer's real property trades or businesses is based on all relevant facts and circumstances. Once a taxpayer determines the real property trades or businesses in which personal services are provided, he can't redetermine them later unless the original determination was clearly erroneous or there's been a material change of facts and circumstances. (Reg § 1.469-9(d)(1))

NOTE – BROKER OR LICENSED RE AGENT

Code Section 469(c)(7)(C) language uses the term "brokerage trade or business" which the IRS interpreted as meaning that a real estate professional had to be a licensed broker. However, a court case interpreted that to include licensed real estate agents. See the details following.

RE PROFESSIONAL DEFINITION – FAVORABLE RULING FOR LICENSED RE AGENTS

A taxpayer generally qualifies as a real estate professional for a particular tax year if:

(1) More than half of the personal services that he or she performs during that year are performed in real property trades or businesses in which he or she materially participates; and

(2) He or she performs more than 750 hours of services during that tax year in real property trades or businesses in which he or she materially participates.

Real Property Trade or Business - The term "real property trade or business" is defined as "any **real property** development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or **brokerage trade or business**." (Code Sec. 469(c)(7)(C)) In determining whether a taxpayer meets the material participation standard, the participation of his spouse is taken into account. (Code Sec. 469(h)(5))

The term "brokerage" is not defined in Code Section 469, the legislative history of that section, or any court decision. But the "brokerage trade of business" terminology included in the text of the Code Section 469(c)(7)(C) has always been interpreted by the IRS to only count for those with a "Broker's" license and did not apply to a licensed real estate agent.

Court looked at the definition in the ordinary and usual (dictionary) sense and has held that a licensed real estate agent's activities counted for purposes of the passive loss exception for qualifying real estate professionals. The taxpayer didn't have to be licensed as a real estate broker to be treated as engaged in the real estate brokerage trade or business. Because she met the material participation standard for qualifying real estate professionals, the agent and her husband could claim losses they incurred on two rental properties they owned.

Real Property Broker Under the Passive Rules - The IRS, in Chief Counsel Advice 201504010 determined:

1. A real estate agent who brings together buyers and sellers of real property **MAY BE engaged in a real property brokerage trade or business** under § 469(c)(7)(C).
2. A mortgage broker who is a broker of financial instruments **IS NOT in a real property brokerage trade or business** within the meaning of § 469(c)(7)(C). This position is backed up by the result in the *Guarino* case discussed next.

<u>*Mortgage Brokerage Not a Real Estate Profession*</u> – In a Tax Court Small Case that cannot be cited as precedent, the Court determined that a taxpayer who was in the mortgage broker business was not a real estate professional under Code Sec 469(c)(7)(C) and therefore losses on his rental properties were subject to the general Sec 469 passive activity rules. While the taxpayer's mortgage brokerage activity constitutes a "brokerage" trade or business, it does not constitute a "real property brokerage" trade or business, said the Court, because the taxpayer was not brokering real estate; he was brokering financial services. The Court went on to cite legislative history of the statute as supporting this distinction and that Congress considered including "financing operations" in the activities listed in section 469(c)(7)(C) but specifically did not do so. (*Guarino v. Commissioner., U.S. Tax Court, T.C. Summary Opinion 2016-12, (Mar. 14, 2016)*)

Trust can qualify as a real estate professional – In *Frank Aragona Trust, (2014) 142 TC No. 9*, the Tax Court ruled that a trust that owned real estate properties qualified for the exception for real estate professionals and therefore was not subject to the passive activity loss (PAL) limitations. In that ruling, the Court found that services performed by individuals on behalf of a trust may be considered personal services performed by the trust. The trust's material participation would allow it to avoid the 3.8% net investment income tax on passive activity.

<u>PROOF OF PARTICIPATION</u>

According to Reg. Sec. 1.469-5T(f)(4), "the extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means," including "but not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries." The Courts, while recognizing that the regulations are somewhat ambivalent on this issue, have frequently denied taxpayers eligibility as a real estate professional because of inadequate, untimely, or irreconcilable records. Uncorroborated estimates of the time devoted to real estate activities have caused many taxpayers to lose their cases. The Tax Court will not allow a post-event "ballpark guesstimate" of hours of participation. (*Bailey v Commissioner, T.C. Memo 2001-296*)

So a taxpayer trying to qualify as a real estate professional for purposes of the Sec. 469(c)(7) rule should keep contemporaneous records (appointment books, calendars, or narrative summaries) of the number of hours spent performing services (both in real estate trades or businesses and other personal services). Notations should be specific as to the amount of time spent and activities performed.

<u>MATERIAL PARTICIPATION</u>

The following tests determine material participation (only one test needs to be met to qualify a taxpayer as a material participant):

- <u>***Time Tests***</u>. A taxpayer is a material participant in an activity if the taxpayer:
  (1) Participates **500 Hours or More** during the tax year;
  (2) Provides "**substantially all the participation"** in the activity;
  (3) **Spends more than 100 hours** on the activity and nobody spends more time than this on the activity; or
  (4) **Spends Aggregate Time** over 500 hours on all "significant participation activities" (SPA's). A SPA is an activity in which the taxpayer spends over 100 hours during the year, but cannot meet one of the three other time tests.
- <u>***Prior participation tests***</u>. A taxpayer may be a material participant based on prior participation rather than TIME. The taxpayer may meet either of these criteria:
  (5) Participate in the activity "materially" **in any 5 of the last 10 tax years**; or
  (6) Taxpayer is in a personal service business and was a **material participant in any 3 previous tax years.**

Material Participation Joint Return
The material participation requirement is determined by taking into consideration a married couple's joint participation.

Limited Partners – A limited partner meets the material participation test if he qualifies under the:

- 500 hours of participation rule,
- Five of ten years of material participation rule, or
- Three years of material participation rule.

A partnership interest isn't treated as a limited partnership interest for the individual's tax year if the individual is a general partner as well as a limited partner in a partnership during the partnership's tax year ending with or within the individual's tax year. However, this treatment appears to conflict with the Senate Report which says that where a taxpayer has both a limited partnership interest and a general partnership interest, lack of material participation is conclusively presumed with respect to the limited partnership interest and material participation for purposes of any other interest is determined by the relevant facts and circumstances.

750 HOURS OF PARTICIPATION

To qualify as a real estate professional a taxpayer must perform more than 750 hours of services during that year in real property trades or businesses in which he materially participates. (Code Sec. 469(c)(7)(B)(ii))

Married Taxpayers - Spouses filing a joint return qualify as real estate professionals only if one spouse separately satisfies the above tests (Code Sec. 469(c)(7)(B), Reg § 1.469-9(c)(4)), without regard to the other spouse's services.

750 Hours Requirement
The personal service requirement of 750 hours must be met by only one of the spouses. They cannot combine their joint hours to meet that requirement.

Each Interest Treated as a Separate Activity Unless Aggregation Elected - In determining whether a taxpayer is a real estate professional, each of his interests in rental real estate is treated as a separate activity, unless he elects (by filing a specified statement with his original income tax return) to treat all interests in rental real estate as one activity. (Code Sec. 469(c)(7)(A); Reg § 1.469-9(g)) The election is binding for the tax year it's made and for all future years in which the taxpayer qualifies. Failure to elect in one year doesn't bar the election in a later year. (Reg § 1.469-9(g)(1)). See page 3.26.05 of this chapter for more on this election.

The material participation requirement is most commonly satisfied by participating in the activity for more than 500 hours during the tax year. A real estate professional with multiple rental real estate interests, who wants to treat all these interests as nonpassive but who has not elected to treat all those interests as a single activity, would have to satisfy this test separately for each interest.

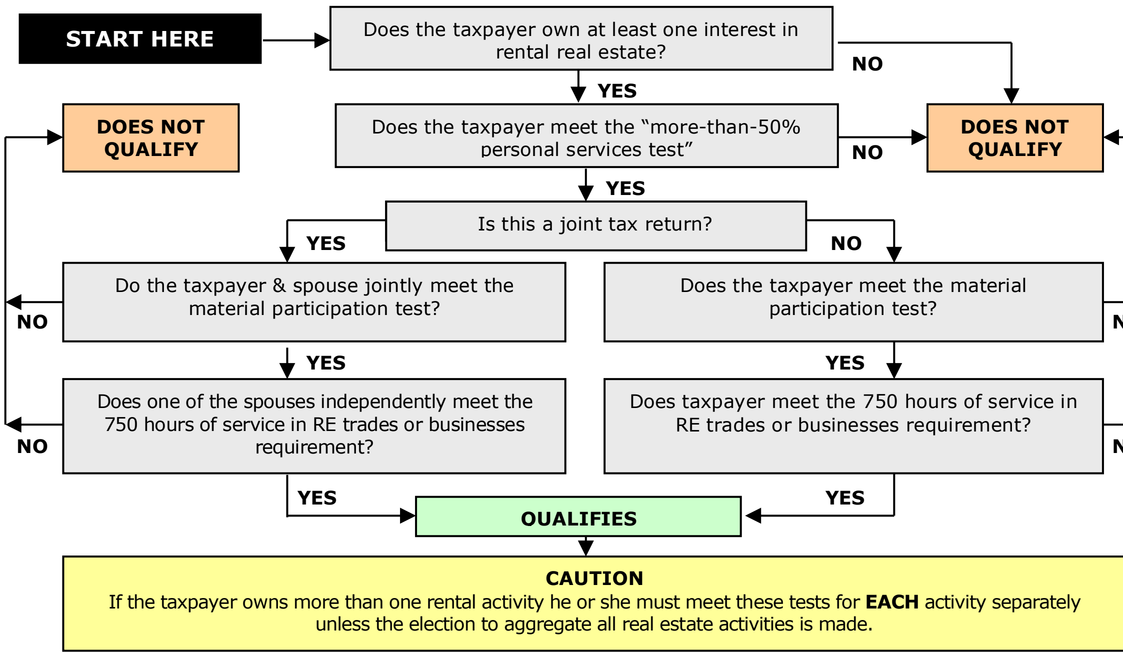
Example: *Peter owns three rentals but did not file the election to treat all of them as a single activity. If Peter is unable to qualify under one of the other material participation tests, he would need to participate in each rental activity for 500 hours a year. At minimum, that would result in 1,500 hours per year or just over 28 hours a week. If Peter had filed the election to treat all three interests as a single activity he would only need to participate in the combined rentals 500 hours a year (just under 10 hours a week).*

Travel Time for the 750-Hour Test - Taxpayer's log originally showed fewer than 750 hours spent on her rental properties, but after it was revised to include travel time from her home to one of her properties, the test was passed. IRS didn't accept the revised log, arguing the travel time was included in the original, but the Tax Court disagreed and held in taxpayer's favor. (Leyh, Richard S., (2015) TC Summary Opinion 2015-27) This is contradictory to a prior ruling where travel between home and a place of business (cattle breeding activity) did not qualify as work related travel. (Truskowsky, Thomas E., (2003) TC Summary Opinion 2003-130). **CAUTION**: in the Leyh decision the Tax Court did not consider the commuting issue. Generally, travel between home and the first business location would not be deductible unless the taxpayer’s home qualifies as the site of a business under the home office rules.

On-Call Time Doesn’t Qualify for the 750 Hour Test - An individual who owned four real estate rental properties could not count the hours that he considered himself "on call" to perform services on the properties toward the 750-hour threshold. The Tax Court said the law and regulations refer to “work performed,” so on-call time, unassociated with services actually performed by the taxpayer, did not count toward the 750-hour requirement (*Moss v Commissioner, U S Tax Court, CCH Dec 58,336, 135 T.C. No. 18).*

Short-Term Rentals Not Included For Purposes of Meeting the 750-Hour Test – The Tax Court, in *Bailey, TC Summary Opinion 2011-22*, ruled that a taxpayer didn't meet the qualifying real estate professional's exception to the *per se* passive activity loss (PAL) rule because one of her properties didn't count for purposes of meeting the 750-hour test since it was used for short-term rentals.

Citing Reg. § 1.469-1T(e)(3)(ii), the Tax Court held that when a taxpayer spends time on a real estate property that is rented for periods averaging less than 7 days, that property is no longer a “rental activity.” Therefore, the time spent on the property is not included for purposes of counting hours for the 750-hour test to be a real estate professional.



ELECTION TO AGGREGATE ALL RENTAL REAL ESTATE INTERESTS

For purposes of the rule exempting rental real estate activities of real estate professionals from automatic treatment as passive activities, a taxpayer may elect to treat all interests in rental real estate as one activity.

> ***Example:*** *John owns interests in three rental buildings, X, Y and Z. He elects to treat the three buildings as a single rental real estate activity. Therefore, in determining whether John's activities with respect to these buildings are passive or nonpassive, John's activities and participation with respect to all three buildings are taken into account in the aggregate.*

Making the election - The election is made by filing a statement with the taxpayer's original income tax return for the tax year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the tax year and is making the election under Code Sec. 469(c)(7)(A).

The election may be made in any year in which the taxpayer is a qualifying taxpayer. The failure to make the election in one year doesn't bar the taxpayer from making the election in a later year.

This election is binding for the tax year in which it's made and for all future years in which the taxpayer is a qualifying taxpayer, even if there are intervening years in which the taxpayer isn't a qualifying taxpayer. The election won't have effect in years during which the taxpayer isn't a qualifying taxpayer. Instead the taxpayer's activities will be those determined under "grouping of activity" rules of Reg § 1.469-4.

No valid election was made where a taxpayer failed to attach an election statement to his return. To make an election, a taxpayer must clearly notify IRS of his intent to do so. *(Kosonen, Matti, (2000) TC Memo 2000-107)*

IRS Allowing Late Aggregation Elections – Real estate professionals who follow procedures announced by the IRS in **Rev Proc 2011-34** will be eligible for an extension of time to file the election to aggregate real estate interests as a single activity, without having to apply for a private letter ruling or pay a user fee. To be eligible, the taxpayer must provide a statement, attached to an amended return for the most recent tax year and signed under penalties of perjury (see the Rev Proc for the required wording), stating that he or she:

- Had failed to make the election only because the election would not have been timely;
- Had filed returns consistent with having made an election and aggregating the activities;
- Had timely filed (within 6 months of the due date, excluding extensions) each return that would have been affected by the election if it had been timely made; and
- Has reasonable cause for not making a timely election.

The reason for failing to make a timely election must be explained, and must contain the declaration required by § 1.469-9(g)(3), including the year for which the late election is being made. At the top of the statement, note “FILED PURSUANT TO REV. PROC. 2011-34.” Mail the amended return to the IRS Service Center where the taxpayer’s current year return will be filed.

The IRS will notify the taxpayer if their request for extension to make the election is granted. A taxpayer receiving relief under this revenue procedure is treated as having made a timely election to treat all interests in rental real estate as a single rental real estate activity as of the taxable year for which the late election was requested.

Revoking the election – The election may be revoked if there is a material change in the taxpayer’s facts and circumstances. The fact that an election is less advantageous to the taxpayer in a particular year is not, of itself, a material change in the taxpayer's facts and circumstances. Similarly, a break in the taxpayer's status as a qualifying taxpayer is not, of itself, a material change in the taxpayer's facts and circumstances.

The election may be revoked only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the election year. To revoke the election, the taxpayer must file a statement with his or her original income tax return for the year of revocation containing (1) a declaration that the election is revoked under section 469(c)(7)(A) and (2) an explanation of the nature of the material change.

Reason to make the election - Electing to treat all of a taxpayer's rental real estate activities as a single activity may make it easier to meet the material participation requirement (resulting in treatment of the rental real estate activities as nonpassive).

Reason not to make the election - It may not be advisable for a taxpayer to make the election to aggregate all rental real estate interests if he has positive net income from rental real estate activities and passive losses from activities other than rental real estate activities. In that case, treating the rental real estate activities as passive would be advantageous, because the taxpayer could use the losses from the other passive activities to offset the income from the rental real estate activities. But if, under these circumstances, the taxpayer made the election to aggregate all rental real estate interests, the rental real estate activities might not be treated as passive, in which case the passive losses from the non-rental real estate activities could not be used to offset the income from the rental real estate activities, and might even be suspended and thus not deductible at all until the taxpayer disposes of the entire activity.

Prior Year Disallowed Passive Loses From Rental Real Estate - Real estate professionals that make the aggregation election may use prior year disallowed passive losses from any of the rental real estate activities that the taxpayer has elected to aggregate, to offset current net income from the aggregated rental real estate activities, regardless of which rental real estate interests within the aggregated activity produced the income or prior-year losses. Moreover, this rule applies even if the disallowed prior year losses arose before the aggregation election was made.

Example: *The facts are the same as the previous example above. In Year 1, John has $30,000 of disallowed passive losses allocable to building X and $10,000 of disallowed passive losses allocable to building Y. In Year 2, John has $5,000 of net income from building X, $5,000 of net loss from building Y, and $10,000 of net income from building Z. John makes the election to treat the three buildings as a single rental real estate activity effective in Year 2. In that year, John participates in the operation of the three buildings for more than 500 hours. He thus materially participates in the combined activity making the combined activity a nonpassive activity.*

A passive activity is any activity:

- *that involves the conduct of any trade or business, and*
- *in which the taxpayer does not materially participate.*

Because of the election, disallowed passive losses from Year 1 of $40,000 ($30,000 plus $10,000) are allocated to the combined activity. John’s net income from the activity for Year 2 is $10,000 ($5,000 – $5,000 + $10,000). This net income is nonpassive income. Under Code Sec. 469(f), the net income from a former passive activity may be offset with the disallowed passive losses from the same activity. As a result, John may offset the $10,000 of net income from the buildings with an equal amount of disallowed passive losses allocable to the buildings, regardless of which buildings produced the income or losses, leaving zero net income from the buildings in Year 2. Moreover, John has $30,000 ($40,000 – $10,000) of disallowed passive losses remaining from the buildings after Year 2.

The election to aggregate all rental real estate interests isn't intended to alter the rules relating to the material participation of a limited partner. H Rept No. 103-111 (PL 103-66) p. 614.

Limited Partner - If a taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest, the combined rental real estate activity is treated as a limited partnership interest of the taxpayer for purposes of determining material participation. Accordingly, the taxpayer won't be treated as materially participating in the combined rental real estate activity unless the taxpayer satisfies one of the material participation tests allowed to limited partners explained above. Reg § 1.469-9(f)(1).

If a real estate professional makes the election to treat all interests in rental real estate activities as a single rental real estate activity, and the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than 10% of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the tax year, the taxpayer may determine material participation under any of the tests that apply to rental real estate activities.

CALIFORNIA DIFFERENCES

California does not conform to the Federal treatment of real estate professionals' passive losses. Thus "real estate professionals" who materially participate in their rental activities may deduct their rental losses without limitation for Federal purposes, but they may be limited by the passive loss rules for CA.

NOTES

TANGIBLE PROPERTY CAPITALIZATION AND REPAIR REGULATIONS

Overview

Background: IRC Sec. 263 requires that amounts paid to acquire, produce or improve tangible property must be capitalized and depreciated over its useful life. However, IRC Sec. 162 allows materials, supplies, and repair and maintenance costs to be expensed. But neither IRC section provided bright line definitions and the IRS frequently found itself embroiled in disagreements with taxpayers. Wishing to resolve the issue, the IRS has assembled an extensive set of regulations that are intended to clarify the distinction between improvements that must be capitalized and repairs, materials and supplies that can be expensed.

CAUTION, THIS MATERIAL IS LIMITED IN SCOPE!
Although there will be occasional references to issues that apply to large businesses, this material generally covers only the issues that apply to small taxpayers and businesses. It does not include rotable or temporary spare part issues and regulations.

The Details

Effective Date: These regulations became effective for tax years beginning on or after January 1, 2014 but optionally allowed taxpayers to retroactively apply the regulations to tax years beginning on or after January 1, 2012 (Ann. 2013-7). This opportunity has expired.

Subsequently the IRS issued Rev. Proc. 2015-20 providing **simplified filing for small businesses** and allowed them to apply the regulations prospectively but giving up retroactive audit protection and the ability to make retroactive adjustments based on the new regulations. Those taxpayers adopting the simplified method are permitted to make certain tangible property changes without filing a Form 3115 (used to make accounting method changes) but give up Sec 481(a) adjustments for the prior years (Sec 5 of Rev. Proc. 2015-20).

The regulations are actually a set of rules that apply in different circumstances and include a number of safe-harbors. Below is a list of the items to be covered in this chapter and a reference to the corresponding IRC section or regulation.

UNIT OF PROPERTY (UOP):

At the beginning of any discussion related to the tangible property capitalization and repair regulations, one must have an understanding of a unit of property (UOP). The determination of a unit of property is based on the **functional interdependence standard**.

UOP defined - For purposes of the tangible property capitalization rules:

UOP for assets other than buildings - Generally a UOP consists of all the components that are functionally interdependent (i.e., where placing in service of one component is dependent on the placing in service of other component(s)). (Reg. Sec. 1.263(a)-3(e)(3)(i))

UOP for a building - Generally is the building and its structural components. (Reg § 1.263(a)-3(e)(2)(i))

In general, amounts paid for new buildings or for permanent improvements or betterments made to increase the value of any property or the cost of restoring the property must be capitalized. A unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer result in **betterment** to the unit of property (UOP), **restore** the UOP, or **adapt the UOP to a new or different use**.

UOP for assets OTHER THAN BUILDINGS - In general, for real or personal property that isn't classified as a building, all the components that are functionally interdependent comprise a single UOP. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer. (Reg. § 1.263(a)-3(e)(3)(i))

> ***Example – Not Functionally Interdependent:*** *Xavier is a self-employed accountant who purchased a laptop computer and a printer for use in his business. The computer and printer are separate units of property because they are not functionally interdependent since placing the computer in service is not dependent on placing the printer in service.*

> ***Example – Functionally Interdependent:*** *Lorna is the proprietor of a nursery and landscaping business. She purchased a battery-powered golf cart to use getting around the nursery grounds. She purchased the cart chassis from one vendor and the battery from another and assembled the two components. Because the cart can't operate without the battery, the electric golf cart is a single unit of property.*

UOP for BUILDINGS - In general, each building and its structural components are one UOP - "the building." Amounts are treated as paid for an improvement to a building, and thus capitalized, if they improve:

(1) the **building structure**; or

(2) any designated **building system**.

A ***building structure consists*** of a building and its structural components (Reg. Sec 1.48-1(e)) (unless the component is a building system). (Reg. § 1.263(a)-3(e)(2)(ii)) Under Reg. § 1.48-1(e)(2), the term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; and other components relating to the operation or maintenance of a building.

> ***Example -*** *If a business restores a building structure, such as replacing the entire roof down to the rafters, the expense generally is treated as an improvement to the single UOP consisting of the building. Similarly, if it improves a building system, such as an improvement to the heating, ventilation, and air conditioning (HVAC) system, then the expense constitutes an improvement to the building UOP.*

A ***building system*** consists of the following nine structural components. Each of them (including their sub-components) is a building system that **is separate from the building structure, and to which the improvement rules must be separately applied** (Reg. § 1.263(a)-3(e)(2)(ii)(B)):

1. Heating, ventilation, and air conditioning (HVAC) systems, including motors, compressors, boiler, furnace, chillers, pipes, ducts, and radiators;
2. Plumbing systems – including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property lines and between buildings and other permanent structures;
3. Electrical systems – including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from property line to and between buildings and other permanent structures;
4. Escalators;
5. Elevators;
6. Fire-protection and alarm systems – including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire fighting equipment, such as extinguishers and hoses;
7. Security systems for the protection of the building and its occupants – including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit;
8. Gas distribution system – including associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures; and
9. Other structural components identified by IRS in published guidance.

Thus the building structure and the building systems comprise a single UOP, "the building," and any improvement, to any of the systems of that building, including the structure itself, constitute an improvement to the building.

***Example 3 (Reg. Sec. 1.263(a)-3) -* Building structure and systems; condominium** - C owns a condominium unit in a condominium office building and uses the condominium unit in its business of providing medical services. The condominium unit contains two restrooms, each of which contains a sink, a toilet, water and drainage pipes and other bathroom fixtures. C pays an amount for labor and materials to perform work on the pipes, sinks, toilets, and plumbing fixtures that are part of the condominium. If an amount paid by C for work on pipes, sinks, toilets, and plumbing fixtures is an improvement (for example, a betterment) to the portion of the plumbing system that is part of C's condominium, C must treat this amount as an improvement to the condominium.

Depreciation - The **UOP definitions apply only for purposes of the capitalization rules, but not for depreciation purposes**. For example, treating an asset as part of a larger unit of property for capitalization purposes doesn't affect how that asset is treated for depreciation purposes. Thus, the characterization of an asset for depreciation purposes overrides UOP rules.

Notwithstanding the UOP rules, a component (or a group of components) of a UOP **must be treated as a separate UOP for depreciation purposes if, when the taxpayer initially placed the UOP in service, the taxpayer:**

(1) Properly treated the component as being within a different class (see page 3.27.06) of property under Code Sec. 168(e) for MACRS depreciation purposes than the class of the UOP of which the component is a part; **OR**

(2) Properly depreciated the component using a different depreciation method than the depreciation method of the UOP of which the component is a part. (Reg. § 1.263(a)-3(e)(5)(i))

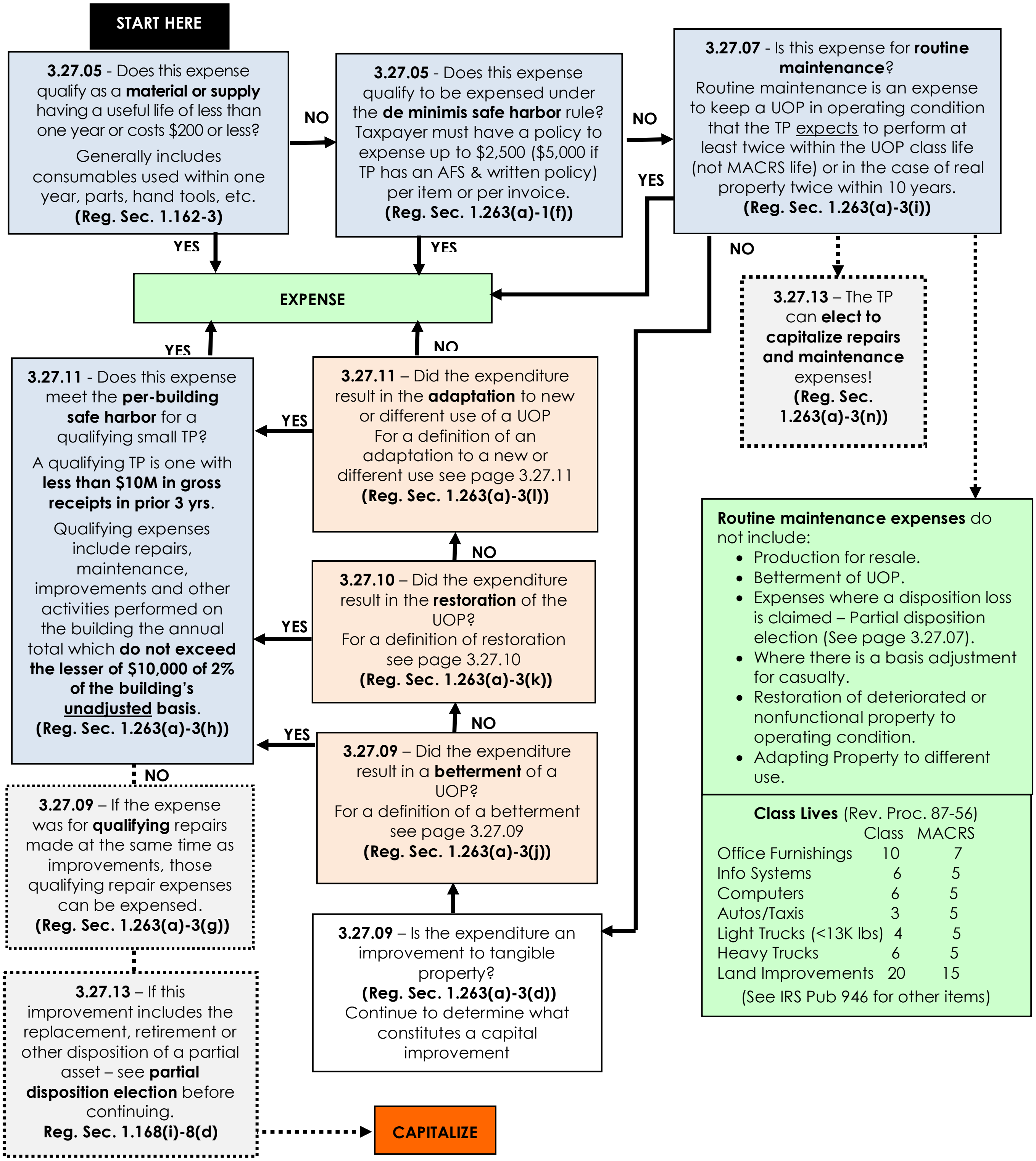
Example *– Tires used on transport industry trucks are often depreciated as a separate asset over five years rather than over the three-year period that applies to the remaining portion of the truck. The tires are a separate unit of property in the year the truck is placed in service (reg. §1.263(a)-3(e)(6), ex. 16).*

Special rules are included in the regulations for leased property, condominiums and cooperatives (not discussed here).

CONTINUE TO NEXT PAGE

EXPENSE OR CAPITALIZE FLOW CHART

This flow chart provides an **overview** of the expensing options under capitalization and repair regulations. Please note that the numbers preceding the text in each box refers to the page number in this chapter where there is more detail, in most cases including more detailed flow charts, for each expensing option. When you are unsure whether you can write off an expenditure, we recommend you begin with this flow chart.

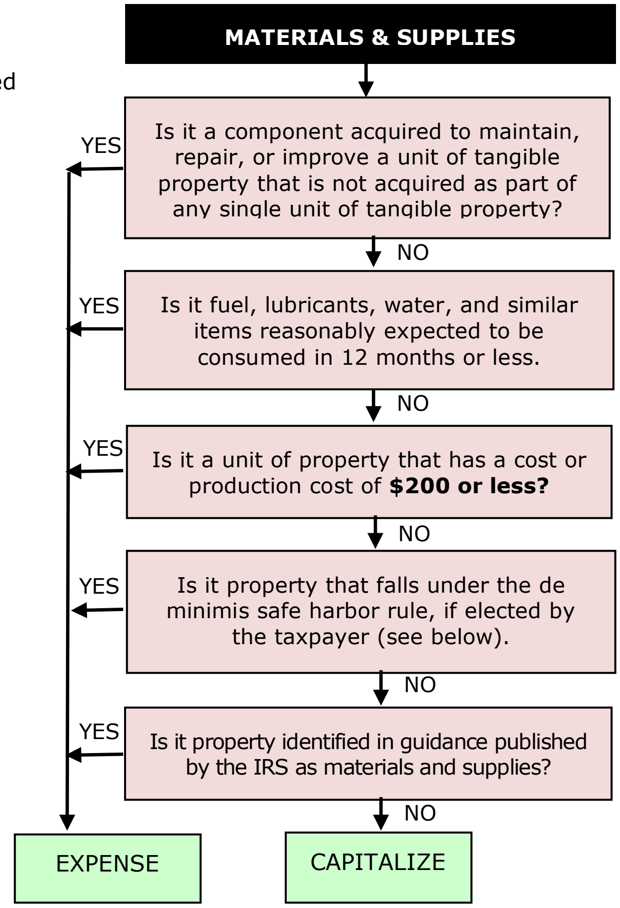


MATERIALS AND SUPPLIES - Reg. Sec. 1.162-3

The cost of acquiring or producing materials and supplies is deductible in the tax year in which the materials and supplies are used or consumed in the taxpayer's operations. "Materials and supplies" means tangible property that is used or consumed in the taxpayer's operations that is not inventory and that:

1. Is a component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property (Example: replacing the engine in a fork lift);
2. Consists of fuel, lubricants, water, and similar items that is reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations (Example: a barrel of grease used to lubricate vehicles);
3. Is a unit of property (UOP) with an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;
4. Is a UOP that has a cost or production cost of **$200 or less**;
5. Is any property that meets the de minimis rule (see below) **OR**
6. Is identified in guidance published by the IRS as materials and supplies for which treatment is permitted under §1.162-3(d).

Meaning of "Materials & Supplies"
It is important to understand that the term "materials and supplies" applies to more than just consumables and includes a variety of items including tangible property. Be sure to familiarize yourself with the list above.



DE MINIMIS SAFE HARBOR RULE - Reg. Sec. 1.263(a)-1(f)

The de minimis safe harbor rule allows businesses to expense rather than capitalize the purchase of tangible property based on the safe-harbor cost of the item. This regulation applies differently to large businesses and small businesses.

- *Large Businesses* – For purposes of these regulations are ones with "applicable financial statements" (audited financial statements, SEC filings or other government non-tax financial report filing duty).
- *Small Businesses* – Are those without "applicable financial statements".

To adopt a de minimis safe harbor, a business must have an accounting procedure in place before the beginning of the business's tax year that specifies the business's de minimis safe harbor. Failure to do so will result in a safe harbor amount of zero and the only items that can be expensed would be those with a useful life of one year or less or those for which the Sec 179 election is made.

Safe Harbor Amounts - The amount of the safe-harbor is not a single fixed amount for all businesses, but rather an amount adopted by the business subject to a maximum amount. The maximum amounts are:

- For Large Businesses the maximum is $5,000
- For Small Businesses the maximum is $2,500

Example: *Mom and Pop's corner grocery is a small business so they can establish a de minimis safe harbor for any amount between $0 and $2,500.*

Accounting Procedure – In order to establish a de minimis safe harbor, the business must have an accounting policy in effect before the start of the tax year. The regulations don't require a written accounting procedure for small businesses. However, consider how you might prove the policy was in place if it is not in writing.

CAUTION, ANNUAL ELECTION ALSO REQUIRED
In addition to the accounting procedure, **EACH** year the business (or an individual if the business is reportable on Sch C, E, or F) must include an election on its timely filed return (including extensions) to apply the de minimis safe harbor. **The election automatically extends to materials and supplies.**

A taxpayer or small business that has elected to apply the de minimis safe harbor for the acquisition of tangible property **must** apply the de minimis safe harbor to amounts paid for all materials and supplies that meet the safe harbor requirements of the de minimis safe harbor (there are exceptions for rotable and temporary spare parts not covered in this material). If the taxpayer properly applies the de minimis safe harbor to amounts paid for materials and supplies, then these amounts are not treated as amounts paid for materials and supplies under the general expense rules.

Example – *ClientWhys, Inc., a small business, purchases 30 laptop computers. Each laptop computer is a separate unit of property (UOP) costing $1,450 each. ClientWhys has a written accounting policy allowing ClientWhys to expense amounts paid for units of property costing $2,500 or less AND has elected to apply the de minimis safe harbor to the current year and thus ClientWhys will expense the computers.*

DE MINIMIS VERSUS SEC 179 EXPENSING
One can always utilize the Sec 179 election to expense qualified personal tangible property and that might be considered the most efficient way. However, Sec 179 has recapture issues and investment limits. So don't dismiss the de minimis safe harbor without considering its benefits.

The following is a short form accounting policy prepared by ClientWhys. It has not had any legal review. Use at your own risk. Those companies with formal accounting policies in place may wish to use a more formal format.

Accounting Policy - **DE MINIMIS SAFE HARBOR RULE**

Per the provisions of IRS Regulation § 1.263(a)-1(f)(1) [insert Company Name] does hereby elect to apply the de minimis safe harbor expense rules for all units of property (UOP):

1. Costing $______ or less per invoice (or per item as substantiated by the invoice), or
2. Having a useful life (as defined by Sec 1.162-3(c)(4)) of 12 months or less.

______________________________________ __________________________
Signature of Owner or Officer Date:

This procedure must be in place on the first day of the tax year to apply to the tax year. This procedure is irrevocable without IRS consent, via a letter ruling.

The following is a de minimis election statement format prepared by ClientWhys. It has not had any legal review. Use at your own risk. Check to see if your software has this election built in. The election is attached to a timely filed return, including extensions. **Remember this election must be made annually!**

SECTION 1.263(a)-1(f) DE MINIMIS SAFE HARBOR ELECTION

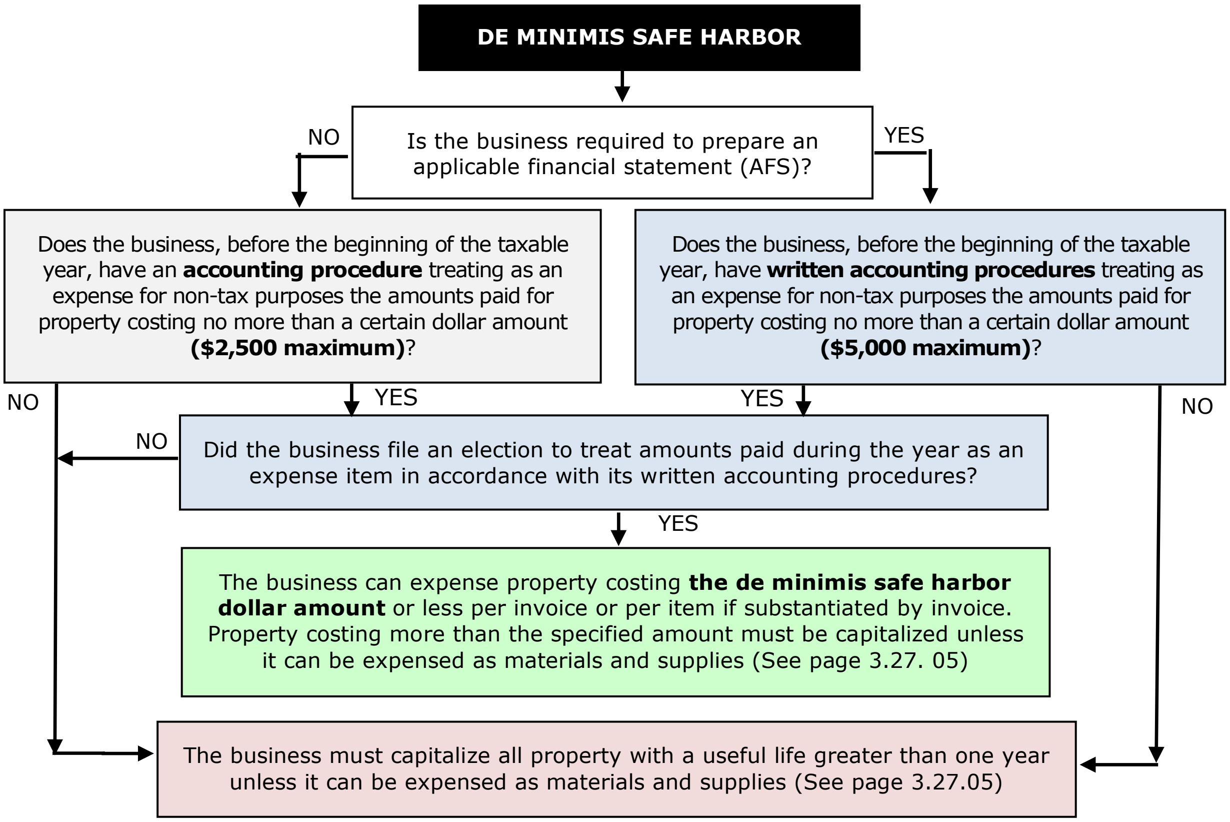
[Name] [Tax ID Number] [Address]

[Name] has an accounting policy adopting the de minimis safe harbor of Treasury Regulation Section 1.263(a)-1(f), and elects to apply the de minimis safe harbor to the [year] tax return.

CAUTION – REALLY IMPORTANT!!!
In general, most clients are not familiar with this election requirement and need to be contacted and made aware of this annual requirement before year-end.

Exceptions to the De Minimis Safe Harbor – The de minimis safe harbor does not apply to amounts paid for property that is or is intended to be included in inventory property; land; and certain rotable, temporary, and standby emergency spare parts a taxpayer elects to capitalize and depreciate; and standby emergency spare parts the taxpayer accounts for under the optional method of accounting (note rotable, temporary, and standby emergency spare parts are not covered in this material).

All or Nothing Election – A taxpayer making this election must make the election for all amounts paid for qualifying expenses during the taxable year including materials and supplies.



<u>SAFE HARBOR FOR ROUTINE MAINTENANCE</u> – (Reg. Sec. 1.263(a)-3(i))

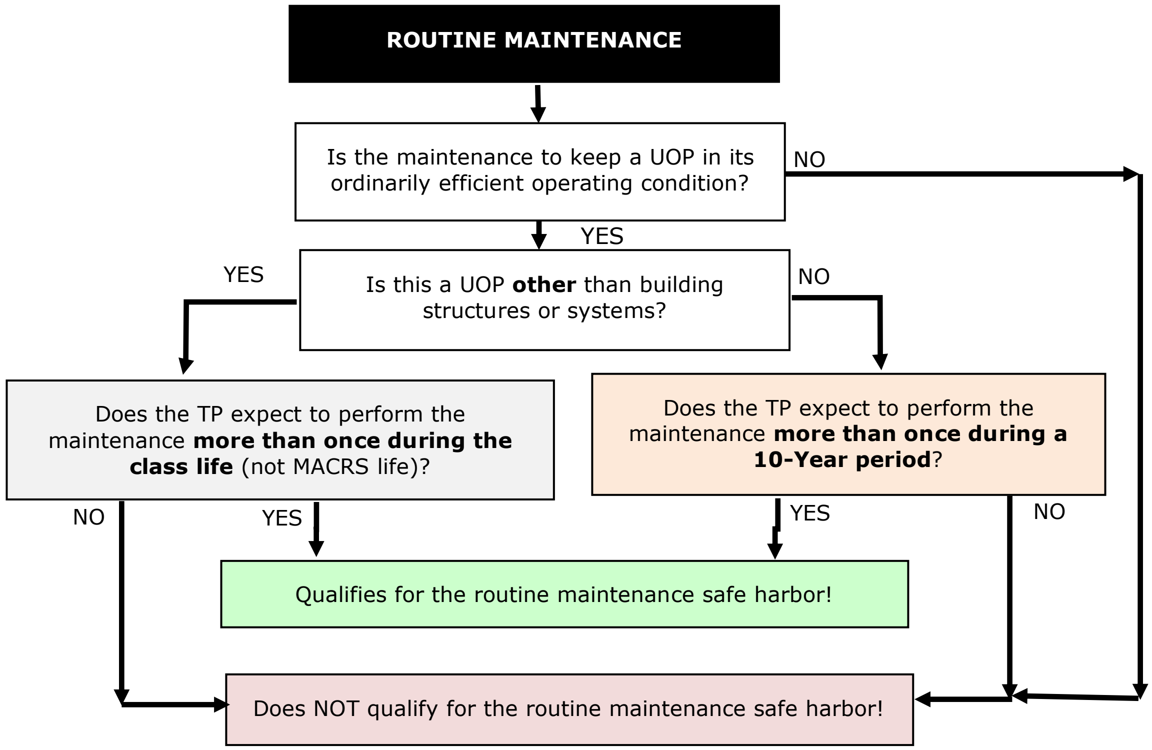
Amounts paid for routine maintenance (as described below) on a unit of tangible property, or in the case of a building (as described below) is deemed not to improve that unit of property, and are expensed if they are not otherwise required to be capitalized (Reg. § 1.162-4(a)). Factors to be considered in determining if an expense is routine maintenance include the recurring nature of the activity, industry practice, manufacturer's recommendations, and the taxpayer's experience. The regulations define routine maintenance as:

- Maintenance the taxpayer expects to perform to keep the unit of property (UOP) in its ordinarily efficient operating condition, **and**
- When the taxpayer places the UOP in service, the taxpayer expects to perform the activities more than once during:
  - **The class life** (not the depreciable life) of the UOP, other than building structures or systems.
  - A **10-year period** for building structures or systems.

Class Life

Class life is not the same as the MACRS recovery class and is described in Rev. Proc. 87-56. The following is a comparison between MACRS recovery periods and class lives.

MACRS Recovery Period	Class Life
3-Year	4 years or less
5-Year	More than 4 years but less than 10
7-Year	10 or more but less than 16
10-Year	16 or more but less than 20
15-Year	20 or more but less than 25
20-Year	25 or more



Routine Maintenance (Other than Buildings) – The cost of routine maintenance performed on a UOP that isn't a building or a structural component is treated as not improving the UOP, and is thus currently deductible. Routine maintenance refers to recurring activities, such as inspecting, cleaning, and testing, and replacing parts with comparable and commercially available replacement parts.

Activities are routine only if, at the time the UOP is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life of the UOP. A taxpayer's expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the class life of the UOP, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service.

With respect to a taxpayer that is a lessor of a UOP, the taxpayer's use of the UOP includes the lessee's use of the UOP.

> ***Example (Regulations example #9)*** *– A towboat operator purchases a towboat including its two diesel engines, which are considered a single unit of property. The class life of the towboat is 18 years. The operator is aware that every four years he will need to perform routine maintenance on the two engines to keep them in their ordinarily efficient operating condition. Since the routine maintenance occurs more than once during the towboat's 18-year class life, the maintenance is considered routine. As a result, the amounts paid for the scheduled maintenance to the towboat engines in Year 5 are deemed not to improve the towboat and are not required to be capitalized.*

Routine Maintenance for Buildings **-** Routine maintenance for a UOP that's a building unit is the recurring activities that a taxpayer expects to perform as a result of using the property to keep the building structure or each building system in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the building structure or each building system, and the replacement of damaged or worn parts with comparable and commercially available replacement parts.

Routine maintenance may be performed any time during the useful life of the building structure or building systems. However, the **activities are routine only if the taxpayer reasonably expects to perform the activities more than once during the 10-year period** beginning when the building structure or the building system on which the routine maintenance is performed is placed in service by the taxpayer.

A taxpayer's expectation will not be deemed unreasonable merely because it does not actually perform the maintenance a second time during the 10-year period, as long as the taxpayer can otherwise

substantiate that its expectation was reasonable when the property was placed in service. Factors to be considered in determining whether maintenance is routine and whether a taxpayer's expectation is reasonable include the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical property. For a taxpayer that is a lessor of all or part of a building, its use of the building unit of property includes the lessee's use of its unit of property. (Reg. § 1.263(a)-3(i)(1)(i))

> ***Example (Regulations example #14)*** *– In Year 1, Harry acquires a new office building, which he uses to provide services. The building contains an HVAC system, which is a building system. In Year 1, when Harry placed his building into service, he reasonably expected that every four years he would need to pay an outside contractor to perform detailed testing, monitoring, and preventative maintenance on its HVAC system to keep the HVAC system in its ordinarily efficient operating condition. This scheduled maintenance includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the HVAC system and many of its component parts. If inspection or testing discloses a problem with any component, the part is repaired, or if necessary, replaced with a comparable and commercially available replacement part. The scheduled maintenance at these intervals is recommended by the manufacturer of the HVAC system and is routinely performed on similar systems in similar buildings. In Year 4, he pays amounts to a contractor to perform the scheduled maintenance. Since this routine maintenance occurs more than once every 10 years, the maintenance is considered routine and the costs of the maintenance need not be capitalized.*
>
> *However, if Harry does not perform this scheduled maintenance on his building again until Year 11, Harry's reasonable expectation that he would perform the maintenance every 4 years will not be deemed unreasonable merely because he did not actually perform the maintenance a second time during the 10-year period, provided that he can substantiate that its expectation was reasonable at the time the property was placed in service. If Harry can demonstrate that his expectation was reasonable in Year 1, then the amounts he paid for the maintenance of the HVAC system in Year 4 and in Year 11 are within the routine maintenance safe harbor and need not be capitalized.*

Repairs undertaken contemporaneously with improvements - The regulations specifically provide that indirect costs made at the same time as an improvement, but that do not directly benefit or are not incurred by reason of the improvement, don't have to be capitalized under Code Sec. 263(a). (Reg. § 1.263(a)-3(g))

> ***Example -*** *A company takes a truck out of service to overhaul its chassis. During the overhaul, the truck's broken tail-lights are replaced and tears in the driver's seat are mended. The expenses to fix the lights and seat are deductible as repairs.*

Ineligible expenses - These safe harbor provisions do not apply to costs incurred for:

- The production of property or for resale (inventory).
- For the betterment of a unit of property
- For the cost of replacing components if a retirement loss is claimed, and gain or loss is realized upon the sale of the replaced component.
- For which a basis adjustment is required on account of a casualty loss or event;
- To restore deteriorated and nonfunctional property to its ordinarily efficient operating condition;
- To adapt property to a new or different use;
- To repair, maintain, or improve rotable or temporary spare parts that were deducted when first installed.

Accounting Method Change - Because the above regulations are based primarily on prior law, taxpayers who were previously in compliance with the rules will generally be in compliance with the regulations. In that case, no action is required. Taxpayers that aren't in compliance or that otherwise want to change their method of accounting to use the routine maintenance safe harbor should file Form 3115, Application for Change in Accounting Method, and compute a Code Sec. 481(a) adjustment. Qualifying small taxpayers conform automatically in 2014 and later years comply without filing a 3115 (Rev. Proc. 2015-20)

IMPROVEMENTS TO TANGIBLE PROPERTY – Reg. Sec. 1.263(a)-3(d))

Generally, a taxpayer who owns a unit of property must **capitalize the amounts** paid to improve the UOP that result in a **betterment** to the UOP, **restores** the UOP or **adapts** the UOP to a new or different use. So, if a taxpayer restores a building structure or makes a betterment, the expense is treated as an improvement to the single UOP consisting of the building.

Betterment costs (Reg. Sec. 1.263(a)-3(j)) - which must be capitalized, consist of amounts paid:

- To ameliorate (improve, perfect, upgrade, enhance) a material condition or defect that either existed before the taxpayer acquired the UOP or arose during its production, whether or not the taxpayer was aware of the condition or defect when it was acquired or produced;

- That results in a material addition (including a physical enlargement, expansion or extension) to the UOP; or
- That results in a material increase in capacity, productivity, efficiency, strength, or quality of the UOP or the output of the UOP.

Whether an expense results in a betterment depends on the facts and circumstances, such as the purpose of the expense, the physical nature of the work performed, and the effect of the expense on the UOP. In the case of a building, an amount results in a betterment to the UOP if it results in a betterment to the building or any of the building system properties listed in 1 through 9 on page 03.27.02.

> ***Example:*** *Kim owns a small retail shop. A storm damages the roof of Kim's shop by displacing numerous wooden shingles. She pays a contractor to replace all the wooden shingles on the roof with new wooden shingles. Kim is not required to treat the amount paid to replace the shingles as a betterment because it does not result in a material addition, or material increase in the capacity, productivity, efficiency, strength, or quality of the building structure compared to the condition of the building structure prior to the storm.*
>
> *If wooden shingles were not available on the market and Kim paid the contractor to replace all the wooden shingles with comparable asphalt shingles, the replacement of the old shingles with asphalt shingles would not, by itself, result in a betterment (improvement) to the building structure. However, if the new shingles were made of a material that was a lightweight composite, was maintenance-free and did not absorb moisture, and came with a 50-year warranty and a Class A fire rating, the amount paid for these shingles is considered a betterment. It is a betterment because there was a material increase in the quality of the shop building structure as compared to the condition prior to the storm. Therefore, the amount Kim paid for the betterment to the building structure is an improvement and must be capitalized.*

> **Note:** There are a total of 21 various examples of betterments in the regulations.

Restoration costs (Reg. Sec. 1.263(a)-3(k)) – Restoration costs must be capitalized. An amount **restores** a UOP if it:

(i) Is for the replacement of a component of a UOP for which the taxpayer has properly deducted a loss for that component, other than a casualty loss;

> ***Example*** - ***Replacement of loss component*** - *TP owns a freezer used in TP's manufacturing business that is not part of a building structure or the HVAC system. Several components of the walk-in freezer cease to function and the taxpayer decides to replace them. The TP abandons the old freezer components and recognizes a loss from the abandonment of the components. The TP replaces the abandoned freezer components with new components and incurs costs to acquire and install the new components. The TP must capitalize the amounts paid to acquire and install the new freezer components because the TP replaced components for which it had properly deducted a loss.* (Reg. Sec. 1.263(a)-7, Ex 1)

(ii) Is for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;

> ***Example*** - ***Replacement of sold component*** - *Same facts as in the previous example, except that the TP did not abandon the components but instead sold them to another party and properly recognized a loss on the sale. The TP must capitalize the amounts paid to acquire and install the new freezer components because the TP replaced components for which it had properly taken into account the adjusted basis of the components in realizing a loss from the sale of the components. .* (Reg. Sec. 1.263(a)-7, Ex 2) Note: the new components also would have to be capitalized if the sale had resulted in a gain instead of a loss.

(iii) Is for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss or relating to a casualty event. However, the amount paid for restoration of damage to the unit of property that must be capitalized under this paragraph (k) is **limited** to the excess (if any) of—

- The amount of the adjusted basis of the single, identifiable property for determining the loss allowable on account of the casualty, over
- The amount paid for restoration of damage to the UOP that also constitutes an improvement.

Example - Restoration after casualty loss *- TP owns an office building that it uses in its trade or business. A storm damages the office building that has an adjusted basis of $500,000. The TP deducts a casualty loss of $50,000, and properly reduces its basis in the office building to $450,000. The TP hires a contractor to repair the damage to the building, including the repair of the building roof and the removal of debris from the building premises. The TP pays the contractor $50,000 for the work. The TP must treat the $50,000 amount paid to the contractor as a restoration of the building structure because the TP properly adjusted its basis in that amount as a result of a casualty loss, and the amount does not exceed the $50,000 ($500,000 - $450,000) limit. Therefore, the TP must treat the amount paid as an improvement to the building unit of property and must capitalize the amount paid. (Reg. Sec. 1.263(a)-7, Ex 3)*

(iv) Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

Example - Restoration of property in a state of disrepair *– The TP owns and operates a farm with several barns and outbuildings. The TP did not use or maintain one of the outbuildings on a regular basis, and the outbuilding fell into a state of disrepair. The outbuilding previously was used for storage but can no longer be used for that purpose because the building is not structurally sound. The TP decides to restore the outbuilding and pays an amount to shore up the walls and replace the siding. The walls and siding are part of the building structure and the TP must treat the amount paid as a restoration of the building structure because the amounts return the building structure to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use. Therefore, the TP must treat the amount paid to shore up the walls and replace the siding as an improvement to the building UOP and must capitalize the amount paid. (Reg. Sec. 1.263(a)-7, Ex 6)*

(v) Results in the rebuilding of the unit of property to a like-new condition after the end of its class life. A unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or a similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications. Generally, a comprehensive maintenance program, even though substantial, does not return a unit of property to a like-new condition.

(vi) Is for the replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property. Generally, a major component is a part or combination of parts that performs a discrete and critical function in the operation of the unit of property. A substantial structural part is a part or combination of parts that comprises a large portion of the physical structure of the unit of property.

Note: There are a total of 31 various examples of restorations in the regulations.

Adapting to a New Or Different Use (Reg. Sec. 1.263(a)-3(l)) **-** A taxpayer must capitalize as an improvement an amount paid to adapt a unit of property to a new or different use. In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's ordinary use of the unit of property at the time originally placed in service by the taxpayer.

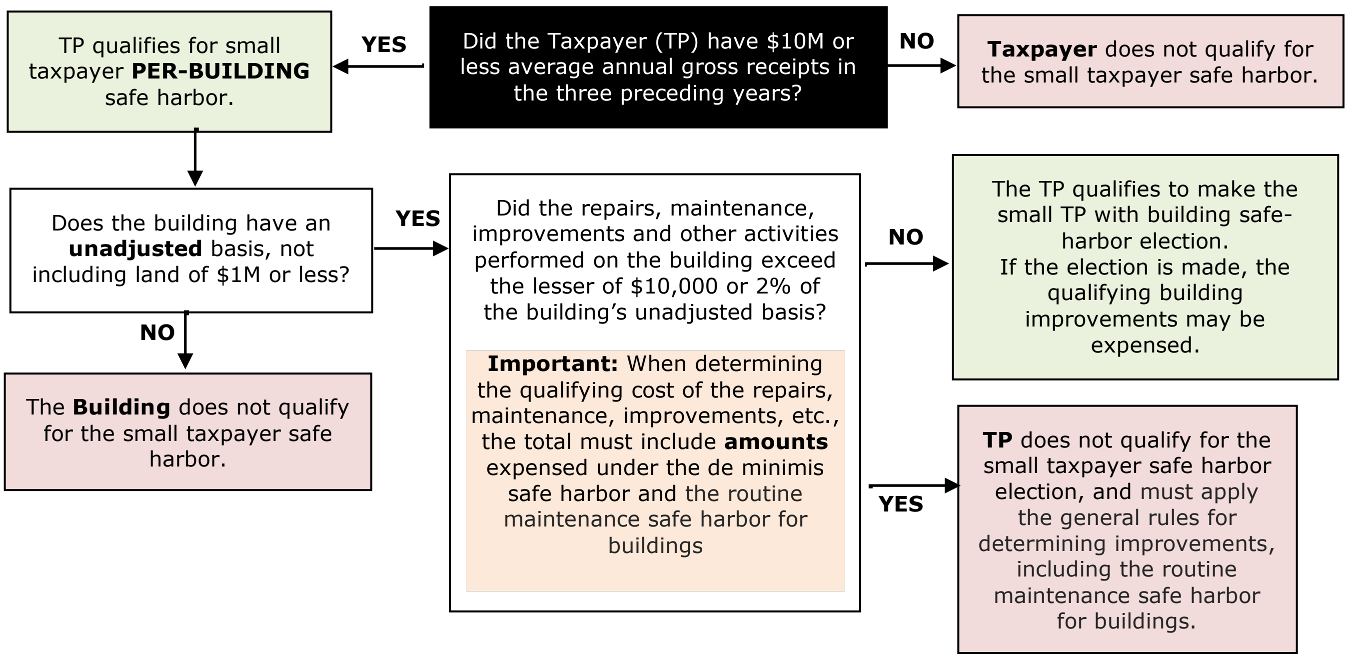
Note: There are a total of 7 examples of adaptations in the regulations.

PER-BUILDING SAFE HARBOR FOR QUALIFYING SMALL TAXPAYERS - (Reg. Sec. 1.263(a)-3(h))

This safe harbor permits qualifying small taxpayers (those with **$10 million or less average annual gross receipts in the three preceding tax years**) to elect not to treat as capitalized expenses - in other words, to currently deduct - improvements made to an eligible building property (one with an **unadjusted basis of $1 million or less, not including land value**). This safe harbor election applies only if the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities performed on the eligible building **does not exceed the lesser of $10,000 or 2% of the building's unadjusted basis**.

This safe-harbor rule applies to tax years beginning on or after January 1, 2014. However, a taxpayer may choose to apply the safe harbor to tax years beginning on or after January 1, 2012.

Under this safe harbor, qualifying small taxpayers include amounts expensed (not capitalized) under the *de minimis* safe harbor election and under the routine maintenance safe harbor for buildings to determine the annual amount paid for repairs, maintenance, improvements, and similar activities performed on the building. If the amount paid for repairs, maintenance, improvements, and similar activities performed on a building unit of property exceeds the per-eligible-building threshold **(lesser of $10,000 or 2% of unadjusted basis)** for a tax year, then the safe harbor doesn't apply to any amounts spent during the tax year. In such cases the taxpayer must apply the general rules for determining improvements, including the routine maintenance safe harbor for buildings.



Example (Regulations Example #1) - Safe harbor applies *- Albert is a qualifying taxpayer (his 3-year average of gross receipts is less than $10 million) that owns an office building in which he provides consulting services. Albert's building has an unadjusted basis of $750,000, not counting the basis of the land. Albert pays $5,500 for repairs, maintenance, improvements and similar activities to the office building. Because Albert's building unit of property has an unadjusted basis of $1,000,000 or less, his building constitutes eligible building property. The aggregate amount paid by Albert for repairs, maintenance, improvements and similar activities on this eligible building property does not exceed the lesser of $15,000 (2% of the building's unadjusted basis of $750,000) or $10,000. Therefore, Albert may elect to not apply the capitalization rule to the amounts paid for repair, maintenance, improvements, etc., and can expense them.*

Example (Regulations Example #2) - Safe harbor does not apply *- Assume the same facts as in Example 1, except that Albert pays $10,500 for repairs, maintenance, improvements, and similar activities performed on his office building during the year. Because this amount exceeds $10,000 (the lesser of $15,000 (2% x $750K) or $10,000, Albert may not apply the safe harbor for small taxpayers to the total amounts paid for repairs, maintenance, improvements, and similar activities performed on the building. He will need to capitalize (depreciate) the improvements, but can deduct the expenses for repairs and maintenance under the usual rules.*

New Business – For new businesses, the average annual gross receipts are determined using the average gross receipts for the number of taxable years that the taxpayer or predecessor has been in existence. For short years, the gross receipts are annualized.

Gross Receipts – For this purpose, gross receipts include the taxpayer's receipts for the taxable year that are properly recognized under the taxpayer's methods of accounting used for Federal income tax purposes for the taxable year. Included are total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources, such as interest (including original issue discount and tax-exempt interest), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. For sales of capital assets or sales of property used in a trade or business, gross receipts are reduced by the taxpayer's adjusted basis in such property. See Reg. Sec. 1.263(a)-3(h)(e)(iv) for additional information on the definition of gross receipts.

Unadjusted Basis:

- **Owned property** is the cost of the building not reduced by depreciation. Land cost is not included.
- **Leased property** is the total amount of undiscounted rent over the entire period of the lease, including reasonably anticipated renewals.

Condominiums and coops - Treated as individual building properties.

Making the Election:

- The election is an annual election, and irrevocable for the year once made.
- For partnerships and S-corporations the election is made at the entity level, not by the partner or shareholder.
- The election statement should be titled "Section 1.263(a)-3(h) Safe Harbor Election for Small Taxpayers and include the taxpayer's name, address, tax ID number and a description of each eligible building property for which the taxpayer is making the election.

Accounting Method Change – None required.

ELECTION TO CAPITALIZE REPAIR AND MAINTENANCE EXPENDITURES - Reg. Sec. 1.263(a)-3(n)(1)

This provision of the regulations will generally be applied by larger businesses that wish to reduce the administrative burden of maintaining two separate accounting systems. A taxpayer choosing this option may elect to treat repair and maintenance expenditures (only those defined under Reg. Sec. 1.162-4 - Repairs) as depreciable capital expenditures if the taxpayer:

- Incurs these amounts in carrying on the taxpayer's trade or business, and
- Treats these amounts as capital expenditures on its books and records regularly used in computing income.

A taxpayer that makes this election must apply it to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that taxable year. Any amounts for which this election is made shall not be treated as amounts paid for repair or maintenance under §1.162-4.

Caution – This election is limited to repairs and maintenance included in Reg. Sec. 1.162-4. Items expensed under other provisions of the Regulations are not covered by the election.

Time and manner of election – The election is made by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year.

The election statement must be titled "Section 1.263(a)-3(n) Election" and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under §1.263(a)-3(n). In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group by the common parent, and the statement must also include the names and taxpayer identification numbers of each member for which the election is made. In the case of an S Corporation or partnership the election is made at the entity level.

Accounting Method Change - No accounting method change is required to exercise this election

PARTIAL DISPOSITION ELECTION — Reg. Sec. 1.168(i)-8(d)

A taxpayer may make an election under this provision to report the gain or loss on the replacement, retirement or other disposition of a partial asset. However, if the taxpayer makes this election the taxpayer **must**:

- Capitalize the replacement portion under the same asset class as the disposed portion, and
- The asset must be within the asset classes 00.11 through 00.4 of Rev. Proc. 87-56 (described below).

This election does not apply to betterments or an adaptation of the asset to a new or different use.

What does a partial disposition election accomplish? – It allows taxpayers to elect gain or loss on the replacement, retirement or other disposition of a partial asset. A good example of that would be replacing the roof on a building that is not completely depreciated. Prior to the release of the new regulations the old roof would have to remain on the books as part of the whole asset and if not already depreciated to zero, continue to be depreciated.

Example – Rental Roof: *Mel owns a residential rental property that needs a new roof. Mel determines the retiring roof has an unadjusted basis of $25,000 (27.5-year MACRS life, straight line) on which he has taken $16,817 in depreciation, leaving it with a remaining undepreciated basis of $8,183. If Mel elects a partial disposition for the roof, it will result in an ordinary loss of $8,183. However, he will have to capitalize the replacement roof and depreciate it over 27.5 years and forego any option to expense the roof under any other provision.*

Which Part of the Roof?

When it comes to the requirement to capitalize or expense a roof one has to consider which part of the roof they are dealing with. For taxes, the roof is generally broken down into two elements, the structural component (for example the underlying plywood) and the membrane (shingles, asphalt covering, tar paper, etc.). Thus, if a taxpayer replaced only the membrane that would be repair, whereas replacing the underlying roof plywood would be a capital betterment. If the underlying roof plywood were replaced then the entire cost of replacing the roof, including the membrane, would have to be capitalized.

CAUTION: The final regulations allow partial dispositions of assets held in single or multiple asset accounts but dramatically limited the availability of this election for those taxpayers who have the assets in general asset accounts (GAA). GAAs are not covered in this material.

Asset Classes

00.11	Office furniture, fixtures and equipment
00.12	Information systems (computers and peripheral equipment)
00.13	Typewriters, calculators, adding and accounting machines, copiers, duplicating equipment
00.21	Airplanes (not used in commercial or contract carrying of passengers or freight) and all helicopters
00.22	Automobiles, taxis
00.23	Buses
00.241	Light general-purpose trucks
00.242	Heavy general-purpose trucks
00.25	Railroad cars and locomotives
00.26	Tractor units for use over-the-road
00.27	Trailers and trailer-mounted-containers
00.28	Vessels, barges, tugs and similar water transportation equipment
00.3	Land improvements directly added to land whether such improvements are Sec 1245 or Sec 1250 property, e.g., sidewalks, roads, canals, waterways, drainage facilities, sewers, wharves/docks, bridges, fences, landscaping, shrubbery, radio/televisions transmitting towers
00.4	Industrial steam and electric generation and/or distribution systems

Example (based on Regulations Example #1) – Partial Disposition NOT elected *- Alicia owns an office building with four elevators. She replaces one of the elevators. The elevator is a structural component of the office building. In accordance with Reg. §1.168(i)-8(c)(4)(ii)(A), the office building, including its structural components, is the asset for disposition purposes. Alicia does not make the partial disposition election provided under Reg. §1.168(i)-8(d)(2) for the elevator. Thus, the retirement of the replaced elevator is not a disposition. As a result, depreciation continues for the cost of the building, including the cost of the retired elevator and the building's other structural components, and Alicia does not recognize a loss for this retired elevator. If Alicia must capitalize the amount paid for the replacement elevator pursuant to §1.263(a)-3, the replacement elevator is a separate asset for disposition purposes pursuant to Reg §1.168(i)-8(c)(4)(ii)(D) and for depreciation purposes pursuant to section 168(i)(6).*

Example (based on Regulations Example #2) – Treated As Separate Asset *- The facts are the same as in Example 1, except Alicia accounts for each structural component of the office building as a separate asset in her fixed asset system. Although Alicia treats each structural component as a separate asset in her business' records, the office building, including its structural components, is the asset for disposition purposes in accordance with Reg §1.168(i)-8(c)(4)(ii)(A). Accordingly, the result is the same as in Example 1.*

Example (based on Regulations Example #3) – Partial Disposition Election Made - *The facts are the same as in Example 1, except Alicia makes the partial disposition election for the elevator. Although the office building, including its structural components, is the asset for disposition purposes, the result of Alicia making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. Thus, depreciation for the retired elevator ceases at the time of its retirement, and Alicia recognizes a loss upon this retirement. Further, Alicia must capitalize the amount paid for the replacement elevator, and the replacement elevator is a separate asset for disposition and depreciation purposes pursuant to section 168(i)(6).*

<u>*Asset*</u> – Solely for the purposes of the partial election the term asset or a portion of an asset is limited to an asset in asset classes 00.11 though 00.4 (See previous table).

<u>*Determining the unadjusted basis of an asset included in a multiple asset account*</u> – The taxpayer can use any reasonable method to determine what portion of the entire asset basis is assigned to the partial disposition. Although the regulations say “any reasonable method,” they also provide three examples of reasonable methods:

A. Discounting the cost of the replacement asset to its placed-in-service year cost using the Producer Price Index for Finished Goods or its successor, the Producer Price Index for Final Demand, or any other index designated by guidance in the Internal Revenue Bulletin;
B. A pro rata allocation of the unadjusted depreciable basis of the multiple asset account or pool based on the replacement cost of the disposed asset and the replacement cost of all of the assets in the multiple asset account or pool; and
C. A study allocating the cost of the asset to its individual components.

CAUTION – Making this election may not provide the best outcome for the taxpayer since the taxpayer must capitalize rather than expense the replacement asset.

Example – Compare Partial Asset Sale to Repair – *Assume an apartment building has 20 window AC units that originally cost $750 each. One of those units failed and needs to be replaced. The AC units are being depreciated over a class life of 27.5 years. The replacement AC unit cost $1,200 and the labor to install was $100. The old unit was taken out of service, and the new unit was placed in service, in June.*

	Elect Partial	*Treat as Disposition*	*Repairs*
Unadjusted basis of the retired AC unit:	*750*		
Prior depreciation of AC unit:	*<273>*		
Adjusted basis of retired AC unit:	*477*	*477*	
Current Year depreciation for retired AC unit:	*27*	*13*	*27*
Cost of replacement AC unit:	*1,200*		*1,200*
Labor to install replacement AC unit:	*100*		*100*
Current Year depreciation for new AC unit:	*24*	*24*	*0*
CURRENT YEAR’S LOSS/DEDUCTIONS		***524***	***1,327***

<u>*Partial disposition election after IRS disallows repair deduction*</u> – A taxpayer may make a delayed partial disposition election if the IRS disallows the taxpayer’s repair deduction and requires that amount to be capitalized. The delayed election is made by applying for a change in accounting method, Code 198. However, the asset for which the change is being made must have been owned by the taxpayer at the beginning of the change year.

<u>*Making the election*</u> – No formal election is required. The election is made by applying the partial disposition provisions for the taxable year in which the portion of an asset is disposed of by the taxpayer by reporting the gain, loss, or other deduction on the taxpayer's timely filed, including extensions, original Federal tax return for that taxable year. No accounting method change is needed or allowed to make this election.

<u>*Revoking the election*</u> – To revoke a partial disposition election, the taxpayer must do so via a request for a letter ruling.

CALIFORNIA DIFFERENCES

California follows the federal capitalization and repair regulations except California will only follow the de minimis safe harbor increases on a prospective basis only. Thus for CA purposes the increase from $500 to $2,500 will only apply to years beginning on or after 1/01/16. Because no retroactive increase is allowed for CA, the FTB will not follow the audit protection provisions of IRS Notice 2015-82 in excess of $500 for pre-2016 tax years.

NOTES

CANNABIS (Marijuana) BUSINESS ISSUES

Overview

Marijuana is classified as a Schedule I drug under the Controlled Substances Act (CSA) and as such is subject to IRC 280E, which denies a deduction for ordinary business expenses. Also according to federal law, banks and financial services companies cannot knowingly establish accounts with businesses that sell drugs that are illegal under federal law.

Related IRS Publications and Forms

Pubs Forms

- IRC Sec 280E
- Schedule C
- Form 1120-S
- Form 1065
- Chief Counsel (20150411)

Does a Cannabis Business Qualify for the Sec 199A Pass Through Deduction?

TCJA

The IRS has not provided any specific guidance to that question. The big concern of course is the limitations imposed by Section 280E, which in part says "No deduction or credit shall be allowed for any **amount paid or incurred** during the taxable year in carrying on any trade or business…" Since the 199A deduction is not predicated on an "amount paid or incurred" the Sec 199A deduction might apply to cannabis trades and businesses. **However**, when the wage limit applies, the Sec 199A deduction takes into account wages paid by the business. Is that enough to kill the 199A deduction? Only time and the IRS' and courts' interpretations will tell. (The IRS passed on the opportunity to take a position in the final Sec 199A regulations released in February 2019.) Also, without being able to deduct business expenses, cannabis business's QBI is inflated, not something Congress intended. Also see a discussion of Altman vs Commissioner, TC Memo 2018-83, at the end of this chapter.

Sec 280E in its entirety*: "No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted."*

The Details

As marijuana businesses have been legalized in over half of the states, the issues of how these businesses can report their income and pay their taxes are relevant to more tax practitioners than ever before.

Marijuana is classified as a Schedule I drug under the Controlled Substances Act (CSA), which is the statute prescribing federal U.S. drug policy. Under the CSA, the manufacture, importation, possession, use and distribution of certain substances is regulated. Thus, for federal purposes, the sale of marijuana is an illegal business. This position has been substantiated in the Tax Court and affirmed by the Ninth Circuit Court of Appeals (Olive, Martin, (2012) 139 TC 19, affd (2015, CA9)).

Business Expenses & Credits - For tax reporting purposes, the big stumbling block is IRC Sec 280E, which was passed in 1982 during the Reagan administration and which prohibits deductions or credits in connection with the trade or business of trafficking in illegal drugs. This prohibition applies even if the sale of marijuana is permitted under state law. Thus, taxpayers in the business of selling marijuana cannot reduce their taxable income through either related deductions or credits.

Cost of Goods Sold - However, while related business expenses, such as those otherwise allowed under Sec 162, are not deductible, cost of goods sold (COGS) is allowed. This is because IRC Sec 61(a)(3) provides that "**gross income**" includes net "**gains** derived from dealings in property," and this property includes controlled substances produced or acquired for resale. These "gains derived from dealings in property" refer to gross receipts less COGS, or the adjusted basis of merchandise sold during the taxable year. This result is necessary to conform to the language of the 16th Amendment to the US Constitution, which gave Congress the authority to tax "income" but not "gross receipts." When property is sold, only the gain from the sale is income. Gain is well recognized as gross receipts (gross sales price) less the basis (cost) of the property sold (see Section 1.61-3 (a) of the Income Tax Regulations; Sec 1001 (a), Sec 1011 (a), and Sec 1012 (a)); and S. REP. NO. 97-494 (Vol. I), at 309 (1982)). The Senate bill was adopted in conference (CONF. REP. NO. 97-760, at 598 (1982), 1982-2 C.B. 650).

For a business selling marijuana, COGS clearly includes the cost of the marijuana itself. What else might COGS include? Advice from the IRS Chief Counsel (20150411 (12/10/14)) provides some guidance for determining COGS in this situation, as summarized here:

When Sec 280E was enacted in 1982, an "inventoriable cost" was a cost capitalized to inventories under Sec 471 and its regulations. Thus, for example, a marijuana reseller in that era using an inventory method would have capitalized the invoice price of the marijuana purchased, less trade or other discounts, plus the costs of transportation and other necessary charges incurred in acquiring possession of the marijuana. Similarly, a marijuana producer using an inventory method would have capitalized direct material costs (e.g., marijuana seeds or plants), direct labor costs (e.g., those due to planting, cultivating, harvesting or sorting), indirect costs as listed in Category 1 of Reg Sec 1.471-11(c)(2)(i) and possibly Category 3 indirect costs as listed in Sec 1.471-11(c)(2)(iii).

Sec 263A was enacted 4 years after Sec 280E; it expanded the types of inventoriable costs compared to the rules under Sec 471. A reseller still is required to treat the acquisition costs of property as inventoriable. However, a reseller also is now required to capitalize purchasing, handling and storage expenses. In addition, both resellers and producers are required to capitalize a portion of their service costs, such as the costs associated with their payroll, legal and personnel functions. Thus, under Sec 263A, resellers and producers of property are required to treat some deductions as inventoriable costs. However, Sec 280E and the flush language at the end of Sec 263A(a)(2) prevent a taxpayer who is trafficking in a Schedule I (such as marijuana) or Schedule II controlled substance from obtaining a tax benefit by capitalizing disallowed deductions. If a taxpayer subject to Sec 280E were allowed to capitalize the additional Sec 263A costs, Sec 263A would no longer affect only timing and would become a provision that converted nondeductible expenses into capitalizable costs. Thus, the Chief Counsel's office concluded that a taxpayer trafficking in a Schedule I or Schedule II controlled substance is entitled to determine inventoriable costs using Sec 471's applicable inventory-costing regulations as they existed when Sec 280E was enacted.

Multiple Businesses – If a taxpayer selling marijuana is engaged in multiple trades or businesses, just one of which involves the sale of marijuana, only those expenses related to marijuana sales are disallowed under IRC Sec 280E (Californians Helping to Alleviate Medical Problems, Inc, (2007) 128 TC 173). However, sloppy bookkeeping practices can lead to problems in the event of an audit, so it is recommended that each business be operated separately, as the use of separate accounting for each can establish which expenses do not apply to the marijuana trade. Expenses that are shared by the businesses can be allocated by a reasonable method.

Excise Tax – Many states levy excise taxes on the sale of legal marijuana. According to a Chief Counsel Announcement (CCA 201531016), the taxpayer who pays state marijuana excise tax should treat that expenditure as a reduction in the amount realized on the sale of property under IRC Sec 164(a) – not as part of the inventoriable cost of that property or as a deduction from gross income. In addition, the CCA noted that IRC Sec. 280E doesn't preclude this treatment because, although it prohibits deductions and credits for marijuana-related businesses, this excise tax is neither a deduction from gross income nor a tax credit.

Seized Items – A taxpayer cannot include cash or the cost of controlled substances seized by law enforcement in his or her COGS (Beck, Jason R., (2015) TC Memo 2015-149).

Banking Issues – According to federal law, banks and financial services companies cannot knowingly establish accounts with businesses that sell illegal drugs. Banks that handle marijuana money can be charged with money laundering. Businesses restricted to cash are also "targets for assaults" that endanger the public. The lack of banking services can lead marijuana businesses to have problems making federal deposits using the required electronic funds transfer. The business has to make arrangements for its payroll service or another trusted third party to make electronic deposits on its behalf. Some credit unions and small banks that are chartered by their state, not the federal government, have tried to fill the void by offering basic banking services to the cannabis industry.

The IRS has established a payment option for individual taxpayers who need to pay their taxes with cash. In partnership with ACI Worldwide's OfficialPayments.com and the PayNearMe Company, individuals can now make a payment without the need of a bank account or credit card at certain retail establishments nationwide. There is a $1,000 limit and the number of deposits is limited by the type, generally only two per month. Details at: https://www.irs.gov/payments/pay-with-cash-at-a-retail-partner

Tax Return Preparers & Accountants – Another potential problem is that the Bank Holding Company Act treats accountants and tax-return preparers as financial institutions (16 CFR 313.3(i)(2)(h); 16 CFR 313.3(k)(2)(viii)) for purposes of information disclosure. Tax preparation and accounting firms are listed as financial activities, along with banks, insurance companies and financial firms, in 12 CFR 225.28(b)(6)(vi) and referenced in Sec 4(k)(4)(G) of the

Bank Holding Company Act. Does this fact, in conjunction with the banking issues discussed previously, preclude an accountant or tax return preparer from establishing a business relationship with a business that sells illegal drugs?

In the Q&A session at the end of the IRS webinar given 7/19/17 by OPR Director Stephen Whitlock, the question was asked whether it is OK for those covered by Cir 230 to prepare returns for clients who have marijuana businesses in states where selling marijuana is legal. The answer was that as long as the federal tax laws are applied, such as the deduction/credit prohibition of Sec 280E, the IRS won't have a problem with the preparer (i.e., won't consider the preparer as aiding and abetting an illegal activity).

Several State Boards of Accountancy have issued guidance generally agreeing that providing accounting services to a marijuana business is not in itself a discreditable act. The AICPA does not, at press time, have a standard regarding providing accounting services to marijuana businesses. However, there is a white paper available at www.aicpa.org discussing the issues. Search "marijuana" from the website.

Malpractice Insurance – All policies generally include exclusions for criminal acts. Since the sale of marijuana is still illegal for federal purposes, it would be wise to consult with your insurance carrier related to your coverage when providing services to marijuana businesses.

S Corporations and Reasonable Compensation – Working shareholders of S corporations are required to take reasonable compensation for their services in the form of W-2 wages. However, those wages fall into the category of a business deduction, which, except to the extent allocable to cost of goods sold, a cannabis business may not deduct. Not allowing the business deductions increases the K-1 flow through income. Thus the stockholder-employee will have to report the W-2 income and the pass through income, effectively causing his reasonable compensation to be taxed twice. This outcome was confirmed in a case that came before the Tax Court in 2018 (J.M. Loughman, TC Memo. 2018-85).

Altman vs Commissioner (TC Memo 2018-83) - In the Altman case the taxpayer was appealing a lower court's decision confirming IRS audit results for disallowing expenses under Sec 280E. What is interesting in the case was the taxpayer was allowed depreciation and Sec 179 deductions. However, the court did not provide an explanation as to why these expenses were deductible, and it appears the court did so based upon the original audit results, so it may have not been an issue before the court. So don't hang your hat on those results.

CALIFORNIA DIFFERENCES

FTB Exception to the No Cash Policy - The FTB has a "No Cash Policy" in all field offices. This was done to streamline processes, save costs, and reduce risk to customers and state employees. Although this policy achieved the intended goals, it creates a hardship for taxpayers who are unable to open bank accounts (for example, marijuana businesses). In order to address this concern, the FTB established an exemption to the "no cash" policy that was implemented on July 1, 2016. Effective that date:

- A taxpayer who needs to pay in cash must request an exemption to the "No Cash Policy" using the No Cash Policy Exemption Request form, FTB 3711 PC, available on the FTB web site at https://www.ftb.ca.gov/forms/misc/3711.pdf.
- To request an exemption, the taxpayer will need to provide an explanation for their inability to pay using the FTB's provided methods. The No Cash Policy Exemption Request form must be signed by the taxpayer, partner, corporate officer or POA.
- Submit the request at one of five FTB field offices, or scan and email it to FTBCashPayments@ftb.ca.gov, or fax it to 916.843.0262.
- The FTB will review the exemption request and mail a letter of determination to the taxpayer within two business days.
- If the exemption is approved, the taxpayer is responsible for contacting one of the five FTB field offices to make an appointment prior to making their cash payment. The addresses of the field offices are included in the Form 3711 instructions. However, no phone numbers are provided – so makes you wonder if they really want to provide an appointment.
- An approved exemption is good for all future transactions at any of the five FTB offices for the rest of the calendar year. The exemption request must be renewed each year, no later than December 31st.

If the taxpayer is required to make mandatory e-payments, it is recommended that they also complete and submit Form 4107, Mandatory e-Pay Election to Discontinue or Waiver Request for individuals, or Form 3816, Electronic Funds Transfer Election to Discontinue or Waiver Request for business entities, each time a cash payment is made.

Cannabis Taxation Electronic Funds Transfer

Governor Brown has signed into law AB 1741. The law temporarily exempts a person licensed to engage in commercial cannabis activity whose estimated tax liability under the act averages $20,000 or more per month, from a requirement to remit specified taxes under the Medicinal and Adult-Use Cannabis Regulation and Safety Act (MAUCRSA) by electronic funds transfer if the CDTFA deems it necessary to facilitate collection of amounts due. The temporary extension expires January 1, 2022. AB 1741 took effect immediately upon enactment on August 28, 2018.

California follows federal rules related to the Sec 280E restriction on the deductibility of expenses and allowance of tax credits, except in the case of C-Corporations, which are allowed the expenses and most state tax credits if otherwise eligible.

NOTES

REASONABLE COMPENSATION

Determining a reasonable shareholder salary for an S corporation is required and may be one of the most difficult tasks related to S corporation accounting and tax preparation.

S corporation shareholders enjoy tax advantages that other entity types don't offer. Only the portion of their cash distributions that is characterized as reasonable compensation (W-2 wages) is subject to payroll taxes while the profits passed through on the K-1 are not subject to SE tax. Compare that to a partnership where the entire profits are subject SE tax.

Note: if a partnership's "business" is rental of real estate, none of the profits would be subject to SE tax and limited partners don't pay SE tax on profits. But guaranteed payments would be subject to SE tax.

RAPID FINDER

RELATED IRC AND IRS PUBLICATIONS AND FORMS

- IRS Fact Sheet 2008-25
- Pub 535 (2018) Page 8
- IRC Sec 162
- Reasonable Compensation – Job Aid for IRS Valuation Professionals – An IRS Publication (see below) Link:

https://www.irs.gov/pub/irs-utl/Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf

The Internal Revenue Code establishes that any officer of a corporation, including S corporations, is an employee of the corporation for federal employment tax purposes. S corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages.

WHO'S AN EMPLOYEE OF THE CORPORATION?

Generally, an officer of a corporation is an employee of the corporation. The fact that an officer is also a shareholder does not change the requirement that payments to the corporate officer be treated as wages. Courts have consistently held that S corporation officer/shareholders who provide more than minor services to their corporation and receive or are entitled to receive payment are employees whose compensation is subject to federal employment taxes.

The Treasury Regulations provide an exception for an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration. Such an officer would not be considered an employee.

WHAT'S A REASONABLE SALARY?

The instructions to the Form 1120S, U.S. Income Tax Return for an S Corporation, state:

"Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

The amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go to the shareholder, a salary amount must be determined and the level of salary must be reasonable and appropriate.

There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case.

SOME FACTORS CONSIDERED BY THE COURTS IN DETERMINING REASONABLE COMPENSATION:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

The problem here, of course, is that it is easy for the IRS to list contributing factors used by the courts in determining reasonable compensation and leave it to the corporation to quantify these factors into a reasonable salary, and still have the ability to challenge the selected amount later if an auditor, off the top of their head, decides the compensation is unreasonable. The IRS has a long history of examining S corporation tax returns to ensure that reasonable compensation is being paid, particularly so if no compensation is shown being paid to employee-stockholders.

IRS PUBLICATION – REASONABLE COMPENSATION

The IRS, in 2014, released a 26-page publication titled "Reasonable Compensation – Job Aid for IRS Valuation Professionals." However, the publication specifically indicates that it is not an official pronouncement of law and like the Revenue Manual cannot be used, cited, or relied upon as such.

In the Publication's "Background" it States: The Reasonable Compensation issue usually involves a determination of whether the amount of compensation paid is reasonable so that it is deductible under section 162 of the Internal Revenue Code for income tax purposes. In some cases, the Reasonable Compensation issue comes up when the amount of compensation paid may be lower than reasonable to avoid the payment of employment taxes.[1] For tax-exempt entities, the issue involves the application of section 4958, taxes on excess benefit transactions, and reflects a concern that excessively high compensation may unduly enrich officers, directors, trustees or key employees of the tax-exempt entity at the expense of the qualified charitable purpose.

[1] According to Treas. Reg. § 1.162-7(a), "The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services."

Valuation Approaches – The publication includes three approaches to determine reasonable compensation:

- **Market Approach** – How much compensation would be paid for this same position, held by a non-owner in an arms-length employment relationship, at a similar company.
- **Income Approach** - Is based on an "Independent Investor Test," which seeks to determine whether an independent investor would be satisfied with his/her return on investment when looking at the financial performance of the taxpayer's business in conjunction with the subject employee's level of compensation.
- **Cost Approach** – Is based on the hours spent by the employee down to the various duties performed, quantifies the amount of time devoted to the different responsibilities, and compares the employee's salary to market compensation for comparable positions.

The valuations approaches require access to local labor statistics and may be best left to professionals who provide reasonable compensation evaluation services.

IRC SEC 199A DEDUCTION

> *"Qualified business income (QBI) does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business, and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services" (199A Committee Reports)*

The advent of the Sec 199A deduction beginning in 2018 adds an additional level of complexity to reasonable compensation for the following reasons.

- The S corporation's employee-stockholder's wages are NOT included in qualified business income (QBI) when computing the employee-stockholder's 199A deduction. Thus, the larger the wages the smaller the K-1 flow through income (QBI) and thus the smaller the 199A deduction, which is 20% of QBI (or 20% of the individual's adjusted taxable income if less). In this case it would be the tendency of an S corporation to pay the stockholder a smaller salary in order to maximize the flow through income and as a result the 199A deduction.

- Where married taxpayers filing a joint return have taxable income that exceeds a threshold amount of $321,400 ($160,725 for married filing separate and $160,700 for other statuses) for 2019 ($315,000 (other filing statuses $157,500) for 2018), the 199A deduction begins to be subject to a wage limitation, and once the taxable income for married taxpayers filing a joint return exceeds $421,400 ($210,725 for MFS and $210,700 for other statuses) for 2019 ($415,000 (other filing statuses $207,500) for 2018), the 199A deduction becomes the lesser of 20% of the QBI or the wage limitation. For these high-income taxpayers there is a tendency for the S corporation to pay stockholders less wage income in order to benefit from the Sec 199A deduction.
- Where an S corporation is a specified service trade or business (see chapter 3.24) the Sec 199A deduction phases out for married taxpayers filing a joint return with taxable income between $321,400 and $421,400 ($160,725 and $210,725 MFS, $160,700 and $210,700 other statuses) for 2019 ($315,000 and $415,000 (other filing statuses $157,500 and $207,500) for 2018). And, although the wage limitation is used in computing the phase out, once the taxpayer's taxable income exceeds $421,400 (MFS $210,725, other filing statuses $210,700) for 2019 ($415,000 MFJ and other filing statuses $207,500 for 2018), the taxpayer receives no benefit from the wage limitation and therefore would again want to minimize their reasonable compensation in order to minimize FICA taxes.

Of course, taxpayers cannot pick and choose a reasonable compensation to minimize taxes or maximize deductions. There-in lies a trap for tax practitioners who do not take into consideration the factors related to reasonable compensation. There are firms that have the data necessary to determine reasonable compensation, and in **JD & Associates, Ltd. v. United States,** the IRS used Risk Management Association (RMA), an expert in the field of reasonable compensation, for data to determine reasonable compensation.

COMMERCIAL SOURCES

We searched the Internet for services that provide the needed data in report form to determine reasonable compensation. A major source in the field seems to be RC Reports. **We have no experience with them so cannot vouch for them**, but they do have an impressive website with some high-powered references. https://rcreports.com/ They charge a membership fee.

TAX CUTS & JOBS ACT

Don't overlook the fact that in the early stages of tax reform (TCJA) the bill included a safe harbor definition of reasonable compensation of 70% compensation and 30% flow-through income. It also allowed a larger (more taxpayer favorable) allocation to flow through income where a taxpayer could prove investment in the business justified a larger allocation. That provision did not make the cut and was not included in the final bill, although it provides some insight into Congressional thinking on the subject.

GUARANTEED PAYMENTS (PARTNERSHIP)

There has been substantial concern in the tax industry after the passage of the TCJA that Congress might be trying to apply the rules of reasonable compensation to partnership guaranteed payments. This concern was prompted by the fact that guaranteed payments are excluded from a partnership's QBI for purposes of computing the Sec 199A deduction, the same as shareholders' wages (reasonable compensation) are excluded from the QBI of an S corporation, since there was not a modifier included in Sec 199(c)(4) that limits the application of reasonable compensation to S corporations. Here is that section of the Code:

> **199A(c)(4)** Treatment of reasonable compensation and guaranteed payments — Qualified business income shall not include—
>
> > **199A(c)(4)(A)** reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,
> >
> > **199A(c)(4)(B)** any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and
> >
> > **199A(c)(4)(C)** to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

However at an American Bar Association Section of Taxation meeting in San Diego on February 9, 2018, Dana Trier, Treasury deputy assistant secretary for tax policy, said the lack of a modifier to reasonable compensation has raised concerns that the government may broaden reasonable compensation to other entities. "From where I sit . . . that reference to reasonable compensation is not an indication to redo the law of reasonable compensation."

Despite those assurances, Trier noted that section 199A(c)(4) was "written as it's written," and Treasury has the power to issue guidance expanding reasonable compensation beyond subchapter S corporations. Treasury will exercise that power "if someone above me makes that decision," he said.

IRS REVENUE RULINGS & COURT CASES

IRS Revenue Ruling 74-44 – Dividends (dividends in this context means distributions) that two sole shareholders of an electing small business corporation arranged to receive instead of reasonable compensation in the same amounts for services they performed constituted "wages" for which the corporation was liable for the taxes imposed by the FICA and the FUTA and the withholding of income tax.

Spicer Accounting v. United States, 918 F.2d 90 – 66AFTR 2nd 90-5806 (1990) – Taxpayer accounting corporation sought a refund for FICA and FUTA taxes paid to the IRS on behalf of Mr. Spicer. Taxpayer contends that payments paid to Mr. Spicer were dividends, since payments made to stockholders in a subchapter S corporation are not wages. The court found that because payments received by Mr. Spicer were for substantial services rendered, these payments are "wages" subject to FICA and FUTA. Taxpayer asserts, in the alternative, that it was not liable for FICA and FUTA because Mr. Spicer was an independent contractor, not an employee. The Court denied Taxpayer's claim finding that there is no evidence that Mr. Spicer was an independent contractor. Finally, the Court held that Sec. 530 of the Revenue Act of 1978 does not relieve Taxpayer from FICA and FUTA liability for the years at issue (1981 and 1982), because Taxpayer's treatment of Mr. Spicer as a stockholder, not as an employee, was unreasonable. Therefore, the Court affirmed the district court's decision.

Watson v. U.S. 107 AFTR 2nd 2011-311 (DC IA) 12/23/2010 - The IRS recharacterized dividend and loan payments from David E. Watson, P.C. to its sole shareholder and employee, David E. Watson as wages. In light of this recharacterization, Watson was assessed additional employment taxes, interest and penalties for each of the eight calendar quarters in 2002 and 2003. He paid the fourth quarter 2002 assessment of $4,063.93 and filed a claim for refund of that amount on or about June 27, 2007 and the IRS subsequently denied his request for a refund.

Watson filed an action contending that the assessments were illegal, and requesting a refund of the amount paid. The IRS filed an Answer and Counterclaim resisting Watson's request for refund, and requesting Judgment against Watson in the amount of $44,457.39 for additional assessments, penalties, and interest for the seven additional quarters in 2002 and 2003 for which Watson did not make payment. Although Watson received a minor adjustment in the amount owed, the IRS prevailed.

CALIFORNIA DIFFERENCES

California conforms to federal treatment of reasonable compensation (but California does not conform to the Sec 199A deduction).

NOTES

PENSIONS AND ANNUITY DISTRIBUTIONS

Overview

When the Form 1099-R taxable amount is blank or when box 2b (taxable amount not determined) on the 1099-R is checked, the taxpayer's investment in the contract must be determined and the taxable portion of the pension or annuity determined under IRS rules in effect at the time the distribution begins. If there is no investment in the contract, all of the payments received during the year are taxable.

$$\text{Monthly excludable amount} = \frac{\text{After-Tax Investment in Contract}}{\text{\# Payments (Simplified General Rule)}}$$

Simplified General Rule after 1997:

Annuitant Age	**# Payments**
55 and under	360
56-60	310
61-65	260
66-70	210
71 and over	160

Annuitant & Beneficiary (Jt lives)

Age	**# Payments**
110 or under	410
111-120	360
121-130	310
131-140	260
141 or over	210

Pubs Forms

Related IRS Publications and Forms

- **Pub 575** – Pensions & Annuities
- **Pub 939** – General Rule for Pensions and Annuities
- **Form 1098-Q** – Qualifying Longevity Annuity Contract Information
- **Form 1099-R** -Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

RAPID FINDER

The Details

DETERMINING TAXABLE AMOUNT

Generally, most pension plan trustees will include both the gross distribution amount and the taxable distribution amount on a 1099-R and no additional calculations are needed to determine the taxable amount.

However, when the taxable amount is blank or when box 2b (taxable amount not determined) on the 1099-R is checked, the taxpayer's investment in the contract must be determined and the taxable portion determined under one of the IRS specified methods. The method you must use is the method in effect the first year of the pension distribution. **The method currently in effect is the "Simplified General Rule."**

DEFINITIONS

Pension vs. annuity - A pension is a series of payments made to an individual at his/her retirement while an annuity is a series of payments under a contract (e.g., an insurance annuity).

Tax-sheltered annuity - A special kind of annuity contract purchased for a public school employee or the employee of a tax-exempt organization. This type of arrangement is also commonly referred to as a 403(b) plan.

Qualified employer plan - An employer's stock bonus, pension, or profit-sharing plan that meets Internal Revenue Code (IRC) requirements. A qualified plan gives its participants special tax benefits—e.g., tax deferral of contributions, rollover privileges, special 10-year averaging in some cases, etc.

Nonqualified employer plan - An employer's plan that doesn't meet IRC requirements; it doesn't receive most of the benefits afforded to a qualified employee plan.

TYPES OF PENSIONS/ANNUITIES

Fixed Period - Pays definite amounts regularly for a specific length of time.

Single Life - Pays definite amounts regularly for life with payments ending at the death of the annuitant.

Joint and Survivor - First annuitant receives certain amount regularly for life. After the first annuitant's death, second annuitant receives a definite amount regularly for life. What is paid to second annuitant may or may not be different than what the first annuitant received.

Variable - Payments may vary in amount for a definite period of time or for life. Amount received may be dependent on "variables" like profits earned by annuity plan or cost-of-living adjustments.

Disability - Made to an individual who is under retirement age, but receives payments because of his/her disability.

DECEDENT'S UNRECOVERED INVESTMENT IN PENSIONS

If a retired person dies before recovering the entire basis in a pension or annuity that started after 1986, the unrecovered portion is allowed as a Tier 1 (not subject to the 2% of AGI adjustment) miscellaneous itemized deduction on the retiree's final income tax return. *(Code Sec. 67(b)(10);Code Sec. 72(b)(3)(A))*

Thus, if the annuity is for the joint lives of a retiree and a designated beneficiary, the deduction would apply to the final return of the last to die. Otherwise, it would be allowed on the final return of the retiree decedent.

> ***Example -*** *Bill Smith, age 65, began receiving retirement benefits in 2019 under a joint and survivor annuity. Bill's annuity starting date is January 1, 2019. The benefits are to be paid for the joint lives of Bill and his wife Kathy, age 65. Bill had contributed $31,000 (post-tax) to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,200 a month, and Kathy is to receive a monthly survivor benefit of $600 upon Bill's death.*
>
> *Under the simplified method, Bill's tax-free monthly amount is $100 ($31,000 ÷ 310). Upon Bill's death, if Bill has not recovered the full $31,000 investment, Kathy will also exclude $100 from her $600 monthly payment. If Bill and Kathy die before 310 payments are made, a miscellaneous itemized deduction will be allowed for the unrecovered cost on the final income tax return of the last to die.*

MULTIPLE PLANS

An employee may receive benefits from more than one plan under a single trust of an employer. If this is true, the employee may have to treat each plan as a separate contract and may be considered to have received more than one pension or annuity, depending on the circumstances. The plan administrator should be able to tell an employee whether each contract needs to be treated separately.

QUALIFIED DOMESTIC RELATIONS ORDER (QDRO)

A QDRO is a judgment, decree, or order relating to payment of child support, alimony, or marital property rights to a spouse, former spouse, child or other dependent. The order has to contain certain specific information like the amount of the participant's benefits to be paid to each alternate payee.

Spouse or former spouse - If a spouse or former spouse receives retirement benefits from a participant's plan under a QDRO, the former spouse must report the payments just as though he/she were the plan participant. The early distribution penalty does not apply, regardless of the alternate payee's age. The taxability is computed by allocating the spouse/former spouse a share of the investment in the contract and figuring the taxable portion accordingly (see below for computing taxability when there is investment in the contract).

Child or dependent - If a child or dependent receives a distribution under a QDRO, the amount is taxed to the plan participant.

EX-SPOUSE'S MILITARY RETIREMENT PAY AWARDED IN CONNECTION WITH DIVORCE

A taxpayer who, in connection with a divorce, is awarded an ownership interest in his or her ex-spouse's military retirement pay, is treated as receiving pension payments (includible as pension income in the taxpayer's gross income under Code Sec. 61(a)(11)), even though the retirement pay was earned by the ex-spouse. Thus, where, in connection with a divorce, a taxpayer received a portion of her ex-spouse's military retirement pay as her share of community property, that portion was pension income to her under Code Sec. 61(a)(11). Similarly, where, in a non-community property state (VA), a taxpayer was awarded ownership of a portion of her ex-spouse's military retirement pay in connection with a divorce, that portion was taxable to her as pension income. This is because pension payments are gross income to the party who owns the right to those payments pursuant to a division of property in a divorce.

(Pfister, Gay M., (2002) TC Memo 2002-198) A district court in the Fifth Circuit came to the same conclusion. *(Chiarello, Emily D. v. IRS, (2006, DC TX))* The imposition of income tax withholding on the retiree does not prevent the amount paid to the former spouse from being included in gross income. *(Mitchell, Maria Antoinette Walton, (2004) TC Summary Opinion 2004-160)*

PUBLIC SAFETY OFFICERS EXCLUSION FOR HEALTH & LONG-TERM CARE INSURANCE

Eligible retired public safety officers (police, firefighters) may elect to exclude governmental retirement plan distributions that don't exceed their health or long-term care premiums, if the distributions are paid directly to insurers. The exclusion is limited to $3,000 per year. Any amount excluded isn't deductible as a medical expense for itemized deductions and isn't includible as health insurance for the self-employed heath insurance deduction (PPA § 845). See chapter 7.02 – Medical, for details.

PARTIAL ANNUITIZATION OF NON-QUALIFIED ANNUITIES

The partial annuitization of a nonqualified annuity, endowment, or life insurance contract is permitted.

Under this rule, if any amount is received as an annuity for a period of 10 years or more, or during one or more lives, under *any portion* of an annuity, endowment, or life insurance contract:

- that portion will be treated as a separate contract for annuity taxation purposes;
- the investment in the contract will be allocated pro rata between each portion of the contract from which amounts are received as an annuity, and the portion of the contract from which amounts are *not* received as an annuity, and
- a separate annuity starting date will be determined for each portion of the contract from which amounts are received as an annuity. (Code Sec. 72(a)(2))

Thus, holders of nonqualified annuities are allowed to elect to receive a portion of an annuity contract in the form of a stream of annuity payments, leaving the remainder of the contract to accumulate income on a tax-deferred basis.

Since "any portion" of an annuity contract is not defined, IRS guidance is needed to expand on this area of the partial annuitization rule.

The partial annuitization rule does not apply to the special rules for qualified employer retirement plans under Code Sec. 72(d).

DISABILITY RETIREMENT PAYMENTS (WORKERS' COMPENSATION)

Retirement payments are not taxable if they are received pursuant to a workers' compensation act or a statute in the nature of a workers' compensation act. However, such payments are not excludable to the extent they are determined by reference to the employee's age or length of service or prior contributions, even if the retirement occurs due to an occupational injury. (Reg. § 1.104-1(b)) The annual Form 1099-R issued by the former employer should reflect the portion of the retirement payments that is taxable.

Retirement Benefits Exceed Disability Benefits - The Court of Appeals for the Ninth Circuit has affirmed a Tax Court decision that a retired member of the Los Angeles County Sheriff's Department could not exclude from income the amount by which his retirement benefits exceeded the amounts that he was entitled to receive on account of his disability, finding that the excess was subject to tax under Reg. § 1.104-1(b) because it was calculated in reference to the taxpayer's length of service. The Court also rejected the taxpayer's challenge to the validity of that reg. (Sewards v. Comm., (CA 9 5/12/2015))

Payments to surviving spouse - The exclusion for workers' compensation applies to benefits paid under a workers' compensation act to the survivor or survivors of a deceased employee (Reg § 1.104-1(b) , or under a statute which is in the nature of a workers' compensation act to the survivors of a deceased employee (Rev Rul 80-44). A statute authorizing benefits for employees' survivors can qualify as a statute in the nature of a workers' compensation act if it requires as a prerequisite to payment a determination that the cause of the employee's death was service-related.

However, continuation benefits paid to the surviving spouse of a deceased firefighter under a statute that didn't distinguish between job related and non-job related disabilities weren't excludable. Although the benefits qualified as a continuation of the employee's benefits under Rev Rul 80-44, since the statute wasn't in the nature of a workers' compensation act, the spouse's benefits were a mere continuation of the deceased employee's taxable benefits and weren't excludable (IRS Letter Ruling 9445003).

See also "Sick Pay" in chapter 02.01.06.

PERIODIC PENSION/ANNUITY PAYMENTS

Generally, distributions from pensions and annuities are made in regular, periodic payments. Distributions are tax-free to the extent the participant has after-tax dollars in a plan ("investment in the contract") and the balance is taxable.

Information needed to figure annuity taxability - When determining the taxability of pensions, the following data should be available:

(1) Amount of both employer AND employee contributions to the plan.
(2) Amount of each annuity payment AND how often it is paid (e.g., monthly).
(3) "Starting date" of the annuity. This is the later of the first day of the first period for which a payment is received under the contract or the date when the obligation under the contract becomes certain.

Example - Determining Starting Date - *Frank completed all payments required by his annuity contract on 01/01/XX. The annuity provided for monthly payments beginning 08/01/XX. The 08/01 payment covered the period beginning 07/01/XX. Frank's annuity starting date is 07/01/XX.*

(4) Length of time the annuity payments will continue (e.g., for a set number of years, over the lifetime of the taxpayer only, over the lives of the taxpayer and spouse or other beneficiary).
(5) Guarantees of a specific minimum return (i.e., "refund feature").
(6) Age of the annuitant, spouse and other beneficiary.

A taxpayer's "investment in the contract" (cost) consists of:

- The taxpayer's own after-tax contribution to the plan, and
- Funds contributed by an employer and included in the taxpayer's taxable income.

However, certain items may have to be subtracted from the cost:

(a) Premium refunds, rebates, "dividends";
(b) Premiums paid for disability or health benefits;
(c) Value of the refund feature, but only if the taxable part of the annuity is computed under the General Rule, as described below. Regs describe how to compute the refund feature.

SIMPLIFIED GENERAL RULE TABLES

Table #1 Annuity Start Date	Before 11/19/96	After 11/18/96
Annuitant Age	# of Payments	# of Payments
55 or under	300	360
56-60	260	310
61-65	240	260
66-70	170	210
71 or over	120	160

Table #2 Annuity Start Date	Only for Annuities Starting After 1997
Combined Ages Of Annuitant And Beneficiary	# of Payments
110 or Under	410
110-120	360
121-130	310
131-140	260
141 or over	210

METHODS FOR TAXING PENSIONS

Fully Taxable Pensions **-** Annuity payments are 100% taxable if there is no investment in the contract. Most often these pensions consist of distributions from cash or deferred arrangements (401(k) plans), simplified employee pensions (SEPs), or tax-sheltered annuities.

Partially Taxable Pensions **–** For pensions that begin after 1986, the "Simplified General Rule" is used to compute the taxable portion of a pension when there is an investment in the contract. There are two "General Rules" - one effective for pensions that began after 11/18/1996 and those started before that date

To determine the taxable portion of a partially taxable pension using the general rule, use the Simplified General Rule tables and the worksheet below.

WORKSHEET - PENSIONS BEGINNING ON OR AFTER 7/1/1986

1. Enter the total pension or annuity payments received this year………………………..…………… ___________
2. Enter your cost in the plan (contract) at the annuity starting date…………………..…………… ___________
3. Enter the appropriate number from Table 1 above. But if your annuity starting date was after 1997 and the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 above………………….…………… ___________
4. Divide line 2 by the number on line 3 …………………………………………………….…………….. ___________
5. Multiply line 4 by the number of months for which this year's payments were made. If your annuity starting date was before 1987, enter this amount on line 8 below and skip lines 6, 7, 10, and 11. Otherwise, go to line 6……………..….…………… ___________
6. Enter any amount previously recovered tax-free in years after 1986……………..….…………… ___________
7. Subtract line 6 from line 2..………………………………………………………………..…..…………… ___________
8. Enter the smaller amount of line 5 or line 7………………………………………………..…..…………… ___________
9. Taxable amount for year. Subtract line 8 from line 1. Enter the result, but not less than zero. Note: If your Form 1099–R shows a larger taxable amount, use the amount on this line instead……………………………………………..…………………………… ___________
10. Add lines 6 and 8……………………………………………………………………………………….……………… ___________
11. Balance of cost to be recovered. Subtract line 10 from line 2..……….……………………..…. ___________

Example - Simplified General Rule - *Assume the following facts:*

Type of annuity:	*One life, 401(a) plan*
Starting date:	*01/01/19*
Investment in contract:	*$30,000*
Monthly annuity:	*$1,000*
Age of recipient:	*62*

The taxable portion of the payouts would look like the following:

1.	*TOTAL PAYMENTS RECEIVED this year*	*$12,000*
2.	*INVESTMENT IN THE CONTRACT*	*$30,000*
3.	*Appropriate number of payments from table above*	*260*
4.	*MONTHLY EXCLUSION - divide line 2 by line 3*	*$ 115*
5.	*TENTATIVE EXCLUSION- line 4 times # months this year (12)*	*1,380*
6.	*Total excluded payments in all prior years*	*0*
7.	*REMAINING COST at beginning of year – line 2 less line 6*	*30,000*
8.	*CURRENT YEAR EXCLUSION - lesser of line 5 or line 7*	*1,380*
9.	*TAXABLE AMOUNT – line 1 less line 8, not less than zero*	***$10,620***
10.	*COST RECOVERED TO DATE – line 6 plus line 8*	*1,380*
11.	*COST REMAINING TO BE RECOVERED – line 2 less line 10*	*$28,620*

USING THE GENERAL OR SIMPLIFED GENERAL RULE

(1) ***Starting date after 1986 and before 11/19/1996:*** These annuitants must use the General Rule unless the Simplified General Rule is elected. However, the total amount of income that can be excluded as return of capital can't be more than the investment in the contract less the value of any refund feature. Thus, when the investment in the contract is used up, the annuity is fully taxable. Otherwise, computations are like those described above.

(2) ***Starting date after 07/01/86 and before 01/01/87****:* Recipients of such distributions must use the General Rule unless the Simplified General Rule, described above, is elected. Use the same procedures described in (1) above.

(3) ***Starting date before 07/02/86*****:** For such distributions, the General Rule applied when cost was not recovered within 36 months (the old Three-Year Rule). First-year calculation of these annuities determines the AMOUNT RECEIVED during the year AND the investment in the contract. The expected return is computed as follows:

(a) If the term for the annuity is fixed (e.g., $200 a month for 30 years), multiply the payment amount specified for each period by the number of months to be paid per the contract (e.g., $200 x 12 months x 30 years);

(b) If the annuity is for life (of the taxpayer, taxpayer and spouse, or taxpayer and other beneficiary), use IRS annuity tables. The annuity factors found in the tables equate with the number of years the annuity is expected to be received. Multiply the factor by 12 months and the result by the monthly annuity amount (or the annuity factor times the amount received yearly).

Portions of the annuity tables are reproduced in chapter 4.02, but Regs 1.72-9 and IRS Publication 939 contain the full text.

(c) Once you know the expected return, compute the EXCLUSION RATIO by dividing the investment in the contract by the expected return. This exclusion ratio (expressed as a percentage) is the tax-free amount. In later years, use the same exclusion ratio and apply it to the "annuity amount" (i.e., the original level of payments). Cost of living or other adjustments are fully taxable. The exclusion ratio doesn't change no matter how long the annuitant lives or how much is actually excluded.

NONPERIODIC PENSION PAYMENTS

Nonperiodic payments are also termed "amounts not received as an annuity." They include all payments other than periodic payments. The amount of such payments that are subject to tax depends on when the payments are made in relation to the annuity starting date. If they are made before the annuity starting date, their tax treatment depends on the type of contract or transaction from which they result.

Nonperiodic payments on or after annuity starting date - A plan participant who receives a nonperiodic payment from an annuity contract on or after the annuity starting date is generally fully taxable on the amount. A cost-of-living increase in a pension after the initial starting date is considered "an amount not received as an annuity"; thus, it is fully taxable.

Nonperiodic payments before annuity starting date - Such payments are only partially taxable because part of the payment is allocated to investment in the contract. To figure the nontaxable portion, use the following formula (determine "balance in the account" on the date the payment is received).

$$\textbf{Amount received} \times \frac{\textbf{Investment in the contract}}{\textbf{Balance in the account}}$$

For distributions from plans other than qualified retirement plans, generally the payment is only partially taxable. Allocate first to earnings to compute the taxable part, then to investment in the contract to figure the nontaxable part. This type of treatment generally applies to commercial annuity contracts purchased directly by the taxpayer. The taxable portion is the smaller of: (a) the nonperiodic distribution, or (b) the excess of the cash value of the contract (figure this without regard to any surrender charge) just before receipt of the distribution over the participant's investment in the contract at that time.

> ***Example - Taxability of an Insurance Annuity*** *- Will bought an annuity from an insurance company. Before the annuity starting date, he received a distribution of $7,000. The cash value of the annuity at that time was $16,000, and Will's investment in the contract was $10,000. Since the distribution is allocated first to earnings, Will must include $6,000 in income ($16,000 - $10,000). The remaining $1,000 is tax-free.*

RETIREMENT INCOME BY PARTNERSHIP TO A NONRESIDENT RETIRED PARTNER

States are prohibited from taxing the retirement income paid by a partnership to a nonresident retired partner under any written plan, program, or arrangement in effect immediately before retirement begins. Certain adjustments to retirement payments under pension or deferred compensation plans, including cost-of-living adjustments, do not disqualify such plans under the "substantially equal periodic payments" test. (Sec. 114(b)(1)(I))

LONGEVITY ANNUITIES BENEFIT FROM FINAL REGULATIONS

A longevity annuity is a deferred annuity that is scheduled to commence at an advanced age. Longevity annuities make it easier for retirees to use a limited portion of their savings to purchase guaranteed income for life starting at an advanced age, such as 80 or 85, to address the risk of outliving their assets. Once that risk is addressed, a retiree's task of generating income from his remaining assets would be more manageable because it would be limited to a fixed period of time.

However the required minimum distribution (RMD) rules had made it difficult for taxpayers to acquire longevity annuities with their retirement funds because the value of the longevity annuity would have to be included in the account balance used to determine the taxpayer's RMD for the year.

Final regulations (T.D. 9673) related to "qualified longevity annuity contracts" (QLACs) modify the required minimum distribution rules in order to facilitate the purchase of deferred annuities that begin at an advanced age. Highlights of the final regs:

- To qualify as a QLAC, distributions must begin no later than age 85.
- Prior to annuitization, the value of QLACs is excluded from the account balance used to determine required minimum distributions.
- The regulations permit a QLAC to be offered under a defined contribution plan but not a defined benefit plan.
- To qualify as a QLAC, the amount of the premiums paid for the contract cannot exceed the lesser of $125,000 (inflation-adjusted to $130,000 for 2019 and 2018) or 25 percent of the employee's account balance.
- If purchased for an IRA, the amount of the premiums paid for the contract under an IRA on a given date may not exceed $130,000 ($125,000 before 2018). If, on or before the date of a premium payment, an IRA owner has paid premiums for the same contract or for any other contract that is intended to be a QLAC under the IRA or under any other IRA, plan, or annuity, the $130,000 ($125,000 before 2018) limit is reduced by the amount of those other premium payments. Further, the amount of the premiums paid for the contract under an IRA on a given date generally may not exceed 25 percent of the sum of the account balances (as of December 31 of the calendar year before the calendar year in which a premium is paid) of the IRAs (other than Roth IRAs) that an individual holds as the IRA owner.
- The $125,000 limitation is subject to inflation adjustment in $10,000 multiples, effective after 2014.
- An annuity purchased under a Roth IRA cannot be treated as a QLAC.

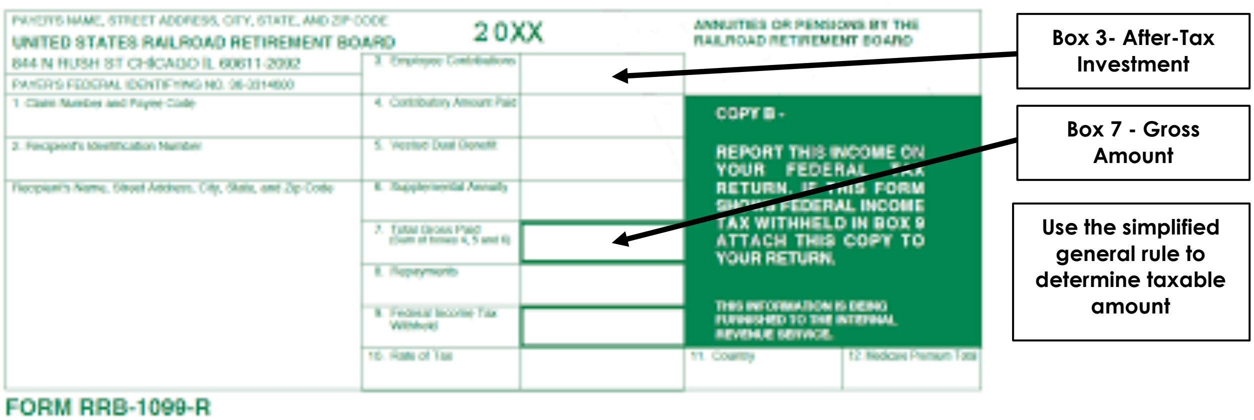
- If an annuity contract fails to be a QLAC solely because premiums for the contract exceed the premium limits, then the contract will not fail to be a QLAC if the excess premium is returned to the non-QLAC portion of the employee's account by the end of the calendar year following the calendar year in which the excess premium was paid.
- A QLAC may provide for a single-sum death benefit paid to a beneficiary in an amount equal to the excess of the premium payments made with respect to the QLAC over the payments made to the employee under the QLAC. If a QLAC is providing a life annuity to a surviving spouse (or will provide a life annuity to a surviving spouse), it may also provide a similar return of premium (ROP) benefit after the death of both the employee and the spouse.
- A QLAC may not include a variable contract, an equity-indexed contract, or a similar contract.
- If on or after July 2, 2014, an existing contract is exchanged for a contract that satisfies the requirements to be a QLAC, the new contract will be treated as purchased on the date of the exchange and therefore may qualify as a QLAC. In such a case the fair market value of the contract that is exchanged for a QLAC is treated as a premium that counts toward the QLAC limit.

Form 1098-Q – The IRS has created Form 1098-Q, Qualifying Longevity Annuity Contract Information, to be used to report the status of longevity annuity contracts held by defined contribution plans, IRAs, and eligible governmental plans, to participants and the IRS.

RAILROAD RETIREMENT

Pensions and annuities paid by the Railroad Retirement Board (RRB) are reported on Form RRB-1099-R, which is a green form, as opposed to the blue RRB-1099, which reports RR equivalent Social Security benefits. Box 7 of the RRB-1099-R shows the gross amount paid, without any reduction for taxpayer contributions. Box 3 shows the employee's after-tax investment in the contract – use the simplified general rule to determine the amount that reduces the taxable amount reported in Box 7. Box 8 shows any repayments. See chapter 9.05, Claim of Right, for how to deduct or take a tax credit for the repayment. For additional information on Railroad Retirement benefits, see IRS Pub 575, page 6 (2018).

Railroad Pension – RRB 1099-R



CANADIAN "IRA" EQUIVALENT PLANS

Residents of the U.S. and beneficiaries of one of the following Canadian plans:

- A registered retirement savings plan (RRSP),
- A registered retirement income fund (RRIF),
- A registered pension plan, or
- A deferred profit-sharing plan

Have been taxed on the accrued earnings from these plans unless they made the election under the US-Canada Tax Treaty Article XVIII(7).

IRS Rev. Proc. 2014-55 – simplified the reporting requirements. Previously Form 8891 was used to report contributions to, undistributed earnings of and distributions from the Canadian plans and to make the election under the US-Canada Tax Treaty Article XVIII(7) to defer taxation on undistributed earnings.

An eligible individual can make that election under the provisions of Rev Proc 2014-55. An "eligible individual" is a beneficiary of a Canadian retirement plan who:

A) Is or at any time was a U.S. citizen or resident while a beneficiary of the plan;
B) Has met his or her U.S filing requirements for all years during which the individual was a U.S. citizen or resident;
C) Has not previously reported undistributed accrued earnings from a plan during any taxable year in which the individual was a U.S. citizen or resident; and

D) Has reported any and all distributions received from the plan as if the individual had made an election under Article XVIII(7) for all years during which the individual was a U.S. citizen or resident.

Election Procedure for an Eligible Individual - An eligible individual (defined above) who did not previously make an election under Article XVIII(7) will be treated as having made the election in the first year in which the individual would have been entitled to elect the benefits under Article XVIII(7). No forms need to be filed for any year. Once an election is made pursuant to section 4.02 of Rev Proc 2014-55 with respect to a Canadian retirement plan, that election is in effect for all subsequent taxable years through the year in which a final distribution is made from the plan, unless the election is revoked with the consent of the Commissioner.

Effect on Prior Elections - A beneficiary who previously made an Article XVIII(7) election with respect to a Canadian plan on Form 8891 or under the procedures set forth in Revenue Procedure 2002-23 (or an eligible individual who is treated as having made the election per Rec Proc 2014-55) is not required to file Form 8891 or a similar statement for taxable years ending after December 31, 2012.

Effect on Other than an Eligible Individual - Beneficiaries who have reported on their U.S. Federal income tax return undistributed income that has accrued in a Canadian retirement plan during a taxable year are not "eligible individuals" and consequently are not eligible to make an election under Article XVIII(7). Undistributed income will remain currently taxable. If such a beneficiary desires to make an Article XVIII(7) election with respect to a Canadian retirement plan, the beneficiary must seek the consent of the Commissioner.

Note: Annuitants and beneficiaries of these Canadian plans are not required to file Form 3520 or 3520-A. However, beneficiaries may be required to file FinCen Form 114 (FBAR) related to foreign financial accounts and trusts valued at over $10,000.

OTHER ISSUES

Exchange – Inherited Annuities - According to PLR 201330016, a taxpayer who had elected to annuitize her inherited non-qualified annuities (elected to receive the payout over her lifetime) was allowed to exchange those annuities for annuities with higher payouts as provided by IRC Sec. 1035(a)(3). A PLR is non-binding and only applies to the taxpayer who made the request, but it also shows how the IRS regards a certain issue.

CALIFORNIA DIFFERENCES

California generally conforms to Federal treatment of pensions. However, foreign equivalents to Social Security are generally taxable to CA. See Chapter 2.03.

Taxation of Out-of-State Pensions - P.L. 104-95 prevents states from taxing the pensions of former residents of any state received after December 31, 1995 (R&TC 17952.5). Benefits received after 1995 from the following plans are not subject to out-of-state taxation:

- IRC Sec. 401(a) trusts exempt from taxation under IRC Sec. 501(a)
- **IRC Sec. 403(a) annuity plans**
- IRC Sec. 403(b) annuity contracts
- IRC Sec. 408(k) plans
- IRC Sec. 414(d) government plans
- IRC Sec. 457 deferred compensation plans
- IRC Sec. 501(c)(18) trusts
- IRC Sec. 7701(a)(37) individual retirement plans
- Pensions meeting the "substantially criteria" paid to partners. ***

> ***Example*** *– Tom was a CA resident from 7/1/08– 8/1/19, when he moved to Texas. He receives a pension of $1,000 per month from his former CA employer. The pension cannot be taxed by CA while he is a non-resident of CA.*

P.L. 104-95 also limits deferred compensation (including IRC Sec. 401(k) plans) and other distributions from two types of nonqualified plans from out-of-state taxation:

- IRC Sec. 3121(v)(2)(C) plans, if payments are made at least annually and spread over the actuarial life expectancy of the beneficiaries, or if they are spread over at least a 10-year period; and
- Plans that are trusts under IRC Sec. 401(a), but exceed limits laid down in IRC Sec. 401(a)(17) and IRC Sec. 415.

**** H.R. 4019 signed into law in 2006 specifically includes payments by partnerships to partners retroactive to pension payments received after 12/31/95. This bill was in response to a position taken by the State of New York that the provisions of Code Sec. 3121(v)(2)(C) apply only to employees, not partners, and the state was attempting to tax pension income of "out-of-state" partners.*

Taxation of Canadian RRSPs and RRIFs – These Canadian retirement plans do not qualify as IRAs under either federal or California law. California does not recognize the U.S.-Canada treaty provision allowing an election to defer taxation of the earnings of these plans until distributions are received. Thus, the interest, dividends or capital gains earned by these plans annually are taxed by California and are an adjustment on Schedule CA. The amount taxed becomes the taxpayer's basis in the plan for CA purposes and will not be taxed again when distributions are actually received.

Uniform Lifetime Table

Final Regulations §1.401(a)(9)-5

Generally, this table is used to determine the minimum required distribution from defined contribution plans. Also used by IRA owners. ***Exception:*** *If the taxpayer's spouse is the sole beneficiary, then the distribution period is the longer of the distribution period determined from this table or the Joint and Last Survivor Table.*

Age	Applicable Divisor	Age	Applicable Divisor	Age	Applicable Divisor	Age	Applicable Divisor
70	27.4	82	17.1	94	9.1	106	4.2
71	26.5	83	16.3	95	8.6	107	3.9
72	25.6	84	15.5	96	8.1	108	3.7
73	24.7	85	14.8	97	7.6	109	3.4
74	23.8	86	14.1	98	7.1	110	3.1
75	22.9	87	13.4	99	6.7	111	2.9
76	22.0	88	12.7	100	6.3	112	2.6
77	21.2	89	12.0	101	5.9	113	2.4
78	20.3	90	11.4	102	5.5	114	2.1
79	19.5	91	10.8	103	5.2	115 +	1.9
80	18.7	92	10.2	104	4.9		
81	17.9	93	9.6	105	4.5		

SINGLE LIFE TABLE*

Age	Factor	Age	Factor	Age	Factor	Age	Factor
0	82.4	29	54.3	58	27.0	87	6.7
1	81.6	30	53.3	59	26.1	88	6.3
2	80.6	31	52.4	60	25.2	89	5.9
3	79.7	32	51.4	61	24.4	90	5.5
4	78.7	33	50.4	62	23.5	91	5.2
5	77.7	34	49.4	63	22.7	92	4.9
6	76.7	35	48.5	64	21.8	93	4.6
7	75.8	36	47.5	65	21.0	94	4.3
8	74.8	37	46.5	66	20.2	95	4.1
9	73.8	38	45.6	67	19.4	96	3.8
10	72.8	39	44.6	68	18.6	97	3.6
11	71.8	40	43.6	69	17.8	98	3.4
12	70.8	41	42.7	70	17.0	99	3.1
13	69.9	42	41.7	71	16.3	100	2.9
14	68.9	43	40.7	72	15.5	101	2.7
15	67.9	44	39.8	73	14.8	102	2.5
16	66.9	45	38.8	74	14.1	103	2.3
17	66.0	46	37.9	75	13.4	104	2.1
18	65.0	47	37.0	76	12.7	105	1.9
19	64.0	48	36.0	77	12.1	106	1.7
20	63.0	49	35.1	78	11.4	107	1.5
21	62.1	50	34.2	79	10.8	108	1.4
22	61.1	51	33.3	80	10.2	109	1.2
23	60.1	52	32.3	81	9.7	110	1.1
24	59.1	53	31.4	82	9.1	111+	1.0
25	58.2	54	30.5	83	8.6		
26	57.2	55	29.6	84	8.1		
27	56.2	56	28.7	85	7.6		
28	55.3	57	27.9	86	7.1		

*Included in the Final Regulations for the Minimum Required Distributions from Qualified Plans. Effective 1/1/2003 Reference Final Regulations *§1.401(a)(9)-5*

ANNUITY TABLE V

Single Life - Unisex: This table is generally used when the annuity recipient does not have a designated beneficiary and the annuity began after 06/30/85. For ages less than 35, consult IRC Section 72, Table V.

Age	Factor	Age	Factor	Age	Factor
35	47.3	62	22.5	90	5.0
36	46.4	63	21.6	91	4.7
36	46.4	64	20.8	92	4.4
37	45.4	65	20.0	93	4.1
38	44.4	66	19.2	94	3.9
39	43.5	67	18.4	95	3.7
40	42.5	69	16.8	96	3.4
41	41.5	68	17.6	97	3.2
42	40.6	70	16.0	98	3.0
43	39.6	71	15.3	99	2.8
44	38.7	72	14.6	100	2.7
45	37.7	73	13.9	101	2.5
46	36.8	74	13.2	102	2.3
47	35.9	75	12.5	103	2.1
48	34.9	76	11.9	104	1.9
49	34.0	77	11.2	105	1.8
50	33.1	78	10.6	106	1.6
51	32.2	79	10.0	107	1.4
52	31.3	80	9.5	109	1.1
53	30.4	81	8.9	108	1.3
54	29.5	82	8.4	110	1.0
55	28.6	83	7.9	111	.9
56	27.7	84	7.4	112	.8
57	26.8	85	6.9	113	.7
58	25.9	86	6.5	114	.6
59	25.0	87	6.1	115	.5
60	24.2	88	5.7		
61	23.3	89	5.3		

JOINT AND LAST SURVIVOR TABLE

Included in the Final Regulations for the Minimum Required Distributions from Qualified Plans.
Effective 1/1/2003 Reference Final Regulations *§1.401(a)(9)-5*

Ages	55	56	57	58	59	60	61	62	63	64	Ages
55	35.6	35.1	34.7	34.3	33.9	33.5	33.2	32.9	32.6	32.3	55
56	35.1	34.7	34.2	33.7	33.3	32.9	32.6	32.2	31.9	31.6	56
57	34.7	34.2	33.7	33.2	32.8	32.4	32.0	31.6	31.3	31.0	57
58	34.3	33.7	33.2	32.8	32.3	31.9	31.4	31.1	30.7	30.4	58
59	33.9	33.3	32.8	32.3	31.8	31.3	30.9	30.5	30.1	29.8	59
60	33.5	32.9	32.4	31.9	31.3	30.9	60.4	30.0	29.6	29.2	60
61	33.2	32.6	32.0	31.4	30.9	30.4	29.9	29.5	29.0	28.6	61
62	32.9	32.2	31.6	31.1	30.5	30.0	29.5	29.0	28.5	28.1	62
63	32.6	31.9	31.3	30.7	30.1	29.6	29.0	28.5	28.1	27.6	63
64	32.3	31.6	31.0	30.4	29.8	29.2	28.6	28.1	27.6	27.1	64
65	32.0	31.4	30.7	30.0	29.4	28.8	28.3	27.7	27.2	26.7	65
66	31.8	31.1	30.4	29.8	29.1	28.5	27.9	27.3	26.8	26.3	66
67	31.6	30.9	30.2	29.5	28.8	28.2	27.6	27.0	26.4	25.9	67
68	31.4	30.7	29.9	29.2	28.6	27.9	27.3	26.7	26.1	25.5	68
69	31.2	30.5	29.7	29.0	28.3	27.6	27.0	26.4	25.7	25.2	69
70	31.1	30.3	29.5	28.8	28.1	27.4	26.7	26.1	25.4	24.8	70
71	30.9	30.1	29.4	28.6	27.9	27.2	26.5	25.8	25.2	24.5	71
72	30.8	30.0	29.2	28.4	27.7	27.0	26.3	25.6	24.9	24.3	72
73	30.6	29.8	29.1	28.3	27.5	26.8	26.1	25.4	24.7	24.0	73
74	30.5	29.7	28.9	28.1	27.4	26.6	25.9	25.2	24.5	23.8	74
75	30.4	29.6	28.8	28.0	27.2	26.5	25.7	25.0	24.3	23.6	75
76	30.3	29.5	28.7	27.9	27.1	26.3	25.6	24.8	24.1	23.4	76
77	30.3	29.4	28.6	27.8	27.0	26.2	25.4	24.7	23.9	23.2	77
78	30.2	29.3	28.5	27.7	26.9	26.1	25.3	24.6	23.8	23.1	78
79	30.1	29.3	28.4	27.6	26.8	26.0	25.2	24.4	23.7	22.9	79
80	30.1	29.2	28.4	27.5	26.7	25.9	25.1	24.3	23.6	22.8	80
81	30.0	29.2	28.3	27.5	26.6	25.8	25.0	24.2	23.4	22.7	81
82	30.0	29.1	28.3	27.4	26.6	25.8	24.9	24.1	23.4	22.6	82
83	29.9	29.1	28.2	27.4	26.5	25.7	24.9	24.1	23.3	22.5	83
84	29.9	29.0	28.2	27.3	26.5	25.6	24.8	24.0	23.2	22.4	84
85	29.9	29.0	28.1	27.3	26.4	25.6	24.8	23.9	23.1	22.3	85
86	29.8	29.0	28.1	27.2	26.4	25.5	24.7	23.9	23.1	22.3	86
87	29.8	28.9	28.1	27.2	26.4	25.5	24.7	23.8	23.0	22.2	87
88	28.8	28.9	28.0	27.2	26.3	25.5	24.6	23.8	23.0	22.2	88
89	29.8	28.9	28.0	27.2	26.3	25.4	24.6	23.8	22.9	22.1	89
90	29.8	28.9	28.0	27.1	26.3	25.4	24.6	23.7	22.9	22.1	90
91	29.7	28.9	28.0	27.1	26.3	25.4	24.5	23.7	22.9	22.1	91
92	29.7	28.8	28.0	27.1	26.2	25.4	24.5	23.7	22.9	22.0	92
93	29.7	28.8	28.0	27.1	26.2	25.4	24.5	23.7	22.8	22.0	93
94	29.7	28.8	27.9	27.1	26.2	25.3	24.5	23.6	22.8	22.0	94

JOINT AND LAST SURVIVOR TABLE – CONTINUED

Included in the Final Regulations for the Minimum Required Distributions from Qualified Plans.
Effective 1/1/2003 Reference Final Regulations *§1.401(a)(9)-5*

Ages	55	56	57	58	59	60	61	62	63	64	Ages
95	29.7	28.8	27.9	27.1	26.2	25.3	24.5	23.6	22.8	22.0	95
96	29.7	28.8	27.9	27.0	26.2	25.3	24.5	23.6	22.8	21.9	96
97	29.7	28.8	27.9	27.0	26.2	25.3	24.5	23.6	22.8	21.9	97
98	29.7	28.8	27.9	27.0	26.2	25.3	24.4	23.6	22.8	21.9	98
99	29.7	28.8	27.9	27.0	26.2	25.3	24.4	23.6	22.7	21.9	99
100	29.7	28.8	27.9	27.0	26.1	25.3	24.4	23.6	22.7	21.9	100
101	29.7	28.8	27.9	27.0	26.1	25.3	24.4	23.6	22.7	21.9	101
102	29.7	28.8	27.9	27.0	26.1	25.3	24.4	23.6	22.7	21.9	102
103	29.7	28.8	27.9	27.0	26.1	25.3	24.4	23.6	22.7	21.9	103
104	29.6	28.8	27.9	27.0	26.1	25.3	24.4	23.5	22.7	21.9	104
105	29.6	28.8	27.9	27.0	26.1	25.3	24.4	23.5	22.7	21.9	105
106	29.6	28.8	27.9	27.0	26.1	25.3	24.4	23.5	22.7	21.9	106
107	29.6	28.8	27.9	27.0	26.1	25.2	24.4	23.5	22.7	21.8	107
108	29.6	28.8	27.9	27.0	26.1	25.2	24.4	23.5	22.7	21.8	108
109	29.6	28.7	27.9	27.0	26.1	25.2	24.4	23.5	22.7	21.8	109
110	29.6	28.7	27.9	27.0	26.1	25.2	24.4	23.5	22.7	21.8	110
111	29.6	28.7	27.9	27.0	26.1	25.2	24.4	23.5	22.7	21.8	111
112	29.6	28.7	27.9	27.0	26.1	25.2	24.4	23.5	22.7	21.8	112
113	29.6	28.7	27.9	27.0	26.1	25.2	24.4	23.5	22.7	21.8	113
114	29.6	28.7	27.9	27.0	26.1	25.2	24.4	23.5	22.7	21.8	114
115+	29.6	28.7	27.9	27.0	26.1	25.2	24.4	23.5	22.7	21.8	115+

JOINT AND LAST SURVIVOR TABLE – CONTINUED

Included in the Final Regulations for the Minimum Required Distributions from Qualified Plans.
Effective 1/1/2003 Reference Final Regulations *§1.401(a)(9)-5*

AGES	65	66	67	68	69	70	71	72	73	74	AGES
65	26.2	25.8	25.4	25.0	24.6	24.3	23.9	23.7	23.4	23.1	65
66	25.8	25.3	24.9	24.5	24.1	23.7	23.4	23.1	22.8	22.5	66
67	25.4	24.9	24.4	24.0	23.6	23.2	22.8	22.5	22.2	21.9	67
68	25.0	24.5	24.0	23.5	23.1	22.7	22.3	22.0	21.6	21.3	68
69	24.6	24.1	23.6	23.1	22.6	22.2	21.8	21.4	21.1	20.8	69
70	24.3	23.7	23.2	22.7	22.2	21.8	21.3	20.9	20.6	20.2	70
71	23.9	23.4	22.8	22.3	21.8	21.3	20.9	20.5	20.1	19.7	71
72	23.7	23.1	22.5	22.0	21.4	20.9	20.5	20.0	19.6	19.3	72
73	23.4	23.4	22.2	21.6	21.1	20.6	20.1	19.6	19.2	18.8	73
74	23.1	22.5	21.9	21.3	20.8	20.2	19.7	19.3	18.8	18.4	74
75	22.9	22.3	21.6	21.0	20.5	19.9	19.4	18.9	18.4	18.0	75
76	22.7	22.0	21.4	20.8	20.2	19.6	19.1	18.6	18.1	17.6	76
77	22.5	21.8	21.2	20.6	19.9	19.4	18.8	18.3	17.8	17.3	77
78	22.4	21.7	21.0	20.3	19.7	19.1	18.5	18.0	17.5	17.0	78
79	26.0	25.2	24.4	23.7	22.9	18.9	18.3	17.7	17.2	16.7	79
80	22.1	21.3	20.6	20.0	19.3	18.7	18.1	17.5	16.9	16.4	80
81	21.9	21.2	20.5	19.8	19.1	18.5	17.9	17.3	16.7	16.2	81
82	21.8	21.1	20.4	19.7	19.0	18.3	17.7	17.1	16.5	15.9	82
83	21.7	21.0	20.2	19.5	18.8	18.2	17.5	16.9	16.3	15.7	83
84	21.6	20.9	20.1	19.4	18.7	18.0	17.4	16.7	16.1	15.5	84
85	21.6	20.8	20.1	19.3	18.6	17.9	17.3	16.6	16.0	15.4	85
86	21.5	20.7	20.0	19.2	18.5	17.8	17.1	16.5	15.8	15.2	86
87	21.4	20.7	19.9	19.2	18.4	17.7	17.0	16.4	15.7	15.1	87
88	21.4	20.6	19.8	19.1	18.3	17.6	16.9	16.3	15.6	15.0	88
89	21.3	20.5	19.8	19.0	18.3	17.6	16.9	16.2	15.5	14.9	89
90	21.3	20.5	19.7	19.0	18.2	17.5	16.8	16.1	15.4	14.8	90
91	21.3	20.5	19.7	18.9	18.2	17.4	16.7	16.0	15.4	14.7	91
92	21.2	20.4	19.6	18.9	18.1	17.4	16.7	16.0	15.3	14.6	92
93	21.2	20.4	19.6	18.8	18.1	17.3	16.6	15.9	15.2	14.6	93
94	21.2	20.4	19.6	18.8	18.0	17.3	16.6	15.9	15.2	14.5	94
95	21.1	20.3	19.6	18.8	18.0	17.3	16.5	15.8	15.1	14.5	95
96	21.1	20.3	19.5	18.8	18.0	17.2	16.5	15.8	15.1	14.4	96
97	21.1	20.3	19.5	18.7	18.0	17.2	16.5	15.8	15.1	14.4	97
98	21.1	20.3	19.5	18.7	17.9	17.2	16.4	15.7	15.0	14.3	98
99	21.1	20.3	19.5	18.7	17.9	17.2	16.4	15.7	15.0	14.3	99
100	21.1	20.3	19.5	18.7	17.9	17.1	16.4	15.7	15.0	14.3	100
101	21.1	20.2	19.4	18.7	17.9	17.1	16.4	15.6	14.9	14.2	101
102	21.1	20.2	19.4	18.6	17.9	17.1	16.4	15.6	14.9	14.2	102
103	21.0	20.2	19.4	18.6	17.9	17.1	16.3	15.6	14.9	14.2	103
104	21.0	20.2	19.4	18.6	17.8	17.1	16.3	15.6	14.9	14.2	104

ANNUITY TABLE VI
Joint and Last Survivor: Unisex

Ages	55	56	57	58	59	60	61	62	63	64	Ages
55	34.4	33.9	33.5	33.1	32.7	32.3	32.0	31.7	31.4	31.1	55
56	33.9	33.4	33.0	32.5	32.1	31.7	31.4	31.0	30.7	30.4	56
57	33.5	33.0	32.5	32.0	31.6	31.2	30.8	30.4	30.1	29.8	57
58	33.1	32.5	32.0	31.5	31.1	30.6	30.2	29.9	29.5	29.2	58
59	32.7	32.1	31.6	31.1	30.6	30.1	29.7	29.3	28.9	28.6	59
60	32.3	31.7	31.2	30.6	30.1	29.7	29.2	28.8	28.4	28.0	60
61	32.0	31.4	30.8	30.2	29.7	29.2	28.7	28.3	27.8	27.4	61
62	31.7	31.0	30.4	29.9	29.3	28.8	28.3	27.8	27.3	26.9	62
63	31.4	30.7	30.1	29.5	28.9	28.4	27.8	27.3	26.9	26.4	63
64	31.1	30.4	29.8	29.2	28.6	28.0	27.4	26.9	26.4	25.9	64
65	30.9	30.2	29.5	28.9	28.2	27.6	27.1	26.5	26.0	25.5	65
66	30.6	29.9	29.2	28.6	27.9	27.3	26.7	26.1	25.6	25.1	66
67	30.4	29.7	29.0	28.3	27.6	27.0	26.4	25.8	25.2	24.7	67
68	30.2	29.5	28.8	28.1	27.4	26.7	26.1	25.5	24.9	24.3	68
69	30.1	29.3	28.6	27.8	27.1	26.5	25.8	25.2	24.6	24.0	69
70	29.9	29.1	28.4	27.6	26.9	26.2	25.6	24.9	24.3	23.7	70
71	29.7	29.0	28.2	27.5	26.7	26.0	25.3	24.7	24.0	23.4	71
72	29.6	28.8	28.1	27.3	26.5	25.8	25.1	24.4	23.8	23.1	72
73	29.5	28.7	27.9	27.1	26.4	25.6	24.9	24.2	23.5	22.9	73
74	29.4	28.6	27.8	27.0	26.2	25.5	24.7	24.0	23.3	22.7	74
75	29.3	28.5	27.7	26.9	26.1	25.3	24.6	23.8	23.1	22.4	75
76	29.2	28.4	27.6	26.8	26.0	25.2	24.4	23.7	23.0	22.3	76
77	29.1	28.3	27.5	26.7	25.9	25.1	24.3	23.6	22.8	22.1	77
78	29.1	28.2	27.4	26.6	25.8	25.0	24.2	23.4	22.7	21.9	78
79	29.0	28.2	27.3	26.5	25.7	24.9	24.1	23.3	22.6	21.8	79
80	29.0	28.1	27.3	26.4	25.6	24.8	24.0	23.2	22.4	21.7	80
81	28.9	28.1	27.2	26.4	25.5	24.7	23.9	23.1	22.3	21.6	81
82	28.9	28.0	27.2	26.3	25.5	24.6	23.8	23.0	22.3	21.5	82
83	28.8	28.0	27.1	26.3	25.4	24.6	23.8	23.0	22.2	21.4	83
84	28.8	27.9	27.1	26.2	25.4	24.5	23.7	22.9	22.1	21.3	84
85	28.8	27.9	27.0	26.2	25.3	24.5	23.7	22.8	22.0	21.3	85
86	28.7	27.9	27.0	26.1	25.3	24.5	23.6	22.8	22.0	21.2	86
87	28.7	27.8	27.0	26.1	25.3	24.4	23.6	22.8	21.9	21.1	87
88	28.7	27.8	27.0	26.1	25.2	24.4	23.5	22.7	21.9	21.1	88
89	28.7	27.8	26.9	26.1	25.2	24.4	23.5	22.7	21.9	21.1	89

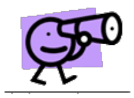
ANNUITY TABLE VI - CONTINUED
Joint and Last Survivor: Unisex

AGES	55	56	57	58	59	60	61	62	63	64	AGES
90	28.7	27.8	26.9	26.1	25.2	24.3	23.5	22.7	21.8	21.0	90
91	28.7	27.8	26.9	26.0	25.2	24.3	23.5	22.6	21.8	21.0	91
92	28.6	27.8	26.9	26.0	25.2	24.3	23.5	22.6	21.8	21.0	92
93	28.6	27.8	26.9	26.0	25.1	24.3	23.4	22.6	21.8	20.9	93
94	28.6	27.7	26.9	26.0	25.1	24.3	23.4	22.6	21.7	20.9	94
100	28.6	27.7	26.8	26.0	25.1	24.2	23.4	22.5	21.7	20.8	100
101	28.6	27.7	26.8	25.9	25.1	24.2	23.4	22.5	21.7	20.8	101
102	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.7	20.8	102
103	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.7	20.8	103
104	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8	104
105	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8	105
106	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8	106
107	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8	107
108	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8	108
109	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8	109
110	28.6	27.7	26.8	25.9	25.1	24.2	23.3	22.5	21.6	20.8	110
111	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8	111
112	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8	112
113	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8	113
114	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8	114
115	28.6	27.7	26.8	25.9	25.0	24.2	23.3	22.5	21.6	20.8	115

ANNUITY TABLE VI - CONTINUED
Joint and Last Survivor: Unisex

AGES	65	66	67	68	69	70	71	72	73	74	AGES
65	25.0	24.6	24.2	23.8	23.4	23.1	22.8	22.5	22.2	22.0	65
66	24.6	24.1	23.7	23.3	22.9	22.5	22.2	21.9	21.6	21.4	66
67	24.2	23.7	23.2	22.8	22.4	22.0	21.7	21.3	21.0	20.8	67
68	23.8	23.3	22.8	22.3	21.9	21.5	21.2	20.8	20.5	20.2	68
69	23.4	22.9	22.4	21.9	21.5	21.1	20.7	20.3	20.0	19.6	69
70	23.1	22.5	22.0	21.5	21.1	20.6	20.2	19.8	19.4	19.1	70
71	22.8	22.2	21.7	21.2	20.7	20.2	19.8	19.4	19.0	18.6	71
72	22.5	21.9	21.3	20.8	20.3	19.8	19.4	18.9	18.5	18.2	72
73	22.2	21.6	21.0	20.5	20.0	19.4	19.0	18.5	18.1	17.7	73
74	22.0	21.4	20.8	20.2	19.6	19.1	18.6	18.2	17.7	17.3	74
75	21.8	21.1	20.5	19.9	19.3	18.8	18.3	17.8	17.3	16.9	75
76	21.6	20.9	20.3	19.7	19.1	18.5	18.0	17.5	17.0	16.5	76
77	21.4	20.7	20.1	19.4	18.8	18.3	17.7	17.2	16.7	16.2	77
78	21.2	20.5	19.9	19.2	18.6	18.0	17.5	16.9	16.4	15.9	78
79	21.1	20.4	19.7	19.0	18.4	17.8	17.2	16.7	16.1	15.6	79
80	21.0	20.2	19.5	18.9	18.2	17.6	17.0	16.4	15.9	15.4	80
81	20.8	20.1	19.4	18.7	18.1	17.4	16.8	16.2	15.7	15.1	81
82	20.7	20.0	19.3	18.6	17.9	17.3	16.6	16.0	15.5	14.9	82
83	20.6	19.9	19.2	18.5	17.8	17.1	16.5	15.9	15.3	14.7	83
84	20.5	19.8	19.1	18.4	17.7	17.0	16.3	15.7	15.1	14.5	84
85	20.5	19.7	19.0	18.3	17.6	16.9	16.2	15.6	15.0	14.4	85
86	20.4	19.6	18.9	18.2	17.5	16.8	16.1	15.5	14.8	14.2	86
87	20.4	19.6	18.8	18.1	17.4	16.7	16.0	15.4	14.7	14.1	87
88	20.3	19.5	18.8	18.0	17.3	16.6	15.9	15.3	14.6	14.0	88
89	20.3	19.5	18.7	18.0	17.2	16.5	15.8	15.2	14.5	13.9	89
90	20.2	19.4	18.7	17.9	17.2	16.5	15.8	15.1	14.5	13.8	90
91	20.2	19.4	18.6	17.9	17.1	16.4	15.7	15.0	14.4	13.7	91
92	20.2	19.4	18.6	17.8	17.1	16.4	15.7	15.0	14.3	13.7	92
93	20.1	19.3	18.6	17.8	17.1	16.3	15.6	14.9	14.3	13.6	93
94	20.1	19.3	18.5	17.8	17.0	16.3	15.6	14.9	14.2	13.6	94
95	20.1	19.3	18.5	17.8	17.0	16.3	15.6	14.9	14.2	13.5	95
96	20.1	19.3	18.5	17.7	17.0	16.2	15.5	14.8	14.2	13.5	96
97	20.1	19.3	18.5	17.7	17.0	16.2	15.5	14.8	14.1	13.5	97
98	20.1	19.3	18.5	17.7	16.9	16.2	15.5	14.8	14.1	13.4	98
99	20.0	19.2	18.5	17.7	16.9	16.2	15.5	14.7	14.1	13.4	99
100	20.0	19.2	18.4	17.7	16.9	16.2	15.4	14.7	14.0	13.4	100
101	20.0	19.2	18.4	17.7	16.9	16.1	15.4	14.7	14.0	13.3	101
102	20.0	19.2	18.4	17.6	16.9	16.1	15.4	14.7	14.0	13.3	102
103	20.0	19.2	18.4	17.6	16.9	16.1	15.4	14.7	14.0	13.3	103
104	20.0	19.2	18.4	17.6	16.9	16.1	15.4	14.7	14.0	13.3	104

LUMP-SUM DISTRIBUTIONS



QUALIFICATIONS

- Only applies to plan participants **born before January 2, 1936 (Age 83 in 2018)**
- Only distributions from an employer's or self-employed individual's qualified plan: profit-sharing, stock purchase, pension or 403(a) annuity plan
- **Whole balance** must be **distributed**
- Uses **1986 Tax Rates**
- Can only be **used once after 1986**
- Distributions prior to 1986 must be included in computation
- Must have been in plan any part of **at least five years** (exception – beneficiary)
- Payment must be as a result of:
  1. **Separation from service**,
  2. **Death**, or
  3. **Disability** (applies to self-employed taxpayers only).

RAPID FINDER

Related IRC and IRS Publications and Forms

- **Form 4972** – Tax on Lump-Sum Distribution
- **Pub 575** – Pension and Annuity Income
- **IRC Sec. 402(d)** (prior to amendment by the Small Business Job Protection Act of 1996)
- **IRC Sec. 402(e)(4)(D)**

LUMP-SUM DISTRIBUTIONS

A "lump-sum distribution" is a special nonperiodic payment that can qualify for preferential tax treatment. It is a distribution (usually of cash and/or stock) from a qualified retirement plan, and it is generally made up of several parts:

- A taxpayer's after-tax contributions to the plan, which are tax-free at distribution;
- The taxable portion of the distribution attributable to pre-1974 active participation in the plan (this may qualify for long-term capital gain treatment as described below);
- The taxable part of the distribution, which is ordinary income (post-1973 additions to the plan).

QUALIFICATIONS

To qualify as a lump-sum distribution, the distribution must be **all** of the following:

1. A distribution from an employer's or self-employed individual's qualified plan--profit-sharing, stock purchase, pension or 403(a) annuity plan;
2. The whole balance credited to the recipient, excluding voluntary deductible employee contributions;
3. Payment within one tax year of the recipient (incidental payouts after the close of the tax year are permitted, but will be taxed as ordinary income). The entire payout does not need to occur in a specific year (e.g., the year the taxpayer retires), but it could take place years after a taxpayer's separation from company service;
4. Payment must be made because the employee: (a) "separated from service" (i.e., a common law employee retired, quit, was fired, or laid off from a job), or (b) reached age 59-1/2, or (c) died, or (d) became disabled (applies to self-employed taxpayers only). ***"Separation from service"*** means complete severance from all relationships between an employee and employer.
5. An employee must have a minimum of five years of plan participation before the distribution (waived if paid to a deceased employee's beneficiary). In *Robert Boyer, TC Memo 1988-220*, the Tax Court held that the 5-year requirement didn't mean 5 full years but "any part of at least 5 years."

10-YEAR AVERAGING

There is a special 10-year averaging computation for plan participants **born before January 2, 1936**. Generally, the only plans that qualify for the lump-sum averaging are Keogh, 401(k), and 403(a). SEPs, IRAs, 403(b) and

Nonqualified Deferred Comp plans are not allowed to use the lump sum averaging rules. For a large portion of the planning cases, the need to take a sizeable lump-sum distribution up front occurs very rarely.

Must include "all such amounts received during tax year." The Tax Court stated that an election to use 10-year averaging for a lump-sum distribution is available only if all lump-sum distributions received in a given year are included in the election ***(O. Fowler, 98 TC, No. 34)***.

Taxability options, regardless of the taxpayer's age:

A) **Rollover:** The taxable part of the distribution can be rolled over in whole or in part to an IRA (or other qualified plan). The part rolled over will not be currently taxed; the part not rolled over will be taxed as ordinary income.

B) **Ordinary income:** The whole distribution (taxable part) can be included as ordinary income on Schedule 1, Form 1040 (2018 draft), and taxed along with other income at regular rates.

AVERAGING OPTIONS AVAILABLE TO TAXPAYERS

If 10-year averaging is elected, 1986 tax rates are used to compute the tax on Form 4972. *Note: 10-Year averaging tax approximation table included at the end of this section.* ***Born before January 2, 1936*** – Two options available:

1) Treat the entire distribution (ordinary and capital gain) as ordinary income and compute the tax using the 10-year averaging on Form 4972.

2) Report the ordinary income portion of the distribution on Form 4972, using 10-year averaging to figure the tax. Report the capital gain portion of the distribution on Form 4972, using a flat 20% rate to compute the tax. ***(Note: this rate has not been reduced to reflect the current 0% and 15% maximum capital gains tax rates.)***

One-time option - If a taxpayer used either the 5-year (no longer available) or 10-year averaging methods for any lump-sum distribution received after 1986, a taxpayer can't use them for any other distribution received in a later year. However, if the beneficiary of a deceased plan participant makes the election to use one of these methods for an inherited lump sum, that election doesn't affect any election the beneficiary can make for his/her own qualified plan. A taxpayer can also make such an election as beneficiary of more than one qualifying person.

> ***Example - Beneficiary's Use of Special Averaging -*** *In 2019 Ethel's 86-year-old brother died. Ethel was the beneficiary of her brother's retirement plan and received a lump-sum distribution of the plan's proceeds. Because her brother was born before January 2, 1936, Ethel may elect either method (1) or (2) described above to compute the tax on the distribution. Ethel, who was born in 1935, plans to retire in 2020 and will be receiving a lump-sum distribution from her employer's 401(k) plan. The elections she makes regarding the tax treatment of her brother's distribution won't affect the elections she may make for the distribution from her own plan.*

TO COMPUTE THE AMOUNT OF A LUMP SUM THAT IS TAXABLE

(1) Begin with the total amount of the distribution (cash and stock).

(2) SUBTRACT nondeductible employee contributions not previously recovered.

(3) SUBTRACT "unrealized appreciation" of employer stock (i.e., the current value less cost of the stock to the trust) which is included in the distribution. Net unrealized appreciation on the securities is not taxable until the securities have been sold. However, a taxpayer may elect to include net unrealized appreciation in income in the year the distribution is received. The instructions to Form 4972 describe the procedure to use to make the election.

(4) THE RESULT is the taxable amount.

SPECIAL AVERAGING METHOD OR 20% CAPITAL GAIN ELECTION CAN'T BE USED FOR ANY OF THE FOLLOWING:

(1) U.S. Retirement Plan Bonds distributed with a lump sum.

(2) Any distribution made during the first 5 tax years that the employee was a participant in the plan, unless it was made because the employee died.

(3) The current actuarial value of an annuity contract included in a lump-sum distribution. (However, this value is used to figure tax on the ordinary income part of the distribution under the 10-year tax option method.)

(4) A distribution to a 5% owner that is subject to a penalty, because it exceeds the benefits provided under the plan formula.

(5) A distribution from an IRA.

(6) A distribution of the redemption proceeds of bonds rolled over tax-free to the plan from a qualified bond purchase plan.

(7) A distribution from a qualified plan if the plan participant or his or her surviving spouse previously received an eligible rollover distribution from the same plan (or another plan of the employer that must be combined with that plan for the lump-sum distribution rules), and the previous distribution was rolled over tax-free to another qualified plan or to an IRA.

(8) A corrective distribution of excess deferrals, excess contributions, excess aggregate contributions, or excess annual additions.

(9) A lump sum credit or payment from the Federal Civil Service Retirement System (or the Federal Employees Retirement System).

(10) A distribution from a Sec. 403(b) plan (tax-sheltered annuity).

(11) A distribution from a qualified plan, if any part of the distribution is rolled over tax-free to another qualified plan or IRA.

(12) A distribution from a privately purchased commercial annuity.

(13) A distribution from a Section 457 deferred compensation plan of a state or local government, or a tax-exempt organization.

(14) A distribution from a qualified plan that received a rollover after 2001 from an IRA (other than a conduit IRA), a Section 457 plan or a Section 403(b) tax sheltered annuity on behalf of the plan participant.

(15) A distribution from a qualified plan that received a rollover after 2001 from another qualified plan on behalf of that plan participant's surviving spouse.

(16) Any distribution if an earlier election to use either the 5- or 10-year averaging had been made after 1986 for the same plan participant.

FORM 1099-R

Lump sum distribution recipients should receive Form 1099-R showing the ordinary income and capital gain portions of the distribution. Net unrealized appreciation will also be shown if all or part of the distribution consists of appreciated employer securities. If 10-year averaging is not elected, or the taxpayer doesn't qualify to use it, the ordinary income portion of the distribution is reported as a fully taxable pension on Form 1040 unless it has been rolled over within 60 days of being received or was transferred directly to an IRA or another eligible plan in a trustee-to-trustee arrangement.

TEN-YEAR AVERAGING (FORM 4972) – Tax Approximations

TI	TAX	%	TI	TAX	%	TI	TAX	%
1000	55	5.50	17000	935	5.50	85000	11905	14.01
2000	110	5.50	18000	990	5.50	90000	12705	14.12
3000	165	5.50	19000	1045	5.50	95000	13571	14.29
4000	220	5.50	20000	1100	5.50	100000	14471	14.47
5000	275	5.50	25000	1801	7.20	150000	24570	16.38
6000	330	5.50	30000	2521	8.40	200000	36922	18.46
7000	385	5.50	35000	3347	9.56	250000	50770	20.31
8000	440	5.50	40000	4187	10.47	300000	66330	22.11
9000	495	5.50	45000	5027	11.17	350000	83602	23.89
10000	550	5.50	50000	5874	11.75	400000	102602	25.65
11000	605	5.50	55000	6774	12.32	450000	122682	27.26
12000	660	5.50	60000	7674	12.79	500000	143682	28.74
13000	715	5.50	65000	8574	13.19	750000	259368	34.58
14000	770	5.50	70000	9505	13.58	1000000	382210	38.22
15000	825	5.50	75000	10305	13.74			
16000	880	5.50	80000	11105	13.88			

CALIFORNIA DIFFERENCES

California conforms to Federal treatment, including 10-year averaging based on the 1986 CA tax rates and a capital gain election – but only for participants born before January 2, 1936. The rate for the capital gain election is 5.5% instead of 20%. Use California Schedule G-1.

NOTES

ROLLOVERS

For IRA to Roth Rollovers (Conversions) See Chapter 4.06

Overview

- ***Rollover:*** *Tax-free withdrawal of cash or other assets from one retirement plan and its reinvestment in another retirement program where taxpayer receives the distribution and makes the reinvestment within the rollover period.*
- ***Rollover Period:*** *Generally within 60 days unless a waiver is granted or self-certification applies (120 days for a failed qualified first time homeowner withdrawal)*
- ***Eligible Rollover Distribution:*** *Generally from any qualified plan to any other qualified plan.*
- ***Withholding:*** *20% unless directly transferred.*
- ***Direct Rollovers:*** *Transfer is made directly by the trustee or custodian of one qualified retirement plan to the trustee/custodian of another qualified plan. Also termed a trustee-to-trustee transfer. Qualified plan to Roth IRAs allowed.*

RAPID FINDER

Pubs Forms

Related IRS Publications and Forms

- **Form 1099R** – Distributions from Pension and Annuities
- **Instructions Form 1099R and Form 5498**
- **Pub 575** – Pension and Annuity Income
- **Pub 590 –** Individual Retirement Accounts (IRAs)

The Details

A rollover is a tax-free withdrawal of cash or other assets from one retirement plan and its reinvestment in another retirement program. The amount transferred is excluded from gross income in the year of the transfer. A qualified plan generally must provide participants who receive distributions with the election to have an "eligible rollover distribution" paid directly to an "eligible retirement plan"--i.e., in a trustee-to-trustee transfer. This rule is in accord with the income tax withholding rules for "eligible rollover distributions."

WHO CAN ROLL OVER A RETIREMENT PLAN DISTRIBUTION?

The following taxpayers can qualify to roll over retirement plan distributions:

(1) The pension plan participant,
(2) Spouse of a deceased plan participant,
(3) Non-spouse beneficiary (Post-2006 and beneficiary RMD rules still apply), and
(4) An alternate payee **spouse** under a "qualified domestic relations order."

Surviving Spouse Could Not Roll Over Her Community Property Interest In IRA **-** In a situation where a deceased husband's IRA named the husband's son as sole beneficiary but the state court had assigned half of the IRA to the surviving spouse as community property, the surviving spouse was unable to roll over her portion of the IRA because she was not the named beneficiary. In a private letter ruling the IRS concluded that since community property interests must be disregarded under Code Sec. 408(g), she couldn't be treated as a payee of the inherited IRA for her son and therefore distribution rules must be applied without regard to community property laws, making the entire distribution taxable to the son. (**Private Letter Ruling 201623001**)

QUALIFIED PLAN TO IRA ROLLOVERS FOR NON-SPOUSE BENEFICIARIES

Direct rollovers of distributions from an eligible retirement plan (e.g., a qualified plan) of a deceased employee to a non-spouse beneficiary's IRA are allowed. If the non-spouse beneficiary receives a distribution from a plan, it is not eligible for rollover; the transfer must be trustee-to-trustee. The rollover is treated as an eligible rollover distribution and distributions from the beneficiary's IRA are subject to the RMD rules that apply to inherited IRAs of non-spouse beneficiaries: distributions must begin immediately; they cannot be delayed until the non-spouse beneficiary turns age 70 ½.

CAUTION

The distribution is subject to RMD rules for inherited IRAs. The account needs to be set up as an "inherited IRA" (aka "beneficiary IRA") with the decedent as the owner and the inheritor as the beneficiary (example: "Tom Smith as beneficiary of John Smith"). The beneficiary can get the funds transferred from the decedent's qualified plan into an account that he or she has more control over. There **IS NO** provision allowing postponement of the withdrawal until the beneficiary reaches age 70 1/2 as there is when a spouse inherits.

To the extent provided by IRS, the provision applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary. The IRA must be set up with the trust identified as the beneficiary (IRS Notice 2007-7, Q&A 16).

IRA TO QUALIFIED PLAN ROLLOVERS

When rollovers are discussed, it is generally assumed that the rollover is from a qualified employer plan to an IRA or from an IRA to another IRA. The IRA is generally assumed to be the ending depository of the funds. However, rollovers can be made from an IRA to a qualified plan, which can provide some interesting tax planning opportunities.

Caution

Qualified plans are permitted to receive IRA funds but they are not required by law to accept funds from them, so the plan administrator of the receiving plan should be consulted before attempting a rollover.

Caution

For an amount received by a qualified plan to be a lump-sum distribution eligible for capital gains or special averaging treatment for distributions to individuals born before Jan. 2, 1936, it must contain only funds that originally qualified for the capital gains or special averaging treatment. Thus, regular (non-rollover) contributions should not be made to a rollover IRA if the distributee of the original rollover contribution wants to preserve the chance to roll the original contribution into a qualified plan for purposes of preserving the availability of special averaging and capital gains treatment of distributions from the qualified plan.

Only the taxable amount can be rolled – Generally, only the taxable amount of an IRA may be rolled over to an eligible retirement plan. In other words, nondeductible contributions to an IRA may not be rolled over to an eligible retirement plan. *(Code Sec. 408(d)(3)(H))* In determining the maximum amount that may be rolled over, an IRA aggregation rule applies to avoid tracing problems. **Caution:** See "non-deductible contribution direct rollovers" later in this chapter.

- **Special aggregation rule for determining taxable amount -** An individual may have multiple IRAs and make nondeductible contributions to one or more of them. He does not have to limit a rollover from any of these IRAs to an eligible retirement plan to the actual taxable amount in that particular IRA. That's because, under Code Sec. 408(d)(3)(H)(ii)(II), the part being rolled over is considered to come from amounts in all IRAs other than nondeductible contributions. This is so notwithstanding Code Sec. 408(d)(2)(A), which normally requires basis to be recovered pro rata when amounts are withdrawn from an IRA and the IRA owner has made nondeductible contributions to any IRA. Code Sec. 408(d)(2)(A) achieves the pro-rata recovery rule by treating all IRAs as one IRA in applying the annuity rules of Code Sec. 72 to tax IRA distributions. Code Sec. 408(d)(3)(H)(ii) provides an exception to the usual application of the annuity rules to achieve the result indicated above.

ADVANTAGES OF ROLLOVERS

(1) They postpone the payment of tax until the funds are withdrawn from the new plan;
(2) They provide a taxpayer with the opportunity of being in a lower tax bracket when the funds are withdrawn from the rollover account;
(3) Funds can continue to accumulate in the new plan on a tax-deferred basis.

DISADVANTAGES OF ROLLOVERS

(1) Amounts can't generally be withdrawn prior to age 59-1/2 without penalty;
(2) If the rollover was into an IRA (or a qualified plan that received a post-2001 rollover from an IRA, Sec. 457 or 403(b) plan), withdrawals are ordinary income and don't get any benefit of 10-year averaging.

DIRECT ROLLOVERS - QUALIFIED RETIREMENT PLANS TO ROTH IRAS

Distributions can be rolled over directly into a Roth IRA from:

- Qualified retirement plans,
- Tax-sheltered annuities, and
- Governmental Code Sec. 457 plans.

The rollover, however, is still subject to the usual rules that apply to rollovers from a traditional IRA into a Roth IRA:

- Includible in gross income (except to the extent it represents a return of after-tax contributions), and
- The 10% early distribution tax does not apply

For more information on rollovers (conversions) to Roth IRAs, see Course CPE406 or Chapter 4.06.

DEFINITIONS

"Eligible Rollover Distribution" - Any payout to an employee of all or any portion of the balance to the credit of the employee in a qualified trust. However, it does not include:

(1) Any distribution, which is one of a series of substantially equal periodic payments;
(2) A minimum required distribution;
(3) Returns of excess 401(k) elective deferrals;
(4) The nontaxable portion of the distribution;
(5) Loans treated as distributions, because they didn't meet certain requirements at the time they were made or later (e.g., default) unless a participant's accrued benefits are reduced to repay the loan;
(6) Dividends on employer securities;
(7) Cost of life insurance coverage;
(8) Hardship distributions.

A single sum payment not substantially equal to a periodic payment made before, with or after start of periodic payments is eligible for rollover treatment.

"Eligible Retirement Plans" - Eligible rollover distributions from a qualified retirement plan, IRA, Sec. 403(b) annuity, or Sec. 457 deferred compensation plan may be rolled over to an *eligible retirement plan*, defined as:

- Sec 408(a) Individual Retirement Accounts
- Sec 408(b) Individual Retirement Annuities
- Sec 401(a) Qualified Plans
- Sec 403(b) Qualified Annuities
- Sec 403(b) Tax Sheltered Annuities or
- Sec 457 Governmental plans (deferred compensation plans of state and local governments and tax-exempt organizations).

In other words, an eligible rollover distribution from any type of eligible retirement plan can be rolled into any other eligible retirement plan, provided the new plan agrees to accept the rollover amount.

NON-DEDUCTIBLE CONTRIBUTION DIRECT ROLLOVERS

Generally rollovers only include the taxable amount of a distribution with certain exceptions for:

- Distributions of employer securities with net unrealized appreciation (See below)
- Rollovers that meet the following specific requirements (must provide for separate non-taxable contribution accounting). Thus non–taxable amounts can be rolled over to:
  (1) An IRA (Code Sec. 402(c)(2)(B)), or
  (2) A Code Sec. 401(a) qualified plan (whether or not a defined contribution plan) or a 403(b) annuity contract—
    (a) In a direct trustee-to-trustee transfer,
    (b) That provides, for the amounts rolled over, and the earnings on these amounts, separate accounting for (i) the portion which was includible in income (if not for the rollover exclusion), and (ii) the portion that was not includible in income (determined without regard to the rollover exclusion). Code Sec. 402(c)(2)(A)

After-tax contributions can be rolled over from a qualified retirement plan to:

(1) Another qualified retirement plan (either a defined contribution or a defined benefit plan); or
(2) A tax-sheltered annuity.

The transfer must be made via direct rollover, and the receiving plan must separately account for after-tax contributions and their earnings.

DISBURSEMENTS FROM DESIGNATED ROTH ACCOUNTS TO MULTIPLE QUALIFIED PLANS

The IRS has released the rules, effective January 1, 2016, for disbursements from a "designated Roth account" that is directly rolled over to qualified plans established under section 401(a), section 403(b), or section 457(b). Under these rules, if disbursements are made from a taxpayer's designated Roth account to the taxpayer and also to the taxpayer's Roth IRA or designated Roth account in a direct rollover, **then pretax amounts will be allocated first to the direct rollover, rather than being allocated pro rata to each destination.** Also, a taxpayer will be able to direct the allocation of pretax and after-tax amounts that are included in disbursements from a designated Roth account that are directly rolled over to multiple destinations, applying the same allocation rules to distributions from designated Roth accounts that apply to distributions from other types of accounts as discussed next (T.D. 9769, IRB 2016-23, 6/6/16).

ALLOCATING PRE- AND POST-TAX DISTRIBUTIONS TO MULTIPLE DESTINATIONS

If a distribution on or after January 1, 2015 goes to multiple destinations (for example, part to a direct rollover and part to the employee who makes a rollover within 60 days), after-tax and pre-tax amounts may be assigned to each destination under rules set out in Notice 2014-54, describing proposed amendments to Reg § 1.402A-1. The following summarizes these rules:

Pre-tax Amount Equals or Exceeds Distribution Amount that is directly rolled over to one or more eligible retirement plans: the pre-tax amount is assigned to the portion of the distribution that is directly rolled over, up to the amount of the direct rollover. Thus each direct rollover consists entirely of pretax amounts.

Any Remaining Pre-tax Amount: This amount is assigned to rollovers that aren't direct rollovers (i.e., those done under the 60-day rollover rule), up to the amount of the 60-day rollovers.

Any Additional Remaining Pre-tax Amount, if it is less than the amount rolled over in 60-day rollovers: the recipient can select how the pretax amount is allocated among the plans that receive 60-day rollovers.

Still More Remaining Pre-tax Amount: That amount is includible in the distributee's gross income.

> ***Example – partial direct rollover plus 60-day rollover:*** Clara participates in her employer's qualified plan that does not contain a designated Roth account. Clara's $250,000 account balance consists of $200,000 of pretax amounts and $50,000 of after-tax amounts. She separates from service and is entitled to, and requests, a distribution of $100,000. Under §72(e)(8), the pretax amount with respect to the distribution is $80,000 ($100,000 x $200,000/$250,000). Clara specifies that $70,000 is to be directly rolled over to her new employer's qualified plan and that $30,000 is to be paid to her. Because the pretax amount exceeds the amount directly rolled over, the amount directly rolled over to the new plan consists entirely of pretax amounts. The amount paid to Clara (prior to application of withholding) consists of $10,000 in pretax amounts and $20,000 in after-tax amounts. Prior to the 60th day after the distribution, Clara chooses to roll over $12,000 to an IRA. Because the amount rolled over in the 60-day rollover exceeds the remaining pretax amounts, the amount rolled over to the IRA consists of $10,000 of pretax amounts and $2,000 of after-tax amounts.
>
> ***Example – direct rollovers to traditional and Roth IRAs:*** The facts are the same as in the prior example, except that Clara chooses to make a direct rollover of $80,000 to a traditional IRA and $20,000 to a Roth IRA. She is permitted to allocate the $80,000 that consists entirely of pretax amounts to the traditional IRA so that the $20,000 rolled over to the Roth IRA consists entirely of after-tax amounts.

If the amount rolled over to an eligible retirement plan exceeds the portion of the pre-tax amount assigned or allocated to the plan, the excess is an after-tax amount.

Multiple 1099-Rs - According to Notice 2014-54, if one distribution results in multiple disbursements, each disbursement may be required to be reported on a separate Form 1099-R, in accordance with the instructions to Form 1099-R.

EMPLOYER SECURITIES, NET UNREALIZED APPRECIATION AND ROLLOVERS

When the taxpayer sells or exchanges employer securities received as a distribution from a qualified plan, the "basis" in the stock is the price paid for the stock by the plan. Any increase in stock value prior to distribution is referred to as "net unrealized appreciation" and is not included in the taxable amount of the distribution. If the taxpayer were to take a taxable distribution, the taxpayer would therefore only be taxed on the stock "basis." If the taxpayer then sold the stock, the following would apply:

1. Any gain up to the amount of the "net unrealized appreciation" would be taxed as *long-term* capital gain. *(Reg § 1.402(a)-1(b)(1)(i))*
2. Any part of the gain that is more than the net unrealized appreciation at the time of distribution is a long-term or short-term capital gain, depending on how long the taxpayer held the securities from the date they were distributed to the taxpayer. *(Reg § 1.402(a)-1(b)(1)(i); Notice 98-24 , 1998-17 IRB 5)*

With maximum capital gains rates ranging from 0% to 20%, being taxed currently on the distribution might be a better option than rolling the distribution over to where it would be taxed at ordinary rates when ultimately distributed in a later year. If a taxpayer is under age 59-1/2, the premature distribution penalty will also have to be considered before making a decision.

WITHHOLDING

"Eligible rollover distributions" are subject to a 20% withholding requirement. The requirement can be avoided only if a taxpayer arranges for the distribution to be transferred directly to another retirement plan or IRA.

> ***Example - Withholding on "Eligible Rollover Distributions" -*** *Gray, age 62, retired from ABC Enterprises. His retirement plan at ABC contained $102,000 (pre-tax dollars), which was eligible for rollover. Gray requested that the distribution of the entire amount in the plan be made to him personally; he then intended to roll over the proceeds to an IRA. Because Gray received the retirement plan payout directly, the plan administrator was required to withhold $20,400 ($102,000 x 20%). The net distribution to Gray is $81,600 ($102,000 - $20,400).*
>
> *Gray rolled $81,600 to an IRA within the allotted 60-day period. Six months later, he contacted his tax preparer for tax planning. When he explained the details of the distribution, his tax preparer realized that Gray would owe additional tax on $20,400 ($102,000 - $81,600), because he failed to roll over the entire $102,000. It was too late for Gray to fully fund the rollover IRA by adding $20,400 of other money because the 60-day rollover period had expired.*

AVOIDING WITHHOLDING

Using an IRA to receive a direct transfer of an eligible rollover distribution may help a taxpayer overcome these withholding rules, because IRA distributions are not subject to the 20% withholding requirement.

If a retirement plan recipient elects to have only a portion of an eligible rollover distribution paid directly to another plan, and elects to receive the remainder, the mandatory 20% withholding applies only to the portion not directly transferred. For distributions of less than $200, no withholding is required (aggregate all eligible distributions received within one tax year to determine whether the $200 limit is reached). If the plan administrator doesn't know at the time of the first distribution whether there will be other eligible distributions during the year that would reach the $200 floor, no tax need be withheld on the first distribution.

> ***Example - Partial Trustee-To-Trustee Transfer -*** *Linda, age 60, is to receive a $45,000 cash lump sum distribution. She had contributed $7,000 (post-tax) to the plan. She instructs the plan administrator to transfer $30,000 of the distribution to an IRA and the balance to her.* ***RESULT:*** *The $30,000 IRA deposit is a tax-free rollover. Of the remaining $15,000, $8,000 is taxable as ordinary income and $7,000 is nontaxable recovery of Linda's post-tax contributions to the plan. Linda's employer will withhold 20% ($1,600) of the $8,000 ordinary income amount.*

PARTIAL ROLLOVERS

As indicated above, an employee doesn't have to roll over an entire "eligible rollover distribution." However, the part not rolled is ordinary income and 10-year averaging and/or capital gain treatment, where applicable, can't be used. In addition, net unrealized appreciation in employer securities attributable to nondeductible employee contributions is immediately taxable. If the employee is under age 59-1/2, the portion of the distribution not rolled over generally will be subject to the 10% early distribution penalty.

ROLLOVERS AFTER AGE 70-1/2

Rollovers can be made even after the year a taxpayer reaches age 70-1/2. However, the requirements for IRA "minimum distributions" after age 70-1/2 continue to apply. Amounts required to be distributed at age 70-1/2 cannot be rolled over (TRA '86).

ROLLOVER OF NONCASH DISTRIBUTION

Distributions of property other than cash present special tax problems, but they do qualify for rollover treatment as long as the property is not prohibited by the IRA rules (e.g., investment in certain "collectibles" is prohibited for IRA purposes). The actual noncash property distributed must be rolled over in order to qualify for tax-free treatment. However, the recipient is allowed to sell the property and roll the proceeds. Employees who get a property distribution can't keep the property and roll over its cash equivalent.

Gains and losses on a sale of the distributed property are not recognized if all the proceeds are rolled over. Any increase in the FMV between the time of distribution and the time of rollover is treated as part of the distribution (assuming rollover of the entire distribution). *Code Sec. 402(c)(6)(D)*

> ***Example - Retention of Property in a Rollover -*** *Claire received a payout from her employer's profit-sharing plan. The distribution consisted of $12,000 in cash and $14,000 of other property. Within the sixty-day window, Claire contributed $26,000 in cash to an IRA and kept the property she had received as part of the distribution. Under these circumstances, only $12,000 of Claire's IRA contribution qualifies as a tax-free rollover.*

> ***Example - Sale of Property Before Rollover -*** *Jim received a lump sum distribution of $105,000 ($40,000 was stock and the remaining $65,000 was cash). Within sixty days, Jim sold the stock for $50,000. The maximum Jim may roll over is $115,000 ($65,000 cash plus $50,000 stock proceeds).*

> ***Example - Sale of Distributed Property at a Loss -*** *Assume the same facts as in the previous example, except Jim sold the stock for $25,000. In this case, his maximum rollover is $90,000 ($65,000 cash plus $25,000 stock proceeds). He recognizes no gain or loss on the sale to the extent he rolls over the entire distribution. Neither will he recognize any taxable income from the lump sum distribution. The instructions for the 1040 provide no special instructions for reporting such a non-taxable rollover. Presumably, the entire distribution (in this case $105,000) would be reported as rolled over.*

> ***Example – Sale of Distributed Property at a Loss with Partial Rollover*** *– Maria received an eligible rollover distribution from her employer's noncontributory qualified employee plan of $80,000 in non-employer stock on October 1. Within the same year she sold the stock on November 1 for $70,000 and on November 10, she rolled over $55,000 of the $70,000 sale proceeds. The $15,000 she didn't roll over includes part of the loss from the stock sale. She reports a capital loss of $2,143 ($10,000/$70,000 x $15,000) and ordinary income of $17,143 ($80,000/$70,000 x $15,000)*

THE 60-DAY ROLLOVER PERIOD

In general, the 60-day period for making rollover contributions is not extended for any reason. The period begins to run on the date the check is received, not the date on the check. Certain distributions that become "frozen deposits" during the 60-day rollover period do get a special extension of the 60-day time frame. The time the amount is a frozen deposit doesn't count as part of the 60-day period. After the funds are "unfrozen," the period begins to run again, but it doesn't end until at least 10 days after funds are released. A "frozen deposit" is any deposit which can't be withdrawn because of: (1) bankruptcy or insolvency of a financial institution, or (2) any state requirement imposed because of a financial institution's bankruptcy.

60 Day Deadline Doesn't Apply to Direct Rollover via Check – IRS has ruled that the 60-day deadline on retirement plan rollovers doesn't apply to direct rollovers made by way of a properly drawn check. In this instance the distribution check was given to the taxpayer, but made out to the new employer "for benefit of" the taxpayer; thus the check was not payable to the taxpayer – in effect the taxpayer never received a distribution that was subject to the 60 day rule. The fact that the taxpayer held onto the check drawn by the transferor plan for more than 60 days didn't convert the rollover into a taxable transfer. **PLR 201005057**

120-Day Rollover Period – If funds are withdrawn to purchase a home and the buyer(s) qualifies as a first time homebuyer(s) and the purchase cannot be completed within the 120-day time period, the taxpayer may re-contribute the funds to the IRA account as long as 120 days have not passed since the withdrawal. In other words for first time homebuyers the 60-day rollover period is replaced with 120 days. For this purpose a first-time homebuyer is one who had no present interest in a main home during the 2-year period ending on the date of acquisition of the home, which the distribution is being used to buy, build or rebuild. If married, the spouse also must meet the no-ownership requirement.

Extension of 60-Day Period Due to Certain Disasters – The IRS will postpone certain retirement plan and IRA deadlines, including the 60-day rollover period, for taxpayers affected by a presidentially declared disaster. (Rev Proc 2007-56)

WAIVER OF 60-DAY ROLLOVER RULE

Rev Proc 2003-16, 2003-4 IRB - In this revenue procedure, IRS says it will automatically waive the 60-day rule for qualified plan and IRA rollovers if financial institution error caused the rollover to be untimely and several other conditions are met. Otherwise, taxpayers must apply for a private letter ruling to obtain a hardship waiver (but see "Self-Certifying," below).

Criteria for automatic waiver - The 60-day rule is waived automatically if a financial institution's error caused the rollover to be untimely. The automatic waiver is granted only if ALL of the following apply:

- The financial institution received the funds on behalf of the taxpayer before the 60-day rollover period expires;
- The taxpayer followed all of the financial institution's procedures for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan);
- Solely due to the financial institution's error, the funds are not deposited into an eligible retirement plan within the 60-day rollover period;
- There *would* have been a valid rollover, if the financial institution had deposited the funds as instructed; and
- The funds are actually deposited into an eligible retirement plan within one year from the beginning of the 60-day rollover period. (Rev Proc 2003-16, Sec. 3.03)

Criteria for waiver based on facts and circumstances - If the taxpayer does not meet the criteria for automatic waiver, but still believes that he or she meets the requirements due to the facts and circumstances of his or her situation, the taxpayer can apply for a hardship exception to the 60-day rollover requirement using the procedures outlined in Rev. Proc.2018-4 for letter rulings, accompanied by the required user fee.

Private letter ruling process for obtaining waiver of the 60-day rule - Taxpayers who don't qualify for an automatic waiver of the 60-day rule may be able to obtain a waiver by applying for a private letter ruling. See Rev. Procs. 2003-16 and 2019-4, Appendix D, where the sample letter ruling request in Appendix A can be followed. There is an IRS user fee for this type of private letter ruling.

Effective February 1, 2016, the fee is **$10,000**. (Rev Proc 2016-8 Sec. 6.01(4)) Previously the fee ranged between $500 and $3,000 depending upon the amount of the rollover.

Affected plans - The 60-day waiver rules apply to distributions from an IRA, individual retirement annuity, a qualified plan under Code Sec. 401(a), a Code Sec. 403(b) tax-sheltered annuity, and a Code Sec. 457 eligible governmental plan. (Rev Proc 2016-8)

SELF-CERTIFYING LATE 60-DAY ROLLOVER

A recipient of a retirement plan or IRA distribution who inadvertently misses the 60-day time limit for properly rolling the amount into another retirement plan or IRA now may make a written certification to a plan administrator or an IRA trustee that a contribution satisfies the conditions listed below, and therefore, will be eligible for a waiver of the 60-day rule. Taxpayers may make the certification by using the model IRS letter illustrated below on a word-for-word basis or by using a letter that is substantially similar in all material respects. A copy of the certification should be kept in the taxpayer's files and be available if requested on audit. (Rev. Proc. 2016-47) Use of the self-certification method by eligible taxpayers will generally eliminate the need for the expensive private letter ruling discussed above to request a waiver.

Conditions for self-certification - No prior denial by the IRS - The IRS must not have previously denied a waiver request with respect to a rollover of all or part of the distribution to which the contribution relates.

Reason for missing 60-day deadline - The taxpayer must have missed the 60-day deadline because of the taxpayer's inability to complete a rollover due to one or more of the following reasons:

(a) an error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates;
(b) the distribution, having been made in the form of a check, was misplaced and never cashed;
(c) the distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan;
(d) the taxpayer's principal residence was severely damaged;
(e) a member of the taxpayer's family died;
(f) the taxpayer or a member of the taxpayer's family was seriously ill;
(g) the taxpayer was incarcerated;
(h) restrictions were imposed by a foreign country;
(i) a postal error occurred;
(j) the distribution was made on account of a levy under § 6331 and the proceeds of the levy have been returned to the taxpayer; or
(k) the party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

Up to 30 days allowed to make the contribution – The contribution must be made to the plan or IRA as soon as practicable after the reason or reasons listed above no longer prevent the taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent the taxpayer from making the contribution.

Effective date – This revenue procedure is effective August 24, 2016

Certification for Late Rollover Contribution

[Name]
[Address]
[City, State, ZIP Code]
[Date]

[Plan Administrator/Financial Institution]
[Address]
[City, State, ZIP Code]

Dear Sir or Madam:

Pursuant to Internal Revenue Service Revenue Procedure 2016-47, I certify that my contribution of $ [*ENTER AMOUNT*] missed the 60-day rollover deadline for the reason(s) listed below under Reasons for Late Contribution. I am making this contribution as soon as practicable after the reason or reasons listed below no longer prevent me from making the contribution. I understand that this certification concerns only the 60-day requirement for a rollover and that, to complete the rollover, I must comply with all other tax law requirements for a valid rollover and with your rollover procedures.

Pursuant to Revenue Procedure 2016-47, unless you have actual knowledge to the contrary, you may rely on this certification to show that I have satisfied the conditions for a waiver of the 60-day rollover requirement for the amount identified above. You may not rely on this certification in determining whether the contribution satisfies other requirements for a valid rollover.

Reasons for Late Contribution

I intended to make the rollover within 60 days after receiving the distribution but was unable to do so for the following reason(s) (check all that apply):

___ An error was committed by the financial institution making the distribution or receiving the contribution.

___ The distribution was in the form of a check and the check was misplaced and never cashed.

___ The distribution was deposited into and remained in an account that I mistakenly thought was a retirement plan or IRA.

___ My principal residence was severely damaged.

___ One of my family members died.

___ I or one of my family members was seriously ill.

___ I was incarcerated.

___ Restrictions were imposed by a foreign country.

___ A postal error occurred

___ The distribution was made on account of an IRS levy and the proceeds of the levy have been returned to me.

___ The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite my reasonable efforts to obtain the information.

Signature

I declare that the representations made in this document are true and that the IRS has not previously denied a request for a waiver of the 60-day rollover requirement with respect to a rollover of all or part of the distribution to which this contribution relates. I understand that in the event I am audited and the IRS does not grant a waiver for this contribution, I may be subject to income and excise taxes, interest, and penalties. If the contribution is made to an IRA, I understand you will be required to report the contribution to the IRS. I also understand that I should retain a copy of this signed certification with my tax records.

Signature: ______________________________

DISTRIBUTIONS PAID IN INSTALLMENTS

Letter Ruling 7802035 states that where a distribution from an employer's qualified pension plan is received in more than one installment, each installment may be rolled over within 60 days after receipt, as long as the total distribution is received within the same taxable year, and as long as the final installment is rolled over on or before the sixtieth day after the day on which it is received.

ELECTING OR REVOKING A ROLLOVER

A taxpayer's election to roll over a distribution (total or partial) to another plan is irrevocable. The election must be made in writing to the new plan trustee, stating that the contribution is a rollover contribution. *(Temp. Reg. l.402 (a)(5)-1T*

IRA-TO-IRA ROLLOVER WAITING PERIOD

The IRS in Announcement 2014-15 has cautioned that the Service will adopt the Tax Court position in *Bobrow v. Commissioner (TC Memo 2014-21)* that the once-per-year IRA rollover limitation applies on an aggregate basis, meaning that an individual could not make an IRA-to-IRA rollover if he or she had made such a rollover involving any of the individual's IRAs in the preceding 1-year period. The one year period is measured based on the date a distribution is received. If the second distribution is received before the same date one year later, it occurs within the period barred by the one-year limit (IRC Sec. 408(d)(3)(B)).

> ***Example –*** *Jack takes a distribution from his IRA on June 30 of year one and subsequently rolls over the distribution within the 60-day rollover period. Jack must wait until June 30 of year two before another distribution is eligible for a rollover. Any additional distributions taken during the one-year waiting period would be taxable.*

This is contrary to IRS Proposed Regulation § 1.408-4(b)(4)(ii) and pre-January 2015 editions of IRS Publication 590, Individual Retirement Arrangements (IRAs), which provided that this limitation is was applied on an IRA-by-IRA basis. Consequently, the IRS has withdrawn paragraph (b)(4)(ii) of §1.408-4 of the proposed regulation and revised Publication 590 (now Pub 590-A) to the extent needed to follow the *Bobrow* interpretation.

These actions by the IRS will not affect the ability of an IRA owner to transfer funds from one IRA trustee directly to another, because such a transfer is not a rollover and, therefore, is not subject to the one-rollover-per-year limitation of § 408(d)(3)(B). See Rev. Rul. 78-406, 1978-2 C.B. 157.

Transitional Relief **–** The IRS will not apply the *Bobrow* interpretation of § 408(d)(3)(B) to any rollover that involves an IRA distribution occurring before January 1, 2015.

Roth IRAs - A rollover from a traditional IRA to a Roth IRA (a "conversion") is not subject to the one-rollover-per-year limitation, and such a rollover is disregarded in applying the one-rollover-per-year limitation to other rollovers. **However, a rollover between an individual's Roth IRAs would preclude a separate rollover within the 1-year period between the individual's traditional IRAs, and vice versa.**

SEPs & SIMPLES - In Announcement 2014-32 the IRS clarified that the once per 12-month period rollover limitation also applies to SEPs and SIMPLE plans, but not qualified plans.

Rollovers Initiated in 2014 - The announcement also clarified that a distribution taken in 2014 and rolled over in 2015 (within the 60-day limit) will not count towards the rollover limit in 2015.

Employee Plans - The once-a-year limit on IRA-to-IRA rollovers does not apply to eligible rollover distributions from an employer plan.

Continue to next page

ROLLOVER CHART

Roll From \ Roll To	Roth IRA	IRA (traditional)	SIMPLE IRA	SEP-IRA	457(b) (government)	Qualified Plan [1] (pre-tax)	403(b) (pre-tax)	Designated Roth Account (401(k), 403(b) or 457(b)[2])
Roth IRA	YES	NO	NO	NO	NO	NO	NO	NO
IRA (traditional)	YES[3]	YES	NO	YES	YES[4]	YES	YES	NO
SIMPLE IRA	YES,[3] after two years	YES, after two years	YES	YES, after two years	YES,[4] after two years	YES, after two years	YES, after two years	NO
SEP-IRA	YES[3]	YES	NO	YES	YES[4]	YES	YES	NO
457(b) (government)	YES[3]	YES	NO	YES	YES	YES	YES	YES,[3,5] after 12/31/10
Qualified Plan[1] (pre-tax)	YES[3]	YES	NO	YES	YES[4]	YES	YES	YES,[3,5] after 9/27/10
403(b) (pre-tax)	YES[3]	YES	NO	YES	YES[4]	YES	YES	YES,[3,5] after 9/27/10
Designated Roth Account (401(k), 403(b) or 457(b)[2])	YES	NO	NO	NO	NO	NO	NO	Yes, if a direct trustee to trustee transfer

[1]Qualified plans include, for example, profit-sharing, 401(k), money purchase, and defined benefit plans
[2]Governmental 457(b) plans, after December 31, 2010
[3]Must include in income
[4]Must have separate accounts
[5]Must be an in-plan rollover
For more information regarding retirement plans and rollovers, visit Tax Information for Retirement Plans Community.

CALIFORNIA DIFFERENCES

In addition to the general rollover rules, California does conform to the following changes made in recent years: allowing rollover of qualified plan distributions to a non-spouse beneficiary; rollover of after-tax amounts from one qualified plan to another qualified plan or tax-sheltered annuity; and direct rollover from a qualified plan to a Roth.

NOTES

TRADITIONAL IRAs

Overview

Age Contribution Limit: 70-1/2
Annual Contribution Limits 2019: $6,000 ($7,000 age 50+)
Income Limits: Limited to 100% of compensation
Timing: Contribution by the return due date (without extensions)
Types: Deductible and Nondeductible
AGI Based Deduction Phase-Out - Active Participants in an Employer Plan **(2019):**

- Unmarried: 64 to 74,000
- Joint: 103 to 123,000
- MS: 0 to 10,000
- Spousal IRA: 193,000 to 203,000

Inflation Adjusted: Future Years

Pubs Forms

Related IRC and IRS Publications and Forms

- **Form 5329** – Additional Taxes on Qualified Plans
- **Form 8606** – Nondeductible IRAs
- **Form 8888 –** Direct Deposit of Refund
- **Form 990-T** – Unrelated Business Income
- **Pub 590-A –** Contributions to IRAs
- **Pub 590-B** – Distributions from IRAs
- **IRC Sections 219, 408, 511**

The Details

Nearly everyone under 70-1/2 years of age who receives compensation, either as an employee or as a self-employed individual, can contribute annually the smaller of the annual contribution limit or 100% of "compensation" to a Traditional IRA. The contributed amount may or may not be deductible, depending on the taxpayer's income level and participation in other retirement plans or if so elected by the taxpayer.

RAPID FINDER

IRA CONTRIBUTION LIMITS

YEAR	UNDER AGE 50	AGE 50 AND OVER
Through 2001	2,000	2,000
2002 through 2004	3,000	3,500
2005	4,000	4,500
2006 through 2007	4,000	5,000
2008 – 2012	5,000	6,000
2013 – 2018	5,500	6,500
2019	6,000	7,000
2020	6,000	7,000

Future years: inflation-adjusted in $500 increments; catch-up contribution fixed at $1,000

DEFINITION OF "COMPENSATION" FOR IRA PURPOSES

In order to have an IRA, an individual must receive "compensation." Compensation includes:

- Wages, Tips, Bonuses, Professional fees, Commissions,
- Alimony received (only if taxable),
- Net income from self-employment (reduced by the sole proprietor's own contribution to a Keogh and the above-the-line deduction allowed for part of self-employment tax). **NOTE:** Do not net self-employment losses against wages to determine total compensation, and
- Non-taxable combat pay.

Compensation does not include rents, interest, dividends, nontaxable alimony, pensions, deferred compensation or disability payments.

NO CONTRIBUTIONS AFTER AGE 70-1/2

Contributions cannot be made to a Traditional IRA for the year in which the taxpayer reaches age 70-1/2 or for any later year. Age 70-1/2 is attained on the date that is 6 calendar months after the 70th anniversary of the taxpayer's birth. Thus, individuals born on or before June 30, 949 turn 70-1/2 on or before December 30, 2019 and cannot contribute for 2019 or any later year. However, a 2018 contribution made in 2019 no later than the April due date for the 2018 return, would have been allowed.

PHASE OUT OF IRA DEDUCTIONS FOR ACTIVE PARTICIPANTS

A. Active participants in qualified plans must limit their IRA deductions when their AGI reaches certain "threshold levels."

B. If AGI is below the "threshold," even an active participant may deduct an IRA contribution within the IRA limits described above. The phase-out threshold levels for active participants are shown in the accompanying table: ***(Note: All values are in thousands.)***

Filing Status	2016	2017	2018	2019	2020
Single, HH	61	62	63	64	65
Joint, SS	98	99	101	103	104
Married Separate	0	0	0	0	0
Delta - Single	10	10	10	10	10
Delta - Married	20	20	20	20	20

C. If a taxpayer's AGI exceeds the above thresholds by less than the "Delta Amount", the IRA deduction will be limited; if it exceeds the thresholds by the "Delta Amount" or more, no IRA deduction is allowed.

D. Use the following formula to compute the phase out:

$$\textit{Deduction limit} = \frac{\textbf{(Delta Amount - AGI amount over threshold)}}{\textbf{Delta Amount}} \times \textit{Maximum Deduction}$$

The result is rounded to the next higher $10. If the deduction limit turns out to be $1-$200, the deductible contribution can be as much as $200.

WHAT IS ACTIVE PARTICIPATION IN ANOTHER PLAN?

An individual is an **"active participant"** for a taxable year if either the individual or his/her spouse (with whom the individual files a joint return) participates in any of the following:

Plans That Create "Active Participation":

- A qualified annuity plan;
- A tax-sheltered annuity;
- A simplified employee pension (SEP);
- An employer-sponsored qualified pension, profit-sharing or stock bonus plan;
- A plan established by a governmental agency for its employees, other than an unfunded deferred compensation plan for employees of state and local governments or exempt organizations (§ 457 plan);
- An employee-only contributory plan exempt from tax under *§ 501(c)(18).*

Special rules allow certain members of the Armed Forces reserves and certain volunteer firefighters not to be treated as active participants. *(§ 219(g)(6))*

Special Situations

A. Determination of active participation is made without regard to whether an individual's rights under a retirement plan are vested. ***Notice 87-16, IRB 1987-5*** states that retired taxpayers who are receiving pension benefits ARE NOT active participants in the paying plan.

B. An individual is an active participant in a ***defined benefit plan*** if the individual is eligible to participate, even if he/she elects not to participate. For a ***defined contribution plan***, an individual generally is an active participant if employer or employee contributions or forfeitures are allocated to the employee's account for a plan year ending within the individual's tax year.

C. ***Special rule for a nonactive participant spouse -*** The maximum deductible IRA contribution for an individual who is not an active participant but whose spouse is an active participant, is phased out for the non-active participant based upon their combined AGI. See the AGI phase-out limits in the table to the right.

Year	Phase-out Range
2014	181,000 – 191,000
2015	183,000 - 193,000
2016	184,000 – 194,000
2017	186,000 – 196,000
2018	189,000 – 199,000
2019	193,000 – 203,000
2020	196,000 – 206,000

Example - Phase Out for Joint Taxpayers - *Sandra actively participates in a retirement plan at work, but her husband, Tim, is not involved in any plan. The couple has a combined AGI of $205,000 for 2019.*

Result: Sandra: *No Traditional IRA deduction due to her active participation in another plan and AGI is over $123,000.* ***Tim:*** *No Traditional IRA deduction because combined AGI is over $203,000.*

Assume that the couple's combined AGI was only $125,000.
Result: Sandra: *No Traditional IRA deduction due to her active participation in another plan and AGI is over $123,000.* ***Tim:*** *No active participation & AGI under $193,000; thus he would be allowed a deductible Traditional IRA.*

IRA PHASE OUT MODIFIED AGI

To compute the IRA phase out, AGI is calculated without regard to the IRA deduction, exclusion for savings bond proceeds, adoption expenses reimbursement exclusion, student loan interest deduction, qualified higher education expenses deduction (in years the deduction is applicable), domestic production activities deduction, foreign earned income and/or housing exclusion, or foreign housing deduction, but with regard to taxable social security benefits and the passive loss limitations. This is called modified AGI (MAGI). However, computation of taxable social security is dependent on the IRA deduction, presenting a calculation dilemma. IRS *Announcement 88-38, 1988-10 IRB* provided guidelines for calculating the IRA limitations when a taxpayer has social security income. Tax software uses these guidelines to compute the allowable IRA deduction and taxable Social Security income.

(3)

2019 TRADITION IRA DEDUCTION DETERMINATION TABLE								
Modified AGI Phase-Out Amount	ALLOWABLE TAXPAYER DEDUCTION							
	TP Covered By Retirement Plan			TP **NOT** Covered By a Retirement Plan				
	S/HH	J/SS	MS(2)	J-SP Covered	J-SP Not Covered	S/HH	SS	MS(3)
0-9,999	Full	Full	Part	Full	Full	Full	Full	Part
10,000-63,999	Full	Full	None	Full	Full	Full	Full	None
64,000-73,999	Part	Full	None	Full	Full	Full	Full	None
74,000-102,999	None	Full	None	Full	Full	Full	Full	None
103,000-122,999	None	Part	None	Full	Full	Full	Full	None
123,000-192,999	None	None	None	Full	Full	Full	Full	None
193,000-202,999	None	None	None	Part	Full	Full	Full	None

(1) Modified AGI is regular AGI (before any IRA deductions) increased by any excluded savings bond interest, foreign earned income or housing exclusions, foreign housing deduction, student loan interest deductions, adoption expenses reimbursement exclusion, qualified higher education expenses deduction (in years applicable), and domestic production activities deduction (in years applicable).

(2) If a taxpayer did not live with his/her spouse at any time during the year, filing status for this purpose is considered Single. Determine the IRA deduction from the Single column.

(3) A taxpayer is entitled to the full deduction if he/she did not live with his/her spouse at any time during the year.

NONDEDUCTIBLE TRADITIONAL IRA CONTRIBUTIONS

Individuals may make nondeductible IRA contributions if they:

- Are ineligible for IRA deductions due to active participation and income limits, or
- Elect to treat otherwise deductible contributions as nondeductible.

Election to treat as nondeductible - Calculation/designation of nondeductible IRA contributions is made on *Form **8606*** on the original return. However, it can also be done on an amended tax return filed within the statute of limitations for the year of the original return *(Notice 87-16, 1987-1 CB446).* There is a $100 penalty for overstating the amount of nondeductible contributions and a $50 penalty for not filing Form 8606 when required. The penalties can be waived with reasonable cause.

Taxpayers who make nondeductible contributions to their Traditional IRAs are creating a basis in the IRA, and when they take IRA distributions in the future, a prorated amount of the distribution will be nontaxable. Copies of the Forms 8606 that were filed will substantiate the amount of the basis. Therefore, clients who make nondeductible IRA contributions should be advised to keep copies of the 8606s indefinitely.

> ***Example - Nondeductible IRA Contribution -*** *In 2019, Harry is single and participates in an employer pension plan; he contributes $6,000 to an IRA. His AGI, before an IRA deduction, was $75,000. Since Harry's AGI was over $74,000, he can't deduct any part of the Traditional IRA contribution, but he may designate the contribution as a nondeductible contribution. (In this situation, Harry should consider making a Roth IRA contribution instead of contributing to the traditional IRA.)*

SPOUSAL IRAs

Spousal IRAs are available for married taxpayers who file jointly. Where one spouse has no compensation, the deduction is limited to the smaller of 100% of the employed spouse's compensation or the combined annual limits.

A married couple with unequal compensation that files a joint return is limited on the deductible contributions to the IRA of the spouse with less compensation. The limit is the smaller of:

1. The annual contribution limit, or
2. The total compensation of both spouses, reduced by any deduction allowed for contributions to IRAs of the spouse with more compensation.

Contributions to spousal IRAs do not need to be divided equally between spouses, but neither spouse may make a contribution of more than the annual limit.

The deduction for contributions to both spouses' IRAs may be further limited if either spouse is covered by an employer's retirement plan.

> ***EXAMPLE - Spousal IRA Deduction -*** *Bill and Bonnie, both under age 50, file a joint return in 2019. Bill has $60,000 in wages, and Bonnie earned $225. Neither spouse participates in another retirement plan. The couple can deduct $12,000 in IRA contributions.*
>
> *Assume instead that Bill and Bonnie have an AGI of $113,000 ($10,000 above the phase-out threshold), all from Bill's wages, and Bill is an active participant in an employer plan. His deductible IRA contribution for 2019 is $3,000 (($20,000 - $10,000)/$20,000) x $6,000). Bonnie's spousal IRA deduction limit for 2019 is $6,000 -- she is not an active participant, and the couple's combined AGI is below the $193,000 threshold, thus allowing her a full deduction.*

TIME FOR MAKING CONTRIBUTIONS

A Traditional IRA contribution must be made by the due date (without extensions) of the tax return for the year of the deduction. The contribution can be made after a return is filed, but only if the contribution is made by the return due date.

A return can be amended to deduct an IRA contribution. The amended return does not have to be filed before the original return unextended due date, but the IRA contribution must have been made on or before that due date. IRA contributions mailed to a bank and postmarked no later than the tax return's original due date are considered timely contributions. *(LR 8536085)*

IRA REFUND DEPOSITS

Taxpayers who use direct deposit for their federal refunds can divide their refunds and make deposits into a maximum of three financial accounts including IRA accounts (Traditional, Roth and SEPs, but not SIMPLEs).

The split-refund program allows taxpayers to conveniently designate – at the time they file – and deposit their refunds with any U.S. financial institution as long as they provide valid routing and account numbers.

Taxpayers having their refunds deposited to two or three accounts must attach a Form 8888 to their returns indicating amount for each account and providing account information.

CAUTION - Special Rules for Refund Direct Deposits to IRA Accounts – Direct depositing a federal tax refund to an IRA requires a taxpayer to adhere to a special set of rules:

- *Pre-established Account* - A taxpayer must first establish an IRA account with a bank or other financial institution before a direct deposit can be directed to the account. Of course, the taxpayer must be qualified to make an IRA contribution for the particular year – for example, the taxpayer must have earned income, be younger than 70-1/2 years old for non-Roth IRAs, etc.

- *Trustee Notification* – IRA contributions can be designated for (1) the prior year, (2) the current year, and (3) a combination of years. Thus, a taxpayer must notify the trustee in advance how to allocate the direct deposit funds. If not notified, the trustee can assume the deposit is for the year during which the deposit is made. For example, the 2018 refund credited during 2019 would be assumed to be for 2019. There is lots of room for error and taxpayers must be very careful to make the correct allocation before the deposit is received by the financial institution.

- *Prior Year IRA Contributions* – Contribution for the prior year can only be made up to the un-extended deadline for filing the return for that prior year. If the deposit isn't made by that date, the law precludes the trustee from allocating the deposit to the prior year. This creates a potential hazard for taxpayers filing late in the season and the direct deposit is not made before the due date. The law puts the responsibility for the timely deposit directly on the taxpayer.

PENALTY FOR EXCESS CONTRIBUTIONS

Any contribution to an IRA (either deductible or nondeductible, but not including rollovers) that is more than allowed for the year is an excess contribution and subject to a ***6% penalty***.

<u>Post-70-1/2 Contributions</u> - Contributions made for the year a taxpayer turns age 70-1/2 (and later years) are considered excess contributions. The penalty is calculated on the excess contributed and on any interest it may have earned. The penalty can't be more than 6% of the value of the account and continues to apply each year the excess is allowed to remain in the account. Use ***Form 5329*** to calculate the penalty.

<u>Withdrawing an excess contribution before the return due date</u> **-** If the excess, including interest (or other earnings), is withdrawn by the extended due date of the return and no deduction was taken for the excess:

- No penalty is assessed on the excess or the interest.
- Include the interest on the excess in income in the year of excess contribution (or a taxpayer may return the interest or other earnings paid on the account).
- 10% premature distribution penalty may be charged on interest or other earnings, only if taxpayer is under 59-1/2 *(2018 IRS Publication 590-A, page 35).*

<u>Withdrawing excess contributions after the return due date</u> - If total contributions for the year were not more than the annual contribution limit amount (including excess contributions) AND the taxpayer did not claim any deduction for the excess, a taxpayer may withdraw the excess after the extended due date of the return, without having to include the withdrawal in income. A taxpayer who timely filed their return for the year the excess contribution was made, but who didn't withdraw the excess before filing the return, may make a withdrawal of the excess within 6 months of the original due date of the return and then file an amended return to (1) exclude the deductions for the excess contribution and (2) include the earnings on the excess. On the top of the amended return, write "Filed pursuant to section 301.9100-2" *(2018 IRS Publication 590-A, page 35).*

Excess cannot be applied to an earlier year - A taxpayer cannot avoid an excess contribution penalty by applying the excess against an earlier year in which he/she claimed less than the maximum amount allowable.

Excess applied to later year - The excess amount can be applied to a later year's contribution. While this allows the taxpayer to avoid a withdrawal from the IRA account, it does not avoid the 6% penalty on excess contributions that might remain in the taxpayer's account at the end of the year.

> ***Example - Excess IRA Contribution -*** *Jan's* 2018 *compensation was $1,000, and her* 2018 *compensation was $15,000. She made a $1,400 IRA contribution in '18 ($400 more than the amount she was allowed) and wants to make a $1,500 contribution for '19. The extra $400 Jan put into the 2018 IRA is subject to the 6% excess contribution penalty. However, she would not have to pay that penalty if the excess (including earnings) was withdrawn before the extended due date of her '18 return. Jan can correct the excess contribution problem by withdrawing the $400. However, she could also make the correction by leaving the $400 in the account to apply to her 2019 IRA contribution. If she does the latter, she will make a cash deposit of $1,100 for her 2019 contribution. Her '19 IRA deduction will be $1,500 ($400 applied from '18 and $1,100 in cash).*

Excess contributions due to erroneous rollover information - If a taxpayer received incorrect information from a pension plan administrator and, as a result, rolls over an erroneous amount to an IRA, the taxpayer is allowed to withdraw the excess contribution. No amended return is necessary to show the change; the corrective withdrawal does not need to be included in the taxpayer's income.

<u>CONTRIBUTIONS COUNT FOR SAVER'S CREDIT</u>

Contributions to Traditional IRAs, whether deductible or nondeductible, are eligible contributions for the Retirement Savings Contribution Credit (also called Saver's Credit) available to certain lower-income taxpayers. See Chapter 9.07 for more information on this nonrefundable credit.

<u>IRA DISTRIBUTIONS</u>

Generally, payments from Traditional IRA accounts are currently taxable under the annuity rules of IRC Sec. 72 and must be included as ordinary income in the year received. Neither special averaging nor capital gain treatment is available for the distributions. The annuity rules require the following for IRA distributions when both deductible and nondeductible contributions have been made to the IRA:

Note: *IRS Pub 590-B says to compute RMD for each IRA separately (which makes sense because there could be different beneficiaries that would cause different life expectancy tables to be used – for example if beneficiary spouse's age was +10 years different than IRA owner's age and a non-spouse was beneficiary of another IRA). The "one contract" and "treat all distributions as one" only applies when figuring the taxable and nontaxable portions of a distribution – Sec 408(d)(2).*

- All IRAs are treated as one contract;
- All distributions in a tax year are treated as one distribution; and
- Value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year in which the tax year begins.
- The value of the contract must be increased by the amount of any distributions that occurred during the calendar year.

No Nondeductible Contributions - Where a taxpayer has made no nondeductible contributions to the IRA, there is no investment in the contract. 100% of the distribution is taxable. Alternatively, where both deductible and nondeductible contributions have been made, a portion of the distribution is nontaxable (see "Effect of Nondeductible Contributions" below).

Distributions After Death - Distributions after the IRA owner's death to beneficiaries are taxable to the beneficiaries as income in respect of a decedent (IRD). Nondeductible contributions made by the decedent are taken into account in determining taxability (just as they would have been for the decedent). A beneficiary who is taxed on IRA IRD is allowed a Tier 1 itemized deduction for estate tax attributable to the IRD.

Tax-Free IRA Distributions - The following IRA distributions are 100% tax-free:

- Trustee-to-trustee transfers from one Traditional IRA to another;
- Distribution that is rolled over to another Traditional IRA within 60 days of receiving the distribution (see Chapter 4.04, Rollovers, regarding the one IRA rollover each 12 months limitation);
- Transfer of the account to a spouse or former spouse under a divorce decree;
- Contributions withdrawn by the extended due date of the year to which they apply (provided no deduction is taken for the contribution, and the distribution includes the income earned on the contribution). The income earned on the contribution is, however, taxable and a premature withdrawal penalty may apply.

Acquiring Certain Collectibles - Acquiring certain collectibles in a Traditional IRA is treated as a distribution equal to the cost of the collectible. Collectibles to be avoided are works of art, rugs, antiques, metals or gems, stamps or coins, alcoholic beverages, etc. Certain gold coins are not considered collectibles.

Delayed Check Cashing **–** Rev Rul 2019-19 concludes that an individual's failure to cash a qualified plan or IRA distribution plan distribution check does not permit the individual to exclude the amount of the designated distribution from gross income and does not alter the employer's withholding obligations or Form 1099-R reporting obligations, Thus the distribution is taxable in the year of the distribution. This rule applies if the individual *could* have cashed the check and would apply whether or not the individual keeps the check, sends it back, destroys it, or cashes it in a later tax year.

EFFECT OF NONDEDUCTIBLE CONTRIBUTIONS

Amounts withdrawn from Traditional IRAs containing both deductible and nondeductible contributions are includible in income using the same rules applicable for many pension plans. The nondeductible contributions are considered investment in the contract (i.e., basis). Pub 590-B includes a worksheet to determine the taxable portion of an IRA distribution, where nondeductible contributions have been made to the plan.

DEDUCTING IRA LOSSES

When a Traditional IRA has been **totally** distributed and amounts received are less than the individual's unrecovered basis in the account, a loss is recognized.

The IRA loss recognition rule applies separately to each kind of IRA, and a similar rule applies to Roth IRAs. Thus, to recognize a loss in a Traditional IRA, all amounts must be distributed from all Traditional IRAs (but not Roth IRAs) owned by the taxpayer, and to recognize a loss in a Roth IRA, all amounts must be distributed from all of the Roth IRAs owned by the taxpayer (but not traditional IRAs).

An IRA loss may be claimed as a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040. (*Notice 89-25, Q&A 7, 1989-1 CB 662)* The TCJA suspended deduction of Tier 2 miscellaneous deductions for years 2018 through 2025 so an IRA loss will not be deductible during this period.

> ***Example - Loss on a Traditional IRA Distribution Recognized -*** *A mutual fund IRA, funded with 6 annual nondeductible contributions of $2,000, has a basis of $12,000 ($2,000 x 6). It is the taxpayer's only IRA. The mutual fund lost money, and the account contained only $10,000. The account owner withdrew the entire amount in 2017 and recognized a $2,000 loss in that year.*

BANKRUPTCY EXCLUSION

IRA accounts up to the exemption amount are protected from creditors in bankruptcy. The amount is inflation-indexed every three years. As of April 1, 2019, the exemption is increased to $1,362,800 (*Federal Register, Vol 84, Number 29, Feb. 12, 2019*). The next increase won't be until 2022. However, the Supreme Court ruled unanimously in *Clark v. Rameker, SCt., June 12, 2014, 2014-1 USTC ¶50,317* that an inherited IRA is not exempt from credit claims in bankruptcy.

TAXATION OF PENSIONS BY FORMER RESIDENT STATES

Congress in 1995 passed P.L. 104-95 (H.R. 394) that prevents states from taxing the pensions of **former** residents of any state received after December 31, 1995. This also applies to IRA distributions received by a nonresident beneficiary of an estate or trust.

IRA UNRELATED BUSINESS INCOME

Generally an IRA is exempt from all income taxes. An exception to that is tax on unrelated business income (UBI), which the IRA received from activities that are not substantially related to the functions for which the IRA is allowed an exemption from income tax, such as engaging in a business normally carried on for profit.

The taxation of UBI applies to all exempt entities, and besides Traditional IRAs, includes Roth, SEP, Simple, Coverdell, Archer MSA and HSA Accounts.

A specific exemption of $1,000 applies to UBI, so where the UBI is $1,000 or less, no return need be filed. Where the UBI exceeds the $1,000 exemption, Form 990-T is used to pay the UBI tax. The UBI tax is determined by using a graduated rate schedule (same as for trusts for IRAs or other exempt entities) – 10% – 37% for years after 2017.

The due date of the 990-T is the same as for 1040s and Form 8868 can be used to apply for an extension.

QUALIFIED PLAN PORTABILITY

The law generally allows any **pre-tax** IRA funds to be rolled into any other type of retirement plan, such as a qualified plan, 403(b) annuity, or Section 457 plan maintained by a state or other political subdivision.

Funds in various qualified arrangements — such as qualified plans, 403(b) arrangements and Section 457 plans — can be rolled into any other type of arrangement, rather than merely IRAs. Section 457 arrangements of state governments can accept rollover contributions, and distributions from such arrangements as well as after-tax employee contributions to qualified plans and 403(b)s can be rolled over.

Although the rules for rollover contributions are liberal, rollovers are not possible if the individual cannot receive a distribution from the plan or if the recipient plan does not authorize acceptance of the rollover contribution. See Chapter 4.04 for details on rollovers.

PREMATURE DISTRIBUTIONS: A 10% penalty applies to the taxable portion of a Traditional IRA distribution taken before the IRA owner turns age 59-1/2. The penalty is computed using ***Form 5329.*** However, certain exceptions provide relief from the penalty. See chapter 4.10 for the various exceptions.

REQUIRED MINIMUM DISTRIBUTIONS: A Traditional IRA is subject to the required minimum distribution rules for qualified plans – See Chapter 4.17.

CALIFORNIA DIFFERENCES

For tax years 2007 through 2009 California did not conform to the federal inflation adjusted AGI phase-outs for traditional IRAs. For tax years beginning on or after January 1, 2010, California DOES conform to the federal modified AGI indexed amounts.

2007 – 2009 MAGI* Phase-out for Individuals Who Are Not Active Participants			
Filing Status	Unmarried	Joint	Joint – Spouse Active
MAGI Phase-Out Range	50,000 – 60,000	80,000 – 100,000	150,000 – 160,000

**Use federal MAGI*

<u>*CA Basis May Have Been Created*</u> - If the deductible amount for California was less than it was for federal because of the phase-out difference, basis was created for California, so when distributions are made in the future, part of each one will be nontaxable for California. It is important that the nondeductible amount be tracked so that tax isn't paid on the basis portion of distributions.

HISTORICAL IRA LIMITATIONS: The table (below) summarizes the various limitations, changes and differences between Federal and California law since the inception of the Traditional IRA. For Federal tax purposes, a basis in an IRA could not be possible until the advent of the nondeductible IRA in 1987. However, because of the delayed conformity to Federal rules and different limitations, a California basis could have been established as early as 1975.

For tax years 1996 and after, California law is the same as federal law for IRA deductions – except California did not adopt the higher federal phaseout amounts applicable to qualified plan participants starting in 2007 and through 2009. For additional information on IRA deductions for years prior to 1996, refer to Pension and Annuity Guidelines, (FTB Pub. 1005).

HISTORICAL IRA LIMITATIONS (1975 – 2019)

	FEDERAL					CALIFORNIA				
TAX YEAR	MAX	Percent of EI	NON-WK SPOUSE	OTHER PLAN	NON DED	MAX	% of EI	NON-WK SPOUSE	OTHER PLAN	NON DED
75	1,500	100	0	NO	NO	0	15	0	NO	NO
76	1,500	100	250	NO	NO	1,500	15	0	NO	NO
77-81	1,500	100	250	NO	NO	1,500	15	250	NO	NO
78-86	2,000	100	250	NO	N0	1,500	15	250	NO	NO
87-95	2,000	100	250	PO[1]	YES	2,000	100	250	PO[1]	YES
96-97	2,000	100	2,000	PO[1]	YES	2,000	100	2,000	PO[1]	YES
98-01	2,000	100	2,000	PO[2]	YES	2,000	100	2,000	PO[2]	YES
02	3,000◊	100	3,000◊	PO[3]	YES	3,000◊	100	3,000◊	PO[3]	YES
03	3,000◊	100	3,000◊	PO[4]	YES	3,000◊	100	3,000◊	PO[4]	YES
04	3,000•	100	3,000•	PO[5]	YES	3,000•	100	3,000•	PO[5]	YES
05	4,000•	100	4,000•	PO[6]	YES	4,000•	100	4,000•	PO[6]	YES
06	4,000•	100	4,000•	PO[7]	YES	4,000•	100	4,000•	PO[7]	YES
07	4,000•	100	4,000•	PO[8]	YES	4,000•	100	4,000•	PO[9]	YES
08	5,000•	100	5,000•	PO[10]	YES	5,000•	100	5,000•	PO[11]	YES
09	5,000•	100	5,000•	PO[12]	YES	5,000•	100	5,000•	PO[11]	YES
10	5,000•	100	5,000•	PO[13]	YES	5,000•	100	5,000•	PO[13]	YES
11	5,000•	100	5,000•	PO[14]	YES	5,000•	100	5,000•	PO[14]	YES
12	5,000•	100	5,000•	PO[15]	YES	5,000•	100	5,000•	PO[15]	YES
13	5,500•	100	5,500•	PO[16]	YES	5,500•	100	5,500•	PO[16]	YES
14	5,500•	100	5,500•	PO[17]	YES	5,500•	100	5,500•	PO[17]	YES
15	5,500•	100	5,500•	PO[18]	YES	5,500•	100	5,500•	PO[18]	YES
16	5,500•	100	5,500•	PO[19]	YES	5,500•	100	5,500•	PO[19]	YES
17	5,500•	100	5,500•	PO[20]	YES	5,500•	100	5,500•	PO[20]	YES
18	5,500•	100	5,500•	PO[21]	YES	5,500•	100	5,500•	PO[21]	YES
19	6,000•	100	6,000•	PO[22]	YES	6,000•	100	6,000•	PO[22]	YES

◊Add $500 if age 50 or over •Add $1,000 if age 50 or over

PO[1]: *Phase out with other pension plan S = 25K to 35K, J = 40K to 50K, MS = 0 to 10K*
PO[2]: *Phase out with other pension plan S = 31K to 41K, J = 51K to 61K, MS = 0 to 10K; Spouse w/o pension plan 150K to 160K*
PO[3]: *Phase out with other pension plan S = 34K to 44K, J = 54K to 64K, MS = 0 to 10K; Spouse w/o pension plan 150K to 160K*
PO[4]: *Phase out with other pension plan S = 40K to 50K, J = 60K to 70K, MS = 0 to 10K; Spouse w/o pension plan 150K to 160K*
PO[5]: *Phase out with other pension plan S = 45K to 55K, J = 65K to 75K, MS = 0 to 10K; Spouse w/o pension plan 150K to 160K*
PO[6]: *Phase out with other pension plan S = 50K to 60K, J = 70K to 80K, MS = 0 to 10K; Spouse w/o pension plan 150K to 160K*
PO[7]: *Phase out with other pension plan S = 50K to 60K, J = 75K to 85K, MS = 0 to 10K; Spouse w/o pension plan 150K to 160K*
PO[8]: *Phase out with other pension plan S = 52K to 62K, J = 83K to 103K, MS = 0 to 10K; Spouse w/o pension plan 156K to 166K*
PO[9]: *Phase out with other pension plan S = 50K to 60K, J = 80K to 100K, MS = 0 to 10K; Spouse w/o pension plan 150K to 160K*
PO[10]: *Phase out with other pension plan S = 53K to 63K, J = 85K to 105K, MS = 0 to 10K; Spouse w/o pension plan 159K to 169K*
PO[11]: *Phase out with other pension plan S = 50K to 60K, J = 80K to 100K, MS = 0 to 10K; Spouse w/o pension plan 150K to 160K*
PO[12]: *Phase out with other pension plan S = 55K to 65K, J = 89K to 109K, MS = 0 to 10K; Spouse w/o pension plan 166K to 176K*
PO[13]: *Phase out with other pension plan S = 56K to 66K, J = 89K to 109K, MS = 0 to 10K; Spouse w/o pension plan 167K to 177K*
PO[14]: *Phase out with other pension plan S = 56K to 66K, J = 90K to 110K, MS = 0 to 10K; Spouse w/o pension plan 169K to 179K*
PO[15]: *Phase out with other pension plan S = 58K to 68K, J = 92K to 112K, MS = 0 to 10K; Spouse w/o pension plan 173K to 183K*
PO[16]: *Phase out with other pension plan S = 59K to 69K, J = 95K to 115K, MS = 0 to 10K; Spouse w/o pension plan 178K to 188K*
PO[17]: *Phase out with other pension plan S = 60K to 70K, J = 96K to 116K, MS = 0 to 10K; Spouse w/o pension plan 181K to 191K*
PO[18]: *Phase out with other pension plan S = 61K to 71K, J = 98K to 118K, MS = 0 to 10K; Spouse w/o pension plan 183K to 193K*
PO[19]: *Phase out with other pension plan S = 61K to 71K, J = 98K to 118K, MS = 0 to 10K; Spouse w/o pension plan 184K to 194K*
PO[20]: *Phase out with other pension plan S = 62K to 72K, J = 99K to 119K, MS = 0 to 10K; Spouse w/o pension plan 186K to 196K*
PO[21]: *Phase out with other pension plan S = 63K to 73K, J = 101K to 121K, MS=0 to10K; Spouse w/o pension plan 189K to 199K*
PO[22]: *Phase out with other pension plan S = 64K to 74K, J = 103K to 123K,MS =0 to 10K; Spouse w/o pension plan 193K to 203K*

If amounts not shown, they were not available at publication.

NOTES

ROTH IRAS & QUALIFIED ROTH CONTRIBUTIONS

Taxpayer receives **no tax deduction** when contributions are made.

- **Qualified distributions are tax-free**, including the account earnings.
- **Contributions have the same annual limits as traditional IRAs** and deposits to a combination of Roth and Traditional IRAs cannot, combined, exceed the annual contribution limit. **Annual Contribution Limits 2019:** $6,000 ($7,000 age 50+)
- Qualifications needed to contribute to a Roth IRA:
  - The taxpayer **must have compensation** (same definition as for traditional IRAs).
  - **No age limit** for contributions – thus, contributions can be made after the age of 70½.
  - **Spousal Roth IRAs** are allowed.
  - **No qualified plan limits** - contributions can be made even if the taxpayer is a participant in a qualified plan.
  - **AGI Phase-out** limits apply. Amounts for **2019** are:
    - Married: 193 – 203K
    - MS: 0 – 10K
    - Others: 122 - 137K

But see how to circumvent the AGI phase-out on page 4.06.03.

- Traditional to Roth conversions allowed without AGI or filing status restrictions.
- Required minimum distributions (RMD)
  - **None at any age** while owner is living.
  - Generally same as for traditional IRAs after owner's death.
  - Designated Roth 401(k) and 403(b) are subject to the RMD rules.

TCJA CHANGES	**See Page**
Recharacterization Rule Repealed	4.06.05

RAPID FINDER

Related IRC and IRS Publications and Forms

- **Form 5329** – Additional Taxes on Qualified Plans
- **Form 8606** – Nondeductible IRAs
- **Form 8888 –** Direct Deposit of Refund
- **Pub 590-A –** Contributions to IRAs
- **Pub 590-B** – Distributions from IRAs
- **IRC Sec 408A**

With a Roth IRA, a taxpayer gets no tax deduction when contributions are made. However, what the taxpayer gets is tax-free accumulation, and at retirement, all distributions are tax-free, including the account earnings (if a required holding period is met). Congress provided the means for individuals to convert their existing Traditional IRA into a Roth IRA in the form of a taxable rollover. The rollover allows all future earnings to accumulate tax-free until retirement, but requires the tax on the current IRA to be paid in the year of conversion. Determination of whether it is beneficial for a taxpayer to elect this taxable rollover option generally requires careful tax planning.

CONTRIBUTIONS AND LIMITS

Qualifications - Qualifications needed to contribute to a Roth IRA:

1. Taxpayer must have ***compensation*** (the same definition that is used for Traditional IRAs).
2. Contributions are allowed ***regardless of the taxpayer's age***.
3. ***Spousal*** Roth IRAs are allowed.

4. The taxpayer's ***"modified AGI" must be within certain limits*** based on filing status whether or not participating in a qualified retirement plan.
5. Prior to 2010, MFS taxpayers were not allowed to convert.

Year	Under Age 50	Age 50 and Over
Through 2001	2,000	2,000
2002 - 2004	3,000	3,500
2005	4,000	4,500
2006 - 2007	4,000	5,000
2008 - 2012	5,000	6,000
2013 - 2018	5,500	6,500
2019 - 2020	6,000	7,000

Roth IRA Not Eligible to be S Corp Shareholder - Affirming the Tax Court, the Court of Appeals for the Ninth Circuit has found that a Roth IRA was not an eligible shareholder of an S corporation (*Taproot Administrative Services, Inc. v. Commissioner*, CA-9, 2012-1 USTC ¶50,256).

Roth Contribution Limit

1. If the taxpayer makes no Traditional IRA contribution, the maximum contribution a taxpayer may make to the Roth is the lesser of the annual contribution limit (see table, right), or the taxpayer's taxable compensation. The maximum is phased out, if the taxpayer's modified AGI is within the limits described in the second table below.
2. If a taxpayer contributes to both a Roth and a Traditional IRA, the contribution limit for the Roth is the lesser of the maximum contribution limit reduced by contributions to all Traditional IRAs (excluding SEPs or SIMPLE IRAs), OR the maximum contribution allowed because the taxpayer's modified AGI requires deduction phase out.

Roth Contribution AGI Phase Out

Year	*Joint*	*MS (Living With Spouse)*	*All Others*
2016	184,000 – 194,000	0 – 9,999	117,000 – 132,000
2017	186,000 – 196,000	0 – 9,999	118,000 – 133,000
2018	189,000 – 199,000	0 – 9,999	120,000 – 135,000
2019	193,000 – 203,000	0 – 9,999	122,000 - 137,000
2020	196,000 – 206,000	0 – 9,999	124,000 – 139,000

Modified AGI - means regular AGI:

- Less income from conversion of a Traditional IRA to a Roth account.
- Less minimum required distributions from IRAs.
- Plus Traditional IRA deduction, student loan interest deduction, foreign earned income exclusion, foreign housing exclusion, qualified savings bond interest exclusion, higher education tuition and fees deduction (for years when applicable), domestic production activities deduction (for years when applicable) and adoption expense exclusion.

Computing Roth IRA Phase Out (Using 2019 Rates for Example)

1. Figure MODIFIED AGI.
2. Subtract from the amount in (1):
   - $193,000 if taxpayer files joint return,
   - $0 if taxpayer files MS and lived with his/her spouse at any time during year, or
   - $122,000 for all other taxpayers.
3. Divide result in (2) by $15,000 ($10,000 if filing married joint or married separate).
4. Multiply the contributions limit (before reduction by this adjustment and before reduction for any contributions to a Traditional IRA) by the result in (3).
5. Subtract the result in (4) from the taxpayer's contribution limit before this reduction. This is the reduced contribution limit. Round up to the nearest $10. If the reduced contribution limit is more than $0 but less than $200, increase the limit to $200.

Example – Phase Out of Roth Contribution – *In 2019, JT Loner is single, under age 50, and earned wages of $124,000 and had modified AGI of $124,210. He wants to make the maximum contribution possible to his Roth IRA. He made no Traditional IRA contribution. Since JT's modified AGI is above $122,000, his maximum Roth contribution will be limited as follows:*

1. Modified AGI	*$124,210*		
2. Less phase out threshold		*<$122,000>*	*$2,210*
3. Line (2) divided by $15,000		*.147*	
4. Maximum contribution limit ($6,000) x Line (3)		*$882*	
5. Subtract Line 4 from maximum contribution limit		*$5,118 ($6,000 - 882 = $5,118)*	
6. Maximum Roth contribution (line 5 rounded up to nearest $10)		*$5,120*	

Back Door ROTH IRA - Circumventing the Contribution AGI Phase-Out Limitation - A taxpayer can contribute to a traditional IRA and then convert that traditional IRA to a Roth IRA. This also gives rise to an opportunity to defer income from one year to another by making a deductible IRA contribution in one year and converting it to a Roth IRA in a subsequent year. Options:

1. Make a designated non-deductible Traditional IRA contribution and then convert it into a Roth IRA in a subsequent year. The only tax when converted would be on the earnings. **Caution:** This strategy may not work or work as well if the taxpayer already has other IRA accounts. Remember when a taxpayer has made both deductible and nondeductible IRA contributions all Traditional IRA are treated as one, and for the taxpayer who has other IRA accounts a conversion will be treated as coming ratably from all of them, which may include taxable conversions.

2. Make a deductible Traditional IRA contribution, AGI permitting, and then convert it into a Roth IRA in a subsequent year. This would effectively defer the income from the contribution year to the conversion year.

CONTRIBUTIONS DUE DATE

Contributions to a Roth must be made by the ***unextended* due date** of the taxpayer's return – essentially by the April due date of the tax return.

SAVER'S CREDIT QUALIFICATION

Even though contributions to Roth IRAs are not deductible, they are eligible contributions for the Retirement Savings Contribution Credit (also called Saver's Credit) available to certain lower-income taxpayers. See Chapter 9.07 for more information on this nonrefundable credit.

EXCESS CONTRIBUTIONS PENALTY

A taxpayer who contributes more to a Roth IRA than the year's contribution limit is subject to a 6% excise tax (Form 5329 penalty) on the excess amount. Excess contribution to a Roth IRA for a year is the sum of:

1. That year's contributions (other than rollover contributions) that are more than the contribution limit for the year, plus
2. Any excess contributions for the preceding year, reduced by the total of:
   a. Any distributions out of the Roth IRA for the year, plus
   b. The contribution limit for the year minus the total of all IRA contributions for the year.

Under this formula, excess contributions are reduced as a deemed Roth IRA contribution for each subsequent taxable year to the extent the Roth IRA owner does not actually make a regular IRA contribution in those years (Reg. § 1.408A-3, Q&A-7).

Exceptions to the Penalty – If the excess contributions, plus any earnings, are withdrawn on or before the extended due date of the return, the excess contributions penalty won't apply. The earnings are treated as earned and received in the year the excess contribution was made. Another way to avoid the 6% penalty is to apply the excess contribution to a later year's contribution, provided the contributions for that later year are less than the maximum allowed for that year.

ONLY ONE IRA ROLLOVER ALLOWED EVERY 12 MONTHS

Beginning in 2015, an individual can make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs the individual owns. The limit applies by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit. However, trustee-to-trustee transfers between IRAs and ***rollovers from traditional to Roth IRAs ("conversions") are not limited***. (IRS Announcement 2014-15) See Chapter 4.04 for additional details.

CONVERSIONS TO ROTH IRA ACCOUNTS

An individual (any age) can roll over into a Roth IRA all or part of an eligible rollover distribution they receive from their (or their deceased spouse's):

- Individual Retirement or Annuity Account (except RMD),
- Employer's qualified pension, profit-sharing or stock bonus plan (including a 401(k) plan),
- Annuity plan,
- Tax-sheltered annuity plan (section 403(b) plan), or
- Governmental deferred compensation plan (Section 457 plan).

Roth Conversions for Retirement Plans **-** Under current law, a deferral plan under section 401(k) (including the Thrift Savings Plan), 403(b) or 457(b) governmental plan can have Roth accounts that allow participants to save on a Roth basis. That is, they can make after-tax contributions to the plan and all the principal and earnings are tax-free when distributed.

Plans have allowed participants to convert their pre-tax accounts to Roth accounts, but only with respect to money they have a right to take out of the plan, usually because they have reached age 59½ or separated from service. The American Taxpayer Relief Act (ATRA) allows any amount in a non-Roth account to be converted to a Roth account in the same plan, whether or not the amount is distributable. The amount converted would be subject to regular income tax.

Strategy - Segregating Deductible & Non-deductible Traditional IRA Contributions – Generally, rollovers are thought of as transfers from a qualified plan to an IRA or from one IRA to another IRA. However, a taxpayer may roll assets from a Traditional IRA to other qualified plans including 401(k) plans, 403(a) and 403(b) annuities and 457 governmental retirement plans (assuming the plan will accept the IRA funds).

However, the law only allows the taxable portion of the IRA to be moved to qualified plans (Code Sec. 408(d)(3)(A)(ii)). For taxpayers who have mixed IRAs (including both deductible and nondeductible contributions), this provides a means to segregating the taxable and nontaxable amounts and then later converting the nontaxable portion without paying any conversion tax (except on any interim earnings). Thus, the taxable portion can be rolled into a qualified plan, leaving the nontaxable portion in the IRA where it can be converted to the Roth IRA.

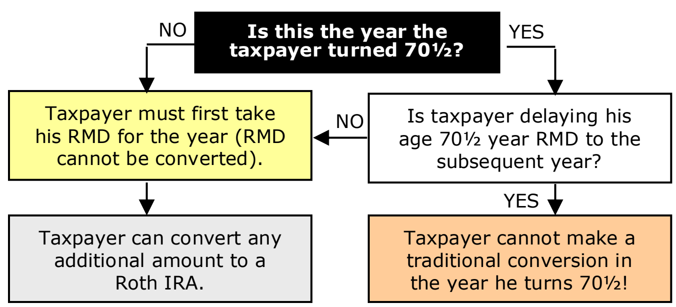
Taxability of a Conversion **-** A Traditional IRA may include some post-tax contributions if a taxpayer made nondeductible contributions to the IRA. These post-tax contributions are treated as a nontaxable basis in the IRA and are not taxed in the conversion to a Roth IRA. The balance of the IRA funds is taxed in the year of the rollover as additional income. All of the taxpayer's traditional IRAs, SEP-IRAs and SIMPLE IRAs are aggregated when determining the amount taxable at conversion. Unless 100% of all of the IRAs are converted to a Roth IRA, not all of the nontaxable basis is excluded from tax at conversion.

> ***Example – Taxable Amount at Conversion of Mixed IRAs****: In earlier years, Irene had made deductible SEP-IRA contributions of $25,000. In 2015 through 2019 she only made nondeductible contributions to a regular IRA of $14,000. In 2019, the SEP's value is $32,000 and the IRA's value is $16,000. Irene converts the regular IRA to a Roth IRA in 2019. Although Irene's basis in her IRAs is $14,000, she can only use $4,084 of the basis in the conversion ($14,000/$48,000 = 29.17% x $14,000 = $4,084), leaving $11,916 of the $16,000 she converted as taxable.*

Converting Simple IRAs **–**Although a SIMPLE IRA can also be converted to a Roth IRA under the same rules described above, a taxpayer can't convert any amount distributed from the SIMPLE during the 2-year period that begins with the date of first participation in the SIMPLE.

Paying the Tax on a Conversion **-** Where does the money come from to pay this tax liability on a conversion to a Roth? The taxpayer can pay the liability from other funds or from IRA funds. However, if the tax is paid from IRA funds, those funds are not part of the rollover and therefore are subject to early withdrawal penalties if the taxpayer is under 59½ at the time of the withdrawal.

Conversions After Reaching Age 70½ - IRA owners are permitted to make Traditional to Roth conversions after reaching age 70½, provided that they first take the RMD for the year; the RMD amount cannot be converted (Code Sec. 408(d)(3)). Thus, if the taxpayer, in the year he turns 70½, wishes to delay the RMD until the subsequent year, he would not be able to also make a conversion in that year (Preamble to TD 8816, 2/3/1999).



IS A 529 PLAN THE RIGHT CALL?

Historically the Sec 529 plan has been the most popular way to save for college. There are an estimated 13 million accounts with assets exceeding $275 billion. The cost of a traditional college education keeps going up and up, but today's on-line education costs are just a fraction of the expense of a traditional college education. On-line classes may come to be the standard in the years to come. The Sec 529 plans may not be suitable as the education savings mechanism of the future, as they lock up huge sums of money that can be applied penalty-free only to pay for the high costs of a traditional school.

With technology evolving at such a rapid rate the Internet may be the solution to the high cost of college education, and huge sums may not be needed to pay for college expenses. Parents and grandparents, who are the ones that usually fund a child's education, need to think about their retirement as well, since there are no grants, scholarships, loans or tax credits to help individuals with retirement well into their 80s.

One possible alternative is a Roth IRA where, like a Sec 529 plan, the earnings accumulate tax-free and there is no penalty if the funds withdrawn are qualified distributions or a return of contributions. Funds not withdrawn for education can be used for retirement. Of course, to contribute to a Roth IRA, the account owner must have earned income but AGI cannot exceed the top of the AGI-based threshold range for the year, and annual contributions are limited to the overall IRA contribution limitations.

RECHARACTERIZATION RULE REPEALED

TCJA The Act repeals the special rule that allows a traditional IRA to Roth IRA **conversions** to be later unwound. Thus, for example, under the provision, a **conversion** contribution to a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion). The provision is effective for taxable years beginning after December 31, 2017. (IRC Sec. 408A(d)(6)(B)(iii) as amended by TCJA Sec. 13611(a).

However, recharacterization is still permitted with respect to *contributions*. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA (Conference Report). Thus, if an individual makes a Roth IRA contribution the contribution can be converted to a traditional IRA contribution, or vice versa, provided the conversion is accomplished before the unextended due date for the return (IRA contribution must be made by the April return due date).

Note: This rule applies for conversions from a traditional IRA, SEP or SIMPLE to a Roth IRA. The new law also prohibits recharacterizing amounts rolled over to a Roth IRA from other retirement plans, such as 401(k) or 403(b) plans (IRS FAQ).

Special Rule For Conversions Made in 2017 - A Roth IRA conversion made in 2017 may be recharacterized as a contribution to a traditional IRA if the recharacterization is made by October 15, 2018. A Roth IRA conversion made on or after January 1, 2018, cannot be recharacterized (IRS FAQ)

> ***Commentary****: This change can be a problem for individuals whose retirement funds are invested, for example, in a stock fund and the fund declines in value after the conversion and the converted amount can no longer be recharacterized to avoid the tax on the declined value.*

CONVERSION IMPACT ON OTHER TAX CONSEQUENCES

When considering whether or not to convert to a Roth IRA, the impact on various tax benefits due to increasing AGI by the taxable conversion amount must be carefully considered. For instance, a conversion may cause the taxpayer to lose part or all of certain tax benefits, like:

- American Oppty/Lifetime Learning Credits
- Earned Income Tax Credit (EIC)
- Child Tax Credit
- Saver's Credit
- Adoption Credit
- Higher Education Interest Deduction
- Medicare B & D Premiums – 2 Years Later
- Tuition and Fees Deduction (applicable yrs.)
- Medical Itemized Deductions
- Miscellaneous Itemized Deductions (applicable yrs)
- Nontaxable Social Security
- Favorable Tax Brackets
- Capital Gains Rates
- Special Loss Allowance for Rental Real Estate

Higher-income taxpayers face a potential additional tax related to the Affordable Care Act (health care) provisions: the 3.8% net investment income surtax applies when modified AGI exceeds certain thresholds. A higher AGI due to a Roth conversion could push the taxpayer over the threshold. Also, the additional income from a conversion could negatively impact taxpayers who might otherwise be eligible for credits for health care insurance premiums.

FACTORS IMPACTING THE CONVERSION ANALYSIS

The following are considerations that could have the most impact on the result of a conversion to a Roth.

After-Tax Cost of Traditional IRAs - Any analysis will need to factor in whether the taxpayer intends to continue contributing to the IRA. As part of that consideration, taxpayers of lesser means may not be able to afford to make the maximum annual contribution to an IRA if it is not deductible. Therefore, affordability of a nondeductible IRA contribution currently may have more influence over the decision than future benefits. Consider that taxpayers with a combined state and Federal tax rate of 37% can fund a deductible $6,000 Traditional IRA with $3,780 after-tax dollars, whereas they would need a full $6,000 for the equivalent Roth contribution.

Payment of the Roth IRA Conversion Tax - The monies used to pay the rollover tax will reduce the capital available for investment earnings, whether the conversion tax is paid from IRA funds or other available funds. Therefore, the benefits of the Roth IRA will need to be reduced by the tax and penalties (if any) AND the resulting loss of earnings over the lifetime of the IRA.

Tax Benefits of a Traditional IRA - If a taxpayer has the option of having a Deductible IRA or a Roth IRA, the tax savings produced by the Deductible IRA need to be included on the plus side for the Traditional IRA. These savings will produce investment accumulation which can be as much or more than the original savings.

Impact On Social Security Taxability and Medicare Premiums - During retirement years, some taxpayers will find that distributions from their IRA accounts will impact the taxability of their social security benefits. If this is a planning consideration, the conversion to a Roth IRA before retirement will produce tax-free distributions during retirement and could reduce or eliminate the taxability of the social security benefits. Individuals participating in Medicare who have modified AGI over $85,000 ($170,000 if filing jointly) pay higher Medicare B and D premiums. Qualified distributions from Roth IRAs are not included in MAGI, so converting a Traditional IRA to a Roth for these individuals before they enroll in Medicare may be beneficial.

IMPACT ON ESTATE TAXES AND BENEFICIARIES

Both Traditional and Roth IRAs will be includible in a decedent's estate and taxed if the estate is large enough. Traditional IRAs are included in an estate and are also taxable to the beneficiary. Roth IRAs will be includible in the estate, but qualified distributions are not taxable to the beneficiary. This can be a significant benefit to taxpayers with large estates and may be reason enough to convert.

ROTH DISTRIBUTIONS:

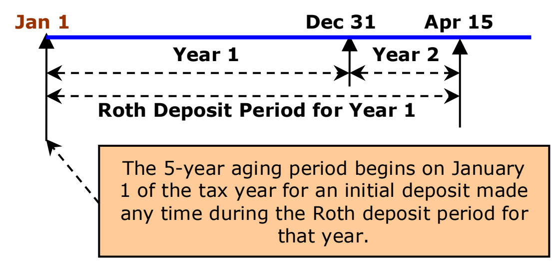
Qualified Distribution - Distributions from a Roth are nontaxable only if they are "*qualified distributions.*"
Qualified Distribution Definition - A qualified distribution is generally any payment or distribution from a Roth IRA:

1. That meets the five-year aging requirement discussed below (Sec 408(d)(2)(B)), **AND**
2. That meets one of the following conditions (Sec 408(d)(2)(A)):
   - The distribution is made after the IRA owner reaches the age of 59-1/2,
   - The distribution is made after death of the individual,
   - The distribution is made on account of the owner becoming disabled, **OR**
   - The distribution is for first-time homebuyer expenses, as detailed in chapter 4.10 on Early Withdrawal Penalty Exceptions.

Other distributions are non-qualifying, and earnings on the IRA are taxed when distributed.

Five-Year Qualifying Period - The five-tax-year period (that determines whether a Roth distribution is a "qualified distribution") begins with the first tax year for which the individual made a contribution to a Roth IRA established for the individual (Code Sec 408A(d)(2)(B)). That is, the five-tax-year holding period:

- **Begins** on the earlier of:
  (a) The first day of the individual's tax year *for which* the first regular (i.e., non-rollover) contribution is made to any of the individual's Roth IRAs or
  (b) The first day of the individual's tax year *in which* the first conversion contribution is made to any of the individual's Roth IRAs; and
- **Ends** on the last day of the individual's fifth consecutive tax year beginning with the tax year described above (Reg § 1.408A-6, Q&A 2).



Thus, if an individual whose tax year is the calendar year makes a first-time regular Roth IRA contribution for Year 1 any time between Jan. 1 of Year 1 and the April due date of Year 2, the five-tax-year period begins on Jan. 1 of Year 1. See illustration above.

Converted IRAs - A conversion of a regular IRA into a Roth IRA after the five-tax-year period has begun will not start the running of a *new* five-year period. (S Rept No. 105-174 (PL 105-206) p. 144)

Initial Deposit Starts Five-Tax-Year Holding Period For All Subsequent Deposits
Thus, once the five-tax-year holding period has been met, any distribution from the Roth IRA, even one allocable to contributions made *within five years* before the distribution, may be excludable as a qualified distribution **except as noted below for**:

- Corrective distributions,
- Rollovers from a "Designated Roth Account", and
- Beneficiaries.

Corrective Distribution Exceptions - The initial contribution to a Roth IRA does *not* start the five-tax-year holding period if that initial contribution is:

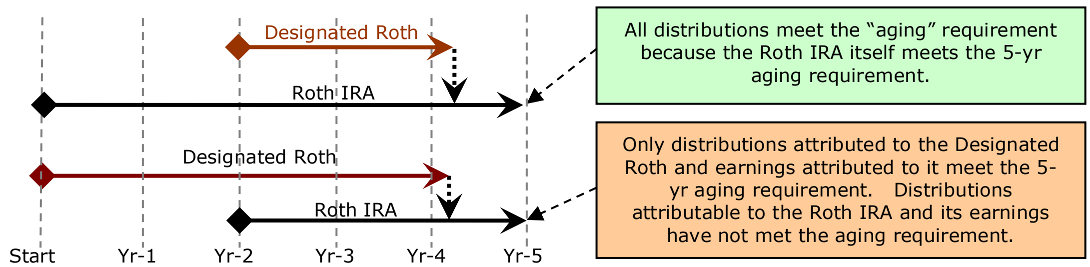
(1) Distributed as a corrective distribution. Any amount distributed as a corrective distribution is treated as if it was never contributed (Reg § 1.408A-6, Q&A 2);
(2) Revoked within seven days under Reg § 1.408-6(d)(4)(ii)(A), or
(3) Recharacterized (Preamble to TD 8816, 2/3/1999).

Beneficiaries – The following special rules apply to inherited Roth IRAs:

- General Rule - The five-tax-year holding period for a Roth IRA held by an individual as a beneficiary of a deceased Roth IRA owner **is determined independently** of the five-tax-year period for the beneficiary's own Roth IRA. (Reg § 1.408A-6, Q&A 7(b))

- Surviving Spouse - if a surviving spouse treats the Roth IRA that was owned by the decedent spouse as his or her own, the five-tax-year period for any of the surviving spouse's Roth IRAs (including the one that the surviving spouse treats as his or her own) ends at the earlier of the end of either (Reg § 1.408A-6, Ex 7(b)):
  - (1) The five-tax-year period for the decedent's Roth IRA, or
  - (2) The five-tax-year period for the spouse's own Roth IRAs.

Designated Roth Account - The five-tax-year holding period for determining a qualified distribution from a Roth IRA is determined independently of the five-tax-year holding period for determining a qualified distribution from a "designated Roth account" (discussed later in this chapter). Thus, an individual cannot count the tax years that he has had a designated Roth account towards the five-tax-year holding period for Roth IRAs, even if he rolls over an amount from the designated Roth account to the Roth IRA (Preamble to TD 9324, 4/27/2007).



NONQUALIFIED DISTRIBUTION PENALTY

If, within the 5-year period starting with the year of a *conversion* contribution, any part of a withdrawal from a Roth IRA that is from the taxable part of an amount converted, may be subject to the **10% additional tax on premature distributions**, unless one of the Sec. 72(t) exceptions applies. The 10% penalty applies **only** to the part of the conversion contribution that is included in income. Moreover, it applies as though the amount is includible in gross income in the year of the withdrawal, even if no conversion income is includible. Unless an exception applies, the taxable part of other Roth IRA distributions that are not qualified distributions is subject to the 10% penalty on premature distributions. The following early withdrawal exceptions apply to IRAs (codes refer to Form 5329, line 2, identifiers):

- Unreimbursed Medical Expenses (in excess of 7.5% or 10% (depending on year) of AGI whether or not itemizing) (**Code 05**)
- Permanent Disability (**Code 03**) or Death (**Code 04)**
- Beneficiary Exception (**Code 04 – "Death"**)
- Annuity or "Substantially Equal Payments" Exception (**Code 02**)
- Distribution as result of an IRS Levy (**Code 10**)
- Qualified Reservist Distributions – At Least 180 Days on Active Duty (**Code 11**)
- Contributions Returned Before the Due Date (**Code 12 – "Other"**)
- Medical Insurance – Receiving Unemployment Benefits (**Code 07**)
- Higher Education Expense (**Code 08**)
- First-time Homebuyer – Maximum $10,000 per taxpayer from their respective accounts (**Code 09**)
- Rollover to Health Savings Account

Note: Where an IRA account contains both Roth contributions and conversion amounts, the early withdrawal penalty can be avoided if the distributions are limited to an amount equal to the Roth contributions or less. That is because the distribution ordering rules (discussed later) specify that the distribution amounts are first allocated to Roth Contributions and then followed by conversion contributions.

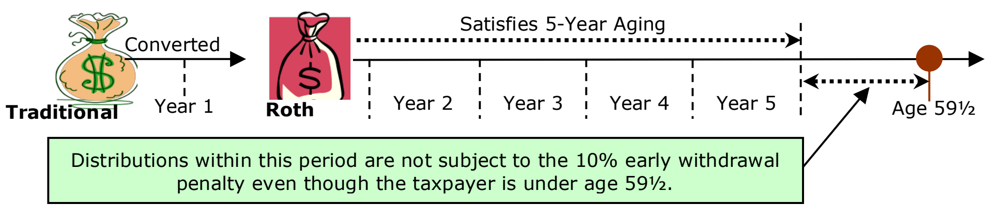
Example: *A Roth IRA contains $21,000 attributable as follows:*

• *Roth contribution for 2015*	*$5,000*
• *Roth contribution for 2016*	*$5,000*
• *Traditional IRA converted to a Roth IRA in 2015*	*$3,000*
• *Traditional IRA converted to a Roth IRA in 2016*	*$7,000*
• *Earnings*	*$1,000*

- **Scenario #1** – In 2019, the taxpayer, age 50, withdraws $10,000 from the Roth IRA. The distribution is tax- and penalty-free since, per the withdrawal ordering rules, the distribution comes first from Roth contributions.

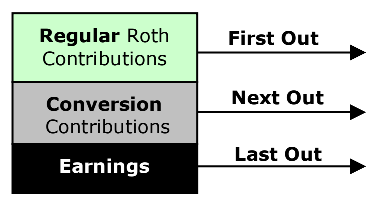
- **Scenario #2** – In 2019, the taxpayer, age 50, withdraws $15,000 from the Roth IRA. The $15,000 is allocated first to the Roth contributions, making the first $10,000 tax- and penalty-free. The remaining $5,000 is attributable to the conversion and, although it is not taxable (because it was already taxed when converted), the $5,000 is subject to the 10% early distribution penalty because it had not been in the IRA for the required five years, resulting in a $500 penalty tax. No penalty exceptions apply!
- **Scenario #3** – In 2019, the taxpayer, age 50, withdraws the entire balance of $21,000 from the Roth IRA. As with the previous examples, the first $10,000 is tax- and penalty-free. The next $10,000 is attributable to the conversion and is tax-free but subject to the 10% early withdrawal penalty because it had not been in the IRA for the required five years, resulting in a penalty tax of $1,000. The remaining $1,000 is attributable to earnings; since it had not met the 5-year aging requirement, it is subject to taxation <u>and</u> the 10% penalty, resulting in a $100 tax penalty plus the tax on the $1,000. No penalty exceptions apply!
- **Scenario #4** – In 2020, the taxpayer, age 51, withdraws the entire account balance. Let's assume the earnings amount is unchanged. The taxpayer's first conversion ($3,000) has now met its 5-year aging requirement so that the first $13,000 withdrawn is not subject to tax or penalty. However, the next $7,000 of converted funds has not met the 5-year aging requirement and, although it is tax-free, it is subject to the 10% penalty. Although the Roth account has met the 5-year aging requirement, it is still not a qualified distribution because the taxpayer is under the age of 59½ and, as a result, the $1,000 earnings are subject to both tax and the 10% penalty. No penalty exceptions apply!

Converted Amounts After 5 Years But Before Age 59½: An individual who would not reach age 59½ (or satisfy any other exception to the 10% early withdrawal tax) in five years, can nonetheless convert a traditional IRA to a Roth IRA, and receive distribution of the contribution *after* five tax years, without being subject to the 10% tax, even though the same distribution from the unconverted IRA would have been subject to the 10% tax.



<u>ORDERING RULES FOR WITHDRAWALS</u>

In determining the taxable amount of Roth IRA distributions that are not qualified distributions, distributions are treated as made in the following order (determined as of the end of the tax year and exhausting each category before moving on to the following category):



(1) From contributions and qualified rollover contributions other than from a traditional IRA. Thus, this category includes:

 (a) **Regular Roth IRA contributions**,

 (b) **Rollover contributions** from other Roth IRAs (not from traditional IRAs), and

 (c) **Rollover contributions from a designated Roth** account (Code Sec. 408A(d)(4)(B)(ii)(I)).

(2) From "**conversion contributions**," i.e., qualified rollover contributions ***other than*** **from a Roth IRA or a designated Roth account**, starting with the amounts first converted, on a **first-in, first-out basis**. (Code Sec. 408A(d)(4)(B)(ii)(II)) Distributions allocated to a conversion contribution are treated as coming first from the *taxable portion* of the contribution (Code Sec. 408A(d)(4)(B)); and

(3) From **earnings**. (Reg § 1.408A-6, Q&A 8(a)(3))

Aggregation Rules (grouping and adding rules) **-** To determine the taxable amounts distributed, distributions, and contributions by grouping and adding them together as follows.

- All withdrawals from all the taxpayer's Roth IRAs during the year are added together.
- All regular contributions made during and for the tax year are added together (including those made by the April 15 due date of the return).
- All conversion contributions made during the year are added together.

RECHARACTERIZED CONTRIBUTIONS

- Any recharacterized contributions that end up in a Roth IRA are added to the appropriate contribution group for the year that the original contribution would have been taken into account if it had been made directly to the Roth IRA.
- Any recharacterized contribution that ends up in a Traditional IRA is disregarded for the purposes of grouping both contributions and distributions. Any amount withdrawn to correct an excess contribution (including the earnings withdrawn) is also disregarded for this purpose.

MINIMUM REQUIRED DISTRIBUTIONS

Roth IRA Owners - no minimum distributions from a Roth IRA have to be made while the Roth IRA owner is alive. This means that those who don't need to utilize their Roth IRA to meet expenses during retirement can leave it untapped for heirs. **Exception:** Designated Roth 401(k) and 403(b) plans (discussed later) are subject to the RMD rules.

Beneficiaries – The post-death minimum distribution rules, with the exception of the "at-least-as-rapidly" rule, which apply to traditional IRAs also apply to Roth IRAs. Thus, the entire Roth IRA must generally be distributed (Reg § 1.408A-6) (Code Sec. 408A(c)(5)):

- Within five years of the owner's death **or**
- Over the life expectancy of a designated beneficiary, and distributions commence prior to the end of the calendar year following the year of the owner's death **or**
- Where the sole beneficiary of a Roth IRA is the Roth IRA owner's surviving spouse:
  - The spouse may delay distributions until the Roth IRA owner would have reached age 70½ or
  - May treat the Roth IRA as his or her own. This is commonly referred to as a Beneficial IRA which is left in the decedent's name and distributions are not subject to premature distribution penalties. The spouse must begin taking distributions over his or her life expectancy using the Single Life Table in the year following the owner's death (or if earlier, the year in which the IRA owner would have reached age 70-1/2).

FORM 8606

In the year an amount is converted from a traditional, SEP or SIMPLE IRA to a Roth IRA, or a nonqualified distribution is received from a Roth IRA (see 8606 instructions), Form 8606 must be filed. This form need not be filed solely to report a contribution to a Roth IRA or for rollovers from qualified retirement plans.

ROTH IRA LOSS RECOGNITION

The IRA loss recognition rule applies separately to each kind of IRA, including Roth IRAs. Thus, to recognize a loss in a Roth IRA, all amounts must be distributed from all Roth IRAs (but not traditional IRAs) owned by the taxpayer, and to recognize a loss in a traditional IRA, all amounts must be distributed from all of the traditional IRAs owned by the taxpayer (but not Roth IRAs).

If a Roth IRA loss may be claimed, it is as a miscellaneous itemized deduction, subject to the 2%-of-adjusted-gross-income limit that applies to certain miscellaneous itemized deductions on Schedule A, Form 1040. Per the TCJA, deduction of Tier 2 expenses is suspended for years 2018 through 2025, so no Roth IRA loss is deductible during this period.

QUALIFIED ROTH CONTRIBUTION PROGRAM (aka Designated Roth Account)

Code Section 402A allows employers to create a type of elective deferral program, referred to as a "Qualified Roth Contribution Program," "Designated Roth Account," "Roth 401(k)" or "Roth 403(b)." Under these plans, participants contributing to a 401(k) plan or a 403(b) (tax-sheltered annuity) program may irrevocably designate a portion of their contributions as Roth contributions.

The employee's contributions to the Roth 401(k) or Roth 403(b) are on an after-tax basis, but at retirement the earnings and pay-outs of the employee's contributions are tax-free. In many respects, the decision whether to designate a portion of elective deferrals as Roth contributions is similar to the decision of whether to make a regular deductible contribution to an IRA or a nondeductible contribution to a Roth IRA, although more individuals will be in a position to make the decision.

- Available **only if the employer's plan offers** the Qualified Roth option.
- Can **designate part or all** of the contribution to the Qualified Roth option.
- The election once made is **irrevocable**.
- Not subject to the regular Roth AGI contribution limits.
- Designated Qualified Roth amount **cannot exceed the annual limit for elective deferral** contributions, \$19,000 (\$25,000 if age 50 or over) for 2019.
- **Subject to the required minimum distribution (RMD) rules** at age 70½. However, the RMD can be avoided if the Qualified Roth is rolled into a Roth IRA before reaching the age of 70½.

- **5-year qualifying period** determined separately from a Roth IRA (See page 04.06.08).
- **Qualified distributions** are tax-free (See qualified distributions page 04.06.08).
- **Employer's matching contributions** cannot be designated as to the Qualified Roth and will be taxed when distributed.
- **Rollover** to a Roth IRA is permitted.
- The employer (plan sponsor) must maintain separate Roth accounts and keep **separate records for each Roth** account from the time the initial designated Roth contribution is made.
- **Distributions** from Roth 401(k) and Roth 403(b) accounts **may be rolled over**, but only to other Roth accounts in a 401(k) plan or 403(b) arrangement, or to a Roth IRA.
- Under the general rules of **elective deferrals, distributions** from Roth 401(k) accounts are permitted only when the participant terminates employment, dies, becomes disabled, reaches age 59½, or due to hardship (if allowed by the plan).
- Unlike Roth IRAs, distributions of Roth 401(k) contributions are not permitted for the purpose of the **first-time purchase of a home**. However, the work-around for this is to make a trustee-to-trustee transfer from the Roth 401(k) to a Roth IRA and then take a distribution from the Roth IRA to use for first-time home purchase expenses.

Excess Deferrals – In general, when a 401(k) or 403(b) plan participant has excess deferrals (i.e., more than the annual limit is contributed), the excess must be distributed and included in income. However, if Roth 401(k)/403(b) contributions are distributed as excess deferrals no later than April 15 of the year following the contribution year, they will not be subject to tax (because they were after-tax contributions), but the earnings on the excess Roth 401(k) or 403(b) contributions will be taxed when distributed.

If the plan doesn't distribute the excess Roth 401(k)/403(b) contributions by April 15, the Roth 401(k)/403(b) contributions will be taxed twice. The first time was when the contribution was made. The second time will be upon distribution, at which time the earnings on the excess contributions will also be taxed.

Taxation of Distributions – Like Roth IRA contributions, Roth 401(k)/403(b) contributions and related earnings are generally not included in gross income when distributed, if they are "qualified distributions," meaning the distribution was made:

1. After the participant reached age 59-1/2, died or became disabled, ***AND***
2. More than 5 years after the first Roth 401(k) or Roth 403(b) contribution to the plan or a predecessor Roth 401(k)/403(b) plan. (See 5-year qualifying period on page 04.06.08.)

Retirement Funds Can Be Converted to a Designated Roth Account – A participant in a 401(k), 403(b) and 457 retirement plan that also includes a Designated Roth account may, in a qualified distribution, roll over the portion of the plan that is not in a Designated Roth account into the Designated Roth account. The IRS terms this action an "in-plan rollover." The rollover does not count towards the maximum limit on elective deferrals for the year.

The rollover, if elected by the employee (or surviving spouse), is made by direct transfer within the plan. Rollovers from other plans are not permitted. Once the rollover is made, future distributions from the designated Roth account conform to the rules for Designated (Qualified) Roth Accounts discussed above.

CAUTION: A plan that includes a Designated Roth program is permitted, but *not required,* to allow rollover contributions (described above) to a designated Roth account. (Com Rept)

Plans have allowed participants to convert their pre-tax accounts to Roth accounts, but only with respect to money they have a right to take out of the plan, usually because they have reached age 59½ or separated from service. The American Taxpayer Relief Act (ATRA) allows any amount in a non-Roth account to be converted to a Roth account in the same plan, whether or not the amount is distributable.

This is, however, not a tax-free rollover. The rollover amount is included in the taxpayer's gross income for the year.

CAUTION: Although the rollover generally is not subject to the 10% early withdrawal penalty, future distributions of funds that are in the Designated Roth account that are attributable to rollovers that have not met the 5-year aging rule would be subject to the 10% penalty. (For more on the 5-year aging rule see page 04.06.08).

A plan participant who elects an in-plan Roth rollover cannot later recharacterize the rollover, as could be done with rollovers to Roth IRAs prior to 2018. (IRS Notice 2010-84)

Government 457 Plans & Designated Roth IRA Accounts - Governmental section 457 plans are "applicable retirement plans" that can offer a qualified Roth contribution program, effective beginning in 2011. (Code Sec. 457(e)(1)(C))

Thus, a section 457 plan maintained by a state, its political subdivision, agency, or instrumentality, or the state subdivision's agency or instrumentality, can include a qualified Roth contribution program. This provision does not apply to plans of nonprofit organizations.

UNRELATED BUSINESS INCOME: See chapter 4.05

CALIFORNIA DIFFERENCES

California conforms to the Federal Roth IRA rules, including the federal phase-out amounts for Roth IRA contributions. Thus, for California purposes, taxpayers may use the same elections for state purposes as they use on their Federal returns.

California conforms to the federal Roth conversion rules.

Continue to next page for the Roth Conversion Checklist

NOTES

2019 ROTH CONVERSION CHECKLIST

Taxpayer:___________________________________

SSN: _________________________________

Tax Year: _________

CHECKLIST

❑ Yes ❑ No Does the taxpayer have a basis in the IRA to be rolled over?

If so, what is the basis amount? $ _________________

❑ Yes ❑ No Is the taxpayer planning a partial IRA rollover conversion?

Is allocation between accounts required? ❑ Yes ❑ No

❑ Yes ❑ No Is the taxpayer under 59-1/2?

❑ Yes ❑ No Is the taxpayer married?

If so, is the spouse the beneficiary? ❑ Yes ❑ No

❑ Yes ❑ No Will the taxpayer pay the rollover tax from the IRA funds?

❑ Yes ❑ No Will the taxpayer continue to make annual contributions to the IRA?

If so, how much? $ _________

For how many years? ________

❑ Yes ❑ No Does the taxpayer intend to withdraw from the Roth IRA?

If so, at what age? _________

For how many years? ________

If not, explain:___________________________________

❑ The investment rate of return the t/p expects during accumulation period:____%

❑ The investment rate of return the t/p expects during distribution period: ____%

❑ Taxpayer's marginal tax brackets during conversion: Fed:____% State: ____%

Itemizing? ❑ Yes ❑ No

❑ Taxpayer's marginal tax brackets during distribution: Fed:____% State: ____%

Itemizing? ❑ Yes ❑ No

❑ Yes ❑ No Is the taxability of Social Security an issue?

During conversion period? ❑ Yes ❑ No

During distribution (retirement)? ❑ Yes ❑ No

❑ Yes ❑ No Is the taxpayer's gross estate a consideration?

❑ Yes ❑ No Will rollover conversion impact other tax benefits during conversion period?

If so, what: ____________________________________

IRA COMPARISONS – 2019

(This is an abbreviated overview. Refer to the appropriate chapter for full details)

TYPE:	TRADITIONAL	ROTH
CONTRIBUTIONS		
Annual Limit (Smaller of):	Earned Income [*] Contribution Limit	Earned Income [*] Contribution Limit
	[*] Includes alimony and non-taxable combat pay	
Non-Working Spouse (Smaller of):	Limited to Working Spouse E.I. Contribution Limit	Limited to Working Spouse E.I. Contribution Limit
Contribution Limit 2019	$6,000 ($7,000 age 50 & up)	$6,000 ($7,000 age 50 & up)
Age Limits	70-1/2	None
AGI Phase Out (2019)	(With Other Qualified Plan)	(With or W/O Other Qualified Plan)
Joint	$103 - 123K [1]	$193 - 203K [1)]
MS	$0 - 10K	$0 - 10K
All Others	$64 - 74K [1]	$122 – 137K [1]
Spouse	$193 - 203K [1]	$193 - 203K [1)]
No Other Qualified Plan	None - All Filing Statuses	Not Applicable
	[1] *Inflation adjusted*	
WITHDRAWAL SEQUENCE		
Rollover Funds	Annuity Rules	1st –Regular Contributions, Next – Conversions & Rollovers [2] Last - Earnings
Basis (Pre-taxed funds)	Annuity Rules	
All Other Funds	Annuity Rules	
PENALTY-FREE WITHDRAWALS		
Under Age 59-1/2	72(t) Rules	Basis after 5 yrs
Age 59-1/2 and Over	OK	OK if in plan 5 yrs
First-Time Home Buyer	$10,000	Basis + $10,000
Education	Qualified Use	Qualified Use
Death of IRA Owner	Beneficiaries	Beneficiaries
Disability	Yes	Yes
TAX-FREE WITHDRAWALS		
Under Age 59-1/2	Basis Only - Annuity Rules	Basis after 5 yrs
59-1/2 And Over	Basis Only - Annuity Rules	All funds
MANDATORY WITHDRAWALS		
Age	70-1/2	None
Minimum	Annuity Rules	Not Required if owner alive

[2] Traditional IRA conversions, and direct rollovers from qualified plans, on FIFO basis.

Continued Next Page

TYPE:	TRADITIONAL	ROTH
ROLLOVERS		
Frequency	One per 12 months(3)	One per 12 months(3)
To Same Type IRA	Partial or All OK	Partial or All OK
(3) Trustee-to-trustee transfers don't count as a rollover for frequency limit; effective 1/1/15, the one rollover per 12-month period limit applies on an aggregate basis not a per account basis		
To Roth IRA	OK - Penalty-Free	---
Partial	OK - Pro-rata All IRAs	---
Time Limits - General	60 days of Distribution	60 days of Distribution
- First Time Homebuyer	120 days of Distrib. – Failed Purchase	120 days of Distrib. – Failed Purchase
DEATH OF IRA OWNER		
Beneficiary - Spouse		
- Others	See Minimum Required Distributions (Chapter 4.17)	

DEFINITIONS

Basis: Previously taxed funds

Earned Income (E.I.): Generally income subject to social security taxes, non-taxable combat pay and taxable alimony.

Annuity Rules: Payment over the lifetime of the IRA owner and (if applicable) the IRA owner's beneficiary. Nontaxable portion is distributed ratably with taxable portion under the usual rules.

NOTES

EARLY WITHDRAWAL PENALTY EXCEPTIONS

- **Early withdrawal penalty**: 10%
- **Applies to:** Taxable Distributions to taxpayers under the age of 59½

PENALTY EXCEPTION OVERVIEW & APPLICATION

Exception	Code*	IRA	Qualified Plans	Government Plans	Page
60-Day Rollover	--	√	√	√	4.10.01
Unreimbursed Medical Expense Exception	05	√	√	√	4.10.02
Disabled Exception	03	√	√	√	4.10.02
Beneficiary Exception	04	√	√	√	4.10.03
Annuity (Substantially Equal Payments)	02	√	√	√	4.10.03
Distribution as a Result of an IRS Levy	10	√	√	√	4.10.05
Qualified Reservist Distribution	11	√	√	√	4.10.05
Qualified Domestic Relations Order (QDRO)	06		√	√	4.10.05
Separation from Service (Age 55 or Older)	01		√	√	4.10.06
Contributions Returned Before Due Date	12	√			4.10.06
Medical Insurance Exception	07	√			4.10.06
Higher Education Expense Exception	08	√			4.10.06
First Time Homebuyer Exception	09	√			4.10.07
Public Safety Employees (Age 50 or Older)	01			√	4.10.08
Federal Workers' Phased Retirement	12			√	4.10.08

*for Form 5329, Part I, line 2

Related IRC and IRS Publications and Forms

- **Form 5329 –** Additional Tax on Qualified Plans (including IRAs)
- **Form 5329 -** Instructions
- **Pub 530 –** First Time Homebuyers
- **Pub 575 –** Pension and Annuity Income
- **Pub 590-B –**Distributions from Individual Retirement Plans (IRAs)
- **Sec 72(t)(2)**

Generally, if a taxpayer is under age 59-1/2 and withdraws assets (money or other property) from a qualified plan including Traditional IRAs, the taxpayer must pay a 10% additional tax, commonly referred to as a penalty (IRC Sec. 72(t)). This tax is 10% of the part of the distribution that the taxpayer was required to include in gross income the year of the distribution.

Caution – Delayed Check Cashing – Rev Rul 2019-19 concludes that an individual's failure to cash a qualified plan or IRA distribution plan distribution check does not permit the individual to exclude the amount of the designated distribution from gross income and does not alter the employer's withholding obligations or Form 1099-R reporting obligations, Thus the distribution is taxable in the year of the distribution. This rule applies if the individual *could* have cashed the check, and would apply whether or not the individual keeps the check, sends it back, destroys it, or cashes it in a later tax year

A number of exceptions provide relief from the early withdrawal penalty, as explained below.

EXCEPTIONS THAT APPLY TO ALL QUALIFIED PLANS:

Some exceptions apply to all qualified plans, while some apply only to Traditional IRAs. Those listed in this section apply to all qualified plans, unless otherwise noted.

60-Day Rollover To Another Qualified Plan – A taxpayer can avoid both the income tax and the penalty on an early distribution if the distribution is rolled over into an eligible retirement plan within 60-days of receipt (Code Sec. 402(c)(1)). The IRS may waive the 60-day rollover period for equitable reasons, including cases of casualty, disaster, or other events beyond an individual's control such as bank error, if certain conditions are met. (Code Sec. 402(c)(3)) Taxpayers, as of August 24, 2016, may provide written certification to a plan administrator or an IRA trustee that he or she missed the 60-day deadline because of not being able to complete a rollover due to one or more of 11 situations provided for in Rev Proc 2016-47. See page 04.04.07 for details.

Some taxpayers use the 60-day rollover provision as a source for a short-term loan. However, there are built-in hazards for the 60-day rule:

One rollover per 12 months rule - Code Sec 408(d)(3)(B) limits the number of IRA rollovers to one per one-year period. The IRS historically interpreted the one rollover per year to mean one rollover from each of the taxpayer's IRAs, and this position had been published in IRS Publication 590 for 2013. However, the tax court in *Bobrow v.*

Commissioner (TC Memo 2014-21) reached the conclusion that the once-per-year IRA rollover limitation applies on an aggregate basis, meaning that an individual could not make an IRA-to-IRA rollover if he or she had made such a rollover involving **any** of the individual's IRAs in the preceding 1-year period.

The IRS has adopted the Tax Court position but provided transitional relief by not applying the court's interpretation to IRA rollovers occurring before January 1, 2015. (Ann. 2014-15) See Chapter 4.04 for additional information.

Twenty percent withholding rule – Another barrier to completing a 60-day rollover is the mandatory 20% withholding of federal income tax requirement when a qualified plan distribution isn't transferred trustee-to-trustee. Because 20% of the distribution went to withholding tax, the taxpayer only received 80% of the funds and cannot recoup the withholding until filing time. Thus they would have to make up the 20% from other sources to complete a 100% rollover.

Direct transfers - A distribution from a qualified retirement plan or IRA that is transferred directly by the trustee of the plan to the trustee of another qualified plan or to another IRA does not count as a rollover and does not trigger the once-per-year rollover limitation; direct transfers are not subject to withholding.

Unreimbursed Medical Expenses Exception - Amounts withdrawn to pay unreimbused medical expenses that would be deductible on Schedule A during the year and that for 2017 or 2018 exceed 7.5% of the taxpayer's AGI are exempt from penalty. The percentage increases to 10% starting in 2019. This is true even if the taxpayer does not itemize.

Enter unreimbursed medical expense………………………………………………………………...	___________
Enter 10% (or 7.5% when applicable) of the taxpayer's AGI for the year….........	<___________>
Penalty exempt amount…………………………………………………………………………………….	___________

Disabled Exception - If a taxpayer becomes disabled before reaching age 59-1/2, any amounts withdrawn because of the disability are not subject to the 10% additional tax. A taxpayer is considered disabled if the taxpayer can furnish proof that he/she cannot perform any substantial gainful activity because of the physical or mental condition. A physician must determine that the taxpayer's condition:

- ❑ Can be expected to result in death, **or**
- ❑ Is expected to be of a long, continued and indefinite duration.

In determining whether an individual's impairment makes him unable to engage in any substantial gainful activity, the regulations provide that the primary consideration is to be given to the nature and severity of the impairment, but other factors, such as the individual's education, training, and work experience, must also be considered. Substantial gainful activity is the activity, or a comparable activity, in which the individual customarily engaged prior to becoming disabled or prior to retirement if the individual was retired at the time the disability arose. Whether or not the impairment in a particular case constitutes a disability is to be determined with reference to all the facts in the case. (Reg. 1.72-17A(f))

The following are examples of impairments that would ordinarily be considered as preventing substantial gainful activity:

- Loss of use of two limbs;
- Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;
- Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;
- Cancer which is inoperable and progressive;
- Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;
- Mental diseases (e.g. psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;
- Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;
- Permanent and total loss of speech;
- Total deafness uncorrectible by a hearing aid.

The existence of one or more of the impairments described above will not, in and of itself always permit a finding that an individual is disabled as defined in Sec 72(m)(7). Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity.

AIDS did not constitute disability (West, TCS) - The Tax Court noted that the taxpayer did not qualify as disabled, because he had been able to engage in substantial gainful activity during the year at issue.

Depression constituted disability - Tax Court has held that a former postal employee's depression qualified her for the disability exception to the 10% premature withdrawal penalty tax on qualified plans. Her psychologist's conclusion that there was a fair prospect of her eventual return to work in some capacity didn't mean that her condition was not indefinite. *(Mary L. Coleman-Stephens, TC Summary Opinion 2003-91)*

In contrast, and more typical of the outcome of cases involving mental illness, in an earlier 2003 case *(Keeley v. Commissioner, TC Summary Opinion 2003-53)*, the Tax Court held that the taxpayer's depression was not a qualified disability for the 10% penalty exception. In the Court's opinion the taxpayer's condition was remediable, and it did not require him to be institutionalized or put under constant supervision, conditions noted in the regulations for a mental illness to be a disability.

Beneficiary Exception - If a taxpayer dies, the benefits distributed to a taxpayer's beneficiary or estate are exempt from the early withdrawal penalty. ***Caution:*** If a decedent's spouse chooses to treat the distribution as his/her own and later receives a distribution before reaching age 59-1/2, it may be subject to the penalty.

Annuity or "Substantially Equal Payments" Exception - This exception essentially allows a taxpayer to retire early and take withdrawals before reaching age 59-1/2. For qualified plans, this exception applies only for distributions that begin after the taxpayer separates from service. To qualify for this exception, the payments:

- ❑ Must be part of a series of substantially equal payments over the taxpayer's life, or the joint life expectancies of the taxpayer and the taxpayer's beneficiary, **and**
- ❑ Payments under this exception must continue for at least 5 years, or until the taxpayer reaches age 59-1/2, whichever is the longer period. This 5-year rule does not apply if a change from an approved distribution method is made because of the death or disability of the IRA owner.

Example*: Dan began taking eligible payments at age 56 on December 1, 2014. He may not take a different distribution or alter the amount of the payment until December 1, 2019, even though his fifth payment was taken on Dec. 1, 2018.*

Example*: Sue began taking substantially equal periodic payments on Dec. 1, 2012. She turns 59½ on July 1, 2019. She may not take a different distribution or alter the amount of the payment until July 1, 2019.*

Methods - Code Section 72(t) does not include a specific method of computing the payments. In **Notice 89-25, 1989-1 CB 662,** modified by **Rev. Rul. 2002-62**, the IRS suggests three methods that might be used in computing the payments. Several letter rulings have also been issued approving other methods.

The following summarizes the methods outlined in Rev. Rul. 2002-62. Methods 1 through 3, explained below, are applicable for any series of payments starting on or after January 1, 2003, but could have been used for distributions starting in 2002. As the examples for Methods 1 through 3 show, the amount of the annual payment varies significantly with the method chosen.

- ***Method 1, Required Minimum Distribution (RMD) Method (RR 2002-62) –*** The annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined for each year. If this method is chosen, no modification in the series of substantially equal periodic payments will be deemed made, even if the amount of payments changes from year to year, provided there isn't a change to another method of determining the payments.

Example: *Taxpayer is age 55, spouse is age 50; qualified retirement plan account balance is $303,000; taxpayer's first distribution is in 2019. Generally, the Uniform Lifetime Table would be used, unless (1) there is no designated beneficiary, in which case the Single Life Expectancy Table is used, or (2) the distribution is from a Joint and Last Survivor annuity for which the Joint and Last Survivor Table is used.*

	Factor	Annual Distribution
Single Life	29.6	$10,236
Uniform Lifetime	41.6	$ 7,284
Joint and Last Survivor	38.3	$ 7,911

CAUTION:
The RMD Method may not allow an affected taxpayer to withdraw enough from their IRA to meet their current financial obligations while they wait for their Social Security or other retirement plan payments to kick in.

- ***Method No. 2, Fixed Amortization Method (RR 2002-62) –*** The annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years determined using the chosen life expectancy table and the chosen interest rate (defined below). Once calculated, the annual payment would not change, and the same amount would be distributed in later years.

Example: *Same facts as above, plus the chosen interest rate is 3.5% (for the purpose of these examples, assume that this is an eligible rate). The annual distribution would be as follows depending on the Life Expectancy Table used:*

	Factor	Annual Distribution
Single Life	29.6	$16,602
Uniform Lifetime	41.6	$13,936
Joint and Last Survivor	38.3	$14,483

- ***Method No. 3, Fixed Annuitization Method (RR 2002-62) –*** Divide the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer (or the joint lives of the individual and beneficiary). The annuity factor is derived using the mortality table in Appendix B of Rev. Rul. 2002-62 and using the chosen interest rate (defined below). Under this method, the annual payment determined for the first distribution year remains the same amount in each succeeding year.

  Example: *Under the fixed annuitization method, using the facts as in the example just above, the single life annuity factor would be 18.336 and the annual distribution $16,525 ($303,000/18.336). For a joint life expectancy, the annuity factor is 21.485 and the distribution would be $14,103 ($303,000/21.485).*

Rules and definitions for Methods 1 – 3:

- **Life Expectancy Tables** – that can be used are:
  1. Uniform Lifetime Table from Appendix A of Rev Rul 2002-62 (shown at 4.02.1), **or**
  2. The Single Life Expectancy Table (partially illustrated at 4.02.2; complete table in Reg. 1.401(a)(9)-9, Q&A 1), **or**
  3. Joint and Last Survivor Table (partially illustrated at 4.02.4; table in Reg. 1.401(a)(9)-9, Q&A Use the number from the chosen table for the distribution year that is for the employee's (or IRA owner's) age on his or her birthday in that year. If the Joint and Last Survivor Table is used, the age of the beneficiary on the beneficiary's birthday in the year is also used. For Method 1, the same life expectancy table used for the first distribution year must be used in each following year.

     If the Joint and Last Survivor table is used, the survivor must be the actual beneficiary of the account for the year of the distribution, determined for the year on January 1, and without regard to changes in the beneficiary during that or prior years. If there is more than one beneficiary, the identity and age of the beneficiary used for Methods 1 – 3 is determined as explained in chapter 4.17 at "Determine Beneficiaries' Life – Multiple Beneficiaries." Essentially use the oldest beneficiary's life expectancy. If, in any year there is no beneficiary, use the Single Life Table for that year.

- **Interest Rates** - The interest rate that may be used is any rate that is not more than 120% of the federal mid-term rate for either of the two months immediately preceding the month in which the distributions begin. The revenue rulings that contain the applicable federal mid-term rates are available on the IRS web site by searching for "applicable federal rate".
- **Account Balance** – The account balance used to determine payments must be determined in a reasonable manner based on the facts and circumstances.

  Example: *An IRA with daily valuations made its first distribution on 07/15/19. According to the regulations, when using Method 1, it would be reasonable to determine the yearly account balance based on the value of the IRA from 12/31/18 to 07/15/19. In subsequent years, using the same method, it would be reasonable to use the value either on 12/31 of the prior year or on a date within a reasonable period before that year's distribution.*

- **Modifications to Payments** - Under all three methods, IRS will consider that there is a modification to the series of payments if, after the first valuation date, there is:
  1. Any addition to the account balance other than gains or losses,
  2. Any nontaxable transfer of a portion of the account balance to another retirement plan, or
  3. A rollover by the taxpayer of the amount received resulting in such amount not being taxable.

CAUTION - Payers of qualified "substantially equal" payments will prepare Form 1099-R with a code 2 (early distribution, known exception) in Box 7. However, the Form 1099-R instructions tell payers to use code "1" (early distribution, no known exception) if they don't know if the taxpayer meets the requirements for the "substantially equal" exception. This could happen if the taxpayer transfers his IRA or qualified plan account from the custodian who was originally involved when the payment plan was set up to a different custodian or trustee (for example, from one brokerage to another), even if the payments have not been modified. In this event, Form 5329 (Part I) will need to be prepared and included with the taxpayer's income tax return to justify why no penalty has been included in the return. Any transfer of accounts should be done trustee-to-trustee to avoid the possibility that the taxpayer would be considered to have received an additional payment (even if it is rolled over timely) and then be disqualified from the "substantially equal" exception.

Distribution as result of an IRS Levy - The 10% penalty tax on early withdrawals (under Code Sec. 72(t)) does not apply to withdrawals from a qualified plan or IRA made on account of a levy under Code Sec. 6331 on the plan or IRA. (§ 72(t)(2)(A)(vii))

This exception applies to distributions only if the qualified plan or IRA is actually levied on. The 10% penalty tax still applies if the taxpayer withdraws amounts from a qualified plan or IRA to pay taxes in the absence of a levy, or even if the taxpayer makes a plan or IRA withdrawal in order to cause the IRS to release a levy on a separate property interest of the taxpayer.

> ***Example – IRS Levy –*** *Taxpayer, age 40, has $15,000 in his IRA, including $5,000 in nondeductible (after-tax) contributions. IRS issues a notice of levy to the IRA custodian for the collection of taxes owed by the taxpayer, and levies on the entire $15,000 in his IRA in Year 1. On his Year 1 income tax return, the taxpayer must report taxable income of $10,000 ($15,000 withdrawal less $5,000 nondeductible contributions). However, under Code Sec. 72(t)(2)(A)(vii), the taxpayer is not subject to the 10% early withdrawal tax on the distribution. But if the taxpayer had withdrawn the money to pay taxes in the absence of a levy, the 10% penalty would apply, and the additional tax would be $1,000.*

Pension Plan Garnishment - IRS has privately ruled that qualified retirement plans won't be disqualified for paying some participants' and beneficiaries' benefits to satisfy their criminal fines under garnishment orders relating to federal criminal statutes. IRS also concluded that the distributions would not be subject to the 10% early withdrawal penalty tax, mandatory withholding or written notice requirements. PLR 200426027

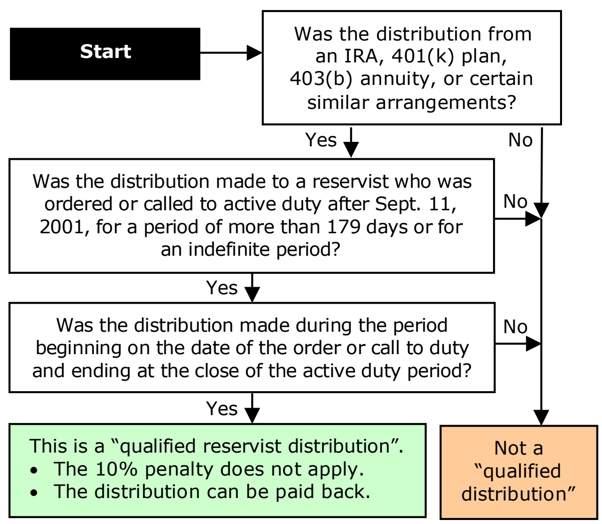
In another ruling, IRS privately held that a federal court seeking to collect a fine in an individual's criminal case would not violate the anti-alienation rule by garnishing the individual's Code Sec. 401(k) plan account balance. However, that ruling did not address the 10% additional tax, or whether the payments would be subject to mandatory withholding. See PLR 200342007.

Qualified Reservist Distributions - The 10% early withdrawal penalty tax does not apply (retroactively) to a "qualified reservist distribution." A qualified distribution is:

(1) From an IRA or attributable to elective deferrals under a 401(k) plan, 403(b) annuity, or certain similar arrangements;

(2) Made to individuals who (because of their being members of a reserve component) are ordered or called to active duty after Sept. 11, 2001, for a period of more than 179 days or for an indefinite period; and

(3) Made during the period beginning on the date of the order or call to duty and ending at the close of the active duty period.



Pay-Back Option - Those who receive a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to their IRAs in an aggregate amount not to exceed the amount of the distribution (i.e., they may make "pay back" contributions).

Original Distribution Taxability - No provision is made to allow the taxpayer to amend the return on which the original distribution was reported to recover the regular tax that was paid on the amount that is paid back. Since the amount that is paid back is not deductible, it may be appropriate for the taxpayer to contribute the pay-back to a Roth IRA; there the earnings on the repayment will grow tax-free and distributions will be tax-free (if the age and holding period requirements are satisfied). If the nondeductible pay-back is made into a Traditional IRA, when the funds are distributed at retirement, they will be partially tax-exempt based on the ratio of nondeductible contributions to total contributions. In the year the distribution is paid back, the taxpayer is required to file Form 8606 to report the nondeductible contribution.

EXCEPTIONS THAT APPLY TO QUALIFIED PLANS OTHER THAN AN IRA

Qualified Domestic Relations Order (QDRO) - A QDRO is a judgment, decree, or order relating to payment of child support, alimony, or marital property rights to a spouse, former spouse, child or other dependent. The order has to contain certain specific information like the amount of the participant's benefits to be paid to each alternate payee.

<u>Spouse or former spouse</u> - If a spouse or former spouse receives retirement benefits from a participant's plan under a QDRO, the former spouse must report the payments just as though he/she were the plan participant. **The early distribution penalty does not apply**, regardless of the alternate payee's age. The taxability is computed by allocating the spouse/former spouse a share of the investment in the contract and figuring the taxable portion accordingly. If the recipient spouse rolls over the distribution to an IRA, or there is a direct trustee-to-trustee transfer, the recipient spouse will not be taxed currently on the plan benefits received under the QDRO, but distributions from the IRA before that spouse is age 59½ will be taxed and subject to the 10% penalty unless one of the other exceptions applies.

<u>IRAs</u> - The QDRO exception to the 10% penalty does not apply to distributions from IRAs, but Code Sec. 408(d)(6) provides that the transfer of an individual's interest in an IRA to his spouse or former spouse incident to divorce is not a taxable transfer and that the transferred amount is to be treated as the IRA of the transferee spouse. Thus, the tax on early distributions does not apply.

Separation from Service - Distributions from a qualified retirement plan after separation from service in or after the year the taxpayer reached age 55 (see below for a special rule for certain public safety employees). ***Note:*** Distributions of this type are rarely coded on Form 1099-R as an early distribution.

This exception applies only where the taxpayer separates from employment after reaching age 55. The Tax Court ruled the exception did not apply in the case of a taxpayer who retired from his job when he was age 53 but who waited until after he turned 55 to make a withdrawal from his qualified retirement plan (*Williams v. Commissioner, T.C. Summary 2008-53, 5/19/08*). A taxpayer must be age 55 or older, and then separate from employment, for an early distribution to be excepted from the 10% penalty.

EXCEPTIONS THAT APPLY TO IRA ACCOUNTS ONLY

Contributions Returned Before the Due Date - If the taxpayer made an IRA contribution for the tax year, it can be withdrawn tax-free by the extended due date of the tax return provided:

1. Taxpayer did not take a deduction for the contributions withdrawn, **and**
2. The taxpayer also withdraws any interest or other income earned on the contributions, **and**
3. The taxpayer includes in income, for the year in which the withdrawal was made, any earnings on the contributions withdrawn.

Medical Insurance Exception - This exception allows taxpayers that qualify to make penalty-free withdrawals to pay for medical insurance. The amount that is exempt from penalty cannot be more than the amount the taxpayer paid during the year for medical insurance for taxpayer, spouse, and dependents. To qualify for this exception, the taxpayer:

1. Must have lost his/her job,
2. Received unemployment compensation for 12 consecutive weeks,
3. Made IRA withdrawals during the year he/she received unemployment **or** in the following year, and
4. Made the withdrawals no later than 60 days after being reemployed.

Higher Education Expense Exception - Withdrawals made during the year for qualified higher education expenses for the taxpayer, spouse or children or grandchildren of the taxpayer or spouse are exempt from the early withdrawal penalty. The part not subject to the tax is generally the amount that is not more than the qualified higher education expenses for the year at an eligible educational institution. To compute the qualified higher education expenses, use the worksheet below.

1. Enter tuition, fees, books, supplies, and equipment…………….________
2. If student is at least ½ time, enter room & board expenses ________
3. **Total expenses (1 + 2)**…………………………………………………………………………...__________ **(A)**
4. Distributions from a Coverdell Education Savings Acct………..________
5. Scholarships, such as a Pell grant………………………………………..________
6. Employer-provided educational assistance……………………………________
7. Any tax-free payment (See note.)………………………………………..________
8. Total tax-free funds (4 thru 7) (Don't include a gift, bequest, or devise.)…<__________> **(B)**
9. **Qualified Higher Education Expenses (A) – (B)** ………………..………………..._________

Note: Refers to any tax-free payment (other than a gift, bequest, or devise) due to enrollment at an eligible educational institution.

For this exception to apply, the qualifying expenses and distribution from the IRA must occur in the ***same*** tax year. A pre-age 59-1/2 IRA distribution used to pay down credit card debt that had been incurred to pay qualified higher education expenses in the two years prior to the distribution year did not qualify for exception from the penalty (*L.L. Lodder-Beckert, T.C. Memo 2005-162*).

A Tax Court case concluded that amounts paid for a computer, housewares, appliances, furniture, bedding, and books in connection with the taxpayers' daughter's enrollment at a university did not qualify for the education expense exception to the IRA early withdrawal penalty because they weren't shown to be required for her education. *(Gorski, TC Summary Opinion 2005-112)*

First-Time Homebuyer Exception - To qualify for treatment as a first-time homebuyer distribution, the distribution must meet *all* the following requirements:

1. It must be used to pay qualified acquisition costs before the close of the 120th day after the day the distribution was received.
2. It must be used to pay qualified acquisition costs for the main home of a first-time homebuyer (defined later) who is any of the following:
   a. Taxpayer, taxpayer's spouse
   b. Taxpayer or spouse's child or grandchild
   c. Taxpayer or spouse's parent or other ancestor
3. When added to all the taxpayer's prior qualified first-time homebuyer distributions, if any, the total distributions cannot be more than $10,000. A husband and wife meeting the definition of first-time homebuyers and purchasing an eligible home together *can* each withdraw up to $10,000 from each of their respective IRAs without incurring any penalty for early withdrawal.

<u>*First-Time Homebuyer*</u> **-** Generally, the taxpayer is a first-time homebuyer if the taxpayer had no present interest in a main home during the 2-year period ending on the date of acquisition of the home for which the distribution is being used to buy, build, or rebuild. If the taxpayer is married, the taxpayer's spouse must also meet this no-ownership requirement.

<u>*Date of Acquisition*</u> **-**The date of acquisition is the date that a taxpayer:

- Entered into a binding contract to buy the main home for which the distribution is being used, **or**
- Began building or rebuilding the main home for which the distribution is being used.

<u>*Failed Purchase*</u> – If the purchase cannot be completed within the 120-day time period the taxpayer may re-contribute the funds to the IRA account as long as 120 days have not passed since the withdrawal. In other words, for first time homebuyers the 60-day rollover period is replaced with 120 days. In addition, the rollover is disregarded for purposes of the one rollover every year limitation. (Section 72(t)(8)(E))

Strategies

Strategies - Navigating the First-Time Homebuyer Quirks - Except for some special exceptions, when a taxpayer withdraws funds from an IRA or a Qualified Plan before attaining the age of 59½, the taxpayer will incur a 10% early withdrawal penalty in addition to paying tax on the distribution. One of the exceptions allows each taxpayer who qualifies as a "First-Time Homebuyer" to make a $10,000 penalty-free withdrawal from an IRA to purchase a home. (§72(t)(2)(F)) At first glance, one would assume the exception (1) only applies to the first home a taxpayer ever purchased, (2) the funds cannot come from another qualified plan such as a 401(k) plan, and (3) the home purchased must be for the taxpayer(s). One who made such assumptions would be in error.

Although this penalty exception applies to IRA withdrawals only, there is nothing to prevent a taxpayer from transferring or rolling over funds from a qualified plan, such as a 401(k) plan, self-employment plan, SEP, 403(b), etc., into an IRA and then taking the distribution from the IRA to achieve a penalty-free distribution.

Since the legislation was designed to assist individuals to get into the housing market, one would assume that a taxpayer's "first home" means just that. However, that is not the case as the tax code is far more liberal. A first-time homebuyer is a taxpayer (and spouse, if married) that has no ownership interest in a main home in the two-year period preceding the acquisition of the home.

In fact, the home does not even need to be the taxpayer's own home, since the taxpayer is permitted to use this special exclusion for the purchase of a first-time home for the taxpayer's or spouse's child, grandchild, parent or other ancestor so long as the home meets the definition of "first home" for the relative. Thus, the exclusion permits a taxpayer to use the exclusion to help a qualified relative.

If married, this exception applies to both spouses separately; thus, each could withdraw up to $10,000 ($20,000 combined) from their individual IRA accounts and avoid the early withdrawal exception. This is, however, a lifetime exclusion so when added to all the taxpayer's prior qualified first-time homebuyer distributions, if any, the total distributions cannot be more than $10,000.

CAUTION!

Even though a first-time homebuyer withdrawal might be penalty-free, it is still taxable. In addition, the distribution must be made within the 120-day period preceding the home's acquisition.

EXCEPTIONS THAT APPLY TO GOVERNMENT PLANS ONLY

Public Safety Employees (Age 50+) Not Subject to 10% Penalty Tax (§ 72(t)(10)).

The 10% early withdrawal tax does not apply to distributions from a governmental defined benefit pension plan to a qualified public safety employee who separates from service after age 50. A qualified public safety employee is:

(1) Any employee of a State or political subdivision of a State who provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision, or

(2) Effective after December 31, 2014, any Federal law enforcement officer, Federal customs and border protection officer, Federal firefighter, or any air traffic controller. Added by the ''Defending Public Safety Employees' Retirement Act'' of 2015.

Applies to Original Distribution Only - this exception applies only to the original distribution from the government plan. If the employee rolls the funds into an IRA or defined contribution plan, any subsequent distribution is subject to the 10% penalty. (Notice 2007-7 Q9)

1099-R Coding - A payer is permitted to use distribution code 2 (early distribution, exception applies) in box 7 of Form 1099-R. However, a payer is also permitted to use distribution code 1 (early distribution, no known exception) if the payer does not know whether the exception under § 72(t)(10) applies. (Notice 2007-7 Q10). If the 1099R shows code 1, but the taxpayer qualifies for the exception and is not subject to the 10% penalty, use Code 01 on Form 5329.

Exception for Federal Workers' Phased Retirement

H.R. 4348, the Moving Ahead for Progress in the 21st Century Act (aka MAP-21) was signed by the President on July 6, 2012. The bill includes a provision of phased retirement for federal employees, effective after the Office of Personnel Management issues implementing regulations, which they did on November 6, 2014, and the various agencies decide whether to and how to implement the program. Media reports indicate that very few government employees have applied to participate in this program so far, with most retirement-age employees who leave government service either retiring fully or going to work in the private sector. Some departments have indicated they won't be adopting the phased retirement program any time soon.

This provision allows certain federal employees to phase into retirement at the end of their careers. Phased retirees would work part-time while receiving proportionately reduced pensions. At full retirement, the phased retiree will receive a composite retirement annuity that also includes the portion of the employee's retirement annuity attributable to the reduced work schedule.

Payments under a phased retirement annuity and a composite retirement annuity received by an employee participating in this new program are exempt from the early distribution penalty. (Code Sec. 72(t)(2)(A)(viii), as amended by Act Sec. 100121(c).

CALIFORNIA DIFFERENCES

The California penalty rate for early retirement plan or IRA distributions is 2.5%. The amount of the early distributions included in income for California purposes may differ from the amount reported on the federal return if the amount of contributions deducted for California was different than the federal amount (for example, because California and federal maximum contribution amounts were not the same in some years). The California penalty applies to the amount of the early distribution taxable on the California return.

California generally conforms to the exceptions allowable under Federal law. If the FTB levies the plan to pay delinquent state taxes, the distribution will be subject to federal penalty but exempt from penalty by CA. Legislation will be needed before California conforms to the exception for federal workers' phased retirement payments.

California does not penalize a taxpayer who fails to make their required minimum distribution.

NOTES

SELF-EMPLOYED RETIREMENT PLANS

(Keogh Plans)

RAPID FINDER

- **Contribution Due Date: Extended Due Date**
- **Plan Existence:** Plan must be **set up before year-end**
- **Defined Benefit Contribution $ Limit For 2019:** Amount contributed can't create an annual benefit in excess of the larger of **$225,000** or 100% of participant's average compensation for highest 3 years
- **Defined Contribution $ Limit For 2019: $56,000**
- **Defined Contribution % Limit**:
  - Profit Sharing: **25% (20% of the net) –** (contributions **discretionary**)
  - Money Purchase: **15% (13.141%) -** (contributions **mandatory**)
- **Minimum Funding Standards for Under-funded Plans–** Paid during year in quarterly installments:
  (1) 90% of the current plan year's required contribution, or
  (2) 100% of the required contribution for the preceding plan year.

Combo Self-Employment and 401(k) Plans

Self-employed taxpayers can combine 401(k) plans with Keogh and SEP plans to increase the deductible annual contribution. For more information on the combo plans and examples, see Course CPE 418 or Chapter 4.18 "Solo 401(k) Plans." Also see Chapter 9.09 for discussion of the pension start-up credit available for small businesses.

Related IRS Publications and Forms

- **Pub 560** – Retirement Plans for Small Business
- **Form 5500** – Annual Return/Report of Employee Benefit Plans
- **Form 5500EZ** – Annual Return of One Participant (Owners & Their Spouses) Retirement Plans

KEOGH PLANS

Retirement plans for self-employed individuals are often referred to as Keogh plans, even though the distinction between qualified plans of corporate employers and self-employed retirement plans generally was eliminated many years ago. A Keogh plan can only be established by an employer, so a sole proprietor or partnership (not an individual partner) can set up a plan. In general, Keogh plans may be divided into two categories:

DEFINED BENEFIT PLANS - are those where annual contributions are set by determining the amount necessary to provide a SPECIFIC retirement benefit to the plan participant. The formula for figuring contribution amounts is not based on current earnings but on actuarial assumptions and computations. These plans are more costly to administer than defined contribution plans (below), but can yield greater tax benefits, especially for the taxpayer who starts a plan later in life. The maximum annual benefit for this kind of plan is shown in the table that follows.

Maximum Benefit – Defined Benefit Plans

Year	2014	2015	2016	2017	2018	2019	2020
Max Annual Benefit	210,000	210,000	210,000	215,000	220,000	225,000	
IRS Notice	2013-73	2014-70	2015-75	2016-62	2017-64	2018-83	

If amount not shown, it was not available at publication date.

DEFINED CONTRIBUTION PLANS - establish an individual account for each person in the plan and plan benefits are based on the amount contributed to each account, plus earnings. Keogh plans in this category are divided into two types:

(a) **Profit-sharing plans** base contributions on a proportion of company profits. The contributions are discretionary, so a taxpayer does not have to make a contribution every year.

(b) **Money purchase plans** are those where contributions are not based on company profits but rather are mandatory each year at a fixed percentage of compensation. A penalty is assessed for failure to make a required contribution to a money purchase plan (use ***Form 5330***).

The information in this chapter provides basic guidance for defined contribution Keoghs of sole proprietors who have no employees.

Keoghs and SE Income **-** Keogh plans are available only for taxpayers with ***Self-Employment (SE) Income;*** contribution limits are based on net SE income. Plan contributions cannot be made on the basis of SE income from a ***partnership except at the partnership level***. The self-employed individual's deduction of plan contributions made on his/her own behalf is an adjustment to income on Form 1040, specifically on Schedule 1, line 15 (draft 2019); contributions on behalf of employees are deducted on Schedule C.

IRAs and Keogh Plans - A self-employed taxpayer can deduct contributions to BOTH an IRA and a Keogh plan (subject to the IRA active-participation rules). The IRA contribution is computed based on compensation and SE income less the Keogh contribution and the deduction allowed for 50% of self-employment tax.

Figuring the SE tax **–** Before one can calculate a Self-Employment retirement contribution the SE Tax must be determined. For purposes of computing the SE tax, the law provides a deduction equal to 7.65% of net SE earnings. Thus the net earnings for determining the SE tax is the regular net earnings from self employment multiplied by .9235 (100% less 7.65%). **CAUTION:** If the taxpayer is receiving a premium assistance credit under the Affordable Care Act the following calculation will require several iterations in conjunction with calculation for the credit until the difference is within $1.

The computation does not include the additional 0.9 percent Medicare tax on the self-employment income of certain high-income taxpayers. (Code Sec. 1402(a)(12))

Example *– For 2019, the SE tax rate is 15.3%. Peter has 2019 self-employment income of $75,000. His SE tax would be $10,597 ($75,000 x .9235 x .153). For 2019 50% of the SE tax is allowed as a deduction arriving at AGI (Sec. 164(f) deduction).*

Figuring the maximum Contribution – The maximum contribution is 25% of SE Income (net profit from the business under which the plan is established) minus the SE tax deduction allowed by Sec 164(f) and the retirement contribution itself. Using some math (see box on right) we find that actually equates to 20% of SE Income.

Where: X = SE Retirement Contribution.
Y = SE Income net of 50% deduction

$X = .25\,(Y - X)$

$X = .25Y - .25X$

$1.25X = .25Y$

$X = .25Y/1.25$

$X = .2Y$

Max Contribution = 20% of SE Income

Example – *Continuing the example from above, Peter's maximum contribution for the year would be determined as follows:*

Net SE Income		*75,000*
Net SE Income x .9235	*69,263*	
SE Tax (69,263 x .153)	*10,597*	
SE Tax times 50%		*< 5,299>*
Net		*69,701*
Max Contribution (.2 x 69,701)		*13,940*

Proof:

Net SE Income	*75,000*
§164(f) SE Tax deduction	*<5,299>*
Contribution	*<13,940>*
Net	*55,761*
Max. Contribution Rate	*x .25*
Max. Contribution	*13,940*

Common Law Employees - For purposes of a Keogh plan, a self-employed individual is both an "employer" and an "employee." A "common law employee" performs services for an employer who has the right to control and direct both the results of the work and how it is done. For Keogh plan purposes, common law employees are not self-employed with respect to income from their work, even if that income is self-employment income for social security purposes. Thus, such common law employees as ***ministers, members of religious orders, and full-time insurance sales people*** may not establish Keogh plans with respect to their earnings from those sources.

Limits on Contributions to Defined Contribution Plans - The limits are inflation-adjusted in $1,000 increments. The maximum annual Keogh contribution to a defined contribution plan is ***the smaller of "25% of compensation"*** or:

Maximum Contribution – Defined Contribution Plans

2014	2015-16	2017	2018	2019	2020
$52,000	$53,000	$54,000	$55,000	$56,000	

If amount not shown, it was not available at publication date.

The maximum annual compensation that can be taken into account for qualified retirement plan purposes is inflation-adjusted in $5,000 increments.

Maximum Compensation Considered when Computing Deduction

2014	2015-16	2017	2018	2019	2020
$260,000	$265,000	$270,000	$275,000	$280,000	

If amount not shown, it was not available at publication date.

Profit-Sharing Plan: A profit-sharing plan contribution is limited to ***25% of compensation***. Annual contributions are discretionary.

Money Purchase Plan: A money purchase plan has a 25% contribution limit. **Annual contributions are mandatory.**

Profit-Sharing Plans are Generally the Best Option

With a contribution limit at 25%, Profit-Sharing Plans have the same contribution limit as Money Purchase Plans without the mandatory contribution requirement. Prior to 2001 profit sharing plans (PS) were limited to 15% and they were combined with money purchase plans (MP) to attain the 25% limit, 15% of the contribution being discretionary. The current 25% limit virtually makes stacked plans (15% PS and 10% MP) obsolete. However, older plans may still be in existence and must be funded correctly. Stacked plans still in existence should be converted to 25% profit sharing plans or 25% SEP plans.

TIMING OF KEOGH CONTRIBUTIONS: Contributions must be made by the ***EXTENDED DUE DATE*** of the return to which the contribution applies; the plan must be set up ***BEFORE YEAR-END*** of the year to which the contribution applies.

COVERAGE REQUIREMENTS: In general, an employee must be allowed to participate in a Keogh when:

(1) The employee reaches age 21, and

(2) The employee completes one year of service [two years of service if a plan provides 100% vesting (i.e., the right to an accrued benefit is completely nonforfeitable) after two years of service]. Sole proprietors who consider setting up Keogh plans which cover employees should be advised to consult a knowledgeable pension administrator.

REQUIRED DISTRIBUTIONS: If retirement occurs prior to age 70-1/2, distributions from a Keogh plan must begin by April 1 of the year after the participant turns 70-1/2. A Keogh participant who is still employed after age 70-1/2 must begin distributions by April 1 of the year that follows the year in which he/she *retires*, if allowed by the terms of the plan. However, for a five-percent owner the required beginning date is April 1 of the year following the year in which the individual reaches age 70-1/2, even if still working.

> *Definition of 5%-owner* - An employee of a corporation is a five-percent owner when the employee owns more than five percent of the employer's outstanding stock or stock possessing more than five percent of the total combined voting power of all of the employer's stock. When the employer is not a corporation, a five-percent owner is any employee who owns more than five percent of the capital or profits interest in the employer.

Thus, a non-corporate sole proprietor with a Keogh plan must begin distributions from the plan by April 1 of the year after he/she turns 70-1/2.

AGE LIMIT FOR CONTRIBUTIONS: Unlike an IRA there is no age limit for contributing to a Keogh account. Contributions can be made even if the taxpayer has reached age 70-1/2 and is taking required minimum distributions.

RETURNS AND REPORTING: The Keogh plan administrator or employer must file an annual return by the last day of the seventh month following the end of the plan year (July 31 for calendar year plans). Plans can easily obtain a 2-1/2 month extension by filing Form 5558, Application of Extension of Time to File Certain Employee Plan Returns. A one-participant SEP is not required to report under this requirement. ***Generally, self-employed plans will file a 5500 EZ (See Chapter 4.12).***

DIRECTOR FEES - KEOGH DENIED TO SHAREHOLDER-EMPLOYEE

A self-employed individual is one who has net earnings from self-employment. "Net earnings from self-employment" means gross income from any trade or business, less deductions which are attributable to such trade or business. But a "trade or business" for this purpose excludes "the performance of services by an individual as an employee" (Code Sec. 1402(c)(2)).

Directors' fees are self-employment income (Rev Rul 72-86). Thus, since directors' fees are self-employment income, a corporate director may establish a Keogh plan based on directors' fees.

An officer of a corporation who performs more than minor services and receives remuneration for such services is a considered an employee. A director of a corporation in his capacity as such is not an employee of the corporation (Code Sec. 3121(d)(1)) (Reg § 31.3121(d)-1(b)).

The Tax Court has held that director fees paid by a company to its president, sole shareholder, and sole director were actually wages paid for his day-to-day involvement in running the business. Since the fees were wages, he had no self- employment income and thus couldn't deduct contributions he made to a self- employed Keogh-type pension plan. Burbach, TC Memo 2019-17

CALIFORNIA DIFFERENCES

California conforms to Federal treatment but has no annual return filing requirement.

NOTES

ANNUAL RETURN – ONE PARTICIPANT PENSION PLANS

Due Date: **July 31st** (calendar year plans)
Form: Generally Form **5500-EZ**
Extension: 2-1/2 Months – Form 5558
Filing Required if:

- Assets of all related plans **exceed $250,000**, or
- It is the final year of the plan.
- Certain foreign plans – see 5500-EZ instructions

Late filing penalties - **$25 per day** up to $15,000 maximum

RAPID FINDER	
5500-EZ	4.12.01
Due Date	4.12.02
E-File	4.12.02
Extension	4.12.02
Filing Information	4.12.02
Late Filing Penalty	4.12.02
Mandatory E-file	4.12.01
Paid Preparer Info	4.12.02
Penalty Relief	4.12.02

Related IRS Publications and Forms

- **Form 5500-EZ** – Annual Return of A One Participant Plan (Owners/Partners and Their Spouses) Retirement Plan or A Foreign Plan
- **Form 5558** – Application for Extension to Time to File Certain Employee Plan Returns

One-participant plans with assets of $250,000 or less as of the close of the plan year do not have to file a return for that year. For example, a calendar year plan with assets of $265,000 on Dec. 31, 2018 had a 2018 filing requirement, but if the same plan's assets were $240,000 on Dec. 31, 2019, no filing is required for 2019.

ABOUT RETURNS AND REPORTING:

The Keogh plan administrator or employer must file an annual return by the last day of the seventh month following the end of the plan year (July 31 for calendar year plans). Plans can easily obtain a 2-1/2 month extension by filing Form 5558, Application of Extension of Time to File Certain Employee Plan Returns. One participant SEP is not required to report under this requirement. ***Generally, self-employed plans will file a 5500-EZ.***

Mandatory Electronic Filing of Form 5500 Annual Return/Reports (but not 5500-EZ) - Under the Department of Labor's Final Rule on Annual Reporting and Disclosure, Form 5500 Annual Returns/Reports must be filed electronically. The all-electronic EFAST2 system allows the public to submit and access filings online at www.efast.dol.gov.

Filers and preparers can register for an account, complete the required forms and schedules online (in multiple sessions), print a copy for their records and submit it at no cost.

CAUTION
The Form 5500-EZ cannot be submitted electronically. A "one-participant" plan (see the instructions for the Form 5500-SF) that is eligible to file Form 5500-EZ and is not required to file under Title I of ERISA may elect to file Form 5500-SF electronically with EFAST2 rather than filing a Form 5500-EZ on paper with the IRS. Such a "one-participant plan" that is not eligible to file Form 5500-SF must file Form 5500-EZ on paper with the IRS. For more information on filing the Form 5500-EZ, see the instructions for Form 5500-EZ.

QUALIFICATIONS FOR USING THE 5500-EZ:

To use the EZ form, the plan must be a defined benefit pension plan or a defined contribution profit-sharing or money purchase pension plan, other than an Employee Stock Ownership Plan (ESOP), that meets the following requirements:

(1) The plan covers: (a) only the taxpayer and the taxpayer's spouse, and the business (whether incorporated or unincorporated) is wholly owned by the taxpayer, or the taxpayer and his spouse, or (b) only partners in a business partnership, or the partners and their spouses;
(2) The plan meets the Code Sec. 410(b) minimum coverage requirements without being combined with any other plan that covers other employees of the same business;
(3) The plan does not provide benefits for anyone but the owner, the owner and his spouse, or one or more partners and their spouses;
(4) The plan does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of businesses under common control; and
(5) The plan does not cover a business that leases employees.

If the plan is ineligible to use Form 5500-EZ, then Form 5500, and detailed schedules, must be used.

WHO MUST FILE FORM 5500-EZ

If the above requirements are met and the plan had more than $250,000 in assets at the end of the plan year, Form 5500-EZ must be filed. Note: A taxpayer who has more than one one-participant plan must combine the plans' assets for purposes of the $250,000 test.

Final plan year - All one-participant plans should file the Form 5500-EZ for their final plan year indicating that all assets have been distributed. The final plan year is the year in which distribution of all plan assets is completed. Check the "final return" box at the top of Form 5500-EZ if all assets under the plan(s) (including insurance/annuity contracts) have been distributed to the participants and beneficiaries or distributed to another plan.

FILING DUE DATE: Form 5500-EZ must be filed by the last day of the seventh month following the end of the plan year (e.g., July 31 for calendar year plans) unless an extension is granted. If the filing due date is a Saturday, Sunday, or legal holiday, the return may be filed on the next day that is not a Saturday, Sunday, or legal holiday.

EXTENSION: A one-time extension to file Form 5500-EZ of up to 2-1/2 months may be obtained by filing Form 5558. A copy of Form 5558 must be retained with the plan's records. One-participant plans automatically receive an extension of time to file Form 5500-EZ (without filing a Form 5558) if the following conditions are met:

- The plan year and the employer's tax year are the same;
- The employer has been granted an extension to file its Federal income tax return to a date later than the normal due date for filing the Form 5500-EZ; and
- A copy of the IRS extension to file the income tax return is retained with the plan's records.

Caution: *If the filing deadline for any plan is extended automatically, it cannot be extended further by filing a Form 5558 after the original due date.*

LATE FILING PENALTIES: The Internal Revenue Code imposes a penalty of $25 a day (up to $15,000) for not filing returns in connection with pension, profit-sharing, etc., plans by the required due date. Experience has shown the penalties will be abated for reasonable cause.

LATE FILER PENALTY RELIEF: The IRS provides penalty relief for one-participant plans (owner-spouse) including partnerships. The relief is available to the plan administrator or plan sponsor of: (1) certain small business (owner-spouse) plans and plans of business partnerships, and (2) certain foreign plans. Under the program, no penalty is required to be paid for late filing. To participate in the relief, the taxpayer:

- Must include a Form 14704, Transmittal Schedule – Form 5500-EZ Delinquent Filer Penalty Relief Program, with each submission.
- Must submit the delinquent return on the Form 5500-EZ that applied for the plan year for which the return was delinquent. However, for plan years prior to 1990, the current year form may be used.
- Must file the returns manually; they cannot be filed through the Department of Labors EFAST2 filing system.
- Must mark in red letters in the top margin of the first page of the return (above the title of the form): "Delinquent Return Submitted under Rev. Proc. 2015-32, Eligible for Penalty Relief."
- Each submission must be accompanied with a payment of $500 for each year's return, up to a maximum of $1,500 per plan.

Send submissions to Internal Revenue Service, 1973 North Rulon White Blvd., Ogden, UT 84404-0020.

For additional information on the penalty relief program, see Rev Proc 2015-32, which can be found at https://www.irs.gov/irb/2015-24_IRB.

USE FILLABLE FORM: Form 5500-EZ is a scannable form. Although a manually prepared form can be submitted, it is best practice to download the fillable form from the IRS website, complete it on your computer, and then print, sign and mail it.

Paid Preparer Information Optional - While Treasury regulations require all paid tax return preparers to obtain a Paid Preparer Tax Identification Number (PTIN) and put the PTIN on all tax forms, currently the Form 5500 series does not provide an entry field for a preparer's PTIN.

WHERE TO FILE:

Paper filed returns - The plan administrator or the employer (owner) must sign and date the return. The Form 5500-EZ is filed with IRS at Ogden, Utah 84201-0020.

Electronically filed returns - One-participant plans may satisfy their filing obligation under the Code by filing Form 5500-SF (short-form) electronically under EFAST2 (in place of Form 5500-EZ), provided that the plan covered fewer than 100 participants at the beginning of the plan year. Form 5500-SF must be used and filed electronically instead of filing a paper Form 5500-EZ if the filer is required to file at least 250 returns of any type with the IRS, including Forms W-2 and 1099, income tax returns, employment tax returns, and excise tax returns, during the calendar year that includes the first day of the applicable plan year. Eligible one-participant plans need complete only the following questions on the Form 5500-SF:

Part I, lines A, B, and C;	Part II, lines 1a–5b, 5d(1) & (2), 5e;	Part III, lines 7a–c and 8a;
Part IV, line 9a;	Part V, line 10g; and	Part VI, lines 11–12e

The EFAST2 filing system and additional instructions are available at: www.efast.dol.gov.

California has no similar filing requirement.

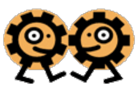
SIMPLIFIED EMPLOYEE PENSION PLANS

Overview

- **Contribution Due Date: Extended Due Date**
- **Plan Establishment**: Plan may be set up and funded before the expiration of the extended due date for the taxpayer's return.
- **Contribution $ Limit (2019): $56,000**
- **Contribution % Limit**: **25% (20% of the net)**
- **Contributions are allowed after age 70.5** (Code Sec. 219(b)(2))

RAPID FINDER

Contribution Limits	4.13.01
Distributions	4.13.02
Due Date	4.13.02
Employees	4.13.01
Partnership	4.13.01
Post 70.5 Contributions	4.13.02
SARSEP	4.13.02
Self-employment	4.13.02
SEP versus IRA	4.13.01
Simple IRA Effect	4.13.02
Sub-S Corporation	4.13.01
UBI	4.13.02
Vesting	4.13.01



The Details

A Simplified Employee Pension (SEP) is an alternative to a Keogh plan, designed to be easily administered to meet the needs of a small business. The limit on SEP contributions is similar to that of the Keogh profit-sharing plan.

A sole proprietor who has a Keogh plan can terminate the plan and roll over the funds to a SEP (***LR 8033090***). Unlike the Keogh, a SEP can be set up after the end of the plan year. A 5500-series return is not required to be filed for a SEP covering only one person. However, if employees are covered, certain notifications are required.

IMPORTANT NOTES

(1) A SEP plan is a qualified plan and the amount contributed to a SEP plan is **NOT** treated as an IRA contribution for purposes of limiting traditional and Roth IRA contributions where the taxpayer would otherwise qualify for traditional or Roth IRA contributions. However, due to the "active participation" rules, deductions of contributions to a traditional IRA by a SEP participant may be limited depending on the individual's AGI.

(2) When figuring the taxable and non-taxable portions of an IRA distribution or conversion, the SEP IS treated as an IRA and is included in the rule where "all IRAs are treated as one."

(3) A SEP plan is considered an IRA for purposes of limiting IRA rollovers to one rollover per 12-month period. See Chapter 4.04.

SELF-EMPLOYED INDIVIDUALS: An individual in business for himself or herself, and whose business isn't incorporated, is self-employed. Sole proprietors and partners are self-employed. For retirement plan purposes, sole proprietors are treated as both an employer and an employee. (Pub 560, pg 5).

NET EARNINGS FROM SELF-EMPLOYMENT: Net earnings include a partner's distributive share of partnership income or loss (other than separately stated items, such as capital gains and losses). **It doesn't include income passed through to shareholders of S corporations**. (Pub 560, pg 5).

EMPLOYEE PARTICIPATION AND VESTING: An employer (this can be a self-employed person) can contribute to a retirement account established for each employee who:

(1) Is at least 21 years of age;
(2) Has worked for the employer in at least three of the immediately preceding five calendar years;
(3) Has received at least the minimum compensation (see table) in the calendar year.

	2009-2014	2015+
Minimum Compensation	$550	$600

All eligible employees must participate in the plan, but nonresident aliens with no U.S. earned income and employees covered by collective bargaining units are not required to be covered. The SEP plan must be written, and contributions must be 100% vested when made (i.e., nonforfeitable). A SEP cannot discriminate in favor of officers, shareholders, self-employed individuals, or highly-compensated employees.

An employee participating in a SEP can be allowed a deduction for his/her own contributions to an IRA subject to the limitations on AGI for active participants (a SEP is a qualified plan under the IRA active-participation rules).

CONTRIBUTION LIMITS: The maximum annual contribution to a SEP plan is ***the lesser of "25% of compensation"*** (20% of net profit after deducting the SEP contribution for the self-employed proprietor's contribution) or:

2013	2014	2015-16	2017	2018	2019	2020
$51,000	$52,000	$53,000	$54,000	$55,000	$56,000	

If amount not shown, it was not available at publication date.

SEP contributions on behalf of an owner-employee are computed in the same manner as for a profit-sharing Keogh.

Computing the maximum contribution – The maximum contribution for a self-employed individual is determined in the same manner as a SE Retirement (Keogh) plan. For examples see page 4.11.02.

No catch-up contribution - The catch-up contribution allowed for age 50 and over participants of Traditional and Roth IRAs is not allowed for SEP-IRAs.

EXCESS CONTRIBUTIONS: An employee may avoid the 6% excise tax on excess SEP contributions, and the 10% early distribution tax on the early withdrawal of the excess contributions, by *withdrawing* excess contributions from his SEP-IRA *on or before* the due date (including extensions) for filing the employee's income tax return for the tax year for which the contributions were made (Code Sec. 408(d)(4)).

EFFECT OF SIMPLE IRA CONTRIBUTIONS ON SEP CONTRIBUTION LIMITS: Contribution limits of SIMPLE and SEP plans are separate, and therefore, an employee participating in a SIMPLE-IRA who is also self-employed with a SEP for the business can make the maximum allowed salary deferral of $13,000 for 2019 ($12,500 2015 - 2018) plus a $3,000 (2015 - 2019) catch-up contribution for the SIMPLE-IRA; the employer must also contribute to the SIMPLE plan. The contributions to the SEP plan (that is not a SARSEP) are not reduced by the contributions of either the employee or the employer to the SIMPLE IRA plan. Thus for 2019 the individual can make up to a $56,000 SEP contribution. If the business sponsors another defined contribution plan in addition to the SEP, the individual's contributions for himself to all of the business's plans would be limited to 25% of net SE earnings, up to $56,000 for 2019.

ELECTIVE DEFERRAL SEP CONTRIBUTIONS (SARSEP): An employer currently is not allowed to establish a SARSEP. However, those participating (including new participants--i.e., employees hired after '96) in a plan established pre-1997 can continue to contribute. The allowable deferral amounts are inflation adjusted for years after 2006 in $500 increments.

SARSEP Elective Deferral Contribution Limits

Year	2013-14	2015-17	2018	2019	2020
Under Age 50	17,500	18,000	18,500	19,000	
Age 50 and over	23,000	24,000	24,500	25,000	

If amounts not shown, they were not available at publication date.

Elective deferrals are available only if:

(1) At least 50% of the employees eligible to participate in the SEP elected deferral contributions.
(2) The employer had no more than 25 employees who were eligible to participate in the SEP at any time during the preceding year.
(3) The average deferral percentage for highly-compensated employees wasn't more than 125% of the average deferral percentage of all other employees who were eligible to participate.

TIME FOR MAKING CONTRIBUTIONS: SEP contributions are timely if made by the extended due date of the employer's tax return. A self-employed individual has until his extended return due date both to establish and to make deductible contributions to a Simplified Employee Pension (SEP). (Code Sec. 404(h)(1)(B))

WHERE TO DEDUCT: SEP contributions made on behalf of employees are deducted by a sole proprietor as an expense on Schedule C. The sole proprietor's own contribution to the SEP is deducted as an adjustment to income on Form 1040, Schedule 1, line 15 (draft 2019).

DISTRIBUTIONS: Distributions from SEPs are taxed in much the same way as IRA distributions. SEP distributions are not eligible for special averaging techniques (i.e., 10-year averaging for lump sums received by employees born before 1/2/1936). The early withdrawal penalty applies to distributions prior to a participant's reaching age 59-1/2.

CONTRIBUTIONS AFTER AGE 70.5: SEPs are IRAs, rather than defined contribution plans, and thus Code Sec. 411(b)(2)(A)'s requirement that benefits continue to accrue to an employee's account regardless of the employee's age does not apply. The general rule for IRAs is that no deduction for an IRA contribution is allowed for a beneficiary who has reached age 70-1/2. However, for an employer contribution to a SEP, this rule does not apply (Code Sec. 219(b)(2)).

Thus, employers must make contributions to the account of employees who are 70-1/2 or older under the same participation rules used for other employees, despite the fact that these employees are receiving required minimum distributions from the SEP. A self-employed individual age 70-1/2 or over can also make SEP contributions for himself or herself, but must take required minimum distributions. (Pub 560, Chp 2, Pg 6)

UNRELATED BUSINESS INCOME: See chapter 4.05

CALIFORNIA DIFFERENCES

California conforms to Federal treatment.

401(k) PLANS

Overview

Type of Plan: Employer
2019 Contribution Limits: $19,000 ($25,000 if age 50 and over)
Special Provisions: Loans and hardship distributions
Premature Distribution Penalty: Yes

Cash or deferred arrangements (CODAs), popularly known as "401(k)" plans (referring to the code section that covers such plans) allow an employee to choose whether the employer should pay a certain amount directly to the employee in cash, or instead pay that amount on the employee's behalf into a qualified trust as a means for the employee to save for retirement. However, the amount an employee can elect to defer for a tax year is capped (see table below).

Pubs Forms

Related IRS Publications and Forms

- **Pub 575** – Pension and Annuity Income
- **Pub 4222** - 401(k) Plans for Small Businesses
- **Form 5329** - Additional Taxes on Qualified Plans

The Details

401(k) PLAN CONTRIBUTION LIMITS

In a "cash or deferred arrangement" (CODA) eligible employees are entitled to elect to receive part of their compensation from their employer in cash or have it contributed to the plan on a pre-tax basis. This type of arrangement is often referred to as a 401(k) plan;

401(k) is the IRC section that permits such plans. There is an annual limit to the amount of deferred compensation that each employee may contribute to the 401(k) plan.

401(k) Contribution Limits

Year	2015-17	2018	2019	2020
Under Age 50	18,000	18,500	19,000	
Age 50 and over	24,000	24,500	25,000	

If amounts not shown, they were not available at publication date.

Catch-Up Contributions - Individuals age 50 and over can make additional annual "catch-up" contributions to salary reduction plans including 401(k) plans, provided the plan permits catch-up contributions. The allowable "catch-up" amount is indexed for inflation in $500 increments.

Catch-Up Contributions Exempt from Regular Limits - Catch-up contributions are exempt from the regular dollar limits on deferrals. Provided that all 401(k) plan participants are permitted to make catch-up contributions, they are exempt from nondiscrimination rules.

Additional Limits

Year	2017	2018		2019	2020
Deferral Limit	54,000	55,000		56,000	
Compensation Limit	270,000	275,000		280,000	

If amounts not shown, they were not available at publication date.

Additional limits – In addition to the limit on elective deferrals, annual contributions to all of an employee's retirement accounts – including elective deferrals, employee contributions, employer matching and discretionary contributions and allocations of forfeitures to the accounts - may not exceed the lesser of 100% of the employee's compensation or the amounts shown in the table. Also, the amount of compensation that can be taken into account when determining employer and employee contributions is limited to the amounts indicated in the table.

MULTIPLE 401(k) PLAN CONTRIBUTION LIMITS

It is not uncommon for individuals to have multiple employers, each with a 401(k) plan. This can possibly create a situation where the employee makes an excess elective deferred compensation contribution. The maximum annual contribution for 2019 is 19,000 ($25,000 if age 50 and over).

The limit does not just apply to each 401(k) plan to which the employee makes elective deferrals, but instead applies to the aggregate amount of all the elective deferrals made by the employee for the year to all plans which permit such contributions, including:

- Code Sec. 401(k) deferred compensation plans,
- Code Sec. 408(k) SEP IRAs,
- Code Sec. 408(p)(2) SIMPLE Plans, and

- Code Sec. 403(b) annuity plans (TSAs)

However, Code Sec. 457 plans (government plans) are not included in the overall deferral limitations

> ***Example -*** *Sam is a 45-year-old individual who participates in employer Y's qualified cash or deferred arrangement. For January through July Sam deferred $13,800 into Y's qualified cash or deferred arrangement. Sam subsequently leaves employer Y's employment and begins working for employer Z. During the remainder of 2019, Sam defers an additional $6,000 under Z's qualified cash or deferred arrangement. Sam's elective deferral contributions for 2019 total $19,800. Since Sam is under age 50, Sam's maximum allowable contribution for 2019 is $19,000 and he has $800 in excess contributions.*

To the extent taxable, the distribution of the excess deferral is taxable in the year distributed (Reg. Sec. 1.402(g)-1(e)(8)(i)). Thus, an excess deferral for 2019 distributed in 2020 would be taxable in 2020. Such a distribution would appear on a 1099-R for 2020 with a code 8. It is not subject to the early distribution penalty of Sec 72(t).

Correcting Excess Contributions - After the close of the tax year, but not later than April 15 (or earlier as specified in the plan), the taxpayer may notify each plan under which elective deferral contributions were received by the plan for the year. The notification must also identify the extent, if any, the contribution consisted of designated Roth contributions (Reg. Sec. 1.402(g)-1(e)(2)(i)). No later than April 15 after the close of the taxable year, the plan may distribute the excess and any earnings associated with the excess contribution to the taxpayer (Reg. Sec. 1.402(g)-1(e)(2)(ii)).

CAUTION

Here is the result of not correcting an excess 401(k) contribution before April 15 of the subsequent year.

- The excess is taxable in the year of the excess contribution (but not subject to the premature distribution penalty).
- Whenever the excess is withdrawn it is taxable again (i.e. no basis is established by virtue of the excess being taxed).

PLAN QUALIFICATION

A 401(k) plan must meet all of the normal tax qualifications rules, nondiscrimination rules and in addition, all of the following requirements:

(1) Amounts must not be distributed except by reason of:
  - (a) Retirement, death, disability, or other separation from service,
  - (b) Hardship,
  - (c) Attaining the age of 59-1/2 for profit-sharing or stock bonus plans,
  - (d) In a lump sum upon termination of the plan, or
  - (e) In a lump sum upon the employer's disposition of (i) substantially all of its trade or business assets, or (ii) subsidiary.

(2) Employee's elected contributions must be nonforfeitable.
(3) Employee must be able to elect the employer's contribution be paid (a) in cash, or (b) as plan contribution.
(4) Elective deferral cannot exceed the inflation-adjusted annual limit (see chart above).
(5) Meet certain special nondiscrimination rules for actual deferral percentage tests, so highly compensated employees can't elect a disproportionately higher amount of their salary.

REQUIRED MINIMUM DISTRIBUTIONS (RMD)

In general, distributions from a qualified plan must begin no later than April 1 of the year following the year in which the employee attains age 70 1/2 or (except in the case of a 5-percent owner), if later, retires. This date is called the required beginning date. (Code Section 401(a)(9)).

HARDSHIP DISTRIBUTIONS

If the particular plan permits, participants are allowed to take a "hardship" distribution from the plan. Generally a "hardship" distribution is described as cash withdrawal to satisfy an immediate and heavy financial need of the employee (plan participant) and is necessary to satisfy the financial need. Tax regulation 1.401(k)-(1)(d)(3)(iii)(B) specifies the following as distributions on account of an immediate and heavy financial need:

(1) Expenses for (or necessary to obtain) medical care that would be deductible under the Code Sec. 213(d) (which includes expenses for the care of a spouse, dependent or primary beneficiary under the plan);
(2) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(3) Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, dependents, or primary beneficiary under the plan;
(4) Payments necessary to prevent the eviction of the employee from the employee's principal residence, or foreclosure on the mortgage on that residence;
(5) Payments for burial or funeral expenses for the employee's deceased parent, spouse, children, dependents or primary beneficiary under the plan; or
(6) Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction.

Proposed Reg. 1.401(k)-(1)(d)(3)(iii)(B) applies to distributions made in plan years beginning after December 31, 2018 says that a distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee unless the employee has obtained all other currently available distributions (including distributions of ESOP dividends under section 404(k), but not hardship distributions) under the plan and all other plans of deferred compensation, whether qualified or nonqualified, maintained by the employer. In addition, for a distribution that is made on or after January 1, 2020, the employee must represent (in writing, by an electronic medium, or in such other form as may be prescribed by the Commissioner) that he or she has insufficient cash or other liquid assets to satisfy the need. The plan administrator may rely on the employee's representation unless the plan administrator has actual knowledge to the contrary.

Caution: Even though hardship withdrawals are allowed, they are still taxable distributions, and unless they meet certain exceptions, are also subject to the early withdrawal penalty. Other rules include the following:

(1) For plan years beginning before 2019, an employee is barred for 6 months from making elective and employee contributions in order to qualify as a hardship distribution. This provision was removed in the Bipartisan Budget Act of 2018 (P.L. 115-123), effective for plan years beginning after 2018.
(2) No hardship distributions will be eligible for rollovers. The 20% federal withholding tax requirement does not apply to hardship distributions.

Disaster Areas – In some cases an individual who took a hardship distribution to buy or build a principal residence in a designated disaster area, and the residence wasn't purchased or constructed due to the disaster, is allowed to recontribute the amount as a rollover contribution to an eligible retirement plan. Thus, the distribution that is rolled over would not be taxable. The hardship distribution and recontribution must fall within certain dates as shown in the table below for the California wildfires and 2017 Hurricanes Harvey, Irma and Maria. (Bipartisan Budget Act of 2018, Act Secs 20101 and 20102(b) and Disaster Tax Relief and Airport and Airway Extension Act of 2017, Act Secs. 501 and 502(b))

Designated Disaster	Distribution Received	Recontribution Date
California Wildfires	After 3/31/17 and Before 1/15/18	10/8/17 - 6/30/18
Hurricanes Harvey, Irma or Maria	After 2/28/17 and Before 9/21/17	8/23/17 - 2/28/18

EMPLOYEE PLAN LOANS

A loan from a qualified plan isn't treated as a taxable distribution if it is:
(1) Repaid within five years (except for certain home loans), and
(2) Does not exceed the lesser of:
  a. $50,000, or
  b. The greater of:
    i. ½ of the nonforfeitable accrued benefit in the plan, or
    ii. $10,000

The plan loan must be amortized in substantially level payments, at least quarterly, over the term of the loan. The level amortization requirement does not apply while an employee is on leave without pay for up to one year. (Code Sec 72(p)(2))

Disaster Areas– In some cases, not all, the maximum loan amount is increased to $100,000 and the payback period extended in federally declared disaster areas. Be sure to double check for special provisions in these cases.

CAUTION – CLIENT ALERT!

401(k) loans typically don't survive a change of employment. When the client leaves their employment, most plans require the loan to be repaid or treat the borrowed amount as a taxable distribution from the plan. This is further complicated if the client is under age 59-1/2, when the distribution is treated as a premature distribution subject to the premature distribution penalty. Caution your clients if an employment change is in their future and they cannot repay the loan. They should carefully consider the tax impact before switching jobs.

ROTH CONTRIBUTION PROGRAM

Employers are allowed to create a type of elective deferral program, referred to as a "Qualified Roth Contribution Program," under which participants contributing to a 401(k) plan designate a portion of their contributions as Roth contributions. (See Chapter 4.06 for details.)

ROTH CONVERSIONS

A deferral plan under section 401(k) (including the Thrift Savings Plan), 403(b) or 457(b) governmental plan can have Roth accounts that allow participants to save on a Roth basis. That is, they can make after-tax contributions to the plan and all the principal and earnings are tax-free when distributed. Plans have been able to allow participants to convert their pre-tax accounts to Roth accounts, but only with respect to money they have a right to take out of the plan, usually because they have reached age 59½ or separated from service.

The American Taxpayer Relief Act (ATRA) of 2012 allows any amount in a non-Roth account to be converted to a Roth account in the same plan, whether or not the amount is distributable. The amount converted would be subject to regular income tax. This provision was put in the law as a money-raiser, with over $12 billion of additional tax projected to be collected from taxpayers taking advantage of the liberalized conversion rules in the 10 years after enactment.

INVOLUNTARY CASHOUTS

"Default Option" for distributions from qualified plans (Code Sec 401(a)(31)) - The plan administrator must provide for a default rollover of any involuntary distributions from a qualified plan, unless the participant specifically makes another election. *To remain qualified, plans must provide that if:*

(1) *A distribution of a nonforfeitable accrued benefit of less than $5,000 but more than $1,000 is made, and*

(2) *The distributee does not make an election to have the distribution paid directly to another qualified plan or IRA, and does not elect to receive the distribution directly, the plan administrator will make the transfer to an IRA and notify the employee.*

ADVANTAGES OF 401(k) PLANS

In several important ways, 401(k) plans are superior savings vehicles to IRAs:

- **Employer Matching** - Most employers match part of their workers' 401(k) contributions, resulting in potentially greater build-up of savings in a 401(k) plan than in an IRA.
- **Tax-Free Loans** - Participants in 401(k) plans can take tax-free loans from their account, which is not permitted for IRAs. (Individuals have unlimited ability, subject to a 10 percent penalty tax, to withdraw funds from an IRA, while 401(k) withdrawals prior to retirement or change of employer typically require a demonstration of hardship.) Although extensive borrowing can negate the tax-deferred build-up of savings, the 401(k)-loan feature is highly prized by employees who want the security of knowing they have access to at least some of their plan savings.
- **Automatic Deduction** - The payroll reduction feature of the 401(k) results in gradual forced saving of money that the employee does not have the chance to spend. Brokerage houses have automatic deposit programs for IRAs, but they are far less commonly used.
- **Higher Contribution Limits** – The most obvious difference is that the annual maximum contribution to a 401(k) plan is more than three times the IRA limit for participants under age 50 and even more for those 50 and older.

401(K) ESCALATOR FEATURES

As part of the "Savings Initiative" guidance (Rev Rul 2009-30), employers may modify their automatic 401(k) enrollment plans to include a default escalator feature that will automatically periodically increase an employee's 401(k) contribution without the employee's affirmative election. Default contributions are treated as elective contributions. The ruling clarifies that (1) an automatic increase in a default contribution percentage may be based in part on increases in an employee's plan compensation, and (2) the default contribution percentage for all eligible employees may be increased on other than the first day of the plan year. These situations were illustrated as follows in the Revenue Ruling:

Plan A – Default first plan year contribution is 4%. (Note: The maximum default contribution can never exceed 11%). Each subsequent plan year the contribution is increased by the greater of:

(1) One percentage point, or
(2) A number of percentage points calculated as 30% of the percentage increase in the eligible employee's base pay for such first pay period over the eligible employee's base pay for the immediately preceding pay period (rounded to the nearest whole percentage).

> ***Example*** *– Base pay at start of period was $3,000 per month and the base pay for the period immediately preceding the adjustment is $3,300. The percentage increase is 10%. 30% of the increase is 3% (30% of 10%). Thus the employee's 401(k) contribution will automatically be increased by 3 percentage points, but not to exceed a contribution rate of 11%. Had this been the employee's second year, the contribution percentage would have increased to 7% (4% plus 3%).*

Plan B – Default first year contribution is 3%. (Note: The maximum default contribution under this plan can never exceed 10%). Each subsequent year the contribution is increased by 1 percentage point until the maximum of 10% is reached. The increase is effective the first pay period after April 1. This type of plan is permitted even though the default contribution percentage increases on a date other than the first day of the plan year.

Employee may elect out - Any eligible employee may elect at any time not to make elective contributions (including not to make default contributions) or to have the employer contribute a different percentage of plan compensation.

UNUSED PAID TIME OFF RETIREMENT PLAN CONTRIBUTIONS

As part of the "Savings Initiative," guidance (Rev Rul 2009-31 and Rev Rul 2009-32) provides that qualified retirement plans (401(k) and profit-sharing plans) can be modified to allow annual contributions of an employee's unused paid time off (PTO). One ruling covers the contribution of unused PTO, determined as of the end of the plan year, and the other deals with post-severance contribution of accumulated and unused PTO.

Annual Unused PTO – The company's PTO and Profit-Sharing Plan is amended to provide that unused PTO cannot be carried over to a subsequent year. The dollar equivalent of the PTO is contributed to the profit-sharing plan, not to exceed the annual contribution limits (or less if the employee so elects). Any excess is paid to the employee by February 28 of the subsequent year. (Rev Rul 2009-31)

Unused PTO, Terminated Employment – The company's PTO and Profit Sharing Plan is amended to provide that unused PTO is allocated to the terminated employee's profit sharing account, not to exceed the annual contribution limits (or less if the employee so elects), and any excess is paid to the employee within 60 days of termination. (Rev Rul 2009-32)

CALIFORNIA DIFFERENCES

California conforms to the Federal treatment of 401(k) plans.

NOTES

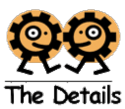
TAX-SHELTERED ANNUITIES

- **Contribution Limits**: **$19,000 (2019)** for Elective Deferrals
- **Age 50+** Make-Up Contributions**: $6,000 (2015 - 2019)**
- **15-Year Employment** Service: **$3,000 Additional** Contribution
- **Premature Pension Distribution Penalty**: Applies
- **RMD Rules:** Generally Apply

RAPID FINDER

15 Years of Service	4.14.01
Age 50	4.14.01
Contribution Limits	4.14.01
Elective Deferrals	4.14.01
Employee Loans	4.14.02
Loans	4.14.02
Minimum Distributions	4.14.02
Premature Distributions	4.14.02
Roth Conversions	4.14.02

Related IRC Section and IRS Publications and Forms
- **Pub 571** – Tax-Sheltered Annuity Programs for Employee of Public Schools and Certain Tax-Exempt Organizations
- **Pub 575 –** Pension and Annuity Income
- **Form 5329** - Additional Taxes on Qualified Plans
- **Sec 403(b)**



Employees of tax-exempt educational, charitable and religious organizations or public schools get special tax advantages from annuities bought for them, or contributions made to custodial accounts, by the exempt employer. These plans are most frequently encountered when dealing with public school teachers.

CONTRIBUTION LIMITS

Contributions to 403(b) accounts are limited to the **lesser** of:

(1) the ***limit on annual additions,*** which is the lesser of 100% of the employee's compensation or $56,000 for 2019 or

(2) the ***limit on elective deferrals*** (see table below).

If the only contributions were elective deferrals made under a salary reduction agreement, the maximum amount that can be contributed is the lesser of the annual additions limit or the elective deferrals limit.

If only nonelective contributions were made, the annual additions limit applies. Nonelective contributions are employer contributions that are not made under a salary reduction agreement, and include matching contributions, discretionary contributions, and mandatory contributions from the employer.

If contributions included a combination of elective deferrals and employer's nonelective contributions, the maximum that can be contributed is the limit on annual additions.

The elective deferral limits are the same as for other defined contribution plans, such as the 401(k), including allowing individuals age 50 and over to make additional contributions.

403(b) Elective Deferral Contribution Limits [(1)]

Year	2013	2014	2015-17	2018	2019	2020
Under Age 50	17,500	17,500	18,000	18,500	19,000	
Age 50 and over	23,000	23,000	24,000	24,500	25,000	

[(1)] *Employees with 15 years or more of service with a public school, hospital, home health service agency, health and welfare service agency, church or association of churches are eligible for an additional amount ($3,000 in most cases, but see IRC § 402(g)(7)).*

Worksheets are available in IRS Pub 571 to assist in determining the contribution limits.

CAUTION – AGGREGATE CONTRIBUTION LIMITS

The contribution limits to 403(b) TSA plans, 408(p)(2) SIMPLE plans, 408(k) SEP IRAs and 401(k) plans apply on an aggregate basis. That is the total to all four plans cannot exceed the annual limit. See chapter 4.14 for corrective distributions.

PREMATURE DISTRIBUTION

403(b) plans are subject to the premature distribution penalty rules.

EMPLOYEE PLAN LOANS

A loan from a qualified plan isn't treated as a taxable distribution if it is:

(1) Repaid within five years (except for certain home loans), and
(2) Does not exceed the lesser of:
   a. $50,000, or
   b. The greater of:
      i. ½ of the nonforfeitable accrued benefit in the plan, or
      ii. $10,000.

The plan loan must be amortized in substantially level payments, at least quarterly, over the term of the loan. The level amortization requirement does not apply while an employee is on leave without pay for up to one year. (Code Sec 72(p)(2))

MINIMUM DISTRIBUTIONS

CAUTION!
Distributions from Tax-Sheltered Annuities (Code Sec. 403(b) accounts) do not satisfy the distribution requirements from IRAs and distributions from IRAs will not satisfy the distribution requirements from Section 403(b) contracts or accounts.

403(b) plans generally follow the same RMD requirements as other qualified plans. However, there are some exceptions:

- **IRS Letter Ruling 9345044 – Age 75** - IRS has privately ruled that participants in a tax-sheltered annuity plan maintained for teachers and other employees as authorized by a city's administrative code may defer distributions of their account balances until the earlier of age 75 or retirement.

  IRS said that a participant's required beginning date under the plan would be April 1 of the year following the later of the calendar year in which the participant attains age 70-1/2 or the calendar year in which the participant retires under Code Sec. 401(a)(9)(C). Therefore, deferral of distributions of an individual's account balance until the earlier of attainment of age 75 or the April 1 following the year of the participant's retirement satisfied the required beginning date requirements.

- **IRS Letter Ruling 8632058 – Pre-July 27, '87 Distributions** - In a private letter ruling that applied pre-July 27, '87 distribution rules, IRS approved a Code Sec. 403(b) annuity that permitted distributions beginning no later than age 75, in the form of a joint and 100% spousal survivor annuity.

ROTH CONVERSIONS

A deferral plan under section 401(k) (including the Thrift Savings Plan), 403(b) or 457(b) governmental plan can have Roth accounts that allow participants to save on a Roth basis. That is, they can make after-tax contributions to the plan and all the principal and earnings are tax-free when distributed. Plans have been able to allow participants to convert their pre-tax accounts to Roth accounts, but only with respect to money they had a right to take out of the plan, usually because they reached age 59½ or separated from service.

The American Taxpayer Relief Act (ATRA) of 2012 allows any amount in a non-Roth account to be converted to a Roth account in the same plan, whether or not the amount is distributable. The amount converted would be subject to regular income tax.

CALIFORNIA DIFFERENCES

California follows Federal Law, so no adjustment to federal adjusted gross income is required.

REQUIRED MINIMUM DISTRIBUTIONS

Age 70-1/2 and Beneficiary Minimum Distribution Rules

RAPID FINDER

Required Minimum Distribution (RMD):

- Beginning date is generally later of the following:
  - Year in which the taxpayer reaches age 70-1/2, or
  - In the case of qualified plans the year of retirement.
- Can wait until April 1st of the following year – but must take two distributions in that year
- Generally, use the Uniform Lifetime Table (except when spouse is more than 10 yrs younger)
- Annual RMD = (Account Balance 12/31 of Prior Year)/(Life Expectancy from IRS table)

Spouse as <u>Sole</u> Beneficiary:

- Roll into his or her own – then follow rules as if he or she had originally funded the IRA, or
- Distribute within five years of death, or
- Leave as is – decedent's name – begin distributions by later of 12/31 of subsequent year or 12/31 of the year the decedent would have turned 70-1/2 - avoids 10% penalty.

Other Beneficiaries:

- Distribute within five years of death, or
- Roll over (trustee-to-trustee) and take RMD for beneficiaries.
- Lifetime pay out based on oldest beneficiary
  - Can split IRA if split by the end of the year following the year of the decedent's death - then distribute over individual lifetimes

Penalty – 50% of the amount that should have been withdrawn and wasn't
Penalty Abatement – Possible with reasonable cause and corrective distributions
Delayed Check Cashing – Rev Rul 2019-19 – See chapter 4.10

SEE FLOW CHART ON PAGE 04.17.09

<u>REQUIRED MINIMUM DISTRIBUTIONS (RMDs)</u>: To prevent an individual from investing in tax-deferred retirement plans, including Traditional IRAs, but never withdrawing from the plans, the account owner is REQUIRED to take a MINIMUM (as calculated per regulations) DISTRIBUTION (RMD) beginning in the year the IRA owner reaches age 70.5 (unless he or she qualifies for the first year exception explained below). (Code Sec 401(a)(9)) In the case of a qualified plan, the first distribution must be taken no later than April 1 of the year following reaching age 70.5 (but see "Qualified Plan Required Beginning Date" below for exception). Failing to take the correct amount of minimum distribution (also known as excess accumulation) results in a penalty of 50% of the difference of what should have been withdrawn and what was withdrawn–but see page 04.17.02 for how a waiver of the penalty may be obtained.

<u>Uniform Distribution Method for Lifetime Payouts</u> **-** In general, the required minimum distribution for each year is determined by dividing the account balance as of the end of the preceding year by the age-based factor from the Uniform Lifetime Table (Reg § 1.401(a)(9)-5). This table is used regardless of the identity of the beneficiary or age differential between account owner and designated beneficiary, unless the account owner's spouse is the sole beneficiary and is more than 10 years younger than the account owner (see exception when spouse is more than 10 years younger than the owner later).

Uniform Lifetime Table

Age	Distrib Period	Age	Distrib Period	Age	Distrib Period	Age	Distrib Period	Age	Distrib Period	Age	Distrib Period
70	27.4	77	21.2	84	15.5	91	10.8	98	7.1	105	4.5
71	26.5	78	20.3	85	14.8	92	10.2	99	6.7	106	4.2
72	25.6	79	19.5	86	14.1	93	9.6	100	6.3	107	3.9
73	24.7	84	15.5	87	13.4	94	9.1	101	5.9	108	3.7
74	23.8	80	18.7	88	12.7	95	8.6	102	5.5	109	3.4
75	22.9	82	17.1	89	12.0	96	8.1	103	5.2	110	3.1
76	22.0	83	16.3	90	11.4	97	7.6	104	4.9	111	2.9

$$\frac{\textbf{TOTAL VALUE}^{(1)}}{\textbf{DISTRIBUTION PERIOD}^{(2)}} = \textbf{MINIMUM DISTRIBUTION}$$

(1) ***Determining Total Value:*** *The total value is based on the account's value at the end of the business day on December 31st of the* ***PRIOR*** *year. Although the RMD for the year can be taken from any one or a number of the taxpayer's IRA accounts (Reg §1.408-8, Q&A 9), the minimum distribution amount must be figured separately for each account, and then totaled to determine the RMD. The 12/31 value is not reduced by the first-time RMD taken between January 1 and April 1 in the year following the end of the year the taxpayer turns 70½.*

(2) ***Determining the Distribution Period:*** *The IRS provides two tables for use in determining the IRA owner's life expectancy (referred to as "distribution period" by the IRS). Generally, IRA owners will use the "Uniform Lifetime Table", illustrated above, to determine their "distribution period."*

If the IRA owner's spouse is the sole beneficiary (on all the IRA accounts), the Joint and Last Survivor Table may be used (available in IRS Publication 590-B). However, the Uniform Lifetime Table will always produce the smallest minimum distribution, unless the spouse is more than 10 years younger than the IRA account owner. The Preamble to the final regulations provides that for lifetime distributions, the marital status of the IRA owner (or employee, if RMDs are made from a qualified plan account) is determined on January 1 each year (Reg. § 1.401(a)(9)-9, Q&A 3, PLR 200250037).

Determining Age: *Use the owner's oldest attained age for the year of the distribution.*

RMD in Year of Owner's Death **-** Often the question arises related to the need for a required minimum distribution (RMD) in the year of the IRA owner's death. Information on this requirement is sketchy at best. The following has been gleaned from the regulations and IRS Publication 590-B.

Died before required beginning date – If the IRA owner passed away before his or her distribution required beginning date, then there is no RMD for the year of death. Where an IRA owner dies after reaching age 70.5, but before April 1 of the next year, no minimum distribution is required because death occurred before the required beginning date. (Pub 590-B, 2018)

Died after required beginning date – An RMD is required if the owner died on or after the required beginning date (Reg § 1.401(a)(9)-5, Q&A 4(a)). The IRA beneficiaries are responsible for figuring and distributing the owner's required minimum distribution in the year of death. (2018 Pub 590-B, Pg. 8).

Where an IRA owner dies before receiving his or her entire RMD in the year of death, the unpaid amount must be distributed to the named beneficiaries or, if none, the decedent's estate (Reg. § 1.401(a)(9)-5, Q&A 4(a)). Presumably, the amounts received before death would be taxed on the decedent's final return and the remaining amount paid after death would be taxed to the beneficiary or estate (but see spouse beneficiary below). It would also appear the RMD amounts not distributed in the year of death would be subject to the 50% excess accumulation penalty. However, that penalty can be waived for reasonable cause if a corrective distribution is taken later and the spouse (if filing jointly with the decedent on the decedent's final return) or estate executor requests penalty relief per the instructions for Form 5329.

Spouse Beneficiary - Where the spouse of the deceased owner becomes the owner of the IRA in the year of death, the spouse is required to take a distribution based upon the decedent's age and thereby satisfy the decedent's RMD requirements (2018 Pub 590-B, Pg. 8). It is *assumed* that if the spouse fails to do so, the spouse will be subject to the 50% excess accumulation penalty but see the penalty waiver above.

First Year IRA RMD Exception – If a taxpayer so chooses, he or she can delay an IRA RMD for the first year until the second year, thus making the distribution includible in the second year's tax return. This is sometimes desirable if the taxpayer has substantial wages or other income in the year age 70.5 is reached and expects less income the next year. In this situation, by delaying the distribution to the second year the tax bracket could be substantially lower. If the taxpayer chooses that option, then:

- The first year RMD must be taken by April 1 of the following year, and
- The taxpayer must also take the second year RMD distribution by December 31 of year two, thus doubling up the distributions in year two.

Qualified Plan Required Beginning Date – In general, distributions from a qualified plan must begin no later than April 1 of the year following the year in which the employee attains age 70 1/2 or (except in the case of a 5-percent owner), if later, retires. This date is called the required beginning date. (Code Section 401(a)(9)). This "retirement, if later" exception does not apply to IRAs.

Penalty for Not Taking an RMD - The penalty for failing to take the required minimum amount is 50% of the amount that should have been withdrawn but wasn't. However, the IRS in Pub 17, Pub 575 and the instructions for Form 5329, provides a very liberal policy for waiving the penalty. Generally, you must show that the failure to take the required distribution was due to reasonable cause and that steps are being taken to remedy the shortfall.

The instructions indicate that the taxpayer must file Form 5329, and request relief in a statement attached to the return. The statement should include: a reason for the under-distribution and the steps taken to remedy the under-distribution. On Form 5329, Part IX, complete lines 52 (minimum required distribution) and 53 (actual amount distributed). Enter "RC" and the amount to be waived in parentheses on the dotted line next to line 52. Then subtract this amount from the total shortfall figured without regard to the waiver amount and enter the result on line 54. If line 54 is greater than zero, multiply the amount by 50% and enter the result on line 55. This is the excess accumulation penalty to be included on Form 1040, Schedule 2, line 6 (draft 2019). The IRS says that they will review the information provided and decide whether to grant the request for a waiver.

The return should not be e-filed because the electronic return originator (ERO) may submit to IRS with Form 8453 only certain forms or their attachments, and the Form 5329 attachment is not one of these. Instead, the ERO retains the 5329 penalty-waiver statement, and thus IRS would not see the waiver request if the return were e-filed.

IRA BENEFICIARY ISSUES

Qualified Plan to IRA Rollovers for Non-spouse Beneficiaries - Direct transfers (trustee-to-trustee) of distributions from an eligible retirement plan (e.g., a qualified plan) of a deceased employee to a non-spouse beneficiary's IRA are permitted. The transfer is treated as an eligible rollover distribution and distributions from the beneficiary's rollover IRA (don't combine with the beneficiary's existing IRA) are subject to the RMD rules that apply to inherited IRAs of non-spouse beneficiaries.

This provision applies to amounts payable to a beneficiary under a:

- Qualified retirement plan or
- Code Sec. 403(b) (Tax Sheltered Annuity) annuity or
- A governmental Code Sec. 457 plan (deferred compensation plans of state and local governments and tax-exempt organizations).

To the extent provided by IRS, the rule described above applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary.

BENEFICIARY DISTRIBUTIONS AFTER RMDs HAVE BEGUN:

When an IRA owner dies ***after beginning*** the required distributions and the beneficiary is an individual, the beneficiary must begin taking distributions the year after the IRA owner's death as follows:

Spouse as Sole Beneficiary **-** The IRS permits a sole beneficiary spouse far more options than it does other beneficiates. When the spouse is the sole beneficiary, the spouse has the options listed below. ***Caution:*** *The sole beneficiary requirement is not met if the beneficiary is a trust, even if the spouse is the sole beneficiary of the trust.*

- **Spouse Under 70-1/2 -** Convert the IRA to his or her own account, thereby delaying additional mandatory distributions until he or she reaches age 70-1/2. ***Caution***, if spouse is under the age of 59.5, after the conversion the distributions would be subject to the premature distribution penalty until the spouse turns 59-1/2.
- **Spouse 70-1/2 or Older -** Convert the IRA to his or her own account and begin taking RMD based on the surviving spouse's attained age using the Uniform Distribution Table.
- **Treat as own** - Elect to treat the IRA as the spouse's own IRA (commonly referred to as a Beneficial IRA) – IRA is left in the decedent's name and distributions are not subject to premature distribution penalties. The spouse must begin taking distributions over his or her life expectancy using the Single Life Table in the year

- following the owner's death (or if earlier, the year in which the IRA owner would have reached age 70-1/2). Later, after the spouse is no longer subject to the premature distribution penalty, the IRA can be converted to his or her own, and the choice can be made to stop taking distributions until age 70-1/2.
- **5-Year Option** - May elect to take the entire account by the end of the fifth year following the year of the owner's death. If this election is made, no distribution is required for any year before that fifth year. A distribution under the 5-year option is not subject to early withdrawal penalties.

Other Individual Beneficiaries - If the beneficiary or beneficiaries (including the spouse) include individuals other than the spouse, then the first required distribution is in the calendar year following the year of the IRA owner's death. These distributions are not subject to the premature distribution penalty. Using the Single Life Table, the post-death distribution period used to determine the RMD is the **longer** of:

- **The remaining life expectancy of the deceased IRA owner** using the deceased's attained age in the year of death and subtracting one for each subsequent year after the date of death.
- **The remaining life expectancy of the IRA beneficiary** using the beneficiary's attained age in the year of death and subtracting one for each subsequent year after the date of death.

However, in lieu of the two options above, any beneficiary who is an individual may elect to take the entire account at any time before the end of the fifth year, following the year of the owner's death. If this election is made, no distribution is required for any year before that fifth year.

DISTRIBUTIONS WHERE OWNER DIES BEFORE RMDs HAVE BEGUN:

When an IRA owner dies ***before*** the required distributions beginning date (generally, April 1 following the year in which the owner attains age 70-1/2), the beneficiary has the following choices:

If the Sole Beneficiary is the Owner's Spouse **-** The spouse may choose one of the following options, or if not used, the rules for non-spouse beneficiaries apply.

- **Rollover** - The spouse can roll over the decedent's IRA into his or her own IRA. Once rolled into the spouse's IRA, any future withdrawals would be treated as his or her own, and if the spouse is under 59-1/2 at the time of the distribution, the premature distribution penalty will apply.
- **Treat as own** - Elect to treat the IRA as the spouse's own IRA. This is commonly referred to as a Beneficial IRA – IRA is left in the decedent's name and distributions are not subject to premature distribution penalties. The spouse must begin taking distributions over his or her life expectancy using the Single Life Table in the year following the owner's death (or if earlier, the year in which the IRA owner would have reached age 70-1/2). Later, after the spouse is no longer subject to the premature distribution penalty, the IRA can be converted to his or her own, and if desired, distributions may cease until age 70-1/2.

If a Non-Spouse Beneficiary is Designated - A non-spouse beneficiary may roll over an inherited IRA if the plan allows it, and the distribution is made directly from one trustee to another. The account balance will be distributed by one of the methods described below. The determination of whether the five-year or lifetime payout rule applies depends on the provisions of the IRA. It may be silent as to which rule (5-year or lifetime payout) applies (see "IRA Silent" below), specify which rule applies, or it may allow the owner (or beneficiary) to elect which rule applies. *(Reg. § 1.401(a)(9)-3, Q&A 4)*

- **For the Five-Year Payout** - May be entirely distributed at any time before five years after the IRA owner's death and the total can be taken in multiple distributions during the five year period *(Code Sec. 401(a)(9)(B)(ii)).* A non-spouse beneficiary is permitted to directly roll over the beneficiary's entire benefit until the end of the fourth year, but as of January 1 of the fifth year following the year the plan owner died, no amount payable to the beneficiary is eligible for rollover *(IRS Notice 2007-7, Q&A 17).* If the 5-year rule applied to the non-spouse beneficiary under the plan making the direct rollover, the 5-year rule also applies for the purpose of determining RMDs under the IRA to which the rollover contribution is made *(IRS Notice 2007-7, Q&A 19).*
- **For the Lifetime Payout** - May be distributed to (or for the benefit of) the designated beneficiary, over his life or over a period that doesn't extend beyond his life expectancy *(Code Sec. 401(a)(9)(B)(iii); Code Sec. 408(a)(6)*). If this method is used, distributions must begin no later than Dec. 31 of the calendar year immediately following the calendar year in which the IRA owner died *(Reg. § 1.401(a)(9)-3, Q&A 3(a)).*

Example: *The IRA owner dies March 12th, and the designated beneficiary of his IRA is a nephew. If the lifetime payout option is chosen, payments from the IRA must begin by Dec. 31 of the following year.*

IRA is Silent as to the Distribution Method

- **The lifetime payout rule applies** if the beneficiary is the decedent's spouse, and the IRA:
  (1) Does not contain provisions specifying the methods of distribution after an IRA owner's death, or allowing the choice to be made by an IRA owner or beneficiary, or
  (2) Allows a choice to be made, but the choice is not exercised and the IRA doesn't specify the payout method, or
  (3) Allows a choice to be made and the lifetime payout method is chosen, or
  (4) Specifies that the lifetime payout method is to be used.
- **The five-year payout rule applies** if the IRA provides for only this method, or it provides a choice between five-year and lifetime payouts, and the IRA owner chose or the surviving-spouse beneficiary chooses the five-year method. (Reg. § 1.401(a)(9)-3, Q&A 4)

DETERMINING BENEFICIARIES' DISTRIBUTION PERIOD – MULTIPLE BENEFICIARIES:

If more than one beneficiary is designated on the date on which the designated beneficiary is determined (generally, as of Sept. 30 of the year following the year of the IRA owner's death), then the IRA is paid out over the oldest beneficiary's life expectancy.

The beneficiaries' remaining life expectancy is determined using the:

- Oldest beneficiary's age as of his or her birthday in the calendar year immediately following the IRA owner's death, or
- For those accounts that were separated by the end of the year after the year after death, the age of each beneficiary.
- Where the beneficiaries include the spouse, account separation must be completed by September 30th instead of year-end to take advantage of the spouse sole beneficiary provisions.

Sub-IRAs OK'd Where Estate Was Named IRA Beneficiary – A Private Ruling (PLR 201128036) permitted an IRA with an estate named as the beneficiary to be divided up into sub-IRAs set up for the beneficiaries of the estate. Although the move allowed each beneficiary to separately invest his or her share of the IRA, they were still locked into a short payout period (based on the decedent's age at death). With better tax planning on the IRA owner's part, however, they could have qualified for a much longer tax-deferred payout period.

OTHER INHERITED IRA ISSUES

Dividing (Separating) an Inherited IRA - Generally, except for nondeductible contributions, Inherited Traditional IRA accounts are taxable to beneficiaries, and the tax laws provide for certain mandatory beneficiary payouts.

Where there are multiple beneficiaries to an IRA, conflicting interests can arise. One beneficiary may want the money all up front, while another one wants to spread it out over time. There can also be conflicting investment strategies. In addition, the distribution period is determined using the oldest beneficiary's age, which accelerates the payout.

These conflicts can be avoided by dividing the accounts. The law allows an IRA to be divided into separate accounts for each beneficiary, thus giving each the opportunity to select the option that best suits their particular circumstances.

CAUTION: For the separate or "subaccount" IRA to be treated as a separate account for required minimum distribution (RMD) purposes, **it must be established no later than the last day of the year following the year of the IRA owner's death**. (Reg. § 1.401(a)(9)-8, Q&A 2(a)(2))

Additionally, a separate accounting must allocate all post-death investment gains and losses for the period before the separate accounts are established on a pro rata basis in a reasonable and consistent manner among the separate accounts. However, once the separate accounts are actually established, separate accounting can provide for separate investments for each separate account under which gains and losses from the investment of the account are only allocated to that account. Alternatively, investment gain or losses can continue to be allocated among the separate accounts on a pro rata basis. A separate accounting must allocate any post-death distribution to the separate account of the beneficiary receiving that distribution. (Reg. § 1.401(a)(9)-8, Q&A 3)

Disclaiming an Inherited IRA – The law allows a designated beneficiary to disclaim an inherited IRA and permits the naming of a new beneficiary by the executor of the estate. A beneficiary can also be eliminated by distribution of the benefits. The IRS ruled in ***Rev. Rul. 2005-36*** that a qualified disclaimer is valid even after the beneficiary disclaiming the IRA has received a required minimum distribution from the IRA for the year of the decedent's death. Disclaimed amounts cannot include the RMD amount or the income attributable to it. The disclaimed amount and the post-death earnings on it either can be:

- Paid outright to the successor beneficiary (taxable at that time to the successor beneficiary), or
- Segregated and kept in a separate IRA account with the successor heir named as beneficiary (thus allowing lifetime withdrawal and retention of the IRA tax-deferral benefits).

Lack of Designated Beneficiary - A designated beneficiary need not be specified in the name of the plan in order to be a designated beneficiary as long as the individual is identifiable under the plan. If an individual is not designated as a beneficiary (for example, when someone's estate is named as the beneficiary), the employee or IRA owner is treated as having no designated beneficiary. However, an exception applies to trust beneficiaries, who may be treated as designated beneficiaries if:

1. The trust is valid under state law (or would be, except for the fact that there is no corpus),
2. The trust is irrevocable or will become irrevocable, by its terms, on the employee or IRA owner's death,
3. The beneficiaries with respect to the trust's interest in the employee's or IRA owner's benefit are identifiable from the trust instrument, and
4. Relevant documentation has been timely provided to the plan administrator (Reg. § 1.104(a)(9)-4,Q&A-5).

Q&A-4 of the regulation provides that in order to be a designated beneficiary, an individual must be a beneficiary as of the date of the employee's death.

CAUTION!

Distributions from Qualified Plans and Tax-Sheltered Annuities (Code Sec. 403(b) accounts) do not satisfy the distribution requirements from IRAs. And distributions from IRAs will not satisfy the distribution requirements from Section 403(b) contracts, accounts or qualified plans.

Similarly, distributions from Roth IRAs will not satisfy the distribution requirements applicable to IRAs or Section 403(b) accounts or contracts, and distributions from IRAs, Section 403(b) contracts, or qualified plans will not satisfy the distribution requirements from Roth IRAs.

Required minimum distributions from inherited IRAs must be determined separately from distributions required to be made from IRAs of which the taxpayer (beneficiary) is the owner, and vice versa.

RMD INFORMATION REPORTING REQUIREMENT:

With regard to information reporting of RMDs (required minimum distributions), trustees, custodians, and issuers of IRAs must do the following (Reg 1.408-8, Q&A 10; Notices 2002-27, 2003-34, 2009-9):

- Identify to IRS on Form 5498 (IRA Contribution Information) for the immediately preceding year each IRA for which a minimum distribution is required to be made to an IRA owner. The amount of the required distribution need not be reported to IRS.
- Provide, by January 31st of the year **in which the RMD must be made, one of two types of information statements to the IRA owner required to** receive a RMD:
  (1) A report of the amount of the annual RMD distribution for the calendar year and the date by which it must be made. The amount can be based on simplified assumptions. For example, it can be assumed that the regular life expectancy table for IRA owners applies (i.e., the IRA beneficiary is assumed not to be a spouse who is more than 10 years younger than the IRA owner).
  (2) A statement informing the IRA owner that he must take a minimum distribution with respect to the IRA for the calendar year and the date by which the distribution must be made, and including an offer to furnish him, upon request, with a calculation of the amount of the RMD for the IRA for that calendar year.

  The information must be reported to IRA owners by Jan. 31 of the year in which the RMD must be made.

QUALIFIED CHARITABLE DISTRIBUTION (QCD) - Tax-Free IRA Distributions for Charitable Purposes

This provision (Code Sec 408(d)(8)) originated in 2006 and after multiple temporary extensions was made permanent by the Protecting Americans from Tax Hikes Act of 2015.

To constitute a qualified charitable distribution (QCD), the distribution must be made:

(1) Directly by the IRA trustee to a Code Sec. 170(b)(1)(A) charitable organization (other than an organization (private foundations) described in Code Sec. 509(a)(3)) or a donor-advised fund (as defined in Code Sec. 4966(d)(2)); and

(2) On or after the date the IRA owner attains age 70-1/2.

Substantiation - The taxpayer must have the same type of acknowledgment of their contribution that would be needed to claim a deduction for a charitable contribution. See Chapter 07.08.

Maximum Contribution – No more than $100,000 per year of IRA distributions made directly to charitable organizations can be excluded from the IRA owner's gross income. If filing a joint return and both spouses have an IRA, each spouse can have a qualified charitable distribution and each can exclude up to $100,000 from income per year.

No Charitable Contribution **–** Amounts excluded as a QCD, up to the $100,000 limit, cannot be used as charitable contributions on Schedule A.

Charitable AGI Limitations – QCDs are not subject to the charitable contribution percentage limits since they are not included in gross income and are not claimed as a charitable contribution.

Excess Contributions - Amounts in excess of the $100,000 limit cannot be carried over. The excess would be treated as (1) an IRA distribution and (2) a charitable contribution subject to the usual percentage-of-AGI limits.

Required Minimum Distribution (RMD) – The amount of a QCD is treated as being part of the taxpayer's RMD for the tax year.

Regular IRAs (Traditional or Roth) Only - The exclusion does not apply to distributions made from "ongoing" simplified employee pensions (SEPs), or "ongoing" SIMPLE IRAs. The term "ongoing" means the plan is maintained under an employer arrangement under which an employer contribution is made for the plan year in which the QCD is made. However, the exclusion would apply to SEPs and SIMPLEs where the taxpayer is retired and the employer will not contribute to the account during the year. (Notice 2007-7, Q&A 36).

Caution - Direct Transfer Requirement – A QCD must be made *directly by the IRA trustee* to a charitable organization. Thus, a distribution made to an individual, and then rolled over to a charitable organization, would not be excludible from gross income. The result would be a separate IRA distribution and charitable contribution, both subject to the normal rules. A check from the IRA made payable to an eligible charitable organization that is delivered to the organization by the IRA owner will be considered to be made directly by the IRA trustee to the organization. (Notice 2007-7, Q&A 41)

Some IRA trustees provide the IRA owners with check writing privileges on their IRA accounts. If a taxpayer over age 70.5 writes a check from his IRA account and delivers it to a qualified charitable organization, will that count as a direct transfer to charity? The IRS provides no specific guidance on the issue, other than Notice 2007-7, Q&A 41 cited above. However, it would appear that a check written by the taxpayer from the IRA account to a qualified charity **MAY** meet the requirements of Q&A 41, since the funds are transferred directly to the charity through normal banking channels and the taxpayer has no access to the funds during the transfer process.

Distribution Allocation for Non-Deductible Contribution Amounts - The distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. Proper adjustments must be made in applying the Code Sec. 72 annuity rules to other distributions made in that and later tax years to reflect the amount treated as a qualified charitable distribution under this special rule.

> ***Example:*** *Ira Owner is over age 70-1/2 and has a traditional IRA with a balance of $100,000 consisting of $20,000 of nondeductible contributions and the balance attributable to deductible contributions and earnings. He has no other IRA accounts. He makes a direct distribution of $80,000 to a qualified charitable organization. By the special rule, the contribution is treated as coming from the income first. The remaining $20,000 consists only of nondeductible contributions and will not be taxable on distribution.*

Reporting QCDs – The total of all IRA distributions are included on line 4a of 2019 draft 1040. Then subtract the amount of the QCD and any Form 8606 adjustments from the line 4a amount and enter the result on line 4b. Also enter "QCD" in the margin for line 4b. See the instructions for Form 8606 Line 7 and 1040 Lines 4a and 4b.

QUALIFIED LONGEVITY ANNUITY CONTRACTS

IRS Regulations 1.401(a)(9)-6, finalized in 2014, provide some relief for individuals who want to stretch out their retirement funds by generally allowing taxpayers to use up to the lesser of 25% or $125,000 of their retirement account to purchase a qualified longevity annuity contract (QLAC) within the account. The $125,000 limit is adjusted for inflation and for years 2018 and 2019 is $130,000. The amount used to purchase the QLAC is subtracted from the account balance and would thus reduce the RMD from the retirement account each year until a specified time in the future when distributions must begin from the annuity.

Although not a perfect solution to not taking distributions, a QLAC can in effect delay the distributions associated with funds used to purchase the QLAC until as late as the pre-determined date for the start of the annuity payments, but no later than age 85.

> ***Example:*** *Dan, who is age 72, has a traditional IRA account with a balance of $700,000. From the IRS annuity table, for age 72, Dan has an expected distribution period (life expectancy) of 25.6 years, and his RMD for the year would be $27,344 ($700,000/25.6). However, Dan could have purchased a QLAC in the amount of $130,000 (the lesser of 25% of $700,000, which is $175,000, or $130,000) with IRA funds prior to the end of the year, thus reducing his IRA account balance currently subject to mandatory distribution to $570,000. As a result, his RMD for the year would be $22,266. In addition, his QLAC would begin distributions at whatever date Dan selected for the start date, but at least by age 85.*

Since Social Security (SS) income becomes taxable when one-half the taxpayer's SS benefits plus the taxpayer's other income, including non-taxable interest income, exceeds $25,000 ($32,000 for married taxpayers filing jointly), using a QLAC to reduce a taxpayer's RMD income could actually reduce the tax on the taxpayer's SS income.

QLACs do not apply to Roth IRAs since there are no RMD requirements and the income is generally tax-free.

See page 04.01.06 for additional information about QLACs.

IRD INCOME

When a client comes in with a 1099-R or Schedule K-1 with income from an inherited individual retirement account (IRA), ask two very important questions:

(1) Was there a Form 706 filed for the estate?

(2) If so, was there a tax liability on the 706?

If the answer to both questions is yes, then your client is eligible for a Tier 1 miscellaneous (not subject to the reduction by 2% of adjusted gross income) itemized deduction (See Chapter 1.05 – Death of a Taxpayer for additional details).

STILL WORKING RULE TO DELAY RMDS

Generally, taxpayers that are participants is qualified retirement plans are required to start taking required minimum distributions (RMDs) from the plan no later than April 1 of the year after which they turn 70½.

Still Working Exception - However, there is an exception that applies to certain plan participants who are still working. An employee's RBD (required beginning date) for receiving distributions from a qualified plan is April 1 of the year **following the later** of the calendar year the employee:

- Reaches age 70 1/2 or
- The calendar year in which they retire from employment with the employer maintaining the plan.

> **CAUTION:** The employer's plan may require the retirement plan participant to begin RMDs under the normal rules, in which case the taxpayer cannot take advantage of the "still working "exception.

> **CAUTION:** The above rule does not apply to distributions from IRAs (including those established in conjunction with a SEP or SIMPLE IRA plan) and distributions from qualified plans to more-than-5% owners.

When Does Retirement Begin? – A taxpayer retires in a given calendar year unless he works at least one day in the following year! A taxpayer who is older than 70½, who is laid off in a given year by the employer, must begin RMDs from that employer's retirement plan in the next calendar year.

Only Applies to Current Employer – The "still working" exception only applies to retirement plans of the taxpayer's current employer. RMDs from other plans and IRAs cannot be delayed under the "still working" exception.

Part-Time Employment – The IRS has taken no official position on this issue of what constitutes part-time employment for this purpose. So, it seems that if a person is considered to be an employee under the Code, that person is "still working" for the purpose of the still-working exception (even if the ongoing work is part time).

Possible Strategy - Where the employer's qualified plan permits, the employee could roll other taxable qualified pension amounts and IRAs into the employer's qualified plan, thus potentially delaying the RMDs from these other plans also. HOWEVER, the rollover must be completed in a year before the employee reaches age 70½ – otherwise the regular RMD requirements will kick in for those accounts.

Only pretax dollars can be rolled into an employer's plan so care must be taken not to roll non-deductible contributions into the employer's plan. However, any non-deductible contributions left behind can be withdrawn without any taxability or converted to a Roth IRA with little or no tax liability and avoid any RMD requirements on those funds as well.

Final Word – Care should be taken to review the provisions of the employer's plan to ensure there are no detrimental provisions related to the "still working" provision, the treatment of rollover funds and the accessibility to funds in case of an unexpected need.

Also keep in mind the taxpayer will have larger RMDs the longer the distributions are delayed, which could mean higher tax brackets or more of their Social Security benefits becoming taxable, just to mention a couple of the potential disadvantages.

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CALIFORNIA DIFFERENCES

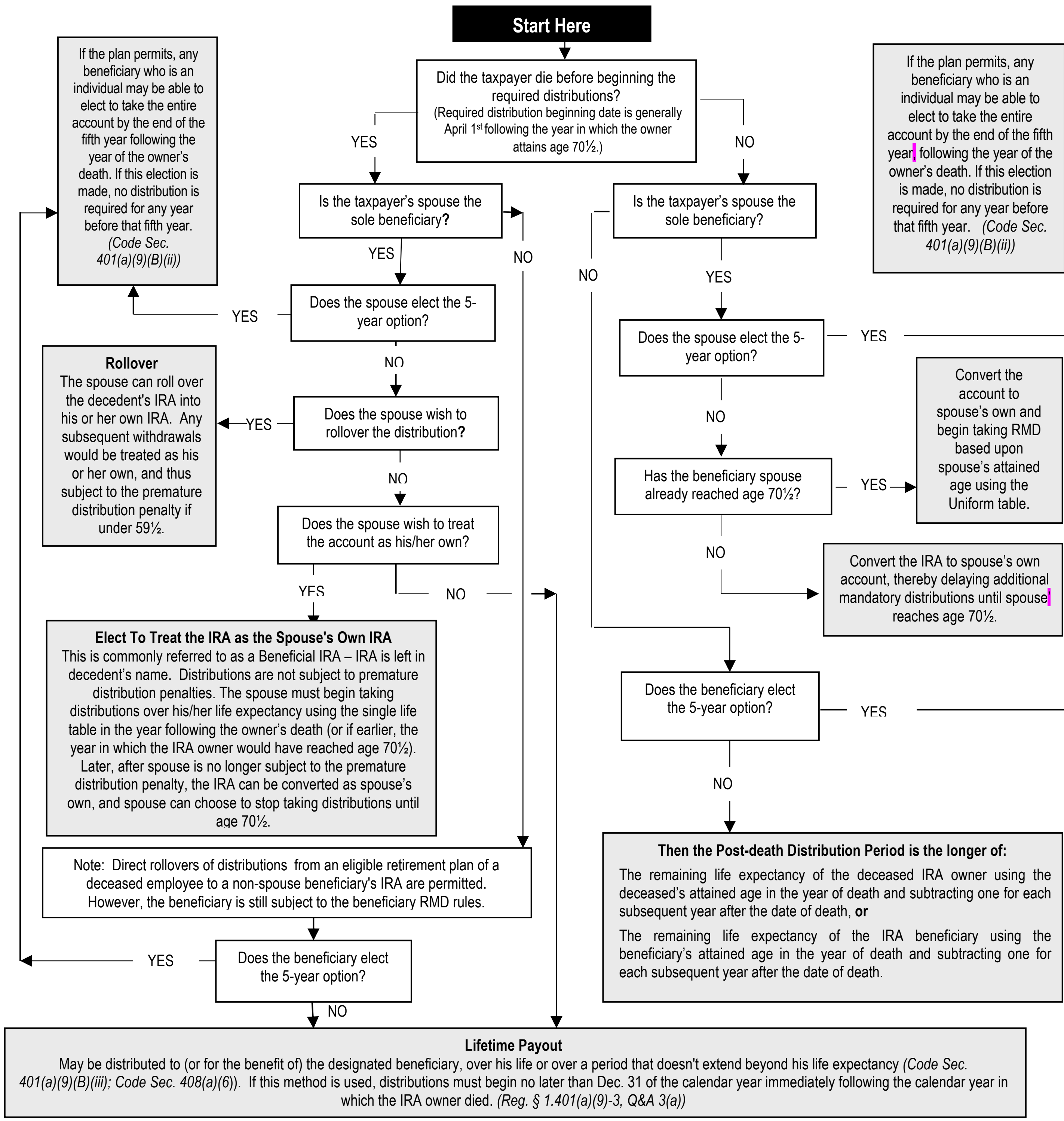
California generally conforms to Federal treatment, including qualified charitable distributions from IRAs. However, California does not have a penalty for excess accumulation in a qualified retirement plan or IRA, i.e., California does not penalize a taxpayer who fails to make their required minimum distribution.

NOTES

POST-DEATH (NON-ANNUITY)

REQUIRED MINIMUM IRA DISTRIBUTIONS

CAUTION: This is an abbreviated summary of the post-death RMD rules for Traditional IRAs and may not cover all of the possible situations or options.



SOLO (Mini) 401(k)

Overview

What is a Solo 401(k)? A Solo 401(k) (also called an Individual 401(k) Plan) is a retirement plan designed specifically for self-employed individuals who have no full-time employees other than themselves and/or their spouse. Key benefits of the Solo 401(k):

- Allows the taxpayer to manage their own account directly without any brokers, banks, or trust companies being the middleman.
- Contribute amounts approximately equal to the 401(k) and profit-sharing amounts combined.
- Legally avoid the UBIT tax that would apply to certain self-directed IRA transactions.
- Participate in Roth contributions to the 401(k) element (not the profit-sharing part) of the plan regardless of the AGI limitations that apply to regular Roth contributions.
- Transfer existing retirement funds into the Solo 401(k).
- Taxpayer can direct his or her investments with absolutely no restrictions on investment choices (including real estate, private companies, foreign assets, precious metals, etc.).

RAPID FINDER

Pubs Forms

Related IRS Publications and Forms

- **Pub 575** – Pension and Annuity Income
- **Pub 4222** - 401(k) Plans for Small Businesses
- **Also See Chapter 4.06**– Qualified Roth Contribution Programs

The Details

Eligibility – A Solo 401(k) plan is not a different kind of 401(k) plan — it merely takes advantage of relaxed rules that apply when the only plan participant is the owner (or the owner and his or her spouse). The Solo 401(k) is available to self-employed individuals and business owners with no full time W-2 employees other than themselves or a spouse. (A self-employed individual who has employees would generally be required to make contributions for those other employees and follow strict nondiscrimination and administrative rules of the 401(k) plan.) Employing independent contractors (1099 workers) would not necessarily disqualify a self-employed individual from a Solo 401(k). Sole proprietorships, partnerships, LLCs and corporations (including both subchapter S and C corporations) would qualify. (Code Sec. 401(a)(35)(E)(iv))

Federal law generally allows plans to be designed to exclude the following types of employees:

- Employees under age 21.
- Employees with less than one year of service.
- W-2 employees who work less than 1,000 hours per year.
- Certain union employees.
- Certain nonresident alien employees.

Contribution Limits - The annual maximum Solo 401(k) contribution is limited to the dollar amounts listed in the table below, but not exceeding 100% of compensation.

Maximum Contribution

2014	2015-16	2017	2018	2019	2020
$52,000	$53,000	$54,000	$55,000	$56,000	

If amount not shown, it was not available at publication date.

The Solo 401(k) contribution consists of two parts: the salary deferral contribution and the profit sharing contribution. For 2019, the salary deferral contribution (same as the 401(k)) permits as much as 100% of the first $19,000 ($25,000) if age 50 or over) of compensation as a tax-deductible contribution. In addition, a profit sharing contribution is permitted equal to 20% of net self-employment income for unincorporated businesses or 25% of W-2 income for incorporated businesses.

Given sufficient income, a self-employed individual and spouse (assuming the spouse is employed in the same business) may contribute, for 2019, up to $112,000 combined. Because of the way the contribution is calculated a larger contribution usually can be made into a Solo 401(k) than to a Keogh or SEP IRA at the same income level.

CAUTION – 401(k) LIMIT

The $19,000 limit on salary deferral contributions to a 401(k) plan applies on a per person, rather than a per plan basis. So, any elective deferral contribution made to a 401(k) plan outside of the Solo 401(k) plan would reduce the otherwise allowable $19,000 deductible contribution amount to the "solo" 401(k).

Discretionary Funding - Each year the funding of the Solo 401(k) plan is completely discretionary and flexible. Funding can be increased, decreased, or skipped entirely if necessary.

Where Deducted - Subchapter S and C corporations or LLCs electing to be taxed as a corporation can generally deduct the salary deferral contribution from personal W-2 earnings and the profit-sharing contribution as a business expense.

For a sole proprietorship, partnership or an LLC taxed as a sole proprietorship, the owner's salary deferral and profit-sharing contributions are deductible only from personal income (i.e., on Schedule 1 (draft 2019) of Form 1040 as an adjustment to gross income), not as an expense of the business. (Contributions to a qualified retirement plan on behalf of employees are deductible business expenses.)

Deadlines:

Establishing the Plan - The deadline for establishing a Solo 401(k) is December 31st for an individual or fiscal year end for corporations.

Contributions - For unincorporated businesses the deadline is the tax filing date of April 15 of the next year plus extensions. For incorporated businesses the deadline is 15 days after the close of the fiscal year.

Roth Contributions – Solo 401(k) designated Roth contributions fall under the rules for "Qualified Roth Contributions" that are covered in chapter 4.06 of this text. Provided the plan document permits Roth contributions, participants in a Solo 401(k) can elect to make after-tax or Roth contributions with the salary deferral portion of the Solo 401k. The annual maximum salary deferral contribution is $19,000 or $25,000 if age 50 or older for 2019.

Caution

Designated Roth contributions in a Solo 401(k) plan are subject to the age 70½ required minimum distributions (RMD). However Roth IRAs are not subject to the RMD rules and the Roth contribution can be rolled into a Roth IRA before reaching the mandatory distribution age to avoid the mandatory distributions.

Roth Aging Element - Designated Roth contributions to a Solo 401(k) plan are subject to the normal 5-year aging rules to avoid distribution penalties.

Plan Administrator Responsibilities – The self-employed individual can act as his or her own plan administrator. Responsibilities include making timely payments according to the loan amortization schedule if a loan has been taken, and filing Form 5500 if plan assets exceed $250,000.

Plan Loans - Another important distinction between the Solo 401(k) plan versus other self-employed retirement plans is that it permits (if so stated in the plan documents) the small business owner to borrow 1/2 of the funds in the 401(k) ($50,000 maximum) for any reason at any time, tax free and penalty free. The loan generally must be repaid as follows:

- To be repaid over an amortization schedule (established before taking the loan) of 5 years or less, although a 10-15 year payback is allowable for the purchase of a home.
- Regular payments no less frequently than quarterly.
- At a reasonable rate of interest… generally interpreted as prime rate + 1%

There are no tax consequences if loans are repaid on schedule.

Strategy

Using rollover provisions (see below) a Solo 401(k) owner can consolidate his or her other plans and IRAs into the 401(k) plan, making them eligible for the loan provisions.

Rollover Provisions - The Solo 401(k) is a qualified plan and rollovers that meet the normal rollover requirements can be made to and from a Solo 401(k). This includes IRA, Rollover IRA, 401k, SEP IRA, Keogh Plans (including Profit Sharing and Money Purchase), Defined Benefit Plans and 403b Plans.

Strategy

The maximum amount of a traditional IRA distribution that can be rolled over to an eligible retirement plan may not exceed the part of the amount distributed that would be includible in gross income if it weren't rolled over (Code Sec. 408(d)(3)(A)(ii)). Thus, if a taxpayer has an IRA that includes non-deductible contributions, the taxpayer can roll over the taxable portion into the Solo 401(k) leaving the already taxed funds in the IRA that can then be converted into a Roth IRA. Note that there are no Roth conversion AGI limits.

Turnkey Plans – The Solo 401(k) plan is useful where a small employer has no non-highly compensated employees. The plan documents are generally drafted with the <u>assumption</u> that the goal is to maximize contributions and that there will not be any eligible non-highly compensated employees. In addition, most turnkey plans are established as low cost plans requiring little, if any, professional administration and without nondiscrimination testing.

CAUTION – Potential Employees in the Future

Care should be taken to provide for the potential that the business may grow and non-highly compensated employees may in fact one day become eligible to participate in the plan, at which time the employer may be obligated to make significant contributions for unanticipated participants.

Most financial firms offer turnkey plans. Consult a broker dealer or search “solo 401(k)” on the Internet.

CAUTION - Employer Aggregation Rules

An employer that is part of a controlled group of corporations, partnerships, proprietorships or affiliated service groups under Code Sec. 414(b), (c), or (m) must continue to take into consideration employees of those related entities for purposes of determining whether the Solo 401(k) satisfies the applicable qualification requirements, including the minimum coverage requirements.

<u>Example #1 – No Full-Time Employer Plan</u> **-** Kevin has full-time employment earning $70,000 a year. But he also works as an Internet programmer on the side, developing and designing websites for small businesses. For 2019, his net earnings from self-employment (Schedule C gross income minus related business expenses) is $10,000. If Kevin has a combined profit-sharing and 401(k) (cash-or-deferred) arrangement, he can put away and deduct nearly the entire $10,000 of net earnings, consisting of:

(1) Net Profit…………………………………………………………………………. $10,000
(2) Profit after SE tax Deduction ($10,000 – ($10,000 x .9235 x .153 x .5))…… $9,293
*(3) **Profit Sharing Contribution** (20% of $9,293)………………………………………………... **$1,859***
*(4) **401(k) arrangement** - the lesser of:*
- *(a) Net profit less profit-sharing contribution ($9,293 − $1,859) = **$7,434**;*
- *(b) Maximum Profit-sharing contribution less the allowable Contribution $56,000 - $1,859 = **$54,141;** or*
- *(c) The maximum regular deferral amount for the year* 2019 *of:* ***19,000**.*

*(5) The smaller of (a), (b) or (c) from (4) is……………………………………………..………………. **<u>$7,434</u>***
*(6) Total combined allowable contribution is…………………………………………………………..……..**$9,293***

*<u>Example #2 – Full-Time Employer Plan</u> **-** What if the taxpayer also had a 401(k) arrangement with his employer? The annual maximum applies to all plans of a taxpayer. Therefore, if Kevin makes an elective $17,000 contribution to his full-time employer’s plan, the maximum he can contribute to his own plan would be $2,000 ($19,000 - $17,000). Thus, in the example above, Kevin’s contribution to his own self-employed combo plans would be limited to $3,859 ($1,859 + $2,000).*

*<u>Example #3 – Taxpayer Age 50 or Older</u> **–** What if Kevin were age 50 or older? Taxpayers age 50 and older are allowed an additional catch-up contribution of $6,000 for* 2019*. In Example #2, he could make an additional deductible catch-up contribution of $6,000 for* 2019 *bringing his total contributions to $9,859 (1,859 + 2,000 + $6,000), which is more than his net SE income of $9,293, so his contributions are limited to net SE income. In Example #1 the additional catch up contribution amount will not benefit him since he is already contributing his entire net SE income and IRC § 414(v)(2)(A) caps total contribution at no more than “compensation,” the SE net income in this case.*

<u>Example #4 – Incorporated Business</u> **–** *Susan Lewis, age 49, is the sole employee of an incorporated business. Her earned income is $100,000 in 2019. Under the law, Susan can contribute $25,000 to a SEP-IRA ($100,000 x .25), $16,000 plus 3% of $100,000) to a Simple IRA or $25,000 to a profit sharing or money purchase plan. However, she can contribute $44,000 to a Solo 401(k) plan ($25,000 employer contribution plus $19,000 employee deferral), still under the $56,000 maximum for the year. If Susan were age 50 or over, she could also make a catch-up contribution of $6,000, increasing her Solo 401(k) contribution total to $50,000.*

<u>Note:</u> Generally, 401(k) plan contributions for an unincorporated business will be slightly lower than the above amounts. For unincorporated businesses, compensation is net profit minus the applicable percentage of self-employment taxes deductible as an adjustment on Form 1040 minus employer contributions.

Business Owner & Spouse - Although single-participant 401(k) plans are limited to the business owner and his or her spouse, business owners should note the added benefits of having his or her spouse as the business's only other employee. Having the spouse on the payroll gives the business owner the opportunity to shelter some or all of his or her income by having the spouse make an elective deferral to a 401(k) plan in addition to the business making a profit-sharing contribution. Although the spouse and the business would be responsible for their respective share of employment taxes on the salary, combined employer and employee contributions can be up to the lesser of $56,000 for 2019 or 100% of compensation. This limit applies separately to the business-owner and spouse, thus allowing a combined total of up to $112,000 for 2019. In addition, if age 50 or over, each individual could defer an additional $6,000 each year.

Comparative Example – Taxpayer Age 55 with $130,000 net profit from his business in 2019.

	Simple IRA	**SEP IRA**	**Solo 401(k)**
Net Profit: $130,000 Net times .9235: $120,055 SE Tax Deduction*: $9,184 Profit Sharing	0	24,163 (4)	24,163(4)
Deferral	13,000 (1)	0	19,000 (6)
Employer Contribution	3,602 (2)	0	
Catch Up Contribution	3,000 (3)	0 (8)	6,000 (5)
Tentative Contribution	19,602	24,163	49,163
Maximum Allowed	56,000(7).	56,000(7).	56,000(7)
Allowable Contribution	19,602	24,163	49,163
Percent of Compensation	15.08%	18.59%	37.82%

*(($120,055 x 12.4%) + ($120,055 x 2.9%)) x 50%

(1) 2019 Simple IRA maximum is: $13,000
(2) Assume the maximum 3% employer contribution ($120,055 x .03)
(3) 2019 Simple IRA catch-up limit is $3,000
(4) ($130,000 - $9,184) x .20
(5) The 401(k) age 50 and over catch-up contribution limit for 2019 is $6,000
(6) The 2019 401(k) contribution limit is $19,000
(7) $56,000 *is the maximum allowable total contribution for 2019.*
(8) Catch-up Contributions not permitted for SEPs.

NOTES

DEFERRED COMPENSATION PLANS – SEC 457

Maximum Contribution is the lesser of:

- Applicable Dollar Amount
- 100% of compensation

Applicable Dollar Amount:

- For 2019 - $19,000
- Double that amount in the last 3 years before retirement
- Age 50+ Catch-up Amount - $6,000 (2015 through 2019)
- Age 50 Catch-up and final 3-yr catch-up cannot be combined

RAPID FINDER

Related IRS Publications and Forms

- **Pub 525 –** Taxable and Nontaxable Income
- **Pub 575 –** Pension and Annuity Income
- **Form 5329** - Additional Taxes on Qualified Plans

Deferred compensation plans seldom have any consequence to the preparation of the actual tax return. However, an overview is provided here so you can respond to client inquiries.

Code Section 457 plans apply to deferred compensation plans of state and local governments and tax-exempt organizations.

Employees and independent contractors of state and local governments and tax-exempt organizations (except churches) can participate in an "eligible deferred compensation plan" that allows them to defer receipt of, and exclude each year from gross income, employer contributions made on their behalf to the plan up to the lesser of the applicable dollar limit or 100% of annual compensation. The amount in Form W-2, Box 1 (wages) already reflects the deferred and excluded wages, so no adjustment to income is required when preparing the employee's return.

ANNUAL COMPENSATION LIMIT

The maximum amount which may be deferred under the plan for a tax year may not exceed the lesser of:

(1) Applicable dollar amount, or

(2) 100% of annual compensation.

APPLICABLE DOLLAR AMOUNTS:

Year	2014	2015-17	2018	2019	2020
Amount	17,500	18,000	18,500	19,000	

If amount not shown, it was not available at publication date.

Inflation Adjustments - The applicable dollar amount is adjusted for cost-of-living increases. Any cost-of-living increase that is not a multiple of $500 will be rounded to the next lowest multiple of $500.

Special Catch-Up Rule – Under a special catch-up rule the limit will be twice the otherwise applicable dollar amount limits in the three years before retirement.

Age 50 Catch-Up Amounts

Year	2009-2014	2015-2019	2020
Amount	5,500	6,000	

Age-50 Catch-Up Contributions – An individual who will reach age 50 by the end of the year, and who has contributed the maximum amount to the Sec. 457 plan for the year, may contribute an additional amount. This amount is the lesser of the excess of that year's compensation over any other elective deferrals made by the participant, or the amount shown in the table. **CAUTION:** The age 50 catch-up rule and the final 3-year catch-up rule may not both be used in the same years.

PUBLIC SAFETY OFFICERS' EXCLUSION FOR HEALTH & LONG-TERM CARE INSURANCE

Eligible retired public safety officers (police, firefighters) may elect to exclude governmental retirement plan distributions that don't exceed their health or long-term care premiums, if the distributions are paid directly to insurers. The exclusion is limited to $3,000 per year. Any amount excluded isn't deductible as a medical expense for itemized deductions and isn't includible as health insurance for the self-employed health insurance deduction. (Code Sec 402(l)(7)) See chapter 7.02, Medical, for additional details.

QUALIFIED DOMESTIC RELATIONS ORDER (QDRO)

The QDRO rules applicable to governmental plans and church plans will apply to Section 457 plans for purposes of determining whether a distribution is made under a QDRO. *(Code Sec. 414(p)(11))*

Thus, where a spouse (or former spouse) of a participant in a Section 457 plan receives a distribution under the terms of a QDRO from the Section 457 plan, the spouse (or former spouse) will be treated as the distributee and taxed on the benefits received. Section 457 plan distributions made to an alternate payee other than a spouse (or former spouse) under a QDRO are taxable to the participant.

GOVERNMENT 457 PLANS & DESIGNATED ROTH IRA ACCOUNTS

A deferral plan under section 457(b) governmental plan can have Roth accounts that allow participants to save on a Roth basis. That is, they can make after-tax contributions to the plan and all the principal and earnings are tax-free when distributed. (Code Sec. 457(e)(1)(C)) Plans had been able to allow participants to convert their pre-tax accounts to Roth accounts, but only with respect to money they had a right to take out of the plan, usually because they reached age 59½ or separated from service.

The American Taxpayer Relief Act (ATRA) of 2012 allows any amount in a non-Roth account to be converted to a Roth account in the same plan, whether or not the amount is distributable. The amount converted is subject to regular income tax.

ROLLOVERS

An individual who receives a payment from a governmental Code Sec. 457 plan can roll it over tax-free to (a) an IRA, (b) a Code Sec. 401(a) qualified plan, (c) a Code Sec. 403(a) qualified annuity plan, or (d) a Code Sec. 403(b) tax-sheltered annuity plan as well as to another Code Sec. 457 plan.

EARLY WITHDRAWAL PENALTIES

For purposes of the additional tax on early distributions, an eligible governmental section 457 deferred compensation plan is treated as a qualified retirement plan, but only to the extent that a distribution is attributable to an amount transferred from a qualified retirement plan. Qualified retirement plans include: tax-sheltered annuities, qualified pension plans, profit-sharing plans, stock bonus plans, 401(k) plans, qualified annuities and IRAs.

Correctly Completing Form 5329, Part I - Enter the total distribution on line 1. On line 2, enter the amount of the distribution not subject to the additional tax. Also, on line 2, enter exception code 12. The result on line 3 is the amount of the distribution subject to the additional tax. On line 4, enter 10 percent of any amount on line 3.

CALIFORNIA DIFFERENCES

California conforms to Federal treatment.

SIMPLE PLANS

RAPID FINDER

Overview

Employers with 100 or fewer employees, each of whom received at least $5,000 in compensation for the preceding year, and with no other employer-sponsored retirement plans may adopt savings incentive match plans for employees (SIMPLE). A SIMPLE retirement account may take the form of an IRA or may be part of a §401(k) plan.

- Maximum employee elective contribution under age 50 (2019): $13,000
- Maximum employee elective contribution age 50 and over (2019): $16,000
- Required employer matching contribution:
  - **3%** of employee compensation or
  - **2%** of employee compensation **with $280,000 cap** (2019)
- Two year rollover waiting period

Related IRC and IRS Publications and Forms

Pubs

- **Form 5305-SIMPLE** - With a Designated Financial Institution
- **Form 5304-SIMPLE** - No designated financial institution
- **Form 5305-SA** - SIMPLE Individual Retirement Custodial Account

Forms

- **Form 5305-S** - SIMPLE Individual Retirement Trust Account
- **Form 8881** – Credit for Small Employer Pension Plan Startup Costs
- **Pub 560** - Retirement Plans for Small Business (SEP, SIMPLE and Qualified Plans)
- **Pub 4284** - Simple IRA Retirement Plan Checklist
- **Pub 4334** - SIMPLE IRA Plans for Small Businesses
- **IRC Sec 408(p)**

The Details

Employers with 100 or fewer employees, each of whom received at least $5,000 in compensation for the preceding year, and with no other employer-sponsored retirement plans, may adopt savings incentive match plans for employees (SIMPLE). A SIMPLE retirement account may take the form of an IRA (not a Roth) or may be part of a §401(k) plan.

As an IRA or as part of a 401(k) plan, SIMPLE retirement plans allow employees to make elective contributions up to the annual limit (see table below). Employers must match the contributions dollar-for-dollar up to 3% of the employee's compensation. The 3% may be lowered to not less than 1% for two out of every five plan years. Alternatively, for an IRA SIMPLE plan, an employer may make a 2% non-elective contribution for each eligible employee, taking into account no more than $280,000 (for 2019) in compensation for each employee.

SIMPLE IRA/401(k) Elective Contribution Limits

Year	2008	2009 -12	2013-14	2015-18	2019	2020
Under Age 50	10,500	11,500	12,000	12,500	13,000	
Age 50 and over	13,000	14,000	14,500	15,500	16,000	

If any amounts are not shown, they were not available at publication date
Employer matching contributions are not treated as elective contributions

<u>*Combination Plans Limitations*</u> – A SIMPLE Plan is classified a qualified employer salary reduction plan which has the following impact on other retirement plans:

(1) **Overall Salary Reduction Plan Limits** – If the employee participates in any other salary reduction contributions (elective deferrals) the salary reduction contributions under a SIMPLE IRA plan also count towards the overall annual limit of $19,000 for 2019.

CAUTION – AGGREGATE CONTRIBUTION LIMITS

The contribution limits to 403(b) TSA plans, 408(p)(2) SIMPLE plans, 408(k) SEP IRAs and 401(k) plans apply on an aggregate basis. That is, the total contributed to all four plans cannot exceed the annual limit. See chapter 4.14 for corrective distributions.

(2) **IRA Limits** – Since a SIMPLE plan is an employer plan, the contribution to the SIMPLE plan does not reduce the amount that can be contributed to an IRA

(3) **Traditional IRA Contributions** – SIMPLE plans are employer plans and thus trigger the AGI limitation for Traditional IRA contributions by plan participants.

(4) **SEP Limits** – If the employee who participates in a SIMPLE plan is also self-employed in his or her own business, contributions the individual makes to his or her own SEP plan (that is not a SARSEP) are not reduced by the contributions made to the employer's SIMPLE IRA plan by either the employee or the employer.

Employer Mandatory Matching Contributions – The employer must make either:

(1) A matching contribution equal to the amount the employee contributes, up to 3% of the employee's compensation for the year, (Code Sec. 408(p)(2)(C)(ii)(I)) **OR, electively**, as little as 1% in no more than two out of the previous five years, if the employer timely notifies the employees of the lower percentage (Code Sec. 408(p)(2)(C)(ii)(II)), or

(2) A non-elective contribution of 2% of compensation for each employee eligible to participate who has at least $5,000 of compensation from the employer for the year and taking into consideration no more than $280,000 of compensation (for 2019). See table below for other years. (Code Sec. 408(p)(2)(B)(i))

CAUTION: The elective reduced employer contribution does not apply to SIMPLE plans that are part of a 401(k) plan.

No other contribution can be made. Employer contributions must be made no more than 30 days after the month for which the contributions are to be made. Compensation is the same as wages for income tax withholding plus the amount of the employee's elective deferrals. For self-employed individuals compensation is net self-employed earnings without regard to the SIMPLE plan provisions. The definition of compensation includes wages paid to domestic workers, even though those amounts are not subject to income tax withholding.

Max. Compensation for Computing Non-Elective Employer Contribution

Year	2014	2015-16	2017	2018	2019	2020
Maximum	260,000	265,000	270,000	275,000	280,000	

If any amounts are not shown, they were not available at publication date

Employer matching contributions - The employer is generally required to match each employee's salary reduction contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. This requirement does not apply if the employer makes non-elective contributions.

Example: *Employee, John, earns $25,000 and chooses to defer 5% of his salary. Dave, the employer, has net earnings from self-employment of $40,000, and chooses to contribute 10% of his earnings to the SIMPLE IRA. The employer makes 3% matching contributions.*

John's (the employee) contributions are determined as follows:

Salary reduction contributions ($25,000 x .05)	*$1,250*
Employer matching contribution ($25,000 x .03)	*750*
Total contributions	***$2,000***

Dave's (the employer) contributions are determined as follows:

Salary reduction contributions ($40,000 x .10)	*$4,000*
Employer matching contribution ($40,000 x .03)	*1,200*
Total contributions	***$5,200***

Employee Election - Each employee eligible to participate must be given the right to elect for a calendar year to (a) participate in the arrangement, or (b) modify the amounts subject to the arrangement:

- During the 60-day period immediately preceding the beginning of a calendar year (i.e., Nov. 2 through Dec. 31 of the preceding calendar year); or
- For the year during which an employee becomes eligible to elect to have salary reduction contributions made, the 60-day period that includes either the date the employee becomes eligible, or the day before that date.

A SIMPLE plan may provide additional or longer election periods for employees to enter into salary reduction agreements or modify prior agreements. For example, a SIMPLE plan can provide a 90-day election period instead of the 60-day period. Also, a SIMPLE plan can provide quarterly election periods during the 30 days before each calendar quarter, in addition to the 60-day period.

Contribution Timing – Employer contributions to SIMPLE accounts are deductible in the employer's tax year in the calendar year for which the contribution applies but can be made up to the extended due date of the employer's tax return.

Participation Termination - An employee must be able to elect to terminate participation in the arrangement at any time during the year (Code Sec. 408(p)(5)(B)).

Cash Election - An employee eligible to participate in a SIMPLE IRA plan is required to make an election between his employer paying him cash or making a contribution to a SIMPLE IRA on his behalf (Code Sec. 408(p)).

Employee Contributions - Salary reduction contributions for regular employees must generally be deposited not later than the close of the 30-day period following the last day of the month in which amounts otherwise would have been payable to the employee in cash.

Employer Subsequently Fails Qualifications - A qualifying employer that maintains a SIMPLE plan but later fails to qualify may continue to maintain the plan for two years after its last year of eligibility, subject to certain restrictions for acquisitions, dispositions and similar transactions.

Automatic Enrollment - SIMPLE plans may also incorporate an automatic contribution arrangement which permits an employer to make contributions to an employee's SIMPLE IRA without the employee having made an affirmative election to participate in the plan. The code does not require that the employee receive cash where he doesn't make an affirmative election to have that amount contributed to the SIMPLE IRA.

Employees Age 70½ and Over – Elective contributions can be made to SIMPLE IRAs by employees who have reached age 70½ even though IRA contributions are otherwise not permitted by individuals who have reached this age. (Code Sec. 219(b)(4))

Two-Year Period for Rollovers – Unlike participants in qualified plans, which are not allowed to take in-service distributions, participants in a SIMPLE are allowed to receive distributions subject to certain restrictions. Participants in a SIMPLE plan can transfer (trustee-to-trustee) the IRA to another SIMPLE plan in a tax and penalty free transfer. However, no other transfers are allowed within the two year period beginning with the date of participation in the SIMPLE plan without being taxable and subject to a 25% penalty.

> Those wishing to convert their SIMPLE IRA funds to a Roth IRA will need to meet the two-year requirement to avoid the 25% penalty.

One IRA Rollover Per 12 Months Limitation – An individual receiving an IRA distribution on or after January 1, 2015, cannot roll over any portion of the distribution into an IRA if the individual has received a distribution from any IRA, including a SIMPLE IRA, in the preceding 1-year period that was rolled over into an IRA. This rule does not apply to trustee-to-trustee transfers. (IRS Announcement 2014-32) See Chapter 4.04 for additional information.

FICA & FUTA - Matching and non-elective contributions to a SIMPLE account are excludable from an employee's income for FITW, FICA and FUTA purposes. But salary reduction contributions to a SIMPLE plan, while excludable from income and for income tax withholding, are subject to FICA (Social Security/Medicare) withholding and for FUTA purposes.

Saver's Credit – Contributions to SIMPLE plans qualify for the saver's credit that benefits lower-income taxpayers.

Small Business Start-up Credit – A SIMPLE plan qualifies for the Small Business Start-Up Credit (use Form 8881).

Only Plan Limitation – The SIMPLE plan can be the only plan offered by a qualified employer.

100-Employee Limitation - For purposes of applying the "100-employee limitation" and in determining whether an employee is eligible to participate in a SIMPLE IRA plan (i.e., whether the employee had $5,000 in compensation for any two preceding years), an employee's income includes the employee's elective deferrals under a 401(k) plan, a salary reduction SEP, and a 403(b) annuity contract.

401(k) Non-Discrimination Test – A 401(k) plan that meets the SIMPLE 401(k) plan requirements for the year is treated as meeting the non-discrimination test applicable to employee elective deferrals.

Top Heavy Rules - A SIMPLE 401(k) plan is not subject to the top-heavy rules for any year for which the SIMPLE 401(k) rules are met, *if* the plan allows only the contributions allowed under the SIMPLE 401(k) rules.

Rollovers Into Simple Plans - For contributions made after December 18, 2015, SIMPLE IRA owners may, after the plan has existed for two years, roll over amounts from a traditional IRA, SEP plan, 401(k) plan, 403-b plan, 457(b) plan and other qualified plans into their SIMPLE IRA. (IRC Sec 408(p)(1) as amended by the PATH Act of 2015, Division Q, Act §306(a))

Unrelated Business Income - See chapter 4.05

CALIFORNIA DIFFERENCES

California conforms to SIMPLE plans.

NOTES

HEALTH SAVINGS ACCOUNTS

Overview

- **Eligible Individual is:**
  - One covered by a high-deductible health plan (HDHP).
  - NOT one (generally) covered by any other non-.
  - NOT one covered by Medicare.
  - NOT one claimed as a dependent of another.

- High-deductible health plan (HDHP) definition (2019)

Annual	Self-Only	Family
Minimum Deductible	$1,350	$2,700
Max Out-Of-Pocket Expenses	$6,750	$13,500

- 2019 Monthly Contribution Limit:
  - **Self only** – **$291.67** (1/12 of the $3,500 annual cap)
  - **Family coverage - $583.33** (1/12 of the annual limit)
  - **Age 55 annual catch-up -** $83.33 **($1,000/12)**
- Above-the-line deduction
- Earnings accumulate tax-free and distributions are tax-free if for qualified medical expenses.

SEE FLOW CHART PAGE 04.21.03

Pubs

Forms

Related IRC and IRS Publications and Forms

- **Code Sec 223 –** Health Savings Accounts
- **Form 5329 –** Use to determine 10% penalty
- **Form 8889 –** Health Savings Accounts
- **Pub 969 –** Health Savings Accounts

HSA AS A SUPPLEMENTAL RETIREMENT VEHICLE

Strategies

Establishing and contributing to an HSA can be more than just a way for individuals to save taxes and gain control over their medical care expenditures. It can also be a retirement vehicle, especially for taxpayers who are maxed out on their other retirement plan options or who can't contribute to an IRA because of the income limitations.

There is no requirement that medical expenses must be paid or reimbursed from the HSA, so a taxpayer can maximize tax-free growth in the account by using funds from other sources to pay routine medical costs. Later, distributions can be used tax-free to pay post-retirement medical expenses. Or, if used for non-medical purposes, a retiree age 65 or older will pay income tax, but not a penalty, on the distribution. Unlike IRAs, no minimum distributions are required to be made from HSAs at age 70½ or any other age.

RAPID FINDER

WHAT IS AN HSA?

The Details

Tax-favored HSAs can only be established by eligible individuals who are covered by a high-deductible health plan (HDHP) and not covered under any other health plan which is not an HDHP, unless the other coverage is permitted insurance or coverage for accidents, disability, dental care, vision care, or long-term care. Eligible individuals may, subject to statutory limits, make contributions to HSAs, and employers as well as other persons (e.g., family members) also may contribute on behalf of eligible individuals. (Code Sec. 106, Code Sec. 223)

An account holder gets the deduction for contributions to his HSA even if someone else (e.g., a family member) makes the contributions. (Code Sec. 62(a)(19)) Employer contributions to an HSA are excludable from the employee's income, and distributions for qualifying medical expenses are tax-free.

Contributions to HSAs are an above-the-line deduction, amounts in an HSA may be accumulated tax-free, and distributions are tax-free if used to pay or reimburse qualified medical expenses. Many of the rules related to HSAs are similar to rules that apply to IRAs and Archer Medical Savings Accounts.

An HSA is a tax-exempt trust or custodial account established exclusively for the purpose of paying qualified medical expenses of the account beneficiary who is covered under a high-deductible health plan (defined below). Coverage under a high-deductible health plan is looked at on a month-by-month basis.

Eligible Individual - To be eligible to establish an HSA, an individual, for any month:

1. Must be covered under a high-deductible health plan (HDHP) on the first day of the month;
2. Is not also covered by any other health plan that isn't an HDHP, except certain permitted coverage (see below);
3. Is not entitled to benefits under Medicare (i.e., generally individuals who haven't yet reached age 65); and
4. Is not claimed as a dependent on someone else's return.

Health Flexible Spending Accounts (FSA) & HSAs **-** A health FSA (Code Sec 213), offered by an employer, as part of the employer's qualified cafeteria plan, allows employees to contribute up to $2,700 (2019) in pre-tax dollars annually to be used by the individual to pay medical expenses of the individual, their spouse and dependents during year. Unused amounts are generally forfeited. However, the plan **either** can have a grace period of up to 2½ months after the end of the plan year in which to use up the unused amount **or** allow up to $500 of unused amounts from the end of the plan year to be used to pay or reimburse qualified medical expenses in the following year. Unused amounts in excess of the carryover amounts are forfeited (cannot be returned to the employee). The carryover amount does not reduce the maximum contribution amount allowed for the carryover year. There are two types of health FSA plans:

- **General Purpose Health FSA** – One that reimburses all qualified medical expenses without restriction that is classified as a "health plan that constitutes other coverage" and having such coverage would make the individual **ineligible to make contributions to an HSA.**
- **HSA-compatible Health FSA** – One that is a limited-purpose health FSA, a post-deductible health FSA, or a combination of the two.

FSA Carryover and HSA Eligibility - The impact of health FSA carryover from one year to the other on HSAs is dealt with in Chief Counsel Advice 201413005. The following is a synopsis of the Chief Counsel's advice where there is carryover from year 1 to year 2:

FSA Type Year One	FSA Type Year Two	HSA Qualified In Carryover Year?
Gen'l Purpose	Gen'l Purpose	NO – Entire Year
Gen'l Purpose	HSA Compatible*	Yes
Gen'l Purpose	None	Yes – Provided Carryover is Declined

** Assumes general purpose health FSA carryover rolled into HSA compatible health FSA.*

Medicare Coverage - IRS has interpreted being "entitled to benefits under Medicare" to mean both eligibility and enrollment in Medicare. An individual who is otherwise eligible, but who is not actually enrolled in Medicare Part A, may contribute to an HSA until the month actually enrolled in Medicare. *(IRS Notice 2004-50; IRS Notice 2008-59)* If an individual has delayed applying for Medicare, when they do apply, their enrollment may be back dated for up to 6 months. Thus, any contributions made to their HSA during the period of retroactive coverage will be considered excess contributions. (IRS Pub 969) Retroactive Medicare coverage can be for up to 6 months, so those with an HSA who plan to delay enrollment in Medicare should stop making contributions to their HSA at least 6 months before Medicare enrollment to avoid a tax penalty for excess contributions. See page 4.21.06 for more on excess contributions.

VA Coverage - An individual who is eligible to receive Department of Veterans Affairs (VA) medical benefits will be treated as an eligible individual if otherwise qualified and no VA medical benefits have been received during the preceding three months. The 3-month rule does not apply if the medical benefits consist solely of disregarded coverage (defined below) or preventive care ***(IRS Notice 2008-59)***.

Indian Health Service (IHS) - An individual who is eligible to receive medical services at an IHS facility, but who has not actually received such services during the previous three months, is an eligible individual within the meaning of § 223(c)(1) who may establish and make tax-free contributions to an HSA. However, an individual generally is not an eligible individual if the individual has received medical services at an IHS facility at any time during the previous three months. Notice 2004-2, Q&A-6, provides that the receipt of permitted coverage, such as dental and vision care, or the receipt of preventive care, such as well-baby visits, immunizations, weight-loss and tobacco cessation programs, does not affect an individual's eligibility. ***(IRS Notice 2012-14)***

Other Allowed Insurance – An individual will not be prevented from establishing an HSA if, in addition to an HDHP, the individual has coverage for benefits provided by "permitted insurance," under which substantially all the coverage provided relates to:

- Worker's compensation laws;
- Tort liabilities;
- Liabilities relating to ownership or use of property, such as automobile insurance;
- Insurance for a specific disease or illness, such as cancer insurance; and
- Insurance that pays a fixed amount per day (or other period) of hospitalization.

In addition, eligibility for an HSA will not be compromised merely because the individual also has coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care—collectively termed "disregarded coverage". Discount cards entitling the holder to discounts for health care services or products at managed care market rates will not disqualify the individual from being an eligible individual for HSA purposes, if the individual is required to pay the health care costs until the high-deductible health plan's deductible is satisfied.

State Required Coverage – Generally, if a state requires a health plan to provide certain benefits without a deductible or at a deductible that is less than the minimum annual deductible, the plan may not be an HDHP.

HIGH-DEDUCTIBLE HEALTH PLANS (HDHPs)

An HDHP is a health plan that satisfies certain requirements with respect to out-of-pocket expenses and annual deductibles based on whether the coverage is for "self-only" or "family." Family HDHP coverage is a health plan covering one eligible individual and at least one other person, whether or not that other person is an eligible individual.

The monetary requirements for an HDHP are:

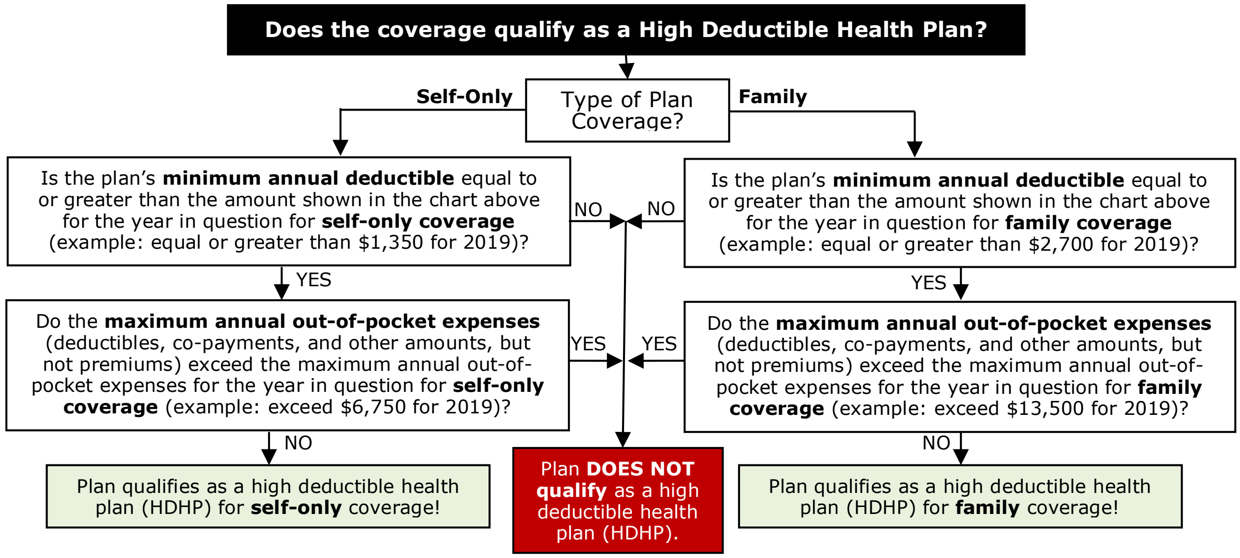
	Minimum Annual DEDUCTIBLE						Maximum Annual OUT-OF-POCKET EXPENSES					
Coverage	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Self-only	1,300	1,300	1,300	1,350	1,350	1,400	6,450	6,550	6,550	6,650	6,750	6,900
Family	2,600	2,600	2,600	2,700	2,700	2,800	12,900	13,100	13,100	13,300	13,500	13,800

HSA Interaction with the ACA Deductible-Free Preventive Care Requirements

Generally, under section 223(c)(2)(A), an HDHP may not provide benefits for any year until the minimum deductible for that year is satisfied. However, section 223(c)(2)(C) provides a safe harbor for the absence of a deductible for preventive care. Therefore, an HDHP may provide preventive care benefits without a deductible or, in some cases with a deductible below the minimum annual deductible otherwise required. Notice 2004-23 clarifies that preventive care generally does not include any service or benefit intended to treat an existing illness, injury, or condition.

In response to a directive from Pres. Trump for the Secretary of the Treasury to issue guidance to expand the ability of patients to select HDHPs that can be used alongside an HSA, the IRS, in consultation with HHS, has determined that certain medical care services received and items purchased, including prescription drugs, for certain chronic conditions should be classified as preventive care for someone with that chronic condition, and thus won't disqualify participation in an HSA when the HDHP provides coverage for these items without a deductible. These medical services and items are limited to the specific medical care services or items listed below, but the IRS and HHS will periodically review and update the list. (Notice 2019-45)

Preventive Care for Specified Conditions	For Individuals Diagnosed with. . .
Angiotensin Converting Enzyme (ACE) inhibitors	Congestive heart failure, diabetes, and/or coronary artery disease
Anti-resorptive therapy	Osteoporosis and/or osteopenia
Beta-blockers	Congestive heart failure and/or coronary artery disease
Blood pressure monitor	Hypertension
Inhaled corticosteroids	Asthma
Insulin and other glucose lowering agents	Diabetes
Retinopathy screening	Diabetes
Peak flow meter	Asthma
Glucometer	Diabetes
Hemoglobin A1c testing	Diabetes
International Normalized Ratio (INR) testing	Liver disease and/or bleeding disorders
Low-density Lipoprotein (LDL) testing	Heart disease
Selective Serotonin Reuptake Inhibitors (SSRIs)	Depression
Statins	Heart disease and/or diabetes



Out-of-Pocket Expenses include deductibles, co-payments and other amounts, but not insurance premiums. A plan is not disqualified as an HDHP merely because it does not have a deductible (or has a small deductible) for preventive care. A family plan will qualify as an HDHP only if amounts are not payable from the HDHP until the family collectively has incurred medical expenses in excess of the minimum annual deductible.

> ***Example – Family Plan Does Not Qualify:*** *Joe has a medical insurance plan that provides coverage for himself and his family. The plan will pay covered medical expenses of any member of Joe's family if the family member has incurred covered medical expenses during the year of over $1,000, even if the family as a whole has not incurred medical expenses over $2,700 for 2019. So, if Joe's medical expenses were $1,500 during the year, the plan would pay $500. This plan would not qualify as an HDHP because it provides family coverage with an annual deductible of less than $2,700.*

> ***Example – Family Plan Qualifies:*** *If the coverage for Joe and his family from the example above was that the plan had a $5,000 family deductible and provided payments for covered medical expenses if any member of Joe's family incurred over $2,700 of expenses, the plan would qualify as an HDHP.*

> ***Example – Family Plan May Qualify:*** *An otherwise qualified HDHP provides family coverage in 2019 with a $2,700 deductible for each family member. Once a family member satisfies the $2,700 deductible, 100% of that person's covered benefits are covered by the plan. The plan has no express limit on out-of-pocket expenses. Because the limit on maximum out-of-pocket expenses for 2019 is $13,500, this plan will qualify as an HDHP only for a family with 2 to 4 covered individuals ($2,700 x 4 = $10,800), which is under the ceiling for 2019. This plan would not qualify for a family with over 5 covered individuals (6 x $2,700 = $16,200, which exceeds the $13,500 maximum for 2019).*

Deductible Period Over 12 Months - If a plan's deductible can be satisfied over a period longer than 12 months, the minimum annual deductible must be increased to take the longer period into account when determining if the plan satisfies the HDHP deductible requirement.

> ***Example – Deductible Period Exceeds 12 Months:*** *Fiona's self-only health plan takes into account medical expenses incurred in the last 3 months of 2018 to satisfy the deductible for calendar year 2019, a total deductible period of 15 months, and for that period the plan's deductible is $1,800. The calculation to determine if the deductible meets the HDHP minimum annual deductible requirement is: $1,350 x 15 months = 20,250/12 = $1,688, the minimum amount that the HDHP deductible must be for 15 months. Because the plan's deductible, $1,800, exceeds $1,688, the plan qualifies as an HDHP.*

HOW HSAs ARE ESTABLISHED

An eligible individual can establish an HSA (or multiple HSAs) with a qualified HSA trustee or custodian (insurance company, bank, or similar financial institution) in much the same way an IRA is established. No permission or authorization is required from IRS. There is no requirement that the individual have earned income. If employed, an eligible individual may establish an HSA with or without involvement of the employer. Joint HSAs between a husband and wife are not allowed; each spouse who is an eligible individual who wants to contribute to an HSA must have a separate HSA.

HSA funds may be invested in the same type of investments approved for IRAs. They may not invest in life insurance contracts or collectibles. Account beneficiaries are prohibited from entering into the same type of "prohibited transactions" as applicable to IRAs. Amounts treated as distributed because of a prohibited transaction are not considered used to pay for qualified medical expenses and must be included in gross income and are subject to an additional 20% penalty.

CONTRIBUTIONS TO HSAs

Any eligible individual, whether **employed, unemployed or self-employed, may contribute to an HSA**. Unlike IRAs, there is no requirement that the individual have compensation and there are **no phase-out rules** for high-income taxpayers. For an HSA established by an employer, the employee, the employer or both may contribute to the HSA. Family members or any other person may also make contributions to an HSA on behalf of an eligible individual. ***(Notice 2004-23; Notice 2004-50)*** If an individual has more than one HSA, the aggregate annual contributions to all the HSAs are subject to the limit.

Contributions to an HSA **must be made in cash** (no stock or other property). Payments to the HDHP and contributions to the HSA can be made through an employer's cafeteria plan.

Maximum Contribution – General Limitation – The maximum annual contribution to an HSA is the sum of the limits **determined separately for each month**, based on status, eligibility and health plan coverage as of the first day of the month.

The maximum annual monthly contribution is determined as follows:

- **Self-only** coverage (monthly) = 1/12 of the self-only dollar limit for the year.
- **Family** coverage (monthly) = 1/12 of the family coverage dollar limit for the year.

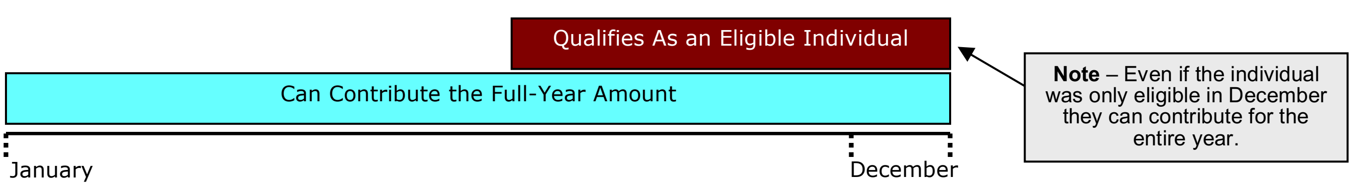
	MAXIMUM ANNUAL CONTRIBUTION					
	2015	**2016**	**2017**	**2018**	**2019**	**2020**
Self-only coverage:	$3,350	$3,350	3,400	3,450	3,500	3,550
Family coverage:	$6,650	$6,750	6,750	6,900*	7,000	7,100

*As a result of the TCJA change in how inflation adjustments are calculated, the IRS in Rev Proc 2018-18 revised the original 2018 maximum of $6,900 to $6,850, but then 2 months later in Rev Proc 2018-27 reinstated $6,900 as the 2018 family coverage contribution limit. Refer to Rev Proc 2018-27 for information and clarification on how to treat a distribution of an excess contribution (and earnings) that took place based on Rev Proc 2018-18.

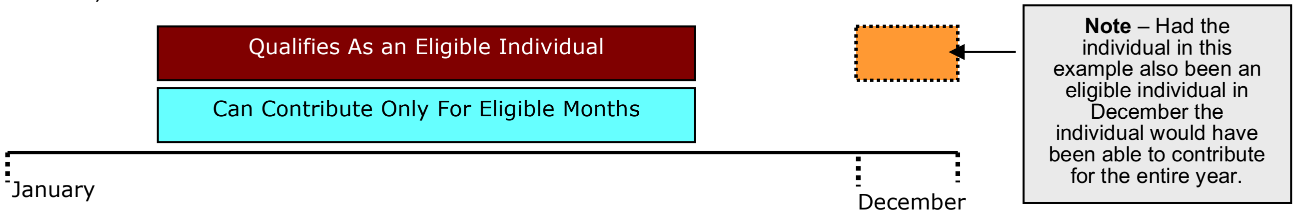
Additional Catch-up Contribution – Individuals (and their spouses covered under the HDHP), age 55 and older, who are not enrolled in Medicare are allowed to increase their HSA contribution. The catch-up contribution, like the annual contribution limit, is computed on a monthly basis. The annual amount has been $1,000 since 2009.

FIGURING THE CONTRIBUTIONS

Individuals Who Are Eligible on the Last Day of the Year– An eligible individual who establishes an HSA plan during the year and is still an eligible individual during the last month of the year (December) can contribute the full-year amount (does not need to prorate the contribution). *Notice 2008-52, 2008-25 IRB 1166*



Individuals Who Are NOT Eligible on the Last Day of the Year – An individual who was eligible during the year but not eligible during the last month of the year (December) must prorate their contributions for the year. *Notice 2008-52, 2008-25 IRB 1166*



Correcting Contributions Made for Ineligible Periods - When an individual's full-year contribution was based on the "last month" rule (i.e., when considered to be an eligible individual for the entire year if an eligible individual on the first day of the last month of the tax year – December 1 for most taxpayers), the individual must remain eligible during a "testing period." The testing period begins with the last month of the tax year and ends on the last day of the 12th month following that month. For example, the testing period for a calendar-year individual who became eligible on December 1, 2019 would be December 1, 2019 through December 31, 2020 If, at any time during a particular testing period the individual is *not* an "eligible individual", except by reason of death or a disability, then:

(a) The individual's gross income for the tax year that includes the first month in the testing period for which he is not an eligible individual is increased by the aggregate amount of all of his HSA contributions which could not have been made; and

(b) A 10% additional tax will be imposed for any tax year on the amount of the increase described in item (a), above. Code Sec. 223(b)(8)(B); Notice 2008-52, 2008-25 IRB 1166.

No Contributions After Enrollment in Medicare – After an individual has reached the Medicare eligibility age (generally 65), and has **actually enrolled** in Medicare, including Medicare D, no further contributions, including catch-up contributions, can be made to the individual's HSA.

Example – Computing Contribution in Year Enrolling in Medicare: *Becky's 65th birthday is in July 2019, at which time she enrolled in Medicare. Becky was participating in self-only coverage under an HDHP with an annual deductible of $1,350. She is not eligible to make HSA contributions after June 2019. Her monthly contribution limit is $370.83 (($3,450/12) + ($1,000/12)) and the maximum she may contribute for the year is $2,224.98 (6 x $370.83)) for coverage from January through June.*

Spouse with Family Coverage – Where a husband and wife each has family HDHP coverage, the general rule is that each spouse may set up a separate HSA and they may divide the HSA annual contribution limit between them as they wish. If each spouse has just self-only HDHP coverage, each spouse may contribute to their respective HSA. If either spouse of a married couple has family coverage, both are treated as having family coverage. If each spouse has family coverage under a separate health plan, both spouses are treated as covered under the plan amount divided equally between the spouses, unless they agree to a different division. Both spouses may make the catch-up contribution for individuals age 55 or over without exceeding the family coverage limit.

When Can Contributions Be Made? Contributions can be made in one or more payments at any time from January 1 of the tax year up to the unextended due date for filing the eligible individual's federal return for the tax year (usually April 15 for calendar year filers). Although the annual contribution is determined monthly, the maximum contribution may be made on the first day of the year. However, if the individual is later determined not to be eligible for the entire year, some or all of the contribution is treated as an excess contribution (see below).

TAX TREATMENT OF HSA CONTRIBUTIONS

Within the limits noted above, contributions to HSAs (including contributions by family members or other persons on behalf of an eligible individual) are deductible by the eligible individual in determining AGI, i.e., an **above-the-line deduction**. Contribution to the HSA may not be deducted as an itemized medical expense deduction.

Employer Contributions - If an eligible individual's employer contributes to the employee's HSA, the contributions (within the limits) are treated as employer-provided coverage for medical expenses under an accident or health plan and are **excludable from the employee's gross income**. They are not subject to income tax or FICA withholding (or FUTA tax). Contributions to an employee's HSA through a cafeteria plan are treated as employer contributions. An employee may not deduct the employer's HSA contributions as either an HSA contribution or a medical expense on his or her return.

Partnership and S Corp Contributions – If a partnership or S corporation contributes to a partner's or shareholder's HSA, the tax treatments are as follows:

- If Partnership treats the contribution as a guaranteed payment made for services - it is includible in the partner's gross income and treated as self-employment income. The partner, if otherwise qualified for an HSA, may deduct the contribution as an adjustment to gross income.
- If Partnership treats the contribution as a distribution to the partner under Section 731 - it is not deductible by the partnership, doesn't affect the distributive share of partnership income and deductions, and isn't includible by the partner as self-employment earnings. The HSA contribution is reported as a distribution of money on Schedule K-1(1065). (Under Sec 731, a partner includes the distribution of money as income only to the extent that the amount of money received exceeds the partner's adjusted basis in the partnership prior to the distribution; basis in the partnership is reduced, but not below zero, by the amount received.) The partner, if otherwise eligible, is allowed an above-the-line deduction for the HSA contribution.
- S Corp contributes to the HSA of a 2% shareholder who is an employee - the amount is treated as a guaranteed payment includible in the shareholder-employee's gross income. The contribution amount is deductible by the shareholder-employee as an above-the-line HSA contribution provided he or she is otherwise eligible under the HSA rules.

Excess Contributions – Contributions in excess of the limits noted above are not deductible. Contributions by an employer to an employee's HSA are included in the gross income of the employee to the extent they exceed the limits, or if they are made on behalf of an employee who is not an eligible individual. In addition, a **6% excise tax** for each tax year is imposed on the account beneficiary for excess individual and employer contributions, unless the excess contributions and the net income on the excess are paid to the account beneficiary by the due date (including extensions) of the return for the tax year. If the excess is **withdrawn timely**, then:

- Only the net income on the excess contributions is includible in the account beneficiary's gross income for the tax year of the distribution;
- The excise tax is not imposed; and
- The distribution of the excess contributions is not taxed.

TAX TREATMENT OF HSA DISTRIBUTIONS

Non-Qualified Distributions – Distributions from an HSA are permitted at any time, and if used exclusively to pay for qualified medical expenses of the account beneficiary, his or her spouse, or dependents, are excludable from gross income. Distributed amounts not used to pay for qualified medical expenses are includible in the account beneficiary's gross income and are subject to a 20% penalty tax. However, the penalty does not apply if the distribution is made on account of the beneficiary's:

- Death;
- Disability; or
- Attaining age 65.

Amounts withdrawn from an HSA to pay for the account's administration and maintenance fees are not treated as taxable distributions. (If these fees are paid directly by the account beneficiary or employer, they will not be considered contributions to the HSA, and therefore, won't count toward the annual maximum contribution limit.)

Qualified Medical Expenses – are unreimbursed expenses paid by the account beneficiary, his or her spouse, or dependents for medical care as defined in Code § 213(d), i.e., generally the same definition used for itemized-deduction medical expenses. Amounts paid for medicine or a drug are qualified medical expenses for HSA distribution purposes only if the medicine or drug is a prescribed drug (determined without regard to whether such drug is available without a prescription) or is insulin. The qualified medical expenses must be incurred only after the HSA has been established. Medical expenses paid or reimbursed by HSA distributions cannot also be claimed as a medical expense for itemized deduction purposes.

Generally, health insurance premiums are ***not*** qualified medical expenses for HSA purposes, except for the following:

1. Qualified long-term care insurance;
2. COBRA health care continuation coverage;
3. Health care coverage while receiving unemployment compensation; and
4. For individuals age 65 or over, premiums for Medicare A, B or D, Medicare HMO, and the employee share of premiums for employer-sponsored health insurance, including premiums for employer-sponsored retiree health insurance (but not Medigap policies).

HSA distributions to pay long-term care insurance premiums are excludable only up to the annual age-based limit that applies for deducting long-term care premiums as medical expenses.

> ***Example – Long-term Care Insurance Premiums:*** *Paula is age 41, and in* 2019*, pays a premium of $1,290 for a qualified long-term care insurance contract. For persons over age 40 and through age 50 in 2019, the limit for deducting long-term care premiums as a medical expense is $790 (See chapter 7.02). Paula's HSA can only reimburse her up to $790 tax-free for the long-term care premiums. But if Paula is reimbursed the entire $1,290 from the HSA, she will have to include $500 ($1,290 - $790) in gross income and pay a $100 penalty (20% x $500) because the additional $500 is not considered a qualified medical expense.*

The tax-free treatment of distributions from an HSA continues even if the account beneficiary is no longer an eligible individual (because of enrolling in Medicare or no longer having an HDHP), as long as the distributions are used exclusively to pay qualified medical expenses.

HSA trustees or custodians and employers who contribute to an employee's HSA are not required to determine whether HSA distributions are used for qualified medical expenses. Individuals who establish HSAs make that determination and should maintain records to substantiate that the distributions were used exclusively for qualified medical expenses.

There is ***no time limit*** on when a distribution from an HSA must be taken to pay or reimburse qualified medical expenses, but the HSA trustee may put reasonable restrictions on the frequency and minimum amount of distributions. To be excludable from the account beneficiary's gross income, he or she must keep records sufficient to later show that the distributions were exclusively to pay or reimburse qualified medical expenses, that the expenses weren't previously paid or reimbursed from another source, and that the medical expenses have not been taken as an itemized deduction in any prior tax year.

PROHIBITED TRANSACTIONS

If an HSA beneficiary engages in a prohibited transaction, the HSA ceases to be an HSA as of January 1 of the year that the forbidden activity occurs, and the fair market value of the account as of January 1 is deemed distributed but not treated as being used for payment of medical expenses. Thus, it is taxable, and subject to a 20% penalty. Examples of prohibited transactions include borrowing funds from the HSA or pledging the HSA as security for a loan; selling, exchanging or leasing property between the beneficiary and the HSA; furnishing goods or services between the beneficiary and the account; and transferring HSA assets to or for use by or benefit of the beneficiary. ***(IRS Notice 2008-59, Part V)***

RETURN AND INFORMATION REPORTING

IRS Form 8889, Health Savings Accounts (HSAs), must be filed with the individual's income tax return if during the tax year:

- A contribution was made to the HSA.
- A distribution was made from the HSA.
- Income is reportable because the individual became an ineligible individual due to failing the testing period.
- An HSA was inherited.

The following information returns are prepared by the employer or trustee of the HSA and provide some of the information necessary to complete Form 8889:

Form W-2: employer contributions to an HSA plus the amounts the employee has elected to contribute to the HSA through a Sec. 125 (cafeteria) plan must be reported on the employee's Form W-2, Box 12, Code W.

Form 1099-SA: distributions from an HSA are reported by the trustee.

Form 5498-SA: filed annually by the trustee, this form shows the amount of annual contributions to the HSA.

DEATH OF ACCOUNT BENEFICIARY

Any balance in the HSA at the account beneficiary's death becomes the property of the individual named in the HSA instrument as the beneficiary of the account. If that beneficiary is the **surviving spouse**, the HSA becomes the spouse's HSA, and the surviving spouse will be subject to income tax only to the extent distributions from the HSA are not used for qualified medical expenses.

Non-spouse beneficiary - If the beneficiary is other than the surviving spouse, the HSA ceases to be an HSA as of the date of the account beneficiary's death, and the heir is required to include in gross income the fair market value of the HSA assets as of the date of death. For that person (other than the decedent's estate), the includible amount is reduced by any payments from the HSA made for the decedent's qualified medical expenses, if paid within one year after death. Because the HSA is income in respect of a decedent, the non-spouse beneficiary is allowed an estate tax deduction with respect to the part of the estate tax attributable to the value of the HSA that he or she had to include in income.

UNRELATED BUSINESS INCOME: See chapter 4.05

CALIFORNIA DIFFERENCES

To date, California has not adopted health savings accounts. This means:

- Contributions to HSAs are not deductible or excludable from wages for California.
- If the HSA contributions were excluded from an employee's federal wages, the California wages will be higher by the amount of the HSA contribution. The "state wages" box of Form W-2 should reflect this higher amount. The difference between federal and California wages is an adjustment on Schedule CA.
- Earnings in an HSA are currently taxable to California. This amount will not appear on either Form 1099-SA or 5498-SA; generally the amount will be included on a year-end statement from the trustee. Or the taxpayer may have to request the information from the trustee or may be able to obtain it from his or her online HSA account.
- A California taxpayer will have a basis in the HSA equal to the amount contributed (and not deducted for California) plus the earnings previously taxed. Therefore, if a distribution is made from the HSA that is not used to pay for qualified medical expenses, it is taxable for federal purposes, but will not be taxable for California to the extent of California basis.
- An IRA, Archer MSA, HRA, or FSA distribution rolled into an HSA will be treated as a nonqualifying distribution, taxable and possibly subject to penalty, for California. However, the California basis of the HSA will be increased by the amount of the distribution from the other plans that is taxed.
- Medical expenses paid or reimbursed with HSA distributions that aren't deductible for federal purposes should be allowed as medical expenses for California itemized deductions (subject to the usual 7.5% of AGI reduction); adjustment is made on Schedule CA.

CALSAVERS RETIREMENT SAVINGS PROGRAM

Background – The state of California has been trying for a few years to set up a retirement savings program for employees who aren't covered by an employer's 401(k) or other retirement plan. The initial plan was called the California Secure Choice Retirement Program and was to be tied into the federal *my*IRA program. Due to lack of participation, *my*IRAs were discontinued. Then there was a court case, *Howard Jarvis Taxpayers Association v. The California Secure Choice Retirement Savings Program,* challenging whether the state's retirement savings program was legal under the federal ERISA law. The court ruled that it doesn't violate ERISA, but also allowed the plaintiff to file an amended complaint, so the case may not be over.

New program - California has created a new retirement savings program called CalSavers that is being implemented over a 3-year period. The law creating this program requires most California employers that don't offer an employer-sponsored retirement plan to participate. The program is administered by a private-sector financial services firm (Ascensus College Savings Recordkeeping Services, LLC) and overseen by the California Secure Choice Retirement Savings Investment Board (the Board) chaired by the State Treasurer.

Registration of employers opened July 1, 2019, and the state is encouraging eligible employers to join the program any time prior to their registration deadline. Employers can register on the CalSavers web site: https://www.calsavers.com. The staggered deadlines for registering with the state, based on employer size, are:

Number of Employees	Registration Deadline
More than 100	June 30, 2020
51 to 100	June 30, 2021
5 to 50	June 30, 2022

Employer's responsibility - Employers have a limited role in the program, mainly to sign up employees, disseminate information about CalSavers, and submit participating employees' contributions that come from payroll deductions. Employers cannot make contributions to the program and there are no fees for employers. Since CalSavers is not sponsored by the employer, the employer is not responsible for the program or liable as a program sponsor. Employers are not permitted to endorse the program or encourage or advise employees on whether to participate, how much (if any) to contribute or provide investment help.

Employees' accounts – Each participating employee's CalSavers account is an after-tax Roth IRA, and the employee is responsible for their investment choices, which initially include a money market fund, target retirement date funds, bond fund, global equity fund, and environmentally and socially conscious fund. If the employee hasn't made an investment selection, the first $1,000 contribution will go into the money market fund and thereafter contributions will be put into a Target Retirement Date Fund. Investments in CalSavers are not guaranteed or insured by the Board, the State of California, the Federal Deposit Insurance Corporation (FDIC), or any other organization. Depending on the investment selected by the employee, the annual asset-based fee ranges from 0.80% to 0.95%, according to the 48-page 2019 program disclosure booklet available online at: https://cdn.unite529.com/jcdn/files/CAER/pdfs/program_description.pdf

Eligible participants and contribution rates - To participate the employee must be at least 18 years old and have either an SSN or an ITIN. (A sole proprietor or partner in a partnership that is an eligible employer also qualifies to participate.) The default contribution rate for each employee is 5% of gross pay but employees can opt out of the program or change their contribution rate at any time. The minimum contribution rate is 1% and the maximum is 100% of available compensation up to the federal annual IRA contribution limits. An employee who doesn't opt out will be enrolled automatically after 30 days. The contribution percentage automatically increases by 1% each year starting January 1, 2020, up to a maximum contribution rate of 8%, but the employee can choose to opt out of automatic escalation.

Employees can join the program on their own if they do not have access to a retirement savings plan through their employer. Those who choose to self-enroll in CalSavers separate from an employer arrangement need to link their bank account to their CalSavers account through the CalSavers website.

Participating employees should be mindful of the AGI limitations for contributing to Roth IRAs and the annual IRA contribution limitations to avoid over-contributions that could result in tax and penalty liabilities.

NOTES

COVERDELL EDUCATION SAVINGS ACCOUNTS

A Coverdell Education Savings Account is a ***nondeductible*** education savings account. The investment earnings from these accounts accrue and are withdrawn tax-free, provided the proceeds are used to pay qualified higher education expenses of the account beneficiary.

- Contributions are **nondeductible.**
- Annual contribution is limited to **$2,000.**
- Contributions are subject to an **AGI Phase Out** (no annual Inflation adjustment).
    - Joint - 190,000 – 220,000
    - Others - 95,000 - 110,000
- Earnings are tax-free if used for qualified expenses.
- Expenses include **Kindergarten and above.**
- 6% excess contribution penalty
- 10% unqualified distribution penalty
- Can be rolled over or transferred to another qualified member of the taxpayer's family who is between the **ages 0 and 29**.
- Mandatory distributions prior to **age 30** except for special needs students.

RAPID FINDER

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Delayed Distributions	5.01.06
Distributions	5.01.04
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Excess Contributions	5.01.02
Kindergarten	5.01.01
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Mandatory Distributions	5.01.04
Military Academies	5.01.04
Military Death Gratuity	5.01.05
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Related IRC and IRS Publications and Forms

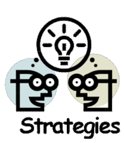
- **Pub 970** – Tax Benefits for Education
- **Form 1099-Q** – Payments from Qualified Education Programs
- **Form 5498-ESA** - Coverdell ESA Contribution Information
- **Form 5329 –** Add'l Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts
- **IRC Sec 530**

CONTRIBUTIONS

Contributions to a Coverdell Education Savings Account are limited per year and per beneficiary. The contributions can be made by anyone, including the beneficiary, providing the modified AGI of the contributor is less than the phase out limit. **Maximum contribution is $2,000**. *Contributions can be made to a qualified state tuition program and a Coverdell Education Savings Account in the same year.*

Coverdell or Section 529 Plan? Frequently, taxpayers will ask if it is better to contribute to a Coverdell Account or to a Section 529 Plan. Until the TCJA of 2017, Coverdell funds could be used for kindergarten and up, while Section 529 plans only applied to post-secondary education. This difference in the two arrangements was diminished for federal purposes as of 2018, when distributions from Section 529 plans of up to $10,000 per year per beneficiary became available to be used for grades K-12 also. ***Caution***: some states have not expanded the definition of eligible expenses for their Section 529 plans to include expenses incurred for schooling below college level.

The advantages of a Section 529 plan are control, larger contributions, and no AGI phase-out.



Strategy - It may be to a taxpayer's advantage to place the first $2,000 contributed toward a student's education fund in a Coverdell and then any additional amount can be set aside in a Section 529 plan.

GENERAL DIFFERENCES BETWEEN COVERDELL & SEC 529 PLANS		
	Coverdell	**Sec 529 Plan**
Maximum Annual Contribution	$2,000	$15,000/ Person(1)
AGI Phase Out Threshold Begins at	95K/190K	No Income Limitation
Use of Funds	Kindergarten thru Post-Secondary2)(3)	Kindergarten thru Post-Secondary(2)(3)

(1) The limit is based upon a combination of gift tax considerations and maximum plan contribution limits that vary from state to state. Generally, the maximum is around $250,000, although the limit may be much higher for some states, such as California where the cap is $529,000. Individuals can give five years' worth of gifts in one year under a special gift tax provision. The annual gift limit illustrated in the table is for 2019.
(2) K-12 expenses limited to $10,000 per beneficiary per year
(3)Some states only allow plan funds to be used for post-secondary expenses.

WHO CAN CONTRIBUTE

In addition to individuals, including the child, corporations and other entities (including tax-exempt organizations) are permitted to make contributions to Coverdell accounts.

MAGI PHASE OUT

The annual contribution per beneficiary is available in full only to an individual contributor with modified AGI below the phase out limits. These amounts are:

Filing Status	Modified AGI
Joint Filers	190,000 – 220,000
All Others	95,000 - 110,000

MAGI PHASE OUT DOES NOT APPLY TO CORPORATIONS OR OTHER ENTITIES

Corporations and other entities (including tax-exempt organizations) are permitted to make contributions to Coverdell Education Savings Accounts, regardless of the amount of the income of the corporation or entity during the year of the contribution. *(Com Rept. ¶ 5015)*

MODIFIED AGI

The contribution limit is phased out ratably for individual contributors with "modified AGI" between the initial and top modified AGI levels. "Modified AGI" is AGI increased by non-U.S. income excluded under the foreign provisions *(§ 911, 931, or 933)*. *The obvious solution to a contributor being limited by their AGI is for the contributor to gift the funds for the contribution to either the beneficiary or someone else whose modified AGI is low enough to allow the contribution on behalf of the beneficiary, or see paragraph immediately above.*

CONTRIBUTIONS

Contributions CANNOT be made that:

- Aren't made in cash;
- Are made after the accountholder reaches age 18 (special needs students discussed later), or
- Exceed the annual contribution limit (except for rollovers).

TIMING OF CONTRIBUTIONS

Contributions to a Coverdell account must be made by the due date (without extensions) of the contributor's tax return, i.e., April 15 most years for most individual taxpayers. *(Code Sec. 530(b)(4))*

EXCESS CONTRIBUTION PENALTY

A 6% excise tax applies to excess contributions to these accounts--i.e., any contribution over the annual limit. However, the excise tax won't apply:

- If excess contributions made during the year are distributed before the first day of the 6th month of the following tax year – generally June 1 for most individuals. (*Code Sec. 530(d)(4)(C))* The distribution must include any earnings attributable to the excess contribution.
- To rollover contributions. (*Code Sec. 4973(e)(2)(B))*

The 6% tax is imposed on the individual whose Coverdell ESA(s) received the excess contributions, i.e., the beneficiary. It is computed on Form 5329.

Excess contribution - An "excess contribution" to Coverdell ESAs maintained for any beneficiary for a year is the sum of:

(1) The amount by which the contributions to all Coverdell ESAs for the beneficiary in a year exceeds:

(a) $2,000, or

(b) if less, the maximum amount allowed under Code Sec. 530(c) (the contribution limit for each contributor). (*Code Sec. 4973(e)(1)(A*))

(2) The excess contribution for the preceding year, reduced by the sum of:

(a) Distributions from the Coverdell ESA during the current year (other than rollover distributions) (*Code Sec. 4973(e)(1)(B)(i))*, and

(b) The excess of: (i) the maximum amount which may be contributed to Coverdell ESAs for the current year, over (ii) the actual contribution for the current year. *(Code Sec. 4973(e)(1)(B)(ii))*

Example – Excess contribution *- Truman is five years old. Coverdell accounts were established for Truman by three of his relatives.*

	Contributed	*AGI Allowable*
Relative #1	*$1,000*	*-0-*
Relative #2	*$1,500*	*$500*
Relative #3	*$2,000*	*$1,000*
Total	*$4,500*	*$1,500*

Since AGI limited contributions are less than the $2,000 annual limit, the amount of the excess contributions to Truman's Coverdell account for the year is $3,000 ($4,500 – $1,500). Therefore, Truman is liable for a $180 penalty (6% × $3,000).

The 6% tax can be paid with funds withdrawn from one or more of the beneficiary's Coverdell accounts. However, if the withdrawal of contributions, plus earnings on these contributions, is not made by the due date (including extensions) of the beneficiary's return for the tax year in which the contributions were made, then the withdrawal would be subject to an additional 10% tax.

QUALIFIED EXPENSES

If a beneficiary's "qualified education expenses" in a year equal or exceed total Coverdell account distributions for the year, the distributions are 100% excluded from the beneficiary's gross income.

- **Definition –** In addition to POST SECONDARY education (same definition as for education credits), qualified expenses also include ELEMENTARY and SECONDARY school expenses. The term "school" for this definition includes any school which provides elementary or secondary education (Kindergarten through grade 12) as determined under state law *(IRC §530(b)(3)(B)).*

  Qualified elementary and secondary education expenses are defined *(Code Sec. 530(b)(3))* as—

  (a) Expenses for tuition, fees, academic tutoring, special needs services in the case of a "special needs beneficiary," books, supplies, and other equipment which are incurred in connection with the enrollment or attendance of the designated beneficiary of a Coverdell account's trust as an elementary or secondary school student at a public, private, or religious school. (*Code Sec. 530(b)(3)(A)(i))*

  (b) Expenses for room and board, uniforms, transportation, and supplementary items and services (including extended day programs) which are required or provided by a public, private, or religious school in connection with the enrollment or attendance of the designated beneficiary at the school. (*Code Sec. 530(b)(3)(A)(ii))*

  (c) Expenses for the purchase of any computer technology or equipment *(as defined in Code Sec. 170(e)(6)(F)(i)),* or for Internet access and related services if the technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years that the beneficiary is in school. (*Code Sec. 530(b)(3)(iii))* But this will not include expenses for computer software designed for sports, games or hobbies, unless the software is educational in nature. (*Code Sec. 530(b)(3)(A))* Qualified higher education expenses also include amounts paid to buy tuition credits or certificates, or to make contributions to an account, under a qualified state tuition program for the beneficiary of the account (*Code Sec. 530(b)(2)(B)).*

- **Room and Board Expenses** - Room and board expenses qualify as higher education expenses only if the beneficiary is enrolled at an eligible educational institution for at least a half-time basis. For this purpose, room and board expenses generally are the school's posted room and board charge, or $2,500 per year for students living off-campus and not at home. *(Conf Rept No. 105-220 (PL 105-34) p. 363)*

COORDINATION WITH ED CREDITS & QUALIFIED STATE TUITION PROGRAMS

A taxpayer can claim an American Opportunity credit or a Lifetime Learning credit for a tax year and exclude from gross income amounts distributed (both the principal and the earnings portion) from a Coverdell account for the same student, as long as the distribution is not used for the same educational expenses for which a credit was claimed. *(Com Rept, see ¶ 5015)*

If for any individual - The aggregate distributions during the year from a Coverdell account and from a qualified state tuition program, exceed the total amount of qualified education expenses (after application of the rules coordinating distributions from Coverdell accounts with the American Opportunity and Lifetime Learning credits, discussed above), then the taxpayer will have to allocate those expenses among those distributions for purposes of determining the amount of the exclusion from income under the rules on distributions from Coverdell accounts and the rules on distributions from qualified state tuition programs*. (Code Sec. 530(d)(2)(C)(ii))*

DISTRIBUTIONS

Distributions are generally taxed under rules similar to those for annuities. Distributions will be considered made up of principal (under all circumstances excludable from gross income) and earnings (which may or may not be excludable from income).

Distributions used entirely to pay qualified expenses: The entire distribution is tax-exempt.

Distributions used partially (or not at all) to pay qualified expenses: When all or part of the distribution is used for other than qualified expenses, then all or a portion of the earnings are taxable as computed under the annuity rules.

Example: *The Coverdell account for Billy Smith contains $10,508 of which $7,000 was from contributions to the account and $3,508 is attributable to earnings. Billy withdraws $6,000 from the Coverdell account and uses $5,000 for qualified educational expenses and $1,000 for a down payment on a car. Under the annuity rules, 66.62% ($7,000/$10,508) of the distribution is treated as principal ($6,000 x .6662 = $3,997) and is excludable from taxation in all circumstances. The balance, $2,003, is allocated to earnings and is taxable unless used for qualified educational expenses. For Billy, 16.67% ($1,000/$6,000) of the distribution was used for other than qualified purposes. Therefore, 16.67% of the earnings, $334 ($2,003 x .1667), is subject to tax and a 10% penalty (see more on the penalty below).*

	Dollars	***Percent***
Coverdell Account Value..	*10,508*	*100.00*
Basis (Contributions)..	*< 7,000>*	*66.62*
Earnings (Taxable if not used for qual expenses)......	*3,508*	*33.38*
Withdrawal for Qualified Educational Expenses...	*5,000*	*83.33*
Withdrawal for Purchase of Car...........................	*1,000*	*16.67*
Total Withdrawal...	*6,000*	*100.00*
Portion of Distribution attributable to earnings..............	*6,000 x .3338 = $ 2,003*	
Taxable Portion (Not used for qualified expenses).........	*2,003 x .1667 = $ 334*	
Probable Tax and Penalty (12% +10%)..	*$73*	

Distributions due to the death of the beneficiary: At the death of the designated beneficiary, the account balance must be distributed within 30 days after the beneficiary's death to his/her estate.

Mandatory distributions prior to age 30: The funds must be withdrawn or rolled over to another qualified Coverdell account (see rollovers) prior to the beneficiary attaining the age of 30. Distributions that are not rolled over are taxable and subject to penalties under the same annuity rules that apply for distributions used partially to pay qualified expenses. We assume that if the funds are not distributed, they will be subject to an annual 6% (excise tax) excess contributions penalty.

Special needs students**:** Age limitations don't apply to "special needs beneficiaries." The definition of a "special needs student" will be determined under regulations issued by the IRS. Congress wants IRS regulations to define a "special needs beneficiary" as including an individual who because of a physical, mental, or emotional condition (including learning disability) requires additional time to complete his or her education. *(Com Rept)*

Thus, contributions may continue to be made to a Coverdell account for a special needs beneficiary after the beneficiary reaches age 18. In addition, in the case of a special needs beneficiary, a deemed distribution of any balance in a Coverdell account will not occur when the beneficiary reaches age 30. *(Com Rept)*

Beneficiaries Attending Military Academies**:** Coverdell education savings accounts and qualified tuition programs are allowed, without an additional penalty on the earnings portion of the withdrawals, for beneficiaries attending specified military academies.

Paid to another Coverdell account: Distributions aren't taxable to the extent the amount is paid to another Coverdell account for the beneficiary, or member of the beneficiary's family *(defined in §2032A(e)(2))* within 60 days of the distribution. In addition, just one distribution from a Coverdell account can be rolled over to another Coverdell account in a 12-month period.

ROLLOVERS

Like IRA accounts, the Coverdell account funds can only be rolled over once a year. They can be transferred at will for the benefit of the same beneficiary. However, unlike IRAs, a Coverdell account can also be rolled or transferred to another qualified member of the taxpayer's family (as defined in *§ 152(a), same as relationship test for dependents*) who is between the ages 0 and 29.

Military Death Gratuity May be Rolled to Coverdell Accounts - Military death gratuity and amount received under the Service members' Group Life Insurance (SGLI) program may be rolled over to a Roth IRA or Coverdell education savings account without regard to the Roth or Coverdell contribution limits that otherwise apply. (Code Sec. 408A(e) and Code Sec. 530(d)(9)).

The rollover must be made no later than one year after the date on which the military death gratuity or SGLI payment is received. The maximum amount that can be contributed to a Roth IRA or Coverdell Savings Account is limited to the sum of the military death gratuity and SGLI payments that the individual receives.

CHANGE OF BENEFICIARY (OWNERSHIP)

The beneficiary (owner) can be changed on the Coverdell account as long as the new beneficiary is a qualified member of the taxpayer's family (as defined in *§152(a))* who is between the ages 0 and 29.

OTHER REQUIREMENTS

- The account can't be invested in life insurance contracts,
- The account's assets can't be commingled except in common trust or investment funds, and
- The trustee must be a bank or other person who will administer the trust as required (to the IRS' satisfaction).

WITHDRAWAL PENALTY

A 10% withdrawal penalty, computed on Form 5329, applies to the TAXABLE PORTION of all distributions, unless the distribution is:

- Made after the death of the designated beneficiary,
- Attributable to the beneficiary's disability, or
- Made on account of a scholarship or other payment described in *§25A(g)(2)* [education credits] to the extent the amount of the distribution isn't more than the amount of *§25A(g)(2)* payment.
- Excess contributions (over the dollar limit for the year) and the excess is returned, along with income attributable to it on or before June 1 of the tax year following the calendar tax year in which the contribution was made and the net income is included in the account beneficiary's income in the year of the contribution.

Example - Excess Contributions to Coverdell Accounts and Corrections - *Bill and Jana, a married couple with a modified AGI of $225,000, contributed $2,000 to their 16-year-old daughter's Coverdell account in 2019. In 2020 (before the 2019 return due date), the couple realized that their modified AGI was too high for them to qualify for a 2019 contribution. As a result, the $2,050 in the Coverdell account ($2,000 contribution plus $50 of earnings) was distributed to their daughter. The daughter's 2019 gross income will include the $50 of earnings on the account. The daughter will also be subject to the 10% distribution penalty on the $50 of earnings.*

Daughter's Distribution......	*$ 2,050*	*Tax (Presumed to be 10%).......*	*$ 5*
Basis.............................	*<2,000>*	*10% Penalty...........................*	*$ 5*
Taxable Portion................	*$ 50*		

TRANSFERS BETWEEN SPOUSES

Transfer of a Coverdell account to a spouse or former spouse under a divorce decree isn't a taxable transfer. The transfer of a Coverdell account to a surviving spouse at the death of the beneficiary isn't a taxable transfer either. However, if the Coverdell account is transferred at the beneficiary's death to anyone other than the surviving spouse, the account stops being a Coverdell account as of the death of the Coverdell account beneficiary. In that case, the value of the account is taxable to the recipient.

LOSS OF COVERDELL ACCOUNT STATUS

A Coverdell account loses its status as a Coverdell account if the accountholder or his beneficiary engages in a prohibited transaction with the account. And an individual's use of a Coverdell account as security for a loan is treated as distribution of the amount used as security.

REPORTING REQUIREMENTS

A trustee of a Coverdell account must report to the IRS and the beneficiary on contributions, distributions, etc. Contributions and rollovers are included on Form 5498-ESA, Coverdell ESA Contribution Information. The trustee reports distributions and the amounts that represent earnings and basis on Form 1099-Q, Payments from Qualified Education Programs. A $50, $100 or $270 penalty, depending on when the delinquent form is filed, applies for each failure to report without reasonable cause. The $270 amount applies for 1099s required to be filed in 2019 (i.e., for 2018 forms) or 2020 (most likely 2019 forms).

DELAYED DISTRIBUTIONS

Even though contributions to the Coverdell account are not permitted past the age of 18, the funds can remain in the Coverdell account and continue to accrue investment earnings up to the mandatory distribution age (prior to age 30). The longer the income accrues tax-free in the account the greater the benefit derived by the recipient. To maximize the tax-free income, one would want to delay the distribution as long as possible and still be able to utilize all of the funds for qualified purposes. Interplay with the American Opportunity credit must also be considered because this credit applies only to the first four years of post-secondary education and since the same expenses cannot be utilized for both.

GROWTH FACTOR - ACCUMULATION PAST AGE 18

(ANNUALLY)		INVESTMENT RATE OF RETURN					
YRS	AGE	2%	4%	6%	8%	10%	12%
1	19	1.020	1.040	1.060	1.080	1.100	1.120
2	20	1.040	1.082	1.124	1.166	1.210	1.254
3	21	1.061	1.125	1.191	1.260	1.331	1.405
4	22	1.082	1.170	1.262	1.360	1.464	1.574
5	23	1.104	1.217	1.338	1.469	1.611	1.762
6	24	1.126	1.265	1.419	1.587	1.772	1.974
7	25	1.149	1.316	1.504	1.714	1.949	2.211
8	26	1.172	1.369	1.594	1.851	2.144	2.476
9	27	1.195	1.423	1.689	1.999	2.358	2.773
10	28	1.219	1.480	1.791	2.159	2.594	3.106
11	29	1.243	1.539	1.898	2.332	2.853	3.479

The table above assumes the Coverdell account is not immediately utilized and allowed to continue to accumulate during the period in which no contributions are allowed and up to the age at which mandatory distribution or qualified rollover is required.

UNRELATED BUSINESS INCOME: See chapter 4.05

CALIFORNIA DIFFERENCES

California conforms to Federal with respect to the Coverdell accounts, but California has no state education credits. Taxable distributions are subject to a 2-1/2% penalty, computed on FTB Form 3805-P.

EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

Overview

- **Type of plans**:
  - Non-accountable – included in W-2 as income
  - Accountable - excluded
- **Maximum excluded amount per year**: $5,250
- **No double benefit**
- **Education**:
  - Need not be job-related
  - Games, hobbies, sports generally not allowed
- **Expenses**: Do not include meals, lodging or transportation

Pubs Forms

Related IRC and IRS Publications and Forms
- **Pub 970 –** Tax Benefits for Education
- **IRC Sec 127**

RAPID FINDER

Accountable Plans	5.02.01
Discrimination	5.02.01
Education Credits	5.02.01
Employer Provided	5.02.01
Excludable Benefit	5.02.01
Games	5.02.01
Highly Compensated	5.02.01
Hobbies	5.02.01
Laid Off Employees	5.02.01
Lodging	5.02.01
Meals	5.02.01
Non-accountable Plans	5.02.01
Qualifying Expenses	5.02.01
Reimbursed Expenses	5.02.01
Retirees	5.02.01
Sports	5.02.01
Supplies	5.02.01
Tools	5.02.01
Travel	5.02.01
Working Condition Fringe	5.02.01

EXCLUDABLE EMPLOYER BENEFIT

The Details

An employee includes the value of educational benefits provided by an employer in income unless the benefit qualifies as an excludable employer benefit. To qualify as an excludable employer benefit, the benefit must be:
- A working condition fringe,
- Paid for by the employer under an accountable plan, or
- Provided under an educational assistance program of the employer.

***Working condition fringe benefits*:** Any employer-provided expense that an employer pays for an employee is excludable from the employee's income as a working condition fringe benefit if, had the employee paid for the benefit, the amount paid could have qualified as a deductible employee business expense (even if no deduction could be claimed because of the TCJA suspension of Tier 2 miscellaneous itemized deductions).

***Reimbursed education expenses*:** If an employer pays for an employee's education expenses, the payment is considered a payment under a reimbursement arrangement.

- If the payment is made under a "nonaccountable plan," the reimbursed amount is included in the employee's income.
- However, a payment under an employer's accountable plan is excludable from the employee's income. An accountable plan is one where the employee documents the expense to the employer. In addition, the expense reimbursed must be deductible by the employee if he/she had paid for it were it not for the TCJA suspension of Tier 2 deductions. Any excess reimbursement over the expense amount must be returned to the employer.

***Employer-provided educational assistance programs*:** An employee doesn't have to include in income amounts paid by the employer for educational assistance under a qualified educational assistance program. The maximum amount of educational assistance that can be excluded is $5,250 for any calendar year.

NOTE: Even if an educational benefit is not excludable under an assistance program, it may be excludable as a working condition fringe benefit. No American Opportunity or Lifetime Learning credit, or any other education-related tax benefits, may be claimed for amounts excludable under an educational assistance program.

***What expenses qualify for the educational assistance exclusion*?** Excludable assistance under a qualified plan includes: (1) The employer's payment of education expenses of an employee, including, among others, tuition, fees, books, supplies, and equipment; and (2) Employer-provided courses for the employee, including books, supplies, and equipment.

Educational assistance doesn't include tools or supplies (other than textbooks) that the employee may keep after the course of instruction ends. Nor does it include meals, lodging or transportation.

***Meaning of education*:** For the purpose of educational assistance, education is any training that improves an individual's capabilities, whether or not job-related or part of a degree program. Education may be furnished directly by the employer or through a third party (e.g., an educational institution). Education involving sports, games, or hobbies doesn't qualify for the exclusion, unless it is related to the business of the employer or is required for a degree program.

***Other Requirements*:**

Be sure to remember the following points:

(1) Retirees or laid-off employees are eligible for the exclusion,

(2) Self-employed individuals and partners who have qualified plans in place also qualify, and

(3) Educational assistance plans may not discriminate in favor of highly-compensated workers.

CALIFORNIA DIFFERENCES

California conforms to Federal law.

NOTES

EDUCATION CREDITS

Overview

American Opportunity Tax Credit (AOTC)

- Maximum annual credit per eligible student: **$2,500**
- Credit Based on: **100% of the 1st $2,000 & 25% of the next $2,000** of qualifying expenses.
- **40% refundable**
- **Phase-out Range** (no annual inflation adjustment)**:**

  Unmarried Filing Status: $ 80,000 – $ 90,000
  Joint Filing Status: $160,000 - $180,000
  Married Separate: No Credit Allowed

Lifetime Learning Credit

- Maximum annual credit per family: **$2,000**
- Credit based on: **20% of the first $10,000 of Qualified Expenses**
- **Phase-out Range (2019)** (inflation adjusted)**:**

  Unmarried Filing Status: $58,000 – $68,000
  Joint Filing Status: $116,000 – $136,000
  Married Separate: No Credit Allowed

RAPID FINDER

Pubs Forms

Related IRC and IRS Publications and Forms

- **Publication 970** – Tax Benefits for Education
- **Form 8863** – Education Credits
- **Form 1098-T** – Tuition Statement
- **IRC Sec 25A**

Credit	AOTC	Lifetime
Number of post-secondary education years applicable	First 4	Any
Limited to students enrolled on at least a ***half-time basis***	Yes	No
Is allowed for a student ***taking only one course***	No	Yes
Is allowed for ***graduate level & professional degree courses***	No*	Yes
Is allowed for a course of instruction at an eligible educational institution to ***acquire or improve job skills***	No	Yes
Available to a student that has been convicted of a Federal or state ***felony drug offense***	No	Yes
Modified AGI Phase out	Yes	Yes
Refundable	Partially	No
AMT Deductible	Yes	Yes

*A student who was an undergraduate during the first part of the taxable year and (1) became a graduate student that same year, (2) has not completed the first 4 years of post-secondary education as of the beginning of the tax year, and (3) has not claimed the AOTC for more than 4 years, will qualify to claim the AOTC for qualified expenses during the entire tax year. (IRS AOTC FAQs #13)

AMERICAN OPPORTUNITY TAX CREDIT (AOTC)

The Details

Eligible Student - Generally, an eligible student for the AOTC can be the taxpayer and spouse and their dependents that are enrolled at an eligible educational institution for at least one academic period (semester, trimester, quarter) during the year.

The dependent is any person for whom the taxpayer claims a dependency exemption. It generally includes the taxpayer's qualified child who is under age 19 or who is a full-time student under age 24. The student must also meet ***all*** of the following requirements.

1) Had ***not completed the first 4 years*** of postsecondary education before the tax year of the credit.

2) For at least ***one academic period*** beginning in the tax year of the credit, was ***enrolled at least half-time*** in a program leading to a degree, certificate, or other recognized educational credential.
3) An eligible student is one that has no felony drug conviction. Having no felony drug conviction means the student has not been convicted of a Federal or state felony offense for possession or distribution of a controlled substance as of the end of the taxable year for which the credit is claimed.

Allowance Period - The AOTC is allowed with respect to qualified tuition and related (QT&R) expenses paid for **the first four years of the student's post-secondary education** in a degree or certificate program, if the student has not completed the first four years of post-secondary education before the beginning of the fourth tax year. And, for each eligible student, the AOTC may be claimed for four tax years (Code Sec 25A(i)(2)). **Note:** There is nothing in the law that limits the credit to just expenses incurred to obtain a bachelor's degree.

Credit Amount – Allowed on a per-eligible-student basis, the AOTC equals the sum of:
(a) 100% of the first $2,000 of each eligible student's QT&R expenses **plus**
(b) 25% of the next $2,000, of that student's QT&R expenses.

Proposed Regulations (effective for 2016)
Course materials for the AOTC include books, supplies and equipment required for enrollment or meaningful attendance in a course of study, whether or not the course materials are purchased from the institution.

Filing Status	Phase-Out Range
Unmarried Filing Status	$ 80,000 – $ 90,000
Joint Filing Status	$160,000 - $180,000
Married Separate	No Credit Allowed

Credit Phase-Out Provisions - For higher-income taxpayers, this credit begins to phase out for modified AGI (MAGI) in excess of $80,000 ($160,000 for married couples filing jointly). The phaseout amounts are not inflation indexed. MAGI is the taxpayer's regular AGI increased by: Foreign earned income and housing exclusion and housing deduction (§911), amounts excluded by taxpayer from sources in American Samoa (§931), and amounts excluded by taxpayer from sources in Puerto Rico (§933).

Portion of the Credit is Refundable - 40% of the AOTC (after application of the phase-out limitation) is refundable (Code Sec 25A(i)(5)). The <u>refundable provision</u> does not apply to:

- A taxpayer who is a child subject to the kiddie tax rules. (Generally any child under age 18 or any child under age 24 who is a student whose earned income is less than one-half of the child's support, who has at least one living parent, and does not file a joint return may be subject to the "kiddie tax," depending on the amount of the child's investment income). (Com Report; Chief Counsel Advice 201509030)
- Residents of a U.S. possession. However, the refundable portion may be claimed as credit in the possession in which they reside.

Any portion of the credit that isn't used to offset the taxpayer's regular tax or that isn't refundable is lost – it cannot be carried over or carried back to another year.

Example – Refundable Portion of AOTC*: Albert, who is not subject to the kiddie tax rules, is eligible for a $2,500 AOTC and his MAGI is below the phaseout threshold. The maximum refundable portion of Albert's AOTC is $1,000 ($2,500 x .4). His tax liability is $1,900. After first using the credit to offset his tax liability, he has $600 of credit remaining ($2,500 – 1,900). He is entitled to a refundable credit of $600, the lesser of the maximum portion of the credit that could be refunded ($1,000) or the balance of the credit left after reducing his regular tax to zero.*

If Albert's tax had been $1,300, he would have $1,200 of credit left after offsetting his tax ($2,500 – 1,300). But he could only claim a refund of $1,000 of the remaining credit.

Example – Refundable Portion of AOTC*: Bob and Carlene are married and file a joint return. They are eligible for a $2,500 AOTC, and their modified AGI is $170,000, which exceeds the phaseout threshold, so they must reduce their AOTC by 50% ((170,000 - $160,000)/$20,000) to $1,250. Therefore, the maximum refundable portion of their AOTC would be $500 ($1,250 x .4).*

AMT – The AOTC is allowed against the AMT (IRC Sec 25A(i)(5)).

Integrity Provisions - The PATH Act of 2015 added integrity provisions with regards to claiming the credit. These provisions prohibit:

- An individual from retroactively claiming the AOTC by amending a return for any prior year in which the individual, or a student for whom the credit is claimed, did not have a taxpayer identification number (Act Sec 206).
- The credit from being claimed for any year beginning after 2015 unless the taxpayer includes the employer identification number of any institution to which qualified tuition and related expenses were paid with respect to the individual (student) (Act Sec 211).

Preparer Due Diligence - The PATH Act of 2015 added preparer due diligence requirements similar to those imposed for the EITC. It includes a $530 (2019) ($520 (2018); $510 (2016 and 2017)), indexed for inflation, preparer penalty for not meeting the due diligence requirements. These requirements are effective for 2016 returns filed in 2017 (Act Sec 207). Starting with tax year 2016, Form 8867, Paid Preparer's Due Diligence Checklist, covers the due diligence requirements for the AOTC, EITC and child tax credits, with Head of Household filing status due diligence requirements added beginning for tax year 2018. The completed Form 8867 or successor form must be included with any return on which any of these tax benefits is claimed. The data entered on the Form 8867 must be based on information provided by the taxpayer or otherwise reasonably obtained by the preparer. The preparer must retain for the period described in the Form 8867 instructions copies of any documents provided by the taxpayer and on which the preparer relied in completing Form 8867 and, for the AOTC, the worksheet from Form 8863 instructions (or a comparable worksheet).

Taxpayer Disallowance Periods - The PATH Act of 2015 added disallowance periods for taxpayers who improperly claim the credit. Beginning for 2016 returns, where a taxpayer improperly claims the credit, a disallowance period applies where no credit is allowed. Where the improper claim is due to (Act Sec 208):

- Fraud - the disallowance period is 10 years.
- Reckless or intentional disregard of rules and regulations (not fraud) - the disallowance period is 2 years.

LIFETIME LEARNING CREDIT (LLC)

Eligible student - An eligible student can be the taxpayer and spouse and their dependents that are enrolled at an eligible educational institution for at least one academic period (semester, trimester, quarter) during the year. However, unlike the AOTC there is no "half-time student" requirement and single courses can qualify. The dependent is any person for whom the taxpayer claims a dependency exemption. It generally includes the taxpayer's qualified child who is under age 19 or who is a full-time student under age 24.

Credit Amount – The Lifetime Learning Credit is equal to 20% of up to $10,000 of qualified tuition and related expenses paid during the tax year. The maximum credit is $2,000 and it is not refundable.

Family Credit limit – Unlike the AOTC, which is allowed per student, the LLC is calculated on a per-family (i.e., per taxpayer return) basis with a maximum annual credit of $2,000.

Allowance Period – The Lifetime Learning credit is not limited to expenses incurred in the first four years – as is the case for the AOTC– of post-secondary education and may be claimed for an unlimited number of tax years.

Qualified Education – Unlike the AOTC where only the first four years of post-secondary education qualifies, the LLC can be used for graduate-level and professional degree courses and is allowed for a course of instruction at an eligible educational institution to acquire or improve job skills.

Modified AGI Phase Out - For purpose of the LLC, modified AGI is the taxpayer's regular AGI increased by: Foreign earned income and housing exclusion and housing deduction (§911), amounts excluded by taxpayer from sources in American Samoa (§931), and amounts excluded by taxpayer from sources in Puerto Rico (§933). The phase out thresholds are indexed for inflation.

LIFETIME LEARNING CREDIT MAGI PHASEOUT RANGES

Filing Status	2015	2016	2017	2018	2019	2020
Unmarried Filing Status	55K-65K	55K-65K	56K-66K	57K-67K	58K-68K	
Joint Filing Status	110K-130K	111K-131K	112K-132K	114K-134K	116K-136K	
Married Separate	No Credit	No Credit	No Credit	No Credit	No Credit	

OTHER ISSUES THAT APPLY TO BOTH CREDITS (unless otherwise noted)

Who Pays and Who Gets the Tuition Credit - The regulations provide that solely for education credit purposes, if a third party (someone other than the taxpayer or a claimed dependent) makes a payment directly to an eligible educational institution for a student's qualified tuition and related expenses, the student is treated as receiving the payment from the third party, and, in turn, paying the qualified tuition and related expenses. Furthermore, qualified tuition and related expenses paid by a student are treated as paid by the taxpayer if the student is a claimed dependent of the taxpayer. *(Reg §1.25A-5(a), Reg §1.25A-5(b))*

> ***Example:*** *If one divorced parent pays qualified tuition to a college for a child, but the other parent has custody of the child (and is eligible to claim the child as a dependent), the custodial parent is treated as having paid the tuition directly to the college. (Reg § 1.25A-5(b)(Ex.3))*

> ***Example:*** *If a grandparent pays the qualified tuition directly to the institution, the parents, assuming they claim the student as a dependent, would be the ones qualified to claim the education credit.*

The regulations also provide that if a taxpayer is eligible to but does not claim a student as a dependent, only the student can claim the education credit for the student's qualified tuition and related expenses. *(Reg § 1.25A-1(f))*

***Example:** Connie has one dependent, her son Frank. Frank pays qualified tuition and related expenses to attend State University during the year. Although Connie is eligible to claim Frank as a dependent on her federal return, she does not do so. Frank is allowed to claim an education tax credit on his return, assuming he meets all other requirements for the credit. Connie cannot claim the credit for Frank's education expenses.*

The result is the same even if Connie had paid Frank's tuition and related expenses – if she doesn't claim Frank as a dependent, the credit can only be claimed by Frank.

Of course, the AGI phase-out is another factor that plays into education credit planning.

Eligible educational institution - Eligible institutions generally include any accredited public, nonprofit, or proprietary post-secondary institution eligible to participate in the student aid programs administered by the Department of Education.

Eligible Expenses – The following are defined as eligible expenses (Reg. § 1.25A- 2(d)):

- Tuition
- Fees required for the enrollment or attendance
- Student activity fees paid to the educational institution
- Course materials *(Reg. § 1.25A- 2(d))*
- Comprehensive university fees and bundled fees (required general fees) - ***must be allocated between qualified expenses and personal expenses.***

Proposed Regulations *(effective for 2016)*

The proposed rules clarify that for the **AOTC** the definition of qualified tuition and related expenses includes books, supplies and equipment required for enrollment or attendance at an eligible institution. For this purpose "required for enrollment or attendance" means that the course materials are needed for "meaningful attendance or enrollment" in a course of study, *whether or not the materials are purchased from the institution or an outside vendor*.

For the **Lifetime Learning Credit**, the amount paid for books, supplies and equipment is an eligible expense only if these items cannot be purchased from a vendor. That is, they will qualify if they must be *purchased from the educational institution as a condition of attendance*.

Do computers qualify? Computers are not specifically spelled out in the regulations as they are for Sec 529 expenses. According to the AOTC FAQs on the IRS web site (as of 2/8/19), and in answer to the question "Does a computer qualify for the AOTC?" the IRS says "It depends. The amount paid for the computer can qualify for the credit if you need the computer for attendance at the educational institution."

Expenses that DO NOT qualify - *WHETHER OR NOT paid directly to the educational institution:*

- Room(1)
- Board(1)
- Insurance
- Other similar Personal, Living, or Family Expenses
- Medical Expenses
- Transportation

(1) Even though these expenses do not qualify as expenses for the educational credits, these expenses could be qualified expenses paid from Coverdell accounts or Sec 529 plans.

***Example – Fees Paid Directly to Educational Institution** - University V offers a degree program in Dentistry. In addition to tuition, all students enrolled in the program are required to pay a fee to University V for the rental of dental equipment. Because the equipment rental fee must be paid to University V for enrollment and attendance, the tuition and the equipment rental fee are qualified tuition and related expenses (applies for both the AOTC and LLC).*

***Example – University Required Expenses** - First-year students at College W are required to obtain books and other reading materials used in its mandatory first-year curriculum. The books and other reading materials are not required to be purchased from College W and may be borrowed from other students or purchased from off-campus bookstores, as well as from College W's bookstore. College W bills students for any books and materials purchased from College W's bookstore. Under the proposed regulations:*

- ✓ *If the taxpayer claims the LLC - the expenses paid to College W for the first-year books and materials purchased at its bookstore are not qualified tuition and related expenses, because the books and materials are not required to be purchased from College W for enrollment or attendance at the institution.*
- ✓ *If the taxpayer claims the AOTC – the expenses paid to College W for the books and materials are qualified tuition and related expenses, provided they are needed for meaningful attendance in the student's course of study. (Prop Reg 1.25A-2(d)(7), Ex. 3)*

Treatment of a Comprehensive or Bundled Fee - If a student is required to pay a fee (such as a comprehensive or a bundled fee) to an eligible educational institution that combines charges for qualified tuition and related expenses with charges for personal expenses, the portion of the fee that is allocable to personal expenses is not included in qualified tuition and related expenses. The determination of what portion of the fee relates to qualified tuition and related expenses and what portion relates to personal expenses must be made by the institution using a reasonable method of allocation. *(Reg. § 1.25A-2(d)(4))*

> ***Example – Bundled Fees*** *- College Y requires all students to live on campus. It charges a single comprehensive fee to cover tuition, required fees, and room and board. Based on College Y's reasonable allocation, sixty percent of the comprehensive fee is allocable to tuition and other required fees not allocable to personal expenses, and the remaining forty percent of the comprehensive fee is allocable to charges for room and board and other personal expenses. Therefore, only sixty percent of College Y's comprehensive fee is a qualified tuition and related expense.*

Prepayment Rule - If qualified tuition and related **expenses** are paid by the taxpayer during one tax year for an **academic period** that begins during the **first three months** after that tax year, that **academic** period is treated as beginning during the tax year in which the payment is made. In other words, if qualified tuition and related **expenses** are paid during one tax year for an **academic period** that begins during the first three months of the taxpayer's next tax year (i.e., in January, February, or March of the next tax year for calendar year taxpayers), an education credit is allowed with respect to the qualified tuition and related expenses only in the tax year in which the expenses are paid. (Reg § 1.25A-5(e)(2)(i); Terrell, TC Memo. 2016-85, Dec. 60,599(M))

CAUTION: The opposite is not true. Tuition payments made in one year for the next year cannot be credited to the next year because of the cash basis taxpayer rules (McCarville, TC Summary Opinion 2016-14). This is a mistake your clients can easily make.

> ***Example – Prepayment Rule*** *– Alan, who is a calendar year taxpayer and not a dependent of another taxpayer, enrolls full-time at College Z, with the Spring 2018 his first semester of attendance. He continues at College Z through the Spring 2019 semester. The following recaps his tuition payments during that period:*

Amount Billed	*Date Bill Rec'd*	*Applies to Semester*	*Amount Paid*	*Date Paid*
$5,000	*Dec 2017*	*Spring 2018*	*$1,000*	*12/15/17*
			$4,000	*2/15/18*
$7,000	*Aug 2018*	*Fall 2018*	*$7,000*	*9/1/18*
$7,000	*Dec 2018*	*Spring 2019*	*$1,000*	*12/15/18*
			$6,000	*2/15/19*

> *He may claim an education tax credit on his 2017 return with respect to the $1,000 he paid to College Z on Dec. 15, 2017 for the 2018 spring semester. Alan may claim an education credit on his 2018 return with respect to the $12,000 he paid to College Z during 2018 ($4,000 + $7,000 + $1,000). On his 2019 return, he may claim an education credit with respect to the $6,000 he paid to College Z on Feb. 15, 2019. (Prop Reg 1.25A-5(e)(2)(ii))*

Hobby Courses - Qualified tuition and related expenses do not include expenses that relate to any course of instruction or other education that involves sports, games, hobbies, or any noncredit course, unless the course or other education is part of the student's degree program, or in the case of the Lifetime Learning Credit, the student takes the course to acquire or improve job skills. (Reg. § 1.25A- 2(d)(5))

> ***Example – Hobby Courses*** *- As a degree student at College Z, Student A is required to take a certain number of courses outside of her chosen major in Economics. To fulfill this requirement, Student A enrolls in a square dancing class offered by the Physical Education Department. Because Student A receives credit toward her degree program for the square dancing class, the tuition for the square dancing class is included in qualified tuition and related expenses.*

Half-Time Student Requirement - For purposes of the AOTC for at least ***one academic period during the year****,* the student must be enrolled for at least half of the normal full-time workload for his course of study. (Code Sec. 25A(b)(3)(B)) Form 1098-T has a check box for the institution to indicate if the student was a half-time student.

> ***Example – Less than Half-time Student for Part of a Year*** *- Emily graduates from high school in June 2018 and is enrolled in an undergraduate degree program at College for the 2018 fall semester on a full-time basis. For the 2019 spring semester, Emily again is enrolled at College on a full-time basis. For the 2019 fall semester, Emily is enrolled in less than half the normal full-time course work for her degree program.*

2018		***2019***	
Spring	*Fall*	*Spring*	*Fall*
Not Enrolled	***Full Time***	***Full Time***	*Less Than ½ Time*

Because Emily is enrolled in an undergraduate degree program on at least a half-time basis for at least one academic period that begins during 2018 and at least one academic period that begins during 2019, Emily is an eligible student for taxable years 2018 and 2019 (including the 2019 Fall semester when Emily enrolls at College on less than a half-time basis).

Proposed Regulations (effective for 2016)

Language is added to Reg 1.6050S-1(b)(2) to require the educational institution to include on Form 1098-T the number of months during the calendar that the student was enrolled for the normal full-time workload for the student's course of study at the institution. For this purpose, one day in a month is treated as an entire month. However, neither the 2018 nor 2019 Form 1098-T includes a box where this information would be reported – just the check-off box to indicate whether the student was at least a half-time student.

Credit Reduction for Scholarships - For education credit purposes, qualified tuition must be reduced by tax-free scholarship amounts (including fellowships) excluded from income under Code Sec. 117 except to the extent, by the terms of the scholarship, it may (or must) be applied to room and board AND THAT PORTION IS REPORTED AS TAXABLE INCOME if a tax return is required to be filed. (Reg. § 1.25A-5(c)(3))

***Example – Tax-free Scholarship** – Marty is a junior at College. His tuition for the year was $9,500 and his room and board expenses were $7,500. Marty received a tax-free scholarship payment during the year of $8,000. Marty's mother and father are separated and Marty is claimed by his mother as her dependent. Marty's father paid the $9,500 tuition. Since the scholarship was tax-free, the scholarship income must first offset Marty's tuition expense ($9,500 - $8,000), leaving $1,500 of the tuition payment that can be used towards the tuition credit. Therefore, if Marty's mother otherwise qualified, she would be entitled to an* AOTC *of $1,500 (100% of up to the first $2,000 of expenses) if he is enrolled on at least a half-time basis or a Lifetime Learning credit of $300 ($1,500 x 20%) if he is enrolled less than half time.*

Scholarships can be either tax-free or taxable. Often the question arises what happens if the scholarship amount in Box 5 (Scholarships or Grants) of the 1098-T is larger than the expenses in Box 1 (Payments *Received* for Qualified Tuition and Related Expenses)? Is the difference a taxable scholarship? It depends. The 1098-T instructions tell the form's preparer (the educational institution) to enter in Box 1 "the total amount of payments received for qualified tuition and related expenses from all sources during the calendar year" related to the student and that "the amount reported [in Box 1] is not reduced by scholarships and grants reported in box 5." The Form 8863 (Education Credits) instructions caution that the amount in Box 1 of the 1098-T may be different from the amount of education expenses that was paid (or treated as having been paid), and that when completing Form 8863, to use only the amounts actually paid (plus any amounts treated as having been paid), reduced as necessary by tax-free assistance including tax-free scholarships or fellowship grants.

A scholarship is tax free only if the student is a candidate for a degree at an eligible educational institution, and only to the extent it is used to pay for (a) tuition and fees required to enroll at or attend the institution and (b) course-related expenses such as books, supplies, fees and equipment required for the courses by the school for all students in the particular course of instruction. Expenses paid from a scholarship for room and board, travel, research, insurance and equipment or other expenses not required by the institution to enroll or attend don't qualify. So to the extent the scholarship is used for non-eligible expenses, it is taxable. Worksheet 1-1 in IRS Pub 970 can be used to determine how much of a scholarship is taxable.

Payments for Services - Scholarship or fellowship grants are taxable to the recipient if they are paid for teaching, research, or other services as a condition for receiving the grant, unless the payments are received under:

- The National Health Service Corps Scholarship Program,
- The Armed Forces Health Professions Scholarship and Financial Assistance Program, or
- A comprehensive student work-learning-service program (as defined in section 448(e) of the Higher Education Act of 1965) operated by a work college (as defined in that section).

When part of the scholarship is taxable because it was payment for services, i.e., wages, the scholarship provider should issue a Form W-2 for the taxable amount. It is possible that this amount may also be included in the Box 5 amount on Form 1098-T. Therefore, an analysis of the make-up of the Box 5 amount must be performed to ensure that there isn't duplicate reporting of income.

Third-Party Installment Plan **-** Where an outside company agrees to collect tuition payments over a period of time (usually 10 months) and remits the payments to the educational institution on a predetermined schedule, the date of the payment for purposes of computing the education credit is determined as follows:

- **Where the outside agent is an agent of the taxpayer**, the taxpayer is treated as having paid qualified expenses on the date the company pays the higher-education institution.
- **Where the outside company is an agent of the higher-education institution,** the taxpayer is treated as paying the qualified expenses on the date the taxpayer pays the outside company. (Reg. § 1.25A-5(e)(4))

Form 1098-T Mandatory - Beginning for the 2016 tax year, a taxpayer will not be allowed to claim the AOTC, the Lifetime Learning credit or, for years before 2018 or later years if extended by Congress, the higher education tuition deduction, unless the taxpayer has received a Form 1098-T from the educational institution (Trade Act Sec 804(a)(1)). Thus, taxpayers won't be able to file their returns on which they claim education tax benefits until they have received the Form 1098-T.

1098-T Received by a Dependent – 1098-Ts received by a dependent of the taxpayer are treated as received by the taxpayer (Trade Act Sec 804(a)(2)).

Proposed Regulations (effective for 2016)

An exception to the above requirement applies if the taxpayer (or taxpayer's dependent) has not received a Form 1098-T by the later of January 31 of the year following the year to which the education credit relates or the date the income tax return is filed. This exception applies only if the taxpayer (or taxpayer's dependent) (1) has requested the educational institution to provide a 1098-T after January 31 but before the return is filed, and (2) has cooperated fully with the educational institution's efforts to obtain the information necessary to furnish the statement. A further exception to the 1098-T requirement is that the educational institution is not required to provide a 1098-T for students who: took only non-credit courses; are nonresident aliens, unless the form is requested by a student; or had their qualified tuition and related expenses entirely waived or paid entirely with scholarships. The exception also applies for students for whom the school does not maintain a separate financial account and whose qualified tuition and related expenses are covered by a formal billing arrangement between an institution and the student's employer or a governmental entity, such as the Department of Veterans Affairs or the Department of Defense.

Until the proposed regs are finalized, if the institution is exempt from providing a 1098-T under current regulations, a taxpayer who doesn't receive a 1098-T may claim an education credit if the taxpayer is otherwise qualified, can demonstrate that the taxpayer (or taxpayer's dependent) was enrolled at an eligible educational institution, and can substantiate the payment of qualified tuition and related expenses.

CAUTION

Practitioners should avoid claiming the education credits or the higher education tuition deduction for clients that have not received a corresponding 1098-T.

An eligible educational institution will send the student a Form 1098-T, Tuition Statement, generally by January 31 of the year following the year of attendance. Starting with the 1098-Ts for 2018, institutions must report payments received in Box 1 and no longer have the option of reporting only amounts billed (Box 2), as was the case in prior years. However, either of these amounts may differ from what was actually paid, so the 1098-T amount cannot be relied on without further inquiry of the taxpayer to determine the amounts actually paid. The 1098-T also provides other information, such as adjustments made for prior years, the amount of scholarships or grants, reimbursements, or refunds, and whether the student was enrolled at least half-time or was a graduate student.

Expenses Not Included On The 1098-T - A taxpayer that substantiates payment of qualified tuition and **related expenses** that are not reported on Form 1098–T, ''Tuition Statement'', may include those expenses in computing the amount of the education tax credit allowable for the taxable year. (Prop Reg 125A-1(f))

Coordination with Coverdell ESAs & Qualified Tuition Programs - A taxpayer can claim an AOTC or LLC for a tax year and exclude from gross income amounts distributed (both the principal and the earnings portion) from a Coverdell Education Account for the same student, as long as the distribution is not used for the same educational expenses for which a credit was claimed.

Special Situations

- **Source of funds used to pay expenses:** The credits can be claimed for expenses paid with a student's earnings, loans, gifts, inheritances, and personal savings. However, if higher education expenses are paid with a tax-free scholarship, Pell grant, or employer-provided educational assistance, no credit is allowed for those amounts.
- **Credits not available for same student in one tax year:** For each eligible student, a taxpayer can elect for any tax year only one of the credits. For example, if the taxpayer elects to take the AOTC for a child, he/she can't, for that same child, also claim the LLC for that year.
- **AOTC vs. LLC:** A taxpayer can claim the AOTC for four years of a child's post-secondary education and claim the LLC for that same child in other tax years.
- **Multiple students in family:** If a taxpayer pays qualified expenses for more than one eligible student in the same year, he/she can choose to take credits on a per-student, per-year basis. This means that, for example, the taxpayer can claim the AOTC for one child and the LLC for another child in the same tax year.
- **Recapture of credits:** If a taxpayer receives a refund in a later year of an amount used to figure a higher education credit, the credit may have to be recaptured.
- **Nonresident alien taxpayers and dependents:** If a taxpayer or the taxpayer's spouse is a nonresident alien for any portion of the taxable year, no education tax credit is allowed unless the nonresident alien is treated as a resident alien by reason of an election under Section 6013(g) or (h). In addition, if a student is a nonresident alien, a taxpayer may not claim an education tax credit with respect to the qualified tuition and related expenses of the student unless the student is a claimed dependent (as defined in §1.25A-2(a)). A "claimed dependent" is a dependent the taxpayer can claim on their tax return. Among other requirements, a nonresident alien student must be a resident of a country contiguous to the United States in order to be treated as a dependent.

Strategies

Potential Gifting-Education Credit Strategy - Prior to the kiddie tax age being increased to include full time students through age 23, a commonly used tax strategy was to gift appreciated stock to a child and then have the child sell the stock at a lower tax rate and use the funds to pay for the child's education. Since there is no longer any tax benefit to gifting appreciated stock to a full time student under 24 to pay for education, what if the grandparents or other trusted relative or friend are in a lower tax bracket and....

The child's parents gift each grandparent or sets of grandparents enough appreciated stock that when sold would yield an after tax amount that the grandparent in turn uses to pay the child's tuition?

- Gifts used for education (only tuition) are not subject to gift tax so the grandparents would have no gift tax issues. **Caution** - grandparents (or whoever) would need to make tuition payments directly to the educational institution to avoid the gift tax issue if the amount gifted exceeds the annual gift exclusion.
- If the grandparents are retired their income might be such that they would be in the zero capital gains tax rate. **Caution** – Be careful that the additional income from including the gain upon sale of the stock doesn't cause the grandparents to have more taxable Social Security or have other detrimental effects on AGI-based limitations.
- Assuming the parents claim the child as a dependent, and their MAGI permits, they would be able to claim the education tax credit since the credit goes to the individual claiming the dependent even if they did not pay the tuition.

CAUTION - If the parents' MAGI causes the education credit to be phased out (or eliminated), it makes using this strategy less appealing – but if they would have sold the stock to pay for the education expenses anyway, transferring the gain to the grandparents would still be an appropriate strategy as it will reduce the parents' AGI for various phaseouts. It would help lower the parents' state tax, especially if the state doesn't have a capital gain tax rate but could increase the grandparents' state tax – so you'd need to run the actual numbers to see if there's an overall family savings.

CALIFORNIA DIFFERENCES

California has no equivalent credits.

ClientWhys™ 2019 Education Benefits Table

Code Section	Sec 25(A)	Sec 25(A)	Sec 221	Sec 529	Sec 530	Sec 135(a)	Sec 72(t)
DESCRIPTION	AMERICAN OPPORTUNITY	LIFETIME LEARNING	HIGHER EDUCATION INTEREST	COLLEGE SAVINGS PLAN	COVERDELL EDUCATION ACCOUNT	SAVINGS BOND INTEREST	PENALTY-FREE IRA DISTRIB.
Tax Benefit:	Tax Credit(2)	Tax Credit	AGI Deduction	Tax-Free Growth	Tax-Free Growth	Federal Exempt	Penalty-Free (1)
	100% 1st $2,000 25% 2nd $2,000 Annually/Student	20% of first: $10,000 Annually/Family	$2,500	Only limited by Gift Tax Considerations & Plan Cap Spec Needs Any Age	$2,000 Per Child/Yr <19	Unlimited For Designated Amounts	Unlimited Withdrawal
AMT Offset	YES	YES	---	---	---	---	---
AGI Phase Out:	Payer	Payer '19	Debtor '19		Contributor	Purchaser ' 19	N/A
Joint	160 - 180,000	116 - 136,000	140-170K		190K-220K	221,600 - 151,600	
Single, HH	80 - 90,000	58 - 68,000	70-85K	NONE	95K –110K	81,100 – 96,100	Not
MS	No Credit	No Credit	No Deduct		95K -110K	Can't Purchase	Applicable
Dependent Of Another	No Credit	No Credit	No Deduct		95K -110K	81,100 – 96,100	
Eligible Student:	25A(b)(3)	25A(b)(3	25A(b)(3)	529	530(b)(1)	135(a)(2)	72(t)(7)
Taxpayer	YES	YES	YES	Any Individual (Account Beneficiary)	Any Individual (Account Beneficiary)	For bonds purchased after 89 by Individual over 24 yrs. old	YES
Spouse	YES	YES	YES				YES
Dependent	YES	YES	YES				YES
Nondependent Child/Grand	NO	NO	NO				YES
Unrelated Individual	NO	NO	NO				NO
Minimum Attendance:	Students enrolled at least half time		Eligible student at least half time		Half time to deduct room and board expenses		
Status		N/A		N/A		N/A	N/A
Duration	One academic period	N/A	N/A	N/A	N/A	N/A	N/A
Qualifying Education:							
Elementary/Secondary	NO	NO	NO	YES(3)	YES	NO	NO
Post-Secondary				post-2017			
First 4 Years	YES	YES	YES	YES	YES	YES	YES
Any	NO	YES	YES	YES	YES	YES	YES
Post Graduate	NO	YES	YES	YES	YES	YES	YES
Enrolled In:							
Degree Program	OK	OK	OK	OK	OK	YES	OK
Certificate Program	OK	OK	OK	OK	OK	YES	OK
Recognized Credential	OK	OK	OK	OK	OK	YES	OK
Job Improvement Skills	NO	OK	NO	NO	NO	NO	OK
Qualifying Expenses:	25A(f)	25A(f)	221(d)(2)	529(e)(3) *	529(e)(3);530(b)(3)	135(c)(2)	529(e)(3)
Tuition Req'd	YES	YES	YES	YES/YES	YES	YES	YES
Tuition Fees	YES	YES	YES	?/YES	YES	YES	YES
Sports/Hobby Fees	Maybe	Maybe	NO	NO	NO	NO	NO
Room	NO	NO	YES	NO/YES	YES	NO	YES
Board	NO	NO	YES	NO/YES	YES	NO	YES
Books/Supplies/Equip	YES	Maybe	YES	NO/YES	YES	NO	YES
Travel	NO	NO	NO	NO	NO	NO	NO
Computer/Internet Access	Maybe	NO	YES	NO/May	YES K-12	NO	YES
Other Capital Items	NO	NO	NO	NO/YES	YES	NO	YES
Expense Offsets:	25A(g)(2)	25A(g)(2)	25A(g)(2)	529	25A(g)(2)	135(d)	25A(g)(2)
Excludable:							
Employer Benefits	YES	YES	YES	YES	YES	YES	YES
Coverdell Distrib.	YES	YES	YES	YES	N/A	YES	YES
Scholarship Grants	YES	YES	YES	YES	YES	YES	YES
Fellowship Grants	YES	YES	YES	YES	YES	YES	YES
Tax-Free Ed Benefits	YES	YES	YES	YES	YES	YES	YES
EE/I Bond Interest	YES	YES	YES	YES	YES	N/A	YES
Expenses Used For:							
American Opportunity Cr	N/A	YES	NO	NO	NO	YES	No Mention
Lifetime Learning Cr.	YES	N/A	NO	NO	NO	YES	No Mention
Schedule A or 2106 when appl.	YES	YES	NO	No Mention	No Mention	YES	No Mention
Interest Deduction Allowed Elsewhere			No Deduction				
Qualifying Institutions:							
Post-Secondary Institutions	YES	YES	YES	YES	YES	YES	YES
Certain Vocational Schools	Maybe	Maybe	Maybe	Maybe	Maybe	YES	Maybe
Certain Medical Training	Maybe	Maybe	Maybe	Maybe	Maybe	YES	Maybe
Elementary/Secondary Schools	NO	NO	NO	YES	YES	NO	NO
Other Disallowances:							
Felony Drug Conviction	YES	NO	N/A	N/A	N/A	N/A	N/A
Student Has No TIN	YES	YES	Silent	N/A	N/A	N/A	N/A
Married Taxpayers	Must File JT	Must File JT	Must File JT	N/A	N/A	Must File JT	N/A

(1) Disability, death, and medical exception to penalty takes precedence over the education exception.

*Left of slash = K-12; right of slash = post-secondary

(2) 40% Refundable

(3) Max. $10,000/year per beneficiary

NOTES

QUALIFIED TUITION PROGRAMS
Sec 529 Plans

RAPID FINDER

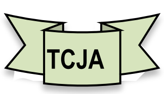
Qualified Tuition Plans (sometimes referred to as Section 529 Plans) are plans established to help families save and pay for education expenses in a tax-advantaged way and are available to everyone, regardless of income.

These plans, also known as qualified tuition programs (QTPs), allow taxpayers to gift large sums of money for a family member's elementary, high school and college education, while continuing to maintain control of the funds. The earnings from these accounts grow tax-deferred and are tax-free, if used to pay for qualified higher education expenses. Prior to 2018 only college education expenses were eligible expenses.

They can be used as an estate-planning tool as well, providing a means to transfer large amounts of money without gift tax. With all these tax benefits, 529 plans are an excellent vehicle for funding education.

Related IRC and IRS Publications and Forms

- **Pub 970** – Tax Benefits for Education
- **Form 1099-Q** – Payments from Qualified Education Programs
- **Form 709** - United States Gift (and Generation-Skipping Transfer) Tax Return
- **IRC Sec 529**



TCJA Changes

- Kindergarten through Grade 12 Distributions – 5.05.04
- Recontribution of Refunded Tuition - 5.05.04
- Rollover to an ABLE Account - 5.05.05

Sec 529 Plan Distributions – Distributions from a qualified tuition program are excludable to the extent used to pay for qualified education expenses. A "qualified tuition program" includes prepaid educational service accounts (i.e., tuition credits or certifications) established and maintained by eligible educational institutions, rather than just state-sponsored QTPs.

- Distributions from a QTP are excludable from gross income to the extent used to pay for qualified education expenses. For years after 2017, distributions of up to $10,000 per year per plan beneficiary to pay for attendance at a public, private or religious elementary or secondary school are also excludable.
- "Qualified higher education expenses" include special needs services for special needs beneficiaries in connection with their enrollment at an eligible education institution.
- The room and board allowance included in qualified higher education expenses is limited to that for attendance under specified federal financial aid programs, or, for a student living in housing owned or operated by an eligible educational institution, the actual amount charged by the educational institution for room and board.
- A 10% penalty tax is imposed on the amount of a QTP distribution that is includible in income.
- Taxpayers are permitted to claim an American Opportunity or Lifetime Learning credit for college tuition and expenses and exclude amounts distributed from a QTP during the same tax year for the same student, but not with respect to the same expenses.
- Tax-free 60-day rollovers are permitted (not more than once in 12 months) from one QTP to another QTP with the same designated beneficiary.

- "Family member" for purposes of beneficiary changes and rollovers includes first cousins of the original beneficiary.
- A contribution to a qualified tuition account (or for a prepaid tuition contract) qualifies for annual gift tax exclusion ($15,000 for 2019) and, to the extent of the exclusions, is exempt from the generation-skipping transfer (GST) tax. A contributor may contribute in a single year up to 5 times the annual gift tax exclusion amount to a qualified tuition account and, for gift tax and GST tax purposes, treat the contribution as having been made ratably over the five-year period beginning with the calendar year in which the contribution is made. A distribution from a qualified tuition account or prepaid tuition contract generally is not subject to gift tax or GST tax. See also "Gift and Estate Tax Considerations" later in this chapter.
- QTP account balances or prepaid tuition benefits generally are excluded from the gross estate of any individual for estate tax purposes. Amounts distributed on account of the death of the designated beneficiary, however, are includible in his gross estate. If the contributor elected the special five-year allocation rule for the annual gift tax exclusion (described above), any amounts contributed that are allocable to the years within the five-year period remaining after the year of the contributor's death are includible in the contributor's gross estate.

TYPES OF PLANS

Section 529 Plans come in two types, allowing taxpayers to either save funds in a tax-free account to be used later for eligible education costs, or to prepay tuition for qualified universities.

College Savings Plans **–** Allow taxpayers to contribute after-tax dollars that are invested in some sort of savings vehicle – typically mutual funds. Many of these plans offer stock funds when a child is quite young, which will then be transferred to more conservative investments (like bond funds) as the child gets closer to college age. As with any investment, there are no guarantees of growth and the plans are subject to the normal investment risks, even though state governments sponsor them. A big plus for these plans is they are not geared towards in-state schools or a specific institution, but meant to be applied to whichever school a child chooses to attend.

Prepaid Tuition Plans - As the name implies, a Prepaid Tuition Plan allows parents to pay for college education at today's tuition rates. By locking in the tuition payments, worries about the increase of tuition costs in the future can be set aside. This gives the assurance that the child will have the money to attend college when that time comes. These plans sound very attractive; however, most of these plans guarantee that the taxpayer will be covered only if their child chooses to go to a public in-state college or university. Therefore, if the taxpayer's child decides to attend an out-of-state school, the taxpayer won't be fully covered, simply because these plans are not meant to fund the higher costs of private or out-of-state education. **However, prepaid tuition programs can be established and maintained by educational institutions, including private institutions.**

CONTROL

If the taxpayer makes sacrifices to save for a child's education, the taxpayer certainly wants to make sure those savings end up being used for education and not some other purpose. 529 Plans allow the taxpayer to keep control of the account. If the taxpayer saves money for college in a UGMA or UTMA (the name depends on the state in which the taxpayer lives and are essentially custodial accounts set up for minors), the account becomes the child's property once he or she reaches the age of majority — usually 18 or 21 — at which time the taxpayer loses control. So while the taxpayer's intent may have been to use the funds saved in the UGMA/UTMA for college expenses, the child may have other ideas how to spend the money. Unlike UGMA/UTMAs, Section 529 plans are not irrevocable gifts and the taxpayer retains control. Control stays in the hands of the adult responsible for the account. Generally, this is the same person who contributed the money, but it doesn't have to be the case. Someone else, for example, a grandparent, could make the donation but name the child's parent as the account owner. Money does not come out of the account without permission from the account owner. If the designated beneficiary of the plan decides not to go to school, then the account owner can simply change the beneficiary to someone else in the family.

Account Owner (AO) – The AO is the person who, under the terms of the QTP or any contract setting forth the terms under which contributions may be made to an account for the benefit of a designated beneficiary (DB), is entitled to select or change the DB of an account, to designate any person other than the DB to whom funds may be paid from the account, or to receive distributions from the account if no other person who is entitled to receive distributions is designated (Prop Reg § 1.529-1(c), under which taxpayers may rely).

TAX BENEFITS

There is no federal tax deduction for making contributions, but taxes on the earnings within a 529 Plan are tax-deferred while they are held in the account and are tax-free when withdrawn to pay for qualified education expenses. Distributions from plans of private institutions can qualify to be tax-free. This allows taxpayers to accumulate money for a child's education expenses at a much faster rate than if they had to pay tax on the investment gains and earnings.

To be tax-free when withdrawn, the funds must be used to pay for qualified schooling expenses such as tuition, room and board, books, supplies and equipment. However, room and board expenses do not qualify for elementary or secondary school students. The more time a taxpayer has until their child needs the money for education, the more significant this tax-free compounding becomes.

Information Reporting – If distribution has been taken from the plan, the plan administrator will issue a **Form 1099-Q**. The recipient's name and Social Security number on the 1099-Q will be the designated beneficiary's if the QTP distribution was made directly to the beneficiary or an educational institution. Otherwise, the account owner will be listed as the recipient. If the distribution exceeds the "adjusted qualified education expenses" – qualified education expenses reduced by any tax-free scholarships or fellowships, VA education assistance, Pell grants, and similar nontaxable payments – information on the 1099-Q will be used to determine what portion of the earnings may be taxable. If the distribution is totally nontaxable, no reporting of the distribution is required on the recipient's income tax return. Any taxable amount is included on the "other income" line of the recipient's Form 1040 (line 8 of 2019 draft Schedule 1).

Example: *Over several years Naomi's parents had contributed $18,000 to a qualified tuition plan they set up that is administered by their state government. During the tax year, Naomi enrolled in college and had $6,700 of qualified education expenses; some of the expenses were offset by a $3,100 tax-free scholarship. The balance was paid from a $3,700 withdrawal from the QTP, which had a balance of $27,000 when the distribution was made. Form 1099-Q issued to Naomi shows $1,200 of the distribution is earnings. Since the amount of the distribution exceeds the adjusted qualified education expenses Naomi had, part of the earnings included in the distribution is taxable.*

Total qualified education expenses	*6,700*
Less scholarship	*<3,100>*
Adjusted qualified education expenses.	*3,600*

1,200 x 3,600/3,700 = 1,168 (nontaxable part of earnings)
1,200 – 1,168 = 32 (taxable part of earnings)

HOW MUCH CAN BE CONTRIBUTED?

Unlike Coverdell Education Savings Accounts for which the annual contribution is limited to $2,000, Sec. 529 Plans allow taxpayers to put away larger amounts of money limited only by the contributor's gift tax concerns and the contribution limits of the intended state plan. There are no income or age limitations for the Sec. 529 Plans. The maximum amount that can be contributed per beneficiary is based on the projected cost of a college education and will vary between state plans. Some states base their maximum on an in-state four-year education, while others use the cost of the most expensive schools in the U.S., including graduate studies. Most have limits in excess of $200,000 with some topping $475,000. Generally, once an account reaches that level, additional contributions cannot be made, but that doesn't prevent the account from continuing to grow.

Contributions to a 529 education savings plan must, by Federal law, be made in cash and always consist of after-tax money. Most programs also have a minimum contribution that is within everyone's budget. Many have payroll or automatic withdrawal programs.

DISTRIBUTIONS

Distributions from a Sec 529 follow the Code Sec. 72 annuity rules meaning that distributions are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account. So, the part of the distribution representing the amount paid or contributed to the QTP doesn't have to be included in income, because that part is a return of the investment in the plan.

TCJA

Kindergarten through grade 12 - The limit for the post 2017 special allowance for kindergarten through grade 12 (high school) is $10,000 per beneficiary. See page 5.05.04 for more details

Computation of Earnings **-** Under prior law for purposes of applying section 72, all Sec 529 qualified tuition programs of which an individual was a designated beneficiary were treated as one program. The PATH Act eliminated the aggregation requirement for distributions after December 31, 2014.

Refunds & Recontribution of Funds - The PATH Act created a new Sec 529(c)(3)(D) to address situations in which Sec 529 qualified tuition program funds are distributed for a beneficiary's qualified higher education expenses, but some portion of those expenses subsequently are refunded to the beneficiary, for example, when the beneficiary drops a class mid-semester. Now the portion of a distribution refunded to a Sec 529 beneficiary is not subject to income tax to the extent that, within 60 days of the date of the refund, it is recontributed to a Sec 529 qualified tuition program of which the individual is a beneficiary.

DESIGNATED BENEFICIARY

A "designated beneficiary" in a qualified tuition program is:

1. The initially-named individual who receives benefits;
2. In the case of a change in beneficiaries within the same family, the new beneficiary, and
3. A scholarship recipient under a qualified state tuition program as part of a scholarship program operated by a state or local government or exempt organization. *(§501(c)(3))*

QUALIFIED EDUCATION EXPENSES

Qualified expenses under a Sec. 529 plan are the costs required for a beneficiary's enrollment at an eligible higher educational institution and include:

- *Higher Education Tuition*
- *Elementary and Secondary School Tuition Expenses* – TCJA adds withdrawals for elementary or secondary school tuition expenses but limits the annual withdrawal for each beneficiary to $10,000 (regardless of the number of 529 plans in the beneficiary's name)[1]. **Note: this special amount is for tuition only**. Elementary or secondary means kindergarten through grade 12 as determined under State law, consistent with the definition applicable for Coverdell education savings accounts. This special $10,000 amount applies for tuition paid to public, private or religious schools. [1] Per IRS Notice 2018-58.
- *Fees*,
- *Books,*
- *Supplies,*
- *Equipment*,
- *Computers* - Effective beginning in 2015, the PATH Act provides that Sec 529 qualified higher education expenses also include expenses for the purchase of computer or peripheral equipment (as defined in section 168(i)(2)(B)), computer software (as defined in section 197(e)(3)(B)), and Internet access and related services, if such equipment, software, or services are to be used primarily by the Sec 529 plan beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution. Computer software designed for sports, games, or hobbies is qualified only when the software is predominantly educational in nature. (Amended Sec 529(e)(3)(A)(iii))
- *Reasonable room and board costs* by a student enrolled at least half-time (generally limited to the school's posted room and board charge, or $2,500* per year for a student living off-campus and not at home)**, and
- Expenses of a special needs beneficiary that is necessary in connection with his or her enrollment or attendance at the eligible educational institution.

**§472 of the Higher Education Act of 1965*

*** Code Sec 529(e)(3)(B) references Sec 25A(b)(3) in defining students whose room and board costs are eligible expenses, and Sec 25A(b)(3) says the student must meet certain requirements of the Higher Education Act of 1965; therefore, room and board expenses of elementary and secondary school students would not qualify.*

TIMING OF REIMBURSEMENTS

Apparently reimbursements can be made in a year other than the year of the expenses since the code and publications are all silent on the issue. However, the taxpayer had better have documentation to prove this is not a double benefit (reimbursing for expenses used as a deduction or credit in a prior year and not exceeding the annual $2,500 off-campus room and board expenses - tough documentation requirements should the distribution be challenged).

RECONTRIBUTION OF REFUNDED QUALIFIED HIGHER EDUCATION EXPENSES

When qualified higher education expenses are refunded (for example, when a student drops a class mid-term), the regs IRS plans to issue will:

- Permit the entire recontributed amount to be treated as principal, thus eliminating the need to determine the earnings portion, and allowing the entire refund to be tax-free if recontributed to the plan within 60 days of the refund;
- Provide that the recontributed amount won't count against the Sec 529(b)(6) limit on contributions on behalf of the designated beneficiary (related to contributions in excess of those necessary to provide for the qualified higher education expenses of the beneficiary); and

- Specify that the recontributed amount must be to the Sec 529 plan for the benefit of the beneficiary who received the refund but the recontribution doesn't have to be into the same plan from which the original distribution was made.

ROLLOVER FROM A QTP TO AN ABLE ACCOUNT

QTP distributions made Dec. 23, 2017 through Dec. 31, 2025, to the ABLE account of the designated beneficiary or a family member of the beneficiary won't be taxable if:

TCJA

(1) The distributed funds are contributed to the ABLE account within 60 days of the withdrawal from the QTP and

(2) That distribution plus all other contributions to the ABLE account for the year that are subject to the annual gift tax exclusion do not exceed that limitation.

A direct transfer or rollover that would result in the gift tax limitation being exceeded would be subject to income tax plus a 10% penalty, so the regs IRS plans to issue will require the QTP to prohibit the direct transfer amount.

This rollover provision is only available 2018 through 2025. The amount of the rollover is limited, when combined with other contributions, to the annual ABLE account maximum. See Chapter 5.06 for additional information.

HIGHER EDUCATION CREDITS

Taxpayers can claim an American Opportunity credit or Lifetime Learning credit for a taxable year and exclude from gross income amounts distributed (both the principal and the earnings portion) from a Sec. 529 Plan on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

PENALTIES

If the earnings from the 529 Plan are withdrawn and not used for qualified education expenses, the earnings withdrawn will be subject to both regular taxes and a 10% penalty. When applicable, the penalty is computed on Form 5329. Before becoming concerned, remember, had the taxpayer not utilized the tax deferral benefits of the Sec 529 Plan, they would have accumulated significantly less in the account that may more than offset the 10% penalty. Penalties can be avoided by making a tax and penalty-free rollover from one 529 Plan to another, and remember, a taxpayer can change beneficiaries to a 529 Plan without penalty.

IMPACT ON FINANCIAL AID

Predicting financial aid eligibility is no easy task since it is based on a myriad of factors, including income, the age of the parents, and the methodology used. A question that always arises when discussing the benefits of saving for college is the impact those savings will have on future financial aid. Investing in a college savings plan can affect financial aid eligibility to some degree, but 529 plans are typically viewed as a parental asset, rather than a child's and that means that a financial aid officer would count only a small portion of the assets toward the financial aid eligibility. If the account owner is not the parent or dependent student (perhaps a grandparent), eligibility for financial aid is not affected, but distributions from grandparent-owned plans will likely be attributed to the student.

LOSSES

If a contributor has a loss from his or her investment in a qualified tuition program (QTP), he or she can take the loss on his or her tax return, but only when all amounts from that account have been distributed and the total distributions are less than the contributor's unrecovered basis. The loss is claimed as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit.

TCJA

The TCJA suspended the 2%-of-AGI threshold category of deductions for 2018 through 2025, so in those years, no QTP loss is allowed.

GIFT & ESTATE CONSIDERATIONS

Normally, gift tax doesn't apply to amounts paid by one individual on behalf of another individual <u>directly</u> to a qualifying educational organization as tuition for that other individual. *(Code Sec. 2503(e))*. However, since contributions to qualified tuition programs are not paid directly, that exclusion does not apply.

Section 529 Plans are often promoted as an estate-planning device for wealthy grandparents, since making a large contribution to a 529 Plan reduces their taxable estate much quicker than the annual gift exclusion. But while the assets leave their estate, they don't leave their control.

<u>Completed Gifts</u> - Contributions to Section 529 Plans are considered completed gifts and are subject to the gift tax rules. Under these rules, individuals can annually give away (gift) up to the annual exclusion amount to another

individual (twice that amount for a married couple) without triggering gift taxes or reducing their lifetime gift and inheritance exclusion.

<u>Five-Year Option</u> – Where contributions exceed the annual exclusion amount, a donor may elect to take certain contributions to a QTP into account ratably over a five-year period in determining the amount of gifts made during the calendar year. The provision is applicable only with respect to contributions not in excess of five times the annual exclusion amount available in the calendar year of the contribution. Any excess may not be taken into account ratably and is treated as a taxable gift in the calendar year of the contribution. Thus an individual could contribute five times the annual exemption and a couple twice that amount. The gift would reduce the donor's estate by the full amount of the gift by the end of the five-year period. Should the donor die before the five-year period elapses, any amount in excess of the allowable annual exclusions would revert back to the donor's estate.

No additional gift could be given to the beneficiary of the Section 529 Plan for that entire five-year period without triggering a gift tax return filing requirement, and potentially gift tax, unless there is an increase in the annual exclusion amount.

<u>Annual Exemption Increases During Five Year Period</u> - If in any year after the first year of the five year period the amount of the annual exclusion is increased, the donor may make an additional contribution in any one or more of the four remaining years up to the difference between the exclusion amount as increased and the original exclusion amount for the year or years in which the original contribution was made (Prop. Reg. 1.529-5(b)(2)(iv)).

> ***Example -*** *In Year 1, when the annual gift exclusion is $10,000, Paul, who is divorced, makes a contribution of $60,000 to a QTP for the benefit of his child, Chris. Paul elects under section 529(c)(2)(B) to account for the gift ratably over a five year period beginning with the calendar year of contribution. Paul is treated as making an excludable gift of $10,000 in each of Years 1 through 5 and a taxable gift of $10,000 in Year 1. In Year 3, when the annual exclusion is increased to $12,000, Paul makes an additional contribution for the benefit of Chris in the amount of $8,000. Paul is treated as making an excludible gift of $2,000; the remaining $6,000 is a taxable gift in Year 3.*

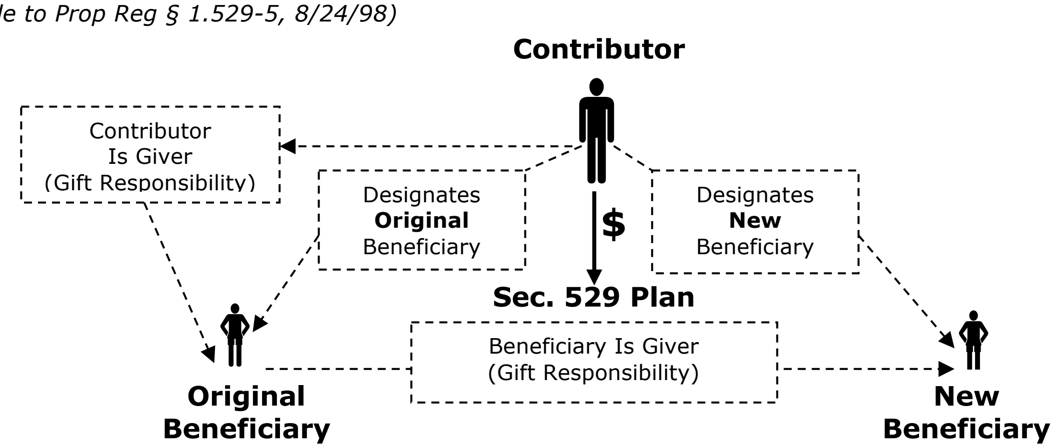
<u>Multiple Five-Year Options</u> – Although overlapping five-year periods are not allowed according to the provisions of Prop. Reg. 1.529-5(b)(2)(v), it would appear that additional five-year periods can be elected once the current five-year period has been completed.

<u>Gift Tax Return</u> - A gift tax return must be filed for the year of the contribution, if the gift exceeds the annual gift tax exclusion amount. If claiming the special five-year exemption, Form 709A cannot be used. Only the 709 includes the special box in Schedule A (line B) providing the election. The following is the text of that election:

> ☐ *Check here if you elect under Section 529(c)(2)(B) to treat any transfers made this year to a qualified state tuition program as made ratably over a five-year period beginning this year. See instructions. Attach explanation.*

The explanation must include the total amount contributed per individual beneficiary, the amount for which the election is being made, and the name of the individual for whom the contribution was made. Please see the instructions for Form 709 for additional information.

<u>Change of Beneficiary</u> - Contribution to a QTP is a completed gift from the contributor to the designated beneficiary. Therefore, any subsequent transfer occurring by reason of a change in the designated beneficiary or a rollover from the account of the original designated beneficiary to the account of another beneficiary is treated as a transfer from the original designated beneficiary to the new beneficiary. ***This is the result even though the change in beneficiary or the rollover is made at the direction of the contributor*** under the terms of the contract. *(Preamble to Prop Reg § 1.529-5, 8/24/98)*



Taxable Transfer? Such a transfer is not a taxable gift if the new beneficiary: *(Prop Reg § 1.529-5(b)(3)(ii) ["Taxpayers may rely," Prop Regs, 8/24/98]*

(1) Is a member of the family of the old beneficiary, **and**

(2) Is assigned to the same generation as the old beneficiary.

Generation-Skipping Tax - Under proposed regs, the portion of a contribution to a qualified tuition program that is excludible from taxable gifts under the gift tax annual exclusion also satisfies the requirements of Code Sec. 2642(c)(2), and therefore, is also excludible for purposes of the generation-skipping transfer (GST) tax. *Prop Reg § 1.529-5(b)(1) ["Taxpayers may rely," Prop Regs, 8/24/98].*

Death of a Beneficiary **-** No interest in a qualified tuition program is included in the estate of any person for estate tax purposes. However, amounts distributed on account of the beneficiary's death are included in the beneficiary's estate. Thus, if the beneficiary's interest is rolled over to another beneficiary, there are no transfer tax consequences if the beneficiaries are in the same generation. If the new beneficiary is in a lower generation than the deceased beneficiary, the five-year rule may be applied to exempt from the gift tax up to $75,000 of the transfer for 2019 (5 x $15,000, the current annual exemption).

SUPPORT - AN UNANSWERED QUESTION

To date the IRS has not provided any guidance related to whether a distribution from a Sec 529 plan constitutes support to the student provided by the account owner or the account beneficiary (the student). Some tax professionals take the position that the distributions are support provided by the beneficiary (student) since the contributions to Sec 529 Plans are considered to be completed gifts. This issue can have a significant impact when determining whether the beneficiary is a dependent of his or her parents or is self-supporting, and who claims the beneficiary's exemption, education credits, tuition deduction (in years when available), and other tax benefits.

PLAN SPONSORS

Originally, Section 529 Plans were only state-sponsored programs but now have been expanded to allow educational institutions, either public or private, to establish and operate prepaid tuition plans. For college savings plans and state-sponsored prepaid tuition plans, taxpayers are actually investing in a program authorized by the Federal government and run by the various states, or a state agency or instrumentality. To attract their own residents, some states offer tax deductions for contributions, while others will disregard the account balances when calculating state financial aid. **It is important to understand that taxpayers are not limited to establishing a plan with their resident state.** They should investigate the various state plans available and evaluate their performance, expenses, and investment options before selecting a plan.

CALIFORNIA DIFFERENCES

California's version of a Section 529 college savings plan, which was established in 1999, was renamed in 2017 to ScholarShare 529. The URL remains *www.scholarshare.com.*

- This savings plan program invests in special investment portfolios.
- For the taxpayer's beneficiaries, allocations are weighted more heavily towards equities, and as beneficiaries become older, allocations are weighted more heavily towards bonds and money market instruments.
- Other state's programs may be used by California residents & vice versa.
- Education is NOT LIMITED to California educational institutions.
- Account maximum is $529,000 as of July 2019.

New Law & Stuff

Conformity with Federal Changes - AB 91 (signed by the governor 6/27/2019) generally conforms to the changes relating to Sec 529 plans made by the TCJA and the Consolidated Appropriations Act of 2016, including the following:

- A distribution is not taxable, if, within 60 days of distribution, it is transferred to the credit of another beneficiary who is a "member of the family" as defined in IRC Sec 529(e)(2) or is rolled into an ABLE account for the same beneficiary or a family member.
- Refunded amounts re-contributed to the plan within 60 days will not be taxable.
- Distributions used to purchase computers, computer software, internet access and related services are qualified education expenses and thus not taxable.

Nonconformity with Federal Changes - California did not conform to the TCJA provision allowing tax-free distributions from 529 plans for amounts used to pay tuition expenses at a public, private or religious elementary, middle, or high school. Therefore, these distributions are taxable for California and subject to a 2.5% penalty. See table below.

SEC 529 PLAN COMPARISONS – FEDERAL/CALIFORNIA		
ACTION	**FEDERAL**	**CALIFORNIA**
Distribution to transfer funds to another family member's 529 plan within 60 days.	YES	YES
Distribution to transfer funds to an ABLE account within 60 days.	YES	YES
Refunded amounts re-contributed to the plan within 60 days will not be taxable.	YES	YES
Allows tax-free distributions from 529 plans for amounts used to pay Kindergarten through grade 12 tuition expenses.	YES	**NO**
Distribution to pay tuition expenses at a public, private or religious elementary, middle, or high school.	YES	**NO**
Distributions used to purchase computers, computer software, internet access and related services are qualified education expenses.	YES	YES

Direct Deposit of Refunds to ScholarShare Savings Plan – Income tax refunds can be directly deposited into the taxpayer's ScholarShare 529 College Savings Plan account. See Form 540 or 540-2EZ instructions.

Matching Grant – New ScholarShare accounts may be eligible to receive dollar-for-dollar matching contributions up to $225 into the account from ScholarShare 529. See the plan's website for additional information.

NOTES

ABLE ACCOUNTS

“Achieving a Better Life Experience” (ABLE) Accounts

RAPID FINDER

Overview

Qualified ABLE programs provide the means for individuals and families to contribute and save for the purpose of supporting individuals, blind or severely disabled before turning age 26, in maintaining their health, independence, and quality of life. The contribution and distribution rules are loosely modeled after Sec. 529 Plans.

Pubs Forms

Related IRC, IRS Publications and Forms or Other References

- H.R. 647, the *Achieving a Better Life Experience (ABLE) Act of 2014*
- IRC Sec 529A
- Reliance Regulations Sec 1.511-2; 1.513-1; and 1.529A-1 through 1.529A-7
- **Form 1099-QA** – Distributions from ABLE Accounts
- **Form 5498-QA**–ABLE Account Contribution Information

New Law & Stuff

TCJA CHANGES	**See Page**
Additional Contributions by Beneficiaries	5.06.02
Saver’s Credit	5.06.03
Rollovers from Sec 529 Plans Now Allowed	5.06.03

The Details

Federal law enacted in 2014 authorizes States (or their agencies or an instrumentality) to establish and operate an ABLE program. Under the ABLE program, an ABLE account may be set up for any eligible state resident, which would generally be the only person who could take distributions from the account. ABLE accounts are very similar in function to Sec 529 plans. However, they should not be considered as estate planning devices, as is sometimes the case with 529 plans; the main purpose of ABLE accounts is to shelter assets from means testing required by government benefit programs. Individuals can contribute to ABLE accounts subject to Gift Tax limitations. Distributions to the disabled individual are tax free if the funds are used for qualified expenses of the disabled individual.

State Program - A state or state agency or instrumentality can establish an ABLE Program for a beneficiary who is a resident of either the state that maintains the program or of a contracting state that hasn't established an ABLE program but has entered into a contract with a program state to provide the contracting state's residents with access to the program state's ABLE program. Program limitations:

- Must provide a separate accounting for each designated beneficiary;
- Limits the designated beneficiary's investment direction to no more than two times in a calendar year;
- Prohibits the use of any interest or any portion of an interest in the program as security for a loan; and
- Provides adequate safeguards to prevent excess aggregate contributions.

Beneficiary Changes State Residency - A qualified ABLE program may permit a beneficiary to continue to maintain his or her ABLE account that was created in that state, even after the beneficiary is no longer a resident of that state. (Prop Reg §1.529A-2(o))

Eligible Beneficiary - Must be severely disabled before turning age 26, based on marked and severe functional limitation or receipt of benefits under the SSI or Disability Insurance (DI) programs. However, an individual does not need to receive SSI or DI to open or maintain an ABLE account, nor does the ownership of an account confer eligibility for those programs.

The designated beneficiary of an ABLE account is an eligible individual who established the account and is its owner. (Code Sec. 529A(e)(3))

An individual is an eligible individual for a tax year if, during that tax year:

- The individual is entitled to benefits based on blindness or disability under the Social Security disability insurance program (title II of the Social Security Act) or the SSI program (title XVI of the Social Security Act),
-

and that blindness or disability occurred before the date on which the individual reached age 26, (Code Sec. 529A(e)(1)(A)) or

- A disability certification for the individual has been filed with IRS for the tax year. (Code Sec. 529A(e)(1)(B))

A disability certification is one made by the eligible individual, or his parent or guardian, that certifies that:

1. The individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind, within the meaning of Sec. 1614(a)(2) of the Social Security Act (Code Sec. 529A(e)(2)(A)(i)(I)), and
2. That blindness or disability occurred before the date on which the individual attained age 26. (Code Sec. 529A(e)(2)(A)(i)(II))

The certification must include a copy of the individual's diagnosis relating to the individual's relevant impairment(s), signed by a licensed physician meeting the criteria of Sec. 1861(r)(1) of the Social Security Act. (Code Sec. 529A(e)(2)(A))

Designated beneficiaries can open an ABLE account by certifying, under penalties of perjury, that (1) they meet the qualification standards, including their receipt of a signed physician's diagnosis (if necessary), and (2) they will retain that diagnosis and provide it to the program or the IRS on request. Eligible individuals with disabilities will not need to provide the written diagnosis when opening the ABLE account, and ABLE programs will not need to receive, retain, or evaluate detailed medical records (Notice 2015-81).

Annual Re-certification **-** A qualified ABLE program generally must require annual re-certifications that the beneficiary continues to satisfy the definition of an eligible individual. However, a qualified ABLE program may deem an annual re-certification to have been provided in appropriate circumstances. For example, a qualified ABLE program may permit certification by an individual that he or she has a permanent disability (Prop Reg § 1.529A-2(d)(2)).

Contributions - Eligible individuals will be limited to one ABLE account, and:

- *Total annual contributions*
  - **Prior to 2018** - Total annual contributions by all individuals (including the beneficiary) to any one ABLE account was lmited to no more than the gift tax exclusion amount, which is subject to annual inflation adjustment, and was $14,000 for 2017.
  - **Post 2017 –** The annual limit by all individuals (including the beneficiary) to any one ABLE account continues to be limited to no more than the gift tax exclusion amount, which is $15,000 for 2018 and 2019.

    TCJA

    However, beginning in 2018 and through 2025, TCJA added a provision allowing the beneficiary of the ABLE account to contribute a maximum additional amount equal to the lesser of:

    - The beneficiary's taxable compensation for the year, or
    - The prior year's poverty level for a one-person household.

    The 2018 poverty level for a one-person household was $12,140, which means for 2019, the beneficiary can contribute an additional amount equal to the smaller of the beneficiary's taxable compensation or $12,140.

  CAUTION: Even if a contributor limits his or her contributions to an ABLE account to no more than the annual gift tax exclusion amount, if the contributor has made other gifts (other than direct gifts to providers for medical or schooling) to the ABLE account beneficiary during the year, the gift tax return filing requirement will be triggered.

- *Aggregate contributions* - Aggregate contributions are subject to the State limit for education-related Section 529 accounts. The proposed regulations provide a safe harbor that permits a qualified ABLE program to satisfy the requirement regarding total cumulative contributions if the program prohibits any additional contributions to an account as soon as the account balance reaches the specified contribution limit under such state's program established under Code Sec. 529. Once the account balance falls below the prescribed limit, contributions may resume, subject to the same limitation. Note, however, that if the account balance exceeds $100,000, certain federal benefits will be adversely impacted – see "ABLE Accounts and Other Federal Programs" below.
- *Excess contribution penalty* - The proposed regulations provide that a qualified ABLE program must return contributions in excess of the annual gift tax exclusion (excess contributions) to the contributor(s), along with all net income attributable to those excess contributions. A failure to return excess contributions that exceed the annual gift tax exclusion within the allotted time period will result in the imposition on the designated beneficiary of a six-percent excise tax under Code Sec. 4973(a)(6) on the amount of excess contributions.

- *Contributions by other than the designated beneficiary* - The proposed regulations provide that contributions to an ABLE account by a person other than the designated beneficiary are treated as completed gifts to the designated beneficiary of the account, and that such gifts are neither gifts of a future interest nor a qualified transfer under Code Sec. 2503(e).
- *Contributors* - ABLE programs will not need to request the taxpayer identification numbers (TINs) of contributors to an ABLE account at the time the contribution is made, provided that the program has a system in place to reject contributions exceeding the annual limits. However, if an excess contribution is made into an ABLE account, the program will need to request the contributor's TIN (Notice 2015-81).
- TCJA **Saver's Credit –** For years 2018 though 2025 TCJA allows the beneficiary's additional contribution to qualify for the non-refundable saver's credit. The amount of credit depends on the beneficiary's actual income and can be 10%, 20% or even as much as 50% of up to the first $2,000 contributed, for a maximum credit of $1,000. See chapter 9.07 for additional details related to the saver's credit.

Comment: *The saver's credit is based in part on earned income of the taxpayer. For that reason, only the beneficiary's contribution up to the amount of additional contribution described above counts towards the saver's credit.*

- TCJA **Sec 529 Plan Rollovers** - The Act also provides that a distribution from a Sec 529 qualified tuition plan account is tax-free and penalty-free provided it, within 60 days, is rolled over to an ABLE account of the same designated beneficiary or a member of the designated beneficiary's family. This rollover provision is only available through 2025. The amount of the rollover is limited, when combined with other contributions, to the annual maximum.

For this purposes, a member of the family means, with respect to any designated beneficiary, the taxpayer's: (1) spouse; (2) child or descendant of a child; (3) brother, sister, stepbrother or stepsister; (4) father, mother or ancestor of either; (5) stepfather or stepmother; (6) niece or nephew; (7) aunt or uncle; (8) in-law; (9) the spouse of any individual described in (2)-(8); and (10) any first cousin of the designated beneficiary. (H.R. 1 [TCJA] Conference Committee Report)

Example: Bill, who finished school and graduated, still has $8,000 in his Sec 529 qualified tuition plan that his parents had set up to pay his college tuition. Bill will no longer have any education expenses, so Bill rolls the balance of his Sec 529 plan into his 14-year-old blind niece's ABLE account within the 60 days allowed. There is no tax or penalties on the rollover. However, since contributions to the ABLE account are limited to $15,000 (2019), others may only contribute an additional $7,000 ($15,000 - $8,000) to the niece's ABLE account.

ABLE Account Rollovers - ABLE accounts generally will be eligible to be rolled over only into another ABLE account for the same individual or into an ABLE account for a sibling who is also an eligible individual. Only one rollover per 12-month period is allowed.

Distributions - Distributions, including portions attributable to investment earnings generated by the account, to an eligible individual for qualified expenses are not taxable. Distributions used for non-qualified expenses are subject to income tax on the portion of such distributions attributable to earnings from the account, plus a ten percent penalty on the taxable portion (Prop Reg § 1.529A-3(a)).

Limitation on Number of Accounts - Except with respect to rollovers and program-to-program transfers, no designated beneficiary may have more than one ABLE account in existence at the same time. (Prop Reg § 1.529A-2(c)(2))

Signature Authority - A person other than the beneficiary with signature authority over the account of the beneficiary (for example, a parent or guardian or an individual holding a power of attorney) must not have, nor acquire, any beneficial interest in the account during the designated beneficiary's lifetime and must administer the account for the benefit of the beneficiary. (Prop Reg § 1.529A-2(c)(3))

Qualified Expenses - Proposed regulations provide that qualified disability expenses are expenses that relate to the designated beneficiary's blindness or disability and are for the benefit of that designated beneficiary in maintaining or improving his or her health, independence, or quality of life. (Code Sec. 529A(e)(5)). They include:

- Education,
- Housing,
- Transportation,
- Employment training and support,
- Assistive technology
- Personal support services,
- Health, prevention, and wellness,

- Financial management and admin services,
- Legal fees,
- Expenses for oversight and monitoring,
- Funeral and burial expenses, and
- Other expenses that are approved under IRS regs and consistent with the purposes of Code Sec. 529A(e)(5)

Safeguards - ABLE programs will not need to include safeguards to determine which distributions are for qualified disability expenses, nor will they be required to identify distributions that will be used for housing expenses (Notice 2015-81).

Change of Beneficiary - A change in the beneficiary of an interest in a qualified ABLE program during a tax year isn't treated as a taxable distribution if the new beneficiary is both an eligible individual for the tax year and a member of the family of the former beneficiary. (Code Sec. 529A(c)(1)(C)(ii)). Member of the family for this purpose means a sibling, whether by blood or by adoption, and includes a brother, sister, stepbrother, stepsister, half-brother, and half-sister. (Prop Reg § 1.529A-1(b)(13))

Death of the Beneficiary - Upon the death of an eligible individual, any amounts remaining in the account (after reimbursement, see below) would go to the deceased's estate or to a designated beneficiary and would be subject to income tax on investment earnings, but not on the principal.

Reimbursement (Transfer to State (Code Sec. 529A(f))) - Upon the designated beneficiary's death, any State may file a claim (either with the person with signature authority over the ABLE account or the executor of the designated beneficiary's estate as defined in section 2203) for the amount of the total medical assistance paid for the designated beneficiary under the State's Medicaid plan after the establishment of the ABLE account. The amount paid in satisfaction of such a claim is not a taxable distribution from the ABLE account. Further, the amount is to be paid only after the payment of all outstanding payments due for the qualified disability expenses of the designated beneficiary and is to be reduced by the amount of all premiums paid by or on behalf of the designated beneficiary to a Medicaid Buy-In program under that State's Medicaid plan.

Effective Date - The legislation creating ABLE Accounts is effective for tax years beginning after December 31, 2014.

ABLE Accounts and Other Federal Programs - An individual with an ABLE account can maintain eligibility for means-tested benefit programs such as SSI and Medicaid if his or her ABLE account balance is under $100,000. The first $100,000 in an ABLE account is not counted toward the SSI program's $2,000 individual resource limit; however, account distributions for housing expenses are counted as income for SSI purposes. Assuming the individual has no other assets, if the balance of an individual's ABLE account exceeds $102,000, the individual would be suspended from eligibility for SSI benefits but would remain eligible for Medicaid. States will be required to recoup certain expenses through Medicaid upon the death of the individual.

ABLE Accounts and Bankruptcy – Contributions to an ABLE account by a parent or grandparent of a designated beneficiary are protected in the case of bankruptcy. In order to be protected, ABLE account contributions must be made more than 365 days prior to the bankruptcy filing.

IRS Forms – The IRS has developed two forms that ABLE account programs will use to report relevant account information annually to designated beneficiaries and the IRS — Form 1099-QA for distributions and Form 5498-QA for contributions.

CALIFORNIA DIFFERENCES

ABLE accounts are state established programs authorized under Federal tax lawLegislation (SB 324) was passed by the California legislature and signed by the governor establishing the CalABLE program (new R&TC Section 17140.4). CalABLE accounts are effective January 1, 2016.

AB 91 (signed by the governor 6/27/2019) generally conforms CA law to the changes relating to qualified ABLE accounts made by the TCJA and the Consolidated Appropriations Act of 2016. Thus, California conforms to the TCJA provision allowing ABLE account beneficiaries to contribute their own earnings, up to an amount equal to the federal poverty level amount, to their own account.

New Law & Stuff

However, AB91 does not provide for a tax-free rollover from a 529 plan to an ABLE account.

The CalABLE website is: https://calable.ca.gov/

NOTES

MOVING EXPENSES

Overview

Distance Test: 50 Miles (Greater driving distance from old home)
Time Test:
- Employee: Full time **39 weeks of first 52 weeks.**
- Self-Employed: **39 weeks of first 52 weeks** plus **78 weeks of first 104 weeks.**
- Exceptions: Death, disability, layoff, or transfer.

2019 Mileage Rate: 20 cents per mile
Domestic Moving Deduction Suspended 2018 thru 2025 except active duty military pursuant to military order
Employer Reimbursement: Taxable 2018 - 2025

RAPID FINDER

Pubs Forms

Related IRC and IRS Forms and Publications
- **Pub 521** – Moving Expenses
- **Pub 54 –** Tax Guide for U.S. Citizens and Resident Aliens Abroad (for Foreign Moves)
- **Form 3903** – Moving Expenses
- **IRC Sec 217**
- **IRC 911** – Foreign Moves

New Law & Stuff

TCJA CHANGES	**See Page**
Moving expenses suspended 2018-2025	6.01.01
Transitional relief 2017 expenses reimbursed in 2018	6.01.03
Employer moving reimbursement taxable 2018-2025	6.01.03

The Details

Before 2018 and after 2025, taxpayers who move because of a change of work location may deduct certain related expenses. The moving expense deduction is available for both employees and self-employed individuals if specific conditions are met; this includes taxpayers starting their first job. When moving expenses exceed reimbursements, the excess is an adjustment to gross income.

TCJA

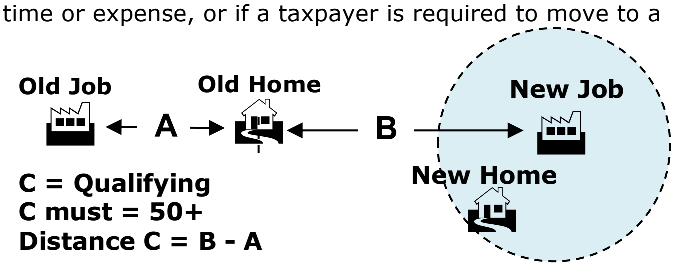
Exception: This provision continues to apply in 2018 through 2025 for moving expenses of members of the Armed Forces on active duty who move pursuant to a military order. (IRC Sec 217(k), added by TCJA)

DEDUCTION QUALIFICATIONS

(1) Generally, moving expenses must be incurred within a time frame which is closely related to the start of the new job. Expenses within ONE YEAR after starting work at the new location are generally acceptable. Rev Rul 78-200 allowed thirty months between job-start and family move because a child in the family was finishing a stage of his education.

(2) To qualify, the move should be to the VICINITY OF THE NEW JOB LOCATION. A taxpayer usually cannot meet this test if the distance to the new job from the new residence is farther than to the new job from the old residence. This test will not apply if the move reduces commuting time or expense, or if a taxpayer is required to move to a new home by an employer.

(3) **The distance requirement:** The distance to the new job from the old home must be at least 50 miles farther than to the old job from the old home. That is, if the taxpayer did not move, the new commute would be 50 miles longer than the old commute. If there was no previous job, measure the distance from the previous residence to the new job.



Example - Moving Distance Test Violated: *In 2017 Lance lived in Lakewood but commuted 60 miles to his job in Longview. He got a new job and moved to Lincoln, which is 90 miles from Lakewood. Since the difference between the old commute and the new commute is only 30 miles, the move is not qualified under the distance test.*

Example - Moving Distance Test Met: *In 2017 Rita lived in Reno and commuted each day to her job in Riverton, a distance of 30 miles. She got a new job and moved to Rapid City, which is 90 miles from Reno. The difference between the old 30-mile commute and the distance from the old home to the new job (90 miles) is 60 miles. This move qualifies under the distance test.*

(4) **The time test:** To meet this test,

- An **EMPLOYEE** must work in the area of the new job **FULL-TIME** for **39 weeks (9 months) out of the first 52 weeks.**
- A **SELF-EMPLOYED** person must work FULL TIME for **39 weeks in the first year** after the move **AND 78 Weeks in the first two years.**

Only one spouse must qualify, but the time test cannot be met by adding the weeks worked by one spouse to the weeks worked by the other spouse. It is not necessary to work for the same employer the whole time.

Exceptions to the time test: The moving expense deduction is allowed if the taxpayer could "reasonably have expected" to fulfill the time requirements but was prevented by:

- Death, Disability,
- Job lay-off, or
- Transfer by his/her employer.
- Allowances are also made for work missed:
  - Because of its SEASONAL NATURE, if the off-season is less than six months and is provided for in the employment agreement (for example, a teacher);
  - For INVOLUNTARY ABSENCES (illness, strike, etc.);
  - For TEMPORARY ABSENCES such as vacation.

If the time test requirement has not been completed when the return is due, the taxpayer can either go ahead and claim the deduction (and amend if the time test ends up not being met) OR can wait and amend the return after the requirement is met.

(5) **Armed forces:** There is no distance or time requirement on a permanent change of station (PCS). If a spouse and dependents of the taxpayer move to or from a different location than the military person, the two moves are treated as one.

(6) **Foreign Moves**

U.S. to a Foreign Country – The expenses of moving from the U.S. or its possessions to a new principal place of work outside the U.S. or its possessions include the reasonable expenses (no dollar ceiling) listed below, but **the expenses may be limited** if the employee also qualifies for the foreign earned income or foreign housing exclusions.

Moving expenses aren't deductible to the extent allocable to exempt foreign-source earned income. In the absence of evidence to the contrary, reimbursement of expenses to move to a foreign country is attributed to future services to be performed at the new place of work. (Reg § 1.911-3(e)(5)(i))

The reimbursement for a foreign move is considered earned solely in the year of the move if the taxpayer qualifies for the earned income exclusion for at least 120 days of the year of the move. If not, the reimbursement must be allocated between the first and second years. See IRS Pub 54 for details related to moving to a foreign country.

Foreign Country to U.S. – If an individual otherwise meets the moving requirements, a move from a foreign country to the U.S. is allowed. Moving expense reimbursement included in income is generally considered to be U.S. source income and the general moving rules will apply. However, if the employer by agreement or company policy provides reimbursement regardless of continued employment with the employer, the reimbursement is considered compensation for past services performed in the foreign country.

(7) **Strategy** - Moving expenses can be deducted in the year they were paid or incurred OR if reimbursed, in the year in which reimbursement is received (as long as the expense is paid before the extended due date of the return).

Strategies

This provides an opportunity to pick the best year for deducting the expenses. (Code Sec. 217(d)(2); Reg § 1.217-2(a)(2)) The taxpayer can also wait until the applicable condition is satisfied; then file an amended return claiming the deduction for the tax year the moving expense was paid or incurred. (Reg § 1.217-2(d))

DEDUCTIBLE EXPENSES AND OTHER LIMITATIONS

Direct expenses to move family and household goods have no dollar limit, but the move must be made by a direct route using the shortest usual time between the locations involved. Only moving expenses which are **reasonable** under the circumstances are deductible. Expenses of moving household goods from a place other than a taxpayer's former home are deductible up to the amount it would have cost to move them from the former home. "Family" includes the people who live with the taxpayer at both the old and the new residence, EXCEPT tenants or employees (unless they are the taxpayer's dependents). Expenses allowed are:

- Shipping,
- Moving Van,
- Truck rental,
- Travel (transportation and lodging, not meals),
- Packing,
- Insurance and in-transit storage,
- Moving pets,
- Passports, and
- Utility connection/disconnection charges.

Car Expenses - To deduct car expenses, use either the standard mileage rate for moving plus parking and tolls OR actual expenses for gas, oil, repairs, parking, tolls (no depreciation, casualties, or capital expenditures).

Standard Auto Rates

2014	2015	2016	2017	2018	2019
23.5	23.0	19.0	17.0	18.0	20.0

If an amount not shown it was not available at publication date.

In-Transit Storage Expenses – In-transit storage and insurance expenses are deductible if incurred within any consecutive 30-day period after removal of the goods and personal effects from the old residence and before delivery to the new residence. Storage costs other than for in-transit storage aren't deductible unless a foreign move is involved. For a foreign move, the cost of storing household goods and personal effects is allowed for all or part of the time while the new job location remains the taxpayer's main job location.

Nondeductible Expenses - Pre-move house hunting costs, temporary living expenses at the new location, loss on sale of a home, and expenses of sale or purchase or lease of a residence are not deductible. Other nondeductible expenses include the cost of a driver's license and car registration at the new location, security deposits, and losses of disposing of club memberships. (2018 Pub 521, pg 4)

MOVING EXPENSE REIMBURSEMENT

TCJA

Armed Forces members and other taxpayers before 2018 and after 2025

Reimbursements to employees or self-employed individuals which aren't for "qualified moving expenses" must be included in their gross income as compensation. A qualified moving expense reimbursement is one received for a **deductible** moving expense--such reimbursements do not have to be included in income. However, no deduction is allowed for any moving expenses for which nontaxable reimbursement is received.

Employer reimbursements for an employee's moving expenses are treated as fringe benefits excludable from an employee's gross income and wages if the:

- Expenses would be deductible by the employee if he or she had directly paid or incurred the expenses; and
- Employee did not deduct the expenses in a prior year.

Reimbursements should be made under rules similar to those relating to an accountable expense reimbursement plan.

As far as **W-2 reporting** goes, reimbursements that qualify as excludable from income are not reported in Box 1 of the W-2; they must, however, be reported in Box 12 for informational purposes. They should be coded "P" to identify them as nontaxable reimbursements.

Reporting the Taxpayer's Moving Expenses and Reimbursements
(Armed Forces members for all years and other taxpayers before 2018 & after 2025)

IF the Form W-2 shows...	AND the taxpayer has...	THEN...
Reimbursement is reported only in box 12 with code P	Moving expenses greater than the amount in box 12	file Form 3903 showing all allowable expenses and reimbursements.
Reimbursement is reported only in box 12 with code P	Moving expenses equal to the amount in box 12	do not file Form 3903.
Reimbursement is divided between box 12 and box 1	Moving expenses greater than the amount in box 12	file Form 3903 showing all allowable expenses, but only the reimbursements reported in box 12.
The entire reimbursement reported as wages in box 1	Moving expenses	file Form 3903 showing all allowable expenses, but no reimbursements.
No reimbursement	Moving expenses	file Form 3903 showing all allowable expenses

TCJA

Taxpayers other than Armed Forces Members for years 2018 through 2025

Employer reimbursement of qualified moving expenses is no longer tax-free; the reimbursements will be treated as taxable income. (Sec 132(g)(2), as amended by TCJA)

Transitional Relief - The IRS has provided transitional relief for employee moving reimbursements received in 2018 for moving expenses incurred prior to 2018. These reimbursements continue be excluded from employee income and deductible as a fringe benefit by the employer. (IR 2018-190)

CALIFORNIA DIFFERENCES

California conforms to the pre-TCJA Federal treatment of moving expenses as an adjustment to income.

Part-Year CA Residents - The following rules apply to part-year residents. If the taxpayer moved:

- *Into California* in connection with a new job, the moving expenses are deductible. When completing the Part-Year Resident Schedule CA for a military taxpayer, enter the amount from column A, line 26, in column E, line 26*. For non-military taxpayers prepare federal Form 3903, Moving Expenses, using California amounts. If there are excess moving expense reimbursements, enter the amount of moving expenses from line 3 of federal Form 3903 on Schedule CA (540NR), line 26, column C. If reimbursements are less than the moving expenses, enter the amount of moving expenses from line 5 of federal Form 3903 on Schedule CA (540NR), line 26, column C.
- *Out of California* in connection with a new job, the moving expenses are not deductible in CA. When completing the Part-Year Resident Schedule CA, enter zero on line 26*, column E.

  Exception: If the taxpayer moved out of California in connection with a new job and received compensation from that job attributable to a California source, the moving expense adjustment will be limited by the ratio of California source compensation from the new job to total compensation from the new job.

  ** 2018 version of Sch CA (540NR)*

A taxpayer moving into California who has taxable moving expense reimbursement will treat that income as California-source income, while a taxpayer moving out of California who is not a California resident after the move would treat any taxable moving expense reimbursement as non-California source income.

NOTES

HIGHER EDUCATION LOAN INTEREST

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Overview

- Maximum Annual Deduction: **$2,500**
- On Behalf Of: **Taxpayer, spouse or dependent**
- Paid or Incurred: Reasonable time before or after expense
- Eligible Student: At least **half time**
- **2019 Phase-out:**
  - Unmarried: $70,000 - $85,000
  - Married Taxpayers: $140,000 - $170,000
  - MS or Dependent of Another: Not allowed
- **Loans that qualify (cannot be mixed use):**
  - Government backed student loans
  - Home equity loans
  - Credit card debt

Pubs Forms

Related IRC and IRS Publications and Forms

- **Pub 970** – Tax Benefits for Education
- **Form 1098-E** – Student Loan Interest Statement
- **Form W-9S** – Request for Student's or Borrower's Social Security Number and Certification
- **IRC Sec 221**

Strategies

Strategy - Within the AGI limits, up to $2,500 of interest on debt to finance higher education is deductible as an adjustment to AGI. Generally, taxpayers perceive this debt to be Government Student Loans. However, this is not the only debt whose interest will qualify for this deduction.

Thus, virtually any debt, including credit card (if used only for education expenses) and home equity debt may qualify (however, see "Home Equity Debt and the Unsecured Election" in this course). Counsel your clients who already have or are likely to borrow for higher education expenses on how debt other than Government Loans can qualify for the deduction. Don't overlook existing debt they have that qualifies.

The Details

MAXIMUM DEDUCTION:

An "above-the-line" deduction (i.e., a deduction for AGI) is allowed for interest payments due and paid on any "qualified student loan," regardless of when a taxpayer first incurred the loan. The maximum deduction per year is $2,500. This is a per return limit, not a per student limit.

QUALIFIED STUDENT LOAN:

A "qualified student loan" is generally one used to pay qualified higher education expenses, i.e., tuition, room and board, and related expenses for attending post-secondary educational institutions, including certain vocational schools, and certain institutions offering postgraduate training. In addition, the expenses must be:

- Incurred on behalf of the taxpayer, spouse, or any dependent of the taxpayer (at the time the loan is incurred), and
- Paid or incurred within a reasonable period of time before or after the debt is incurred, and
- Used for education when the recipient was an eligible student.

"Reasonable period of time" safe harbor - What constitutes a reasonable period of time generally is determined based on all the relevant facts and circumstances. However, qualified expenses are treated as paid or incurred within a reasonable period of time before or after the taxpayer incurs the debt if:

- The expenses are paid with proceeds of a loan from a federal postsecondary education loan program; or
- The expenses relate to a particular academic period and the loan proceeds used to pay the expenses are disbursed within a period that begins 90 days prior to the start of, and ends 90 days after the end of, that academic period. ***(Reg. § 1.221-1(e)(3)(ii))***

A qualified education loan includes a debt used solely to refinance a qualified education loan. Thus, if a qualified student loan is refinanced for more than the original loan, and the additional amount is used for any purpose other than qualified education expenses, none of the interest paid on the refinanced loan is deductible because it then becomes a mixed-use loan. A qualified education loan doesn't include any debt owed to a person who is related to the taxpayer within the meaning of ***§267(b)*** or ***§707(b)(1)*** (controlled partnerships). For example, any of the following loans would qualify so long as the proceeds were used **SOLELY** for the "qualified purpose" (i.e., **mixed use loans don't qualify**

Loans that would qualify:	**Loans that do not qualify:**
Government backed student loans	Loans from related parties
Home equity loans [1]	Pension plan loans
Credit card debt	**Loans that may not qualify**
Personal loans from unrelated parties	Life insurance loans
Private loans from banks or other institutions	

(1) But see "No Double Benefit" in this chapter

If a loan is not subsidized, guaranteed, financed, or is not otherwise treated as a student loan under a program of the Federal, state, or local government or an eligible educational institution, a payee (lender) must request a certification from the payor (borrower) that the loan will be used solely to pay for qualified higher education expenses. ***(Reg. 1.6050S-3(e)(2))*** Form W-9S, Request for Student's or Borrower's Social Security Number and Certification, is provided by IRS for this purpose.

Capitalized interest is deductible as qualified education loan interest. Capitalized interest, for purposes of § 221, means any accrued and unpaid interest on a qualified education loan that, per the terms of the loan, is added by the lender to the outstanding principal balance of the loan.

Loan origination fee – A one-time fee charged by the lender when the education loan is made is deductible as education loan interest but must be amortized over the term of the loan as payments are made. To qualify as education loan interest, the loan origination fee must be for the use of money and not for services such as processing the loan. The loan origination fee does not have to be reported on Form 1098-E for it to be deductible over the loan's term.

QUALIFIED EDUCATIONAL EXPENSES:

To qualify as an eligible loan, it must have been taken out solely to pay the costs of attending an eligible educational institution for an individual during a period in which the individual is a qualified student. Eligible costs include:

- Tuition
- Fees
- Other necessary expenses (including transportation)
- Room and board
- Books and equipment

Such expenses must be reduced by the following:

- Income excluded from ***employer-provided educational assistance***,
- Income excluded from ***U.S. savings bonds*** used to pay higher education expenses,
- Nontaxable distributions from ***Coverdell ESAs***, and
- ***Scholarships, allowances, or other payments*** (such as distributions from Sec. 529 plans) that are excludable from gross income.

Eligible educational institution....includes colleges, universities, and vocational schools eligible to participate in the Department of Education student aid programs (in other words, virtually all accredited public and private post-secondary schools). In addition, institutions conducting internship or residency programs leading to degrees or certificates awarded by an institution of higher education, a hospital, or a healthcare facility which offers postgraduate training also qualify.

Eligible student....is one enrolled in a degree or certificate program and who is at least a half-time student. What constitutes half the normal course load will be determined by the definition of the school being attended. Generally, a full-time student is one carrying at least 12 units.

MODIFIED AGI PHASE OUT: The phase out AGI is inflation adjusted in $5,000 increments.

Filing Status	2014-16	2017	2018	2019	2020
Unmarried Filing Status	65K – 80K	65K – 80K	65K – 80K	70K - 85K	70K - 85K
Joint Filing Status	130K–160K	135K–165K	135K-165K	140K-170K	140K-170K
Married Separate	Not Allowed	Not Allowed	Not Allowed	Not Allowed	Not Allowed
Dependent of Another	Not Allowed	Not Allowed	Not Allowed	Not Allowed	Not Allowed

Modified AGI means AGI determined <u>without regard</u> to: the deduction for qualified education loan interest (§221), the foreign earned income and foreign housing exclusions and foreign housing deduction (§911), the exclusion of income from U.S. possessions (§931), the exclusion of income from Puerto Rico (§933), the qualified higher education tuition and fees deduction (§222) (expired after 2017 but may be extended by Congress), and before 2018 the domestic production activities deduction (§199) (repealed for years after 2017).

The inclusion in income of social security and Tier 1 Railroad Retirement Benefits, with the deduction for qualified retirement contributions, and the limitations on passive activity losses and credits, are determined without regard to the deduction allowed for qualified education loan interest.

<u>WHO CLAIMS THE DEDUCTION:</u> A taxpayer must have a legal obligation to make the interest payments under the terms of the education loan to qualify to deduct the education interest ***(Reg. § 1.221-1(b)(1)).*** No education interest deduction is permitted to a taxpayer who is a dependent of someone else ***(Reg. § 1.221-1(b)(2)).***

> ***Example – Legal Obligation and Dependency:*** *Alice pays $750 of student loan interest during the tax year. Alice is the only person obligated to make the payments. Her parents claim her as a dependent on their return. Alice isn't able to deduct the student loan interest because she was claimed as a dependent by her parents; the parents can't deduct the interest because they are not legally liable for the debt.*

If a third party who is not legally obligated to make an interest payment on an education loan pays the interest on behalf of the borrower who is legally obligated to make the payment, then the borrower is treated as receiving the payment from the third party and, in turn, paying the interest ***(Reg. § 1.221-1(b)(4)).***

> ***Example – Legal Obligation and Not a Dependent:*** *If Alice from the prior example was not claimed as a dependent by her parents, she would be eligible to claim a deduction for the student loan interest she paid. Of course, if she had no income and wasn't required to file, or had to file but had no tax liability, Alice wouldn't get any benefit from the deduction.*

<u>NO DOUBLE BENEFIT</u>: No deduction is allowed under this provision for any amount for which a deduction is allowable under any other Code provision. *<u>If a deduction for interest on a loan for education expenses is allowable under another provision of the Code, apparently the taxpayer must claim the deduction under that provision even though it may be less advantageous to the taxpayer.</u>*

> ***Example – Home Equity Loan*** *- An example of a deduction allowable under another provision might be where a home equity loan is taken out to pay education expenses. However, if the election is made not to treat the loan as qualified home mortgage debt, and the home equity loan were taken out solely for the purpose of paying qualified education expenses, the interest on the loan should qualify for the student loan interest deduction. Note: For years 2018 through 2025 interest paid on home equity debt is generally not deductible for federal as Schedule A home mortgage interest unless the funds were used to make improvements to the home.*

If an individual takes out two separate education loans and the interest on one loan qualifies for deduction under Code § 221, while interest on the other loan qualifies for deduction under some other Code provision, presumably the individual can still take an above-the-line deduction for the maximum amount allowed by the higher education interest rules. The interest deductible under the other provision would not be taken into account in determining whether the maximum deduction allowed under § 221 rules is reached.

<u>NHSC LOAN REPAYMENT AWARDS ARE TAX EXEMPT</u>: The National Health Services Corps (NHSC) loan repayment program provides payment of student loans for participants who provide certain services in areas where shortages of these services exist. NHSC loan repayment awards are exempt from federal income taxes. Thus, individuals will qualify to exclude amounts they received to repay their student loans in exchange for two years serving in a NHSC approved service site.

<u>FORM 1098-E:</u> A financial institution, governmental unit, educational institution or any other person who, in the course of its trade or business, receives $600 or more of student loan interest during the year must file Form 1098-E with the IRS. A copy of it, or an acceptable substitute, must be provided to the borrower. Note, however, that the amount of the interest reported on Form 1098-E may not be fully deductible, or deductible at all.

Continue to next page for CA differences

CALIFORNIA DIFFERENCES

California conforms to the federal student interest deduction (with one exception for a spouse/RDP of a non-California domiciled military taxpayer residing in a community property state – see worksheet in the instructions to Schedule CA (540)).

New Law & Stuff

AB 91 (signed by the governor 6/27/2019) conforms California law to the TCJA provision that certain student loan debt cancelled upon the death or disability of the student is not taxable, effective for loans cancelled after December 31, 2018**. Note:** That means for 2018, CA did not conform.

California law (R&TC Sections 17131 and 17024.5) also exempts NHSC loan repayment awards from California income taxes.

NOTES

FOREIGN EARNED INCOME EXCLUSION

U.S. citizens or resident aliens of the United States who live abroad are taxed on their worldwide income. However, they may qualify under IRC § 911 to exclude from income foreign earnings not to exceed an annual maximum amount. In addition, taxpayers may be able to exclude or deduct certain foreign housing cost amounts.

- To qualify for this exclusion, a taxpayer must:
  - Have foreign earned income,
  - Have a "tax home" in a foreign country, and
  - Be one of the following:
    a. A U.S. citizen who is a ***bona fide resident*** of a foreign country for an uninterrupted period that includes an ***entire tax year***, or
    b. A U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a ***bona fide resident*** of a foreign country or countries for an uninterrupted period that includes an ***entire tax year***, or
    c. A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least ***330 full days during any period of 12 consecutive months***.
- **First/Last years** – Generally the first and last years qualify under the physically present rules.
- **Annual Exclusion Limit** – is inflation adjusted and is $105,900 for 2019.
- **Housing allowance limit** –The limit is the expense in excess of 16% of the exclusion amount for the year and capped at 30% of the taxpayer's exclusion amount for the year (higher cap if expenses incurred in designated high-cost location).
- **Taxpayer's other income** – taxed at marginal rates determined without the exclusion.
- **Earned income –** can be from a foreign or domestic company.
- **Spouse –** may qualify separately.
- **Credit Limitations –** Taxpayers that claim the foreign earned income exclusion are not eligible to claim the earned income tax credit (EITC) or the refundable part of the child tax credit.

RAPID FINDER

Related IRC and IRS Publications and Forms
- **Form 2350 –** Application for Extension of Time to File U.S. Tax Return
- **Form 2555 –** Foreign Income Exclusion
- **Form 2555EZ –** Foreign Income Exclusion
- **Pub 54** – Tax Guide for U.S. Citizens and Resident Aliens Abroad
- **Pub 514** – Foreign Tax Credit for Individuals
- **IRC Sec 911**
- **Notice 2019-24 –** 2019 Elective Housing Allowances

Foreign Earned Income Exclusion — ClientWhys™

The Details

A U.S. citizen's or resident alien's worldwide income generally is subject to U.S. income tax regardless of where the taxpayer is living. However, taxpayers are allowed to exclude from their income a certain amount of foreign earned income and housing allowance if they meet certain requirements while living abroad. The following is a table of the annual limits for this exclusion for recent years followed by qualifications and exclusion computation details.

HISTORICAL EXCLUSION LIMITS

Tax Year	2015	2016	2017	2018	2019	2020
Maximum Exclusion	100,800	101,300	102,100	103,900	105,900	107,600
Housing Daily Base Amount	44.19	44.28(2)	44.76	45.55	46.42	47.04(2)
Housing Annual Base	16,128	16,208	16,336	16,624	16,944	17,216
Housing 30% Cap (1)	30,240	30,390	30,630	31,170	31,770	32,280
Max Housing Exclusion (3)	14,112	14,182	14,294	14,546	14,826	15,064
High Cost Area Listings – Notice #(3)	2015-33	2016-21	2017-21	2018-44	2019-24	

If any amount or Notice number is not shown, it is not available at publication date

The amounts shown (other than the Housing Daily Base Amt.) are for a full year. These amounts must be prorated by the day for taxpayers who only qualify for a partial year.

(1) The housing exclusion is capped at 30% of the earned income exclusion except in what is deemed to be high cost areas (see IRS tables found in the notices listed in the above table) in which case the cap is increased for the specific area. The base amount is equal to 16% of the annual exclusion amount.

(2) Leap Year (366 days)

(3) The IRS is authorized to adjust limitations for high cost areas. Please check the table in the applicable IRS notice before using the standard amounts listed above.

THE EXCLUSION AND MARGINAL TAX RATES

Prior to 2006, both the exclusion and the additional housing allowance where deducted off-the-top. In other words they were excluded at the taxpayer's top tax bracket. However beginning in 2006 the exclusion is taken off the bottom or at the taxpayer's lowest tax bracket leaving the taxpayer's other income to be taxed at the taxpayer's top marginal rates. Result: the taxpayer's "other" income is taxed at higher rates in post-2005 years. A worksheet for calculating the tax is provided in the current year instructions to Form 1040.

REQUIREMENTS TO CLAIM EXCLUSION/DEDUCTION

To claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, a taxpayer must:

- Have foreign earned income,
- Have a "tax home" in a foreign country, and
- Be one of the following:
  a. A U.S. citizen who is a ***bona fide resident*** of a foreign country for an uninterrupted period that includes an ***entire tax year***, or
  b. A U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a ***bona fide resident*** of a foreign country or countries for an uninterrupted period that includes an ***entire tax year***, or
  c. A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least ***330 full days during any period of 12 consecutive months***.

TAX HOME

Tax home is the general area of a taxpayer's main place of work (as employee or self-employed), regardless of where the taxpayer maintains his/her family home. A taxpayer is not considered to have a tax home in a foreign country for any period in which his/her abode is in the U. S. "Abode" has been defined as one's home, habitation, residence, domicile, or place of dwelling. "Abode" has a domestic rather than a vocational meaning and does not mean the same thing as "tax home." The location of abode often depends on where a taxpayer has economic, family, and personal ties.

Example - Abode vs. Tax Home: *Ima Way is employed on an offshore oil rig in the territorial waters of a foreign country and works a 28-day on/28-day off schedule. She returns to her family home in the United States during off periods. Ima is considered to have an abode in the United States and does not satisfy the tax home test in the foreign country. She cannot claim either of the exclusions or the housing deduction.*

Exception **-** The Bipartisan Budget Act of 2018 changed the tax home requirement for contractors or employees of contractors supporting the U.S. Armed Forces in designated combat zones. These individuals may now qualify for the foreign earned income exclusion even if their "abode" is in the United States. The new law applies for tax year 2018 and subsequent years. See "Combat Zone Workers" below.

FOREIGN COUNTRY

The term foreign country usually means any territory (including the air space and territorial waters) under the sovereignty of a government other than that of the U. S. It doesn't include Puerto Rico, Guam, Commonwealth of the Northern Mariana Islands, Virgin Islands, or U.S. possessions such as American Samoa.

Cuba and Guantanamo Bay – Individuals working in Cuba in violation of U.S. travel restrictions are not eligible to exclude income earned in Cuba, housing expenses incurred in Cuba are not qualified housing expenses, and the time spent in Cuba cannot be used in determining if the bona fide residence or physical presence test is met. However, the IRS stated that the U.S. Naval Base at Guantanamo Bay is not located within a restricted country and that qualified individuals who are performing services at the U.S. Naval Base there are eligible for the income and housing exclusion under Code Sec. 911. *Notice 2006-84, 2006-41 IRB*

Seaman on Yacht - The Tax Court has concluded that taxpayers employed on a yacht that was operated primarily in foreign territorial waters met the foreign physical presence requirement and could claim the foreign earned income exclusion under Code Sec. 911 (Form 2555). (*Myron and Thelma Struck, TC Memo 2007-42)*

Workers in Antarctica – The Tax Court agreed with the IRS that for purposes of the Sec. 911 exclusion, Antarctica is not a foreign country *(Dave Arnett v Commissioner, 126 TC No. 5).* Even though Antarctica has been held to be a foreign country in cases involving tort action and labor laws, the Court said that the authority given by Congress to the Treasury secretary to issue regulations prevails for purposes of tax law. Reg. § 1.911-2(h) defines a foreign country for purposes of the foreign income exclusion as "any territory under the sovereignty of a government other than that of the United States." Antarctica operates under an international treaty to which the U.S. is a party. The Tax Court's decision was upheld by the U.S. Court of Appeals (*Arnett v. Comm'r*, 473 F.3d 790 (7th Cir. 2007)).

BONA FIDE RESIDENCE

Determine bona fide residence based on facts of each individual case. The IRS considers intent and nature of the trip and its length. The Tax Court has adopted a general set of factors, which are frequently used to help determine bona fide residency:

- Intention as to the duration of the foreign residence;
- Assimilation into the foreign country;
- Payment of foreign taxes;
- Status as resident of the foreign country;
- Establishment of a foreign home;
- Nature and extent of absences from the foreign country;
- Employer's view of taxpayer's status;
- Location of family;
- Good faith intentions of the taxpayer;
- Nontransient nature of stay in the foreign country.

The taxpayer must reside in a foreign country for an uninterrupted period that includes an entire tax year. However, once the taxpayer has met the uninterrupted period qualification, he/she will qualify as a bona fide resident for the period starting with the date actual residence began and ending with the date of abandonment of the foreign residence. Temporary trips to the U.S. are acceptable.

Waiver of Minimum Time Requirements - Minimum time requirement can be waived if a taxpayer must leave the foreign country due to war, civil unrest, or other adverse conditions. In the first quarter of each year the IRS provides a list of affected countries for the prior tax year and only countries included on that list qualify. In addition, the taxpayer must be residing in the country at the time the event occurs. Rev Proc 2019-15 includes the 2018 additions to the list of adverse-condition countries and supplements Rev Proc 2018-32, which supplemented Rev Proc 2017-26.

PHYSICAL PRESENCE TEST

Taxpayer must be physically present in a foreign country ***330 full days (a day being defined as a 24-hour period which begins at midnight, not counting time over international waters) during a consecutive 12-month period***. **Exception:** The full 330-day requirement is waived if the taxpayer must leave the country due to war, civil unrest or adverse conditions, as explained in the immediately preceding paragraph.

> ***Example:*** *Flying Hi left the U.S. on June 10, arriving in France at 9:00 a.m. on June 11. Hi's first full day in France is June 12.*

The 12-month period can start with any day of any calendar month, ending the day before the same calendar day 12 months later.

__Example:__ Tymand Munee worked in Germany over 20 months starting January 1, 2018 through August 31, 2019. He spends February 2018 and February 2019 on vacation with relatives in Dallas, Texas. Munee is present in Germany for the following two 12-month periods.

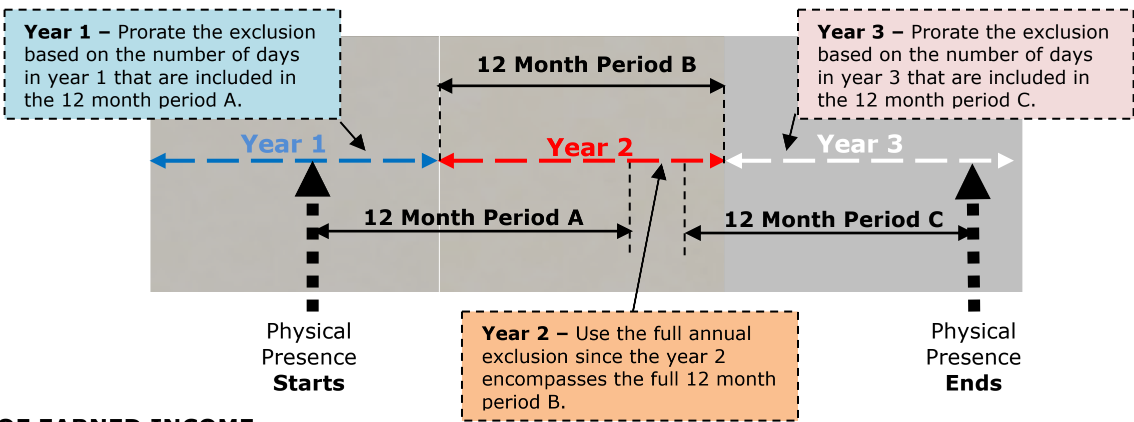
January 1, 2018 through December 31, 2018
September 1, 2018 through August 31, 2019

By overlapping the 12-month periods this way, Munee meets the physical presence test for his entire stay in Germany.

FIGURING THE 12-MONTH PERIOD

There are four rules to remember...

1. The 12-month period can begin with any day of the month. It ends the day before the same calendar day, 12 months later.
2. The 12-month period must be made up of consecutive months. ***Any*** 12-month period can be used if the 330 days in a foreign country fall within that period.
3. Choose the 12-month period that gives the greatest exclusion.
4. ***Any*** 12-month period can overlap another.



SOURCE OF EARNED INCOME

Earned income subject to exclusion includes salaries, wages, commissions, bonuses, professional fees and tips. Earned income also includes allowances or reimbursements for cost of living, overseas differential, family, education, home leave, quarters, and certain moving expenses. Income received for work in a foreign country, is considered as from a foreign source, even if it is paid by an employer located in the U.S.

Foreign earned income doesn't include:

1. Any amounts paid by the U.S. government or its agencies to its employees.
2. Previously excluded value of meals and lodging furnished for the convenience of the taxpayer's employer.
3. Pension or annuity payments, including social security benefits.
4. Amounts included in a taxpayer's income because of an employer's contributions to a nonexempt employee trust or to a nonqualified annuity contract.
5. Recaptured unallowable moving expenses.
6. Payments received after the end of the tax year following the tax year in which the services were performed to earn the income.

Both spouses have foreign earnings - If both taxpayer and spouse qualify, each can choose the foreign earned income exclusion. The maximum exclusion applies individually to the earnings of a husband and wife. Ignore any community property laws when figuring the limit on the exclusion.

Work in one year, paid in next year - If a taxpayer performs services one year but does not get paid for them until the following year, the income is generally considered earned in the year the services are performed. For cash basis taxpayers, report the income on the return for the year it is received.

PART-YEAR EXCLUSION ADJUSTMENT

If a taxpayer qualifies under either the bona fide residence test or the physical presence test for only part of the tax year, he/she must adjust the maximum limit based on the number of qualifying days in the tax year. The number of qualifying days is the number of days within the period in which the taxpayer both has a tax home in a foreign country and meets either test.

FOREIGN HOUSING EXCLUSION OR DEDUCTION

When a taxpayer qualifies for the foreign earned income exclusion under either the bona fide residence or physical presence tests, he/she can also claim an *exclusion or a deduction* from gross income for housing expenses.

The ***housing exclusion*** applies only to amounts considered paid for with employer-provided amounts. The ***housing deduction*** applies only to amounts paid for with self-employment earnings. With the exception of higher-cost locations (see "higher caps for high-cost locations" below), **the housing amount is the** *total of a taxpayer's housing expenses* **for the year** *minus a base amount*. **The base amount is:**

- 16% of the annual exclusion limitation amount.

Housing Exclusion Cap - The housing exclusion is limited to 30% of the taxpayer's earned income exclusion for the year less the base amount. Thus, for 2019, the maximum housing allowance exclusion is $14,826 ((105,900 x .30) – (105,900 x .16))

> ***Example:*** *Bill Howser qualified for the foreign earned income exclusion under the physical presence test for all of 2019. During the year, he spent $26,400 for housing. Bill's housing amount is the lesser of the deduction cap of $14,826 or $9,456 ($26,400 less 16,944*). Thus the deduction is $9,456.*
>
> **$16,944 = 105,900 x .16*

Higher Caps for High-Cost Locations – The Code allows the 30% cap amount to be replaced by higher amounts based on geographic differences in housing costs relative to housing costs in the U.S. Accordingly, Notice 2019-24 identifies locations within countries with high housing costs and provides an adjusted limitation on housing expenses to be used for these localities for tax year 2019. The annual notice and updated table is available on the IRS website; at: https://www.irs.gov/pub/irs-drop/n-19-24.pdf.

Housing expenses include - reasonable expenses paid or incurred for housing in a foreign country for taxpayer, spouse and dependents. These include rent, the fair rental value of housing provided in kind by an employer, and other expenses for housing. Other expenses include repairs, utilities (other than telephone charges), real and personal property insurance, nondeductible occupancy taxes, nonrefundable fees for securing a leasehold, rental (but not the purchase) of furniture and accessories, and residential parking.

Housing expenses ***do not*** include expenses that are lavish or extravagant under the circumstances. They also do not include deductible interest and taxes (including deductible interest and taxes of a tenant) or the costs of buying property, including principal payments on a mortgage. Nor do they include the cost of domestic labor (maids, gardeners, etc.), pay television subscriptions, improvements and other expenses.

> ***Caution!***
>
> ***No double benefit.*** *A taxpayer can't include in housing expenses any amounts that were excluded from gross income as meals or lodging for the convenience of an employer or that were deducted as moving expenses. Note: The TCJA removed the moving expense deduction other than for armed forces members as the move relates to a permanent change of station for years 2018-2025. Armed Forces members aren't eligible to claim a Sec 911 exclusion.*

Foreign Housing Exclusion - If a taxpayer has no self-employment income, the entire housing amount is considered paid for with employer-provided amounts. This means that it can be entirely excluded (up to the limits).

Employer-provided amounts include any amounts paid to a taxpayer by his/her employer that are taxable foreign earned income (without regard to the foreign earned income exclusion) for the tax year. This could include:

a. Salary,
b. Any reimbursement for housing expenses,
c. Amounts the employer pays to a third party for the employee's housing,
d. The fair rental value of company-owned housing furnished to the employee, unless that value is excluded from the employee's income because it is provided for the employer's convenience,
e. Amounts paid by the employer as part of a tax equalization plan, and
f. Amounts paid to the employee or a third party by the employer for the education of the employee's dependents.

If a taxpayer chooses the housing exclusion, he/she must figure it out before determining the foreign earned income exclusion. He/she cannot claim less than the full amount of the housing exclusion to which he/she is entitled.

> ***Caution!***
>
> *Once a taxpayer chooses to exclude either foreign earned income or foreign housing costs, he/she cannot take a foreign tax credit for taxes on income which is excluded.*

Foreign Housing Deduction **-** If a taxpayer has no self-employment income, he/she can't take a foreign housing deduction. How the housing deduction is figured depends on whether the taxpayer has only self-employment income or both self-employment income and employer-provided income. In either case, the amount to deduct is subject to these limits:

a. ***Self-employed -- no employer-provided amounts*** **-** If none of the housing amount includes employer-provided amounts, the housing amount, subject to the limit below, is deducted in figuring adjusted gross income. Claim the deduction by including it in the total on the appropriate line of Form 1040 (draft 2019 Schedule 1, line 22) and write "Form 2555" on the dotted line next to line 22.

b. ***Self-employed and employer-provided amounts*** **-** If a taxpayer is both an employee and a self-employed individual during the year, deduct part of the housing amount and exclude part of it. To find the part that qualifies as a housing exclusion, multiply the housing amount by the employer-provided amounts and then divide the result by the taxpayer's foreign earned income. The balance of the housing amount can be deducted (but the deduction can't be more than the taxpayer's foreign earned income less the total of: (1) The taxpayer's foreign earned income exclusion, plus (2) His/her housing exclusion, if any).

c. Carry over to the next year any part of the housing deduction that is not allowed because of the limits. Carryover is allowed to the next year only. If the taxpayer can't deduct it in the next year, it can't be carried over to any other year.

SPECIAL SITUATIONS

International Airspace — Flight Attendants - Married U.S. citizens/Taiwan residents were denied full Code Sec. 911 income exclusion for the total amount of wages the wife earned while working as an international flight attendant based out of Hong Kong International Airport: to the extent wages were attributable to time the wife was working in international airspace, they didn't qualify as foreign earned income eligible for Code Sec. 911 exclusion. The Tax Court recalculated the excludible amount, upholding with minor adjustments IRS's determination of wage percentage attributable to time the wife was working in or over foreign countries vs. international airspace.

Also, taxpayers were required to include pre-flight and post-flight service time and allocate sick and vacation leave between excludible and non-excludible portions of the wife's income. (William D. Rogers, et ux. v. Commissioner, (2009) TC Memo 2009-111; affirmed by CA Dist of Columbia 4/17/2015)

Combat Zone Workers - Certain U.S. citizens or resident aliens, specifically contractors or employees of contractors supporting the U.S. Armed Forces in designated combat zones, may now qualify for the foreign earned income exclusion. The Bipartisan Budget Act of 2018 changed the tax home requirement for eligible taxpayers, enabling them to claim the foreign earned income exclusion even if their "abode" is in the United States. Effective for tax year 2018 and subsequent years.

Under prior law, many otherwise eligible taxpayers who lived and worked in designated combat zones failed to qualify because they had an abode in the United States. The new law makes it clear that contractors or employees of contractors providing support to U.S. Armed Forces in designated combat zones are eligible to claim the foreign earned income exclusion if they otherwise qualify.
This means that these taxpayers, if eligible, will be able to claim the foreign earned income exclusion on their income tax return beginning in 2018 if they meet the bona fide residence test or the physical presence test. The rule that the foreign earned income exclusion is not available to federal employees or members of the military is unchanged by this law revision (see pages 13 and 14 of the 2018 Pub 54).

Also see Chief Counsel memorandum AM2009-003 - https://www.irs.gov/pub/irs-utl/am2009003.pdf

Married Couples Living Apart - Special rules apply if taxpayer and spouse live apart and maintain separate households. Both may be able to claim the foreign housing exclusion or the foreign housing deduction. This can be done if the spouses have different tax homes that are not within reasonable commuting distance of each other. Otherwise, one spouse only can exclude or deduct a housing amount.

Tax Credits Denied

EITC - Taxpayers that claim the benefit of the foreign earned income exclusion are not eligible to claim the earned income tax credit (EITC). (Sec 32(c)(1)(C))

Refundable Child Tax Credit - Effective for tax years beginning after December 31, 2014, a taxpayer who elects to exclude from gross income any amount of foreign earned income or foreign housing costs is prohibited for that year from claiming the refundable part of the child tax credit. (Sec 24(d)(5) as added by the Trade Preferences Extension Act)

IRA Contributions – A taxpayer who excludes foreign earned income from gross income under Sec 911 may not make an IRA contribution based upon the excluded compensation (Prop. Reg. §1.219(a)-1(b)(3)).

Reelection of IRC §911 exclusion allowed — Once revoked, the election may not be made again by a taxpayer until the sixth taxable year after the year in which the revocation was made (Sec 911(e)(2)). However, reelection may be made earlier than the sixth year if the taxpayer requests reelection via a letter-ruling request (Reg Sec 1.911-7(b)(2)). Relevant facts and circumstances to allow the reelection may include: a period of United States residence, a move from one foreign country to another foreign country with differing tax rates, a substantial change in tax laws of the foreign country of residence or physical presence, and a change of employer.

FORM 2555 Form 2555 is used to claim the foreign earned income exclusion plus the foreign housing exclusion or deduction, if applicable. The computed exclusion amount is carried from Form 2555 to the other income line of the tax return (draft 2019, line 8, Schedule 1) and entered as a negative amount. The IRS has phased out Form 2555-EZ, which is no longer available for use after 2018.

EXTENSION

If the bona fide residence or physical presence tests aren't met before the due date of a taxpayer's tax return, file *Form 2350* with the IRS at the address below by the due date (June 15 if both the tax home and abode are outside the U.S. and Puerto Rico on 4/15) for filing the return. This grants an extension to a date after the taxpayer expects to meet the time requirements. File the extension with:

Department of the Treasury
Internal Revenue Service Center,
Austin, TX 73301-0045

TREATMENT OF FOREIGN EARNINGS FOR SOCIAL SECURITY PURPOSES

Under international social security agreements, the general rule is that an employee who would otherwise be covered by both the U.S. and a foreign social security system is subject exclusively to the coverage laws of the country in which the employee is working. However, under an exception (called the "detached worker exception"), a person who is temporarily transferred to work for the same employer in another country remains covered only by the country from which he or she has been sent.

In U.S. agreements, this detached worker rule generally applies only if the employee's assignment to another country is expected to last 5 years or less. If the transferred employee works for a foreign affiliate of its U.S. employer, the U.S. employer may enter into a Code Sec. 3121(l) agreement with the U.S. Treasury Department with respect to the foreign affiliate to extend coverage of the U.S. Social Security system to services performed outside the U.S. by its U.S. citizen or resident employees. Under this voluntary agreement, the U.S. employer pays an amount equivalent to both the employee and employer's shares of FICA on the wages paid for services covered by the agreement.

However, in a Chief Counsel Advisory the IRS concluded that where a U.S. citizen was permanently transferred to work in a foreign country by his U.S. employer, the U.S. citizen's wages were only subject to the foreign social security taxes and should not be subject to U.S. social security taxes, even if a Code Sec. 3121(l) agreement was entered into with respect to the worker. The reasoning for this position is that the detached worker rule only applies if the employee was transferred to work in a foreign country for five years or less. (CCA 201214023)

CALIFORNIA DIFFERENCES

California does not have an equivalent to the Federal foreign income exclusion provision. Residents of California are taxed on ALL income, including income from sources outside California; the key is whether or not the taxpayer is a resident.

A safe harbor is available for certain individuals leaving California under employment-related contracts. The ***safe harbor*** provides that an individual domiciled in California who is ***outside California under an employment-related contract for at least 546 consecutive days (18 months) will be considered a nonresident*** unless:

- The individual has intangible income exceeding $200,000 in any taxable year during which the employment-related contract is in effect; or
- The principal purpose of the absence from California is to avoid personal income tax.

CAUTION: The safe harbor only applies to employment related income. Thus, other non-exempt CA source income would continue to be taxable to CA as a non-resident, except for CA source pension income, which is not taxable to CA when received by a non-resident (see page 4.01.08).

Spouse Issues: The spouse of the individual covered by this safe harbor rule will also be considered a nonresident while accompanying the individual outside California for at least 546 consecutive days. Return visits to California that in the aggregate do not exceed 45 days during any taxable year covered by the employment contract are considered temporary. However, if the spouse of the taxpayer who meets the safe harbor rule does not also meet the safe harbor rule (e.g., remains in California), then he or she would continue to be a California resident, and generally 50% of the taxpayer's income would not meet the safe harbor and would be taxable to CA. FTB Pub 1031, page 3 includes examples of this situation filing both jointly and separately.

Individuals not covered by this safe harbor must determine their residency status based on their facts and circumstances. The determination of residency status cannot be solely based on an individual's occupation, business, or vocation. Instead, all activities must be considered in the determination of residency status.

California Residents: Taxpayers, who by the facts and circumstances are determined to be California residents, may be able to deduct away-from-home business related travel expenses (for travel, meals, and lodging) on their California tax return while earning income in a foreign country.

NOTES

U.S. SAVINGS BONDS EDUCATION EXCLUSION

Overview

- **Issue:** Series EE or I Bonds issued after 1989
- **Purchaser:** Must be purchased by an individual over the age of 24
- **Exclusion =** $\dfrac{\text{Qualified expenses paid}}{\text{Total redemption proceeds}}$ X Interest
- **2019 AGI Phase-out**
  - **Joint:** $121,600 to $151,600
  - **Unmarried:** $81,100 to $96,100
- No Double Benefit
- Used for Expenses of Education for **Taxpayer, spouse or dependent** at the time the bonds are cashed.
- Applies to Post-Secondary Education Only

RAPID FINDER

529 Plans	6.04.02
Coverdell	6.04.02
Education Credits	6.04.02
Employer Benefits	6.04.02
Expense Reductions	6.04.02
Married Separate	6.04.01
Modified AGI	6.04.02
Phase-Out Levels	6.04.02
Qualifying Bonds	6.04.01
Qualifying Expenses	6.04.02
Ratio, Exclusion	6.04.01
Scholarships	6.04.02
VA Benefits	6.04.02

Pubs Forms

Related IRS IRC, Publications and Forms

- **Pub 970** – Tax Benefits for Education
- **Form 8815** - Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989
- **Form 8818 –** Optional Form to Record Redemption of Series EE and I U.S. Savings Bonds Issued after 1989 (for Individual with Qualified Higher Education Expenses)
- **IRC Sec 135**

The Details

An individual who pays qualified higher education expenses with redemption proceeds from Series EE or I bonds issued after '89 can potentially exclude from income the bond interest. No exclusion is available to a taxpayer using the married filing separate filing status. Form 8815 is used to compute the exclusion. Form 8818 may be used to keep a record of such bonds.

If the taxpayer's total redemption proceeds (principal plus interest) for a tax year exceeds the qualified expenses paid in that year for the taxpayer, spouse or dependent, the amount of interest that is excludable is limited to a fraction of the otherwise excludable portion:

$$\frac{\textbf{Qualified expenses paid}}{\textbf{Total redemption proceeds}}$$

Example: *Greg redeemed $10,000 ($5,000 interest, $5,000 principal) and paid qualifying college expenses of $6,000. The fraction of expenses to redemption amounts is 60%. This means that $3,000 of the interest ($5,000 x .60) is excludable from income. Of course, the principal amount, $5,000, is also excludable.*

ALERT

You may want to advise clients who are depending on the proceeds from savings bonds to pay education expenses to plan well ahead for cashing in their paper-issued bonds as it may take longer than they expect to cash in the bonds. While it used to be common for banks to offer the service of cashing in paper U.S. savings bonds, fewer are doing so now. So clients planning to take their bonds to a local bank should check with the financial institution beforehand to see whether it redeems savings bonds. If it does, there could be a dollar limit per transaction (necessitating several trips to the bank), and the bank will likely require identification, so the client should find out what documents are needed. Some institutions require having an active account open for at least six months, plus proper identification. An alternative for those unable to find a local institution to cash the bonds is to mail them to the U.S. Treasury for redemption. See the treasurydirect.gov web site for further information and mailing instructions.

US Bonds Education Exclusion — ClientWhys™

QUALIFYING BONDS:

The bonds must meet the following requirements for the exclusion to apply:

- They must be purchased by an individual over age 24.
- The purchaser must be the sole owner (or joint owner with spouse).
- The owner may designate a beneficiary for the bonds without losing the exclusion.
- A phase out applies for a taxpayer with "modified AGI" that exceeds the amount shown in the following table.

Filing Status	2015	2016	2017	2018	2019	2020
Unmarried Filing Status (15K)						
Phase Out Begins	77,200	77,550	78,150	79,550	81,100	82,350
Totally Phased Out	92,200	92,550	93,150	94,550	96,100	97,350
Joint Filing Status (30K)						
Phase Out Begins	115,750	116,300	117,250	119,300	121,600	123,550
Totally Phased Out	145,750	146,300	147,250	149,300	151,600	153,550

If any amount is not shown, it is not available at publication date

MODIFIED AGI:

This is AGI determined without this savings bond interest exclusion or Code Sections 911, 931 and 933 exclusions (i.e., the foreign income and housing exclusions and possessions' income exclusions), the exclusion for employer provided adoption assistance, the deduction for qualified higher education tuition and fees (in years this deduction is available), the student loan interest deduction, the domestic production activities deduction (repealed for years after 2017), and after application of Code Section 86 (taxation of social security), Code Section 469 (limits on passive losses) and Code Section 219 (deduction for IRAs).

QUALIFYING EDUCATION EXPENSES:

Qualified higher education expenses for purposes of this exclusion include tuition and fees paid to a higher education institution and contributions to a Coverdell Education Savings Account or a Qualified Tuition Program (Sec 529 plans) for the taxpayer, spouse or dependent. Qualified expenses do not include expenses for room and board or courses involving sports, games, or hobbies that are not part of a degree or certificate granting program.

EXPENSE REDUCTION:

The amount of qualified higher education expenses used in determining the exclusion allowed under the rules for U.S. savings bonds for education must be reduced by:

- The amount of those expenses that are used in determining the American Opportunity and Lifetime Learning Credits;
- Scholarships and fellowships;
- The expenses used to figure the tax-free portion of distributions from a Coverdell ESA or a Qualified Tuition Plan;
- VA education benefits;
- Employer-provided education assistance payments; and
- Qualified tuition reduction amounts.

Reduction is **not** required for gifts and inheritances.

CALIFORNIA DIFFERENCES

California conforms to Federal treatment.

NOTES

WORKER'S COMPENSATION

- Exclusion from income is allowed for payments made under worker's compensation (WC) or a plan "in the nature of worker's compensation". *(IRC Sec 104(a)(1))*
- **Excludable or Not?**
  - Compensation for occupational personal injury or sickness - **YES**
  - Compensation based on employee's age or length of service - **NO**

Strategy - It is not uncommon for protective services personnel benefits to first be paid as retirement payments and then subsequently after board hearings, legal action, etc., be ruled as worker's compensation. Generally in those cases the retirement income is repaid and worker's compensation paid. The repayment of the retirement benefit paid in a prior year gives rise to a "claim of right" deduction or credit (see chapter 9.05).

To be excludable as worker's compensation (WC), the payments must be paid to compensate for occupational personal injury or sickness. However, if the payments are computed and paid using the employee's age or length of service, they <u>are not</u> excludable. Payments which compensate for medical expenses which had formerly been deducted must be included in gross income. Even WC payments made to the survivors of an employee can be excluded from income.

The exclusion doesn't apply to job-related payments that exceed the amounts provided in the applicable WC act. However, excess payments are excludable, if they are received under a special law providing for special payments supplemental to WC.

A "worker's compensation act" provides fixed awards to employees (or their dependents) for employment-related accidents or illness, regardless of fault. To qualify as "in the nature of WC" an act must pay benefits only for job-related injuries or sickness cases.

<u>DETERMINING WHICH PAYMENTS QUALIFY</u>

Certain payments may seem like WC, but in reality are not. For example, ***Morris, (1987) TC Memo 1987-7, 87007*** said that payments to a disabled worker while performing light duty were not excludable--they are considered regular salary. In another case ***(Blackburn, (1950) 15 TC 336),*** continuation of a highway patrolman's salary was compensation for the hazardous nature of his work, not for his injury--the compensation was taxable. ***Pagliano (1994) TC Memo 1994-506*** found that interest on a WC award to compensate for delay of payment was not excludable. However, in another case, ***(Brabson)*** a District Court (Colorado) ruled that prejudgment interest was tied to the concept of fault, and therefore, was excludable as part of damages. The Tenth Circuit Court of Appeals reversed this decision. ***(Brabson, (CA10 1/11/96))***

When benefits are computed based on an employee's length of service or age rather than on injury, they are not excludable. A firefighter's disability pension that converted to normal retirement benefits after 25 years of service lost its character as WC at the time of conversion. Reason: At that time, the payments were based on length of service and were considered retirement benefits. **(*Wiedmater* (1984) TC Memo 1987-540) and *Picard v. Comm. (CA9, 1/26/99) 83 AFTR 2d 99-616***

The Tax Court properly determined that disability retirement payments received by a former county sheriff's department employee who retired with "service-connected" disability didn't qualify for Code Sec. 104(a)(1) income exclusion to the extent the payments exceeded the amount he would have received based solely on disability. Although California's statute authorizing payments was in the nature of a workmen's compensation act, the amount in dispute/"additional amount" was determined by length of service and thus subject to tax under Reg. § 1.104-1(b)'s limitation. (Sewards v. Comm., CA 9, 115 AFTR 2d ¶2015-733)

QDRO Payments - In a private letter ruling (PLR), IRS has concluded that, where a plan for state employees qualifies as a workmen's compensation plan for federal tax purposes, a payment from the plan, that is made pursuant to a domestic relations order to the ex-spouse of a state employee who was disabled on the job, does not qualify for exclusion from gross income (PLR 201521009).

California conforms to the Federal treatment. Where the payments are made from the State Employees' Retirement System (PERS), no 1099R will be issued for the excludable amounts. Generally, if there is a 1099 issued, the income is taxable.

NONE

EDUCATOR'S ABOVE-THE-LINE DEDUCTION

Overview

- **Maximum Deduction**: $250 (2019)
- **Expenses:** Otherwise allowable trade or business expenses (Code Sec 162).
- **Qualified Teacher, Principal, Counselor, Aide:** Kindergarten through Grade 12
- **Minimum Annual Qualifying Hours:** 900
- **Employee Business Expense:** Page 6.07.02
- **Charitable Deduction:** Page 6.07.02

Pubs Forms

- **Related IRS Publications and Forms**
  - **Pub 970** – Tax Benefits for Education
  - **IRC Sec 62(a) and (d)**

RAPID FINDER

ABOVE THE LINE DEDUCTION

The Details

The deduction is limited to the amounts indicated in the table below (inflation adjusted after 2015).

Year	Years thru 2018	2019	2020
Maximum Allowed	$250	$250	$250

If amount not shown it was not available at press time

Qualified Expenses - Qualified expenses are generally otherwise allowable Code Sec. 162 trade or business expenses paid or incurred by the eligible educator that were not reimbursed. The following fall under that category:

- Books,
- Supplies (other than nonathletic supplies for courses of instruction in health or physical education),
- Computer equipment (including related software and services) and other equipment,
- Supplementary materials used by the eligible educator in the classroom, and
- Professional development expenses incurred after 2015 (added by the PATH Act of 2015). These courses must be related to the curriculum in which the educator provides instruction or to the students for which the educator provides instruction.

Eligible Educator - An eligible educator is, with respect to any tax year, an individual who is a kindergarten through grade 12:

- Teacher,
- Instructor,
- Counselor,
- Principal, or
- Aide

Who works in a school for ***at least 900 hours*** during a school year. For this purpose, a school is any school that provides elementary education or secondary education (kindergarten through grade 12), as determined under state law. ***Educators who retire mid-year, who start work in the fall term, or substitute teachers may not meet the 900 hours test.***

Example – *During the tax year, Mary, a 5th grade teacher, worked over 900 hours and spent $200 on classroom supplies that would otherwise be deductible as an employee business expense were it not for the TCJA suspension of tier 2 miscellaneous deductions in years 2018-2025. She received no reimbursement for the materials. Mary can take a $200 AGI deduction on her tax return.*

Example *– Pamela, a kindergarten teacher, retired at the end of the school year in June of the tax year. Pamela worked 8 hours per school day but after accounting for holidays and spring break vacation, she only worked 108 days, for a total of 864 hours during the tax year. She is not eligible to claim the above-the-line deduction for the $225 of classroom supplies she purchased. However, if Pamela retired in a year other than 2018 through 2025 and she itemizes deductions for that year, she may claim them as a business expense, subject to the 2%-of-AGI limitation.*

Example – *During the year, Jack, an 8th grade teacher, had unreimbursed expenses of $800, consisting of the following: $200 for books, and $600 for supplemental materials that were consumed by his class. He worked as a teacher for more than 900 hours. Jack can take a $250 AGI deduction on his tax return. Because Schedule A tier 2 miscellaneous deductions are suspended in 2018-2025, he cannot deduct the balance of the expenses as an itemized deduction. However, if Jack works for a public school and can get his principal to provide him with a contribution receipt, Jack may take the remainder as a noncash contribution to a Governmental Body.*

Limitation - The classroom expense deduction is allowed for expenses only to the extent the amount of those expenses exceeds the amount excludable for the tax year under:

- Higher Education Savings Bond Redemptions - Code Sec. 135
- Qualified State Tuition Program Distributions - Code Sec. 529(c)(1)
- Coverdell Education Savings Account Distribution - Code Sec. 530(d)(2)

OTHER OPTIONS

What are the options for teachers who spend more than $250 on classroom supplies or for teachers and other qualified individuals who do not meet the 900-hour test or other requirements to deduct the $250 above the line? When eligible, teachers should always claim the above-the-line deduction first; then, they should consider the following for the excess. This advice may also help their ineligible colleagues.

Employee Business Expense – One option for years before 2018 and after 2025 is to claim classroom supplies beyond the $250 deduction as employee business expenses on Form 2106. However, employee business expenses are tier 2 miscellaneous itemized deductions, so the expenses might get wiped out or substantially limited by the required reduction equal to 2% of AGI. If the taxpayer is subject to the AMT, employee business expenses are not allowed at all. **Caution:** Employee business expenses must be a condition of employment verified in writing by the employer; this may be difficult to obtain.

Charitable Contribution – Another option would be to claim the expenses as a charitable contribution.

Code Sec. 170(c)(1)) For the purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of a State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

Since public schools are part of a political subdivision of a state, any contribution, whether cash or goods, to the school would be a charitable contribution.

Therefore, a teacher's classroom supplies, if the teacher properly documents them and the school provides a written acknowledgment, would qualify as a noncash charitable contribution. **Caution:** Supplies or equipment that the teacher retains would not be considered a completed gift, and their cost would not qualify as a charitable contribution. For example, if a science teacher purchases a microscope that students use in the classroom but keeps it for personal use when the school year ends, the cost of the microscope would not be deductible as a charitable contribution.

To meet the requirements for noncash contributions, the teacher claiming a contribution to the school must obtain and keep an acknowledgment from the school; the contents of this acknowledgement are based upon the value of the contribution claimed, as explained in chapter 7.08. The acknowledgment must be in the taxpayer's possession before filing the return for the year the contribution was made or before the due date, including extensions, for filing that return—whichever is earlier. See Chapter 7.08 for charitable documentation requirements.

CALIFORNIA DIFFERENCES

California has no similar above-the-line deduction so a Schedule CA adjustment for arriving at AGI is required. However, the amount California doesn't allow may qualify as an employee business expense (miscellaneous itemized deduction) for California, requiring a second adjustment on Sch CA.

NOTES

STANDARD DEDUCTION & PHASE-OUTS

STANDARD DEDUCTION: Except for years 2018 through 2025, to determine taxable income, taxpayers subtract itemized deductions – or a standard deduction, if not itemizing – and exemption allowances from AGI.

Taxable Income Redefined - For years 2018 through 2025 the TCJA substantially increased the standard deduction amounts but suspended the exemption deductions. The TCJA also added the Sec 199A deduction for flow-through businesses (see chapter 3.24), so taxable income for 2018 through 2025 is defined as AGI minus either the standard deduction or the itemized deductions and minus the 199A deduction.

Filing Requirements – TCJA's suspension of exemption allowances also altered the income-based filing requirement. For years 2018-2025 an individual is required to file a federal return if their gross income exceeds their standard deduction amount. ***Exception***: Taxpayers filing married separate status are required to file if their gross income is $5 or more.

The standard deduction consists of a filing status-based basic amount and additional amounts for elderly and blind filers (and their spouses). The additional amounts do not apply to dependents. The amounts are annually adjusted for inflation.

	Tax Year	2015	2016	2017	2018	2019	2020
Basic Amount	Joint & Surviving Spouse	12,600	12,600	12,700	24,000	24,400	24,800
	Head of Household	9,250	9,300	9,350	18,000	18,350	18,650
	Single	6,300	6,300	6,350	12,000	12,200	12,400
	Married Filing Separately	6,300	6,300	6,350	12,000	12,200	12,400
Additional	Joint & Surviving Spouse	1,250	1,250	1,250	1,300	1,300	1,300
	Others	1,550	1,550	1,550	1,600	1,650	1,650

If any amount is not shown, it is not available at publication date

ADDITIONAL STANDARD DEDUCTIONS

The additional standard deductions apply to both the taxpayer and the spouse, but not dependents. Thus, if both spouses were blind they would be entitled to twice the blind amount.

Blind - To claim the additional amount for blind, a taxpayer must be blind or partially blind on the last day of the year. Partial blindness is defined as:

1) Cannot see better than 20/200 in the better eye with glasses or contact lenses, or
2) A field of vision that is not more than 20 degrees.

Elderly **-** To claim the additional amount for elderly, a taxpayer must have attained the age of 65 on the last day of the tax year. **Note:** A taxpayer is considered 65 on the day before his/her 65th birthday. Therefore, if the taxpayer (spouse) was born on 1/1/1955, the elderly addition applies for 2019.

STANDARD DEDUCTION FOR DEPENDENTS

A dependent filing their own return uses the greater of the base amount, or their earned income plus an additional amount, but the total cannot exceed the regular standard deduction for the dependent's filing status.

Tax Year	2015	2016	2017	2018	2019	2020
Base Amount	1,050	1,050	1,050	1,050	1,100	1,100
Additional Amount	350	350	350	350	350	350

If any amount is not shown, it is not available at publication date

OTHER ISSUES

Zero Deductions - The following individual taxpayers have a standard deduction of zero:

- Taxpayers who are married, file MS returns, and either spouse itemizes deductions;
- Nonresident aliens (including dual status aliens, *Rev Rul 74-239, 1974-1 CB 372)*; and
- Taxpayers filing short-year returns because of a change in accounting period. (IRC 63(c)(6))

Election to Change - Taxpayers, who file returns using the standard deduction, may later change their minds and itemize their deductions and vice versa. Any change must be consistent with the rules for married separate taxpayers. Amended returns to claim a refund must be filed within the statute of limitations period.

Strategies

AMT and Itemizing - For AMT purposes, the standard deduction is not allowed. In such cases it may be appropriate to force itemized deductions, which are partially allowed for AMT. See chapter 8.00 for details of this tax saving strategy.

CALIFORNIA DIFFERENCES

Prior to 2018, a taxpayer who does not itemize deductions on the Federal income tax return may itemize deductions on their California return, but must first complete a Federal Schedule A, then make the appropriate adjustments on Schedule CA.

For 2018 through 2025 CA is not expected to conform to any of the federal changes for itemized deductions. At press time the CA legislature had passed and the Governor signed AB 91 conforming some mostly business provisions to TCJA. However, none of those changes impacted CA itemized deductions which continue as they were before TCJA.

California does not increase its standard deduction for elderly or blind taxpayers but does allow additional exemption credits for these situations (see chapter 1.03). For dependents of another, California follows Federal law.

CALIFORNIA STANDARD DEDUCTIONS						
Tax Year	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Joint, HH and SS	7,984	8,088	8,258	8,472	8,802	
Single and MFS	3,992	4,044	4,129	4,326	4,401	
Dependent Minimum	1,000	1,050	1,050	1,050	1,050	

If any amount is not shown, it is not available at publication date.
CA does not publish the current year rates until in the fall of the year.

PHASE-OUT OF ITEMIZED DEDUCTIONS

(Pease Limitation)

Overview

High Income Itemized Deduction Phase-Out:

- **Reduction** – 3% of the AGI in excess of the AGI Phase-out threshold.
- **Maximum reduction** – 80%
- **AMT** – No reduction for the AMT computation

TCJA

This phase-out is **suspended** for tax years 2018 through 2025.

Pubs Forms

Related IRC and IRS Publications and Forms

- **Sec 68** – Overall limitation on itemized deductions.
- **Phaseout Worksheet** – 2017 Schedule A Instructions, Page A-14

The Details

The following information applies for years 2013 through 2017 and after 2025. Certain itemized deductions are subject to phase-out if the taxpayer's adjusted gross income (AGI) is more than the annual limit.

Subject to phase-out	NOT Subject to phase-out
• Taxes • Interest, except investment interest expense • Gifts to charity • Job expenses and most other miscellaneous deductions • Other miscellaneous deductions - excluding gambling and casualty or theft losses	• Medical and dental expenses • Investment interest expense • Casualty and theft losses from personal use property • Casualty and theft losses from income-producing property • Gambling losses

LIMIT ON PHASEOUT:

If the itemized deductions are subject to the limit, the total of all itemized deductions is reduced by the smaller of:

1) ***3%*** of the amount by which the ***AGI exceeds the annual threshold***, or
2) ***80%*** of the itemized deductions that are ***affected by the limit***.

FEDERAL ITEMIZED DEDUCTIONS PHASEOUT THRESHOLDS					
Tax Year	**2014**	**2015**	**2016**	**2017**	**2018-2025**
Single	254,200	258,250	259,400	261,500	NA
Head of Household	279,650	284,050	285,350	287,650	NA
Joint & Surviving Spouse	305,050	309,900	311,300	313,800	NA
Married Filing Separate	152,525	154,950	155,650	156,900	NA

If any amount is not shown, it is not available at publication date

CALIFORNIA DIFFERENCES

The California computation is similar to the Federal computation and utilizes the Federal AGI for the computation, but the phaseout amounts differ. One major difference is that the phase out percentage for California is 6% whereas for federal purposes it is 3%.

If the itemized deductions are subject to the limit, the total of the itemized deductions is reduced by the smaller of:

1) ***6%*** of the amount by which the ***federal AGI exceeds the annual CA limit***, or
2) ***80%*** of the itemized deductions that are ***affected by the limit***.

Computation Worksheet – See Schedule CA Instructions.

CALIFORNIA ITEMIZED DEDUCTIONS PHASEOUT THRESHOLDS					
Tax Year	**2015**	**2016**	**2017**	**2018**	**2019**
Single & Married Separate	178,706	182,459	187,203	194,504	
Head of Household	268,063	273,692	280,808	291,760	
Joint & Surviving Spouse	357,417	364,923	374,411	389,013	

If any amount is not shown, it is not available at publication date
CA does not release the current year's amount until year-end.

NOTES

MEDICAL DEDUCTIONS

Overview

- Medical expenses are the costs of **diagnosis, cure, mitigation, treatment, or prevention of disease**, and the costs for **treatments affecting any part or function of the body** including dental expenses.
- Costs of **equipment, supplies, and diagnostic devices** needed for these purposes are eligible.
- The expenses **include insurance;** including medical, hospital, dental, long-term care (limited), and Medicare B and Medicare D insurance premiums (insurance premiums paid through an ACA exchange allowed only net of the premium assistance credit).
- **Medicare B Premium** for 2019 is: generally, $135.50/**month** or $1,626/full year. CAUTION: Premium for high-income taxpayers will be more.
- Expenses that are merely beneficial to general health do not count
- **Medical Mileage 2019**: 20 cents per mile

Pubs Forms

Related IRC and IRS Forms & Publications

- **Pub 502** – Medical and Dental Expenses
- **Pub 525** – Taxable & Nontaxable Income (recovery worksheet)
- **IRC Sec 213** – Medical, Dental, Etc., Expenses
- **IRC Sec 7702B** – Qualified Long-Term Care Insurance

The Details

MEDICAL FLOOR

Medical deductions are only allowed to the extent total medical expenses exceed a percent of AGI. With the advent of the ACA, this deduction limitation was increased to 10% for most taxpayers, though kept at 7.5% for seniors through 2016. TCJA retroactively extended the 7.5% for all taxpayers, and for both regular tax and AMT, for 2017 and 2018, after which it will return to 10%.

Year	Pre-2013	2013-16	2017-18	Post-2018
Under age 65	7.5%	10%	7.5%	10%
Either Spouse 65 or over	7.5%	7.5%	7.5%	10%
AMT Threshold	10%	10%	7.5%	10%

DEDUCTIBLE MEDICAL EXPENSES CONSIDERATIONS

The following presents infrequent or unusual medical expenses and how they are treated for the medical expense deduction:

Acupuncture - Medical expenses include the amounts paid for acupuncture.

Alcoholism - Amounts paid by an inpatient for treatment at a therapeutic center for alcoholism, and for meals and lodging furnished as a necessary incident to the treatment (Rev. Rul. 72-226), are eligible medical expenses. Cost of transportation to meetings of the Alcoholics Anonymous are expenses "primarily for and essential to medical care" in the case of an alcoholic who attends such meetings (Rev. Rul. 63-273).

Adoption Expenses Paid by Adopting Parent - Medical expense payments made by an adopting parent for medical services rendered to a child even before the child was placed in the parent's home are deductible if:

- The child is a dependent of the adopting parent when services are rendered **or** paid; and
- The expenses are paid by the parent, or agent, for the medical care of the child; and
- They are not reimbursement for expenses by the adoption agency prior to adoption negotiations; and
- The expenses are shown to be directly attributable to the medical care of the child.

The adoptive parents ***cannot deduct the natural mother's childbirth expenses***. Kilpatrick, Benny, (1977) 68 TC 469

RAPID FINDER

Birth Control Pills – A taxpayer can include in medical expenses the amount paid for birth control pills provided they were prescribed by a doctor.

Body Scan - The amount paid for a full-body scan was an allowed expense even though the taxpayer who underwent the test was not experiencing symptoms of illness and had not obtained a physician's recommendation before undergoing the procedure. This procedure was for diagnosis, and since it did not have a non-medical function, it was allowed, in spite of its high cost or the possible existence of less expensive alternatives. Rev. Proc. 2007-72

Chiropractor - The amounts paid to chiropractors for medical care can be included in medical expenses.

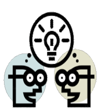
Christian Science Practitioner - The amounts paid to Christian Science practitioners for medical care can be included in medical expenses.

Cosmetic Surgery – This is defined as any procedure, which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease. Cosmetic surgery or other similar procedures can't be taken into account as a medical expense deduction, <u>unless the surgery or procedure is necessary to ameliorate a deformity arising from (or directly-related to) a (1) congenital abnormality, (2) personal injury resulting from an accident or trauma, or (3) disfiguring disease</u>. *Code Sec. 213(d)(9)(A)* IRS specifically ruled that breast reconstruction surgery paid for by a breast cancer patient who had a mastectomy as part of her cancer treatment was a deductible medical expense. *(Rev. Rul. 2003-57, 2003-22, IRB 959)*

IRS allowed the cost of **eye surgery** to correct defective vision, including laser procedures such as LASIK and radial keratotomy, since these procedures are performed to correct a dysfunction of the body. *(Rev. Rul. 2003-57, 2003-22, IRB 959)*

Payments to a dentist to perform a **teeth-whitening** procedure on a patient whose teeth had discolored as a result of age were not deductible because the discoloration was not a deformity, was not caused by a disfiguring disease or treatment, and was done so as to improve appearance. *(Rev. Rul. 2003-57, 2003-22, IRB 959)*

Decedent's Medical Expenses - Medical expenses of the decedent paid before death are claimed as an itemized deduction in the usual manner on the decedent's final return. Medical expenses paid after the decedent's death become the liability of the decedent's estate, and they are claimed on the estate tax return (Form 706) when one is required to be filed. However, expenses that were paid out of estate funds within one year after the day after death can be treated as if paid by the decedent and claimed on the decedent's final return instead. *(IRC §213(c)(1);Reg §1.213-1(d)(1))*


Strategies

Strategy – Consult with the executor. Assuming (a) the decedent will itemize, (b) total medical expenses will exceed the 7.5% or 10%, as applicable, of AGI floor and (c) no Form 706 is required, it is clear that making the election and deducting the medical expenses on the 1040 are appropriate. This also may require filing an extension or filing an original return and then later amending to take the additional medical expenses. If a 706 is being filed, but other expenses or allowed deductions reduce the gross estate to the point no tax is owed, it also makes sense to elect to claim the medical expenses on the decedent's final 1040. To make the election, file a statement in duplicate with the decedent's final return that the expenses are not being claimed on the estate tax return and that the estate waives the right to deduct the medical expenses at any time. The statement must be signed by the estate executor.

Diapers, Adult – See "Elderly Devices"

Disabled Dependent Care Expenses - Some disabled dependent care expenses may qualify as either medical expenses, or work-related expenses for purposes of taking a credit for child and dependent care. The expenses can be applied either way as long as the same expenses are not used to claim both a credit and a medical expense deduction.

DNA Collection Kit – DNA collection kits are used to provide an individual with ancestry data and in some cases for health reasons such as genotyping. Where both ancestry data and medical data are provided the cost of the kits must be allocated and only medical data portion is deductible as a medical expense and the taxpayer must use a reasonable method of allocation (PLR 01933005).

Drug Addiction - Amounts paid by a taxpayer to maintain a dependent in a therapeutic center for drug addicts, including the cost of the dependent's meals and lodging, are deductible medical expenses (Rev. Rul. 72-226).

Egg Donor Expenses - IRS has ruled privately (PLR 200318017) that a woman who can't conceive children using her own eggs may claim a medical expense deduction for the costs of obtaining an egg donor, including associated legal costs. IRS said that a procedure facilitating pregnancy by overcoming infertility similarly affects a structure or function of the body and also may be medical care. Expenses that prepare for and are directly related to a medical care procedure may also constitute medical care, IRS said. For example, Rev Rul 68-452, 1968-2 CB 111, holds that a kidney recipient who pays a kidney donor's surgical, hospital, and transportation expenses may deduct these costs as medical expenses. The ruling concludes that the costs of obtaining an egg donor, including the donor's expenses, are directly related and preparatory to her receiving the donated egg or embryo and may be deducted as medical expenses. IRS said that like other preparatory expenses, legal expenses may be deductible medical expenses if they bear a direct or proximate relationship to the provision of medical care to a taxpayer.

Elderly Devices - Questions frequently arise related to the deductibility of devices or supplies designed primarily for use by the elderly. A number of devices, such as specialized phones with big buttons, pictures in place of the numbers, amplifiers for the hard of hearing, etc., are available without prescription. There are also medical alert devices that the elderly or infirm can wear and get medical help should they fall or have another medical emergency. To be deductible, these devices must meet the definition of a medical expense. In some cases, to meet the definition of a medical device requires the device to be prescribed by a medical professional and sometimes not. For instance, an individual who is deaf would be able to deduct the cost of a text (TTY) phone whether actually prescribed by a doctor or not, while one who is not deaf would not be able to deduct the cost. However, in an examination, the IRS might require proof the individual is deaf. Another example is the purchase of prescription eye glasses, the cost of which would be deductible since they are prescribed, but the purchase of a magnifying glass at the drug store would not. However, where there is a question of whether the device is actually needed medically, a prescription from the doctor may be needed. Such would be the case for specialty phones, medical alert devices, adult diapers, etc.

Equipment and Supplies – IRS has ruled that the Sec. 213(b) prohibition against deductibility of nonprescription medicine or drugs does not apply to such items as crutches, bandages, and diagnostic devices (e.g., blood sugar kits used by diabetics). The costs of such equipment and supplies are deductible if they otherwise meet the general requirement of being paid for the diagnosis, cure, mitigation, treatment, or prevention of disease. *(Rev. Rul. 2003-58, 2003-22, IRB 959)*

Fertility Enhancement - Medical expenses include the cost of the following procedures to overcome an inability to have children (2018 IRS Pub 502, page 7).

- Procedures such as *in vitro* fertilization (including temporary storage of eggs or sperm).
- Surgery, including an operation to reverse prior surgery that prevented the person operated on from having children.

Gender Identity Disorder - IRS acquiesced to the U S Tax Court decision in *O'Donnabhain v Commissioner (134 T.C. 34 (2010)*) and no longer takes the position reflected in Letter Ruling 200603025. Thus, the costs of gender reassignment surgery and hormone replacement will be considered qualified medical expenses for persons with gender identity disorder. (Action on Decision 2011-03)

Guide Dog or Other Service Animal - The cost of a guide dog or other service animal to be used by a visually-impaired or hearing-impaired person, or a person with other physical disabilities, can be included in medical expenses. The amounts paid for the care of these specially trained animals are also medical expenses. *(Rev Rul 57-461; Rev Rul 68-295; IRS Pub 502)* Based on these citations, expenses related to "emotional support animals" would not qualify as a medical deduction.

Health Reimbursement Arrangements (HRA) Payments – Medical expenses paid by an HRA are not deductible since an HRA is a pre-tax plan funded by an employer.

Home Modifications – See "Impairment-Related Expenses."

Household Help as a Medical Expense - The cost of household help cannot be included in medical expenses, even if such help is recommended by a doctor. This is a personal expense that is not deductible. However, certain expenses paid to a person providing nursing-type services may be included. See "Nursing Services" below. Also, certain maintenance or personal care services provided for qualified long-term care can be included in medical expenses.

Insurance Premiums – Amounts paid for insurance including medical, hospital, dental, long-term care (limited), lost or damaged contact lenses, prescription drugs and insulin, and Medicare-B and Medicare-D insurance premiums (see Medicare premiums) are allowed. Premiums paid through an employer's flexible spending arrangement are not deductible because they are paid with pre-tax dollars. The deduction for insurance premiums for coverage acquired through a health exchange (Marketplace) is allowed net of the premium assistance credit. See also "Premium Tax Credit & Marketplace Insurance," later in this text.

Self-Employed Health Insurance Deduction - A self-employed individual (or a partner or a more-than-2%-shareholder of an S corporation) can deduct as an above-the-line expense 100% of the amount paid during the tax year for medical insurance on behalf of himself, his spouse and his dependents subject to the following requirements (Code Sec. 162(l)(1)(B)):

- The deduction cannot exceed the individual's net earnings from self-employment derived from the trade or business for which the plan providing the coverage is established.
- For a more-than-2% S corporation shareholder, that shareholder's wages from the S corporation are treated as his earned income.
- No deduction is available for any month in which the self-employed individual is eligible to participate in a "subsidized" health plan maintained by an employer of the taxpayer, the taxpayer's spouse, or any dependent, or any child of the taxpayer who hasn't attained age 27 as of the end of the tax year. This rule is applied separately to (1) plans that provide coverage for qualified long-term care services, or are qualified long-term care insurance contracts and (2) plans which don't include such coverage and aren't such contracts (Code Sec. 162(l)(2)(B)). Thus, an individual eligible for **employer-subsidized** health insurance may still be able to deduct long-term care insurance premiums, so long as he isn't eligible for employer-subsidized long-term care insurance.

IMPORTANT DEFINITION - The term "subsidized" means at least 50% of the cost of the coverage is paid by the employer (Sec 35(f)(1)).

The health insurance premiums claimed as an above-the-line SE health insurance expense cannot also be claimed as a Schedule A medical expense.

Impairment-Related Expenses - Capital Expenses - Amounts paid for special equipment installed in the home, or for improvements may be included in medical expenses, if their main purpose is medical care for the taxpayer, the spouse, or a dependent. The cost of permanent improvements that increase the value of the property may be partly included as a medical expense. The cost of the improvement is reduced by the increase in the value of the property. The difference is a medical expense. If the value of the property is not increased by the improvement, the entire cost is included as a medical expense.

Certain improvements made to accommodate a home to a taxpayer's disabled condition, or that of the spouse or dependents who live with the taxpayer, do not usually increase the value of the home and the cost can be included in full as medical expenses. These improvements include, but are not limited to, the following items:

- Constructing entrance or exit ramps for the home,
- Widening doorways at entrances or exits to the home,
- Widening or otherwise modifying hallways and interior doorways,
- Installing railings, support bars, or other modifications,
- Lowering or modifying kitchen cabinets and equipment,
- Moving or modifying electrical outlets and fixtures,
- Installing porch lifts and other forms of lifts but generally not elevators,
- Modifying fire alarms, smoke detectors, and other warning systems,
- Modifying stairways,
- Adding handrails or grab bars anywhere (whether or not in bathrooms),
- Modifying hardware on doors,
- Modifying areas in front of entrance and exit doorways, and
- Grading the ground to provide access to the residence. *Only reasonable costs to accommodate a home to a disabled condition are considered medical care. Additional costs for personal motives, such as for architectural or aesthetic reasons, are not medical expenses.*

***In vitro* Fertilization** - Although not specifically addressed in the Code, Regs, etc., it would appear that this procedure would be deductible if performed on the taxpayer claiming the expense. The code specifically allows procedures that affect the structure or function of the body. *(Code Sec 213(d)(1)(A))* It also would be allowed under discretionary surgery performed on the taxpayer. Discretionary medical costs are generally deductible where they are not illegal under Federal law. For example, abortions, vasectomies, and procedures to render the taxpayer incapable of getting pregnant have been held deductible. *(Rev Rul 97-9, 73-201 & 73-603)* According to IRS Pub. 502 (2018, page 7), the cost of procedures to overcome an inability to have children are qualified medical expenses. Such procedures include *in vitro* fertilization (including temporary storage of sperm or eggs) and surgery, including surgery to reverse a prior operation performed to prevent the person from having children.

In Vitro Fertilization Expenses Denied in Absence of Medical Condition **-** A taxpayer was denied a medical expense deduction for *in vitro* fertilization (IVF) expenses. He was a fertile man who used IVF for non-medical reasons. He had no physical or mental condition that prevented him from procreating without the use of IVF technologies. (*W. Magdalin, TC Memo. 2008-293, Dec. 57,629(M)*) Subsequently confirmed in appeals.

Lactation - The IRS in Announcement 2011-14 says that breast pumps and supplies that assist lactation are medical care under Code Sec. 213(d) because, like obstetric care, they are for the purpose of affecting a structure or function of the body of the lactating woman.

Lead-Based Paint Removal - The cost of removing lead-based paints from surfaces in a taxpayer's home to prevent a child who has or has had lead poisoning from eating the paint can be included in medical expenses. These surfaces must be in poor repair (peeling or cracking) or within the child's reach. The cost of repainting the scraped area is not a medical expense. If, instead of removing the paint, the area is covered with wallboard or paneling, treat these items as capital expenses. Do not include the cost of painting the wallboard as a medical expense. (2018IRS Publication 502, page 10)

Learning Disability (Special Education) - Tuition fees paid to a special school for a child who has severe learning disabilities caused by mental or physical impairments, including nervous system disorders can be included in medical expenses. A doctor must recommend that the child attend the school. See "Schools and Education – Special" (discussed later). Tutoring fees recommended by a doctor for the child's tutoring by a teacher who is specially trained and qualified to work with children who have severe learning disabilities may also be included. (2018 IRS Publication 502, page 13, Special Education)

Medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap, in order to qualify the individual for future normal education or for normal living. This includes a school for the teaching of Braille or lip reading. The principal reason for attending must be the special resources for alleviating the handicap. The cost of tuition for ordinary education that is incidental to the special services provided at the school, and the cost of meals and lodging supplied by the school also is included as a medical expense. The distinguishing characteristic of a special school is the substantive content of its curriculum, which may include some ordinary education, but only if the ordinary education is incidental to the school's primary purpose of enabling students to compensate for or overcome a handicap. (PLR 20052103)

The Tax Court has also held and IRS has privately ruled that, where a school attended by a student with a medical problem doesn't qualify as a special school because the ordinary education isn't incidental to the special services provided, the costs of the special program or special treatment (but not the entire tuition) may still be a deductible medical expense

Legal Fees – A taxpayer can include in medical expenses legal fees paid that are necessary to authorize treatment for mental illness. However, do not include in medical expenses fees for the management of a guardianship estate, fees for conducting the affairs of the person being treated, or other fees that are not necessary for medical care. (IRS Publication 502)

Long-Term Care Insurance – Amounts paid for long-term care services and certain premiums paid on long-term care insurance will be includible as medical expenses on Schedule A. Costs of care provided by a relative who is not a licensed professional or by a related corporation or partnership don't qualify. The maximum amount of long-term care premiums treated as medical expenses depends on the insured's age and is inflation-indexed annually. *(IRC Sec 213(d)(10))*

LTC DEDUCTION LIMITATIONS & PER DIEM CAPS						
Age	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
40 or less	380	390	410	420	420	430
41 to 50	710	730	770	780	790	810
51 to 60	1,430	1,460	1,530	1,560	1,580	1,630
61 to 70	3,800	3,900	4,090	4,160	4,220	4,350
71 & older	4,750	4,850	5,110	5,200	5,270	5,430
Per Diem	330	340	360	360	370	380

If any amount is not shown, it is not available at publication date.

Employees generally won't be taxed on the value of coverage under employer-provided long-term care plans. However, the exclusion doesn't apply if coverage is provided through a cafeteria plan. In addition, long-term care services can't be reimbursed tax-free under a flexible spending account.

"Long-term contract" is an insurance contract that provides only coverage of long-term care and meets certain other requirements. Some long-term care riders to life insurance will also qualify. Benefits under a long-term care policy (other than dividends or premium refunds) are generally tax-free. With per diem contracts that pay a flat-rate benefit without regard to actual long-term care expenses incurred, the exclusion is limited to $175 a day indexed for medical cost inflation (amount for 2019 is $370) except when long-term care costs incurred are more than the flat rate and are not otherwise compensated by some other means.

A contract isn't treated as a long-term care contract unless determination of chronically ill takes into account at least five activities of daily living--eating, toileting, transferring, bathing, dressing and continence. Although the contract must take into consideration at least five, the definition of chronically ill (below) only requires the individual to meet two of the five.

"Long-term care services" include necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, maintenance or personal care services prescribed by a licensed practitioner for the chronically ill. *(IRC Sec 7702B(c)(1))*

"Chronically ill person" is one who has been certified by a licensed health care practitioner within the previous 12 months as: (1) unable to perform at least two activities of daily living (eating, toileting, transferring, bathing, dressing, continence) without substantial assistance for a period of 90 days due to loss of functional capacity, (2) having a similar level of disability as determined in regulations, or (3) requiring substantial supervision to protect from threats to health and safety due to severe cognitive impairment. *(IRC Sec 7702B(c)(2))*

The requirement that a qualified long-term care insurance contract must base determination of whether an individual is chronically ill by taking into account five activities of daily living applies only to (1) above (being unable to perform at least two activities of daily living).

Payments made as a charge against the cash surrender value of a life insurance contract - No medical expense deduction is allowed for payment of long-term care coverage under a qualified long-term care insurance contract if the payment is made as a charge against the cash surrender value of a life insurance contract or the cash value of an annuity contract. *(Code Sec 7702B(e)(2))*

Reporting requirements: A taxpayer who receives long-term care benefit payments will receive a Form 1099-LTC from the payer. Refer to the flow chart included in the instructions for Form 8853 for whether or not there are reporting requirements and if there are, which sections of the Form 8853 must be completed.

Medical Reimbursement: Amounts (other than policyholder dividends or premium refunds) received under a qualified long-term care insurance contract are treated as amounts received for personal injuries and sickness and are treated as reimbursement for expenses actually incurred for medical care. (Sec 7702B(a)(2))

Registered Domestic Partners – In states that recognize RDP relationships, the long-term care insurance premiums paid for the domestic partner may also be deductible for state but not federal purposes.

Meals - Medical expenses may include the cost of meals at a hospital or similar institution if the main purpose for being there is to get medical care. The cost of meals that are not part of inpatient care may not be included.

Medical Alert – See "Elderly Devices"

Medical Conferences - IRS has ruled that a taxpayer may deduct the cost of attending a conference relating to a dependent's disease. *(Rev Rul 2000-24, 2000-19 IRB)* In this ruling, the taxpayer was allowed to deduct the cost of the conference registration fee and travel to the conference, because those costs were primarily for a dependent's medical care and the taxpayer's attendance was essential for that care. The cost of meals and lodging were not deductible, because the dependent did not receive medical care at a licensed facility (a prerequisite for medical deduction of meals and lodging).

Medical Marijuana (Controlled Substance) – As a controlled substance that is not recognized as legal by the federal government, the cost of marijuana, even if (1) prescribed by a physician to alleviate pain or other symptoms of an illness or (2) legal under state law, is not deductible for federal purposes. (2018 IRS Publication 520, page 15)

Medicare Premiums – *Medicare Part A* is generally paid through payroll taxes and is sometimes referred to as the hospital insurance (HI) portion of FICA and SE taxes. This amount is not a medical expense. However, a taxpayer not covered under Social Security (or who was not a government employee who paid Medicare tax) can voluntarily enroll in Medicare A. In that case, the Medicare A premiums paid are included as a medical expense. The 2019 Part A premium for these individuals is up to $437/month, an increase from $422 in 2018.

Medicare B and D – Both Medicare B (Medicare premiums) and Medicare D (Medicare prescription drug coverage) are treated and deducted as medical insurance premiums. The amounts paid or withheld from the individual's Social Security income is **based on the taxpayer's MAGI two years previously**. The following tables reflect the Medicare Part B monthly premiums and the Medicare Part D monthly supplement based upon a taxpayer's MAGI. To determine the amount paid, add together both the Part B and D amounts.

Modified AGI - The modified AGI for making the adjustment is the Federal AGI plus the following:

- Tax-exempt interest income;
- United States savings bonds interest used to pay higher education tuition and fees if the interest was excluded from income on Form 8815;
- Excluded foreign earned income and housing costs;
- Income derived from sources within Guam, American Samoa, or the Northern Mariana Islands; and
- Income from sources within Puerto Rico.

Medicare Part C – Under this coverage, also known as Medicare Advantage, the participant pays the monthly Medicare B premium and also pays an additional monthly premium to the insurance company providing the coverage, although in some cases there is no extra premium. Both the cost of Medicare B premiums and any additional Part C premiums qualify as medical insurance premiums.

MONTHLY MEDICARE B PREMIUMS					
Status	Modified AGI (2 YRS PRIOR)	2016	2017	2018	2019
Individuals Married Filing Joint*	$85,000 or less $170,000 or less	$121.80	$134.00	$134.00	$135.50
Individuals Married Filing Joint*	$85,001 - $107,000 $170,001 - $214,000	$170.50	$187.50	$187.50	$189.60
Individuals Married Filing Joint*	$107,001 - $133,500 $214,001 - $267,000	N/A	N/A	$267.90	$270.90
Individuals ('16 or '17) Married Filing Joint* ('16 or '17)	$107,001 - $160,000 $214,001 - $320,000	$243.60	$267.90	N/A	N/A
Individuals Married Filing Joint*	$133,501 - $160,000 $267,001 - $320,000	N/A	N/A	$348.30	$352.20
Individuals (2016 or 2017) Married Filing Joint* ('16 or '17)	$160,001 - $214,000 $320,001 - $428,000	$316.70	$348.30	N/A	N/A
Individuals Married Filing Joint*	Greater than $160,000 Greater than $320,000	N/A	N/A	$428.60	N/A
Individuals (2016 or 2017) Married Filing Joint* ('16 or '17)	Greater than $214,000 Greater than $428,000	$389.80	$428.60	N/A	N/A
Individuals Married Filing Joint*	$160,001 - $499,999 $320,001 - $749,999	N/A	N/A	N/A	$433.40
Individuals Married Filing Joint*	$500,000 & above $750,000 & abpve	N/A	N/A	N/A	$460.50
Married Filing Separate* (if lived apart from spouse all Year, use Individual)	$85,000 or less $85,001 - $129,000 $85,001 - $414,999 Greater than $129,000 $415,000 & above	$121.80 $316.70 N/A $389.80 N/A	$134.00 $348.30 N/A $428.60 N/A	$134.00 $428.60 N/A $428.60 N/A	$135.50 $433.40 $433.40 N/A $460.50

**Premium amount is for each spouse enrolled in Medicare B*

If any amount is not shown, it is not available at publication date

MONTHLY MEDICARE D SUPPLEMENTS *					
Status	Modified AGI (2 YRS PRIOR)	2016	2017	2018	2019
Individuals Married Filing Joint**	$85,000 or less $170,000 or less	NONE	NONE	NONE	NONE
Individuals Married Filing Joint**	$85,001 - $107,000 $170,001 - $214,000	$12.70	$13.30	$13.00	$12.40
Individuals Married Filing Joint**	$107,001 - $133,500 $214,001 - $267,000	N/A	N/A	$33.60	$31.90
Individuals ('16 or '17) Married Filing Joint** ('16 or '17)	$107,001 - $160,000 $214,001 - $320,000	$32.80	$34.20	N/A	N/A
Individuals Married Filing Joint**	$133,501 - $160,000 $267,001 - $320,000	N/A	N/A	$54.20	$51.40
Individuals (2016 or 2017) Married Filing Joint** ('16 or '17)	$160,001 - $214,000 $320,001 - $428,000	$52.80	$55.20	N/A	N/A
Individuals Married Filing Joint**	Greater than $160,000 Greater than $320,000	N/A	N/A	$74.80	N/A
Individuals (2016 or 2017) Married Filing Joint** ('16 or '17)	Greater than $214,000 Greater than $428,000	$72.90	$76.20	N/A	N/A
Individuals Married Filing Joint*	$160,001 - $499,999 $320,001 - $749,999	N/A	N/A	N/A	$70.90
Individuals Married Filing Joint*	$500,000 & above $750,000 & abpve	N/A	N/A	N/A	$77.40
Married Filing Separate** (if lived apart from spouse all year, use Individual)	$85,000 or less $85,001 - $129,000 $85,001 - $414,999 Greater than $129,000 $415,000 & above	NONE $52.80 N/A $72.90 N/A	NONE $55.20 N/A $76.20 N/A	NONE $74.80 N/A $74.80 N/A	NONE N/A $70.90 N/A $77.40

**These amounts represent the average amount, and the amount can vary based upon the insurance plan selected and the geographical area.*

***Supplement amount is for each spouse enrolled in Medicare D and is in addition to plan premium*

If any amount is not shown, it is not available at publication date

Amended AGI – If the taxpayer subsequently amends the tax return for the year on which the AGI adjustment is based and there is a significant reduction in AGI for that year, the taxpayer can submit a copy of the amended return and the premium will be retroactively adjusted.

Effect of Major Life-Changing Events – The Social Security Administration will use a more recent tax year's modified AGI, rather than the one of the second prior year, if the taxpayer experiences a major-life changing event, defined as:

- Death of a spouse;
- Taxpayer's marriage or divorce;
- Taxpayer or spouse stopping work or reducing the number of hours worked;
- Reduction in income from income-producing property due to certain casualties or disasters; and
- Reduction in income or loss of income from certain pensions, such as when a pension plan is terminated.

Married Couples – The monthly adjustment applies to each premium, so if both spouses are enrolled in Medicare, the couple will actually pay double the premium adjustment.

Moving – See travel page 07.02.13

Non-Hospital Institutions - The following are examples of when expenses for nonhospital institutions are deductible:

- All amounts paid by the taxpayer to maintain his mentally disabled son in a specially selected private home (which qualified as an "institution") in accordance with the recommendation of the psychiatrist in charge of the son's case, to help the son adjust to life in the community after living in a mental hospital. *(Rev Rul 69-499, 1969-2 CB 39)*
- Hotel meals and lodging, where taxpayer stayed in and received nursing service in the hotel, after getting appendicitis, having surgery in a hospital and being discharged from the hospital because it needed his hospital room. All of these events took place in New York, while taxpayer lived in Milwaukee. At the time of his discharge, the attending physician said taxpayer was too weak to travel home. *Kelly, Daniel v. Com., (1971, CA7)*
- Amounts paid to maintain a child at a halfway house, including room and board. Admission to the halfway house required the recommendation of a psychiatrist and continued psychiatric supervision during the stay. The house staff included a psychiatrist and mental health counselor. *(IRS Letter Ruling 7714016)*

Nursing Home - Medical expenses include amounts paid for the cost of inpatient care at a hospital or similar institution if the main reason for being there is to receive medical care. This includes amounts paid for meals and lodging.

Allocation of retirement residence fees to resident's medical expenses - Delbert L. Baker, (2004) 122 TC - The Tax Court has approved the use of the percentage method for determining what portion of monthly fees paid by a taxpayer to a continuing care retirement community qualified as deductible medical expenses. In doing so, the Tax Court rejected IRS's contention that the deductible amount had to be determined based on an actuarial analysis taking into account life expectancy and health care level expectancy. But no deduction was allowed for costs related to use of the pool and spa at the facility.

Nursing Services - Wages and other amounts paid for nursing services can be included in medical expenses. Services need not be performed by a nurse as long as the services are of a kind generally performed by a nurse. This includes services connected with caring for the patient's condition, such as giving medication or changing dressings, as well as bathing and grooming the patient. These services can be provided in the home or another care facility.

Generally, only the amount spent for nursing services is a medical expense. If the attendant also provides personal and household services, these amounts must be divided between the time spent performing household and personal services and the time spent for nursing services. However, certain maintenance or personal care services provided for qualified long-term care can be included in medical expenses.

Part of the amounts paid for that attendant's meals are also included in medical expenses. Divide the food expense among the household members to find the cost of the attendant's food. If additional amounts for household upkeep were paid because of the attendant, include the extra amounts with the medical expenses. This includes extra rent or utilities paid, because a larger apartment was needed to provide space for the attendant.

Additionally, certain expenses for household services or for the care of a qualifying individual incurred to allow the taxpayer to work may qualify for the child and dependent care credit. However, the same expense cannot be used for both the credit and the Schedule A medical deduction.

Over-the-Counter Drugs – The costs of over-the-counter drugs are not allowed as a medical deduction unless specifically prescribed by a health care professional; an exception applies for insulin. Over the counter drugs cannot be paid for from health care flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs) unless they are purchased with a prescription. (Rev Rul 2010-23).

Organ Donor – The costs of medical expenses incurred as an organ donor or possible organ donor, including medical care in connection with donating a kidney or other organ and transportation, are deductible medical expenses of the donor. In addition, the organ recipient can deduct the cost of medical care in connection with the donating of the organ, including transportation. (2018 Publication 502, page 13, Transplants)

Phones – See "Telephone"

Physical Exam - The amount a taxpayer paid for an annual physical exam, even though the taxpayer was not experiencing any symptoms of illness, was allowed. It qualified because it was for diagnosis. (Rev. Proc. 2007-72)

Pregnancy Test - The cost of a self-administered pregnancy test was deductible even though its purpose was to test the healthy functioning of the body rather than to detect disease. (Rev. Proc. 2007-72)

Premium Tax Credit & Marketplace Insurance – The amount of health insurance paid through the marketplace that is a medical deduction on Schedule A or treated as self-employed health insurance is the cost of the insurance net of the PTC allowed. Use the following worksheet to determine the deductible amount. (2018 IRS Pub 502, Page 12).

Insurance Premiums	$________
Advance Premium Tax Credit (APTC)	<________ >
PTC Repaid	________
Additional PTC Received	<________ >
Medical Insurance Deduction	$________

<u>*Premium Tax Credit Repayments -*</u> Where a taxpayer repays the PTC, that repayment could increase their medical itemized deduction or their above-the-line self-employed health insurance deduction, depending upon the circumstances. However, contrary to the general rules for cash basis taxpayers, and based on the example in Pub 502, the deduction will go to the year of the credit and not the year in which the credit is repaid.

Example 1 *- Amy is under age 65 and unmarried. The cost of her health insurance premiums in 2019 is $8,700. Advance payments of the premium tax credit of $4,200 are made to the insurance company and Amy pays premiums of $4,500. On her 2019 tax return, Amy is allowed a premium tax credit of $3,600 and must repay $600 excess advance credit payments (which is less than the repayment limitation). Amy is treated as paying $5,100 ($8,700 less the allowed premium tax credit of $3,600) for health insurance premiums in 2019. Using the worksheet from above proves the result:*

Insurance Premiums	*$8,700*
Advance Premium Tax Credit (APTC)	*<4,200>*
PTC Repaid	*600*
Additional PTC Received	*< 0>*
Medical Insurance Deduction	*$5,100*

Example 2 *- The facts are the same as in Example 1, except Amy is allowed a premium tax credit of $4,900 on her tax return and receives a net premium tax credit of $700. Amy is treated as paying $3,800 ($8,700 less the allowed premium tax credit of $4,900) for health insurance premiums in 2019.*

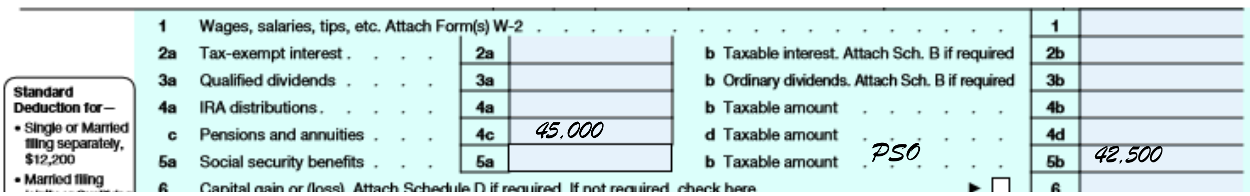
Public Safety Officers (Retired) - Eligible retired public safety officers (police officers, firefighters) may elect to exclude governmental retirement plan distributions that don't exceed their health or long-term care premiums, <u>if the distributions are paid directly to insurers</u>. The exclusion is limited to $3,000 per year. Any amount excluded isn't deductible as a medical expense for itemized deductions and isn't includible as health insurance for the self-employed health insurance deduction (PPA § 845). IRS Notice 2007-7 explains the exclusion for qualifying payouts to public safety officers:

- A public safety officer is an individual serving a public agency in an official capacity, <u>with or without compensation</u>, as a law enforcement officer, a firefighter, a chaplain, or as a member of a rescue squad or ambulance crew.
- The exclusion is available only to public safety officers who separate from service:
  (1) After attaining normal retirement age or
  (2) Due to disability. It is not available to surviving spouses or dependents after the public safety officer dies.
- The exclusion applies only if an eligible retired public safety officer elects to have an amount subtracted from his distributions from an eligible government plan (one described in Code Sec. 414(d) that is either a Code Sec. 403(a) or Code Sec. 403(b) plan, or an eligible governmental plan under Code Sec. 457(b)) and uses that amount to pay qualified health insurance premiums. <u>The employer sponsoring the eligible government plan is not required to offer such an election</u>.
- The <u>distribution must be paid directly to an accident or health insurance plan</u> that provides insurance issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance).
- Benefits attributable to service other than as a public safety officer are eligible for favorable tax treatment under Code Sec. 402(l), as long as the individual separates from service as a public safety officer, because of disability or after attaining normal retirement age, with the employer maintaining the eligible government plan.

Form 1040 Instructions - The amount shown in box 2a of Form 1099-R doesn't reflect the exclusion. Therefore enter the total distributions on line 4c and the taxable amount (after subtracting the excludable amount) on line 4d and enter "PSO" next to line 4d. (2018 1040 Instructions, Pg. 30; draft 2019 Form 1040)

If the taxpayer is retired on disability and reporting his or her disability pension on line 1, include only the taxable amount on that line and enter "PSO" and the amount excluded on the dotted line next to line 1.

Example*: Assume the retired PSO's 1099-R is for $45,000 and the retirement plan administrator made a direct distribution from the retirement plan to the provider of the accident or health plan or long-term care insurance contract in the amount of $2,500 (the maximum allowed is $3,000 per year). The entries on the 1040 would look like this:*


Standard Deduction for—
• Single or Married filing separately, $12,200
• Married filing

1	Wages, salaries, tips, etc. Attach Form(s) W-2					1	
2a	Tax-exempt interest	2a		b	Taxable interest. Attach Sch. B if required	2b	
3a	Qualified dividends	3a		b	Ordinary dividends. Attach Sch. B if required	3b	
4a	IRA distributions	4a		b	Taxable amount	4b	
c	Pensions and annuities	4c	45,000	d	Taxable amount PSO	4d	
5a	Social security benefits	5a		b	Taxable amount	5b	42,500
6	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐					6	

Schools and Education – Special – A taxpayer can include in medical expenses payments to a special school for a mentally impaired or physically disabled person if the main reason for using the school is its resources for relieving the disability. A taxpayer can include, for example, the cost of:

- Teaching Braille to a visually impaired child,
- Teaching lip reading to a hearing-impaired child, or
- Giving remedial language training to correct a condition caused by a birth defect. The cost of meals, lodging, and ordinary education supplied by a special school can be included in medical expenses only if the main reason for the child's being there is for the resources the school has to relieve the mental or physical disability.

Do not include in medical expenses the cost of sending a problem child to a special school for benefits the child may get from the course of study and the disciplinary methods.

Smoking-Cessation Programs - IRS has ruled that uncompensated amounts paid by taxpayers for participation in smoking-cessation programs and for prescribed drugs designed to alleviate nicotine withdrawal are eligible medical expenses. *(Rev Rul 99-28, 1999-25 IRB; IR-1999-55*) However, because of the Code Sec. 213(b) prohibition of deductions for most nonprescription drugs, no deductions are permitted for the costs of nonprescription nicotine gum and certain nicotine patches.

Social Security Taxes for Household Employees - If a domestic employee, such as a nurse, is paid cash wages of $2,100 or more in 2019, there will generally be withholding and social security and Medicare taxes that have to be paid. For more information, see Publication 926, Household Employer's Tax Guide.

Spouse - Prior or Current – A taxpayer can include medical expenses paid for a prior or current spouse provided the taxpayer was married to the spouse either at:

- The time the spouse received the medical services **or**
- At the time the taxpayer paid the medical expenses. (2018 Pub 502, page 3)

Stem Cell Therapy and Storage – Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body including dental expenses (IRC Sec. 213). Thus, it would seem that treatment of an ailment with stem cell therapy would qualify as a medical deduction.

Cord blood contains stem cells that doctors may use to treat disease. Thus, expenses for banking cord blood to treat an existing or imminently probable disease may qualify as deductible medical expenses. However, banking cord blood as a precaution to treat a disease that might possibly develop in the future does not satisfy the existing legal standard that at a minimum a disease must be imminently probable. (IRS Information Letter 2010-0017)

Sterilization - The cost of a legal sterilization (a legally performed operation to make a person unable to have children) can be included in medical expenses.

Surrogate Mother Expenses – (for the tax treatment by the surrogate see chapter 2.01 – Compensation Issues) As with *in vitro* fertilization, this issue is not specifically addressed in the Code, Regs, etc. The Code does tell us that medical expenses are only deductible for the taxpayer, spouse and dependents. The definition of a dependent for medical purposes ignores the gross income and joint return tests. Therefore, it appears that a surrogate mother's medical expenses can only be deducted if she qualifies as a "medical dependent." The unborn fetus is not a dependent until actually born.

<u>The office of Chief Counsel has provided some guidance on this issue in a letter to a taxpayer</u>: Section 213(a) of the Internal Revenue Code allows a taxpayer to deduct the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents (as defined in § 152), to the extent the expenses exceed 7.5 percent [10% after 2018] *of adjusted gross income. Section 152(a)* [prior to amendment by the Working Families Tax Relief Act of 2004] *defines a dependent as (1) an individual listed in the section (2) for whom the taxpayer provided over half of the support for the taxable year.*

A surrogate mother is, of course, neither the taxpayer nor the taxpayer's spouse, and typically is not a dependent of the taxpayer. Nor is an unborn child a dependent. Cassman v. United States, 31 Fed. Cl. 121 (1994) Thus, medical expenses paid for a surrogate mother and her unborn child would not qualify for deduction under § 213(a).

Under very limited circumstances, legal fees may be allowable as medical care expenses. In Gerstacker v. Commissioner, 414 F.2d 448 (6th Cir. 1969), legal expenses incurred to create a guardianship in order to involuntarily hospitalize a medically ill taxpayer were held to be deductible medical expenses because the medical treatment could not otherwise have occurred. However, legal expenses incurred in connection with a surrogate mother are typically not in connection with otherwise-deductible medical care expenses. Thus, the legal expenses likewise would not be deductible under § 213(a). (Associate Chief Counsel Letter #INFO 2002-0291, 12/31/02, Index 213.02-00)

<u>Homosexual Discrimination</u> - The biological father was capable of producing and providing healthy sperm with or without the involvement of an egg donor or a gestational surrogate; [2]-Because the costs attributable to the identification, retention, compensation, and care of the egg donor and the surrogate weren't incurred for the purpose of affecting any function of the father's body, he could not deduct them as "medical care" expenses under; [3]-The father's asserted right to IVF-and-surrogacy-assisted reproduction was not a fundamental right subject to equal rights protection; [4]-There was no evidence that the IRS's actual decision makers engaged in any intentional discrimination because the father was a homosexual, and he had not been treated differently from similarly situated heterosexual taxpayers. (Morrissey vs U.S. 871 F.3d 1260, Appeal Court, 7th Circuit, 9/25/2017)

<u>Note</u>: The surrogacy fee paid to the *surrogate mother is taxable to her and may be subject to SE Tax. IRC Sec* 61 states that all income is taxable unless specifically exempt by another section of the code and since it is providing personal services it may also be subject to SE tax if the surrogate is performing the service as a trade or business. Unfortunately surrogate agencies tell their clients it is not taxable.

Telephone - Included in medical expenses is the cost of special telephone equipment that lets a person who is deaf, hard of hearing or has a speech disability communicate over a regular telephone. This includes teletypewriter (TTY) and telecommunications device for the deaf (TDD) equipment and the repair of the equipment.

Television – Included in medical expenses is the cost of equipment that displays the audio part of television programs as subtitles for persons with a hearing disability. This may be the cost of an adapter that attaches to a regular set. It also may be the part of the cost of a specially equipped television that exceeds the cost of the same model regular television set.

Transplants – See "Organ Donors"

Travel – See page 07.02.12

Weight-Loss Programs - The IRS has concluded that expenses for certain weight-loss programs may be deducted as a medical expense. To be deductible, the program must be undertaken as treatment for a specific disease or diseases (including obesity) diagnosed by a physician. The costs are not deductible by taxpayers who participate in weight-loss programs to improve their general health or appearance. Further, the cost of purchasing diet food items is not deductible. *Rev. Rul. 55-261, 1955-1 CB 307, and Rev. Rul. 79-151, 1979-1 CB 116, are distinguished.*

*<u>Caution</u>***:** IRS Publication 502 takes a restrictive view of this deduction. It says that "You can include in medical expenses amounts you pay to lose weight for a specific disease diagnosed by a physician (such as obesity, hypertension, or heart disease). This includes fees you pay to join a weight reduction group and attend periodic meetings. ***You cannot include membership dues in a gym, health club, or spa*** *but you can include separate fees charged there for weight loss activities***."**

Thus, IRS Publication 502 seems to be saying that no portion of membership dues paid to a gym, health club or spa qualifies as a deductible medical expense in any case—even if the individual joined on the advice of a physician to lose weight to combat a disease.

Wig – A taxpayer can include in medical expenses the cost of a wig purchased upon the advice of a physician for the mental health of a patient who has lost all of his or her hair from disease. (IRS Publication 502)

DEPENDENTS

Medical Dependents - Medical expenses paid for dependents may be deducted by a taxpayer. To claim these expenses, the person must have been a dependent (qualified child or qualifying relative) either at the time the medical services were provided or at the time the expenses were paid. For medical purposes, an individual may be a dependent **even if his gross income precludes a dependency exemption**. *(IRC § 213(a);Reg §1.213-1(a)(3)(i))*

> ***Example*** *– The taxpayers' adult son was seriously injured in a motorcycle accident and did not have medical insurance. His parents paid all of his medical expenses for the year. Their son meets all of the dependent qualifications except for the gross income test. However, under the exception, they can still deduct the medical expenses on their 1040.*

- **Even if the other parent claims the dependency** - A child of divorced parents is considered a dependent of both parents (so that each parent may deduct the medical expenses he or she pays for the child.) A person generally qualifies as a dependent for purposes of the medical expense deduction if that person was a U.S. citizen or national, or a resident of the U.S., Mexico or Canada, and is either a:
  - *Qualifying child*, defined as a child who:
    1) Is the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepsibling, or a descendant of any of them;
    2) At the end of the year was under age 19, under age 24 and a full-time student, or permanently disabled, and is younger than the taxpayer;
    3) Lived with the taxpayer more than half of the year; and
    4) Did not provide his or her own support for the year. **OR**
  - *Qualifying relative*, defined as a person:
    1) Who is the taxpayer's son, daughter, stepchild, foster child (or one of their descendants); brother, sister (or son or daughter of either); father or mother (or ancestor or sibling of either); step-brother or step-sister, step-parent, son- or daughter-in-law, mother- or father-in-law, sister- or brother-in-law; or any other person (except spouse) who lived legally with the taxpayer all year as a member of the household;
    2) For whom the taxpayer provided over half of that person's total support for the calendar year; and
    3) Who is not a qualifying child.

Note that the requirements not to have (a) filed a joint return and (b) gross income in excess of the exemption amount (for a qualifying relative) are not part of the definition of a medical dependent.

Child of Divorced or Separated Parents **-** If either parent can claim a child as a dependent under the rules for divorced or separated parents, each parent can include the medical expenses he or she pays for the child. This is true even if the other parent claims the exemption for the child. *(IRC § 213(d)(5))*

> ***Example*** *– Bob and Jan are divorced and have two minor children. Jan claims the children as dependents and Bob pays their medical insurance and other medical expenses. Under the exception, because Jan claims them as dependents, Bob can claim the medical expenses he pays.*

Support Claimed Under a Multiple Support Agreement **-** A multiple support agreement is used when two or more people provide more than half of a person's support, but no one alone provides more than half. Whoever is considered to have provided more than half of a person's support under such an agreement can deduct medical expenses paid. Any medical expenses paid by others who joined in the agreement cannot be included as medical expenses by anyone.

TRAVEL

Auto Travel – When using a vehicle for medical reasons, deduction is allowed at a specified rate (cents) per mile (see table) or for actual cost of gas and oil (not repairs, maintenance, depreciation, lease fees, etc.).

STANDARD MEDICAL MILEAGE RATE (Cents per mile)						
Year	2015	2016	2017	2018	2019	2020
Rate	23.0	19.0	17.0	18.0	20.0	

If any amount is not shown, it is not available at publication date

Trips - Amounts paid for transportation to another city may be included in medical expenses, if the trip is primarily for, and essential to, receiving medical services. Up to $50 per night for lodging may be included. A trip or vacation taken merely for a change in environment, improvement of morale, or general improvement of health cannot be included in medical expenses, even if the trip is made on the advice of a doctor.

Lodging - The cost of meals and lodging at a hospital or similar institution may be included if the main reason for being there is to receive medical care. Medical expenses may also include the cost of lodging not provided in a hospital or similar institution. The cost of such lodging while away from home may be included if all of the following requirements are met:

1) The lodging is primarily for and essential to medical care.
2) The medical care is provided by a doctor in a licensed hospital or in a medical care facility related to, or the equivalent of, a licensed hospital.
3) The lodging is not lavish or extravagant under the circumstances.
4) There is no significant element of personal pleasure, recreation, or vacation in the travel away from home. The amount included in medical expenses for lodging cannot be more than $50 for each night for each person. Lodging is included for a person for whom transportation expenses are a medical expense, because that person is traveling with the person receiving the medical care. For example, if a parent is traveling with a sick child, up to $100 per night is included as a medical expense for lodging. Meals are not deductible.

Moving – Where a taxpayer is required to permanently relocate for medical reasons, only transportation costs related to the taxpayer are deductible, and the travel costs for the taxpayer's family are not deductible. Other typical moving expenses such as van and storage are not deductible.

In addition, the traditional moving expenses for a job-related move are suspended for years 2018 through 2025.

REIMBURSEMENT

Total medical expenses for the year must be reduced by all reimbursements for medical expenses that are received from insurance, Medicare payments and other sources during the year. Although a policy may provide reimbursement only for certain specific medical expenses, the amounts received from that policy must be used to reduce total medical expenses, including those it doesn't reimburse.

Reimbursement Received in a Later Year - If reimbursement is received in a later year for a medical expense deducted in an earlier year, report as income the amount received from insurance or other sources that is equal to, or less than, the amount previously deducted as medical expenses. However, do not report as income the amount of reimbursement received up to the amount of the medical deductions, which did not reduce taxes for the earlier year. IRS Pub 525 provides worksheets that are useful for figuring the amount of the medical reimbursement or other itemized deduction recoveries that may be taxable.

MEDICAL & AMT

For purposes of AMT, medical expenses are deductible to the extent they exceed 10% (7.5% for 2017 and 2018 per the TCJA) of the regular tax AGI.

CALIFORNIA DIFFERENCES

California generally conforms to Federal. However, CA does not conform to the 10% of AGI federal medical expense reduction. It is 7.5% for all age groups in CA (AB 154 – 2015). Thus, for CA there is a continued AMT adjustment for medical expenses.

NOTES

DEDUCTIBLE TAXES

Overview

- Deductible taxes generally **must be imposed on the taxpayer**
- Must be **paid during the tax year**
- Taxes are **NOT deductible for AMT purposes**

Related IRS Publications and Forms

Pubs Forms

- **Publication 17** – Your Federal Income Tax
- **Publication 525** – Taxable and Nontaxable Income
- **Instructions** – Form 1040
- **Instructions** – Form 1040 (Schedule A&B)

TCJA

Pre-TCJA tax deductions are retained, but limited to a maximum of $10,000, except foreign real property taxes cannot be included. Thus domestic real property tax, foreign income tax (if not claimed as a tax credit), state and local income tax or sales tax as an alternative to state and local income tax, and personal property taxes are still allowed subject to the $10,000 maximum (IRC Sec 164 as amended by TCJA §11042). The combination of these taxes is quite frequently referred to as SALT (state and local taxes) by the press.

IRS RELEASES FINAL SALT REGULATIONS RELATED TO LIMITATION

New Law & Stuff

The IRS has released final regulations related to the SALT limitation imposed by TCJA and the attempts by various states, most notably NY, NJ and CT, to skirt the $10,000 ($5,000 MFS) limitation on the deductibility of state and local taxes. The technique these states attempted to use to get around the limitation was by offering their residents the ability to make a charitable contribution in return for a credit against their state or local taxes, thus converting a limited tax deduction into a fully deductible charitable contribution.

Background for the IRS' Position:

- Section 170(a)(1) generally allows an itemized deduction for any "charitable contribution" paid within the taxable year to a qualified charity which, under Section 170(c), includes a State, a possession of the United States, or any political subdivision of the foregoing, including the District of Columbia.
- Section 164(a) allows a deduction for the payment of certain taxes, including state and local, and foreign, real property taxes, and state and local income or sales taxes and personal property taxes.
- TCJA limited, for years 2018 through 2025, the itemized deduction for state and local taxes to $10,000 ($5,000 MFS) and does not allow a deduction for foreign real estate taxes.
- In 1986 the Supreme Court held that where the taxpayer receives something in return (quid pro quo) for a contribution, the contribution was not tax deductible.

The IRS proposed regulations in August 2018 that generally require a taxpayer that makes a payment or transfers property to or for the use of an entity described in Sec 170(c) for which the taxpayer receives or expects to receive a state or local tax credit in return for such payment, to reduce their charitable contribution deduction by the credit amount because the arrangement created a quid pro quo benefit. However, if the taxpayer received a state and local tax deduction instead of a credit, this would not be a quid pro quo unless the deduction exceeded the amount of the donor's payment or transfer.

The proposed regs also included the following de minimis exception: a state or local tax credit is not treated as a quid pro quo if the credit does not exceed 15% of the taxpayer's payment or 15% of the fair market value of the property transferred by the taxpayer.

The final regulations 1.170A-1(h)(3), released in June 2019, generally follow the proposed regulations. However, regarding the 15% exception the final regulations added that it applies only if the sum of the taxpayer's state and local tax credits received, or expected to be received, does not exceed 15% of the taxpayer's payment or 15% of the fair market value of the property transferred by the taxpayer.

In the preamble to the final regulations, the Treasury and the IRS indicated their concern that the regulations could create unfair consequences for some individuals who itemize their deductions and made a charitable contribution in return for tax credits. Consequently, simultaneously with releasing the final regs, the IRS published Notice 2019-12 saying they intend to publish a proposed regulation amending Treasury Regulation § 1.164-3 to provide a safe harbor for certain individuals who make a charitable contribution in return for tax credits. Under the safe harbor, an individual may treat as a payment of state or local taxes for purposes of Sec. 164 the portion of a payment for which a charitable contribution deduction is or will be disallowed under Regs. Sec. 1.170A-1(h)(3). To qualify for the safe harbor, taxpayers must itemize deductions for federal tax purposes and their total state and local tax liability for the year must be less than $10,000. Until the proposed regulations are issued, taxpayers may rely on Notice 2019-12.

The following examples are based on those in Notice 2019-12.

Example #1 – The taxpayer makes a payment of $500 to a local or state-run charity and receives a dollar-for-dollar credit against the taxpayer's state income tax credit. The taxpayer's state tax liability is $500 or more. For federal purposes the $500 contribution can be treated as a tax payment subject to the $10,000 SALT limitation.

Example #2 – The taxpayer makes a payment of $7,000 to a local or state-run charity and receives a dollar-for-dollar credit against the taxpayer's state income tax. Under state law the credit may be carried forward for three taxable years. The taxpayer's state tax liability for year 1 is $5,000. The taxpayer applies $5,000 of the credit against the year 1 state tax liability and carries the balance forward to year 2 where it is used against the taxpayer's year 2 state tax liability. The taxpayer's year 2 state tax liability exceeds $2,000. For federal purposes the contribution is treated as a tax payment, with the $5,000 treated as a year 1 tax deduction and the $2,000 treated as a year 2 tax deduction. Both the $5,000 and $2,000 are subject to the $10,000 SALT limitation.

Example #3 – The taxpayer makes a payment of $7,000 to a local or state-run charity. In return for the contribution, the taxpayer receives a real property tax credit of $1,750, which is 25% of the contribution, and applies it to his $3,500 property tax bill. For federal purposes the $1,750 is treated as a property tax payment subject to the $10,000 SALT limitation. The balance of the contribution, $5,250, can be deducted as a charitable contribution.

TESTS TO DEDUCT ANY TAX

The Details

1) The tax must be imposed on the taxpayer (except where local law does not specify on whom the tax is imposed). *(Rev Rul 62-149, 1962-2 CB 66)*
2) The tax must be paid during the tax year.

DEDUCTIBLE TAXES

Generally, the following taxes are deductible:

- *Real Property Taxes* - Home and Investment (but not including foreign real property for years after 2018) – **CAUTION** – Generally taxes are only deductible if the taxpayer is on title to the property, and if so, the taxpayer can deduct the portion he or she paid. A frequently raised question relates to equitable or beneficial interest permitting a deduction. Courts have allowed it in very narrow and limited applications. See chapter 7.05 for details of equitable ownership and the deductibility of mortgage interest and taxes.
- *Personal Property Taxes* - This includes the personal property taxes on boats, aircraft, vehicles, etc. (Many of the taxes are combined with and must be separated from registration fees.)
- *Foreign Income Taxes Paid* (**Note:** It is generally always better to take the foreign tax credit.)
- *State and Local Income or Sales Tax* - Taxpayers have the option of deducting on Schedule A the LARGER of:
  (1) State and local *income* tax paid, or
  (2) State and local *sales* tax paid during the year.

- CA 2.5% Early (pre-age 59-1/2) Withdrawal Penalties for premature distributions from retirement plans (Chief Counsel Memo 20072201F)

CAUTION
The 2.5% Early Withdrawal Penalty is included in the state balance due and may have already been deducted as part of state income tax paid. Don't double up!

DETERMINING THE AMOUNT OF THE DEDUCTIBLE INCOME TAX

The state and local income tax that may be deducted on federal Schedule A is a combination of the amounts paid, withheld and applied from a prior year's overpayment of state and local income taxes during the tax year. More specifically, these amounts include state and/or local:

- Estimated tax paid - for example, the installments generally paid in April, June and September of the current year (the year for which the deductions are being itemized), plus the payment usually made in January of the current year for the prior tax year (but see "Required Allocation. . ." below for potential required offset);
- Overpayments from a prior year's return that are applied to the current year's tax;
- Tax paid in the current year with the filing of the prior year's return (including extension payments) or with an amended return (but not penalties for underpayment of estimated tax, late filing or payment, or interest paid);
- Tax withheld on Forms W-2 (including state benefit funds contributions – see below), W-2G, 1099R, SSA-1099, 1099-INT, 1099-DIV, 1099-B, 1099-MISC;
- Tax withheld on real estate transactions; and
- Tax withheld and passed to a beneficiary via the state version of Schedule K-1 (fiduciary).

Indian tribal government - An Indian tribal government that is recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for this purpose. Income taxes, real estate taxes and personal property taxes imposed by that Indian tribal government (or by any of its subdivisions that are treated as political subdivisions of a state) are deductible.

State benefit funds - An employee can deduct mandatory contributions to state benefit funds that provide protection against loss of wages. Mandatory payments made to the following state benefit funds are deductible as state income taxes. (IRS Pub 17, 2018 edition)

- Alaska Unemployment Compensation Fund
- California Nonoccupational Disability Insurance (SDI)
- New Jersey Nonoccupational Benefit Fund
- New Jersey Unemployment Compensation Fund
- New York Nonoccupational Disability Benefit Fund
- Pennsylvania Unemployment Compensation Fund
- Rhode Island Temporary Disability Benefit Fund
- Washington State Supplemental Workmen's Compensation Fund

Caution: Even though VPDI (voluntary plan disability insurance) is included in the California computation of excess (refundable) SDI payments when a taxpayer has more than one employer, it is not deductible as a State Benefit Payment for federal itemized deduction purposes.

Estimated Tax Must Be Reasonably Based – To be able to deduct state and local estimated tax payments, there must be a reasonable basis for making them. For example, a taxpayer knew that a state estimated tax payment she made in December would be completely refunded, but made the estimated tax payment anyway. No deduction is allowed on her federal Schedule A for the December estimated payment because it was not made in good faith on a reasonable basis.

Required Allocation Reduces State Tax Deduction – When a state tax refund is received that is for amounts paid in two or more years, the refund is prorated between the years so as to determine the amount of the refund that may be taxable and the amount of state tax paid in the current year that may be deductible. Typically this situation arises when a taxpayer makes a payment in January of Year 2 for Year 1's state estimated tax and receives a refund in Year 2 based on Year 1's state tax return. It also comes up when an extension payment is made in Year 2 for Year 1's state return, and subsequently a refund from Year 1's return is received in Year 2. In both instances, a portion of the state overpayment is deemed attributable to the payment in Year 2 and isn't taxable, but the nontaxable portion reduces the amount of the Year 2 payment when determining how much of that payment is deductible.

Example – Allocating Refund and Estimated Payments: *Guy's state estimated tax for 2019 is $6,000 and he has no income tax withholding; he made an estimated state tax payment of $1,500 on each of April 15, June 15, and September 15 in 2019 and January 15, 2020. In 2020 he received a state tax refund of $500 from his 2019 return. Guy itemized deductions on his federal returns in both years. The refund must be allocated between 2019 and 2020. Since 75% ($4,500 ÷ $6,000) of the estimated tax was paid in 2019 (and deducted on that year's Schedule A), 75% of the refund, or $375, is potentially taxable on Guy 2020 return. The remaining $125 of the refund is deemed to be from the January 2020 payment, and reduces Guy's deduction for state and local income tax on his 2020 Schedule A to $1,375 ($1,500 - $125), plus any other state and local income tax payments he made or tax withheld in 2020.*

STATE TAX REFUND ALLOCATION WORKSHEET (2019)

1. *2018 allocable* state income tax payments made in *2019*[1]…. _________
2. Total *2018* state income tax payments……………………………… _________
3. Divide line 1 by line 2 ……………………………………………………………………….. _________%
4. *2018* state refund[2] received in *2019* ………………………………….. _________
5. Multiply line 4 by line 3 – this is the portion of the state tax refund deemed nontaxable on *2019* return……………………………………. _________
6. Total state and local income tax payments made in *2019*[3]………………….. _________
7. Line 6 less line 5 – net state and local income tax payments potentially deductible on *2019* Schedule A ………………………… _________

[1]*For example, 2018 estimate installment paid in Jan.''19 and/or extension payment made April '19.*
[2]*include overpayment applied to 2019 estimated tax, refunds by check or direct deposit, and amounts applied to prior years' delinquencies.*
[3]*Include withholding, estimated tax payments and overpayment applied from prior year.*

Foreign Income Taxes – Credit or Deduction - Generally, a taxpayer can either take a deduction or a credit for income taxes imposed by a foreign country or a U.S. possession. However, no deduction or credit is allowed for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or foreign housing exclusion. Generally, the foreign tax on dividends is 15% and after making all the adjustments on Form 1116, the actual tax credit will be less, typically around 12%.

Practice Tip - Tax treaties with most countries set the rates at 15%. When there is a foreign tax withheld but the gross amount of the dividends or interest is not stated, the gross foreign income can be estimated by dividing the tax by 0.15.

Example: Assume the tax withheld is $60. $60/.15 = $400 = Estimated gross foreign income

Strategies

Strategy - Which is better, tax credit or tax deduction? If used as a deduction, the benefit would only be, assuming 37% tax bracket, 5.55% (.37 x .15) as compared to about 12% when used as a credit. Therefore, it is generally better to take the tax credit.

TAXABILITY OF STATE INCOME TAX REFUND

One of the questions that the TCJA raised was how the $10,000 SALT limitation would affect taxability of state income tax refunds. Would the IRS apportion the $10,000 between the types of taxes deducted? Or would it require that the taxes deducted be considered in a specific order, say first state income tax, then real estate tax, then other property tax? Or just the reverse order? Or would the taxpayer be able to choose the order? Finally, in late March 2019, in Rev. Rul. 2019-11, the IRS revealed that the taxability of refunds from 2018 (and returns (and future returns as long as the SALT limitation is in effect) should be based on the tax benefit rule.

Section 111(a) excludes from gross income amounts attributable to the recovery during the taxable year of any amount deducted in any prior year to the extent the amount did not reduce the amount of tax imposed by Chapter 1 of the Code. Section 111 partially codifies the tax benefit rule, which generally requires a taxpayer to include in gross income recovered amounts that the taxpayer deducted in a prior taxable year to the extent those amounts reduced the taxpayer's tax liability in the prior year.

According to the IRS, a taxpayer whose state and local tax deduction was impacted by the TCJA limitation needs to determine how much, if any, of their state tax refund is taxable by recalculating their 2018 itemized deductions and reducing their income tax deduction by the amount of the refund. If the reduction reduces their overall itemized deductions, then the refund will be taxable. The following are examples based on those in Rev Rul 2019-11.

Facts for the examples – all taxpayers are single and all itemized on their 2018 returns:

Taxpayer's Name	*Real property taxes paid in 2018*	*State & local income taxes paid in 2018*	*Other itemized deductions*	*Total Itemized Deductions claimed*	*State tax refund received in 2019*
Angie	*$4,000*	*$5,000*	*$5,000*	*$14,000*	*$1,500*
Brad	*$5,000*	*$7,000*	*$5,000*	*$15,000*	*$750*
Carolyn	*$5,000*	*$6,000*	*$5,000*	*$15,000*	*$1,500*
Devon	*$4,250*	*$6,000*	*$2,500*	*$12,500*	*$1,000*

***Example 1 – State tax refund fully taxable**: Angie's state and local tax deduction was not limited by the SALT limitation because her $9,000 total of SALTs was below the $10,000 limit. Including other allowable itemized deductions, Angie claimed a total of $14,000 in itemized deductions on her 2018 federal return. Had Angie paid only the proper amount of state income tax in 2018 ($7,500), her state and local tax deduction would have been reduced from $9,000 to $7,500 and as a result, her itemized deductions would have been reduced from $14,000 to $12,500, a difference of $1,500. Angie received a tax benefit from the overpayment of $1,500 in state income tax in 2018. Thus, she is required to include the entire $1,500 state income tax refund in her 2019 gross income.*

***Example 2 – State income tax refund not includible**: Brad's SALT deduction was limited to $10,000, so he could not deduct $2,000 of the $12,000 state and local taxes he paid. Had Brad paid only $6,250 ($7,000 – $750), the proper amount of state income tax in 2018, his SALT deduction would still have been $10,000 and his total itemized deductions would have remained $15,000. Brad received no tax benefit from the overpayment of $750 in state income tax in 2018, and therefore, he is not required to include the $750 as income on his 2019 return.*

***Example 3 – State income tax refund partially taxable**: Carolyn was limited to claiming $10,000 as a SALT deduction, so she could not deduct $1,000 of the $11,000 state and local taxes she paid. Had she paid only the proper amount ($4,500) of state income tax in 2018, her SALT deduction would have been reduced from $10,000 to $9,500 and as a result, her itemized deductions would have been reduced from $15,000 to $14,500. Carolyn received a tax benefit from $500 of the overpayment of state income tax in 2018. Thus, $500 of her state income tax refund must be included in her 2019 gross income.*

***Example 4 – Standard Deduction**: Devon's state and local tax deduction was limited to $10,000, so he could not deduct $250 of the $10,250 state and local taxes paid. In 2019, Devon received a $1,000 refund of state income taxes paid in 2018. Had Devon paid only $5,000, the proper amount of state income tax in 2018, his SALT deduction would have been reduced from $10,000 to $9,250, and, as a result, his itemized deductions would have been reduced from $12,500 to $11,750, which is less than the standard deduction of $12,000 that he would have taken in 2018. The difference between Devon's claimed itemized deductions ($12,500) and the standard deduction he could have taken ($12,000) is $500. He received a tax benefit from $500 of the overpayment of state income tax in 2018. Thus, Devon is required to include $500 of his state income tax refund on his 2019 federal return.*

Generally, professional-level tax software will make the calculation of the amount of the state income tax refund that's taxable. However, before Rev Rul 2019-11 was released some software companies had made the assumption that the IRS would require an apportionment of the SALT taxes. Therefore, tax preparers should carefully review any amount of state income tax refund proformaed as taxable for 2019 to be sure the computation follows the revenue ruling method.

DETERMINING THE AMOUNT OF THE SALES TAX

The sales tax is the actual amount paid during the year, which can be determined by the larger of:

(1) Actual receipts for purchases, **OR**
(2) The amount from the IRS income-based table PLUS sales tax paid when purchasing motor vehicles, boats and other items specified by the IRS.

Using the Optional Tables - The optional sales tax tables provide an amount of sales taxes paid based on a taxpayer's:

- **State of residence** - the state where the taxpayer physically resides;
- **Total available income** - AGI plus amounts not reflected in AGI that increase spendable income; and
- **Number of exemptions** - the number included on the taxpayer's tax return subject to a special rule for joint filers living in different states (see below).

The table for each state is based on the state's sales tax rate plus, if applicable, a uniform local sales tax rate. Taxpayers residing in a jurisdiction that imposes an additional sales tax rate are allowed a proportional increase in the sales tax deduction amount found in the optional sales tax tables. See the instructions to Schedule A for the sales tax tables, a worksheet and further information.

Spendable Income - The tables provide an amount of sales taxes paid based on the taxpayer's state of residence, total available income, and number of exemptions. The state of residence is the state where the taxpayer physically resides. Total available income is adjusted gross income (AGI) plus amounts not reflected in AGI that increase spendable income, such as:

- Worker's compensation,
- Public assistance payments,
- Military compensation earned in a combat zone,
- Tax-exempt interest,
- The refundable portion of refundable tax credits,
- The nontaxable part of SS, veterans' or railroad retirement benefits, and
- The nontaxable part of IRA, pension or annuity distributions.

Residing in Multiple States - A taxpayer who uses the tables and lives in different states during the tax year must multiply the amount determined under the tables for each state of residence by a fraction. Its numerator is the number of days the taxpayer was physically a resident in the state and its denominator is the number of days in the year. This is illustrated in an example in Notice 2005-31.

Items that can be added to the table amount - In addition to the amount determined under the optional tables and amounts added for local general sales taxes, taxpayers may deduct allowable actual state and local general sales taxes paid on the purchase of:

- Motor vehicles, Boats, Aircraft,
- Homes (including mobile and prefabricated homes), and
- Materials to build a home.

Definition of motor vehicle for sales tax deduction purposes – A "motor vehicle" includes any of the following, which may be either purchased or leased:

- automobile
- motorcycle
- motor home
- recreational vehicle
- sport utility vehicle
- off-road vehicle
- van
- truck

Strategies

Sales Tax and State Tax Refund - Under the tax benefit rule, the recovery of an amount deducted or credited in an earlier tax year is included in a taxpayer's income in the current (recovery) year, except to the extent the deduction or credit didn't reduce federal income tax (or alternative minimum tax). *(IRC §111(a))* For example, if a taxpayer who used the standard deduction instead of itemizing on his 2018 federal return receives a refund in 2019 from his 2018 state income tax return, that refund is not taxable on his 2019 federal return because he did not deduct the state income tax on the 2018 federal return. While the state will likely issue a Form 1099-G reporting the refund, the taxpayer does not include any of the refund amount on his federal return in this situation.

The recovery (refund) of state income tax is the most common itemized deduction recovery, but taxpayers may also recover amounts for previously deducted medical expenses, real property taxes or mortgage interest. Only itemized deductions that are more than the standard deduction are subject to the recovery rule (unless the taxpayer was required to itemize deductions). If total deductions on the earlier year return were not more than the income for that year, the recovery amount to include on the return for the recovery year is the lesser of the recoveries or the amount by which itemized deductions exceeded the standard deduction.

Where taxpayers have the option to deduct as an itemized deduction either the state (and local) income tax paid during the year or state and local sales tax, on first examination one would assume that (1) if the client chooses to deduct state income tax and subsequently receives a refund from the state, then that refund is taxable, and (2) if they choose to deduct sales tax instead of state income tax and receive a state refund for that year, that refund is not taxable. **Actually the IRS has taken a much more liberal approach to this issue**. Their position is that for purposes of the tax benefit rule the amount of refund includable in income is limited to the excess of the tax the taxpayer chose to deduct over the tax they did not choose to deduct.

Example – *Assume the taxpayer can choose an $8,000 state income tax deduction or a $7,000 state general sales tax deduction. Since the state income tax deduction is the larger, he chooses to deduct the state income tax. In the subsequent year he receives a $2,500 state income tax refund. Using the IRS's more liberal approach the tax benefit derived from deducting the $8,000 state income tax was only $1,000 more than if the $7,000 sales tax deduction was used. Thus the taxpayer benefits from only $1,000 of the state tax deduction and as a result only $1,000 of the $2,500 refund is taxable the next year.*

Strategy – In order to benefit from the IRS' liberal tax benefit rule position you must be able to compute the difference between the sales tax deduction and the state income tax deduction. Thus it is important (when there is a state tax refund and the state income tax deduction exceeds the sales tax deduction) to determine the allowable sales tax deduction for the client and record it in your file. Otherwise there is no way of computing the tax benefit rule.

Be Sure To Look Back – And take advantage of this tax benefit rule.

REAL PROPERTY TAXES (aka REAL ESTATE TAXES)

Delinquent Taxes at Sale - Do not divide delinquent taxes between the buyer and seller if the taxes are for any real property tax year before the one in which the property is sold. Even if the buyer agrees to pay the delinquent taxes, the buyer cannot deduct them. The buyer must add them to the cost of the property. The seller can deduct these taxes paid by the buyer. However, the seller must include them in the selling price.

Minister and Military Personnel Housing Allowances - A minister or a member of the uniformed services who receives an excludable housing allowance can still deduct all (within the $10,000 limitation imposed by the TCJA) of the real estate taxes paid on his/her home.

Homeowner Association (HOA) Dues - Where the components of the HOA fee are itemized and a portion of the fee includes common area real estate taxes, the taxpayer's share of the tax portion can be deducted as real property taxes on Schedule A. This also applies to condominium association fees.

Taxes for Local Benefits or Specific Services - Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of property. Sometimes referred to as Mello Roos Taxes, these include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities and similar improvements. The taxpayer should increase the basis of the property by the amount of the assessment. Itemized charges for services, such as a monthly fee for trash collection and a per unit charge for water service, are not deductible, even though assessed against a specific property or payable to the real estate taxing authority. Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, the taxpayer must be able to show the amount of that part to claim the deduction. If the part of the tax that is for maintenance, repair, or interest cannot be determined, none of it is deductible.

Therefore, it will be necessary for the return preparer to review clients' tax bills to identify potentially nondeductible amounts included in the taxes paid by the clients.

<u>*Exception:*</u> Service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if (2018 Pub 17, Page 167):

- The fees or charges are imposed at a like rate against all property in the taxing jurisdiction,
- The funds collected are not earmarked; instead, they are commingled with general revenue funds, and
- Funds used to maintain or improve services are not limited to or determined by the amount of these fees or charges collected.

Real Property Tax Need Not Be Ad Valorem Tax - In CCA 2012-18, the IRS stated that, contrary to what some of its forms and publications said (at that time), "*there is no statutory or regulatory requirement that a real property tax be an ad valorem* [based on value] *tax to be deductible for federal income tax purposes. Assessments on real property owners, based other than on the assessed value of the property, may be deductible if they are levied for the general public welfare by a proper taxing authority at a like rate on owners of all properties in the taxing authority's jurisdiction, and if the assessments are not for local benefits (unless for maintenance or interest charges).*"

The IRS has updated their forms and publications to reflect the Chief Counsel's interpretation.

Deduct in Year Paid – Many jurisdictions use a fiscal year for real property tax purposes. For example, a tax bill may say that it is for the July 1, 2019 -June 30, 2020 period. Most jurisdictions allow taxpayers to pay their real property taxes in two or more installments without penalty if made timely. So, for example, the taxpayer may make one payment in 2019 for the 2019-2020 tax bill and a second payment in 2020 for the balance of the bill. During 2019 that same taxpayer may have paid the second installment of their 2018-2019 bill if they didn't pay 100% of the 2018-2019 bill in 2018. What's deductible? For cash basis taxpayers, which is the method used by most individuals, only the taxes actually paid in the tax year are deductible. But clients oftentimes are confused about the payments, and could inadvertently misstate the amount paid when completing the organizer or planner that you provide. Therefore, best practice is to see the tax bills and confirm with the client what amounts were actually paid during the tax year of the return you are preparing. Many jurisdictions now include real property tax payment information on their web sites, a useful resource if the client doesn't have the information readily at hand.

Nondeductible Real Estate-Related Payments – The following items related to holding real estate are not deductible as itemized deductions: homeowner or condominium association dues (but see above for a limited exception), transfer or stamp taxes paid when a personal residence is sold, and rent increases or surcharges as a result of the landlord having to pay higher real estate taxes.

HERO Program - The Home Energy Renovation Opportunity (HERO) Plan provides financing for high-cost energy related improvements, such as solar panels, air conditioning, roofing, windows, lighting controls, and landscape-related products, for a taxpayer's home with principal and interest payments added to the taxpayer's property tax bill for the year. It is sometimes referred to as PACE financing.

The fact that the loan payments are included with the property tax payments has led to considerable misunderstanding with many real estate agents and others claiming the entire payment is tax deductible, which is not true. Although included in the tax bill, the HERO payments are separately stated and not deductible as property tax. However, the interest portion of the payment may be deductible as home mortgage interest.

The HERO program originated in Southern California but has since spread to almost all counties in California, and even to Florida and Missouri (Wall Street Journal 7/26/19); ads for this program pop up frequently on the Internet. Some contractors actively promote this program to individuals as a convenient way to finance home improvements since the HERO program has very liberal qualifications, with no money down, fixed rates and variable terms of 5-20 years. However, compared to today's interest rates, those charged by the HERO program are quite high, generally in excess of 8%, and individuals should explore other avenues of financing first.

TAX DEDUCTIONS AND AMT

Taxes deductible on Schedule A for regular tax purposes are NOT ALLOWED as a deduction against the AMT. They are subtracted on line 2a of Form 6251 (2018). If the client is being taxed by the AMT and not receiving any benefit from the deduction, the following strategies might be considered (Caution: Since the long-term capital gain rate is based on the taxpayer's regular tax bracket, there are rare circumstances where an individual transitioning between the 12% and 22% tax bracket might benefit from paying the taxes anyway – see strategy below).

Strategies

Defer Regular Tax-Deductible Tax Payments - Since no tax including state income, property tax, etc., claimed on Sch. A is ever deductible for AMT purposes, conventional wisdom would dictate deferring or accelerating tax payments to the subsequent or prior year if taxed by the alternative method in the current year. When deferring, care should be exercised in regards to late payment penalties and interest on underpayments for certain taxes. For example, if a taxpayer puts off paying their state tax liability until the subsequent year, will the benefit exceed the underpayment penalty? When accelerating tax payment, don't overlook Rev Ruling 82-208 (where IRS ruled that when a taxpayer makes an estimated state tax payment with no reasonable basis for belief that he owes any additional state income taxes, a deduction will be denied for the year of the payment).

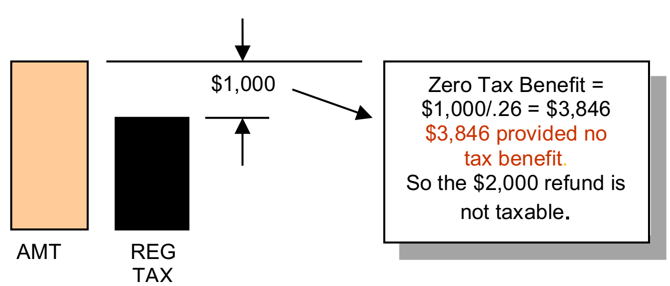
Strategies

Tax Benefit Rule – State Income Tax - When taxed by the AMT, part or none of the state income tax paid is allowed as a deduction. Therefore, to the extent the tentative AMT exceeds the regular taxable income, the taxpayer receives no benefit for the state tax deduction.

To the extent the taxpayer receives no benefit, the state income tax refund is not taxable for regular tax purposes in the subsequent year. Tax software may not make this computation, and the state's refund statement (Form 1099-G) absolutely does not take it into consideration. Therefore, if there is a state refund from the prior year and the taxpayer had some AMT tax, then part or all the refund is not taxable. *(IRC §111(a))*

Example: *In the prior tax year, the taxpayer itemized and his state income tax deduction* was *$5,000, his state tax refund was $2,000 and the AMT (add-on tax) was $1,000. Assuming he was in the 26% AMT bracket and his AMT tax was $1,000, he did not receive benefit from $3,846 ($1,000/.26) of the state income tax deduction. Therefore, any state tax refund up to that amount would not be taxable in the subsequent year. In this example, none of the $2,000 refund needs to be included into income the following year.*

Be Sure To Look Back – Was the taxpayer subject to the AMT on the prior year's return? If yes, apply the tax benefit rule and treat as taxable the amount of refund that reduced the regular tax taxable income below the alternative minimum taxable income (AMTI).



Schedule A Taxes Can Reduce AMT LTCG Tax - The LTCG 0%, 15% and 20% rates for AMT purposes are determined from the taxpayer's regular taxable income for the year (see chapter 2.04). Therefore, for 2019, to the extent a taxpayer's taxable income is at or below $39,375 (single or MFS), $52,750 (head of household), or $78,750 (married joint) – roughly the top of the 12% bracket – their LTCG will be taxed at 0% for **both** AMT and regular tax purposes. This makes the planning choices more difficult. The question being: is there more tax benefit maximizing the tax deduction or minimizing it through other strategies for taxes? Also see next strategy.

Capitalize Property Taxes for Unimproved & Unproductive Real Estate - Taxpayers who are affected by the AMT or who are simply taking the standard deduction can annually elect to capitalize the taxes that they paid on <u>unimproved and unproductive</u> real estate. This means forgoing the deduction and adding the amount of tax paid to the real property's cost basis (Reg Sec 1.266-1(b)(1)).

To make this election, the taxpayer must file a statement with the original return for the year of the election; this statement must specify the item(s) that the taxpayer has elected to capitalize (Reg Sec 1.266-1(c)(3)).

California does not allow a deduction for the following taxes:

- State Benefit Payments – SDI (or VPDI)
- State Early Withdrawal (2.5%) Penalty
- State Income Tax
- Sales Tax
- Foreign Income Taxes Paid (Foreign real property taxes <u>**are**</u> deductible.)

Foreign Property Tax – A frequent question this past tax season was the deductibility of foreign property tax for California purposes. Since California has not conformed to the TCJA itemized deductions changes, foreign property tax is still deductible for California purposes.

Nonconformity with TCJA – California has not conformed to the $10,000 limit for tax deductions for years 2018-2025 imposed by the TCJA. Therefore, if a taxpayer's real property and personal property taxes exceed $10,000, the taxpayer would be able to claim the full amount of the payments as a California itemized deduction.

CA Fire Prevention Fee – For several years, the California State Board of Equalization was required to charge an amount not to exceed $150 as a fire prevention fee (the fire fee) on each structure within a state responsibility area, i.e., an area of the state in which the financial responsibility of preventing and suppressing fires has been determined by the California Board of Forestry and Fire Protection to be primarily the responsibility of the state. This fee has not been deductible as a real property tax (IRS Chief Counsel Advice 201310029).

Effective July 1, 2017, through 2030, this fee is suspended, and as of January 1, 2031, the fee is repealed. (AB 398) These changes are part of the legislation extending the state's cap-and-trade program. It is the intent of the Legislature that moneys derived from the cap-and-trade program auctions or sales will replace the fire prevention fee to continue the funding of the fire prevention activities.

Use Tax Liability Takes Precedence – For purchases of tangible personal property made on or after January 1, 2015, in taxable years beginning on or after January 1, 2015, enacted Assembly Bill 2758 requires payments and credits on a California personal income tax, corporation franchise or income tax, partnership, limited liability company, estate or trust tax, or information return of a taxpayer that reports California use tax on the return to be applied first to satisfy the use tax liability, with any excess amount then being applied to the outstanding taxes, penalties, and interest owed to the Franchise Tax Board (FTB). Previously, the payments and credits had to be applied first to the income and corporate taxes, and associated penalties and interest, and then to the use tax liability.

Use Tax Payments – CA requires individuals who make out of state purchases, including in person, via the Internet by phone or mail order, to pay use tax on those purchases if California sales tax has not been collected by the seller of the item. Those not registered with the California Department of Tax and Fee Administration (CDTFA), formerly the Board of Equalization, can make the use tax payments on their CA income tax return. For those who have made out of state purchases and did not pay use tax, the CDTFA provides an optional use tax table, which is update yearly and included in the Form 540 instructions (see 2018 table below).

The intent of the table is to make it more convenient for taxpayers not registered with the BOE to comply with their use tax obligations by giving taxpayers the option to report their estimated use tax liabilities, determined from a use tax table, instead of calculating and reporting their actual unpaid use tax liabilities.

<u>Use Tax Entry Required</u> - A.B. 1593, signed by the governor October 7, 2017, requires taxpayers to enter a number – which can be a zero – on the use tax line of personal income tax returns beginning with 2017 returns. The act also requires taxpayers who enter a zero on the use tax line to check one of two boxes to validate they either already paid their use tax obligation directly to the CDTFA or that they do not owe use tax.

USE TAX WORKSHEET

1. Enter purchases from out-of-state sellers made without payment of California sales/use tax. If you are choosing the option to estimate the use tax due on individual, non-business items purchased for less than $1,000 each, only enter purchases of non-business items with a purchase price of $1,000 or more. ....$ __________
2. Enter the applicable sales and use tax rate.. __________
3. Multiply line 1 by the tax rate on line 2. Enter result here.........................$ __________
4. If you are choosing the option to estimate the use tax due on individual, non-business items purchased for less than $1,000 each, enter the use tax amount due from the Use TaxTable. If all of your purchases are included in line 1, enter zero.....................$__________
5. Add lines 3 and 4. This is your total use tax..$ __________
6. Enter any sales or use tax you paid to another state for purchases included on line 1

   See worksheet instructions below..$ __________
7. Subtract line 6 from line 5 but not less than zero. This is the total use tax due..........$ __________

   Enter the amount due on Form 540 line 91.

<u>Form Instructions</u>: Report purchases of items that would have been taxable if purchased from a California retailer. For example, include purchases of clothing, but not purchases of prescription medicine.

- *Include handling charges.*
- *Do not include any other state's sales or use tax paid on the purchases.*
- *Enter only purchases made during the year that correspond with the tax return you are filing.*
- *If you traveled to a foreign country and carried items back to California, generally the use tax is due on the purchase price of the goods you listed on your U.S. Customs Declaration less the $800 per-person exemption. This $800 exemption does not apply to goods sent or shipped to California by mail or other common carrier.*
- *If your filing status is "married/RDP filing separately," you may elect to report one-half of the use tax due or the entire amount on your income tax return. If you elect to report one-half, your spouse/RDP may report the remaining half on his or her income tax return or on the individual use tax return available from the California Department of Tax and Fee Administration (CDTFA).*

2018 ESTIMATED USE TAX LOOK-UP TABLE

(AGI)	USE TAX
less than $10,000	$2
$10,000 to $19,999	$7
$20,000 to $29,999	$11
$30,000 to $39,999	$16
$40,000 to $49,999	$21
$50,000 to $59,999	$25
$60,000 to $69,999	$30
$70,000 to $79,999	$34
$80,000 to $89,999	$39
$90,000 to $99,999	$44
$100,000 to $124,999	$52
$125,000 to $149,999	$63
$150,000 to $174,999	$75
$175,000 to $199,999	$86
More than $199,999	AGI by 0.046%

Note: *The 2019 Look-up Table was not available at publication date.*

STATE INCOME TAX DEDUCTION WORKSHEET – 2019

1. *2018* state estimated tax paid in January 2019 and/or state extension payment made in 2019 for 2018 return	__________
2. Offset for *2018* state tax refund (nontaxable) allocated to line 1 amount	<__________>
3. State income tax paid with *2018 return* filed in 2019 *	__________
4. Overpayment from *2018* state return applied to 2019 estimated tax	__________
5. 2019 state estimated tax paid during 2019	__________
6. State income tax w/h from 2019 W-2s	__________
7. SDI (not VPDI) w/h from 2019 W-2s	__________
8. Local income tax w/h from 2019 W-2s**	__________
9. State income tax w/h from 2019 Forms 1099-R and SSA-1099	__________
10. State income tax w/h from 2019 Forms W-2G and 1099-MISC	__________
11. State income tax w/h from 2019 Forms 1099-INT, 1099-DIV, 1099-B	__________
12. 2019 state income tax w/h on real estate sales (CA: Forms 592-B & 593)	__________
13. State income tax w/h passed through from trusts (2019 state Sch K-1)	__________
14. State income tax paid in 2019 for prior year original, amended, audited, and/or corrected returns*	__________
15. Other states income tax paid in 2019 not included above: __________________	__________
16. TOTAL 2019 – STATE INCOME TAX potentially deductible on Sch A – combine Lines 1 through 15	__________

*Do not deduct interest/penalty paid for late filing, late payment or underpayment of estimated tax, but do include any retirement plan 2-1/2% early distribution "penalty" included in the tax paid.
**On California W-2s, SDI may be shown in the "local w/h" box on Form W-2; do not duplicate entries with line 7.

NOTES

HOME MORTGAGE INTEREST

Overview

A deduction is allowed for interest paid on loans secured by a taxpayer's primary home and a second home. Loans are allocated to two categories: acquisition debt and home equity debt. Interest deductions are limited, depending on the category of the underlying debt.

- **Acquisition debt**
  - Debt incurred to purchase, construct or substantially improve principal or second home.
  - It must be secured by the home(s).
  - Initially limited, except for grandfathered debt, to: **$1,000,000** ($500,000 for MS) for loans made before December 16, 2017.
  - **$750,000** ($375,000 for MFS) for loans made after December 15, 2017.
  - Limit declines as mortgage is paid off.
  - Divorce - spouse buy-out debt is acquisition debt.
  - Term can be extended in refinance.
  - Deductible against both regular tax and the AMT.
- **Equity Debt After 2017**
  - No longer deductible as home mortgage interest regardless of when debt incurred.
  - May be traceable to other deductible uses.
- **Equity Debt Prior To 2018**
  - Can be used for any purpose.
  - Equity Debt of 1st and 2nd homes limited to **$100,000**
  - Limit remains at $100,000 even if paid down.
  - Deductible for regular tax but **NOT** AMT.
  - Generally cannot be allocated to other purposes.
- **Excess Debt**
  - Debt in excess of acquisition and equity debt limits.
  - Not deductible as home mortgage interest.
  - Excess debt can be traced to another deductible purpose.
- **Allocating debt**
  - Home mortgage interest cannot be allocated to other uses.
- **Unsecured election** - Treat secured debt as unsecured.
  - Interest allocated by using the general tracing rules.
  - Debt no longer secured by the home; thus none can be allocated back to the home.
  - Unnecessary 2018-2025
- **Home Under Construction -** Can be a qualified home during a construction period of up to 24 months.

New Law & Stuff

Mortgage Insurance Premiums – The 2018 Budget Bill extended this provision through 2017. Thus, unless extended again by Congress, no deduction is allowed for years after 2017. At press time there was little prospect of extenders getting passed.

RAPID FINDER

Related IRC and IRS Publications and Forms

- **Pub 936** – Home Mortgage Interest Deduction
- **Pub 17** – You Federal Income Tax
- **Instructions** – Form 1040 (Schedule A&B)
- **Form 1098** – Mortgage Interest Statement
- **Big Book of Taxes Chapter 215** – Interest Tracing Rules
- **IRC Sec 163(h)(3)**

TCJA

Acquisition Debt Limit Reduced - For years 2018 through 2025, the Act reduces the $1,000,000/$500,000 limit of home acquisition debt to $750,000 ($375,000 for married separate filers), except the lower limit won't apply to indebtedness incurred on or before December 15, 2017. That is, the $1,000,000/$500,000 cap continues to apply to acquisition mortgages on a primary and second residence already in existence prior to December 16, 2017. *(IRC Sec 163(h)(3)(F)(i)(II) as amended by TCJA §11043)*

Commentary: *The TCJA did not change the rule that interest on acquisition debt of the taxpayer's primary and a second residence is deductible. What changed was the lowered cap on the amount of acquisition debt for debt incurred after December 15, 2017.*

Example #1 - *In January 2019, Jim and Donna, who file a joint return, take out a $500,000 mortgage to purchase a main home. The loan is secured by the main home. In February 2019, they take out a $500,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of both mortgages exceeds $750,000, only 75% of the total interest paid is deductible.*

Pre-Dec. 15, 2017 Binding Contract Exception - Taxpayers who entered into a binding written contract before Dec. 15, 2017 to close on the purchase of a principal residence before January 1, 2018, and who purchase such residence before April 1, 2018 are not subject to the $750,000/$375,000 limitations and instead are subject to the $1,000,000/$500,000 limitations. *(IRC Sec 163(h)(3)(F)(i)(IV) as amended by TCJA §11043*

HOME ACQUISITION DEBT - Code Sec. 163(h)(3)(B)

The Details

Home acquisition debt is debt incurred to purchase, construct or substantially improve a taxpayer's principal home or second home. It must be secured by the home(s). *Combined home acquisition debt on the two homes can't be more than:*

- ***For Debt Incurred Before 12/16/18:*** *$1,000,000 ($500,000 for married separate).*
- ***For Debt Incurred After 12/15/2017:*** *$750,000 ($375,000 for married separate*).

***Home Debt Purchase Can Be Home Equity Debt As Well as Home Acquisition Debt* -** In a 2009 Chief Counsel Advice (CCA 200940030) the IRS made it clear that acquisition indebtedness that is incurred by a taxpayer to acquire, construct, or substantially improve a qualified residence can also qualify as home equity indebtedness under Code Sec. 163(h)(3)(C) to the extent it exceeds $1 million. As a result, a taxpayer can deduct interest paid on up to $1.1 million of the debt securing the purchase of his principal residence. This has been reinforced by Rev Ruling 2010-25. **However, this ruling has no effect for 2018 through 2025 when there is no deduction allowed for home equity debt.**

Refinanced debt can also qualify as home acquisition debt, if it doesn't exceed the amount of the old home acquisition debt just before the refinancing. Home acquisition debt is deductible against both the regular tax and the AMT.

HELOCs Can Be Home Acquisition Debt - Home equity lines of credit (HELOCs) can be home acquisition debt. The tax definition of home acquisition debt is debt to acquire, construct or substantially improve the taxpayer's home or second home. Just because the lender's title is equity debt does not preclude a HELOC from qualifying as a home acquisition debt.

Does $1 Mil of Acquisition Debt Limit Apply to Residence or Individual Co-Owners?

According to a Chief Counsel Advice (CCA 200911077) where two or more individuals own a residence with acquisition debt in excess of $1 Million dollars, the individuals jointly can only deduct the interest on the first $1 Million of acquisition debt.

An appeals court overturned an earlier Tax Court ruling (*C. J. Sophy, 138 TC No. 8, Dec. 58,965)* and took the same position the IRS put forward in the 2009 Chief Counsel Advice cited above. However. . .

The Ninth Circuit Court of Appeals reversed the Tax Court's decision and the IRS has announced its acquiescence with the Ninth Circuit's decision. Under this interpretation, unmarried co-owners are collectively limited to a deduction for interest paid on a maximum of $2.2 million, rather than $1.1 million, of acquisition and home equity indebtedness (Voss - IRB 2016-31, p. 193).

This can have significant implications for unmarried co-owners of a home.

TCJA It is presumed this will also apply to the new $750,000 acquisition debt limit.

<u>*Acquisition Debt Declines Over Time*</u> - Acquisition indebtedness is reduced as payments of principal (amortization) are made and cannot be increased by refinancing, except if indebtedness is incurred to substantially improve the residence. ***(H Rept No. 100-391, Part 2 (PL 100-203) p. 1033)*** Generally, acquisition debt will decline as illustrated in Figure #1. As shown, the original acquisition debt balance was $200,000, and it steadily declines over the term of the loan until it reaches zero at the end of the loan term (30 years). The amount and remaining term of the acquisition debt at any point in time always follows the curve of original acquisition debt.

> ***Example #2*** *- After 15 years, the acquisition debt in Figure #1 has declined to approximately $150,000 and only the interest on the $150,000 is treated as acquisition debt interest. After 30 years, the acquisition debt will have declined to zero, at which point there is no deduction for acquisition debt interest on the property.*

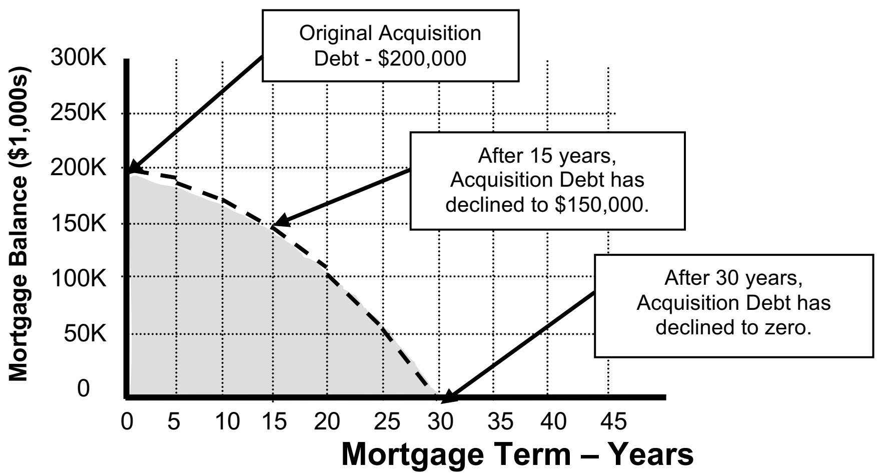


Figure #1

<u>Spousal Buy-Out Debt</u> ***- Notice 88-74, 1988-2 CB 385*** states that, in divorce situations, secured debt incurred to buy out a former spouse's interest in a home is acquisition debt. This rule is applied without regard to Code Section 1041, which treats certain transfers of property between spouses incident to divorce as nontaxable events.

<u>*Record of Original Loan Important*</u> **–** As illustrated in Figure #1, should a taxpayer refinance or add home equity debt, the only way to accurately determine the deductible amount of interest is by knowing the terms of the original acquisition debt. Therefore, it is important that clients retain that information and backup documents. A form for tracking home loans is included at the end of this chapter.

<u>Secured Debt</u> **-** *A* secured debt has three characteristics for purposes of the home mortgage interest rules:

1. It makes the taxpayer's interest in the home specific security for the loan;
2. If the taxpayer defaults on the loan, the home would provide satisfaction for the debt, as with a mortgage or deed of trust;
3. The debt must be recorded according to the applicable state law.

Refinancing Acquisition Debt - Prior to TCJA, taxpayers could refinance acquisition debt for the amount of the amortized balance with an unlimited extended term for the refinanced loan.

Pre-TCJA - Example #3: After 15 years, an original 30-year term acquisition debt of $200,000 has an assumed amortized balance of $150,000. Under law prior to TCJA, a homeowner could refinance that loan for $150,000 for any number of additional years and the debt continued to be acquisition debt.

Under TCJA, the $1,000,000/$500,000 limits continue to apply to refinances of acquisition debt incurred before 12/16/2017. However, TCJA only allows the refinanced acquisition debt to be treated as acquisition debt for the remainder of time left under the terms of the original loan (see exception below).

TCJA

Post-TCJA - Example #4: After 20 years, an original 30-year term acquisition debt of $200,000 has an assumed amortized balance of $100,000. The homeowner refinances the original loan for a new one with a balance of $150,000 and a term of 20 years. Because of TCJA's limits on loan terms, the refinanced loan will only be treated as acquisition debt for the first 10 years (30 years – 20 years) and the interest on the last 10 years of the refinanced loan will not be deductible.

If the principal of the original indebtedness was not amortized over its term, the loan's acquisition debt would continue to be treated as acquisition debt through the expiration of the term of the first refinancing of the indebtedness (or if earlier, the date that is 30 years after the date of the first refinancing). *(Code Sec. 163(h)(3)(F)(iii)(II)) as amended by TCJA §11043).*

Commentary: Where a home acquisition debt is refinanced for an amount more than the current amortized balance of the loan it will result in a loan that is part acquisition debt and part equity debt. When this occurs, you basically treat the debt as two loans, one being acquisition debt and the other equity debt. The interest is allocated, proportionally between the two debts, per Reg. Sec. 1.163-8T interest allocation rules, resulting in deductible acquisition debt interest and equity debt interest. See Chapter 215 – Interest Tracing Rules.

Example #5 – Post-2017 Refinance: *Married taxpayers have an acquisition debt loan with a balance of $175,000. They refinance that loan for $400,000 and do not use any of the proceeds to make improvements to the home. As a result the taxpayers have a mixed debt loan consisting of:*

Home Acquisition Debt…. $175,000
Home Equity Debt………… 225,000
Total Refinanced Debt……$400,000

The interest on the $175,000 portion of the debt is deductible as home acquisition debt interest. The balance of the refinanced debt, $225,000, is excess debt and the interest on this portion of the loan is deductible only if its use can be traced to another deductible use.

Increasing Acquisition Debt – If a home mortgage debt is refinanced, to the extent the new debt replaces the prior acquisition debt and any additional loan proceeds are used to substantially improve the residence, the new debt continues to be home acquisition debt so long as the $1 Million/$750,000 acquisition debt limits are not exceeded.

Refinanced Debt Loan Term – If the term of home acquisition debt is extended beyond its original term, the following rules apply:

- *Refinanced before December 16, 2017* – Where a home acquisition debt was refinanced **before** December 16, 2017, the loan continues to be home acquisition debt for the term of the refinanced loan.

Example #6: *In 2015, the taxpayer refinanced his home acquisition loan, which at the time had an unpaid balance of $835,000 and was amortized over a 25-year period ending in 2030. The new loan is amortized over a 30-year period ending in 2045. The interest on the loan continues to be qualified home mortgage interest until the loan is paid off in 2045.*

- *Refinanced after December 15, 2017* - Where a home acquisition debt was refinanced **after** December 15, 2017, the loan only continues to be home acquisition debt for the term of the original loan.

Example #7: *In 2019, the taxpayer refinanced his home acquisition loan, which at the time had an unpaid balance of $835,000 and was amortized over a 25-year period ending in 2030. The new loan is amortized over a 30-year period ending in 2049. However, the interest on the loan only continues to be qualified home mortgage interest until 2030, the date the original refinanced loan would have been paid off.*

HOME EQUITY DEBT - Code Sec. 163(h)(3)(C)

For Years Before 2018 - Home equity interest was deductible for debt secured by a taxpayer's principal or second home. *The total equity debt on the TWO HOMES couldn't be more than:*

- ***$100,000*** ($50,000 for married separate - Code Sec. 163(h)(3)(C)(ii)), or
- The difference between the acquisition debt on the home and the FMV of the home, if smaller.

There was generally no limitation on the use of home equity debt proceeds; the funds could have been used to purchase a car, pay personal debts, etc., and before 2018 the interest on the debt was still deductible on Schedule A within the limits above. ***Caution: Home equity debt was NOT deductible against the AMT*** (See home mortgage interest and AMT later in this chapter).

For years 2018 through 2025 - The deduction for home equity debt interest is suspended. This applies to both primary and second homes and includes home equity debt incurred prior to TCJA. *(IRC Sec 163(h)(3)(F)(i)(I) as amended by TCJA §11043)*

Commentary: *This law change can have an adverse impact on individuals who used their home as a piggy bank for personal expense purposes. Where the home loans have been refinanced and are partially acquisition debt and partially equity debt, tax preparers will still have to determine what part of the interest is attributable to the acquisition portion of the loan and which part is attributable to the now non-deductible equity portion.*

Commentary*: HERO (aka PACE) program loans are loans secured by the home via a property tax lien. The loans finance substantial energy-related improvements to the home and as such are acquisition debt, and thus the interest is acquisition debt interest, which continues to be deductible under TCJA up to the $1 Million/$750K acquisition debt limits. See also page 07.05.14.*

DETERMINING & TRACING EXCESS DEBT SECURED BY THE HOME

Interest on debt secured by the home must first be allocated to the home to the extent permitted, and any excess can be allocated to the use of the funds per the general tracing rules of Reg §1.163-8T (See Chapter 2.15 - Interest Tracing). Per the tracing rules, where the use of the loan funds can be traced to another purpose, the interest on the excess debt can be allocated to that use.

Example #8 – Allocating Refinanced Debt - *The original purchase money loan was refinanced with an average balance for the year of $300,000. The acquisition debt had declined to $150,000 at the time of the refinance and the interest on the refinanced debt was $10,000 for the year. The interest would be allocated as follows:*

	Debt	***% of Total***	***Interest Allocation***
1. Total Home Debt	*$ 300,000*	*100.00%*	*$10,000*
2. Allowable Acquisition Debt	*<150,000>*	*50.00%*	*$ 5,000*
3. Excess Debt	*$ 150,000*	*50.00%*	*$ 5,000*

The excess generally will not be deductible unless some portion of the loan proceeds could be traced to another tax-deductible purpose. If so, to the extent the proceeds can be traced to that other purpose, the excess can be allocated in accordance with the general interest tracing rule (See chapter 2.15). To illustrate how the interest on the excess debt might be allocated, consider the following situations:

Example 8(a) – ***Proceeds Used for Business*** *- Because the taxpayer could obtain a lower interest rate on a home loan, he refinanced his home loan to obtain the $150,000 needed to finance the startup of a Schedule C business. Since the entire debt is secured by the home, the interest on the refinanced debt must first be allocated to home acquisition and home equity debt. And, since for years 2018 through 2025 equity interest is not deductible as home mortgage interest, the traceable excess debt is $150,000 ($300,000 - $150,000) and can be traced to the taxpayer's Schedule C business.*

Example 8(b) – ***Proceeds Used for Mixed Uses –*** *Assume the taxpayer in example #8(a) used the additional $150,000 proceeds for the following purposes: $35,000 as a down payment on a rental property, $25,000 for his child's college tuition, $50,000 for a new car, and the balance placed in a savings account. The taxpayer could choose to allocate the excess debt of $150,000 in any manner he chooses (Reg §1.163-10T(e)(4)(iii)) between the rental, higher education or investment purposes to maximize his interest deduction; he needs to keep in mind the passive loss, AGI and net investment income limitations that could also further limit the allocated interest deduction.* ***Caution:*** *In this scenario, none of the amount allocated to higher education loan interest is deductible because mixed-use loans are not qualified as education loans. (Reg § 1.221-1(e)(4), EX (6)*

Any Reasonable Method OK In Determining Excess Debt **-** Although the current law limiting the deduction of mortgage interest has been on the books since enactment of the Tax Reform Act of 1986, as amended by the 1987 Omnibus Budget Reconciliation Act, the proposed and temporary regulations issued in 1987 became effective before the OBRA amendment and have not been updated since. According to the IRS in a Chief Counsel Advice, until regulations are issued, taxpayers may use any reasonable method of allocating debt in excess of the acquisition and/or home equity debt limitation. This includes methods described in Reg. § 1.163-10T

Also, using any of these methods does not require making the debt-not-secured-by-residence election of Reg. § 1.163-10T(o)(5), but if the "not secured by" election is made, it applies to the entire amount of the debt, not just a part. When the election isn't made, only the part of the debt in excess of the limitation is traced to how the debt proceeds are used. *(CCA 201201017)*

EFFECT OF HOME IMPROVEMENTS

Home acquisition debt includes debt incurred to purchase, construct or ***substantially improve*** a taxpayer's principal home or second home. Currently, there is no official explanation of the type or degree of work that's required for a substantial improvement. Presumably, the "improvement-versus-repair" rules would be relevant in determining whether there was a substantial improvement for purposes of the acquisition indebtedness rule.

Debt incurred to substantially improve the home will increase the acquisition debt. The home improvement debt can be:

- A separate loan secured by the home, or
- Part of a refinanced home acquisition debt. However, when the home improvement debt is part of a refinanced qualified home acquisition debt then the period of time for which the interest on the debt may be deductible is limited to the term of the original home acquisition debt. See Refinanced Debt Loan Term on page 7.05.04.

LOAN PROGRESS CHARTS

The following are abbreviated loan progress charts for both 30-year and 15-year loans by interest rate. These charts are for illustration purposes only. The balance of the loan is shown as a percentage of the original loan.

> ***Example #9*** *– A 30-year loan with an initial balance of $100,000 and a 7% interest rate will have a balance of $ 53,197 ($100,000 x .53197) at the end of 20 years.*

30-Year Loan Progress Chart

%	5	10	15	20	25	30
3	88.906	76.019	61.051	43.662	23.463	0
4	90.448	78.784	64.543	47.154	25.923	0
5	89.935	78.912	64.765	46.610	23.310	0
6	91.398	81.451	68.035	49.939	25.529	0
7	92.692	83.771	71.125	53.197	27.783	0
8	93.825	85.871	74.019	56.362	30.056	0
9	94.810	87.755	76.708	59.413	32.334	0
10	95.660	89.433	79.189	62.333	34.601	0

15-Year Loan Progress Chart

%	5	10	15
3	71.518	38.433	0
4	73.059	40.164	0
5	68.662	34.339	0
6	70.288	35.932	0
7	71.870	37.535	0
8	73.406	39.145	0
9	74.892	40.759	0
10	76.329	42.370	0

THE MODIFIED FORM 1098 IS A GAME CHANGER

Poorly educated tax professionals routinely enter into their tax return preparation program the entire amount reported on their clients' 1098 forms as fully deductible home mortgage interest, oblivious to or intentionally ignoring the fact that not all of the interest reported on the form may be deductible due to the acquisition and equity debt limitations. The IRS modified Form 1098 beginning in 2016 to ferret out homeowners who are deducting excess home mortgage interest.

New Information:

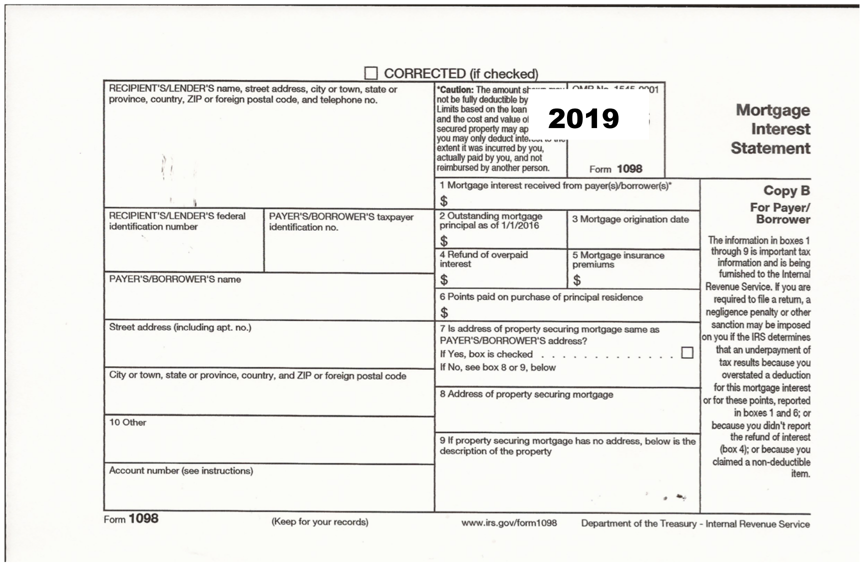
Box 2: – Outstanding Mortgage Principal - generally as of Jan. 1 of tax year or origination date if mortgage originated in tax year

Box 3: – Mortgage origination date

Box 5: – Mortgage Insurance Premiums (not deductible for 2018 or 2019 unless revived by Congress)

Boxes 7, 8, and 9: – Address information of property securing the mortgage.

This extra information will provide practitioners AND the IRS with additional tools to determine whether the loan is acquisition or equity debt, whether the loan balance exceeds the statutory home acquisition or equity debt limits, and whether the amount of interest deductible as home mortgage interest has been (or needs to be) limited. It will also help in figuring out whether the 1098 is associated with the home of the taxpayer.



CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

*Caution: The amount sh... not be fully deductible by... Limits based on the loan and the cost and value o... secured property may ap... you may only deduct inte... extent it was incurred by you, actually paid by you, and not reimbursed by another person.

OMB No. 1545-0901 | 2019 | Form 1098

Mortgage Interest Statement

1 Mortgage interest received from payer(s)/borrower(s)* $

RECIPIENT'S/LENDER'S federal identification number | PAYER'S/BORROWER'S taxpayer identification no.

2 Outstanding mortgage principal as of 1/1/2016 $ | 3 Mortgage origination date

4 Refund of overpaid interest $ | 5 Mortgage insurance premiums $

PAYER'S/BORROWER'S name

6 Points paid on purchase of principal residence $

Street address (including apt. no.)

7 Is address of property securing mortgage same as PAYER'S/BORROWER'S address? If Yes, box is checked . . . . If No, see box 8 or 9, below

City or town, state or province, country, and ZIP or foreign postal code

8 Address of property securing mortgage

10 Other

9 If property securing mortgage has no address, below is the description of the property

Account number (see instructions)

Copy B For Payer/ Borrower

The information in boxes 1 through 9 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points, reported in boxes 1 and 6; or because you didn't report the refund of interest (box 4); or because you claimed a non-deductible item.

Form **1098** (Keep for your records) www.irs.gov/form1098 Department of the Treasury - Internal Revenue Service

ALLOCATING HOME MORTGAGE INTEREST

Debt secured by a taxpayer's home is by definition home mortgage interest and **to the extent it is allowed as home mortgage interest,** it **CANNOT BE ALLOCATED.** However, the **EXCESS** (the amount not allowed as home mortgage interest), as discussed earlier, can be allocated to other uses per the general interest allocation rules. As an alternative, the taxpayer has the option to treat the mortgage as not secured by the home (see "Election to Treat Secured Debt as Unsecured" below.)

Office-in-home (Business use of home) - Where there is business use of a home, the acquisition debt is secured by both the home and the office in the same ratio as the home and business use and is not being allocated. Therefore, the interest paid on the portion of the loan secured by the office becomes home office interest, deductible on the same form or schedule on which the office is deducted, and is not treated as allocated interest secured by the home. On the other hand, <u>in years that allowed a home equity interest deduction</u>, no portion of any allowable interest on equity debt can be deducted as business interest and all of the allowable equity interest is only allowed on Schedule A.

Example #10 – Business Use of the Home – *Assume the taxpayer uses 10% of his home for business for his sole proprietorship. The interest for the year on his $200,000 acquisition debt is $12,000, and the interest on the home equity debt of $50,000 is $3,000. The proceeds of the equity debt were used to pay off credit cards and take a vacation.*

<u>For years other than 2018-2025</u>, the interest will be deductible as follows:

	Total	***Schedule A***	***Schedule C***
Acquisition Debt Interest	*$12,000*	*$10,800*	*$1,200*
Equity Debt Interest	*$ 3,000*	*$ 3,000*	

<u>For years 2018-2025 the breakdown is:</u>

	Total	***Schedule A***	***Schedule C***
Acquisition Debt Interest	*$12,000*	*$10,800*	*$1,200*
Equity Debt Interest	*$ 3,000*	*$ 0*	*$ 0*

Because the proceeds of the equity debt aren't traceable to the business, no part of the interest paid on that debt is deductible on Schedule C.

ELECTION TO TREAT SECURED DEBT AS UNSECURED

Taxpayers can elect to treat any secured debt as unsecured. *(Reg. 1.163-10T(o)(5))* The **election is irrevocable without IRS consent**. By making the election, the interest on the loan can be allocated to use of the proceeds by using the general tracing rules of Reg §1.163-8T.

Caution: By definition, home mortgage debt must be secured by the home. If this election is made, the debt is no longer treated as secured by the home. Therefore, if this election is made, no portion of the interest on the debt can be allocated back to the home.

Unsecured Election Serves No Purpose During 2018 -2025

This election was useful prior to tax reform when the interest on the first $100,000 of equity debt had to be deducted as home equity interest on Schedule A. Electing the debt to be unsecured permitted the tracing rules to be applied to the entire debt, allowing more home equity debt to be traced to another use. However, with the advent of tax reform it is unnecessary since any refinanced home acquisition debt continues to be home acquisition debt and any additional debt is traced to its use using the general tracing rules.

CAUTION: If before the passage of TCJA (before 2018) a taxpayer had utilized the unsecured election, that election is irrevocable without IRS consent and thus the loan continues to be treated as unsecured, and since home acquisition mortgage debt is defined as being secured by the home, none of the interest allocated to home acquisition mortgage debt is deductible on Schedule A or anywhere else.

DEFINITION OF A QUALIFIED RESIDENCE

A qualified residence is a taxpayer's principal home and one other residence. The homes can include a house, co-op apartment, condo, mobile home, house trailer, motor home, timeshare property or houseboat. Taxpayers with more than two homes can choose the property they want for a second home on a year-by-year basis, but for purposes of the mortgage interest rules they can't have more than one second home at any given point in time. A taxpayer does not have to occupy a second home in order for it to qualify. However, if the second home is rented, the vacation home use requirements must be met, i.e., the home qualifies as the taxpayer's home only if it is used by the taxpayer more than the greater of: (1) 14 days, or (2) 10% of the days rented.

NONCONVENTIONAL HOME

The term "nonconventional home" refers to homes that are used on a transient basis such as a motor home and boat. The interest, if otherwise qualifying for the home acquisition mortgage interest, is deductible on Schedule A. However for AMT purposes the following applies:

- *For years prior to 2018* – Per the instructions for the 6251, nonconventional home acquisition debt interest was not deductible for AMT purposes.
- *For years 2018 through 2025* – The instructions for the 6251 no longer make reference to "nonconventional home" interest and there isn't an adjustment line for it on the form. It is therefore assumed there is no longer a restriction for deducting nonconventional home acquisition debt interest.

HOME MORTGAGE INTEREST AND AMT

Home mortgage interest is reported by the lender on Form 1098 and includes all interest from debt secured by the taxpayers' home or homes. Lenders are not required, nor do they attempt, to classify interest as acquisition debt interest, home equity debt interest, nonconventional home, etc. That task is up to the taxpayer and his/her tax return preparer. Use the table below to determine where the home mortgage interest is deductible

Debt	Schedule A	AMT
Acquisition Debt	YES	YES
Acquisition Points	YES	YES
Home Equity Debt (2018 – 2025)	NO	NO
Amortized Refinance Points [1]	YES	YES
Nonconventional Home Interest (Years before 2018)	YES	NO

(1) *Not all amortized refinance points are deductible. If the refinance exceeds the sum of the acquisition debt and the home equity debt, then only the portion of the amortized points representing debt on which the interest is deductible may be used.*

REVERSE MORTGAGE INTEREST

A reverse mortgage is available to an individual age 62 and older. The reverse mortgage must be secured by a first trust deed. Thus, any existing loans have to be paid off with separate funds or with the proceeds from the reverse mortgage. The amount that can be borrowed is based upon age. The older the borrower, the greater amount that can be borrowed and the lower the interest rate. The rules are complicated and depend upon the type of current debt owed by the potential borrower. When a reverse mortgage is paid off, there is accrued interest to be paid along with the loan balance payoff and some of that interest may be deductible.

There are a number of factors to consider in determining whether accrued reverse mortgage interest is deductible and by whom. Under TCJA equity debt interest is not deductible during the years 2018 through 2025. However, if the reverse mortgage refinanced an existing home acquisition debt then when the reverse mortgage loan is paid off a prorated portion of the accrued interest will be deductible home acquisition debt interest.

We generally think of a reverse mortgage as providing for the living expenses of the taxpayers. As we have learned in taxes, always expect the unexpected. The tracing rules apply as with any debt and character of the debt is determined by the use of the funds. Making the assumption that the use is all personal and the interest non-deductible may not be correct. Who knows, the taxpayer may be using the proceeds for his business or investment.

The deductibility of reverse mortgage interest follows the same limits as conventional loans **except the deduction is limited to what would have been deductible each year if the borrower had paid it** and accrues until the loan is paid off, at which time it is deductible.

Debtor Pays Off the Mortgage - If the debtor pays off the reverse mortgage, the deductible accrued interest may be limited. In the case where none of the mortgage is considered acquisition debt, the interest on debt up to the $100,000 limit would be deductible as equity interest if paid before 2018. After 2017 and through 2025 equity interest is no longer deductible. The deductibility of any excess debt would be based upon the interest tracing rules (Temp Reg. Sec 1.163-8T). Generally, reverse mortgage payments are used for personal expenses of the borrower, and therefore the interest on the excess debt is generally not deductible.

> ***Example #11:*** *June, age 70, who owned her home free and clear, took out a reverse mortgage on her home. She subsequently came into a sizeable inheritance and decided to pay off the mortgage. The balance on the loan was $155,000, of which $45,000 was interest and $110,000 principal. Since the principal exceeded the $100K limit for equity debt, the interest will have to be allocated between equity debt interest and excess debt interest. In addition any equity interest paid after 2017 and before 2026 would not be deductible. Any excess debt interest may or may not be deductible depending upon the use of the funds by the borrower.*

A reverse mortgage interest after the decedent's death is allowable as a deduction in respect of a decedent (DRD), deductible under IRC §691(b) either by the estate or by the beneficiary. If the estate is not liable for the obligation then the person who inherits the property from the estate (subject to the obligation) is entitled to the deduction (IRC §691(b)(1)(B)). In either case the interest deduction is limited to what the decedent could have deducted, so the interest limitations apply and equity interest paid after 2017 and through 2025 would not be included.

The decedent's estate pays off the mortgage – Even though the interest accrued on the reverse mortgage before the borrower's death and was paid after the borrower's death, it qualifies as a deduction in respect to the decedent (DRD). Therefore, the estate can deduct the interest on its income tax return (Form 1041) as a DRD (Sec 691(b)(1)(B)). However the amount deductible by the estate is limited to the interest that would have been deductible in the year to which it was attributable based upon the character of the debt (Sec 163(b)(2)). And if the payoff occurs in 2018-2025, any portion of the accrued interest that would have been equity debt isn't deductible.

The beneficiary, who inherits the home, pays off the mortgage – Even though the interest accrued on the reverse mortgage before the borrower's death and was paid after the borrower's death, it qualifies as DRD (Sec 691(b)(1)(B)). Therefore, the beneficiary, if itemizing deductions, may deduct the interest on his or her 1040 income tax return as a DRD. However, the amount deductible by the beneficiary is limited to the interest that would have been deductible in the year to which it was attributable based upon the character of the debt (Sec 163(b)(2)) and the 2018 through 2025 suspension of equity debt.

A beneficiary who inherits a home (subject to a reverse mortgage) is required to either sell the home to satisfy the reverse mortgage debt or pay it off by some other means. If the beneficiary pays off the reverse mortgage by obtaining a new loan, to the extent the new loan is used to pay off the reverse mortgage, it would have the following treatment:

a. Qualified home acquisition debt if the beneficiary uses the home as a first or second home and the loan is secured by the property, ((Code Sec. 163(h)(3)(A); Reg. § 1.163-10T(j)(1)).

b. If not used as a home or second home determine treatment under the general tracing rules for the use of the funds (Reg. § 1.163-8T(a)(3), Reg. § 1.163-8T(c)(1)).

MULTIPLE OWNER-OBLIGOR

Paid From a Joint Checking Account – In Chief Counsel Advice 201451027, where home mortgage payments are made from a joint checking account, with two equal owners, the payments are presumed to be made equally by each owner without competent evidence to the contrary. The CCA uses as reference Rev Rul 59-66, which found that funds paid from a joint checking account of a husband and wife were presumed to have been paid equally by the spouses when a husband and wife file separate returns.

All Paid By One Owner-obligor - Chief Counsel Advice 201451027 concludes that a person who is jointly and severally liable on a home mortgage debt is entitled to deduct all the allowable interest on that debt, provided that person actually pays all the interest.

Death of an Owner-obligor – In determining the amount of interest deductible on the decedent's return, the general rules regarding payment from joint or separate accounts, and joint liability should apply. If the decedent paid interest from a joint account before death, his return should reflect one-half of the interest paid from the joint account before the time of death, in the absence of evidence that the interest was paid from the decedent's separate funds (CCA 201451027).

Multiple Taxpayers Liable on the Mortgage –Where both taxpayers are liable on the mortgage, both are entitled to claim the mortgage interest deduction to the extent of the mortgage interest paid by either taxpayer. If the mortgage interest is paid from separate funds, each taxpayer may claim the mortgage interest deduction paid from each one's separate funds. If the mortgage interest is paid from a joint bank account in which each has an equal interest, under Rev Rul 59-66, it would be presumed that each has paid an equal amount absent evidence to the contrary (CCA 201451027).

Co-owners - CCA201451027 concludes that if co-owners of a house are both liable on a mortgage, each one may take a deduction for the amount each one pays, subject to the limitations and requirements of deducting mortgage interest.

Interest Expense Deductions Related to Co-Owned Property - An interest expense deduction is available only to those who are primarily liable on an underlying debt. However, when two or more persons are jointly and severally liable for a debt, each is primarily liable for the debt; each is entitled to a deduction for the interest on that debt that he/she pays. When co-signers make a gift to another co-signer who paid the interest, this has no effect on the rule.

A father was allowed to deduct the interest he paid on a note which he co-signed with his son as evidence of a student loan to the son for tuition, fees, etc. ***(Rev Rul 71-179, 1971-1 CB 58).***

A father was allowed to deduct mortgage interest paid on a property held in common with his daughter. It didn't matter that he had temporarily conveyed legal title to his daughter to avoid creditors' claims ***(Conroy, Thomas, (1958) TC Memo 1958-6).***

Where mortgaged property is owned jointly, and joint owners are jointly liable on the mortgage, each owner is entitled to a deduction for the mortgage interest he/she actually pays out of his own funds.

However, when there isn't joint liability on the mortgage or where there is right to reimbursement, and one joint owner pays all or part of the mortgage interest, the deductibility is the same as under the rules for taxes (see Chapter 1.07).

Rev Rul 78-362, 1978-2 CB 248 - Are a joint tenant's monthly payments of a mortgage debt on property held jointly regarded as gifts to the other joint tenants?

> **FACTS:** An individual provided funds for the down payment for a purchase of real property and then conveyed two-thirds of the property to his two children; the property was held in joint tenancy. The individual subsequently made payments on the mortgage without expecting reimbursement from the children.
>
> **FINDING:** Transfer of the property was termed a gift to each child--after the transfer, the taxpayer and each of the children held a one-third interest in the property. The subsequent mortgage payments were also considered monthly gifts to each child, each equal to one-third of the mortgage payment. ***Amundson, Brent, (1990) TC Memo 1990-337***
>
> **FACTS:** A taxpayer's sister bought a home which she financed with a mortgage. She then agreed to sell one-half of the property to the taxpayer in return for the taxpayer paying the mortgage. The taxpayer made the mortgage payments, but didn't disclose his ownership or become directly obligated to the mortgagee (he didn't want to incur the fees required for refinancing). However, an unrecorded quitclaim was made on the property.
>
> **FINDING:** The taxpayer had an enforceable, interest-bearing debt to his sister. His payments to the mortgagee were, in effect, payments to his sister. Taxpayer gets an interest deduction for his payments.

MORTGAGE ASSISTANCE PAYMENTS

Payments received under the following programs are in the nature of general welfare (under the "general welfare exclusion") and aren't included in the recipient's gross income:

1. Mortgage assistance payments made by the Department of Housing and Urban Development (HUD) under Sec. 235 of the National Housing Act. The taxpayer-mortgagor doesn't get an interest deduction. IRS regs bar any interest deduction with respect to a taxpayer's indebtedness to the extent of assistance payments made by HUD under Sec. 235 of the National Housing Act (Reg § 1.163-1(d)).
2. Payments made on behalf of homeowners under Department of Treasury's and Department of Housing and Urban Development's (HUD) **Home Affordable Modification Program (HAMP)** to the mortgage holder, where the borrower is eligible for principal reduction of the outstanding balance of a qualifying mortgage pursuant to HAMP's Principal Reduction Alternative (PRA). For information on debt relief under HAMP, see Chapter 2.09.
3. Payments made to or on behalf of homeowners under state housing finance agency programs listed in Notice 2011-14, Appendix, and updated at www.treasury.gov/HHF, with funds allocated from the **Housing Finance Agency's (HFA's) Hardest Hit Fund**. For tax years 2010 through 2021 the safe harbor deduction for taxpayers who receive these payments is the lesser of:
    a. The amounts actually paid during the year to the mortgage servicer, HUD, or the State HFA on the home mortgage, or
    b. The sum of the amounts shown on Form 1098 as interest, real property tax, and, if deductible under Sec. 163(h)(3)(E), deductible mortgage insurance premiums. (Notice 2015-77, as amplified by Notice 2017-40) Note: the PATH Act of 2015 extended the deduction for mortgage insurance premiums only through 2016 and the Bipartisan Budget Act of 2018 further extended the deduction through 2017. While on the 2019 list for potential extension into 2018 and/or 2019, the probability of an extenders bill making it through Congress grows less likely as the legislative year progresses.

    This safe harbor rule applies for a tax year if the homeowner: (a) meets the requirements of Code Sec. 163 and Code Sec. 164 to deduct all of the mortgage interest on the loan and all of the real property taxes on the principal residence; and (b) participates in the EHLP, an SSSP, or a State Program described in the Appendix to Notice 2011-14, in which the program payments could be used to pay interest on the home mortgage.

    Modified Safe Harbor - Notice 2018-63 addresses homeowners who may be affected by the TCJA's $10,000 limitation on deductible property taxes as it relates to the Hardest Hit Fund safe harbor. Under the modified safe harbor, participating homeowners may allocate mortgage payments actually made first to deductible mortgage interest, and thereafter use any reasonable method to allocate the remaining balance of payments made to real property taxes, mortgage insurance premiums, home insurance premiums and principal.

4. Payments made on behalf of homeowners under the Department of Housing and Urban Development's (HUD's) **Emergency Homeowners' Loan Program (EHLP)** or from substantially similar state programs (SSSPs) receiving funding from EHLP. The safe harbor mortgage interest deduction for tax years 2010 through 2021 is the same as for #3 above.

Information reporting – IRS Form 1098-MA is used by the various governmental agencies to report Payments by State Housing Finance Agencies (HFAs) or the Department of Housing and Urban Development (HUD). The following are the box descriptions for that form:

- **Box 1 -** Shows the total amount of State HFA/HUD mortgage assistance payments and homeowner mortgage payments.
- **Box 2 -** Shows the amount of State HFA/HUD mortgage assistance payments.
- **Box 3 -** Shows the amount of homeowner mortgage payments.

SPECIAL CIRCUMSTANCES

Acquisition Debt Timing – Acquisition debt need not be obtained concurrently with the close of escrow. Notice 88-74 specifies that in the case of the acquisition of a residence, debt may be treated as incurred to acquire the residence to the extent of expenditures to acquire the residence made within 90 days before or after the date that the debt is incurred.

Home Under Construction - A home under construction may be treated as a qualified residence for a period of up to 24 months during the construction period, if the property actually becomes the taxpayer's first or second home when completed. Thus, the construction loan interest can be treated as qualified home mortgage interest during that 24-month period and need not be capitalized. Purchasing a lot, planning and designing the home aren't considered "construction." Amended returns are necessary if the taxpayer fails to make the completed home his residence after the construction.

***Example #12: - Deduction of Home Mortgage Interest on Home Under Construction** - Will owns a vacant lot in the mountains. On 05/01/15, he got a loan to begin construction of a vacation house on the lot. On 09/01/17, construction actually began, and the home was completed and occupied by Will on 12/01/19. Will may choose to treat the property under construction as his second home for purposes of deducting home mortgage interest for any 24 months during the period beginning 09/01/17 and ending 12/01/19.*

***Home Destroyed* -** A taxpayer may be able to continue treating their home as a qualified home even after it is destroyed in a fire, storm, tornado, earthquake or other casualty. This means the taxpayer can continue to deduct the interest subject to the normal limits for home mortgage interest. To continue treating a destroyed home as a qualified home, the taxpayer must do one of the following within a reasonable period of time after the home is destroyed:

1) Rebuild the destroyed home and move into it, or
2) Sell the land on which the home was located.

This rule applies whether the home is the main home or a second home that the taxpayer treats as a qualified home. Also, it applies whether or not the home is in a Federal disaster area.

***Converting a Home to a Rental* –** Occasionally, taxpayers will convert their existing home to a rental. The interest deduction for a rental is limited to the interest on the acquisition debt. Had the converted home been previously refinanced, the interest on any debt in excess of the acquisition debt for the property would not be deductible as rental interest. If the excess debt can be traced per the general tracing rules to a deductible use, then the excess interest would be deductible. Otherwise, the excess interest would no longer be deductible.

***Timesharing Arrangements* -** A taxpayer can treat a home owned under a time-sharing plan as a qualified home if it meets all the requirements.

Rental of timeshare**:** If a taxpayer rents out the timeshare, it qualifies as a second home only if the taxpayer also uses it as a home. To qualify as a home, the taxpayer must use the home the greater of: (1) 14 days, or (2) 10% of the days rented. To determine if the taxpayer meets that requirement, count the days of use and rental of the home only during the time the taxpayer had a right to use it.

***Equitable Ownership* –** Home mortgage interest deductions are not necessarily limited to the taxpayers whose name is on the title or mortgage. Rather, taxpayers with an "equitable ownership" in the property may be entitled to deduct the interest.

The general rule is that only the person(s) liable for the underlying debt are entitled to deduct the interest on that debt. However, regulations state: "Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness" (Reg Sec 1.163-1(b)).

Therefore, it is possible for a taxpayer who is not directly liable for the mortgage to be the beneficial or equitable owner of the mortgaged property, and thus allowed a deduction for the interest on the mortgage payments he or she makes. To be the beneficial or equitable owner of a mortgaged property, the taxpayer must assume the burdens and benefits of ownership, often considered by the Tax Court to be whether the taxpayer:

- Has a right to possess the property and enjoy its use, rents or profits;
- Bears the property's risk of loss;
- Has a duty to maintain the property;
- Has a responsibility for insuring the property;
- Is obligated to pay the property taxes;
- May improve the property without consent of the owner; and
- Has the right to obtain legal title at any time by paying the balance of the purchase price.

Examples where taxpayers were equitable owners:

- Taxpayer entered into a binding contract to purchase a residence, and took possession of the residence under an "occupancy agreement" while financing was pending. The occupancy agreement made taxpayer responsible for utility payments and for getting liability and contents insurance on the property. Following a two-month transition period, it also made taxpayer liable for repairs to plumbing, heating, cooling, electrical equipment and appliances. The purchase contract and the occupancy agreement shifted sufficient burdens and benefits of ownership to taxpayer to give him equitable title to the property. (Uslu, Saffet, TC Memo 1997-551)
- Taxpayer's son was the legal owner of the property, but he didn't reside there. Taxpayer lived on the property and covered all expenses and taxes. When the property became rental property, taxpayer and not the son served as landlord, i.e., finding a tenant and providing all services related to the property. Taxpayer held the burden and benefit of ownership exclusively and so was the equitable owner. The son's name was used solely

to procure the mortgage when taxpayer was having financial difficulties. (Njenge, Ndile G., TC Summary Opinion 2008-84*)

- Neither title to the property nor the mortgage obligation was in the taxpayer's name, but taxpayer resided at the property, contributed a significant part of the downpayment, and agreed to be responsible for all mortgage payments. (Edosada, Conrad, TC Summary Opinion 2012-17*).

Examples where taxpayers WERE NOT equitable owners:

- Taxpayers' sons, who lived with their parents in a residence then owned jointly by their father and uncle, didn't prove they held a beneficial interest in the property under then applicable state (CA) law, entitling them to deduct mortgage interest they paid, where they didn't: (i) contribute to the down payment; (ii) show they made any payments for the residence for the 12 preceding years the family lived there; or (iii) show any agreement entered into with their father or uncle giving them an ownership interest. (Daya, Gabriel, TC Memo 2000-360)
- Taxpayer assumed no benefit or burden of ownership on a home legally owned by her brother. Although she made mortgage payments to help her brother, she couldn't establish that she had any right to possession or use of the property or any obligations for its maintenance. (Puentes, Lourdes, TC Memo 2013-277)

Under California law, the owner of legal title to property is presumed to be the owner of full beneficial title as well. This presumption may be rebutted only by clear and convincing proof. One way of overcoming the presumption is by showing that there exists an agreement or understanding between the parties evidencing an intent contrary to that which is reflected in the deed (Van Phan, TC Summary Opinion 2015-1*).

Caution –These cases have unique sets of circumstances and should only be relied upon in cases with the same sets of circumstances, but see * below.

*Pursuant to IRC Sec 7463(b), summary opinions may not be treated as precedent for any other case.

Late Payment Charge on Mortgage Payment **-** A taxpayer can deduct as home mortgage interest a late payment charge if it is not for a specific service performed by the mortgage holder.

Mortgage Prepayment Penalty **-** If a taxpayer pays off the home mortgage early and is charged a prepayment penalty by the lender, the prepayment penalty can be deducted as home mortgage interest.

Mortgage Interest Credit **-** The taxpayer may be able to claim a mortgage interest credit, if the taxpayer were issued a mortgage credit certificate (MCC) by a state or local government. Figure the credit on **Form 8396**, "Mortgage Interest Credit." If the taxpayer takes this credit, the mortgage interest deduction is reduced by the amount of the credit.

Minister and Military Housing Allowances **-** If the taxpayer is a minister or a member of the uniformed services and receives a housing allowance that is not taxable, the taxpayer can still deduct the home mortgage interest.

Mortgage Proceeds Invested in Tax-Exempt Securities **-** The home mortgage interest on home equity or excess mortgage debt is not deductible if the taxpayer used the proceeds of the mortgage to buy securities or certificates that produce tax-free income.

Capitalizing Mortgage Interest – Under certain circumstances taxpayers can elect to capitalize otherwise deductible mortgage interest, taxes and carrying charges on unimproved and unproductive real property in lieu of deducting these expenses. This rule **does not apply to any qualified residence interest**. (Code Sec. 263A(f)(2)(B))

Below Market (Gift) Loans **-** Occasionally when preparing tax returns, we encounter situations where there are loans between family members, or occasionally between employer and employee, with no interest being charged or the rate of interest is below market rates. IRC Sec. 7872 deals with issues related to below market loans including: creating interest income, interest payments, investment interest, gift consequences and certain exceptions to the Sec 7872 treatment. Sec 7872 covers a variety of circumstances; however this discussion deals only with its application to non-business loans between family members or between employer and employee.

Below-Market-Loan – A below-market loan (Sec 7872(a)(1)) is generally a gift or demand loan where the interest rate is less than the applicable federal rate (AFR). The code defines the term "gift loan" as any below-market loan where the forgoing of interest is in the nature of a gift, while a "demand loan" is any loan which is payable in full at any time on the demand of the lender. (Secs 7872(f)(3); 7872(f)(5)) The AFR is established by the Treasury Department and posted monthly. As an example, the AFR rates for March 2019 were:

Term	AFR (Annual) March 2019
3 years or less	2.55%
Over 3 years but not over 9 years	2.59%
Over 9 years	2.91%

A term loan (defined in the Code as any loan that isn't a demand loan) can also be a "below-market" loan if the amount loaned is more than the present value of all payments due under the loan (Code Sec. 7872(e)(1)(B)).

Tax Treatment – Generally, for income tax purposes:

Borrower – Is treated as paying interest at the AFR rate in effect when the loan was made and the interest is deductible for tax purposes if it otherwise qualifies. However, where the loan amount is $100,000 or less, the amount of the forgone interest deduction cannot exceed the borrower's net investment income for the year.

Lender – Is treated as gifting to the borrower the amount of the interest between the interest actually paid, if any, and the AFR rate. Both the interest actually paid and the forgone interest are treated as investment interest.

Exception - The below-market loan rules do not apply to gift loans directly between individuals where the loan amount is $10,000 or less. This exception does not apply to any gift loan directly attributable to the purchase or carrying of income-producing property. (Sec 7872(c)(2))

Employer and Employee - Loans between employer and employee, or independent contractor and the contracting person, are subject to the same rules except that the forgone or below market interest is treated as compensation to the employee or independent contractor. (Sec 7872(b)(1)(B))

MARRIED SEPARATE TAXPAYERS

Treat married separate taxpayers as though they were one taxpayer in applying the home mortgage interest rules. If they own two homes, each may deduct the interest on only one, unless both consent in writing that the deduction for both homes is to be taken by one spouse.

HERO LOANS (PACE FINANCING)

The Home Energy Renovation Opportunity (HERO) Plan provides financing for high-cost energy related improvements, such as solar panels, air conditioning, roofing, windows, lighting controls, and landscape-related products, for a taxpayer's home with principal and interest payments added to the taxpayer's property tax bill for the year. It is sometimes referred to as PACE financing.

Although included in the tax bill, the HERO payments are separately stated and not deductible as property tax. However, the portion of the HERO payment that represents interest is generally deductible as home mortgage interest. Although the interest portion is not spelled out on the property tax bill, the HERO program does supply each borrower with a loan amortization schedule that can be used to determine the amount of interest paid for the year and which may be deductible. With the HERO program no Form 1098 is issued and care must be taken on how the interest is deducted on the tax return to avoid receiving a letter from the IRS.

The HERO program originated in Southern California but has since spread to almost all counties in California, and even to Florida and Missouri (Wall Street Journal 7/26/19); ads for this program pop up frequently on the Internet. Some contractors actively promote this program to individuals as a convenient way to finance home improvements since the HERO program has very liberal qualifications, with no money down, fixed rates and variable terms of 5-20 years. However, compared to today's interest rates, those charged by the HERO program are quite high, generally in excess of 8%, and individuals should explore other avenues of financing first.

MORTGAGE INSURANCE PREMIUMS

For tax years 2007 through 2017 taxpayers could deduct as an itemized deduction the cost of premiums for mortgage insurance on a qualified personal residence. The premiums were deducted as home mortgage interest (line 13 on Schedule A). Unless extended again by Congress, this **deduction will no longer be available after 2017.** While on the 2019 list for potential extension into 2018 and/or 2019, the probability an extenders bill will be enacted is becoming unlikely.

CALIFORNIA DIFFERENCES

California conforms to the Federal treatment of home mortgage interest, except that:

(1) California has not conformed to the TCJA reduction in the acquisition debt limit to $750,000 and continues to follow the pre-TCJA acquisition debt limit of $1 Million.

(2) California has not conformed to the TCJA disallowance of equity interest and continues to follow the pre-TCJA rules allowing equity interest deduction on the first $100,000 of equity debt on the taxpayer's first and second homes.

(2) California does not have a mortgage interest credit (MIC). The amount of mortgage interest that is required to be reduced on the federal return when the MIC is claimed is deductible for state purposes. Restore the amount on Schedule CA.

(3) Mortgage insurance premiums are not deductible for California.

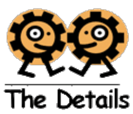
POINTS

- Points paid to purchase a home – deductible in the year of purchase.
- Points paid on a loan to substantially improve the home – deductible in the year paid.
- Generally all other points incurred must be amortized

RAPID FINDER

Related IRC and IRS Publications and Forms

- **Pub 936** – Home Mortgage Interest
- **Sec 461(g)(2)** – Exception to Amortization of Home Points



Cash method taxpayers must capitalize prepaid interest and deduct it over the life of the loan on which it is paid. This general rule for prepaid interest also applies to "points," i.e., the additional interest charge paid when a loan is incurred.

Points are a form of prepaid interest; one point is equal to 1% of a loan amount. Points are often labeled "loan origination fees," "premium charges," etc. At times, certain loan charges may be called points but are really amounts lenders charge for setting up a loan.

Such "service charge points" aren't normally deductible. The other costs, in excess of the pre-paid interest, are includable in the property's basis to the extent they were incurred to acquire or substantially improve the mortgaged property. They would not be deductible at all when the property is refinanced for other purposes. This discussion will involve points in the form of prepaid interest not only on home mortgage loans, but also on loans to buy other kinds of real properties.

WHAT ARE POINTS

Points are generally defined as fees paid to a lender solely for the use or forbearance of money and not for specific services that the lender performs in connection with the borrower's loan and are treated as pre-paid interest. Points are not always designated in the escrow points and frequently are referred to as any of the following:

- Loan origination fees
- Loan processing fees
- Maximum loan charges
- Premium charges, etc.

THE DEDUCTION FOR POINTS

Points, because they constitute prepaid interest, with the exception of the purchase of the taxpayer's primary residence, are deducted ratably over the term of the loan. The following are examples of how this rule applies:

Rental Property – Points paid for a purchase money TD, the refinance of an acquisition loan, or an improvement loan for rental property are not currently deductible and must be amortized over the life of the loan.

Investment Property – Points paid for a purchase money TD or the refinance of an acquisition loan are not currently deductible and must be amortized over the life of the loan. In addition, the annual amount would be treated as investment interest on Schedule A.

Principal Residence – Points, if otherwise deductible, may be currently deductible if (1) the "principal residence exclusion" described below applies, (2) the manner of payment qualifies, and (3) the "other requirements" are satisfied.

Second Home – Points, if otherwise deductible, must be amortized over the life of the loan.

PRINCIPAL RESIDENCE EXCEPTION

An exception to the rule requiring points to be amortized applies to taxpayers who pay points in connection with the purchase or improvement of their principal residence **(Sec 461(g)(2))**. Under this exception, a taxpayer is allowed a current deduction of the full amount of the points paid. To qualify for the exception, both of the following must also apply:

1. It must be established business practice to charge points in the geographic area where the loan is made;
2. The points charged cannot exceed the number of points usually charged in the area.

Option to amortize points on home purchase - **LR 199905033** states that a home buyer may amortize home loan points instead of treating them as currently deductible interest. This ruling is helpful for the home purchaser who finds that a deduction of the points in the year of purchase is of no tax benefit (e.g., the taxpayer didn't have enough deductions to itemize).

EFFECT OF MANNER OF PAYMENT ON DEDUCTIONS

When, in connection with purchasing or improving a principal residence, an individual pays points at the closing of a loan out of his/her own separate, unborrowed funds, the points are currently deductible as long as the statutory requirements are met. Where points are financed, or paid by the seller, different rules may apply for loans to buy a principal home than for loans to improve a principal home.

Loan to buy a principal residence - Points charged in connection with a loan to buy a principal home are considered to have been paid directly by the borrower, if the borrower provides cash at or before loan closing in an amount equal to the point charge. The cash can't have been borrowed as part of the loan transaction; it can come from a down-payment, escrow deposit, etc., applied at closing.

Points paid by the seller - Rev Proc 94-27, 1994-15 IRB 17 states that points paid by the seller (including points charged the seller), connected with the loan on a principal home for the buyer, are treated as paid directly by the buyer from unborrowed funds (the buyer subtracts seller-paid points from the purchase price of the home to compute its basis). **Note:** Even though the buyer gets to deduct seller-paid points, the seller can use the amount as a selling expense.

QUALIFIED RESIDENCE INTEREST LIMITATION

Where an original or refinanced primary or second home acquisition mortgage exceeds $750,000 ($1 Million acquisition debt and $100,000 equity debt for loans incurred before December 16, 2017), the prepaid interest (points) must be proportionately allocated between the allowable limitations and the excess debt in the same manner as home mortgage interest is limited. For married separate filers (MFS), the limitations are 50% of the amounts noted here.

OTHER REQUIREMENTS

The following additional requirements must be met in regard to points:

1. The transaction settlement statement (Form HUD-1) must clearly show the amounts incurred as points. For example, it should state "loan origination fee" or some other official designation.
2. The points should be computed as a percentage of the loan principal.
3. The loan can't be more than the amount that can be treated as acquisition debt (generally $750,000 ($375,000 MFS)).
4. The points can't be paid in lieu of other payments that are normally stated separately (e.g., appraisal, title, and legal fees).

Example - Home Residence Point Deductions - *Bob and Barbara Black bought a home for $170,000. To finance the transaction, they put down $30,000 cash and incurred a $140,000, 25-year loan. The lender charged 3 points ($4,200) as part of the deal; the contract called for the points to be financed. Thus, rather than a loan amount of $140,000, the Black's actual loan principal is $144,200 ($140,000 plus $4,200).*

Result: *Since the Blacks provided cash (the downpayment) at least equal to the amount of points, they may currently deduct the $4,200 points charge. Of course, they must meet all the statutory requirements detailed above.* ***Special Note:*** *Had the Blacks total itemized deductions not exceeded the standard deduction, they could opt to amortize the points rather than deduct them and thereby preserve a deduction for the future that would otherwise be lost.*

VA and FHA Loans - Amounts paid in connection with a VA or an FHA loan that would not be allowed if paid in connection with a conventional loan are not deductible points - an example is the VA Funding Fee. However, for years before 2018, this fee may be deductible as a mortgage insurance premium, subject to the AGI limitations of that deduction (IRS Pub 936). Note: At press time there was a bill in Congress to extend the deduction for mortgage insurance premium, but likelihood of passage is slim.

INFORMATION REPORTING FOR HOME MORTGAGE POINTS

Lenders must report points on a principal residence acquisition loan on Form 1098, box 6 (2019 version). The requirement doesn't apply to points paid in other types of transactions, such as refinanced loans. The borrower deducts allowable points on Schedule A along with other qualified home mortgage interest.

POINTS PAID AS PART OF A REFINANCE

Loan for Home Improvements Only - If a loan is incurred for solely the purpose of improving the taxpayer's principal home and does not include the refinance of an existing loan, the points would be currently deductible provided the points met the requirements included in "other requirements" above and the points are paid by the borrower from separate funds (see "Effect on manner of payment" above).

> ***Example – Loan for Home Improvements Only -*** *Emily and Jay's home is free and clear and they decide to make some major improvements and take out a loan for $100,000, with the proceeds of the loan being used for home improvements within a reasonable period of time. The lender charges them $2,000 in points that they pay from separate funds. The $2,000 is deductible as interest on their Schedule A. Had the points been added to the loan – bringing the loan balance up to $102,000 – the points would not be currently deductible and would have to be amortized over the life of the loan.*

Loan for Home Improvements & Refinance of the Existing Home Loan - If an existing acquisition debt loan is refinanced in order to obtain additional funds for home improvement, and the homeowners incur points as part of the transaction, the points must be proportionately allocated between the refinance of the home and the substantial home improvements. The portion allocated to refinancing the existing loan is amortized over the life of the loan while the home improvement portion is currently deductible. The points still must meet the general requirements for the deductibility of pre-paid interest for a primary residence.

> ***Example – Loan for Home Improvements & Refinance of the Existing Home Loan –*** *Instead of owning their home free and clear, Emily and Jay in our prior example have a $200,000 existing acquisition debt on the home. They refinance the existing loan into a new $300,000 primary loan and pay points in the amount of $6,000. Emily and Jay will use $100,000 to make substantial home improvements within a reasonable amount of time. 66.67% of the new loan was used to retire the old loan. Thus two thirds of the points ($4,000) must be amortized over the life of the loan. Since $100,000 was (or will be) used to make substantial home improvements, the balance of the points ($2,000) is currently deductible.*

Points Paid in Refinancing Deductible - A married couple who refinanced their mortgage, reduced their monthly mortgage payment, and then used the savings to improve their home could deduct the prepaid interest or "points" paid in the refinancing. The points were paid in connection with the improvement of their home under the broad construction of the phrase "in connection with." The couple presented evidence as to the number and cost of the home improvements and testified that the purpose of the refinancing was to obtain funds to make the improvements. Additionally, the improvements began nine days after the refinancing. Although the cost of the improvements exceeded the savings from the refinancing, the difference was not grossly disproportionate ***G.E. Hurley, T.C. Summary Opinion 2005-125***

BALANCE OF AMORTIZED POINTS

Refinance with different lender - When a mortgage is refinanced with a different lender or paid off, the balance of any points being amortized becomes fully deductible in the year the loan was retired.

> ***Example*** - Dan paid $3,000 in points and was amortizing them over the 15-year life of the mortgage, deducting $200 per year. Dan prepaid his mortgage in full this year. He had previously deducted $2,200 in amortized points. He can deduct the remaining $800 of the amortized points this year.

Refinance with same lender - IRS Pub 936 (2018), Page 8 indicates that if a mortgage is refinanced with the same lender the remaining unamortized balance of the points is not currently deductible. Instead, the remaining balance must be amortized over the life of the new loan. This position by the IRS is based upon the fact that a taxpayer must have unrestricted control over the funds in order to deduct the interest, which is very rarely the case. (Ferris v Commissioner, 1939 879 TC 751)

Some Refinancing Costs May Be Deductible - The IRS has issued a reminder to taxpayers that they may be eligible to deduct some costs associated with their home mortgages. Points paid solely to refinance a home mortgage usually must be deducted over the life of the loan. Other closing costs, such as appraisal fees and other non-interest fees, are generally not deductible. If refinancing for a second time, the unamortized balance of points paid for the first refinance may be deductible upon pay-off of the first refinanced loan. Taxpayers also should note that the amount of their adjusted gross income can affect the amount of deductions they can take because of the overall itemized deductions limitation (the overall limitation applies to years before 2018 and after 2025). ***(IR-2002-114)***

CALIFORNIA DIFFERENCES

California conforms to the Federal treatment of points.

NOTES

INVESTMENT INTEREST

Overview

- Is NOT a tier 2 Miscellaneous Deduction
- Interest expense deduction limited to net investment income (NII)
- Excess carried over indefinitely - AMT carryover can be different primarily due to Private Activity Bond Interest
- NII = Investment income less allowed investment expenses
  - Most investment expenses not allowed 2018-2025 because Tier 2 miscellaneous deductions are suspended
- AMT –Generally no AMT adjustment.

RAPID FINDER

Pubs Forms

- **Related IRC and IRS Publications and Forms**
  - **Form 4952** – Investment Interest Expense Deduction
  - **Pub 550** – Investment Income
  - **IRC Sec 163**

Surtax on Unearned Income
Long-Range Planning

The Net Investment Income Tax imposes a surtax on high-income individuals, estates, and trusts. For individuals, the surtax (Sec. 1411) is 3.8% of the lesser of: (1) The taxpayer's net investment income or (2) The excess of modified adjusted gross income over the threshold amount ($250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all others).

For surtax purposes, gross income doesn't include excluded items, such as interest on tax-exempt bonds, which gives taxpayers an opportunity to adjust their portfolios to mitigate or avoid this tax. The definition of investment income may not be the same for the surtax and the investment interest expense limitation. See Chapter 12.05 for details of the Net Investment Income Tax.

TCJA

The deduction for investment interest continues to be deductible (IRC Sec 163). However, the investment interest deduction is limited to net investment income (NII), which is investment income less investment expenses.

TCJA suspended tier 2 deductions, including investment expenses through 2025. Per Sec 163(d)(4)(C) for purposes of the NII limitation, the term "investment expenses" means the deductions **allowed** under this chapter (normal taxes and surtaxes). Thus the bottom line results seem to be:

On the positive side - Investment Interest deduction on Schedule A may be higher than in the past because Sch. A investment expenses will not be used in limiting NII, thus allowing a larger interest deduction.

On the negative side - Investment expenses will not reduce NII, thus possibly causing a larger surtax on NII (the 3.8% surtax).

The Details

Investment interest expense is deductible only to the extent of "net investment income." The amount disallowed because of this provision may be carried over indefinitely. Form 4952 is used to compute the investment interest limitations.

Rev Rul 95-16, 1995-8 IRB 4 states that carryover of excess investment interest to a later tax year isn't limited by a taxpayer's taxable income for the tax year in which the interest was paid or accrued.

DEFINITIONS

Investment interest expense - is all interest on debts used to carry or purchase investment property (e.g., stocks, bonds, or land held for appreciation). However, interest on loans used to buy investments which produce tax-exempt interest income is not deductible as investment interest expense. In fact, such interest is not deductible at all. In addition, interest taken into account in determining gain or loss from a passive activity is NOT investment interest.

Investment expenses - are expenses (other than interest) incurred to produce investment income and which are normally deductible as Tier 2 miscellaneous itemized deductions on Schedule A. **CAUTION:** Under TCJA Tier 2 miscellaneous itemized deductions are not deductible for years 2018 through 2025.

CAUTION

The term Investment Income has a different meaning when applied to the limitations on investment interest (IRC Sec 163) than it does for the Net Investment Income Tax, the 3.8% surtax on NII discussed at chapter 12.05 (IRC Sec 1411). IRC Sec 163(d)(4)(D) says: "Investment income and investment expenses shall not include any income or expenses taken into account under IRC Sec 469 in computing income or loss from a passive activity," whereas Sec 1411 requires that rental income and passive trade and business income be included as investment income.

Investment income for purposes of the investment interest expense includes gross income from:

- Interest, dividends, non-qualified annuities, and royalties, whether received directly or from a pass-thru entity, and not derived from a trade or business;
- Capital gains (other than derived from a trade or business) that are not elected to be taxed at the lower capital gains tax rates;
- Substantially non-depreciable property;
- Equity-financed lending activities;
- Acquisition of certain interests in a pass-through entity licensing intangible property. *(Temp. Reg. 1.469-2T(f)(10)).*

Cancellation of debt income - Cancellation of debt (COD) income can be investment income. In ***LR 9522008,*** the IRS held that discharge of debt on a loan traceable to investment property is investment income, but only to the extent the debt relief income isn't excludable from gross income.

Allocation - Whether a debt is allocable to investment property is to be determined under the interest allocation rules of ***Reg. 1.163-8T*** by tracing the use of the proceeds of the debt.

Strategy - Capital gains election – "Net capital gain" on investment property generally can't be included in investment income for purposes of computing net investment income for the investment interest limitations, unless a taxpayer elects to include all or any part of it as investment income. However, any net capital gain which the taxpayer includes as investment income under this election, <u>must be excluded from the gain that qualifies for the lower tax rates on capital gains</u>. This election will have no effect on the Net Investment Income Tax, the 3.8% surtax on NII computation discussed at chapter 12.05 (IRC Sec 1411), since all capital gains except those derived from a trade or business are included in investment income for purposes of that tax.

<u>**Net capital gain**</u>**:** "Net capital gain" is the excess of net long-term capital gain over net short-term capital losses. The rule doesn't affect the treatment of net short-term capital gain in the calculation of net investment income since short-term capital gain gets no tax rate break.

Example - Capital Gains and Net Investment Income - *Barry had the following capital transactions for the tax year:*

		"Net Capital Gains" Computation:	
Sale of land (LT)	*$50,000*	*Net LT capital gain*	*$50,000*
Stock sale (ST)	*25,000*	*Net ST capital loss*	*0*
Less: Stock loss (ST)	*-10,000*	*Net capital gain*	*$50,000*
Overall net gain	*$65,000*		

Barry can, when computing the investment interest expense:

1. Include $15,000 (the difference between his overall net gain over his net capital gain) in his investment income, or

2. Make the special election and include all or any part of the net capital gain in investment income. Since interest, not allowed because of the limitation, is carried over, it may be deductible in the following tax year or a later tax year. Taxpayers in the higher tax brackets should compare theeffects of postponing the interest deduction to a later year to that of losing the benefit of the capital gain tax ceiling.

Example - Effects of Treating LT Capital Gain as Investment Income - *Ramon's stock investments did well in 2019. He sold stock at a gain of $42,000 on 03/02/19 and is worried about his 2019 tax bill. Ramon is single, and he also paid margin interest this year. His 2019 income and deductions are:*

Income:		***Deductions:***	
Wages	*$ 88,750*	*Taxes $12,305 But Limited To:*	*$10,000*
Interest Income	*475*	*Home Mortgage Interest*	*15,800*
State Tax Refund	*985*	*Margin (Investment) Interest*	*13,248*
Net LT Capital Gain	*42,000*	*Contributions*	*200*
Total Income	*$132,210*	*Total Deductions*	*$39,248*

Ramon's tax liability is a good deal higher when he treats all of his LT capital gain in the usual manner on Schedule D than when he elects to treat $12,773 ($13,248 - $475) of the gain as investment income rather than long-term capital gain. ***REASON:*** *His itemized deductions are appreciably reduced, because he can only deduct $475 of the margin interest under the former scenario.*

Strategy - Dividend election – Qualified dividends (those that would be eligible for the 0%, 15% and 20% tax rates) are not included as investment income for the investment interest expense limitation calculation unless the taxpayer makes an election to treat them as investment income for this purpose. Dividends elected to be investment income are taxed at ordinary income rates and are not eligible for the 0%, 15% and 20% tax rates. This is similar to the capital gains election discussed above.

When and How to Make Election – The elections described above for treating net capital gain and qualified dividend income as investment income must be made on or before the extended due date of the return for the year the net capital gain is recognized, or the qualified dividend income is received. The election is made as part of the investment interest limitation calculation on Form 4952. ***(Reg § 1.163(d)-1(b))*** The elections are revocable with consent of the IRS Commissioner.

Small business stock gain - 50% of the gain on certain qualified **small business stock** (QSBS) held over 5 years is excluded from capital gains. Note: for the following periods, and provided the stock is held over 5 years, the exclusion is:

- 75% gain exclusion for stocks issued after 2/17/2009 and through 9/27/2010.
- 100% gain exclusion for stocks issued after September 27, 2010. The 100% exclusion rate was made permanent by the PATH Act of 2015. In addition, there is no AMT preference when the exclusion percentage is 100%.

Any gain excluded under this provision is not treated as investment income. See chapter 2.07 for details on QSBS.

Net investment income (Except for years 2018 through 2025) – is the excess of investment income over allowed investment expenses. To compute net investment income, use investment expenses AFTER applying the 2% floor on Schedule A. Consider Tier 2 expenses, WHICH ARE NOT INVESTMENT EXPENSES, as the first disallowed by the 2% reduction.

Example - Net Investment Income *- Rick and Rhonda had investment income of $4,000 during the tax year. Their AGI for that year was $55,000, and their Tier 2 miscellaneous itemized deductions were $2,000. Of the Tier 2 expense, $700 was for investment. Compute their net investment income as follows:*

(1) Total Tier 2 deductions	*$2,000*
(2) Less 2% of AGI	*-1,100*
(3) Net Tier 2 deductions	*900*
(4) Amount from (3) considered investment expense	*700*
(5) Net investment income ($4,000 less $700)	*$3,300*

Net investment income (2018 through 2025) – Since TCJA has suspended Tier 2 itemized deductions for years 2018 through 2025, net investment income is not adjusted by investment expenses that in years other than 2018-2025 would be allowed as a tier 2 miscellaneous deduction. So in most cases for 2018-2025 net investment income is simply the sum of investment income.

AMT Considerations – Investment interest is deductible for both regular and AMT purposes to the extent of net investment income. However, because the interest from private activity municipal bonds generally is taxable for AMT purposes, taxpayers with private activity bond income will have a higher net investment income and, therefore for AMT purposes, will be allowed to deduct more investment interest expense. This also creates two investment interest carryovers, one for regular tax and one for the AMT. Generally, most preparation software will make both carryover computations. *Line 2c on the 6251 (2018) compensates for the differences between the regular investment interest deduction and the AMT investment interest deduction*.

Strategies

AMT Strategy (For years other than 2018 through 2025 since investment expenses are not deductible for those years anyway) – Omit Investment Expenses - For both the regular tax and the AMT, the deductible investment interest expense is limited to net investment income (NII). NII is taxable investment income reduced by investment expenses. Investment expenses are reported on Schedule A as investment taxes or as miscellaneous investment expenses. Both of these categories are not deductible for AMT purposes. Therefore, if the taxpayer is taxed by the AMT method, omit investment taxes and expenses from Schedule A. You may wish to double check your software's computation to see if it makes this adjustment automatically. To be on the safe side, simply don't deduct it. **Caution:** This may adversely affect the 3.8% NII Tax (see Chapter 12.05) and the state and overall tax liability.

CALIFORNIA DIFFERENCES

California conforms to the Federal treatment for investment interest, although the amount deductible may be different because of differences in tax-exempt interest and deductible expenses (California does not conform to the TCJA suspension of Tier 2 miscellaneous deductions). Also, since California does not have preferential tax rates for capital gains or dividend income, it may be advantageous to make a separate election to treat net capital gains and/or dividends as investment income when the election has not been made for federal purposes.

NOTES

CHARITABLE CONTRIBUTIONS

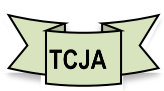
- Made by taxpayers to "qualified charitable organizations"
- **Must itemize** to get benefit
- **No AMT** adjustment
- **All cash** - must be documented with either a bank record or written verification from the charity.
- **Non-Cash** – See documentation requirement details in chapter.
- **Use of Assets** – No deduction
- **Foreign charities** generally not allowed except for Canada, Mexico and in some cases Israel

AGI Contribution Limits

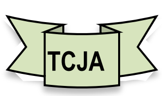
- **50% limit (60% 2018-2025) –** This category includes churches and other houses of worship; tax-exempt educational institutions and hospitals; Federal, state, and local governmental units.
- **30% limit –** Generally all other groups other than 50%-limit organizations including fraternal organizations, public cemeteries, and private non-operating foundations.
- **20% limit -** This applies to gifts of capital gain property made to all qualified organizations other than 50% limit organizations.
- **Carryovers** – 5 years

Related IRC and IRS Publications and Forms

- **IRC Sec 170**
- **Pub 78** – Cumulative List of Organizations (on-line)
- **Pub 526** – Charitable Contributions
- **Pub 561**– Determining Value of Donated Property
- **Pub 4302** – A Charity's Guide to Vehicle Donations
- **Pub 4303** – A Donor's Guide to Vehicle Donations
- **1098-C** – Contributions of Motor Vehicles
- **Form 8282** – Donee Information Return
- **Form 8283** – Noncash Charitable Contributions



Percentage of AGI Limitation – For cash contributions made in years 2018-2025, the 50% of AGI limit is increased to 60%.



Rights to Purchase College Athletic Tickets – A charitable contribution is no longer allowed when a taxpayer makes a payment to a college or university and receives the right to purchase tickets to an athletic event.

Final Regulation Changes (T.D. 9836):

Blank Pledge Card **-** Because a blank pledge card provided by the donee organization to a donor does not show the information required under Code Sec. 170(f)(17) (name of the organization, the date of the contribution, and the amount of the contribution) it is not sufficient substantiation for a cash, check, or other monetary gift.

Reasonable Cause Exception – Proposed regs provided a reasonable cause exception to various non-cash substantiation and reporting rules. However, the final regulations do not provide a standard for the exception and must be determined on a case-by-case basis.

RAPID FINDER

Form 8283 **-** The Preamble to the final regs provides that only Section B, part IV of Form 8283, which is completed for property valued at over $5,000, is a donee acknowledgment, and this acknowledgment only contains some of the information required by Code Sec. 170(f)(8)(B). Accordingly, even a fully-completed Form 8283 does not satisfy the requirements of Code Sec. 170(f)(8) .

Appraisals & Appraisers – Provides qualifications for appraisers (see beginning on page 7.08.08 for details)

QUALIFIED ORGANIZATIONS & AGI CONTRIBUTION LIMITS

IRS Publication 78, available at IRS.gov, lists qualified organizations in a searchable format. Start at this link: https://www.irs.gov/charities-non-profits/tax-exempt-organization-search. For contributions to be deductible, the recipient organization must fit into one or more of the following categories of organizations:

AGI CONTRIBUTION LIMITS	CATEGORIES OF CHARITY ORGANIZATIONS
50%* without any reduction for net operating loss carrybacks *60% 2018-2025 (cash contributions only)	Generally churches, synagogues, mosques, etc.; tax-exempt educational institutions and hospitals; Federal, state, and local governmental units, if the contribution is used for public purposes; publicly supported corporations, trusts, funds, foundations or community chests organized and operated only for charitable, religious, educational, scientific or literary purposes, or to prevent cruelty to children or animals, or to foster certain national or international amateur sports competitions; certain private operating foundations and certain agricultural research organizations.
30%	Generally all other groups other than 50%-limit organizations including fraternal organizations, public cemeteries, and private non-operating foundations. And Gifts of capital gain property to 50%-limit organizations that are deducted at FMV.
20%	Applies to gifts of capital gain property made to all qualified organizations other than 50% limit organizations

DEDUCTION & CARRYOVERS

Contributions in excess of the deduction limits may be carried forward for five years. An amount can be carried over even though an individual does not itemize in the year of the contribution (carryover then equals excess over 50% (or 60% in 2018-2025) of AGI).

Calculating The Deduction And Carryover: Substitute 60% for 50% in 2018-2025

Where:

A = Contributions Subject to the 50% Limit   AA = the lesser of 50% of AGI or A
B = Contributions Subject to the 30% Limit   BB = the lesser of (30% of AGI – AA) or B
C = Contributions Subject to the 20% Limit   CC = the lesser of ((50% of AGI – AA) + (30% of AGI – BB)) or C

Allowable Contribution = AA + BB + CC
Carryover = A + B + C – (AA + BB + CC)

For each category of contributions, deduct first the contributions in that category made in the current year, then the carryover amount (starting with the earliest year). IRS Pub. 526 includes a worksheet that can be used to apply the deduction limits.

FOREIGN CHARITIES

Generally, contributions to foreign charities are not permitted. However, do not mistake U.S. Charities that do charitable work in foreign countries as foreign charities. Certain foreign charities, however, may qualify. These are:

Canadian Charities **-** Donations to certain Canadian charitable organizations covered under an income tax treaty with Canada are deductible. In order to deduct the contribution, the taxpayer generally must have income from sources in Canada. See the United States/Canada Income Tax Treaty for information on how to figure the deduction.

Mexican Charities **-** Donations to certain Mexican charitable organizations covered under an income tax treaty with Mexico are deductible. The organization must meet tests that are essentially the same as the tests that qualify U.S. organizations to receive deductible contributions. To deduct a contribution to a Mexican charity, the taxpayer must have income from sources in Mexico. See the tax treaty between Mexico and US.

Israeli Charities **-** Contributions to certain Israeli charities organized under an income tax treaty with Israel may be deductible. The organization must be created and recognized as a charitable organization under Israeli law. The amount deductible is the amount that would normally be allowed under U.S. rules, but not more than 25% of AGI from Israeli sources.

CLOTHING AND HOUSEHOLD CONTRIBUTIONS:

No deduction is allowed for a charitable contribution of clothing or household items unless the clothing or household item is in:

- Good used condition, or
- Better.

In addition, IRS may deny a deduction for any item with minimal monetary value, such as used socks or undergarments.

The Secretary, in consultation with affected charities, will exercise assiduously the authority to disallow a deduction for some items of low value, consistent with the goals of improving tax administration and ensure that donated clothing and households items are of meaningful use to charitable organizations.

Items not in good or better condition - A deduction may be allowed for a charitable contribution of an item of clothing or a household item not in good used condition or better if the amount claimed for the item is:

- More than $500, and
- The taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.

Household items - Includes furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the provision.

GIFTS TO INDIVIDUALS

No charitable deduction is allowed when a gift is made to private individuals, either directly or within a charitable organization. An individual cannot deduct contributions made directly to a foreign organization (except under certain treaties as noted above).

GIFTS IN LIEU OF SUPPORT

In ***Letter Ruling 9405003,*** the IRS barred a deduction for contributions made by parents to a tax-exempt organization; the gifts were earmarked and actually used to support their son's student ministry.

PERSONAL BENEFITS (Also see Quid Pro Quo Contributions)

Givers may deduct contributions of cash or property, but only to the extent they received no personal benefit from the donation. Often, the IRS attributes at least some (if not total) personal benefit to amounts expended for items like dinner tickets, church school tuition, YMCA dues, raffles, etc. To determine contribution amount, subtract the FMV of the "personal benefit" item from the cost and deduct the remainder. Most charities now allocate the deductible, nondeductible portions.

Personal Benefit Forfeited **-** *Urbauer, TC Memo 1992-170* discusses the issue of whether an unused benefit ticket can produce a contribution. The Urbauers had purchased tickets to their daughter's school music recital. They did not attend and then claimed the entire expense as a contribution. The Tax Court indicated their failure to attend does NOT increase their contribution. Acceptance of the ticket "creates an expectation that taxpayer will attend and assert the right to be seated." The school is then obligated to prepare for this attendance. The Court said: "Taxpayer receives a material benefit merely by having the right to decide whether or not to attend."

Car Washes, Pancake Breakfasts, etc. **-** Taxpayers often want to take deductions for amounts paid for benefit football games, youth-group car washes, parish pancake breakfasts, school plays, etc. The taxpayers have no intention of attending these events, but incur the expense as a direct contribution to the institution. Extending the logic of the *Urbauer* case to some of these expenses may mean that the IRS would not allow them. On the other hand, if the taxpayer returns the ticket to the organization for resale and does not receive a refund of the cost of the ticket, the entire amount paid for the ticket is deductible. *(Rev. Rul. 67-246, distinguished by Rev. Rul. 74-348)*

Moral of this story is to take the cash rebates and then contribute the funds to the favorite charity with a bank record as verification or obtain the appropriate written documentation from the donee organization.

QUID PRO QUO CONTRIBUTIONS

Charitable organizations are required to inform donors that "quid pro quo" contributions over $75 are deductible only to the extent that the gift exceeds the FMV of the goods or services provided by the organization. Quid pro quo contributions are payments made partly as contribution and partly as payment for goods or services. Such contributions don't include any payment made to an organization organized exclusively for religious purposes, in return for which a taxpayer receives solely an intangible religious benefit that generally isn't sold in a commercial transaction.

Charities are required to provide a written statement in conjunction with quid pro quo donations. The statement must give the donor a good-faith estimate of the value of the goods or services included with the "gift." Charities who fail to do this are subject to a $10 per contribution penalty (but capped at $5,000 per fundraising event), unless reasonable cause can be shown. These amounts are not subject to inflation adjustment. (IRC Sec 6714)

College Athletic Event Seating Rights - Prior to the TCJA, if a taxpayer made a payment to a college or university that would be allowable as a charitable deduction except that the taxpayer receives either a direct or indirect right to purchase tickets for seating at an athletic event in the school's athletic stadium, 80% of the payment is treated as a charitable contribution.

The TCJA prohibits any portion of such a payment made in 2018 or later to be treated as a charitable deduction. Thus, the charitable deduction for amounts paid for college athletic seating rights has been effectively repealed.

USE OF AN ASSET FOR CHARITABLE PURPOSES

Granting a charity permission to use or occupy property does not represent payment made to or for the use of the organization. Such an arrangement does not constitute a gift of property. It is merely the granting of a privilege for which no charge is made (Rev Rul 70-477). Thus granting a charity the use of property does not constitute a charitable gift.

> ***Example - Purchase of asset for charity*** - A taxpayer who buys an asset and uses it while performing volunteer services for a charity can't deduct its cost if he retains ownership of it. That's true even if the asset is used exclusively for charitable purposes. *(McCollum, Charles, (1978) TC Memo 1978-435, PH TCM ¶78435, 37 CCH TCM 1817; PLR 8440082)*

> ***Example – Timeshare*** – *Suppose a taxpayer contributes his or her timeshare week to a charity auction. There is no deductible charitable contribution since ownership of the timeshare unit was not given, only the use of the timeshare. Even the cleaning fee paid for the maid service when the winning bidder uses the unit would not be deductible since only expenses associated with services personally rendered by the taxpayer are deductible (Regulation 1.170A-1(g)).*

Cost of maintaining an asset - A taxpayer may deduct the cost of maintaining a personally owned asset to the extent its use relates to providing services for a charity. Thus, for example, a taxpayer was allowed to deduct the fuel, maintenance and repair costs (but not depreciation or the fair rental value) of piloting his plane in connection with volunteer activities for the Civil Air Patrol. *(Rev Rul 58-279, 1958-1 CB 145)* Similarly, a taxpayer who participated in a mounted posse that was a civilian reserve unit of the county sheriff's office could deduct the cost of maintaining a horse (shoeing and stabling). *(Hahn, Eugene, (1979) TC Memo 1979-429, PH TCM ¶79429, 39 CCH TCM 372)*

***Depreciation of Capital Assets* -** No deduction is allowed for the depreciation of a capital asset as a charitable deduction. This includes vehicles (that's why there is no imputed depreciation in the mileage rate), computers, etc.

> ***Example:*** *Kathy volunteers as a member of the sheriff's mounted search and rescue team. As part of volunteering, Kathy is required to provide a horse. Kathy is not allowed to deduct the cost of purchasing or to depreciate her horse. She can, however, deduct uniforms, travel, and other out-of-pocket expenses associated with the volunteer work.*

POSSIBLE RECAPTURE FOR CERTAIN TANGIBLE PROPERTY

A taxpayer must recapture part of a charitable contribution deduction if all of the following statements apply:

1. The taxpayer donated tangible personal property with a claimed value of more than $5,000, and the amount deducted is more than the taxpayer's basis in the property.
2. After the year of the contribution, but within 3 years of the contribution date, the charitable organization sells, trades or otherwise disposes of the property.
3. The organization does not provide a written statement, such as on Form 8282, Part IV, that either certifies (a) its use of the property was substantial and related to the organization's purpose, or (b) its intended use of the property became impossible. An officer of the organization must sign the statement under penalty of perjury.

If all of the above statements are true, the taxpayer must include in income (Form 1040, other income line) the difference between the deduction that was claimed for the property and the taxpayer's basis in the property when the contribution was made. The recapture is included on the return for the year that the organization disposes of the asset.

OTHER ISSUES

TCJA

Business Expenses of Some Public Employees May Qualify as Charitable Contributions **-** Except for years 2018-2025 when tier 2 itemized deductions are suspended by the TCJA of 2017, employee business expenses normally are deducted as a miscellaneous itemized deduction. However, miscellaneous deductions are limited to those expenses that exceed 2% of a taxpayer's Adjusted Gross Income. As a result, these deductions may be reduced or eliminated altogether. Further, they are not deductible for AMT purposes.

However, taxpayers such as teachers, who work for the public school system, can treat their expenses as a charitable contribution, thus eliminating the 2% of AGI limitation. IRS instructions specifically allow contributions of cash or goods to the US Government or state agencies including political subdivisions such as school districts, police departments, etc. The usual substantiation rules for noncash contributions apply.

Entertaining for Charity - A taxpayer may deduct the cost of entertaining others on behalf of a charity (e.g., wining and dining potential large contributors), but the cost of his own entertainment (or meal) is not deductible. *(Louis, Francois, (1966) TC Memo 1966-204, PH TCM ¶66204, 25 CCH TCM 1047)* The meals or entertainment on behalf of a charity may be provided in the taxpayer's home. *(PLR 812107; Rev Rul 69-473, 1969-2 CB 37; Rev Rul 66-10, 1966-1 CB 47)*

Uniforms - The cost of uniforms required to be worn when providing services to a charity are deductible as long as the uniforms have no general utility. The cost of cleaning the uniform also may be deducted. *(Reg. § 1.170A-1(g))* Treat these out-of-pocket expenses as "cash" donations rather than "property" donations.

Charitable Away-From-Home Travel - Volunteers often pay their own way when they travel away from home overnight in connection with charitable work. A volunteer who travels away from home overnight, including to foreign locations, to do charitable work for a qualified organization may generally deduct the same types of expenses that may be claimed by a taxpayer who makes a similar trip for business purposes. (The foreign travel limitations (see Chapter 3.13) that apply to business trips apparently do not apply when doing charitable work overseas.) These out-of-pocket costs are deductible, if they are properly substantiated non-lobbying expenses, they are reasonable in amount, and there is no significant element of personal pleasure, recreation, or vacation in the travel. *(Code Sec. 170(f)(6), Code Sec. 170(j), Reg. § 1.170A-1(g))* Deductible expenses include the taxpayer's out-of-pocket roundtrip travel cost, taxi fares and other costs of transportation between the airport or station and the hotel, lodging and meals. *(IRS Publication 526, 2018 edition, pg. 5,)*

> ***Meals*** - A volunteer traveling away from home overnight for charity may deduct meal costs—under Code Sec. 274(f). ***Note:*** *otherwise allowable charitable meal deductions are not subject to the 50% reduction that applies to business meals.*
>
> ***First-Class Accommodations*** - Tax Court has held that such costs are deductible if they are "reasonable" under the facts and circumstances, using criteria similar to those that would apply if the traveler were on a business trip. *(Cavalaris, TC Memo 1996-308)*
>
> ***Significant Element of Personal Pleasure*** - Any "significant element of personal pleasure" negates a deduction (i.e., not even partial deduction is allowed). Apparently, significant personal pleasure is assumed, if the taxpayer has only minor duties and is not required to perform any duties for the charity for major portions of the away-from-home stay.

Vehicle Travel - A taxpayer may choose between actual expenses and using the charitable mileage rate for the charitable use of their vehicle. Parking fees and tolls are additionally deductible (either method).

> ***Actual method*** - A taxpayer can deduct the cost of gas and oil, but not depreciation, insurance or repairs.
>
> ***Mileage rate*** – The charitable mileage rate, unlike the business, moving and medical mileage rates, is not adjusted annually for inflation as it is fixed statutorily. It changes only when Congress revises the rate, which has been 14 cents since 1998.

Students in Home - *T*axpayers who have a written agreement with a qualified sponsoring organization can deduct up to $50 per month for unreimbursed expenses of keeping a high school (or lower grade level) student in their homes, e.g., exchange student programs. To qualify, the student cannot be the taxpayer's relative or dependent. The following items must be filed with the tax return when this deduction is claimed: a copy of the agreement with the sponsoring organization that placed the student in the taxpayer's home, a summary of the various items paid to maintain the student, and a statement with the date the student became a member of the taxpayer's household, the dates of the student's full-time school attendance, and the name and location of the school. (IRS Pub. 526, 2018, page 21)

S Corp Contributions - The PATH Act makes permanent a provision that a shareholder's basis reduction in S stock when a charitable contribution is made by the corporation is equal to his pro rata share of the adjusted basis of the contributed property (Code Sec. 1367(a)(2), as amended by Act Sec. 307 of Division C).

<u>*Credit Card Rebates*</u> - Rebates from purchases made by credit card companies are not income but instead are an adjustment to the purchase price paid for the item or items purchased (Rev Rul 2005-28). The IRS privately ruled (PLR 201027015) that an individual would qualify for charitable deductions for rebates he designates to be paid to charities under a program offered by the credit card company. However, the IRS also concluded the written acknowledgment format proposed by the taxpayer to be used by the charitable organization does not satisfy the Code Sec. 170(f)(17) record keeping requirements.

<u>*Business Advertising Expense or Charitable Contribution*</u> - A taxpayer engaged in a trade or business who attempts to deduct without limitation payments to various organizations as "goodwill advertising" must be prepared to show their nature as ordinary and necessary business expenses or that the recipients aren't organizations qualifying as charities.

Strategies

<u>Charitable Giving Through Donor-Advised Funds</u> - Contribution to a donor advised fund is a way to warehouse funds in a year in which the donor has an unusually high income (and can benefit from a large charitable deduction) to satisfy the donor's social obligations to make charitable contributions in future years, without incurring the expense of setting up a private foundation and satisfying annual filing and other private foundation requirements.

Donor-advised funds, though they may bear the donor's name, are not separate entities, but are mere bookkeeping entries. They are components of a qualified charitable organization. A contribution to a charity's donor-advised fund may be deductible in the year it is made if it isn't considered earmarked for a particular distributee. The charity must fully own the funds and have ultimate control over their distribution. To document the contribution, the taxpayer must get a written acknowledgement from the fund's sponsoring organization[1] that it has exclusive legal control over the assets contributed (Code Sec. 170(f)(18)(A)). Though the donor can advise the charity, which generally will follow the donor's recommendations, the donor cannot have power to select distributees or decide the timing or amounts of distributions. The charity must also ensure that all distributions from the fund are arm's-length and do not directly or indirectly benefit the donor.

[1] The sponsoring organization cannot be listed in Code Sec. 170(f)(18)(A) (e.g., a war veteran's organization or domestic fraternal lodge).

<u>SUBSTANTIATION RULES</u>

<u>*Cash Contributions*</u> **-** Cash contributions include those paid by cash, check, electronic funds transfer, or credit card. (See special requirements for payroll cash contributions.) Taxpayers cannot deduct a cash contribution, regardless of the amount, unless they can document the contribution in one of the following ways:

1. A bank record that shows the name of the qualified organization, the date of the contribution, and the amount of the contribution. Bank records may include:
   a. A canceled check,
   b. A bank or credit union statement, or
   c. A credit card statement.
2. A receipt (or a letter or other written communication) from the qualified organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
3. Payroll deduction records described below.

<u>*Blank Pledge Card*</u> **-** Because a blank pledge card provided by the donee organization to a donor does not show the information required under Code Sec. 170(f)(17) (name of the organization, the date of the contribution, and the amount of the contribution), it is not sufficient substantiation for a cash, check, or other monetary gift.

<u>Payroll contributions</u> **–** The guidance provided by the IRS (IR-2006-186; Notice 2006-110) for charitable contributions made by payroll deductions became obsolete June 30, 2018 when regulations incorporating the recordkeeping requirements of Code Sec. 170(f)(17) that were issued in 2008 became final.

For contributions by payroll deduction, a taxpayer must keep:

1. A pay stub, Form W-2, or other document furnished by the employer that shows the date and amount of the contribution, and
2. A pledge card or other document prepared by or for the qualified organization that shows the name of the organization. If the employer withheld $250 or more from a single paycheck, the pledge card or other document must state that the organization does not provide goods or services in return for any contribution made to it by payroll deduction. (Existing Reg. Sec. 1.170A-13(f)(11)(i)) (Note: This language is not included in Reg. 1.170A-15(d)(1), which simply says that the pledge card or other document prepared by or at the direction of the donee must show the name of the donee.) A single pledge card may be kept for all contributions made by payroll deduction regardless of amount as long as it contains all the required information. (Reg. Sec. 1.170A-13(f)(11)(ii))

If the pay stub, Form W-2, pledge card, or other document does not show the date of the contribution, the taxpayer must also have another document that does show the date of the contribution. If the pay stub, Form W-2, pledge card, or other document does show the date of the contribution, the taxpayer need not have any other records except those described in (1) and (2).

Cash contributions of $250 or more – To claim a deduction for a contribution of $250 or more, the taxpayer **must** have a written acknowledgment of the contribution from the qualified organization that includes the following details:

- The amount of cash contributed;
- Whether the qualified organization gave the taxpayer goods or services (other than certain token items and membership benefits) as a result of the contribution, and a description and good faith estimate of the value of any goods or services that were provided (other than intangible religious benefits); and
- A statement that the only benefit received was an intangible religious benefit, if that was the case.

If the acknowledgment does not show the date of the contribution, then the taxpayer must have one of the bank records described above that does show the contribution date. If the acknowledgement includes the contribution date and meets the other tests, it is not necessary to also have other records.

The acknowledgment **must** be in the taxpayer's hands before the **earlier** of the date the return for the year the contribution was made is filed, or the due date, including extensions, for filing the return.

Non-cash Contributions

Reasonable Cause Exception

The proposed regulations provided a reasonable cause exception to various non-cash substantiation and reporting rules. The final regulations removed that proposed reg and do not provide a standard for the exception. However, the Preamble indicates that reasonable cause may be determined on a case-by-case basis. Use caution in assuming your client's reasonable cause will be acceptable.

Deductions of Less Than $250 - A taxpayer claiming a non-cash contribution must get and keep a receipt from the charitable organization showing:

1. The name of the charitable organization,
2. The date and location of the charitable contribution, and
3. A reasonably detailed description of the property.

Note: The taxpayer is not required to have a receipt where it is impractical to get one (for example, if the property was left at a charity's unattended drop site).

Deductions of At Least $250 But Not More Than $500 - If a taxpayer claims a deduction of at least $250 but not more than $500 for a non-cash charitable contribution, he or she must have and keep an acknowledgment of the contribution from the qualified organization. If the contributions were made by more than one contribution of $250 or more, the taxpayer must have either a separate acknowledgment for each or one acknowledgment that shows the total contribution. The acknowledgment(s) must be written and include:

1. The name of the charitable organization,
2. The date and location of the charitable contribution,
3. A reasonably detailed description (but not necessarily the value) of any property contributed,
4. Whether or not the qualified organization gave the taxpayer any goods or services as a result of the contribution (other than certain token items and membership benefits), and
5. If goods and or services were provided to the taxpayer the acknowledgement must include a description and good faith estimate of the value of those goods or services. If the only benefit received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.

Contribution Acknowledgment Letter – The IRS denied a taxpayer a substantial deduction for contributions because the acknowledgement letter from the taxpayer's church lacked the "no goods or services provided" statement. A second letter that included the required statement was not acceptable because it was not received contemporaneously. The Tax Court agreed with the IRS. This case shows the importance of scrutinizing an acknowledgement letter to be certain all of the required elements are included, and if something is omitted, the taxpayer needs to request a replacement letter before filing their return. *(Durden v. Commissioner, Dec. 59,061(M), TC Memo 2012-140)*

Doorknob Hangers Insufficient Proof **–** A married couple's charitable contribution deductions were denied because they did not provide to the IRS or the Court a "contemporaneous written acknowledgment" from any of four charitable organizations to which they'd donated noncash items. The Tax Court said, "They produced no acknowledgment of any kind from the Church or Goodwill. And the doorknob hangers left by the truck drivers from Vietnam Veterans and Purple Heart clearly do not satisfy the regulatory requirements. These doorknob hangers are undated; they are not specific to petitioners; they do not describe the property contributed; and they contain none of the other required information." The taxpayers had also claimed over $5,000 of clothing donations during the year with no appraisals that were also denied. (Kunkel v. Commissioner T.C. Memo. 2015-71)

Deductions Over $500 But Not Over $5,000 - If a taxpayer claims a deduction over $500 but not over $5,000 for a non-cash charitable contribution, they must have the same acknowledgement and written records as for contributions of at least $250 but not more than $500 described above. In addition, the records must also include:

- How the property was obtained. For example, by purchase, gift, bequest, inheritance, or exchange.
- The approximate date the property was obtained or, if created, produced, or manufactured by the taxpayer, the approximate date the property was substantially completed.
- The cost or other basis, and any adjustments to the basis, of property held less than 12 months and, if available, the cost or other basis of property held 12 months or more. This requirement, however, does not apply to publicly traded securities. If the taxpayer is not able to provide information on either the date the property was obtained or the cost basis of the property and there is reasonable cause for not being able to provide this information, attach a statement of explanation to the return.

Deductions Over $5,000 - If the taxpayer claims a deduction of over $5,000 for a charitable contribution of one property item or a group of similar property items, they must obtain acknowledgement from the charitable organization. In determining whether the deduction is over $5,000, combine the deductions for all similar items donated to any charitable organization during the year.

Generally, the taxpayer must also obtain a qualified written appraisal of the donated property from a qualified appraiser. For more details on contributions of $5,000 or more, see IRS Pub 561.

- ***Deduction Over $5,000 for One Item -*** When the contribution exceeds $5,000 for one item, Section B of Form 8283 must be completed for each item or group of items for which the taxpayer claimed a deduction of over $5,000. ***Exception:*** This rule does not apply to publicly traded securities that are reported in Section A of the 8283.

TCJA

- ***Appraisal Fees -*** Fees paid to find the fair market value of donated property are not deductible as contributions. They must be claimed as miscellaneous deductions on Schedule A, subject to the 2% of AGI limit. Therefore, for years 2018-2025, because the TCJA of 2017 suspended tier 2 miscellaneous deductions, the cost of the appraisal is not deductible.

CAUTION

The Preamble to the final regulations provides that only Section B, part IV of Form 8283, which is completed for property valued at over $5,000, is a donee acknowledgment, and this acknowledgment only contains some of the information required by Code Sec. 170(f)(8)(B). Accordingly, even a fully-completed Form 8283 does not satisfy the requirements of Code Sec. 170(f)(8).

If a copy of the appraisal must be attached to the tax year of the contribution then it must also be attached to all carryover years.

Aggregate Contributions Over $5,000 - Frequently taxpayers make multiple charitable contributions during the year and if the total of those contributions exceeds $5,000, is a qualified appraisal required?
In determining whether the $5,000 limitation has been exceeded, property and all similar items of property (see below) donated to one or more donees are treated as one property (Code Sec. 170(f)(11)(F)). This rule applies even if the similar items are donated to two or more different charitable donees (Reg § 1.170A-13(c)(1)(i); Reg § 1.170A-16(f)(5)(ii)).

Example: *Jay and Emily made three donations of used clothing during the year, $2,500 worth to the Salvation Army, $1,500 worth to the Vietnam Veterans and $2,000 to Goodwill for a total of $6,000. Because the items were all similar in nature (clothing), and because the total exceeded $5,000, Jay and Emily will need to obtain a qualified appraisal.*

Similar Items of Property - Similar items of property means property of the same generic category or type, such as stamp collections (including philatelic supplies and books on stamp collecting), coin collections (including numismatic supplies and books on coin collecting), lithographs, paintings, photographs, books, nonpublicly traded stock, nonpublicly traded securities other than nonpublicly traded stock, land, buildings, clothing, jewelry, furniture, electronic equipment, household appliances, toys, everyday kitchenware, china, crystal, or silver (Reg § 1.170A-13(c)(7)(iii)).

Exceptions to the $5,000 Limitation - Reduced requirements apply to contributions of non-publicly traded stock for which the claimed deduction is more than $5,000 but not more than $10,000 and additional requirements apply where a deduction of more than $500,000 is claimed. No appraisal is required for contributions of publicly-traded securities for which there are readily available market quotations.

Qualified Appraisal – A qualified appraisal of any property means an appraisal that's treated as a qualified appraisal under IRS regs or other guidance; and conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other prescribed guidance (Code Sec. 170(f)(11)(E)(i)(I)).

Qualified Appraiser – A qualified appraiser is an individual who meets all the following requirements. The individual:

1. Either (a) has earned an appraisal designation from a recognized professional appraiser organization for demonstrated competency in valuing the type of property being appraised, or (b) has met certain minimum education and experience requirements.
2. Regularly prepares appraisals for which he or she is paid.
3. Must have verifiable education and experience in valuing the type of property subject to the appraisal. An individual is treated as having education and experience in valuing the type of property if, as of the date the individual signs the appraisal, the individual has successfully completed (for example, received a passing grade on a final examination) professional or college-level coursework in valuing the type of property, and has two or more years of experience in valuing the type of property. The Preamble to the regs provides that the reference to a passing grade on a final examination in Reg § 1.170A-17(b)(2)(i)(A) is merely an example of what is considered successful completion of professional or college-level coursework, and other evidence of successful completion may be sufficient. However, mere attendance at a training event is not sufficient, and evidence of successful completion of coursework is necessary. The regs provide that coursework must be obtained from professional or college-level educational institutions, appraisal organizations, employer educational programs, or recognized professional trade organizations.
4. Has not been prohibited from practicing before the IRS under section 330(c) of title 31 of the United States Code at any time during the 3-year period ending on the date of the appraisal.

Final regulation 1.170A-17 related to qualified appraisals and qualified appraisers applies to contributions made on or after January 1, 2019, but taxpayers may rely on the rules of this section for appraisals prepared for returns or submissions filed after August 17, 2006.

The appraiser must complete Part III of Form 8283. See IRC Section 170(f)(11)(E), Notice 2006-96, and Regulations section 1.170A-13(c)(5) for details.

Appraisal Timing – Made not earlier than 60 days before the appraisal property's contribution date and no later than the due date (including extensions) of the return on which the charitable contribution deduction's first claimed for the donated property or, if the deduction's first claimed or reported on an amended return, the date the amended return is filed.

TCJA

Appraisal Fees – Appraisal fees are generally not included as part of the charitable contribution; however, they may be deductible as a tier 2 miscellaneous itemized deduction as an expense paid in connection with determining tax liability (Rev Rul 67-461). The TCJA of 2017 suspended the deduction of tier 2 miscellaneous deductions for years 2018 through 2025. Therefore, taxpayers get no tax deduction in those years for costs of appraising donated property.

Form 8283 – Thorough completion of Form 8283, Section B, is a necessity when claiming noncash contributions that require appraisal. In addition to the declaration and signature of the appraiser in Part III, the details of the item(s) donated must be completed in Part I, and Part IV must be completed and signed by a representative of the donee (charitable organization). Generally it is not necessary to attach a copy of the appraisal, but one exception is if the donated property is art valued at $20,000 or more. See the instructions to the 8283 for other times when the appraisal is to be attached.

Caution - Easily Audited

Since written verification or a bank record is required for most contributions, the IRS can easily audit charitable contributions by correspondence. Practitioners should be prudent in accepting their client's word for cash and goods contributions since they may end up as adjustments in the future and any pattern of promoting unverified contributions will be easily identified.

USED CAR, BOAT, PLANE AND OTHER MOTOR VEHICLE DONATIONS

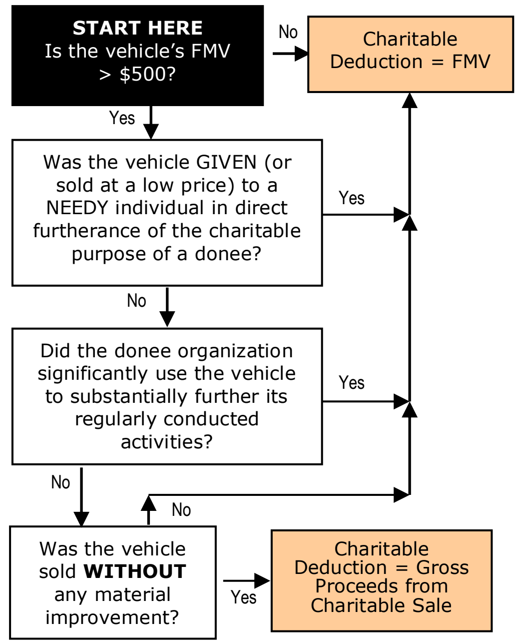
Used Vehicle Donations Severely Restricted - (Code Sec. 170(f)(12), as amended by 2004 Act. Sec. 884(a)) The deduction is limited for motor vehicles (as well as for boats and airplanes) contributed to charity for which the claimed value exceeds $500 by making it dependent upon the charity's use of the vehicle and imposing higher substantiation requirements.

Vehicle Sold Without Significant Intervening Use - If the charity sells the vehicle without any "significant intervening use" (actual, significant use of the vehicle to substantially further the organization's regularly conducted activities) or "material improvement" (e.g., major repairs), the donor's charitable deduction can't exceed the gross proceeds from the charity's sale.

Significant Intervening Use **-** This occurs only if the donee organization actually uses the vehicle to substantially further its regularly conducted activities, and the use is significant. Use includes providing transportation on a regular basis for a significant period of time or significant use directly related to instruction in vehicle repair, but does not include use of the vehicle to provide training in general business skills, such as marketing and sales. Examples of qualifying significant intervening use are delivery of meals every day for a year, or driving 10,000 miles during a one-year period while delivering meals. (Notice 2005-44, Sec. 7.01)

Material Improvement - This includes a major repair or improvement that improves the vehicle's condition in a way that significantly increases its value. Cleaning, minor repairs and routine maintenance aren't enough, nor are: painting, rustproofing or waxing; removal of dents and scratches; cleaning or repair of upholstery; or installation of theft deterrent devices. (Notice 2005-44, Sec. 7.02)

Deductible Vehicle Contribution Flow Chart
Assuming Correct Documentation



Exception for Autos Given (or sold at low price) to Needy Individuals - The gross proceeds limitation on a donor's auto contribution deduction doesn't apply if the charity sells it at a price significantly below FMV (or gives it away) to a needy individual. This nonstatutory exception applies only if supplying a vehicle to a needy individual is in direct furtherance of the charitable purpose of a donee of relieving the poor and distressed or the underprivileged who are in need of a means of transportation. (Notice 2005-44, Sec. 3.02(3), Notice 2005-44, Sec. 7.03)

FMV Defined - The gross proceeds limit doesn't apply if there is significant intervening use or material improvement of the vehicle, or if it is given (or sold at a low price) to a needy individual under the rules explained above. Here, under long-standing rules, the donor's contribution cannot exceed the vehicle's FMV. Under Notice 2005-44, Sec. 5, FMV of a vehicle may be determined by using an established used vehicle pricing guide (i.e., a "blue-book" type reference), but only if it lists a sales price for a vehicle that is the same make, model, and year, sold in the same area, in the same condition, with the same or substantially similar options or accessories, and with the same or substantially similar warranties or guarantees, as the vehicle in question. Dealer retail value can't be used.

Contemporaneous Written Acknowledgement – Additionally, a deduction for donated vehicles whose claimed value exceeds $500 is not allowed unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement from the donee. To be contemporaneous, the acknowledgment must be obtained within 30 days of either: (1) the contribution or (2) the disposition of the vehicle by the donee organization. The donor must include a copy of the acknowledgment with the tax return on which the deduction is claimed. The acknowledgement must contain:

- The name of the donor,
- Taxpayer identification number of the donor, and
- The vehicle identification number (or similar number) of the vehicle.
- If the charity (donee) sells the vehicle without performing a significant intervening use or material improvement of such vehicle, the acknowledgement must say that the vehicle was sold in an arm's length transaction between unrelated parties, and state the gross proceeds from the sale and that the deductible amount may not exceed the gross proceeds.
- Acknowledgement by the donee organization which includes whether the donee organization provided any goods or services in consideration of the vehicle, and a description and good faith estimate of the value of any such goods or services, or, if the goods or services consist solely of intangible religious benefits, a statement to that effect.

Form 1098-C – Form 1098-C incorporates all of the required acknowledgement elements for the donee (charitable organization) to complete. The donor is required to attach copy B of the 1098-C to his or her federal tax return when claiming a deduction for contribution of a motor vehicle, boat or airplane.

CHARITY EASEMENTS

In ***Notice 2004-41***, 2004-28 IRB; IR2004-85, the IRS takes a restrictive view on contributions of partial interests in property that they refer to as "easements" in the notice. The notice and related news release warn taxpayers that the IRS cautions that it will disallow improper charitable contribution deductions for transfers of easements:

(1) On real property to charities, and

(2) In connection with purchases of real property from charities.

In addition, IRS may impose accuracy-related penalties on taxpayers claiming such deductions and excise taxes and other penalties on non-taxpayer participants in these transactions (e.g., promoters, appraisers and charitable organization managers).

Substantial restrictions apply to charitable contributions of partial interests in property, which often render them nondeductible. (§170(f)(3)) These restrictions don't apply, however, and charitable deductions are allowed, for qualified conservation contributions. (§170(f)(3)(B)(iii))

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for a conservation purpose enumerated in Code Sec. 170(h). A qualified real property interest includes a restriction (granted in perpetuity) on the use that may be made of the real property. (Code Sec. 170(h)(2)(C)) Such qualified real property interests are referred to as conservation easements in Notice 2004-41.

One of the permitted conservation purposes is the protection of a relatively natural habitat of fish, wildlife or plants, or similar ecosystem. (Code Sec. 170(h)(4)(A)(ii)). Another is the preservation of open space, including farmland and forest land, for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy. However, if the public benefit of an open space easement is not significant, the charitable contribution deduction will be disallowed. (Code Sec. 170(h)(4)(A)(iii))

The amount of the deduction may not exceed the FMV of the contributed property (i.e., the contributed easement) on the date of the contribution (reduced by the FMV of any consideration received by the taxpayer). (Reg. § 1.170A-1(c)(1)) No deduction is allowable if the: (1) donor (or a related person) reasonably can expect to receive financial or economic benefits greater than those that will inure to the general public as a result of the donation of a conservation easement, or (2) the donation of a conservation easement has no material effect on the value of real property, or enhances rather than reduces the value of real property. (Reg. § 1.170A-14(h)(3))

QUALIFIED CONSERVATION CONTRIBUTIONS (EASEMENTS)

The Protecting Americans from Tax Hikes Act of 2015 made this provision permanent. The 30% of AGI limitation that generally applies to contributions of capital gain property is raised to 50% of AGI for qualified conservation contributions (easements), and the carryover period is increased to 15 years if the conservation easement contribution exceeds the 50% limitation.

Further, if the donor is a qualified farmer or rancher, the 50% limitation is increased to 100%. However, for any contribution of property made after August 17, 2006, that is used or available for use in agriculture or livestock production, the 100% limitation applies only if the contribution is subject to a restriction that the property remain available for agriculture or livestock production. If there is no such restriction, the 50% limitation applies. For this purpose a qualified farmer or rancher is a taxpayer with gross farming or ranching business income that is greater than 50% of total gross income for the year. See IRS Notice 2007-50 for further details.

Example – Non-farmer Donor: *In 2017 taxpayer who is not a farmer or rancher contributes $60,000 to his church (qualifies for the 50% limitation) and in the same year makes a qualified conservation easement donation with a fair market value of $80,000. His AGI is $100,000. He is allowed to deduct $50,000 of the cash contributions, with the unused $10,000 carried forward for up to 5 years. None of the qualified conservation contribution is deductible in the donation year because contributions other than the conservation easement must be used first toward the 50% limitation, but the entire $80,000 qualified conservation contribution is carried forward for up to 15 years.*

Example – Farmer Donor: *Using the same facts as in the example above, except that the donor is a qualified farmer, the deduction in the donation year will be $100,000: $50,000 of the qualified conservation contribution plus $50,000 of the cash contributions. The unused $10,000 of the cash contributions carries forward for up to 5 years and the unused $30,000 of the qualified conservation contribution is carried forward for up to 15 years.*

GIFTS OF APPRECIATED LONG-TERM CAPITAL GAIN PROPERTY

A taxpayer may deduct an amount equal to the FMV for property donated to 50% charities, but limited to 30% of AGI, if that property would have been subject to long-term capital gains rates if sold. At the election of the taxpayer, the donation deduction can be reduced to the taxpayer's basis in the property and the donation will then be eligible for the 50% of AGI limitation. The five-year contribution carryover rules apply to any excess over the 50% and 30% of AGI limitations for the current year.

FORM 8283

This form must be included with the taxpayer's return when noncash contributions of more than $500 are made in a single tax year. The instructions to the form state that failure to file it can result in the loss of the charitable deduction. Form 8283 also asks for information regarding the donated property. If the value of the property (other than publicly-traded securities) exceeds $5,000, an appraisal summary must be completed, including the donee's signature verifying receipt of the gift and an appraiser's signature certifying the worth of the gift. This applies to single gifts valued at over $5,000 and to gifts of similar items (gems, books or whatever) that aggregate over $5,000.

CALIFORNIA DIFFERENCES

California generally conforms to the Federal rules for charitable contributions. However, some areas of nonconformity include the following and adjustment for them is made on Schedule CA, Part II, generally on line 11 or 12 (2018):

- **Qualified Charitable Contributions –** California limits the amount of the charitable deduction to 50% of the taxpayer's federal adjusted gross income. The state has not conformed to the limit increase to 60% for 2018-2025 enacted in the TCJA. Thus, there could be some differences between the amount allowed using federal law and the amount allowed using California law.
- **College Athletic Seating Rights** – TCJA disallows a charitable deduction for college athletic seating rights for years 2018 through 2025. California has not conformed to that disallowance and the deduction is still allowed for California purposes.
- **Charitable Contribution Carryover Deduction** – There may be a difference between the California carryover and the Federal carryover. The adjustment is made on the Schedule CA, lPart II, line 13.
- **College Access Credit** – California allows a credit for contributions made to the College Access Fund. For 2018 the credit is 50% of the amount contributed (see Chapter 9.50 for specifics). When the College Access Credit is claimed on the California return, the taxpayer may claim a deduction for the contribution to the fund on their federal Schedule A, but under Proposed Regulations 1.170A-1(h)(3) the amount deductible will be limited to 50% of the contribution for contributions made after Aug. 27, 2018; contributions prior to that date are 100% deductible. Whatever amount of the College Access Fund contribution is claimed as an itemized deduction on federal Schedule A will need to be entered on Schedule CA, Part II, line 11, column B, as it is not deductible on the state return.

NOTES

MISCELLANEOUS DEDUCTIONS

- **Tier 1** – **Not Subject to the 2%** of AGI reduction
  - Amortizable bond premium
  - Federal estate tax deduction
  - Gambling losses
  - Impairment related work expenses
  - Unrecovered investment in pensions
  - Claim of right deduction (>$3,000)
  - **Tier 2** – **Subject to 2%** of AGI reduction
    SUSPENDED 2018-2025
    - Employee business expenses
    - Home office (employee)
    - Education
    - Legal Fees
    - Investment Expenses
    - Tax Preparation Fees

Related IRC and IRS Publications and Forms

- **IRC Sec 67** – 2% Floor on Miscellaneous Deductions
- **Pub 529 –** Miscellaneous Deductions
- **Pub 463 –** Travel, Entertainment, and Car Expenses
- **Pub 535 –** Business Expenses
- **Pub 970 –** Tax Benefits for Education
- **Form 2106 –** Employee Business Expenses
- **1040, Schedule A –** Itemized Deductions

TIER 1 EXPENSES

Tier 1 expenses are fully deductible on Schedule A (not subject to the 2% of AGI limitation) and are deductible against the AMT. These include impairment-related work expenses for handicapped individuals, Federal estate tax on income in respect of a decedent, repayments of more than $3,000 under claim of right, amortizable premium on taxable bonds, gambling losses to extent of winnings, and unrecovered investment in the contract of the pension of a decedent.

- ***Amortizable Bond Premium -*** Bond premium is the amount paid for a bond that exceeds its face value. A taxpayer can elect to amortize the premium on taxable bonds acquired prior to 10/23/86, and deduct the amortization as a Tier 1 itemized deduction. For bonds purchased after 10/22/86 and before 01/01/88, amortization of the premium is investment interest expense, unless a taxpayer elects to offset the interest income on the bond with the amortized portion of the premium. For bonds acquired after 1987, the amortization of the premium can only offset the interest income on the bond--no Schedule A deduction is available.

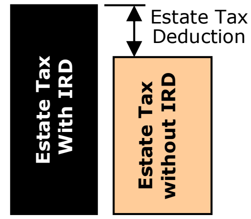
- ***Federal Estate Tax on Income in Respect of a Decedent -*** A taxpayer can deduct the Federal estate tax attributable to income in respect of a decedent that the taxpayer as beneficiary must include in gross income. This is a frequently overlooked deduction, since it is generally up to a beneficiary's preparer to recognize that the deduction exists and calculate the deduction.

When a client comes in with a 1099R or K-1 with income from an inherited IRA, do you ask two very important questions?

(1) Was there a 706 filed for the estate?

(2) If so, was there a tax liability on the 706?

If the answer to both questions is yes, then your client is eligible for a Tier 1 miscellaneous (not subject to the 2% of AGI reduction) itemized deduction. However, with the TCJA's increase in the estate tax exclusion amount to $10 million – adjusted for inflation to $11.4 million for 2019 – fewer estates will be subject to an estate tax so it is more likely than ever that the answers to these questions will be no. Even so, you should be on the lookout for this situation.



Background - Income in Respect of a Decedent (IRD) is included in the decedent's gross estate AND is subject to income tax. To make up for this inequity, a deduction for estate tax is allowed to the ultimate recipient of the income. If the recipient is an individual, it is claimed as a miscellaneous itemized deduction, not subject to the 2% limitation. If the estate receives the income, the deduction is claimed on Form 1041. *(IRC § 691(c)(1)(A);Reg § 1.691(c)-1(a))*

Amount Deductible - The amount of estate tax that is deductible is the part representing the net value of all items in the estate, which are IRD.

Example A: *Sergei, a lawyer, was a cash-basis taxpayer when he died two years ago. At the time he was entitled to $12,000 from clients in payment for services. He had also accrued $8,000 in bond interest at the time of his death. He owed $5,000 in expenses for which his estate became liable. The income and expenses were reported on Sergei's estate tax return. After credits, the estate owed $9,460 in tax. The net value of items included as IRD is $15,000 ($20,000 income less $5,000 expense). The estate tax determined without including the $15,000 is $4,840. The estate tax that qualifies for the deduction is $4,620 ($9,460 minus $4,840).*

Example B: *Assume Diane inherited Sergei's estate (Example A). She collected the $12,000 from the clients this year and will include that amount in income on her current year return. She itemizes deductions and will claim a miscellaneous deduction of $2,772, figured as follows: $12,000/$20,000 x $4,620 = $2,772.*

Caution - This has been an often overlooked tax deduction. The primary reason? There is no IRS form associated with the 706 providing the beneficiaries with the information needed to determine the deduction. Therefore, it is the responsibility of the practitioner to recognize the potential for this deduction when a taxpayer has inherited taxable income.

- ***Gambling Losses to Extent of Winnings*** (Also see Chapter 7.12– Gambling Losses) **–** A taxpayer may deduct gambling losses to the extent of winnings included in total income on Form 1040. In order to verify the losses, a taxpayer should have a record, which includes the following information:
  - The date and specific type of wager;
  - The name and address or location of the gambling establishment;
  - The names of other people present with the taxpayer at the establishment; and
  - The amount won or lost. In addition, documentation like wagering tickets, canceled checks, credit card records, bank withdrawals, etc., should also be available.

- ***Impairment-Related Work Expenses -*** Taxpayers having a physical or mental disability that limits their activities can deduct impairment-related work expenses. For example, an allowable expense would be for the cost of attendant care at the place of the taxpayer's work.

- ***Unrecovered Investment in Pensions -*** If a retired person dies before recovering the entire basis in a pension or annuity (that started after 1986), the unrecovered portion is allowed as a deduction on the retiree's final return. If the annuity is for the joint lives of a retiree and a designated beneficiary, the deduction would apply to the final return of the last to die. Otherwise, it would be allowed on the final return of the retiree decedent. *(Code Sec. 67(b)(10);Code Sec. 72(b)(3)(A))*

  Strategy – If a decedent was drawing a pension and that pension was only partially taxable, then there will be some remaining unrecovered basis. See the example below that shows how to determine the amount of the unrecovered basis.

Example - *Bill Smith, age 65, began receiving retirement benefits in 2017 under a joint and survivor annuity. Bill's annuity starting date is January 1, 2017 The benefits are to be paid for the joint lives of Bill and his wife Kathy, age 65. Bill had contributed $31,000 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,200 a month, and Kathy is to receive a monthly survivor benefit of $600 upon Bill's death.*

Under the simplified method, Bill's tax-free monthly amount is $100 ($31,000 ÷ 310). Upon Bill's death, if Bill has not recovered the full $31,000 investment, Kathy will also exclude $100 from her $600 monthly payment. If Bill and Kathy die before 310 payments are made, a miscellaneous itemized deduction will be allowed for the un-recovered cost on the final income tax return of the last to die.

- ***Claim of Right Doctrine*** (Also see Chapter 9.05 – Claim of Right) **–** Code Section 1341 describes the Claim of Right doctrine which offers benefits to taxpayers who have included an amount in income in one tax year, but have had to repay all or part of it in a later year.

- **For Repayments over $3,000** - Taxpayers can choose between a Tier 1 miscellaneous itemized deduction ***OR*** a tax credit based on the difference in tax with or without the repaid income in the year the income was originally reported. Make both computations and select the one that provides the greater benefit.
- **Repayments of $3,000 or less** - are claimed as Tier 2 miscellaneous itemized deductions.

- ***Excess Deductions on Trust Termination -*** There has been some confusion related to the deductibility of excess deductions flowing through to beneficiaries from a trust on Form 1041-K1 upon termination of the trust. Prior to the passage of the TCJA excess deductions on the termination of a trust were included as part of the beneficiary's tier 2 (subject to the 2% of AGI limitation) miscellaneous itemized deductions. However, TCJA suspended the deduction for tier 2 deductions for years 2018 through 2025, leading many to believe (1) that the pass-through expenses at termination were no longer deductible by the beneficiary and (2) they were no longer deductible on the 1041.

  The IRS subsequently issued Notice 2018-61 notifying taxpayers that the IRS intended to issue regulations dealing with the issue and in the meantime the taxpayers could rely on guidance included in Notice 2018-61, which provides the following:

  - Excess deductions on termination of a 1041 flowing through to beneficiaries from a trust 1041-K1 are deductible on Schedule A. Enter the amount on line 16 – Other Deductions.

  See also the beneficiary instructions to 2018 Form1041-K1, box 11, which also direct that the beneficiary's share of Code A excess deductions are deductible on line 16 of the beneficiary's Schedule A.

CAUTION:
The draft instructions for the 2019 1040 make no mention of the excess deductions on trust termination being deductible on line 16 and draft 1041 instructions had not been issued when this text was completed. We are not sure whether the IRS may have changed its mind for 2019.

TIER 2 EXPENSES

NOTE: All Tier 2 Miscellaneous Itemized Deductions are suspended (not deductible) for the tax years 2018 through 2025.

Tier 2 expenses must be reduced by 2% of AGI before they are deducted on Schedule A and they are not allowed at all for AMT computation purposes. They include such expenses as professional dues, qualified job-related educational expenses, malpractice insurance premiums, job-seeking expenses, employee office-in-home expenses, professional periodical subscriptions, uniforms, union dues, the deductible portion of unreimbursed business meals, expenses related to the production of income, tax preparation fees, and appraisal fees related to property given to charity or involved in a casualty loss.

- ***Tax Preparation Fees*** – For years before 2018 and after 2025, generally tax preparation fees, including the costs of electronic filing, paid by the taxpayer are deductible as Tier 2 expenses. This would also include the purchase of tax preparation software, guides, and instructions. If the taxpayer is self-employed or has rental income property an allocated amount of the tax preparation fees may be deductible on those schedules in lieu of Schedule A. Such allocation continues to be allowed during the 2018-2025 suspension period.

CAUTION (1) - If allocated amounts of tax preparation fees are deducted on Schedule C, E, or F, and those amounts are $600 or more, the taxpayer may need to issue a Form 1099-MISC to the individual or firm who provided those services.

CAUTION (2) – If your return preparation software transfers the fee you charged the client for the prior year return as a pro forma amount for Schedule A miscellaneous deductions, be sure to adjust that amount for the preparation fees allocated to other schedules.

- ***Credit and Debit Card Fees Related to Tax Payment are Deductible -*** Credit or debit card convenience fees charged for paying federal individual income taxes electronically are deductible as a Tier 2 itemized deduction for years before 2018 and after 2025. (IR-2009-37)
- ***Legal Expenses*** (Also see Chapter 7.10 – Legal Expenses) **–** Other than for years 2018-2025, an individual can usually deduct legal expenses incurred in attempting to produce or collect taxable income or paid in connection with the determination, collection, or refund of any tax. The following legal expenses are also deductible:

1) Related to either doing or keeping the taxpayer's job, including expenses paid to defend the taxpayer against criminal charges arising out of his/her trade or business,
2) For tax advice related to a divorce, if the bill specifies how much is for tax advice and it is determined in a reasonable way, or
3) To collect taxable alimony.

- ***Work Clothes and Uniforms –*** For years other than 2018-2025, the cost and upkeep of work clothing is deductible if the following two requirements are met.
    1) They are worn as a condition of employment.
    2) The clothing is not suitable for everyday wear. It is not enough that the clothing be distinctive, it must be specifically required by the taxpayer's employer. Nor is it enough that the taxpayer does not, in fact, wear the work clothes away from work. The clothing must not be suitable for taking the place of the taxpayer's regular clothing.

  Examples of workers who may be able to deduct the cost and upkeep of work clothes are: delivery workers, firefighters, health care workers, law enforcement officers, letter carriers, professional athletes, and transportation workers (air, rail, bus, etc.). Musicians and entertainers can deduct the cost of theatrical clothing and accessories if they are not suitable for everyday wear. IRS contends that white bib overalls and standard shoes, such as a painter might wear, are not distinctive in character or in the nature of a uniform.

  Tax Court Case - The Tax Court has held that a salesman for Ralph Lauren who was required to purchase and wear the designer's apparel while representing the company couldn't deduct the cost of such clothing as unreimbursed employee expenses. The Court found that the clothing was clearly suitable for regular wear and upheld IRS's imposition of an accuracy-related penalty with respect to the related portion of the underpayment. **(Barnes, TC Memo 2016-79)**

  The costs of ***protective clothing*** required for work, such as safety shoes or boots, safety glasses, hard hats and work gloves, are deductible. Examples of workers who may require safety items include carpenters, chemical workers, machinists, oil field workers, pipe fitters, and truck drivers.

- ***Military Uniforms -*** Taxpayers generally cannot deduct the cost of uniforms if they are on full-time active duty in the armed forces. However, armed forces reservists can deduct the unreimbursed cost of uniforms if military regulations restrict the taxpayers from wearing it except while on duty as a reservist. A student at an armed forces academy cannot deduct the cost of uniforms if they replace regular clothing. However, the cost of insignia, shoulder boards, and related items are deductible. Civilian faculty and staff members of a military school can deduct the cost of uniforms. Deductions related to military uniforms are suspended for 2018-2025.

- ***Gift Expenses –*** Only gifts given in the course of a trade or business are deductible and then they are generally limited to $25 per year per person (recipient). (IRC Sec 274(b); Reg. 1.274-3) These expenses would be deducted on Schedule C, E or F, as appropriate. For employees, these are Tier 2 expenses that are suspended for 2018-2025.

    - Married Taxpayers - If the taxpayer and spouse both give gifts, both are treated as one taxpayer. It does not matter whether they have separate businesses, are separately employed, or whether each has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

    - Incidental Costs **-** Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the $25 limit. A cost is incidental only if it does not add substantial value to the gift.

    - Exceptions **-** The following items are not considered gifts for purposes of the $25 limit.
        1) An item that costs $4 or less, and
            a) Has the taxpayer's name clearly and permanently imprinted on the gift, and
            b) Is one of a number of identical items that the taxpayer widely distributes, such as pens, desk sets, and plastic bags and cases.
        2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.

- ***Gift versus Entertainment -*** Any item that might be considered either a gift or entertainment generally will be considered entertainment. However, if the taxpayer gives a customer packaged food or beverages that he intends the customer to use at a later date, treat it as a gift. Entertainment expenses are not deductible after December 31, 2017, per the TCJA. An employee expense of a job-related gift is not deductible for years 2018-2025. See chapter 3.10, Meals and Entertainment.

- ***Car Expenses -*** If an employee uses his car for business purposes in years other than 2018-2025, he may be able to deduct car expenses as a Tier 2 itemized deduction. Generally he can use one of the two following methods to figure his deductible expenses.
    - Actual car expenses.
    - Standard mileage rate.

  Details and options relating to the deduction for the business use of the taxpayer's vehicle is complicated and covered separately in chapter 3.11 (Course CPE 311).

Strategy - Employee Vehicle Deductions - the AMT & 2% Rule

In years other than 2018-2025, the unreimbursed business expenses of an employee can only be deducted as miscellaneous itemized deductions subject to the 2% of AGI reduction. Thus, those who take the standard deduction receive no tax benefit for those expenses. Even when itemizing, taxpayers encounter two additional limitations:

a. For regular tax purposes, the employee business expenses when combined with other expenses in the same category are first reduced by 2% of a taxpayer's income (AGI) and then only the excess is deductible.

b. If the employee is taxed by the AMT, then none of the business expenses are allowed at all.

As a result, many taxpayers are unable to deduct their employee business expenses. However, there are two possible strategies that may help an employee recover some or all of these expenses.

The simplest way is for the employee to negotiate an accountable reimbursement plan with his or her employer. This will allow the employer to provide the employee with nontaxable reimbursement for the expenses. Depending upon the employer's attitude, the employee might need to accept a pay reduction approximately equal to the expense reimbursement.

Another possible strategy involves business assets that must be depreciated. By minimizing the depreciation deductions each year, when the business assets are sold or scrapped, the business basis will be higher than it would be if accelerated depreciation or Sec. 179 deductions were claimed. As a result, a potential deductible business loss has been created. Since the gain or loss from the sale of business assets is treated as income or loss on the face of the tax return, there is no need to itemize to benefit from a loss from the sale of the business asset.

The business asset most likely to fall into this category is the business-use portion of the employee's vehicle. To gain any benefit, the sale must result in a loss. The benefit will vary depending on three variables unique to each situation: the cost of the vehicle, how much depreciation was allowed or allowable for its business use, and the vehicle's sale price.

Example - *A vehicle costing $40,000 was driven a total of 100,000 miles (of which 25,000 miles were for business use), and the vehicle was sold for $12,000. Thus, the vehicle is used 25% as a business vehicle and the loss is determined as follows:*

Sales Price (25% of $12,000)		*$3,000*
Cost (25% of $ 40,000)	*10,000*	
25,000 Business Miles @ $.24/Mile	*<6,000>*	
Basis		*<4,000>*
Net Deductible Loss		*<1,000>*

In the example, the standard mileage rate was used with an imputed depreciation rate of 24 cents per mile (see Chapter 3.11 for a table of actual recent year rates). Using the standard mileage rate minimizes the taxpayer's recordkeeping and produces a low depreciation component. The taxpayer must account for depreciation when selling the vehicle, even though no benefit was derived. The tax benefit rule does not apply to depreciation. (Reg § 1.111-1(a))

- ***Hobby Expenses*** - **Other than for years 2018-2025**, if a taxpayer does not carry on an activity for profit (in other words, it is a hobby), the taxpayer may deduct their hobby expenses, up to the amount of any hobby income, as a tier 2 itemized deduction. Thus hobby income is reported on their 1040 (via Schedule 1, line 8 on the 2019 draft), and, except for years 2018-2025, any expenses, not exceeding the hobby income, are deductible as miscellaneous itemized deductions on Schedule A, assuming the taxpayer is not claiming the standard deduction, in which case they would be reporting income but not deducting the expenses. For 2018-2025, none of the hobby expenses are deductible, so all of the hobby income will be taxable. See Chapter 3.02 for information on "Profit Motive."

- ***Job-Search Expenses*** – Expenses looking for a new job in the taxpayer's current occupation are deductible (**other than for years 2018-2025**), even if a new job is not obtained. To be deductible, the expenses cannot be to look for a job in a new occupation or for a first job. If there is a substantial time gap between the taxpayer's last job and when he or she looks for a new job, the expenses are not allowed.

  The types of expenses that are deductible if looking for a new job in the same occupation include:
    - Fees paid by the taxpayer to employment and outplacement agencies and for career counseling.

- Resume preparation costs, such as typing, printing and mailing.
- Travel and transportation expenses if the trip is primarily to look for a new job. Even if the travel expenses to an area aren't deductible because job search wasn't the taxpayer's primary reason for the trip, the expenses looking for work in the area are allowed.

- ***Investment Fees and Expenses -*** Investment fees, custodial fees, trust administration fees (for revocable trusts), and other expenses paid for managing investments that produce taxable income are deductible in years **other than 2018-2025**. However, the fees are only deductible for the production of taxable income and are not deductible for the production on non-taxable investment income. Where the expenses are for the production of both taxable and nontaxable income, an allocation must be made.

Example – Allocating expenses in years other than 2018-2025 *– Joe Lewis has ABC Financial manage his investment portfolio and ABC charges Joe an annual management fee of one half of one percent of his portfolio value. For the tax year that management fee was $3,700. Joe's portfolio produced a total of $35,000 of taxable and non-taxable income for the year. Of that $35,000, $15,000 was from interest on tax free municipal bonds and the balance, $20,000, was from taxable interest and dividends. Therefore only $2,114 ($3,700 x ($20,000/35,000)) of the management fee is deductible.*

CAUTION – When investment expenses are allowed as a Tier 2 itemized deduction (i.e., in years other than 2018-2025), they must also be taken into account when computing the net investment income for purposes of determining how much investment interest is deductible. Most tax software includes a single entry point for the total of all investment expenses. Attempting to itemize those expenses on a separate line of the return will defeat the software computation.

Strategy (only for years other than 2018-2025) – Where the 2% of AGI will reduce or eliminate an investment expense and the taxpayer has investment interest carryover, consider not deducting the investment expenses so as to maximize the investment interest expense deduction. However, utilizing this strategy will prevent deduction of the investment expenses when determining the net investment income for purposes of the 3.8% net investment income surtax, so the effect on the surtax must also be considered.

- ***Special Rules for Performing Artists -*** Some performing artists are allowed to deduct their employment-related expenses as an adjustment to gross income, thus avoiding the 2%-of-AGI reduction on these expenses. This above-the-line deduction is unchanged by the TCJA. In order for these taxpayers to qualify for this special rule, all of the following must be met:
  (1) They must have ***two or more employers in the performing arts field*** during the tax year (don't count nominal employers who pay less than $200);
  (2) Their business expenses must be ***more than 10%*** of the gross income earned as a performing artist;
  (3) ***AGI (before performance-related expenses) can't be more than $16,000***. Married performers must file joint returns (unless they lived apart all year). The two-employer requirement and 10%-of-gross-income requirement are applied to each spouse separately. However, the $16,000-AGI requirement applies to married performers' joint income.

  Performing arts related expenses are not deducted on Schedule A; they are transferred from Form 2106 to Form 1040, Schedule 1, line 11 (draft 2019).

- ***State and local government officials get "above-the-line" deduction*** *(unchanged by TCJA)* **-** Employee business expenses of an official of a state or local government are deductible ***in computing AGI***, if the official is compensated in whole or in part on a fee basis. The officials for whom this provision is intended are those who provide certain services to the government, and who hire employees and incur expenses in connection with their official duties. Since these expenses are deductions "above-the-line," they are also deductible for AMT purposes.

- ***Firefighter Meals*** – See Chapter 3.10 – Meals & Entertainment

- ***Home Office*** (Also see Chapter 3.15 – Home Office) **–** If an employee uses a part of his home regularly and exclusively for business purposes, in years **other than 2018-2025**, he may be able to deduct a part of the operating expenses and depreciation of the home, or $5 per business-use square foot, up to 300 square feet, if using the simplified method. He can claim this deduction for the business use of a part of the home only if that part of the home is used ***regularly*** and ***exclusively:***
  1) As the taxpayer's principal place of business for any trade or business,
  2) As a place to meet or deal with patients, clients, or customers in the normal course of a trade or business, or
  3) In the case of a separate structure not attached to the taxpayer's home, in connection with the taxpayer's trade or business.

The regular and exclusive business use must be ***for the convenience of the taxpayer's employer*** and not just appropriate and helpful in the taxpayer's job.

CAUTION
The home office deduction can produce some negative effects when and if the home containing the office is sold. Unless the simplified method was used for all years when a home office deduction was claimed, there will be a certain amount of depreciation recapture that cannot be excluded under the home sale rules. If the home office is a separate structure the entire gain from the office portion of the home will not qualify for the exclusion of home gain.

- ***Education Expenses* -** Job-related educational expenditures are deductible by an employee as Tier 2 miscellaneous deductions (in years other than 2018-2025) or on Schedule C for a self-employed individual. Some job-related education expenses may qualify for the American Opportunity Credit or Lifetime Learning credits. The same expense, however, cannot be used for more than one tax benefit.

ADDITIONAL CONSIDERATIONS
If the taxpayer(s) meet certain requirements, some or all of the education expenses discussed here may qualify for a more beneficial tax treatment such as a credit, AGI adjustment (for years available) or, in the case of a self-employed individual, a Schedule C deduction.

  - *Qualifying Education Expenses* **-**To be deductible on Schedule A (for years before 2018 and after 2025), educational expenses must be closely related to the taxpayer's present job. Temporary absence from work, however, will not automatically cause a problem if that absence is a year or less and the taxpayer returns to the same type of work. The specific requirements state that the education must either:
    (a) Maintain or improve skills required in the taxpayer's present job, OR
    (b) Be required by the employer to retain the taxpayer's position.
    NOTE: Educators are allowed to deduct expenses for classes on a new subject they will teach or for training for a school counseling or administrative job. For teachers, this is all considered one line of work.
  - *Nonqualifying Education Expenses* **-** No deduction is allowed for education that:
    (a) Is being completed as part of meeting a minimum requirement for getting a job,
    (b) Is of a general or personal nature, or
    (c) Leads to qualification for a new trade.
  - *New Trade or Business Cases:*
    (1) A software engineer worked as a project manager. The Tax Court ruled she was not entitled to deduct education expenses related to obtaining her executive masters of business administration (EMBA) degree because the education qualified her for a new trade or business. Her employment was largely unrelated to her EMBA coursework, and although she continued to be qualified to manage people as a project manager, she also became qualified to perform many other tasks of business, management, finance and marketing that she was not qualified to perform before enrolling in the EMBA program. (*M.Z. Creigh, TC Summary Opinion 2017-26*)

    (2) This case is also about EMBA program expenses. Here the taxpayer was a finance and accounting professional. Among the issues raised by the IRS when they denied the education expenses were that the EMBA degree was a general degree that did not maintain or improve specific skills required for his employment and that the degree qualified him for a new trade or business. The taxpayer was a well-established finance and accounting business manager at an airport hotel before beginning his EMBA program, and he took courses that improved his managerial and leadership skills in his position as a business manager. Although hired by another company soon after graduating, the taxpayer performed duties that were substantially similar to those of his former job, the degree was not a prerequisite for the job, and considering the courses he took, the taxpayer was not qualified to perform new tasks or activities with the conferral of his degree. Therefore, the expenses qualified. *(A. Kopaigora, TC Summary Opinion 2016-35)*
  - *Deductible Educational Costs Include* **-** Transportation, travel, tuition, books, fees, supplies, etc. For qualified transportation, actual expenses of a car may be deducted, or the taxpayer may use the standard mileage rate.

    Education expenses of a regularly employed individual who goes from work to school on a strictly "temporary basis" can also include the costs of returning from school to home. Roundtrip mileage is also deductible for those who travel from home to school on a temporary basis, regardless of distance or whether the taxpayer attends school on nonworking days. If attendance at school:

(a) Is realistically expected to last (and does in fact last) for one year or less, and facts and circumstances don't indicate otherwise, the temporary basis standard is met.

(b) Is realistically expected to last for more than 1 year or if there is no realistic expectation that the attendance will last for 1 year or less, the attendance is not temporary, regardless of whether it actually lasts for more than 1 year.

(c) Initially is realistically expected to last for 1 year or less, but at some later date the attendance is realistically expected to last more than 1 year, that attendance will be treated as temporary, absent facts and circumstances to indicate otherwise, until the taxpayer's expectation changes. It will not be treated as temporary after the date the taxpayer determines it will last more than 1 year.

If the "temporary basis" test is not met, transportation costs from home to school do not count, but if the employee goes directly from work to school, the one-way costs of transportation qualify. If a taxpayer in this situation goes home before attending school, and the distance from home to school is greater than the mileage from work to school, only the work-to-school distance is deductible.

Example 1 – Educational Transportation to Temporary Location – Going Home Before Class - *Ron works regularly in a nearby town and goes directly from work to home. He also attends school every work night for 3 months to take a course improving his job skills. Since Ron is attending school on a temporary basis, he can deduct the daily roundtrip transportation expenses in going between his home and school, regardless of the distance traveled.*

Example 2** - **Educational Transportation to Temporary Location – Classes on Non-work Days - *Jean attended job-related classes for six consecutive Saturdays; she does not normally work on Saturdays. Since Jean is going to school on a temporary basis, she will be able to deduct the costs of her roundtrip mileage between home and school.*

Example 3** - **Educational Transportation to Non-temporary Location - *Assume that Jean attended job-related classes twice a week for an 18-month period. When Jean began the course of instruction, she knew it was to be for 18 months. On school nights, she drove from work to school and from school to home. Because Jean's school attendance is not temporary, she may deduct only the transportation costs of travel between work and school. If she went home before attending school, and the distance from home to school was greater than the mileage from work to school, only the work-to-school distance is deductible.*

Example 4** - **Educational Transportation Outside Area - *Tim, a stockbroker, works in Washington, D.C. and enrolls in an investment class in Baltimore, Maryland that he realistically expects to last for 1 year or less. He actually attended three nights a week for 3 months. He may deduct his roundtrip transportation expenses between Washington and Baltimore, because he meets the temporary basis test. The distance Tim travels is not relevant.*

The **recordkeeping requirements** are the same for education as for other employee business expenses. The kind of records necessary depends on the nature of the expense (local, away-from-home, etc.).

To the extent a **VA (Veterans Affairs) allowance** represents "subsistence" payments, it is not taxable AND does not reduce expenses. Any VA allowance intended to offset actual educational expenses reduces the expense deduction. ***Rev Rul 83-3*** states that VA benefits paid under 38 USC Section 1677 (1976) are direct reimbursements of education expenses, and benefits under 38 USC Section 1681 (1979) are half for subsistence and half to reimburse expenses.

Example** - **Educational VA Benefits - *Sean, a veteran, paid deductible education expenses in the amount of $1,200 in 2019. He received payments of $810 from the Dept. of Veterans Affairs under 38 USC Section 1681 as reimbursement for his expense. One-half of the reimbursement is for living expense and one-half for education. If it weren't that the TCJA effectively disallows employee business expenses, Sean would have been able to deduct $795 ($1,200 less 1/2 of $810) for his educational expenses before considering the 2% of AGI reduction.*

- <u>Travel as a Form of Education</u> **-** Generally, the IRS has taken the position that "Travel as a Form of Education" for teachers and educators is not an allowable education expense. However, in the court case ***Jorgenson, TC Memo 2000-138***, a high school English teacher was allowed foreign travel as an educational expense when that travel was part of a structured course offered by an education institution. In this particular case, the taxpayer enrolled in courses offered by UC Berkeley and UC Extension. One course entitled "Legendary Greece" involved extensive travel in Greece and another entitled "Southeast Asia, Sacred Places" involved travel to Thailand, Cambodia and Indonesia. The IRS took the position the education was travel as a form of education and therefore not deductible. The court disagreed and determined the courses were academic courses that:

1. Maintained or improved her skills, and
2. Were ordinary and necessary.

Thus, a distinction must be made between travel itself being a form of education (expenses not deductible) and when an individual travels away from home primarily to obtain education (education expenses are deductible). In the latter case the individual's expenditures for travel, meals, and lodging while away from home are deductible.

- *Strategy - Variable Annuity Losses* - Variable annuities typically invest in a variety of stock funds, money market accounts, etc. After the original investment, the annuity may have declined in value and will be worth less today than its original cost.

If the annuity is a non-qualified annuity and is surrendered in a cash-out transaction in a year other than 2018-2025, the loss from the annuity can be claimed as a miscellaneous deduction subject to the 2%-of-adjusted-gross-income limit. (2017 IRS Pub 575, pg. 22)

AMT & MISCELLANEOUS DEDUCTIONS

Miscellaneous deductions are segregated into two categories, Tier 1 or Tier 2 expenses.

- **Tier 1** – Tier 1 expenses are deductible against both the regular tax and the AMT.
- **Tier 2** – Tier 2 expenses are all of the other miscellaneous expenses not included in the Tier 1 group. For regular tax purposes, these expenses are deductible to the extent they exceed 2% of AGI. ***For AMT purposes, they are not deductible at all.*** For years 2018-2025, the TCJA suspends the regular tax deduction of Tier2 expenses. Thus, during the suspension period these expenses won't be deductible for either regular tax or AMT.

Strategies to minimize the effects of AMT for years other than 2018-2025:

Strategy - Have IRA/Pension Fees Deducted from the Pension Accounts* - Some taxpayers who wish to maximize their IRA and other pension accounts will pay the expenses of maintaining those accounts directly (not have them deducted from the pension account). These individuals can then include those expenses in their miscellaneous Tier 2 itemized deductions. However, if they are subject to the AMT, they gain no benefit from those deductions and should consider having the fees deducted from the pension accounts. This strategy also applies to taxpayers who lose the benefit of the deduction because of the AGI limitation and those who take the standard deduction.

Strategy - Negotiate Accountable Reimbursement Plans with Employer* - Taxpayers who have significant employee business expenses should attempt to negotiate an "accountable" reimbursement plan with their employer which would eliminate the need to claim the expenses as a miscellaneous deduction and essentially allow the expenses to be deducted from gross income.

Strategy - Allocate Tax Fees to Other Schedules* - Where possible, allocate the tax preparation fees to other Schedules such as C, E and F. Caution: Don't overlook the 1099 filing requirement if $600 or more is allocated to business schedules.

Strategy - Accelerate or Defer Expenses to Non-AMT Tax Years - Where possible, accelerate or defer the Tier 2 deduction to a tax year where the taxpayer is not subject to the AMT.

*These strategies also have merit for tax years 2018-2025 when the Tier 2 deductions are suspended.

GAMBLING LOSSES – See separate chapter on "Gambling Losses – Chapter 7.12."

TRAVEL EXPENSE - See separate chapter on "Travel Expenses – Chapter 3.12."

MEALS AND ENTERTAINMENT - See separate chapter on "Meals and Entertainment - Chapter 3.10."

TRAVEL OUTSIDE THE UNITED STATES - See separate chapter on "Travel Outside the United States – Ch 3.13."

California generally conforms to the federal rules for the types of expenses classified as miscellaneous deductions. However, significantly, California has not conformed to the TCJA suspension of Tier 2 deductions for years 2018-2025. Therefore, some taxpayers may be able to deduct their employee business expenses or other Tier 2 expenses for state purposes but not for federal. The FTB has modified Schedule CA to accommodate the expanded list of items that differ from the federal Schedule A. Other miscellaneous deduction differences include:

- The federal estate tax in respect of a decedent is not deductible for California.
- The amount of investment expenses could be different for California if the amount of nontaxable income against which the expenses are incurred is different for federal and California. This is illustrated in the following example.

Example – Allocating expenses *– Joe Lewis has ABC Financial manage his investment portfolio and ABC charges Joe an annual management fee of one half of one percent of his portfolio value. For 2019 that management fee was $3,700. Joe's portfolio produced a total of $35,000 of taxable and non-taxable income for the year. Of that $35,000, $15,000 was from tax free municipal bonds and the balance, $20,000, was from taxable interest and dividends. Therefore for federal purposes, if the TCJA suspension of the Tier 2 deductions didn't apply, only $2,114 ($3,700 x ($20,000/35,000)) of the management fee would be deductible. But since it does apply, none of the management fee is deductible. Of the $15,000 muni bond interest, $10,000 was derived from state of California obligations and $5,000 from other states' obligations. California taxes the $5,000 of interest from out-of-state obligations, so the associated investment expense is deductible, and $2,643 ($3,700 x ($25,000/35,000)) of the management fee is deductible for California and will be an adjustment on Sch CA.*

NOTES

LEGAL EXPENSES

Overview

Deductions for legal expenses can be controversial at best and case law indicates many arguments with the IRS over the issue. The Supreme Court has ruled that ***the origin and character of the claim*** determines whether or not legal fees are deductible. The following looks at various types of taxpayer circumstances in which legal expenses (and attorney fees) are likely to occur and discusses probable deductibility (or nondeductibility).

RAPID FINDER

TCJA

Prior to 2018, legal expenses to produce taxable income unrelated to a trade or business or required to be capitalized generally were deductible as a miscellaneous itemized deduction subject to the 2% of AGI reduction (Tier 2 expenses). For years 2018 through 2025, deducting Tier 2 expenses is suspended by the TCJA. This will have a significant impact on recipients of taxable damage awards where the entire award must be reported as income and legal fees taken from the award are no longer deductible.

The Details

ACQUIRING INCOME

In conducting business - Legal fees incurred by a taxpayer in the course of a trade or business are deductible, if they are ordinary and necessary expenses. In ***Harvey (1953) TC Memo 53376***, reasonable legal fees were currently deductible by a businessman even though paid to a relative.

- Legal fees were allowed as a deduction for a corporate officer who was responsible for filing the corporation's Federal tax return. The fees were incurred in relation to his defending an indictment for evasion of the corporation's income tax. His defense was unsuccessful. ***Rev Rul 68-662, 1968-2 CB 69***
- ***Bankruptcy*** – Legal fees connected with a business bankruptcy are deductible. If personal bankruptcy is primarily caused by the failure of a business activity, the legal fees related to the bankruptcy proceedings are partially deductible as a business expense. The courts have used a proration of the fees based on the ratio of business creditor claims to total creditor claims. ***Cox v. Commissioner, Dec. 38,294(M), TC Memo 1981-552***
- Legal expenses related to an involuntary bankruptcy proceeding brought against the taxpayer were allowed. ***Suckow Borax Mines Consolidated Inc., (1953) TC Memo 53244***
- No deduction was allowed, however, for a taxpayer whose business went bankrupt and was later sued for fraudulent transfer of assets to a family trust. The Court held that the origin of the expenses was personal in nature. The Court rejected a lower court judgment that there would have been no bankruptcy, except for the taxpayer's business creditors and a settlement payment would benefit those creditors. The settlement payment made by the taxpayer was, in fact, no more than his personal payment to the trustee to get dismissal of the suit against his family trust. ***Collins, Ralph (1994, CA11) 74 AFTR 2d 94-5336***

***In producing or collecting income*:** Legal expenses (including attorney fees, court costs, etc.) are deductible if incurred in the production or collection of income.

- The reduction of a ***personal expense*** isn't the same thing as the production of income.
- There must be a reasonably close connection between the legal expense and the production or collection of ***taxable*** income.

Example - Legal Expense Deductibility and Nature of Property - *Tara incurred legal expenses to defend herself in an injury suit brought against her by Jim who had slipped on the sidewalk in front of a property she owned. Tara won the case. The deductibility of Tara's expenses depends on the type of property involved in the accident. If the property was a rental, the expenses are deductible. If the property involved was Tara's personal home, no deduction is allowed.*

Cases:

- Legal expense deduction allowed an Army retiree who contested rank and rate of retirement pay at which he retired. ***Rev Rul 72-169, 1972-1 CB 43***
- Deduction allowed for a trip to Ireland with an attorney to collect winnings in Irish Sweepstakes. $1,000 attorney fee allowed. Extortion payment to attorney not allowed. ***Kanelos (1943) TC Memo 43429***
- Deduction allowed for an unemployed engineer in an action to collect unemployment compensation. The action was unsuccessful. ***Mohiuddin (1996) TC Memo 1996-442***
- Legal expense deduction allowed when expenses were incurred to "consider ways" to collect fees for services the taxpayer performed. The Court evidently was not concerned with whether there was, in fact, any action to actually collect the fees. ***Barnes, Thomas (1992) TC Memo 1992-720***

Managing, conserving or maintaining income-producing property - Many cases in this area, covering a great variety of income-producing property types, have seen legal expenses allowed. However, just because a taxpayer may have to sell income-producing property to satisfy a possible adverse judgment doesn't mean he/she can deduct the cost of defending the suit. Examples are:

- Fees paid by a labor union official to successfully defend against Racketeer Influenced and Corrupt Organizations (RICO) charges weren't deductible as expenses incurred to conserve/maintain income-producing property, specifically the taxpayer's certificates of deposit. The CDs weren't acquired from racketeering or through use of proceeds from racketeering. Thus, they weren't forfeitable under RICO. Even the possibility that the taxpayer might have to use the CDs to pay an adverse RICO judgment wasn't enough to permit deductibility on grounds of conservation of the CDs. ***Accardo v. Com., (1991, CA7) 68 AFTR 2d 91-5418***
- Legal expenses to defend a suit for breach of promise to marry were ***nondeductible*** personal expenses, even though satisfaction of an adverse judgment would require sale of income-producing securities. ***Rockwell, Henry (1961) 37 TC 246***

Related to title to property:

- Legal expenses related to acquire, perfect, defend, or clear title to property are capital expenditures and can't be deducted currently as business or investment expenses. However, even though legal expenses may not be immediately deductible, their cost may be recovered through depreciation, depletion, or cost recovery.
- Legal expenses paid to recover property (other than investment property and amount of income that, if and when recovered, must be included as gross income) are part of the cost of the property and not deductible. Such recovery refers to times where ownership of property was lost but has been restored.
- Expenses to acquire, perfect, or defend a leasehold interest generally aren't currently deductible.
- Legal costs related to the disposition of a property are considered a reduction in the amount realized on the sale (expense of sale).
- Fees related to blocking a condemnation are capital in nature.
- Legal fees connected with gifts are generally nondeductible. Making a gift of income-producing property is neither conserving nor managing the property.
- Legal fees for setting up an irrevocable trust were not deductible by a taxpayer who set up the trust for his children to which he transferred a reversionary interest in an existing trust. The legal fees paid to establish the trust were a nondeductible personal expense, not a business expense. ***Mathews, (1973) 61 TC 12***

Opt-out Class Action Lawsuits - IRS has ruled privately that attorney fees paid in an opt-out class action lawsuit weren't includible in class members' or class representatives' gross income, because no contractual obligation for a fee existed between them and litigating counsel. (PLR 200906010)

<u>ALLOCATING LEGAL EXPENSES</u>

Sometimes legal expenses are incurred for multiple purposes-- e.g., both to perfect or defend title and to gain the right to income. In that case, an allocable portion of the expenses relating to income is deductible and the remainder is nondeductible. Where a taxpayer pays attorney fees in a suit to quiet title to land and also to collect rent, the part of the fees allocable to services related to collecting rents would be deductible. ***(Reg §1.212-1(k))***

Suit terms usually control - In deciding whether a legal expense is nondeductible because it relates to title, the nature of the relief asked for in the suit is the controlling factor in determining deductibility. The relief actually granted does not control. Case in point is ***Kelly (1955) 23 TC 682.*** This was a suit to gain title to property. The fact that the judgment awarded only income items did not make all of the legal expenses deductible.

Partially taxable income - Legal fees incurred to collect partially taxable income are deductible to the extent allocable to amounts included in gross income. Examples include social security income (conceivably partly taxable), payments which include both interest (taxable) and principal (reduction of amount realized), damage awards (could be only partially taxable), etc.

> ***Example – Deduction of Legal Fees Connected with Partially Taxable Income (Social Security) -*** *Single taxpayer, Bob, earned income of $31,000, had a short-term capital loss of $2,000, and received $7,000 in social security disability in 2017. $3,500 of the social security was taxable. Bob paid legal fees of $1,000 in connection with his right to receive the social security benefits. He was able to deduct $500 (one-half) of the legal expense as a miscellaneous Tier 2 itemized deduction.* ***Reason:*** *His deduction is allowed in the same proportion as his social security is taxable. Since one-half of his social security income was taxable, one-half of his legal expense is deductible. If this situation occurred in years 2018 – 2025, Bob would have no legal fees deduction because of the TCJA-imposed suspension of Tier 2 deductions.*

Other methods of allocating legal fees:

- **Based on time spent on each issue of the case -** A taxpayer sued to prevent two business associates from terminating his employment and buying his stock at an unreasonably low price. He was allowed to allocate and deduct a larger amount of legal expenses to the employment claim since it involved more work. This was true even though he received $3,168,375 on the stock and only $200,000 for the breach of employment contract. About 29% of the legal fees were determined to be part of stock basis; the remainder were related to the employment and currently deductible. The deductible portion of the legal fees was over $200,000. ***McKeague v. U.S. (1986, Cl Ct) 59 AFTR 2d 87-347***
- **Based on the value of property - In *Nickel, (1989) TC Memo 1989-458,*** the court found that part of a legal fee was deductible even though no income was recovered. The allocation took into account all income recovered at the end of the action. It was based on the total value of stock where the taxpayer's case involved trying to recover stock value and option price. The value of certain bank stock on which the options had expired was weighed less heavily in the allocation ratio than the value of bank stock.

Damage Suits – Legal fees for defending and filing damage suits in a taxpayer's business or in employment are deductible. Those that would be a Schedule A itemized deduction will not be deductible in years 2018-2025. Examples are:

- Defending suit for wrongfully taking property.
- Corporation's defense of its position before the National Labor Relations Board related to liability for compensatory damages to employees.
- Settlement of damage suit in business that could help avoid adverse publicity and controversy.
- Getting a judgment for damages to rental real estate.
- Teacher's action of sex discrimination against a university.

Damages for personal injury or sickness - To the extent a taxpayer can't exclude from income a portion of an otherwise tax-free personal damage award--e.g. due to payment of interest accruing on the settlement funds-- the legal costs are deductible (in years when miscellaneous deductions aren't suspended).

Relating to insurance proceeds - Legal fees to collect on a claim related to a taxpayer's business are deductible. In one case, a taxpayer's building was partially damaged by a fire; his legal expense in gaining recovery was an ordinary and necessary business expense. However, legal fees related to fire destruction of a taxpayer's personal home weren't deductible--they were capital expenses.

Criminal cases

- Legal fees incurred to defend against criminal charges related to a taxpayer's trade or business are deductible. ***(LR 7734004 and several other cases)*** This is true even if the taxpayer is convicted of the crime. ***(Com. v. Terrlier, (1966, S. Ct) 17 AFTR 2d 633)***
- Legal expenses of defending an individual charged with a crime are personal and ordinarily can't be deductible by an employer who paid them. However, the Tax Court held that a corporation could deduct the legal fees it incurred to successfully defend its vice president against a criminal charge ***(Union Investment Co., (1954) 21 TC 659).*** The IRS acquiesced to the Union case.

Corporate business

- **Stockholder matters:** If a stockholder brings a suit that benefits a corporation and its stockholders, the corporation (though a nominal defendant) can deduct legal expenses related to the matters (to the extent the expenses would be otherwise deductible).
- **Valuing of stock:** Generally, legal expense related to appraisals and value of stock is capital in nature and not currently deductible.
- **Pre-incorporation expenses:** Ordinarily corporations can't deduct legal fees related to pre-incorporation matters. Such fees could, perhaps, qualify as start-up expenses.

Fiduciaries and estates

- **When deductible:** Legal expense deduction in this area has been allowed for a trust beneficiary who claimed rights to taxable trust income, for recovery of trust property embezzled by the trustee, and for advice in handling estate corpus (even though income from it was payable to another beneficiary).
- **Right to trust or estate property:** Generally, if legal expenses are incurred to protect an heir's right to property, the expenses aren't deductible. The expenses must be capitalized. Likewise, protecting rights to trust property are normally not deductible.
- **Wills:** Legal expense deductions have been denied for probating a will, contesting a will, and will contests**.**
- **Administration of estate, trust:** Reasonable legal costs of administering an estate or trust are deductible on the fiduciary return, unless the costs are related to tax-exempt income. However, the same expense cannot be deducted on both the estate tax return (Form 706) and the fiduciary income tax return (Form 1041).

Divorce, separations, etc. - Legal costs connected with divorce, separation or support are non-deductible personal expenses. Nondeductibility extends to legal fees incurred in disputes over money claims.

Taxable Alimony – For years other than 2018-2025, the part of legal fees attributable to producing taxable alimony is deductible by the recipient of the alimony. Attorney should stipulate what part of fee relates to alimony to ensure deduction for alimony recipient. See chapter 1.04 for changes to alimony taxability/deductibility created by the TCJA.

Personal matters - No deduction allowed when the case involved the following:

a) Defending drunk driving charge;
b) Invasion of privacy suit;
c) Resisting deportation;
d) Preparing a will;
e) Release from mental hospital;
f) Prosecuting malpractice suits.

WHERE TO DEDUCT LEGAL EXPENSES

- **Tier 2 treatment:** Generally, for years other than 2018-2025, nonbusiness legal expenses are deducted on Schedule A as Tier 2 miscellaneous itemized deductions if paid in relation to the production of taxable income.
- **Related to business:** If related to the taxpayer's: (1) self-employed business, deduct expenses on Schedule C (or Schedule F if farm activity); (2) real estate rental, deduct on Schedule E.
- **Related to capital items:** If the expenses must be added to basis, sale of the related property would be reported on Form 8949 (Schedule D) or Form 4797.
- **Taxable damage awards paid partially to attorney:** When a taxpayer wins a taxable damage award, the following questions come up: is the whole award taxable to the taxpayer even though part of it is paid to an attorney? YES, unless the award is one of the types listed in the next two bullet items. Does the part paid to the attorney come off the top of the judgment and the taxpayer pays tax on only the net? NO. For years 2018-2025, due to the suspension of Tier 2 deductions, none of the attorney fees that would otherwise be reported as miscellaneous itemized deductions will be deductible. For other years, the issue plays an important part in the tax treatment:
  (1) When taken as an itemized deduction, the attorney's fee deduction is limited by the 2% of AGI rule.
  (2) If the taxpayer doesn't itemize, he/she could lose benefit of the deduction.
  (3) If the award is large enough, the taxpayer may be subject to AMT and lose the benefit since miscellaneous deductions are not allowed against AMT.
- **Unlawful discrimination:** A taxpayer may deduct attorney fees and court costs paid in connection with any actions involving a claim of "unlawful discrimination," which includes a number of specific federal statutes (see Code Sec. 62(e)) and any federal, state, or local law regulating any aspect of the employment relationship or prohibiting the discharge of an employee as an adjustment to income (**above-the-line**). *(*Code Sec. 62(a)(20)). The amount of the deduction can be no more than the amount of the award includible in gross income. Note: Because the provision allows an above-the-line deduction as opposed to an itemized deduction, the deduction effectively is allowed for AMT purposes as well.
- **Whistleblower awards:** Attorney's fees and court costs paid in connection with a whistleblower award paid for providing information about tax law violations are deductible above-the-line. (Code Sec 62(a)(21)) However, the deduction is limited to the amount includible in gross income as a result of the reward. For 2018 and later years, this above-the-line deduction is also available to whistleblowers receiving awards under the SEC and Commodity Future Trading Commission whistleblower programs, as well as the State false claims acts.

SUPREME COURT AND CONTINGENT ATTORNEY FEES

The Supreme Court has resolved a conflict among the Federal Circuit Courts of Appeal by holding that contingent fees paid to an attorney out of a taxable damage award or settlement are not excludible from the client's gross income (as a few circuits had held) but rather are includible in the client's gross income and deductible only as miscellaneous itemized deductions (as most courts had held). Specifically, the Court reversed pro-taxpayer decisions in the Sixth and Ninth Circuits. As a result, the portions of the taxpayers' wrongful discharge and employment termination settlements paid to their respective attorneys as contingent fees were includable in their gross income. The Supreme Court said that contingent fees are includible in the client's gross income in cases like this whether or not the attorney-client contracts or respective state laws confer any special rights or protections on the attorneys. ***Commissioner v. Banks (S Ct 1/24/2005) 95 AFTR 2d ¶2005-404, rev'g* John W. Banks, II, *(CA 6 9/30/2003), and rev'g* Banaitis, *(CA 9 8/27/2003)***

WITHHOLDING ISSUES WHEN LEGAL FEES INCLUDED IN BACK PAY AWARDS

Legal fees and interest awarded with back pay should be treated as follows for income tax withholding purposes according to ***Rev Rul 80-364, 1980-2 CB 294:***

- When a court allocated $8,000 as back pay, along with interest amounting to $1,000 plus a $1,000 attorney fee, only the $8,000 in back pay was subject to withholding.
- An individual sued his employer for $15,000 in back pay and, under court order, received $10,000. The court order didn't allocate what portion of the award was attorney fees or interest. The employee paid $1,000 for attorney fees. In this case, the whole $10,000 was subject to withholding.
- A union and company made a settlement agreement that the company would pay the union $40,000 in full settlement of claims. The union paid $6,000 in attorney fees and returned $34,000 to the employees for back pay. Only the $34,000 actually paid to the employees was subject to withholding.

CALIFORNIA DIFFERENCES

Non-Conformity - California has not conformed to the TCJA suspension of Tier 2 miscellaneous deductions for 2018-2025. Therefore, legal expenses that aren't deductible on the federal return because of the TCJA provision will be deductible as an itemized deduction for California, subject to the 2% of federal AGI reduction.

Non-Conformity - California does not conform to the federal change that expands the deduction for attorney's fee related to awards to whistleblowers. (FTB Summary of Federal Income Tax Changes 2018)

NOTES

CASUALTY LOSSES

WHAT IS A CASUALTY LOSS?

A loss caused by a sudden, unexpected event like a fire or storm can be tax deductible. To qualify, actual physical damage to property must occur, not simply a temporary decline in the value of property. The loss can be on any kind of property, either business or personal and generally only property belonging to the taxpayer will qualify.

Rev Rul 73-41, 1973-1 CB 74 states that if a taxpayer leases real property and the terms of the lease say that the taxpayer is responsible for the damage, he/she (lessee) can also qualify for a casualty loss deduction.

GENERALLY ONLY DISASTER LOSSES ALLOWED 2018 THROUGH 2025

An itemized deduction for personal casualty losses is limited in years 2018 through 2025 to losses attributable to federally declared disasters, although a taxpayer may still claim personal casualty losses not attributable to federally declared disasters to the extent of personal casualty gains during this period.

- **Personal Losses** (does not apply to business losses)
  - **Per-Casualty Loss Floor:** $100
    - **10%-of-AGI Limitation -** Does not apply to losses from criminal fraud or embezzlement
- **Net Operating Loss:** Casualty loss can create an NOL
  - Can carry NOL forward if incurred after 2017
  - 3-year carryback allowed for pre-2018 NOLs due to casualty
- **Frozen Bank Deposits – Options**
  - Nonbusiness bad debt
  - Casualty or theft loss
  - Limited Schedule A Loss (see text)
- **Losses from criminal fraud or embezzlement**
  - Are deducted as a casualty loss
  - Are not subject to the $100 limitation
  - Are not subject to the 10% of AGI limitation
- **"Ponzi" Scheme Safe Harbor Deduction – Where loss not readily determinable**
  - 95 percent, for a qualified investor that does not pursue any potential third-party recovery; or
  - 75 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery; Less actual recovery and/or insurance proceeds

RAPID FINDER

- **Rev. Proc. 2018-08** – This procedure provides safe harbor methods for individuals to use in determining the fair market value of property destroyed or damaged in certain casualties in order to compute the amount of their casualty and theft losses for their homes and personal belongings. Details in chapter.
- **Rev. Proc. 2018-09** – This procedure provides a Cost Indexes Safe Harbor Method for individuals to use to determine the amount of their casualty losses to their personal residences as a result Hurricanes Harvey, Irma and Maria in hurricane disaster areas after August 22, 2017 (not discussed in this text).

Related IRC and IRS Publications and Forms

- **IRC Sec 165** - Losses
- **IRC Sec 1033** – Involuntary Conversions
- **Pub 547** – Casualties, Disasters & Thefts
- **Pub 584**– Casualty, Disaster and Theft Loss Workbook (Personal-Use Property)
- **Pub 584-B**– Casualty, Disaster and Theft Loss Workbook (Business)
- **Pub 2194** – Disaster Kit for Individuals & Businesses
- **Form 4684** - Casualties and Thefts
- **Form 4797**- Sales of Business Property & Involuntary Conversions

UNEXPECTED, IDENTIFIABLE EVENT

A casualty loss occurs when there is property damage from a sudden, unanticipated event, NOT FROM GRADUAL, PROGRESSIVE DAMAGE. The following are examples of qualifying events but keep in mind that for years 2018-2025 no deduction for personal casualty losses is allowed except for those attributable to federally declared disasters:

1. Acts of Nature like hurricanes, tornadoes, floods, storms, and volcanic eruptions.
2. Shipwrecks, sonic booms.
3. Vandalism.
4. Fires (except if set by the taxpayer). Smog, but only if caused by a sudden event, e.g., the escape of highly unusual toxic fumes that cause damage to paint on a taxpayer's home, auto, etc. (Rev Rul 71-560).
5. Insolvency of a bank: Taxpayers can elect to treat lost deposits as EITHER casualties OR bad debts. The election is not available to the insolvent bank officers, owners (owning 1% or more), or certain relatives of these owners. The loss may be recognized in the year it can be reasonably estimated, OR it can be claimed in a later year when it is determined no recovery is possible.
6. Car and other accidents (but not if due to willful negligence of taxpayer or if due to breakage under normal conditions).
7. Theft, including burglary, embezzlement and other unlawful acts. Merely losing property is not considered theft; but if the disappearance of the property accompanies an unexpected event, a casualty could result.
8. Damage from insects or drought will normally NOT qualify. But IRS says that a sudden, unexpected, or unusual infestation by beetles or other insects may result in a casualty loss. (Pub. 17, Your Federal Income Tax, 2018 edition, page 185)
9. Terrorist attacks.

CASUALTIES ON PERSONAL USE PROPERTY

The loss for each event is the smaller of the adjusted basis of the property prior to the casualty or the decrease in fair market value. Subtract from this the amount of insurance coverage or other reimbursement received (or expected to be received). Personal property must be valued on an "item-by-item" basis; but for real property, figure the decline in value of the property as a whole, including buildings, plants, trees, etc. The cost of repair is not deductible per se, but it can help measure the change in FMV if restoration does not put the property in better condition than before the casualty.

Repairs may not be used to determine the decrease in FMV unless they:

1. Bring the property back to its condition prior to the casualty.
2. Are not excessive in amount.
3. Repair only actual damage.
4. Do not increase the value of the property.

***Example - Amount of Casualty, Low Basis, High FMV -** Al purchased his home many years ago for $25,000 and made no improvements; it was worth $300,000 before it burned down in 2017. His casualty loss is limited to his basis, $25,000. Al's replacement value insurance paid him $300,000 on the loss. He has a gain of $275,000 as a result of this transaction.*

***Example - Amount of Casualty, FMV Drop -** Assume that Al's home (previous example) had a basis of $80,000 and only the garage portion of his home was burned. The FMV of the property before the fire was $300,000 and $277,000 after. Al's loss is limited to $23,000, the drop in FMV.*

INSURANCE COVERAGE AND REIMBURSEMENT

Taxpayers cannot deduct casualty losses for personal use property damage unless they make a timely claim for the insurance reimbursement (if the property is covered by insurance). This rule does not apply to the "deductible" portion of the coverage.

Other "reimbursement": Although insurance is the most common form of reimbursement for casualties, other types of "reimbursement" also can reduce the amount of loss. These include:

- Federal disaster loan forgiveness.
- Repairs made to rental property by a lessee.
- Damages received in court settlement (after legal fees and expenses).
- Repairs, etc., by relief agencies.
- Grants, gifts, or other payments designated to repair or replace property. However, if there are **no conditions** attached to the funds, they are not considered reimbursement.

REIMBURSEMENT FOR LIVING EXPENSES

An exclusion from gross income is allowed for insurance proceeds received for the temporary increase in living expenses due to a casualty loss of a principal home. The exclusion amount is limited to the increased "actual", reasonable and necessary living expenses as compared to the "normal" living expenses that would be incurred by the taxpayer to maintain his/her customary living standard during the loss period. Living expenses include temporary housing, utilities, meals, transportation and miscellaneous items like laundry, etc. For this purpose, mortgage interest is not considered a living expense.

Example - Reimbursement of Living Expenses - *When fire damaged their home, Greg and Gretchen moved to a motel for a short time, then moved to a rented house. They stayed at the rental for about one month while they were having their home repaired. They incurred the following expenses during this period, compared to their normal household expenditures:*

Description of Expense	***Actual Exp***	***Normal Living Exp***	***Inc/Dec. Due to Casualty***
Rent	*$ 900*	*$ 0*	*$ 900*
Motel costs	*1,000*	*0*	*1,000*
Food	*800*	*500*	*300*
Laundry and cleaning	*50*	*20*	*30*
Utilities	*0*	*75*	*-75*
Transportation costs	*240*	*420*	*-180*
Total	*$2,990*	*$1,015*	*$1,975*

Greg and Gretchen received $2,990 in reimbursement from the insurance company. Of that amount, $1,975 is excludable from their income. Assume that Greg and Gretchen had been renters rather than homeowners. They paid rent of $850 per month prior to the fire. While their landlord does repairs, they owe no rent. Since the couple's actual rent exceeds the normal rent by only $50, they may exclude from income only $1,125 ($1,975 minus $850).

Note: The cost of living expenses incurred as the result of a casualty loss are not included in the deduction for a casualty loss. However, when the taxpayer receives reimbursement from their insurance company, the reimbursement is excludable to the extent that it covers increased "actual", reasonable and necessary living expenses as compared to the "normal" living expenses that would be incurred by the taxpayer to maintain his/her customary living standard during the loss period.

PER EVENT & AGI LIMITATIONS

1. Reduce the casualty amount by $100 for each event ($500 if a 2017 Hurricane disaster loss or a loss in a 2016 disaster area).
2. After combining all personal casualty occurrences for the year, reduce the total by 10% of adjusted gross income (no AGI-based reduction required if a 2017 Hurricane disaster loss or a loss in a 2016 disaster area).

Example - Personal Casualty Loss Computation *- Andy's car (which cost $5,000) was totaled in an accident in 2017. The fair market value at the time of the accident was $3,500. Andy had no collision insurance and his AGI for the year was $25,000.*

Loss (decrease in FMV)	*$3,500*
Less $100 per event	*-100*
Minus 10% of AGI	*-2,500*
Casualty loss deduction	*$900*

If Any's accident had occurred in a year in the 2018 through 2025 period, the $900 loss would not be deductible.

PERSONAL CASUALTY GAINS

Although the TCJA suspended the deduction for most personal casualty losses, an exception to the suspension rule is where a taxpayer has personal casualty gains for the tax year (Sec 165(h)(5)(B)). In such cases, a taxpayer may deduct the portion of the personal casualty loss not attributable to a federally declared disaster (a "nonfederal casualty loss") to the extent the loss doesn't exceed the personal casualty gains (Code Sec. 165(h)(5)(B)(i)). Personal casualty gains occur where the taxpayer receives insurance or other proceeds in excess of the adjusted basis of the destroyed, damaged, or stolen property.

EXAMPLE - Although it is highly unlikely you will encounter taxpayers with three different casualty types for the year, we provide this example to show how non-deductible personal casualty losses can be used to offset casualty gains. *Jack and Sally have an AGI of $100,000 for the current tax year, and the following casualties for the year.*

- *Nonfederal (non-deductible personal) Casualty Loss: $30,000. After the $100 floor: $29,900*
- *Federal Disaster Loss: $40,000. After the $100 floor: $39,900*
- *Personal Casualty Gains: $40,000*

First the nonfederal loss, $29,900, is used to offset the personal casualty gain, $40,000. Any remaining gain, in this case $10,100, is used to reduce the federal disaster loss of $39,900, resulting in a net loss of $29,800, which is now reduced by 10% of the taxpayers' AGI, and the deductible federal disaster loss becomes $19,800.

EXPENSING DEBRIS REMOVAL & DEMOLITION EXPENSES

Generally, deductions are not allowed for the costs of demolishing structures, and the costs are, instead, charged to the capital account of the underlying land. The treatment of the cost of debris removal depends on the nature of the costs incurred. Sometimes the cost of debris removal is an ordinary and necessary business expense which is deductible in the year paid or incurred. However, if the debris removal costs are in the nature of replacement of part of the property that was damaged, the costs are capitalized and added to the taxpayer's basis in the property.

CASUALTIES ON BUSINESS PROPERTY For partial losses (damage), the loss is the smaller of basis or decline in fair market value. For thefts or total losses, the loss is the adjusted basis of the property, regardless of FMV. A reduction must be made for insurance or other recovery, **but there is no $100-per-event or 10%-of-AGI reduction**. Casualty losses for business and income-producing property that are not related to a federally-declared disaster continue to be deductible. Business casualty losses are claimed on Form 4797, while losses from income-producing property not used in a business are deductible on Schedule A, line 16.

Because individuals can't claim miscellaneous deductions for employee expenses for 2018 - 2025, business casualty and theft losses of property used in performing services as an employee cannot be deducted nor applied in the netting process to offset gains. (2018 Form 4684 instructions, page 5)

INVENTORY LOSSES

Theft and other types of inventory casualties are accounted for through the cost of goods sold. There is no separate casualty deduction when there is no reimbursement. If a taxpayer is reimbursed for lost inventory in the year of the loss, the taxpayer may include the reimbursement in income, and adjust the closing inventory accordingly.

NOTE - Inventory and Disaster Loss Election

For income tax purposes, a taxpayer can elect to deduct a casualty loss sustained in an area the President declares to be a disaster area either in the year the loss is sustained or in the preceding year. If the loss is attributable to self-employment income, the deduction must be taken into account for self-employment tax purposes in the same year the taxpayer elects to deduct it for income tax purposes. Thus, where a self-employed individual incurred a casualty loss from damage to inventory in a disaster area and elected to deduct the loss in the previous year, the deduction must also be taken into account in the previous year in figuring the self-employment tax. (Rev Rul 77-94, 1977-1 CB 265)

Example *-* ***Inventory Lost in Casualty -*** *Ward is the sole proprietor of a dress shop. Dresses costing $1,500 were stolen from his shop. Ward's gross Schedule C income for the year was $50,000. His beginning inventory was $10,000 and additional inventory purchased during the year was $14,000. On December 31, his ending inventory was $8,000 (it would have been $9,500 if the theft had not occurred). CALCULATION OF GROSS PROFIT:*

	WITHOUT THEFT	***WITH THEFT***
Beginning inventory	*$10,000*	*$10,000*
Plus purchases	*14,000*	*14,000*
Less ending inventory	*9,500*	*8,000*
Cost of goods sold	*14,500*	*16,000*
Gross receipts	*50,000*	*50,000*
Less COGS	*14,500*	*16,000*
Gross profit	*$35,500*	*$34,000*

Example - Comparison of Results of Personal vs. Business Casualties *– Uninsured auto with cost of $6,000 and FMV of $3,000 was a total loss due to an accident in 2019. Taxpayer's AGI was $25,000. Use was 100% for business*

	IF PERSONAL	*IF BUSINESS*
Cost	*$6,000*	*$6,000*
Depreciation	*0*	*2,000*
Adjusted basis	*6,000*	*4,000*
FMV	*3,000*	*3,000*
Initial limit on loss	*3,000*	*4,000*
Less per-event floor	*100*	*N/A*
Less 10% of AGI	*2,500*	*N/A*
Net amount	*400*	*4,000*
Allowed loss deduction	*$ 0*	*$4,000*

LOSSES FROM INVESTMENT PROPERTY

Losses from income-producing property are deducted as miscellaneous itemized deductions, subject to the 2% of AGI limitation (Tier 2 deductions) The amount of loss must also be shown on page 2, Form 4684. They are not subject to the $100-per-event or 10%-of-AGI limits. For years 2018-2025, the TCJA suspends the deduction for Tier 2 deductions so income-producing losses are not deductible.

The decline in value of stock acquired on the open market after disclosure of accounting fraud or other illegal misconduct of the corporation's officers or directors is not a theft loss. The decline in value is not deductible as a casualty loss ***(IRS Notice 2004-27)***. However, if the stock becomes wholly worthless, a capital loss may be claimed.

CORROSIVE DRYWALL – SAFE HARBOR CASUALTY LOSS (NOT APPLICABLE 2018-2025)

The safe harbor applies to a casualty loss deduction to any individual who pays to repair damage to his or her personal residence or household appliances that results from corrosive drywall (Rev. Proc. 2010-36). For this purpose "corrosive drywall" means drywall that is identified as problem drywall under the two-step identification method published by the Consumer Product Safety Commission (CPSC) and the Department of Housing and Urban Development in their interim guidance dated January 28, 2010. Refer to the CPSC Drywall Information Center at https://www.cpsc.gov for further information.

- *Not Pursuing reimbursement* - Taxpayers who are not pursuing reimbursement, and who do not intend to pursue reimbursement, may claim all unreimbursed amounts paid during the taxable year to repair damage to the taxpayer's personal residence and household appliances as a casualty loss.
- *Taxpayers who are pursuing reimbursement* - or who intend to pursue reimbursement, may claim 75% of the unreimbursed amounts paid during the taxable year to repair damage to the taxpayer's personal residence and household appliances as a casualty loss. These taxpayers may have income or an additional deduction in subsequent taxable years depending on the actual reimbursement amount received.

Losses claimed for the replacement of household appliances are limited to the lesser of the current cost to replace the appliance or the basis of the appliance.

WHEN TO DEDUCT CASUALTY LOSSES

Personal casualty losses that do not result from a federally declared disaster are not deductible in years 2018-2025. (Sec 165(h)(5)(A) as added by the TCJA) To the extent the following information applies to personal casualty losses, it applies to years before 2018 and after 2025.

The loss is ordinarily claimed in the year it occurs, even though out-of-pocket expense for repairs may be incurred in a later year. For thefts, the loss is claimed in the year of discovery. If there is a good prospect that insurance (or other) reimbursement will be received, subtract the expected reimbursement in figuring the loss, then deduct the unreimbursed portion in the loss year. If actual reimbursement is more or less than expected, report additional income or deduction in the year of reimbursement.

Example - Accounting for Casualty Loss Reimbursement *- Art's personal use vehicle was stolen in Year 1. He had paid $12,000 for the car, but it had a FMV of $8,000 at the time of the theft. At the time of the casualty, Art filed a claim with his insurance company for reimbursement of the $8,000, but he had received nothing by December 31 of Year 1. Actual insurance reimbursement received in November of Year 2 was $6,500.*

Total loss	*$8,000*
Probable insurance reimbursement	*8,000*
Loss for Year 1	*0*
Loss for Year 2 (before $100 and 10% reductions)	*$1,500*

Example - Casualty Reimbursement/No Tax Benefit - *James lost a boat during a severe storm in Year 1. The loss was $4,500, but he expected to be reimbursed $3,500. He was not able to itemize his deductions in Year 1, so he got no tax benefit from the loss. In Year 2, James received a $4,500 reimbursement from his insurance company. None of the insurance proceeds is reportable as income in Year 2, because he got no tax benefit from the loss in the year it occurred.*

INVOLUNTARY CONVERSIONS

Reminders – No gain is recognized when property is compulsorily or involuntarily converted into property similar or related in service or use. Where property is involuntarily converted into money or into property that isn't similar or related in service or use, a taxpayer can defer tax on any gain, if he so elects and he buys property that's similar or related in service or use. The cost of the replacement property must be equal to or more than the net proceeds from the converted property, and the replacement must generally be made within two years after the close of the first tax year in which any part of the gain is realized (IRC Sec. 1033(a)(1)). Gain is recognized only to the extent the amount realized on the conversion exceeds the cost of the replacement property (Code Sec. 1033(a)(2)(A)). The basis of the converted property carries over to the replacement property. (Code Sec 1033(b)(1))

Special rules apply regarding a taxpayer's principal residence, or any of the residence's contents, that is compulsorily or involuntarily converted because of a disaster. See next item.

DISASTER LOSSES

Federally Declared Disaster – This is a disaster that occurred in an area declared by the President to be eligible for federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. A list of the designated areas is available on the Federal Emergency Management Agency (FEMA) web site: *www.fema.gov*. Taxpayers in these areas are eligible for special tax breaks as well as non-tax related assistance.

Taxpayer's Principal Residence - If a taxpayer's principal residence, or any of the residence's contents, is compulsorily or involuntarily converted because of a disaster:

- Gain isn't recognized from the receipt of insurance proceeds for contents of the residence that was unscheduled personal property for insurance purposes.
- Insurance proceeds for the residence or any of its contents other than unscheduled personal property are treated as if received for a single item of property. Property that is similar or related in service or use to the converted residence or its contents is treated as property similar or related in service or use to this single item of property.

The rules apply to a taxpayer's principal residence or any of its contents if it **is located in a disaster area and is compulsorily or involuntarily converted as a result of a federally declared disaster**. (Code Sec. 1033(h)(1))

Qualified Disaster Relief Payments - Certain "qualified disaster relief payments" received by an individual are excluded from gross income.

Disaster Losses in General - Special rules apply to losses which occur in areas the President of the United States declares eligible for Federal disaster assistance. The losses must result from the disaster. The FEMA web site noted above lists the designated disaster areas. Taxpayers may elect to claim the loss:

1. In the year it occurs, or
2. On the preceding year's return (either original or amended).

Disaster Losses Offer Special Options - When to take the loss depends upon a number of factors and should be carefully analyzed to determine which year is the most beneficial for the taxpayer. Some of the factors to consider include:

- **The tax brackets for each year** – From purely a tax standpoint, each year should be carefully examined as to which will provide the greatest overall tax benefit and without wasting other tax benefits.
- **The need for immediate cash** – The primary purpose of the special rules allowing the casualty loss to be claimed on the prior year's return is to provide taxpayers access to a tax refund without the need to wait – often many months - to file their return for the year of the loss.
- **Self-Employment tax** – Self-employed taxpayers will also need to consider whether to take a business casualty loss that affects inventory in the current or prior year since the loss can offset self-employment tax as well as income taxes (also see "Note" in "Inventory Losses" section above).
- **Whether the loss will be used up** – If the casualty loss is not fully used up in the year it is first deducted, it can create a net operating loss (NOL).

Making the Election to Claim the Disaster Loss on Preceding Year's Return

The election must be made in writing no later than six months after the due date of the taxpayer's federal income tax return for the disaster year, without regard to any extension of time to file ((Reg Sec. 1.165-11T(f)); Rev Proc 2016-53).

> ***Example:*** *A Federally-declared disaster occurred in Year 2. A calendar-year taxpayer who incurred a loss in that disaster can claim their casualty loss on either their Year 2 return or their Year 1 return. If the prior year (Year 1) return has already been filed, it can be amended by filing a Form 1040X. Either the original or amended prior year return must be filed no later than 6 months after the original due date of the Year 2 return. Thus, the due date will usually be October 15 of Year 3.*

A taxpayer makes a § 165(i) election by deducting the disaster loss on either an original or amended federal tax return for the preceding year. An election statement indicating the taxpayer is making a §165(i) election must be included with the original or amended return. The election statement must contain the following information:

(1) The name or a description of the disaster and date or dates of the disaster which gave rise to the loss.

(2) The address, including the city, town, county, parish, State, and zip code, where the damaged or destroyed property was located at the time of the disaster.

For an election made on an original federal tax return, a taxpayer must provide the above information on Lines 1 or 19 (as applicable) of Form 4684. A taxpayer filing an original return electronically may attach a statement as a PDF document if there is insufficient space on Lines 1 or 19 of the Form 4684 to provide the required information. For an election made on an amended return, a taxpayer may provide the information required by any reasonable means, such as writing the name or a description of the disaster, the State in which the damaged or destroyed property was located at the time of the disaster, and "Section 165(i) Election" on the top of the Form 4684 and providing the rest of the information as required in (1) and (2) above in either the Explanation of Changes on Form 1040X, or directly on the Form 4684, attaching a statement if there is insufficient room on the form.

A sample of a disaster loss election follows:

Election to Claim Early Disaster Loss under Code Sec. 165(i)

Name	**Social Security Numbers**
James & Judy Foster	111-11-1111 & 222-22-2222

The above-named taxpayers elect to claim a disaster loss deduction for the calendar year 2018 pursuant to Code Section 165(i). The disaster that destroyed our house consisted of flooding that occurred during the period May 3, 2019 through June 8, 2019. The house was located at 101 Second St., Beckley, Raleigh County, West Virginia 25801.

[James' signature] [date] [Judy's signature] [date]

When completing Form 4684 (2018 and draft 2019), and the casualty or theft loss is attributable to a federally declared disaster, above line 1 check the box and enter the associated FEMA disaster declaration number, which can be found at https://www.fema.gov/Disasters.

Revoking the Election - The election can be revoked up to ninety (90) days after the due date for making the election.

ADDITIONAL BENEFITS FOR CERTAIN DISASTER LOSSES

Forced Relocation or Demolition – Taxpayers who are forced to relocate or demolish a residence (not necessarily a principal residence), which is in a disaster area, may claim a casualty for the property, regardless of whether a casualty occurred to the residence, if the:

1. Area was declared a Federal disaster area,
2. Taxpayer was ordered by state or local officials to demolish or relocate the residence,
3. Order was made no later than 120 days after the date of the President's disaster declaration, and
4. Residence was determined to be unsafe because of (as a "proximate result of") surrounding conditions *(Sec 165(k)).*

Insurance Proceeds - A taxpayer whose principal residence (or its contents) is damaged in a disaster can qualify for special tax treatment regarding certain insurance proceeds received as a result of the casualty. To qualify, the locale of the residence must be in a Presidential-declared disaster area. The rules stipulate that no gain is recognized on the receipt of insurance proceeds for personal property that was part of the residence's contents, if such property was not scheduled under the insurance policy (scheduled property is property such as jewelry which is covered by a rider under the insurance policy).

Other insurance proceeds received for the residence or its contents may be treated as a common pool of funds. If those funds are used to purchase property similar to the property lost, a taxpayer will need to recognize the gain only to the extent that the pool is more than the cost of the replacement property.

The replacement period for the damaged or lost property is extended to four years after the close of the first taxable year in which any part of the gain on the involuntary conversion is realized.

These rules are extended to renters as well. Renters who receive insurance proceeds related to disaster damage to their property in a rented principal residence also qualify for the disaster loss relief.

Rev Rul 95-22, 1995-12 IRB explains when gain doesn't have to be recognized on the receipt of insurance proceeds for the destruction of a principal home (or contents) in a disaster area. The ruling clarifies that gain recognition is avoided if the proceeds received for the residence and scheduled property are reinvested in a replacement residence and/or any kind of replacement contents, whether separately scheduled or not.

Example: *Earl's home and its contents were destroyed in an earthquake. The contents included furniture and appliances (not "scheduled" separately for insurance purposes). Also destroyed was jewelry and sterling silverware which were each separately scheduled for insurance purposes. Earl's adjusted bases at the time of the loss were: $250,000 – residence, $5,000 – jewelry and $2,000 – silverware. Earl has insufficient records to establish the cost basis for most of the general household items.*

Earl got the following from his insurance company as a result of his loss:

Loss on home	*$300,000*
Jewelry, silverware	*10,000*
Furniture & unsched prop.	*35,000*
Total	*$345,000*

In the following year, Earl spent the following:

Rebuild home	*$300,000*
Home furnishings, etc.	*40,000*
A painting hung in living room	*10,000 (scheduled prop. for insurance purposes)*
Total	*$350,000*

Earl didn't replace the jewelry and silver. Because of the IRS ruling, Earl recognizes no gain on the conversion of the furniture and unscheduled contents; this is true regardless of whether he bought any replacement property. Earl can defer gain recognition on the $310,000 (the common pool of funds) he received as reimbursement for loss of the home, jewelry and silver. This is due to the fact that he spent $350,000 to rebuild and refurnish the home and this exceeds $310,000.

Extended Deadlines - The IRS has the authority to postpone for up to one year certain tax deadlines of taxpayers affected by a federally declared disaster. Examples of deadlines the IRS will postpone in disaster areas are those for filing income, excise and employment tax returns; paying income, excise and employment taxes; and contributing to IRAs. See the IRS web site – www.irs.gov – for news releases and other announcements of covered disaster areas.

Interest Abatement - When the IRS extends the due date for filing and paying tax and waives related penalties (late filing and payment), for a taxpayer in a Presidential-declared disaster zone, it must also abate assessment of underpayment interest for the period of the extension.

PASSIVE LOSS CARRYOVERS

What happens to passive losses on a rental property that is destroyed in a disaster area when it is unlikely that the property would be replaced?

Passive losses are released **upon a total disposition of the property in a fully taxable event** (IRC Sec 469(g)). Thus, to release the passive loss carryovers a taxpayer needs to dispose of the land. Otherwise, the passive loss carryover continues to be attached to the property and can only be used to offset other passive income.

INVENTORYING THE DAMAGE

Personal property should be carefully inventoried for insurance, according to the Federal Emergency Management Agency and the Small Business Administrations. Include the following in the inventory listing:

1. How and when was the property acquired? If purchased, what was the cost? If inherited, what was the value at date of decedent's death?
2. Property value *before and after* the casualty.
3. Cost to replace the property (for insurance purposes).
4. Estimate of repair cost.
5. Separate appraisals are needed for scheduled property (jewelry, artwork, antiques, etc.)

HOME DESTROYED

When a home is destroyed in a casualty the outcome can be quite different than expected by taxpayers. The reason being that their loss is measured from the **lesser** of the home's adjusted basis or the FMV at the time of the loss. Since real property generally appreciates in value, for tax purposes a home that's destroyed will generally result in a casualty gain as opposed to a casualty loss once insurance payment is considered. However, the gain can be excluded under Sec 121 if the taxpayer qualifies and any remaining gain (up to the basis of a replacement home acquired generally within 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized) can be deferred under the involuntary conversion rules of Sec 1033. This is best explained by example.

Example – A wildfire in a disaster area destroys Phil's home which had an adjusted basis of $125,000. Phil is single and has owned and used the home for over 10 years before it was destroyed. Phil's insurance company pays Phil $400,000 for the house. A tax loss is different from a financial loss in that a tax loss is measured from the **lesser** of the home's adjusted basis or the FMV at the time of the loss. So, in this case Phil does not have a tax loss, he has a gain.

The destruction of Phil's home is treated as a sale for tax purposes and since Phil meets the 2 out of 5 years ownership and use tests, the Sec 121 gain exclusion will apply. In addition, any gain in excess of the amount excluded can be deferred under Sec 1033. Here is how it all plays out for Phil…

Insurance company payment	$400,000
Phil's adjusted basis in the home	<125,000>
Realized Gain	275,000
Sec 121 Gain Exclusion	<250,000>*
Remaining Gain	25,000
Phil **elects** to defer gain into replacement	<25,000>**
Net taxable gain	0

* Since the casualty was treated as a sale, presumably Phil would be qualified for another $250,000 Sec 121 exclusion after owning and using the replacement property for two years.

** This amount reduces the basis of Phil's replacement home. This is an election and Phil could instead choose to pay the tax on the gain instead of deferring it. In addition, the deferral cannot reduce the basis of the replacement property below zero; thus, any amount not deferred would be taxable.

PROVING LOSSES

Taxpayers will need to show evidence of the cost of the lost property, evidence of the event causing the loss (e.g., it is very difficult to defend a theft loss without a police report), and evidence of the amount of the loss. It is helpful to have photos of the property before and after the casualty, notes describing the casualty and the property damaged, appraisals, and news clips describing the event. Blue Book values can be helpful in casualties that involve cars.

A qualified appraiser should be used to determine FMV of real property and scheduled personal property. The appraisal should cite values just before and after the casualty. In a disaster, it may be difficult to get an appraiser to "commit" to FMV until prices stabilize. Absent an appraisal, a possible alternative may be to get the written opinion of a real estate broker.

The question how to value trees, plants, etc., often comes up in casualty situations. For example, to value a mature tree, appraisers will often use historical data and estimate the overall loss of FMV in the property. A landscape firm could perhaps determine the cost of bringing landscaping back to its original state--this is a case where cost of repair work may be a good indicator of the amount of loss.

Use of estimates of repair - Where the taxpayer relies on the cost of repairs, and not a competent appraisal, to measure the amount of a casualty loss, the repairs and associated expenditures must actually be made (*Abrams, Paul, (1981) TC Memo 1981-231).* Thus, a taxpayer couldn't use the estimated costs of repairs where no repairs were in fact made (*Farber, Jack, (1972) 57 TC 714)* or where taxpayer did part of the repair work himself and had a contractor do some of the work (*Wheeler, Elvin, (1984) TC Memo 1984-42).* If the taxpayer doesn't intend to have the repairs done, he should get a competent appraisal of the property which shows the decline in the value of the property as a result of the casualty. However, see "Safe harbor methods" below for situations where estimates of repairs will suffice.

But, where a taxpayer uses a competent appraiser to establish the decrease in fair market value of the property resulting from the casualty, the appraiser is entitled to take into account the probable costs of repairing the damaged property, even though the repairs to the property are not, in fact, ever actually made. In computing the probable cost of repairs, however, the cost of repair immediately after the casualty is the relevant figure.

Safe Harbor Methods – The IRS recognizes that taxpayers often have difficulty determining casualty losses based on the decline in fair market value which has frequently resulted in time-consuming and expensive litigation. So to provide certainty to both taxpayers and the IRS, in Rev Proc 2018-08, effective December 13, 2017, the IRS provides safe harbor methods, that a taxpayer may choose to use in determining the decrease in FMV of personal-use residential real property (which we sometimes shorten to "residence" in this discussion) and for personal belongings in lieu of the actual reduction in FMV.

> **CAUTION:** Rev. Proc. 2018-8 can be quite misleading. The "purpose," part of the Rev. Proc. leads the reader to believe that the Rev. Proc. provides an alternate and more taxpayer-beneficial way of determining a casualty loss. The problem is the purpose of the Rev. Proc. is to provide safe harbors to determine fair market value of a property for casualty loss purposes, **NOT** the casualty loss itself. A casualty loss is still the lesser of the adjusted cost basis or the fair market value on the date of the casualty reduced by any insurance reimbursement.

Definitions for this purpose:

- <u>*Personal-use residential real property*</u> – is real property, including improvements (such as buildings and ornamental trees and shrubbery), that is owned by the individual who suffered a casualty loss and that contains at least one personal residence, which can be a single family residence, or a single unit within a contiguous group of attached residential units (for example, a townhouse or duplex), and any structures attached to the residence or single unit. <u>*Ineligible*</u> property includes:
  - a condominium unit or cooperative unit,
  - mobile home or trailer,
  - property of which the taxpayer owns a fractional interest or no interest in the structural components, and

  - a personal residence where part is used as rental property or a home office used in a trade or business or transaction entered into for profit.

- _Personal belonging_ - is an item of tangible personal property that is owned by the individual who suffered a casualty or theft loss and that is not used in a trade or business or in a transaction entered into for profit, and _does not_ include a boat, aircraft, mobile home, trailer, or vehicle, or an antique or other asset that maintains or increases its value over time.

- _No-cost repairs_ – these are repairs made for a de minimis or token cost, donation or gratuity, such as the repair or rebuilding of an individual's residence by volunteers.

Estimated repair cost safe harbor method for residence casualty losses of $20,000 or less – To determine the decrease in the FMV of the personal-use residential real property, the lesser of two repair estimates prepared by two separate and independent contractors, licensed or registered in accordance with state or local regulations, may be used, provided the costs to restore the residence to pre-casualty condition are itemized. Costs that improve or increase the value of the residence above pre-casualty value must be excluded from the estimate. This safe harbor only applies if the loss is $20,000 or less before applying the per-casualty and percentage of AGI reductions.

De minimis safe harbor method for residence casualty losses of $5,000 or less – Under the de minimis method, the cost of repairs required to restore the residence to pre-casualty condition may be estimated by the taxpayer. Costs that improve or increase the value of the residence above pre-casualty value must be excluded from the estimate. The estimate must be done in good faith, and the individual must maintain records detailing the methodology used for estimating the loss. This safe harbor only applies if the loss is $5,000 or less before applying the per-casualty and percentage of AGI reductions.

Insurance safe harbor method for residence casualty - To determine the FMV decrease of the individual's residence, the estimated loss determined in reports prepared by the individual's homeowners' or flood insurance company may be used.

Contractor safe harbor method (Federally declared disasters only) – The contract price for the repairs specified in a contract prepared by an independent and licensed contractor (or one registered in accordance with state or local regulations) may be used if the contract itemizes the costs to restore the residence to the condition existing prior to the disaster. Costs that improve or increase the value of the residence above pre-casualty value must be excluded from the contract price for purposes of this safe harbor. To use the Contractor Safe Harbor Method, the contract must be a binding contract signed by the individual and the contractor.

Disaster loan appraisal safe harbor method (Federally declared disasters only) – Under this method, to determine the decrease in FMV of the individual's residence, an appraisal prepared for the purpose of obtaining a loan of Federal funds or a loan guarantee from the Federal Government may be used. The appraisal should include the estimated loss the individual sustained as a result of the damage to or destruction of their residence from the Federally declared disaster.

De minimis safe harbor method for casualties or thefts of $5,000 or less of personal belongings – The rev proc allows an individual to make a good faith estimate of the decrease in the FMV of the individual's personal belongings, provided the individual maintains records describing the personal belongings affected and detailing the methodology used for estimating the loss. This safe harbor only applies if the loss is $5,000 or less before applying the per-casualty and percentage of AGI reductions.

Replacement cost safe harbor method for personal belongings in Federally declared disasters – This method may be used to determine FMV of most personal belongings located in a disaster area immediately before the disaster in order to compute the casualty or theft loss. If used, this method must be applied to all eligible personal belongings for which a casualty loss is claimed. This method may **not** be used for the following: boats, aircraft, mobile homes, trailers, vehicles, and antiques or other assets that maintain or increase in value over time.

Under this method, first determine the current cost to replace the personal belonging with a new one and reduce that amount by 10% for each year the personal belonging was owned, using the percentages in the Personal Belongings Valuation Table below. A personal belonging owned by the individual for nine or more years, will have a pre-disaster FMV of 10% of the current replacement cost.

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Personal Belongings Valuation Table	
Year	Percentage of Replacement Cost to Use
1	90%
2	80%
3	70%
4	60%
5	50%
6	40%
7	30%
8	20%
9+	10%

Example: *Joe's uninsured furniture was destroyed in a hurricane. He purchased his couch 4 years prior to the hurricane for $800. It would cost $1,100 to replace it. Using the replacement cost safe harbor method, the fair market value of the couch just before the storm would be $660 ($1,100 x 60%). Since the couch was destroyed, its FMV after the hurricane is $0, so the decrease in FMV is $660, which is less than his basis of $800. Therefore, Joe's casualty loss for the couch is $660.*

Effect of no-cost repairs – If any of the safe harbor methods provided in Rev Proc 2018-08 are used to determine the fair market value of or the amount of loss of an individual's residence or personal belongings, the loss must be reduced by the *value* of any no-cost repairs.

NET OPERATING LOSSES

All allowed casualty losses are treated as "business" losses for purposes of computing NOLs. An NOL arising in a year **before 2018** from a casualty loss can be carried back 3 years or carried forward for up to 20 future years and used as a deduction on the carryback or carry-forward returns. For NOLs arising in years ending **after 2017**, the TCJA generally repeals NOL carrybacks, except for certain farm losses, and provides that the carryover is no longer limited to 20 years and is indefinite until it is used up. (IRC Sec. 172(b)(1)(A) amended by TCJA Sec. 13302(b)(1)) Effective for NOLs arising in years beginning after 2017, the NOL deduction can be no more than 80% of the taxable income computed without regard to the NOL deduction for the year. (IRC Sec. 172(a) amended by TCJA Sec. 13302(a)(1)) (See Chapter 3.16 for more on "Net Operating Losses").

GAINS FROM CASUALTY LOSS RECOVERIES AND REPLACEMENT PROPERTY

Where insurance or other recovery is more than the basis of the property, taxpayers will generally have a taxable gain. However, the taxpayer can ELECT TO DEFER THE GAIN by buying a replacement property (this applies to condemned property as well as casualties). The REPLACEMENT PROPERTY generally must be "similar or related in service or use" to the lost property. This is stricter than the "like-kind" rule used in tax-deferred exchanges, and it means that the replacement property must function the same as the lost property. EXCEPTION: Certain real estate replacements need only satisfy the "like-kind" rules. This exception DOES NOT APPLY TO replacement of a taxpayer's condemned residence or to replacement of involuntarily converted realty which is part of the "inventory" of a dealer in real estate.

The replacement period begins on the date of the damage or condemnation and ends two years from the end of the first year in which the taxpayer received insurance proceeds (or a condemnation award or other conversion proceeds). For condemned real estate, the replacement period is three years from the condemnation date. The replacement period may be extended by requesting permission from the IRS. Do this by sending a written request to the Internal Revenue Service Center where the return is filed. The request showing reasonable cause should be filed well before the expiration date of the regular replacement period. If there is reasonable cause, it is possible to file the statement after the end of the replacement period and still have permission granted to extend.

The basis of property acquired through an involuntary conversion is the same as the property lost **plus** any gain recognized **less** any loss recognized. In ***Rev Rul 73-18, 1973-1 CB,*** the IRS said that the basis of acquired property must be allocated between building and the land in the same proportion as was used on the property converted.

FORMS TO USE TO REPORT A CASUALTY LOSS

Compute casualty gain or loss on IRS Form 4684. Carry the result to Form 4797 if a business casualty and/or Schedule A for other allowed casualties. Appraisal fees related to establishing the value of property lost in a casualty are deductible as Tier 2 expenses on Schedule A, so for years 2018-2025 when the TCJA suspends the deduction of Tier 2 expenses, none of the appraisal fees will be deductible.

BASIS ADJUSTMENTS REQUIRED

The basis of the property affected by a casualty must be adjusted, as follows:

- **Decrease basis** by insurance or other reimbursement received and any deductible loss.
- **Increase basis** by the amount spent on repairs to restore the property to pre-casualty condition, but do not include "disaster mitigation payments," which are payments to property owners to be used to reduce the risk of future damage to the property.

INVOLUNTARY CONVERSION NONRECOGNITION WHEN RELATED PARTIES INVOLVED

Nonrecognition of gain under the involuntary conversion rules is not allowed if a taxpayer purchases replacement property from a related party if, for the property involuntarily converted, the total of the amount of realized gain on the property on which there is realized gain is over $100,000. This makes individuals (not just business entities) involved in involuntary conversions subject to the same rules regarding acquisition of replacement property from a related party as are other taxpayers. Since the $100,000 limit is based on "realized gain on the property on which there is a realized gain," a taxpayer can't offset his/her gains with any losses sustained as a result of the involuntary conversion for purposes of determining whether gain exceeds the limitation.

TAX TREATMENT OF BANK DEPOSIT LOSSES

If a "qualified individual" (other than the institution's officers, 1% owners, or those related to either) has a loss on a deposit in a bankrupt or insolvent qualified financial institution, and that loss may be reasonably estimated, the loss may be treated, at taxpayer's election as:

(1) A nonbusiness bad debt (Short-term Form 8949 (Schedule D) loss), **OR**

(2) A casualty or theft loss (reported on Form 4684) deductible under rules that closely follow those for casualty losses, including the $100 and 10%-of-AGI floors. On line 1, of the 4684 show the name of the financial institution and write "Insolvent Financial Institution." Skip lines 2 through 9. Enter the amount of the loss on line 10, and complete the rest of Section A of the form. Include the calculation of the reasonably estimated loss claimed. Code Sec. 165(l)(1) However, since the itemized deduction for personal casualty losses is limited in years 2018 through 2025 to casualties in federally-declared disasters, no bank deposit casualty losses would be deductible in those years.

(3) **If the financial institution was not insured under Federal law** the taxpayer can elect to treat the loss as an ordinary loss deductible on Schedule A (subject to the 2% floor) limited to $20,000 ($10,000 for MS). Any loss in excess of the amount deducted on Schedule A can be deducted as a nonbusiness bad debt. Code Sec. 165(l)(5)(A). As with option (2), no loss would be deductible for 2018-2025 due to the TCJA suspension of tier 2 miscellaneous deductions.

The election is made by claiming the loss (casualty or ordinary) on the return (or timely amended return) for the tax year in which a reasonable estimate of the loss can be made.

PONZI SCHEME LOSSES

Form 4684 includes Section C to compute the loss based upon the Rev. Proc. 2009-20 safe harbor procedures for computing a Ponzi loss.

Revenue Procedure 2009-20 provides an optional safe harbor treatment for taxpayers that experienced losses in certain investment arrangements discovered to be criminally fraudulent. The revenue procedure also describes how the IRS will treat a return that claims a deduction for such a loss and does not use the safe harbor treatment described in the revenue procedure:

- These returns are subject to examination by the service.
- A taxpayer who claims a theft loss deduction without following the safe harbor treatment must (1) establish that the loss was from theft and that the theft was discovered in the year the deduction is claimed, (2) have sufficient documentation to establish the amount of the claimed loss, and (3) be able to prove that no claim for reimbursement for any part of the loss exists for which there is a reasonable prospect of recovery in the tax year of the claimed loss.

- Additional requirements apply if the taxpayer files or amends a return to exclude previously reported investment income that was not actually or constructively received.

Phantom Income - IRS has provided guidance (Program Manager Technical Advice 2013-003) to persons who do not or cannot use the safe harbor procedures provided in Rev Proc 2009-20 and who have "phantom income." This guidance pertains to:

1. Recharacterizing prior withdrawals as a return of capital - While taxpayers generally bear the burden to prove the legitimacy of amounts included in income, amounts that a taxpayer included in income on a return filed in a closed year should be includible in the taxpayer's basis not only for purposes of computing the amount of a theft loss deduction under Code Sec. 165 , but also for purposes of recharacterizing income in open years under Code Sec. 61, and that this treatment applies whether or not the closed-year income was genuine, fictitious, or a combination of both.
2. Treating phantom income as constructively received - In addressing the question as to whether the IRS may assert the doctrine of constructive receipt to claim that a taxpayer has income from a fraudulent investment scheme that can't be recharacterized, the IRS considered the theory that the taxpayer could have withdrawn the taxpayer's entire investment in the scheme. IRS cited cases on both sides of the issue and then concluded, "Under this case law and given the factual nature of the issue, [IRS] has some discretion to determine when to assert the doctrine of constructive receipt in the recomputation of Ponzi income."

Safe Harbor - Under the safe harbor provisions of Rev Proc 2009-20 if a qualified investor follows the procedures prescribed, the IRS will not challenge the following treatment by the qualified investor of a qualified loss—

(1) The loss is deducted as a theft loss;
(2) The taxable year in which the theft was discovered within the meaning of § 165(e) is the discovery year described in section 4.04 of the revenue procedure; and
(3) The amount of the deduction is the amount specified in section 5.02 ("Amount to be Deducted" below) of the revenue procedure.

Amount to be Deducted - The amount specified in section 5.02 is calculated as follows—

(1) Multiply the amount of the qualified investment by—
  (a) 95 percent, for a qualified investor that does not pursue any potential third-party recovery; or
  (b) 75 percent, for a qualified investor that is pursuing or intends to pursue any potential third-party recovery; and
(2) Subtract from this product the sum of any actual recovery and any potential insurance/SIPC recovery. The amount of the deduction calculated under this section 5.02 method is not further reduced by potential direct recovery or potential third-party recovery.

Future Recoveries - The qualified investor may have income or an additional deduction in a year subsequent to the discovery year, depending on the actual amount of the loss that is eventually recovered. See § 1.165-1(d); Rev. Rul. 2009-9.

Statement - By executing the statement provided in Section C of Form 4684 the taxpayer agrees—

(1) Not to deduct in the discovery year any amount of the theft loss in excess of the deduction permitted by section 5 of Rev. Proc 2009-20;
(2) Not to file returns or amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year;
(3) Not to apply the alternative computation in § 1341 with respect to the theft loss deduction allowed by Rev. Proc 2009-20; and
(4) Not to apply the doctrine of equitable recoupment or the mitigation provisions in §§ 1311-1314 with respect to income from the investment arrangement that was reported in taxable years that are otherwise barred by the period of limitations on filing a claim for refund under § 6511.

Definitions - The following definitions apply solely for purposes of Revenue Procedure 2009-20.

- **Specified fraudulent arrangement** - A specified fraudulent arrangement is an arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments, if any, of purported income or principal to some investors from amounts that other investors invested in the fraudulent arrangement; and appropriates some or all of the investors' cash or property. For example, the fraudulent investment arrangement described in Rev. Rul. 2009-9 is a specified fraudulent arrangement.
- **Qualified loss** - A qualified loss is a loss resulting from a specified fraudulent arrangement in which, as a result of the conduct that caused the loss—

  (1) The lead figure (or one of the lead figures, if more than one) was charged by indictment or information (not withdrawn or dismissed) under state or federal law with the commission of fraud,

embezzlement or a similar crime that, if proven, would meet the definition of theft for purposes of § 165 of the Internal Revenue Code and § 1.165-8(d) of the Income Tax Regulations, under the law of the jurisdiction in which the theft occurred; or

(2) The lead figure was the subject of a state or federal criminal complaint (not withdrawn or dismissed) alleging the commission of a crime described in section 4.02(1) of Revenue Procedure 2009-20, and either –
(a) The complaint alleged an admission by the lead figure, or the execution of an affidavit by that person admitting the crime; or
(b) A receiver or trustee was appointed with respect to the arrangement or assets of the arrangement were frozen.

In Rev. Proc. 2011-58 the IRS has broadened this definition in two ways:

- By including schemes in which a **civil** complaint is brought against the lead figure (or an associate entity involved in the fraudulent arrangement) by a state or federal authority that has not been withdrawn, and
- By making an exception for the non-withdrawal requirement for indictments or complaints withdrawn due to the lead figure's death.

- **Qualified investor** - A qualified investor means a United States person, as defined in § 7701(a)(30) --
  (1) That generally qualifies to deduct theft losses under § 165 and § 1.165-8;
  (2) That did not have actual knowledge of the fraudulent nature of the investment arrangement prior to it becoming known to the general public;
  (3) With respect to which the specified fraudulent arrangement is not a tax shelter, as defined in § 6662(d)(2)(C)(ii); and
  (4) That transferred cash or property to a specified fraudulent arrangement. A qualified investor does not include a person that invested solely in a fund or other entity (separate from the investor for federal income tax purposes) that invested in the specified fraudulent arrangement. However, the fund or entity itself may be a qualified investor within the scope of this revenue procedure.
- **Discovery year** - A qualified investor's discovery year is the taxable year of the investor in which the indictment, information, or complaint described in section 4.02 of the revenue procedure is filed. Rev. Proc. 2011-58 expanded this definition to include arrangements involving a civil complaint.
- **Responsible group** - Responsible group means, for any specified fraudulent arrangement, one or more of the following:
  (1) The individual or individuals (including the lead figure) who conducted the specified fraudulent arrangement;
  (2) Any investment vehicle or other entity that conducted the specified fraudulent arrangement, and employees, officers or directors of that entity or entities;
  (3) A liquidation, receivership, bankruptcy or similar estate established with respect to individuals or entities who conducted the specified fraudulent arrangement, in order to recover assets for the benefit of investors and creditors; or
  (4) Parties that are subject to claims brought by a trustee, receiver, or other fiduciary on behalf of the liquidation, receivership, bankruptcy or similar estate described in section 4.05(3) of the revenue procedure.

- **Qualified investment.**
  (1) Qualified investment means the excess, if any, of --
    (a) The sum of --
      (i) The total amount of cash, or the basis of property, that the qualified investor invested in the arrangement in all years; plus
      (ii) The total amount of net income with respect to the specified fraudulent arrangement that, consistent with information received from the specified fraudulent arrangement, the qualified investor included in income for federal tax purposes for all taxable years prior to the discovery year, including taxable years for which a refund is barred by the statute of limitations; over
    (b) The total amount of cash or property that the qualified investor withdrew in all years from the specified fraudulent arrangement (whether designated as income or principal).
  (2) Qualified investment does not include any of the following—
    (a) Amounts borrowed from the responsible group and invested in the specified fraudulent arrangement, to the extent the borrowed amounts were not repaid at the time the theft was discovered;

(b) Amounts such as fees that were paid to the responsible group and deducted for federal income tax purposes;

(c) Amounts reported to the qualified investor as taxable income that were not included in gross income on the investor's federal income tax returns; or

(d) Cash or property that the qualified investor invested in a fund or other entity (separate from the qualified investor for federal income tax purposes) that invested in a specified fraudulent arrangement.

- **Actual recovery** - Actual recovery means any amount a qualified investor actually receives in the discovery year from any source as reimbursement or recovery for the qualified loss.
- **Potential insurance/SIPC recovery** - Potential insurance/SIPC recovery means the sum of the amounts of all actual or potential claims for reimbursement for a qualified loss that, as of the last day of the discovery year, are attributable to--
  (1) Insurance policies in the name of the qualified investor;
  (2) Contractual arrangements other than insurance that guaranteed or otherwise protected against loss of the qualified investment; or
  (3) Amounts payable from the Securities Investor Protection Corporation (SIPC), as advances for customer claims under 15 U.S.C. § 78fff-3(a) (the Securities Investor Protection Act of 1970*),* or by a similar entity under a similar provision.
- **Potential direct recovery** - Potential direct recovery means the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year, against the responsible group.
- **Potential third-party recovery** - Potential third-party recovery means the amount of all actual or potential claims for recovery for a qualified loss, as of the last day of the discovery year, that are not described in section 4.08 or 4.09 of this revenue procedure.

CALIFORNIA DIFFERENCES

Generally, California law conforms to federal law regarding the treatment of casualty and disaster losses, including the safe harbor treatment for Ponzi schemes, with the following exceptions:

Tax Reform Changes – California has not conformed to the changes in the TCJA related to casualty losses but has belatedly and partially conformed to the NOL changes. Thus, for California:

- To be deductible, casualty losses do not have to be disaster-related.
- A casualty loss occurring prior to 2019 that results in a NOL can be carried back 2 years and any balance remaining can be carried forward for 20 years, or an election to forego the carryback can be made. The election to waive the carryback can be made separately for California and federal. For NOLS occurring in taxable years beginning after December 31, 2018, AB 91(signed by the governor 6/27/2019) repeals the 2-year carryback period. California continues to allow a 20-year carryover period and has not adopted the federal rule limiting the NOL deduction to 80% of the carryover year's taxable income. Thus, 100% of the unused CA NOL is carried over.

California Disaster Losses – SB-35, signed into law 9/1/15, allows the Governor to declare a state of emergency (disaster) for California purposes without action by the state legislature. Special legislation is no longer needed. For California purposes, a casualty loss becomes a disaster loss depending upon who declares a disaster:

- **President -** If the U.S. President declares a disaster the disaster loss rules apply for both the state and federal tax returns.
- **Governor -** If the Governor of CA declares a state of emergency, and the President does not, the governor's action only allows disaster treatment on the California return.

A Disaster Loss is Allowed If:

- The loss is sustained in an area declared a disaster for either state purposes or state and federal purposes, and.
- The loss occurs because of the declared disaster.

List of CA Disasters - A complete list of all California disasters declared by the President and/or the Governor is included in the instructions to FTB Form 3805-V. The list covers the disasters through the tax year of the form. A current list is also available on the FTB web site at:

https://www.ftb.ca.gov/file/business/deductions/distaster-codes.html

When to Claim a Disaster Loss - A disaster loss can be claimed on California returns in either the tax year in which the disaster occurs or in the tax year immediately before the disaster took place (same as federal). The time for making the election will be the same for federal and California - no later than six months after the due date of the taxpayer's tax return for the disaster year, without regard to any extension of time to file. Therefore, in most cases the election will need to be made by October 15 of the disaster year.

California Disaster Loss Carryovers & Carrybacks – While disaster losses incurred prior to 2013 cannot be used to compute a California net operating loss (NOL), they are eligible to be carried over and deducted in future years. Generally, for years 2004 through 2012, 100% of excess disaster losses can be carried over for up to five years. If subsequent California legislation identified the disaster for special carryover treatment, excess losses may be carried over for up to 15 years. If disaster losses in 2013 through 2018 result in an NOL the NOL can be carried back 2 years, but the amount of carryback allowed for specific years varies (see Chapter 3.16). SB 35 (discussed above) provides that any law that suspends, defers, reduces, or otherwise diminishes the deduction of an NOL, other than those variations already imposed in existing law, shall not apply to an NOL attributable to these specified disaster losses. The 2-year carryback period for NOLs is repealed, effective for losses beginning in years after December 31, 2018, and the loss can only be carried forward and for a maximum of 20 years.

Use FTB Form 3805V, Net Operating Loss (NOL) Computation and NOL and Disaster Loss Limitations, for the year of the loss to compute the carryover. Even when the federal and California losses stem from the same casualty or disaster event, adjustments may be needed to account for differences in federal and California laws. If the taxpayer has both disaster loss carryovers and NOL carryovers, they are used in the order they were incurred. Disaster loss carryovers are not subject to the California NOL suspensions for years 2008 – 2011.

Postponement Periods – California automatically follows the federal postponement periods announced by the IRS with respect to tax deadlines for taxpayers affected by Presidentially declared disasters. This applies to taxpayers with a California tax-filing requirement even if the disaster occurred outside of California if the taxpayer meets the qualifications to claim a disaster loss anywhere within the U.S.

Documentation – In addition to completing FTB Form 3805V and attaching it to their return on which the loss is claimed, individuals must attach copies of completed federal Form 4684 (using California amounts, if different) and a copy of their federal return (1040 or 1040X), and must attach a written statement that indicates the date and location of the disaster, and if applicable, the election to deduct the loss on the return of the year prior to the loss year.

Disaster Replacement Property Tax Base Year Value Carryover – The CA R&T Code, Sec 69 and 69.3 permit individuals to carry over their property tax base in certain circumstances when there is a disaster loss.

- *Where the replacement property is in the same county* – Where the replacement property is in the same county as the original, the R&TC requires the county to carry over the tax basis to a replacement property so long as the replacement is the same type of property as the property lost in the disaster (R&TC 69).
- *Where the replacement property is in a different county* - Where the replacement property is in a different county than the original, then the R&TC Sec 69.3 only applies to personal residences of the taxpayer. In addition, this provision is available only for counties who adopt the resolution permitting such a transfer of tax basis (R&TC Sec 69.3). Those counties that have adopted such a resolution are:

Contra Costa	Orange	Solano	Ventura
Los Angeles	San Francisco	Sonoma	
Modoc	Santa Clara	Sutter	

For purposes of **R&TC Sec 69.3 (transfer to another County)** the following definitions apply:

- *Substantially damaged or destroyed* - means property where either the land or the improvements sustain physical damage amounting to more than 50% of either the land's or the improvement's full cash value immediately prior to the disaster. Damage includes a diminution in the value of property as a result of restricted access to the property where the restricted access was caused by the disaster and is permanent in nature.
- *Original property* - means a building, structure, or other shelter constituting a place of abode, whether real property or personal property, that is owned and occupied by a claimant as his or her principal place of residence, and any land owned by the claimant on which the building, structure, or other shelter is situated, that has been substantially damaged or destroyed by a disaster.

- *Owner or owners* – means an individual or individuals, but does not include any firm, partnership, association, corporation, company, or other legal entity or organization of any kind.
- *Replacement property* - means a building, structure, or other shelter constituting a place of abode, whether real property or personal property, that is owned and occupied by a claimant as his or her principal place of residence, and any land owned by the claimant on which the building, structure, or other shelter is situated. "Replacement property" does not include any property, including land or improvements, if the claimant owned any portion of that property prior to the date of the disaster that damaged or destroyed the original property.
- *Equal or lesser value* - means that the amount of the full cash value of the replacement property does not exceed one of the following:

  (A) 105% of the amount of the full cash value of the original property if the replacement property is purchased or newly constructed within the first year following the date of the damage or destruction of the original property.

  (B) 110% of the amount of the full cash value of the original property if the replacement property is purchased or newly constructed within the second year following the date of the damage or destruction of the original property.

  (C) 115% of the amount of the full cash value of the original property if the replacement property is purchased or newly constructed within the third year following the date of the damage or destruction of the original property.

Caution:
The foregoing is a short synopsis of R&TC Sec 69. Before advising clients it is strongly recommended that you read the entire text for additional details, requirements and restrictions not included here. In addition, consult the website of any affected county to ensure the county is still participating.

Go to http://leginfo.legislature.ca.gov/faces/codes.xhtml to search for the California code.

NOTES

GAMBLING LOSSES

RAPID FINDER

Gambling Losses

Overview

- Limited to Gains
- Miscellaneous Itemized Deduction
- Not subject to 2% of AGI floor

Related IRC & IRS Publications and Forms

Pubs Forms

- **Chief Counsel Advice Memorandum (CCAM 2008-011)**
- **Code Sec. 165(d)** Wagering Losses
- **Form 5754** – Statement of Person(s) Receiving Gambling Winnings (split winnings)
- **Form W2-G** – Certain Gambling Winnings

Watch Out for Clients with On-Line Gambling Accounts

A tax court case (Hom (DC CA 6/4/2014)) held that an on-line gambler was required to file an FBAR for on-line gaming accounts with out-of-the-country on-line casinos. He was fined for not making an FBAR reporting of his online accounts and the tax court sided with the government. The Appeals Court (9th Cir), however, found that only some of the accounts were foreign financial accounts that would require FBARs. (J.C. Hom, CA-9, 2016-2). Also see page 01.13.06.

The Details

When dealing with gambling winnings and losses there are three general categories:

1. Casual recreational gambler who maintains gambling session records,
2. Casual recreational gambler who keeps no records, and
3. Professional gamblers

CASUAL RECREATIONAL GAMBLER WHO MAINTAINS GAMBLING SESSION RECORDS

Chief Counsel Advice Memorandum (CCAM 2008-011) introduced the concept of "gambling sessions". The CCAM, provided the following analysis:

- It noted that Code Sec. 165(d) uses the words "gains" and "losses" from wagering transactions without ascribing a technical meaning to the terms. In ordinary parlance, it notes that a wagering "gain" means the amount won in excess of the amount bet (basis). The term wagering "loss" means the amount of the wager (basis) lost.
- Does transaction mean every individual single play or a series of plays? The wording of Sec 165(d) uses the plural form "transactions" and Courts considering that reading have found it unduly burdensome and unreasonable to require record keeping for each individual wager (Green, 66 TC 538 (1976); Szkirscak, TC Memo 1980-129).

Thus the CCAM develops a bright-line test. The taxpayer's "accession to wealth" (i.e. wagering gain or loss) is determined when the taxpayer stops gambling, and the CCAM came up with the concept of gambling sessions. The following examples of gambling sessions are used in the CCAM:

***Example** - A casual gambler who enters a casino with $100 and redeems his or her tokens for $300 after playing the slot machines has a wagering gain of $200 ($300 - $100). This is true even though the taxpayer may have had $1,000 in winning spins and $700 in losing spins during the course of play.*

***Example** - A casual gambler who enters a casino with $100 and loses the entire amount after playing the slot machines has a wagering loss of $100, even though he may have had winning spins of $1,000 and losing spins of $1,100 during the course of play.*

Gambling Session – A gambling session is very limited in scope. It must be the same type of uninterrupted wagering during a specific uninterrupted period of time at a specific location. Thus if a taxpayer entered a casino and played slots for an hour, and then switched to craps for the next hour, that would be two separate gambling sessions. If a taxpayer entered Casino #1 and played slots for an hour and then went to Casino #2 and continued to play slots, that would be two separate gambling activities since two locations were involved.

PROPOSED SLOT MACHINE SAFE HARBOR SESSIONS

Notice 2015-21 provides a proposed revenue procedure that, if finalized, will provide an optional safe harbor method for individual taxpayers to determine a wagering gain or loss from certain slot machine play.

CAUTION - The proposed revenue procedure announced in Notice 2015-21 **IS NOT FINAL** and the details of the proposed revenue procedure are provided to illustrate the IRS' thinking related to electronically tracked gambling sessions.

The proposed revenue procedure is based on use of electronically tracked slot machine play which the IRS intended to require of gambling establishments when it proposed regulation § 1.6041-10 (related to information return reporting requirements), issued at the same time as the proposed revenue procedure. Reg. § 1.6041-10 has since been finalized without a requirement for electronically tracking slot machine play and with a rule allowing payers to use an optional aggregate reporting method that is based on an "information reporting period" instead of a "session." The IRS explained in the preamble to the new regulation that they "are still considering the income tax reporting rules in this area" and changed the terminology to avoid confusion.
At publication date of this text the proposed revenue procedure had not been finalized.

Per the proposed revenue procedure a taxpayer determines a wagering gain or loss from **electronically tracked slot machine play** at the end of a single session of play as follows:

(1) A taxpayer **recognizes a wagering gain** if, at the end of a single session of play, the total dollar amount of payouts from electronically tracked slot machine play during that session exceeds the total dollar amount of wagers placed by the taxpayer on electronically tracked slot machine play during that session;

(2) A taxpayer **recognizes a wagering loss** if, at the end of a single session of play, the total dollar amount of wagers placed by the taxpayer on electronically tracked slot machine play exceeds the total dollar amount of payouts from electronically tracked slot machine play during that session.

A taxpayer must use the same session of play if the taxpayer stops and then resumes electronically tracked slot machine play within a single gaming establishment during the same calendar day. If a taxpayer uses the definition of a session of play set forth in section 3.04 of the proposed revenue procedure, for any day in a calendar year at a particular gaming establishment, the taxpayer must use that definition for all electronically tracked slot machine play during the taxable year at that same gaming establishment.

Safe Harbor Electronically Tracked Gambling Session – (Sec 3.04 of the proposed revenue procedure) - If, after engaging in slot machine play at one gaming establishment, a taxpayer leaves that establishment and begins electronically tracked slot machine play at another gaming establishment, a separate session of play begins at the second establishment, even if played within the same calendar day as the first.

Example 1- *A taxpayer engages in electronically tracked slot machine play at X, a casino, by using a player's card. On January 1, the taxpayer plays slot machines at X, for the first time that day, from 3:00 p.m. to 5:00 p.m. At 6:00 p.m., the taxpayer leaves X for dinner. Later that day, the taxpayer returns to X and plays slot machines from 10:00 p.m. to 11:59 p.m. The play at X from 3:00 p.m. to 5:00 p.m. and from 10:00 p.m. to 11:59 p.m. is a single session of play on January 1.*

Example 2 *- Assume the same facts as in Example 1, except that the taxpayer plays from 10 p.m. to 2 a.m. The play from 3 p.m. to 5 p.m. and the play from 10 p.m. through 11:59 p.m. constitute a single session of play. The play from 12:00 midnight to 2 a.m. is another session of play on January 2nd.*

Example 3 *- Assume the same facts as in Example 1, except that the taxpayer goes to another casino, Y, to engage in electronically tracked slot machine play from 7:00 p.m. to 8:00 p.m. The taxpayer has 2 separate sessions of play on January 1: (1) one session of play from 3:00 p.m. to 5:00 p.m. and 10:00 p.m. to 11:59 p.m. at X, and (2) another session of play from 7:00 p.m. to 8:00 p.m. at Y.*

Example 4 *- On January 1, at 3:00 p.m., the taxpayer starts electronically tracked slot machine play at X for the first time that day. At 5:00 p.m., the taxpayer finishes slot machine play for that day and has payouts in excess of wagers of $300. For the single session of play on January 1, the taxpayer has gambling winnings of $300.*

Example 5 *- Assume the same facts as in Example 4, except that at 5:00 p.m., the taxpayer leaves the premises of X to eat dinner at a nearby restaurant. At 8:00 p.m., the taxpayer returns to the premises of X for more slot machine play. The taxpayer places wagers until 11:00 p.m. During the period from 8:00 p.m. until 11:00 p.m., the taxpayer's wagers placed on electronically tracked slot machine play exceeded the total dollar amount of payouts from electronically tracked slot machine play earned by the taxpayer by $75. The taxpayer's wagering gain for the single session of play at X is $225, the extent to which his payouts from electronically tracked slot machine play during that session exceeds the dollar amount of wagers from electronically tracked slot machine play.*

Example 6 *- Assume the same facts as in Example 4, except the taxpayer goes to another area of X and from 5:15 p.m. to 7:00 p.m., engages in additional slot machine play that is not electronically tracked. This revenue procedure applies only to electronically tracked slot machine play (the session from 3:00 p.m. to 5:00 p.m.). Therefore, the taxpayer cannot include the slot machine play from 5:15 p.m. to 7:00 p.m. in the session of play for January 1.*

If and when this Revenue Procedure is finalized, taxpayers using the procedure would have to enter "Revenue Procedure 2015-X" on the "other income" line of the 1040, which, based on the 2019 draft, would be line 8 of Schedule 1.

Reporting Winnings and Losses - Generally, a taxpayer must report the full amount of their gambling winnings for the year as income on their 1040 return. A taxpayer may not reduce their gambling winnings by their gambling losses and report the difference. Instead, gambling winnings are reported in full as income and the losses (subject to limitation as discussed below) are deducted on Schedule A. Therefore, if a taxpayer does not itemize, they are unable to deduct gambling losses.

Form W-2G – This form is issued by a casino or other payer to some winners with a copy going to the IRS. Generally, only winners of the following types of gambling activities will be issued a W-2G:

Bingo - $1,200 or more from one bingo game, without reduction for the amount wagered. All winnings received from all wagers made during one bingo game are combined. (Reg. § 1.6041-10(a))

Keno - $1,500 or more from one keno game reduced by the amount wagered on the same keno game. All winnings received from all wagers made during one keno game are combined. For example, all winnings from all "ways" on a multi-way keno ticket are combined. (Reg. § 1.6041-10(b)(1)(i)(B))

Slot Machines - $1,200 or more from one slot machine play, without reduction for the amount wagered. (Reg. § 1.6041-10(b)(1)(i)(C))

Poker Tournament - Poker tournament players winning $5,000 or more.

If federal income tax has been withheld on the winnings, a W-2G will be issued regardless of the type of gambling activity. Generally, the withholding rate is 24% of the gambling winnings but when withholding is required varies depending on the type of wagering activity. The rate could be 31.58% of the fair market value of noncash payments (e.g., a car won in a sweepstakes) if the payer pays the withholding tax. See instructions to Form W2-G for details.

Frequently, taxpayers with winnings will expect to report only those winnings included on Form W-2G. However, those winnings reported on W-2G forms generally do not include all winnings for the year, and the tax code requires all winnings to be reported. All winnings from gambling activities must be included when computing the deductible gambling losses, which is generally always an issue in a gambling loss audit.

Losses Limited to Gains - An individual not engaged in the gambling business may deduct as a miscellaneous itemized deduction (not subject to the 2% limitation) gambling losses suffered in the tax year, but only to the extent of that year's gambling gains. *(Code Sec. 165(d))*

Gains - "Gains" include "comps" (complimentary goods and services the taxpayer may receive from a casino).

Losses - Losses from one kind of gambling are deductible against gains from another kind. IRS has ruled that transportation, meal and lodging expenses incurred while engaged in gambling activities are nondeductible personal expenses[1] which cannot be deducted against gambling winnings. *(TAM 9808002)*

[1] ***Court Case*** *- Shiosaki, James, (1971) TC Memo 1971-24 - Travel expenses to Las Vegas for gambling were held to be personal and nondeductible. Taxpayer was an engineer*

TCJA

For 2018 through 2025, the TCJA clarifies that "losses from wagering transactions" include any deduction otherwise allowable in calculating federal income tax incurred in carrying on any wagering transaction. For example, this would include the transportation costs traveling to and from a casino. But this also means that taxpayers are prohibited from separately deducting other expenses incurred while gambling. While applying to recreational gamblers and professional gamblers, this provision was aimed at the latter. Congress inserted it because some courts (see "Gambling as a Trade or Business" below) have allowed individuals in the trade or business of gambling to deduct reasonable business expenses which created a business loss that was then not subject to the limitation that gambling losses can't exceed gambling winnings. With TCJA's revised definition of gambling losses, separate deductions for these expenses are eliminated for 2018 through 2025. (IRC Sec 165(d) as amended by the TCJA section 11050(a))

Comps - Gambling casinos often provide their customers with complimentary goods and services ("comps") to encourage future patronage. IRS says that extraordinary comps, such as autos and jewelry, are taxable income. But it reserved the question of whether "normal comps," such as food, drink, lodging and entertainment, can be excluded from income as purchase price adjustments. *(Field Service Advice 1999-519, Vaughn No. 917)*

Libutti, (1996) TC Memo 1996-108 *- Most casinos offer patrons some form of complimentary goods and services, or "comps," as a means of generating business. The Tax Court has allowed one high roller who received over $2.5 Million in comps from a single casino, which issued 1099-MISCs for the amount of the comps, over a three-year period to deduct his gambling losses to the extent of these comps. The deductions were allowed - The Tax Court observed that neither the Code nor the regulations define gains from wagering transactions. The common dictionary meaning of "gain" is "an increase in "wealth" and "from" means "derived or coming out of." Thus, the comps fit within the plain meaning of the statutory text. The Court said that assuming for purposes of Code Sec. 165(d) that the comps are gross income, they increased the taxpayer's wealth and were delivered out of his betting transactions. He would not have received them, but for the fact that he gambled extensively at the casino. The Court noted that receipt of the comps did not directly hinge on the success or failure of the taxpayer's wagers but held that they nonetheless were sufficiently related for purposes of the deduction for gambling losses.*

<u>Netting Specific Wagers</u> - The amount of income from a winning bet or wager is the full amount of the winnings less the cost of placing that specific winning bet or wager. Thus, the winner of a sweepstakes includes as income the amount by which the prize money exceeds the ticket price, and the winner of a horse race includes as income the amount of prize money less the cost of the winning race ticket. *(Hochman v. Commissioner T.C. Memo. 1986-24)* In computing the amount of income from winnings, the cost of losing tickets (or other forms of wager) is <u>not</u> netted against the winnings.

<u>Proving Gambling Losses</u> - An accurate diary or similar record regularly maintained by the taxpayer, supplemented by verifiable documentation will usually be acceptable evidence for substantiation of wagering winnings and losses. In general, the diary should contain at least the following information *(Rev Proc 77-29, 1977-2 CB 538):*

(1) Date and type of specific wager or wagering activity;
(2) Name of gambling establishment;
(3) Address or location of gambling establishment;
(4) Names of other persons (if any) present with taxpayer at gambling establishment; and
(5) Amounts won or lost.

Verifiable documentation includes wagering tickets, cancelled checks and credit records. Where possible, IRS says the documentation should be backed up by other documentation of the activity or visit to a gambling establishment, e.g., hotel bills, airline tickets, etc. Affidavits from "responsible gambling officials" (not further defined) regarding gambling activities can also be used. *(Rev Proc 77-29, 1977-2 CB 538)*

<u>Loss claims based primarily on ticket stubs</u> - The *Cohan* rule doesn't apply if the taxpayer doesn't lay the proper foundation by establishing gambling income and the relation of gambling losses to that income. Racetrack tickets alone, to support the taxpayer's testimony of gambling losses, are of little weight without supporting evidence of their purchase by the taxpayer. The tickets could be the discarded stubs of bettors who lost *(Norgaard, Preben, (1989) TC Memo 1989-390)* or could be winning tickets.

The Tax Court treated as unreliable and gave no weight to an unsigned letter to a taxpayer from Caesar's Palace Casino in Las Vegas that estimated the taxpayer had a net loss of $60,480 during the tax year. *(Mayer, Solomon, (2000) TC Memo 2000-295)*

<u>Other supporting documentation</u> - Winnings and losses may be further supported by the following items *(Rev Proc 77-29, 1977-2 CB 538):*

- ***Keno*** — Copies of keno tickets purchased by the taxpayer and validated by the gambling establishment.
- ***Slot Machines*** — A record of all winnings by date and time that the machine was played.
- ***Table Games*** — Twenty-One (Blackjack), Craps, Poker, Baccarat, Roulette, Wheel of Fortune, etc. The number of the table at which the taxpayer was playing. Casino credit card data indicating whether credit was issued in the pit or at the cashier's cage.
- ***Bingo*** — A record of the number of games played, cost of tickets purchased and amounts collected on winning tickets.
- ***Racing*** — *Horse, Harness, Dog, etc.* — A record of the races, entries, amounts of wagers and amounts collected on winning tickets and amounts lost on losing tickets. Supplemental records include unredeemed tickets and payment records from the racetrack.
- ***Lotteries*** — A record of ticket purchase dates, winnings and losses. Supplemental records include unredeemed tickets, payment slips and winnings statement. Winnings from lotteries and raffles are gambling and therefore are included in gross income. In addition to cash winnings, the taxpayer must include in income bonds, cars, houses, and other noncash prizes at fair market value. If a state lottery prize is payable in installments, the annual payments and amounts designated as interest on the unpaid balance must be included in gross income.

Court Cases:

Gambling losses were allowed in full where - The taxpayer kept a pocket notebook that showed the date a bet was made, the type of bet or name of the player and the amount won or lost. *Presley, Sam Sr., (1979) TC Memo 1979-339*

Gambling losses were allowed in part where - Taxpayer's monthly diary accurately reflected the taxpayer's winnings and losses from the race tracks. *Faulkner, Leon, (1980) TC Memo 1980-90*

Gambling losses were allowed in part where - Cancelled checks issued to pay for gambling losses were offered into evidence. Checks were supported by statements of witnesses, etc. *Jacoby, Oswald, (1970) TC Memo 1970-244*

Gambling losses were disallowed in their entirety where – The taxpayer offered records indicating that he had been extended credit by a casino, but offered nothing to support the assertion that the use of the proceeds resulted ultimately in losses. The Tax Court noted that it was perfectly possible that the use of the credit line resulted in net winnings or in net losses in an amount less than, but not all of, the entire line of credit.

Gambling losses were disallowed in their entirety where – Taxpayers kept no records of losses on their slot machine play. They relied on two undated letters, on a casino's letterhead, estimating the taxpayers' net winnings and losses. But the letters, besides stating they were "for marketing purposes only" and carrying other disclaimers, failed to reflect slot machine winnings and losses. The casino didn't track slot machine winnings and losses unless the patron used a player's club card and the taxpayers admitted they didn't use their cards.

Form 5754 - Use Form 5754 if the gambling winnings belong to someone else or belong to a group of two or more people sharing the winnings, such as by sharing the same winning ticket, and provide to the payer. This enables the payer of the winnings to prepare Form W-2G, Certain Gambling Winnings, for each winner to show the winnings taxable to each.

Lottery payments

Ordinary Income or Capital Gain? - A District Court has held that a state lottery winner realized ordinary income on the sale of his right to receive payments due in the future and not capital gain as he had contended. (*Maginnis, (DC OR 5/28/2002) 89 AFTR 2d 2002-3028)*

Offsetting Current Year Losses – Often, lottery winnings will be payable over a period of several years, similar to an annuity. IRS has ruled that the annual lottery payments retain their character as wagering winnings for purposes of deducting losses from other wagering activities. *(TAM 9808002; Rusnak, TC Memo 1987-249)*

Supreme Court Stance - The Supreme Court has declined to review the holding by the Court of Appeals for the Third Circuit that a lump-sum payment given to a married couple in exchange for the right to their future lottery payments was taxable as ordinary income and not as capital gain. *(George Lattera, (CA 3 1/9/2006) denied 2/20/2007)*

Transfer of Lottery Winnings a Taxable Gift – A waitress received a lottery ticket as a tip from a customer that, unbeknownst to the customer, was a big winner - $5 million (over $10 million if paid out as an annuity over 30 years). The taxpayer decided to share her good fortune with family members. Her attorney prepared incorporation papers for an S corp in which the taxpayer had a 49% interest and her family a 51% interest (17% each to her mother and two siblings), and she then signed over her interest in the winning lottery ticket to the corporation.

The Tax Court held that the transfer resulted in a taxable gift because there was no enforceable contract to share the lottery winnings with her family. Although the family members had made offhand statements through the years about taking care of one another if someone came into money, there had been no prior written agreement by the family members to share winnings, no pattern of buying lottery tickets or pooling of money, and no predetermined sharing percentages. Thus there was no proof that there was a family partnership that owned the ticket. While the court held that there was a taxable gift, it did allow a discounted value for gift tax purposes due to a claim that had been made by a co-worker of the taxpayer that she was obligated to share the winnings with her co-workers. ***(Dickerson, TC Memo 2012-60)***

Raffles - Amounts paid for chances to participate in raffles, lotteries, or similar drawings or to participate in puzzle or other contests for valuable prizes conducted by a charity are not gifts and therefore do not qualify as charitable contributions. (***Rev. Rul. 67-246, Example 5***) These activities would be treated as wagering, and thus the costs would be includible when determining the amount of gambling losses for the year.

GAMBLING AS TRADE OR BUSINESS

Losses Exceeding Winnings - The excess of gambling losses over gambling gains isn't deductible even by a person in the business of gambling and even though gambling is legal where the losses are sustained. Therefore, a professional gambler's losses are limited to his winnings. (*Skeeles, Anna v. U.S., (1951, Ct Cl), Offutt, Roy, (1951) 16 TC 1214)*

Gambling Related Business Expenses – ***CAUTION:*** *The amendment of Sec 165(d) by the TCJA overrides the results of this court case for years 2018-2025.* IRS has issued an action on decision (AOD 2011-06, 12/20/2011) announcing its acquiescence with the Tax Court's decision in *Mayo, (2011) 136 TC*, that the business expenses of a taxpayer engaged in the trade or business of gambling are not subject to Code Sec. 165(d). While, as the Tax Court also held in *Mayo*, Code Sec. 165(d) limits the deduction for gambling losses of a taxpayer engaged in the trade or business of gambling to the taxpayer's gains from wagering transactions, the Court made it clear, and IRS now agrees, that Code Sec. 165(d) does not limit deductions for expenses incurred to engage in the trade or business of gambling. Those business expenses are deductible under Code Sec. 162.

Tournament Poker - The Tax Court has held that tournament poker was a wagering activity subject to the Code Sec. 165(d) loss limits. Thus, the taxpayer, a professional tournament poker player, could only deduct her tournament losses to the extent of her tournament income. *(George E. and Gloria Tschetschot, TC Memo 2007-38)*

Gloria claimed a net loss of $29,933 from her "professional gambler" activity in 2000 on her Schedule C, Profit or Loss From Business. IRS said that Code Sec. 165(d) limited Gloria's losses to her winnings. Gloria contended that her professional tournament poker playing activity was more properly classified as "entertainment and professional sports" than professional gambling and, as a result, her net loss should not be limited by the Code Sec. 165(d) limit on losses from wagering activities.

The Tax Court said that while it was clear that there are differences between tournament poker and other types of poker, none rise to the level of meaningful, substantive differences that would warrant different tax treatment under the Code. It held that betting is so intrinsic to poker that it is nearly impossible to avoid using a word that implies gambling in any way when discussing the topic.

In another case involving a tournament poker player, the Tax Court determined that, as a gambling professional, the player was entitled to deduct from his gross gambling income amounts he paid to enter poker tournaments he did not win and buy-in fees, which were a direct cost of his tournament participation. The same individual was allowed to deduct as a business expense tournament-related hotel costs substantiated with hotel invoices, but was not allowed to include extras such as charges for in-room movies, spa services and alcoholic beverages from the in-room mini-bar, which the court said were nondeductible personal expenditures that did not have a business purpose. *(E. Alabsi, TC Summary Opinion 2017-5)* ***CAUTION:*** *Under the amendment to Sec 165(d) made by the TCJA, the hotel expenses allowed by the Court in this case would not be separately deductible for years 2018-2025.*

Goods & Services - The Supreme Court has held that a full-time gambler is engaged in a trade or business for purposes of Code Sec. 162(a). A taxpayer does not have to offer goods or services to the public in order to qualify his activity as being a trade or business. Where the taxpayer devotes his full-time activity to gambling and it is his intended source of livelihood, basic concepts of fairness demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor, a casino operator or an active trader on the exchanges. *(Com. v. Groetzinger, Robert, (1987, S Ct) 59 AFTR 2d 87-532)*

Amount of Time Spent – Full-Time - A taxpayer who devoted approximately 35 hours per week to horse racing, attended various tracks 175 days out of the 200-day season, gambled at Atlantic City and consistently bought lottery tickets was engaged in the trade or business of gambling. He could deduct the losses incurred from income items (including taxable unemployment compensation and an annual installment from a state lottery win) in computing his adjusted gross income. Taxpayer's activities—attending the track, studying racing forms, interviewing horse owners and riders, placing bets, plus keeping a daily log—showed that he was not pursuing a mere hobby. Employment as a machine operator for two weeks in January did not preclude his status as a "full-time" gambler during the remainder of the year. There is no requirement that an endeavor must begin Jan. 1 to be considered full-time. *(Rusnak, Charles, (1987) TC Memo 1987-249)*

Amount of Time Spent – Part-Time - The Tax Court stated that the aggregate amount of time spent in a gambling activity wasn't as determinative as the fact that the taxpayer had little continuity or regularity to his gambling. Thus, even though he argued that he averaged 20 hours per week gambling, a taxpayer wasn't engaged in the trade or business of gambling where his visits to a casino throughout the year were sporadic, sometimes 3 times a month, sometimes 17 times a month. The semi-retired taxpayer received substantial income from sources other than gambling and did not rely on gambling for his livelihood. *(Erbs, Eldron U., (2001) TC Summary Opinion 2001-85)*

CALIFORNIA DIFFERENCES

California follows Federal law, except that California Lottery winnings are not taxable to California. Therefore, an itemized deduction adjustment is required on Sch. CA if losses are used on the Federal Schedule A to offset the Lottery income on the Federal return. In 2000, California enacted SB 2173 (Ch.00-180), which provided that proceeds from the sale of California Lottery winnings to a third party are exempt from California income tax. *(Gov't Code §8880.68)*

RECORD OF GAMBLING SESSIONS

Reference IRS Chief Counsel Advice Memorandum 2008-011

Taxpayer Name: ____ Page: ______ of: ______

Activity Date	Start Time	End Time	Starting Funds	Ending Funds	Net Gain/Loss
/ /	: ❑AM ❑PM	: ❑AM ❑PM	$	$	$
Type Of Gaming	❑ Slots ❑ Blackjack ❑ Poker ❑ Keno ❑ Craps ❑ Horse Racing ❑ Other: ___________________				
Gambling Establishment:			W-2G Total For This Activity:		

Activity Date	Start Time	End Time	Starting Funds	Ending Funds	Net Gain/Loss
/ /	: ❑AM ❑PM	: ❑AM ❑PM	$	$	$
Type Of Gaming	❑ Slots ❑ Blackjack ❑ Poker ❑ Keno ❑ Craps ❑ Horse Racing ❑ Other: ___________________				
Gambling Establishment:			W-2G Total For This Activity:		

Activity Date	Start Time	End Time	Starting Funds	Ending Funds	Net Gain/Loss
/ /	: ❑AM ❑PM	: ❑AM ❑PM	$	$	$
Type Of Gaming	❑ Slots ❑ Blackjack ❑ Poker ❑ Keno ❑ Craps ❑ Horse Racing ❑ Other: ___________________				
Gambling Establishment:			W-2G Total For This Activity:		

Activity Date	Start Time	End Time	Starting Funds	Ending Funds	Net Gain/Loss
/ /	: ❑AM ❑PM	: ❑AM ❑PM	$	$	$
Type Of Gaming	❑ Slots ❑ Blackjack ❑ Poker ❑ Keno ❑ Craps ❑ Horse Racing ❑ Other: ___________________				
Gambling Establishment:			W-2G Total For This Activity:		

Activity Date	Start Time	End Time	Starting Funds	Ending Funds	Net Gain/Loss
/ /	: ❑AM ❑PM	: ❑AM ❑PM	$	$	$
Type Of Gaming	❑ Slots ❑ Blackjack ❑ Poker ❑ Keno ❑ Craps ❑ Horse Racing ❑ Other: ___________________				
Gambling Establishment:			W-2G Total For This Activity:		

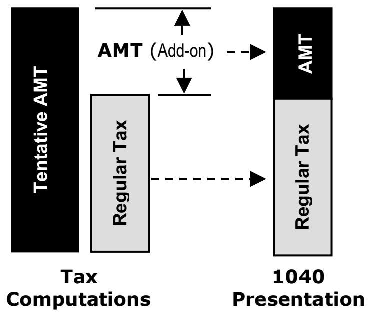
Activity Date	Start Time	End Time	Starting Funds	Ending Funds	Net Gain/Loss
/ /	: ❑AM ❑PM	: ❑AM ❑PM	$	$	$
Type Of Gaming	❑ Slots ❑ Blackjack ❑ Poker ❑ Keno ❑ Craps ❑ Horse Racing ❑ Other: ___________________				
Gambling Establishment:			W-2G Total For This Activity:		

NOTES

AVOIDING OR MITIGATING THE EFFECTS OF AMT

Overview

When Congress originated the AMT and the IRS implemented it, instead of treating it as a separate tax computation and having taxpayers pay the higher of the two computations, they adopted a confusing approach of treating the AMT computation as a series of adjustments to the regular tax. Thus, the AMT as we know it is the add-on delta tax between the full alternative computation known as the tentative alternative minimum tax and the regular tax.



There are numerous differences that must be taken into account when computing the AMT. However, many of those differences apply to big businesses and are seldom, if ever, encountered by individual taxpayers and are only briefly discussed in this material.

OVERVIEW OF THE COMPUTATIONS

The forms below illustrate the difference between the regular tax computation and the tentative AMT computation and differences between the itemized deductions for the regular tax and the AMT. This chapter will look at these differences in detail and explore strategies that can be used to avoid or mitigate the adverse effects of the AMT.

Income Overview

	REGULAR TAX	TENTATIVE AMT
Regular Tax Adjusted Gross Income		
Add Back Regular Tax NOL		Plus
Deduct AMT NOL		Minus
State Tax Refund (Tax Benefit Rule)		Minus
ISO Tax Preference Income		Plus
AMT Depreciation Adjustment		Plus
Private Activity Bond Income		Plus
AMT Adj Gain or Loss (Based on AMT Depreciation)		Plus
Other AMT Preferences and Adjustments		Plus/Minus
Personal Exemptions (suspended 2018 – 2025)	Minus	
Standard Deduction	One or the other	
Itemized Deductions		Ltd
AMT Exemption		Minus
Tax		
Tax on Capital Gains (Based on Regular Tax)	Plus	Plus
Total Tax		

Deductions Overview

	REGULAR TAX	TENTATIVE AMT
Medical		
Medical AGI Adjustment (1)	–	–
Taxes		
Acquisition Debt Interest		
Equity Debt Interest (2)		
Nonconventional Home Interest (6)		
Regular Tax Investment Interest		
AMT Investment Interest (PAB Adj)		
Charitable Contributions		
Tier 1 Miscellaneous		
Casualty Loss (3)		
Tier 2 Misc (Net after 2% AGI Adj) (4)		
Itemized Deduction Phase-Out (5)		
Total Deductions		

(1) *Beginning in 2017 the medical AGI adjustment is the same for regular tax and AMT, effectively eliminating the medical adjustment.*
(2) *Equity debt interest is not deductible 2018 through 2025*
(3) *Only disaster losses are allowed 2018 through 2025*
(4) *Tier 2 miscellaneous deductions are suspended for years 2018 through 2025.*
(5) *The itemized deduction phase-out (Pease limitation) is suspended for years 2018 through 2025.*
(6) *Form 6251 does not limit this deduction for AMT after 2017 although there's been no law change.*

Although Congress did eliminate the Corporate AMT, and even though they had also vowed to eliminate the individual AMT, when the final TCJA was released it was still there. But they did increase the exemption amounts and the exemption amount phase-out thresholds. In addition, TCJA made a number of regular tax changes eliminating certain itemized deductions that caused the AMT in the past. These are:

- Suspension of the equity debt interest deduction for 2018 through 2025,
- Limiting state and local tax deductions to $10,000 for 2018 through 2025,
- Suspending tier 2 (2% of AGI) miscellaneous deductions for 2018 through 2025, and
- Suspending the Pease limitation for 2018 through 2025.

These changes, coupled with the higher AMT exemption amounts, will eliminate the AMT for the vast majority of taxpayers that have been affected by it in the past.

- **Related IRC and IRS Publications and Forms**
  - **Form 6251** – Alternative Minimum Tax
  - **Form 8801** – Credit for Prior Year Minimum Tax
  - **IRC Sec 55**

Note: As complicated as this subject is, there is no specific IRS publication dealing with the AMT. The instructions for Forms 6251 and 8801 do provide some guidance.

Tax Brackets - Where the regular tax currently has seven brackets (10%, 12%, 22%, 24%, 32%, 35% and 37%), the AMT only has two:

Alternative Minimum Tax Rates

AMT Tax Rate		26%	28%
Alternative MinimumTaxable Income (AMTI)	2017	$187,800* or Less	Greater than $187,800*
	2018	$191,100* or Less	Greater than $191,100*
	2019	$194,800* or Less	Greater than $194,800*
	2020	$197,900* or Less	Greater than $197,900*

** For married separate returns, use ½ the amount shown.*

When to Accelerate Income – Take Advantage of the Lower AMT Rates.

As illustrated in the overview, both the regular taxable income and the tentative alternative taxable income begin with the same adjusted gross income before the exemptions, deductions, and AMT adjustments. This creates a situation for high income taxpayers where the regular marginal tax rate is actually higher than the effective AMT tax rate. When this occurs it may be appropriate to accelerate income to take advantage of the lower AMT tax rate. 1.56

Example (2019) *– Subject to AMT with Regular Marginal Tax Rate Higher than the AMT Tax Rate – Single filing status*

	Reg Tax	*AMT*
Regular Tax AGI	*900,000*	*900,000*
ISO Preference Income		*200,000*
Home Mortgage Interest Ded	*<50,000>*	*<50,000>*
State Income Tax Deduction	*<10,000>*	
AMT Exemption		*<71,700>*
AMT Exemptions Phase Out		*71,700*
Taxable Income	*840,000*	*1,050,000*
Marginal Rate	***37%***	***28%***
*Tax**	***275,788***	***290,104***

**Does not include any health care reform surtaxes which are additional when applicable*

Thus, this single taxpayer could accelerate income and enjoy a tax rate of 28%. How much income? The amount that can be added to income is the amount that is added to AGI to bring the AMT tax and regular tax to the same amounts. Because of various AGI limitations, phase-outs etc, the amount is determined using a tax program; keep adjusting the income until the taxes are equal.

AMT Exemptions – For regular tax before 2018 and after 2025, a personal exemption deduction is allowed for the taxpayer, spouse and each claimed dependent. For the AMT, taxpayers are allowed a single exemption (see table) based upon the taxpayer's filing status. In both cases, the exemptions are phased-out for higher income taxpayers. However, for tax years 2018 through 2025, the regular tax exemption deduction is $0 and thus for regular tax purposes there is no phase-out of the exemption allowance.

AMT Exemption

Filing Status	2017	2018	2019	2020
Joint, SS	84,500	109,400	111,700	113,400
Single, HH	54,300	70,300	71,700	72,900
MS	42,250	54,700	55,850	56,700

AMT Exemption Phase Out

Filing Status	Single & HH	Joint & SS	Married Separate
Threshold			
2017	120,700	160,900	80,450
2018	500,000	1,000,000	500,000
2019	510,300	1,020,600	510,300
2020	518,000	1,036,800	518,000
Full Phase Out			
2017	337,900	498,900	249,450
2018	781,200	1,437,600	718,800
2019	797,100	1,467,400	733,700
2020	810,000	1,490,400	745,200
Phase Out	25%	25%	25%

Example - Computing AMT and Exemption Phase out – *Art and Minnie, joint taxpayers, had alternative minimum taxable income of 1,124,100 in 2019. Their AMT is computed as follows:*

(1) Alternative minimum taxable income			*1,124,100*
(2) Tentative Exemption		*111,700*	
(3) Phase-out Threshold	*1,020,600*		
(4) (1) less (3)	*103,500*		
(5) (4) x .25		*<25,875>*	
(6) Allowable Exemption			*<85,825>*
(7) Net Taxable			*1,038,275*
(8) First tier (AMT tax bracket)			*194,800 @ 26% = 50,648*
(9) Second tier (LN7 – LN8) x (AMT tax bracket)			*843,475 @ 28% = 236,173*
(10) Tentative Alternative Minimum Tax (LN8 + LN9)			*286,821*[1]

[1] *Rather than computing the Regular tax and the Alternative Tax and using the larger of the two, the Form 6251 instead computes a tentative AMT and then treats any amount by which the tentative AMT exceeds the regular tax as the AMT (an add-on tax to the regular tax). Although this method calls attention to the additional tax created by the AMT, it tends to add to taxpayer confusion in understanding how the AMT is derived.*

NON-REFUNDABLE PERSONAL CREDITS

Effective for tax years beginning after 2011, the American Taxpayer Relief Act permanently allows an individual to offset his entire regular tax liability and AMT liability by the nonrefundable personal credits.

DIFFERENCES BETWEEN REGULAR AND ALTERNATIVE MINIMUM TAX

This course will explore the difference between the regular tax computation and the tentative AMT computation to facilitate the understanding of the various factors that can create an AMT and the steps that can be taken to avoid or minimize the AMT. The course explanations generally follow the sequence of the Form 6251. The AMT calculation on Form 6251 starts with the regular taxable income amount to which is added or subtracted the AMT adjustments.

References below to the Form 6251-line numbers are from the 2018 Form 6251. The draft 2019 form looks like it will use the same line numbers, but some of the references to 1040 line numbers are different because of changes to the 1040 and Schedule 1 line numbers.

- *Regular Tax Exemptions* **–** Note: regular tax exemptions are suspended for years 2018 through 2025 and thus they no longer create an AMT difference. In prior years, for AMT purposes, the regular personal exemptions are not allowed

- *Itemized Deductions* **-** For AMT purposes, medical is no longer a preference item since the 10% of AGI floor applies to both regular tax and AMT computations. Other deductions allowed for AMT are acquisition debt interest, investment interest, charitable deductions, personal casualty losses (only disaster losses in 2018-2025), and tier 1 miscellaneous deductions.

  For AMT Purposes the Standard Deduction is Not Allowed - In *TCM 2003-23 D.M. Marx*, the Tax Court ruled that the taxpayer cannot take the standard deduction for regular tax purposes and itemize for the AMT. Thus, the same deductions must be used for both computations. This creates sort of a dilemma for those who don't have enough to itemize for regular tax purposes but do have substantial itemized deductions that can be used to offset the AMT.

  Strategies

  Strategy - Taxpayers can elect to itemize - even if the deductions are less than the standard deduction. Schedule A has a specific box to check if this election is being made; see line 18 of the 2018 Schedule A. However, by forcing itemized deductions, the regular tax will be increased and at the same time, the AMT tax will be reduced. This presents a complicated moving target for the tax practitioner.

  Ideally, the itemized deductions should be an amount that will make the regular tax and the tentative AMT the same, thereby bringing the AMT add-on tax to "zero." This can be accomplished by trial and error on your tax program or those with good algebra skills can calculate the ideal amount by keeping in mind the AMT is moving down at 26% or 28%, while the regular tax is increasing at the taxpayer's marginal rate. **Bottom line -** Utilizing this strategy may possibly save a considerable amount of money for taxpayers who are subject to the AMT but whose itemized deductions are somewhat less than the standard allowance.

- *Medical Deductions* **–**The medical AGI reduction percentage has been since 2017 the same for regular tax and AMT, and will continue to be in the foreseeable future as a result of TCJA. Therefore, the medical deduction is no longer an AMT issue.

- *Tax Deductions* – (Form 6251 – 2a) – The taxes claimed as part of regular tax itemized deductions are **NOT ALLOWED** as a deduction against the AMT. They are added back on line 2a of Form 6251. **The effect of not allowing a deduction for taxes is minimized by the $10,000 limit on the deduction for taxes imposed by TCJA for years 2018 through 2015.**

Strategies

Strategy #1 - Defer Regular Tax-Deductible Tax Payments - No itemized tax deduction including state income, sales tax, property tax, etc., is ever deductible for AMT purposes. Conventional wisdom would dictate deferring, where possible, tax payments to the subsequent year if taxed by the alternative method. When deferring, care should be exercised in regards to late payment penalties and interest on underpayments for certain taxes. For example, if a taxpayer puts off paying their state tax liability until the subsequent year, will the benefit exceed the underpayment penalty?

Strategies

Strategy #2 - Prepay Regular Tax-Deductible Tax Payments - Another way to avoid losing the benefit of a tax deduction to the AMT would be to prepay already assessed taxes being paid in installments or estimated tax payments in the prior year if not subject to the AMT. Sometimes planning in advance for a specific event will bring attention to the possibility of the AMT in the subsequent year. If that is the case, then paying as many taxes as legally possible (up to the TCJA limit of $10,000) in advance of the AMT-taxed year without throwing that year into the AMT should be considered.

Caution - In Rev Ruling 82-208, the IRS ruled that when a taxpayer makes an estimated state tax payment with no reasonable basis for belief that he owes any additional state income taxes, a deduction will be denied for the year of the payment.

Strategies

Strategy #3 - Capitalize Property Taxes for Unimproved & Unproductive Real Estate – A taxpayer can annually elect to capitalize property taxes with respect to unimproved and unproductive real estate. Reg § 1.266-1(b)(1)

Strategies

Strategy #4 - Don't Deduct Investment Property Taxes - Investment interest is deductible for AMT purposes. Investment interest expense is limited to net investment income. Net investment income is equal to investment income less investment expenses. Thus, deducting investment expenses for regular tax purposes will only limit the available investment interest expense deduction. The result may be a negative benefit from deducting taxes and investment expenses. ***Note:*** For years 2018 through 2025, the TCJA suspends the miscellaneous deductions that are subject to the 2% of AGI reduction (Tier 2 expenses), so in these years Tier 2 investment expenses won't be deductible anyway. Property taxes aren't part of Tier 2 expenses but are included in the taxes for which a deduction is capped at $10,000 per year by the TCJA.

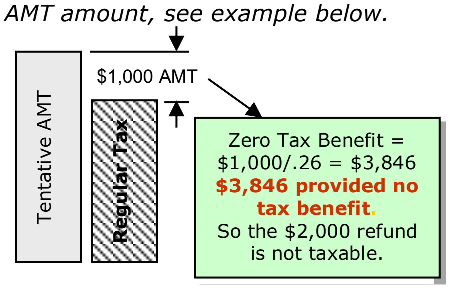
However, the taxpayer may only be marginally in the AMT and it may be appropriate to only limit part of the deductions. The best way to determine the optimal amount is by trying various scenarios using your tax software. Some of the more sophisticated programs may do this analysis automatically. When limiting deductions, you should also consider what the effect will be on the taxpayer's state return. Does state law allow deductions only if they have been claimed on the federal return? You may need to look at the combined federal and state tax liabilities before deciding not to deduct investment taxes and other expenses as a strategy to minimize federal AMT.

Another element to consider is the 3.8% net investment income tax (NIIT) on higher-income individuals. To be able to offset gross investment income by investment expenses for purposes of this tax, the expense must be claimed when figuring regular tax. So, when trying various scenarios to determine whether to limit the investment expense as a way to reduce AMT, be sure to also take the 3.8% NII tax into account. But the investment expenses not allowed as a miscellaneous deduction due to the TCJA suspension won't be deductible for the 3.8% NIIT calculation either.

Strategy #5 - Tax Benefit Rule – State Income Tax – When taxed by the AMT, part or none of the state income tax paid is allowed as a deduction. Therefore, to the extent the tentative AMT income exceeds the regular taxable income, the taxpayer receives no benefit for the state tax deduction. To the extent the taxpayer receives no benefit, the state income tax refund is not taxable for regular tax purposes in the subsequent year. Some tax software makes this computation, some don't.

For sure they do not for a new client that had AMT in the prior year. A state's refund statement (Form 1099-G) absolutely does not take the AMT into consideration. Therefore, if there is a state refund from the prior year and the taxpayer had some amount of alternative minimum tax in the prior year, then part or all the refund may not be taxable. *(IRC §111(a)) The no tax benefit can generally be determined from the AMT amount, see example below.*

***Example – Extrapolating the No Benefit Amount -** In the prior tax year, the taxpayer itemized and his state income tax deduction was $5,000, his state tax refund was $2,000 and the AMT (add-on tax) was $1,000. Assuming he was in the 26% AMT bracket and his AMT tax was $1,000, he did not receive benefit from $3,846 ($1,000/.26) of the state income tax deduction. Therefore, any state tax refund up to that amount would not be taxable in the subsequent year. In this example, none of the $2,000 refund needs to be included into income the following year.*



Be Sure to Look Back – To see if the taxpayer was subject to the AMT on the prior year's return. If they were, apply the tax benefit rule and treat as taxable the amount of refund that reduced the regular tax taxable income below the alternative minimum taxable income (AMTI).

Strategy #6 - Schedule A Taxes Can Reduce AMT LTCG Tax - The LTCG rates for AMT purposes are determined from the taxpayer's regular taxable income for the year. Therefore, to the extent a taxpayer's regular taxable income for 2019 is below $39,376 single, $52,751 head of household, $78, 751 married joint, or $$39,376 married separate, their LTCG will be taxed at 0% for **both** AMT and regular tax purposes. This makes the planning choices more difficult. The question being: is there more tax benefit maximizing the tax deduction or minimizing it through other strategies for taxes?

✸ <u>Home Mortgage Interest</u> –Below is a review of the home mortgage interest limitations.

- **Acquisition Debt** (Code Sec. 163(h)(3)(B)) - Is debt incurred to purchase, construct, or substantially improve a taxpayer's principal home or second home and must be secured by the home. Acquisition debt interest is deductible for AMT purposes. Combined acquisition debt on the two homes can't be more than:
  - $1,000,000 ($500,000 for married separate) for acquisition debts incurred on or before December 15, 2017.
  - $750,000 for acquisition debts incurred after 12/15/2017
  - Refinanced debt can also qualify as acquisition debt, if it doesn't exceed the amount of the acquisition debt just before the refinancing.
- **Home Equity Debt** (Code Sec. 163(h)(3)(C)) - is debt that is not acquisition debt and is secured by a taxpayer's principal or second home. For years other than 2018-2025, for regular tax purposes, the equity debt on the two homes can't be more than $100,000 ($50,000 for married separate), or the difference between the acquisition debt on the home and the FMV of the home, if smaller. **Equity debt interest is NOT deductible for AMT purposes. Note: For years 2018 through 2025 TCJA suspended the deduction of equity debt interest for regular tax purposes, so for those years there is no AMT adjustment for equity interest.**
  - **Nonconventional Home Debt** – Prior to TCJA the 6251 instructions did not allow a deduction for nonconventional home interest as qualified home mortgage interest. The term nonconventional home refers to homes that are used on a transient basis, such as a motor home and boat. However, nonconventional home debt interest no longer appears in the 6251 instructions or on the form itself, and

the presumption is it is now deductible as home mortgage interest to the extent it is acquisition debt interest that's allowed on Schedule A for regular tax purposes. However, we can find no change to IRC Sec 56(e)(2) that says a "qualified dwelling unit" for purposes of the "qualified housing interest" deductible for AMT purposes is a house, apartment, condominium, or mobile home not used on a transient basis. So we don't know on what grounds the IRS has removed as an AMT adjustment the nonconventional home debt interest adjustment.

- _Charitable Contributions_ – The same charitable contributions that are allowed for regular tax purposes are allowed for AMT (with a rare exception – see 6251 instructions page 8). Thus, generally there is no adjustment for charitable contributions on Form 6251.

- _Miscellaneous Deductions_ –Miscellaneous deductions are segregated into two categories, Tier 1 or Tier 2 expenses. Prior to 2018, Tier 1 miscellaneous deductions were allowed for AMT purposes but not Tier 2. **With the advent of TCJA Tier 2 deductions are suspended for years 2018 through 2025. Thus, there is no longer an AMT adjustment for miscellaneous deductions**.

- _Phase-out of itemized deductions_ – Subtract the regular tax overall itemized deduction phase out amount for high-income taxpayers, if any, since it does not apply to AMT tax. Thus, itemized deductions allowed in computing alternative minimum taxable income aren't reduced for high-income taxpayers in computing the AMT. **However, for 2018 through 2025, this is not an issue since TCJA suspended the PEASE phase-out.**

- _Tax Refund_ – (Form 6251 – Line 2b) – For AMT purposes, the taxable refunds of state and local taxes are not included in the AMT computation. A state income tax refund should be an automatic adjustment by your software for prior year clients, but make sure the refund is not taxed for AMT for new clients. Include any refund from Form 1040 Schedule 1, line 10 (2018) (Sch 1, line 1, draft 2019), that is attributable to state or local income taxes. Although rare, this exclusion also applies to refunds of local taxes, real property taxes, personal property tax, foreign income tax and foreign real property tax that are treated as income because they were included as an itemized deduction on a prior year return, and the income cannot be excluded for regular tax purposes on the current return under the tax benefit rules.

- _Investment Interest Expense_ – (Form 6251 – Line 2c) – Investment interest is deductible for both regular and AMT purposes to the extent of net investment income (Note: investment expenses are part of the Tier 2 miscellaneous itemized deductions and therefore not used in the computation of net investment income for years 2018 through 2025). However, investment taxes if allowed as part of the $10,000 cap on taxes would be since that is an investment expense. Because the interest from most private activity municipal bonds is taxable for AMT purposes, taxpayers with private activity bond income will have a higher net investment income and, therefore for AMT purposes, will be allowed to deduct more investment interest expense. This also creates two investment interest carryovers, one for regular tax and one for the AMT. Generally, most preparation software will make both carryover computations. *Line 2c on the 6251 compensates for the differences between the regular investment interest deduction and the AMT investment interest deduction*.

Strategy - Utilize the Capital Gains Election - Income that is subject to the long-term capital gains rates is not investment income for purposes of computing the net investment interest limitation. However, the election to tax LTCG at ordinary rates and include that LTCG income as investment income applies to both the regular tax and the AMT. This will allow a larger deduction for investment interest for both the regular tax and the AMT. This adjustment is generally automatic in most tax preparation software. Therefore, if there is a planning reason not to utilize this election, the software will need to be overridden.

- _Depletion Adjustments_ – (Form 6251 – Line 2d) – The depletion deduction has limits based upon income from an activity and asset basis limitations. This adjustment is the excess of percentage depletion over cost basis. Except with respect to depletion taken by independent oil and gas producers and royalty owners, the excess of the allowable depletion on each depletable asset over the adjusted basis (before considering the current year's depletion) of the property at the end of the year is a preference item. This adjustment is rarely encountered for individual purposes except via pass through entities.

- _Net Operating Loss Adjustments_ – (Form 6251 – Lines 2e and 2f) – The NOL deduction for regular tax purposes is replaced in the AMT tax computation with the NOL computed based upon AMT income and deductions.

Watch out! Frequently when carrying back an NOL to a prior year the AMT NOL is overlooked and not also carried back. When the carryback year is subject to the AMT, failure to include the AMT NOL will reduce or eliminate the benefit of the NOL carryback. It will also generate correspondence from the IRS if filed without the AMT NOL. For NOLs occurring in 2018 and later, the loss is not carried back, but only forward. There is an exception for certain farm losses. See chapter 3.16 for details.

- *Private Activity Bond Interest* - (Form 6251 – Line 2g) – Tax-exempt interest and tax-exempt interest dividends on certain private activity bonds issued after 8/07/86 is a tax preference item (after 9/01/86, for bonds considered governmental bonds by pre-TRA '86 definition). Private activity bonds include those that finance mass-transit facilities, sewage and solid waste disposal facilities and certain multi-family dwellings. Taxpayers may invest in these bonds individually or through holdings in mutual funds that invest in government obligations ("muni bonds"). Tax-exempt interest and the portion of it that is private activity interest is required to be reported by the payer on Form 1099-INT, boxes 8 and 9, respectively. On Form 1099-DIV, the amount of exempt-interest dividends is shown in box 11 and private activity bond interest dividends appear in box 12. The tax preference amount is the private activity interest and dividend income reduced by the related expenses not allowed for regular tax purposes because the income is nontaxable.

  NOTE: The interest on the following bonds that are otherwise considered private activity bonds is not a tax preference: (1) certain mortgage bonds, qualified Veterans' mortgage bonds, and bonds related to residential rental projects issued after July 30, 2008, and (2) bonds issued in 2009 and 2010.

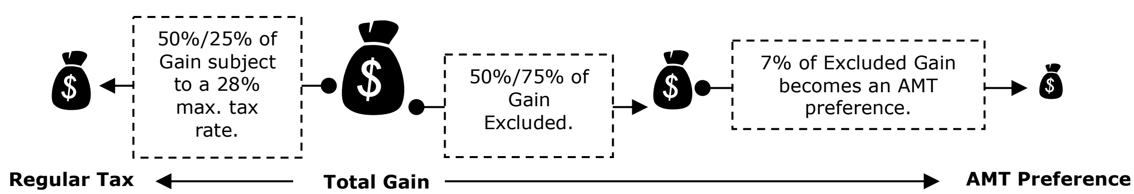
Strategy - Eliminate Investments in Private Activity Bonds – Taxpayers invest in lower yielding muni bonds because they provide tax-free income. However, when a taxpayer is subject to the AMT the tax-free benefit for private activity muni bonds is lost. Therefore, taxpayers who are regularly subject to the AMT should avoid investing in Private Activity Bonds or mutual funds that invest in such bonds (but see "Note" just above). Taxpayers who already have these bonds in their portfolio should consider divesting themselves of these investment vehicles if it makes financial sense.

- *Excluded Qualified Small Business Stock Gain* – (Form 6251 – Line 2h) – Current tax law dictates that non-corporate taxpayers exclude 50%, 75% or 100% of any gain realized on the sale or exchange of "qualified small business stock" held more than 5 years***.*** The exclusion percentage depends on when the stock was issued:

  - 50% gain exclusion for stocks issued after 8/10/1993 and before 2/18/2009.
  - 75% gain exclusion for stocks issued after 2/17/2009 and through 9/27/2010**.**
  - 100% gain exclusion for stocks issued after September 27, 2010.

  Gain from the sale of Sec 1202 stock does not benefit from the special 0%, 15% and 20% capital gains rates. But the gain that isn't excluded will be taxed at a maximum of 28% for regular tax. For AMT, 7% of the excluded Sec 1202 gain is treated as a tax preference, unless the 100% exclusion applies, in which case, none of the gain is considered a tax preference item.

  When the entire preference is subject to the highest AMT rate (28%), the effective rate on the Sec. 1202 gains for AMT purposes is actually 14.98%.



Example – *Assume a taxpayer has a gain of $100,000 from the sale of QSBS originally issued in 2008. If the taxpayer is being taxed by the AMT method at the highest rate, the tax on the QSBS can be estimated as follows:*

CG Tax = ($100,000 x .50 x .28) =	*$ 14,000*
AMT Tax = ($100,000 x .50 x .07 x .28) =	*$ 980*
TOTAL TAX =	***$14,980***

14.98% Overall Tax Rate

- *Incentive Stock Option Preference Income* - (Form 6251 – Line 2i) – If an option is a qualified option (also known as an incentive stock option), then for regular tax purposes, no amount of income is included in income either at the time the option is granted or at the time it is exercised. Income or loss is recognized when the stock is sold. However, to qualify for this treatment, the stock acquired under the option must be held for:

  - ***More than 1 year after*** the stock option was ***exercised***, ***AND***
  - ***More than 2 years after*** the option was ***granted***.

The gain or loss from the sale of ISO stock is generally a capital gain or loss. The gain for regular tax purposes will be the difference between the exercise price and the sales price. If the stock is sold prior to the required holding period, the income to the extent of the bargain element will be treated as ordinary income (wages).

For AMT purposes, taxpayers recognize alternative minimum taxable income (AMT preference income) equal to the excess of the fair market value of the stock on the exercise date over the exercise price. This creates three effects for AMT purposes:

- Preference income in the exercise year, and
- A different stock basis for AMT gain or loss (AMT basis = Exercise price and REG tax basis equals grant price), and
- Since the ISO preference is a deferral item of preference, an Alternative Minimum Tax Credit carryover may also be generated (see AMT credit later).

Example – Exercising an ISO *– In January 2013, Victor is granted an option to purchase up to 20,000 shares of XYZ, Inc. On March 30, 2018, Victor exercises the option and pays $20,000 to acquire 20,000 shares of stock with a FMV of $200,000. The results for 2018 are:*

- ***Regular tax****: No taxable income, Stock Basis of $20,000*
- ***AMT:*** *$180,000 Preference Income ($200,000 - $20,000) and a stock basis of $200,000.*

Example – Results from exercising ISO Stock *– Now look at the steps that need to be taken when the exercised stock is sold and the resulting AMT implications. In this example, Victor disposes of his stock in two transactions during 2019 as follows:*

				Regular Tax		***AMT***	
	Date	*Shares*	*Proceeds*	*Basis*	*Gain/Loss*	*Basis*	*Gain/Loss*
1	*1/20/19*	*100*	*75,000*	*10,000*	*65,000*	*100,000*	*-25,000*
2	*6/05/19*	*100*	*60,000*	*10,000*	*50,000*	*100,000*	*-40,000*

Transaction#1 *– Disqualified disposition, since he sold the stock before meeting the one-year ISO holding requirement. It results in the following tax treatment:*

Regular Tax: *Ordinary Income of $65,000 (NOT a Form 8949/Schedule D transaction)*

AMT: *Short-Term Capital Loss of $25,000*

Transaction #2 *– Since he met the ISO holding period requirements, this transaction results in a qualified disposition with the following tax treatment:*

Regular Tax: *Long-term capital gain of $50,000*

AMT: *Long-term capital loss of $40,000*

Since the Schedule D is computed separately for the regular and AMT tax, the result of the two transactions is a $65,000 AMT Schedule D loss. However, the loss is limited to $3,000 (this produces a separate AMT capital loss carryover). For regular tax purposes, we have a $65,000 ordinary income and $50,000 long-term capital gain. Therefore, the difference between regular tax income and AMTI for this example is $118,000 ($65,000 + $50,000 - <3,000>).

CAUTION: Victor's Schedule D will also need to be refigured for AMT purposes.

Strategy #1 - Exercise ISO in Amounts to Avoid AMT - Taxpayers who are under the AMT threshold might consider developing a multi-year plan to exercise the options in smaller amounts to avoid or minimize AMT.

Strategy #2 - Sell Early and Treat as Nonqualified Option - Taxpayers who will be subject to the AMT in the exercise year should consider exercising and selling in the same year, thus creating a disqualifying disposition and thereby eliminating the preference income.

Strategy #3 - Utilize the AMT Tax Credit - Where a taxpayer will not be subject to the AMT in a subsequent year and has an AMT credit carryover, the taxpayer might consider subjecting themselves to the ISO AMT preference and then recover part or all of the AMT add-on tax in a subsequent year when the AMT credit can be utilized. AMT tax credit is discussed later in this course.

✸ Disposition of Property - *(Form 6251 – Line 2k)* - Difference between Regular and AMT gain or loss. This adjustment is made if property is sold during the year. The gain or loss must be refigured for AMT purposes using the AMT basis for the property. The difference between the gain or loss reported for regular tax and the recomputed AMT gain or loss is the adjustment. This can be a negative amount for property where depreciation, circulation expenses, research and experimental expenses, mining exploration expenses, or pollution control expenses have been different for AMT purposes than for regular tax purposes.

- **Real Property Differences** – prior to 1999 real property had a preference adjustment equal to the difference between the 27.5, 31- or 39.5-year life and the 40-year straight line depreciation. After 1998 there is no preference adjustment for real property. Thus, if a property is sold that was in service before 1999 there will be a favorable difference between the AMT and regular tax gain or loss.
- **Personal Property Differences** – after 1998, personal property depreciated at the 200% MACRS rates had a preference adjustment in the amount of the difference between the 200% and the 150% MACRS rate. Thus, for personal property not fully depreciated there will be a favorable difference between the AMT and regular tax gain or loss.

These differences will result in a favorable AMT adjustment when the asset is ultimately sold. This is true whether or not the taxpayer was subject to AMT in any of the prior years.

However, the first-year **bonus depreciation** allowance applies for both regular tax and AMT and for property on which the bonus allowance is claimed, there is no preference adjustment. If the election was made not to claim bonus depreciation on eligible property put in service before 2016, the property may be subject to a preference adjustment. A provision of the PATH Act of 2015 eliminates the preference adjustment for all property placed into service after 2015 and eligible for bonus depreciation, whether or not the special allowance was elected. (2016 Form 6252 instructions, page 6)

Strategy #1- Differences between Regular and AMT Depreciation Rates

Don't overlook Form 4797 gain or loss differences for the AMT as a result of AMT depreciation, even if the client was not taxed by the AMT in the year the depreciation was taken. The AMT depreciation rate is lower than the regular rate, which could result in a smaller AMT gain and thus reduce the AMTI.

✸ *Depreciation of Property after 1986* - (Form 6251 – Line 2L) – Adjustment for the difference between regular and AMT depreciation. Generally, the taxpayer must refigure depreciation for the AMT, including depreciation allocable to inventory costs, for property that is depreciated for the regular tax using the 200% declining balance method (generally 3-, 5-, 7-, or 10-year property under the modified accelerated cost recovery system (MACRS)). The preference is the difference between the 200% and the 150% MACRS rate. But see "bonus depreciation" in box just above.

Strategy #1 - Use AMT Depreciation Rates - Taxpayers who are regularly subject to the AMT should consider using the 150% declining balance method of depreciation for regular tax and thus avoid the AMT adjustment between the 200% and 150% declining balance methods.

Strategy #2 - Use the Section 179 Deduction - The Section 179 expense deduction is NOT a preference adjustment for AMT. Therefore, the 179 deduction can be used in place of the MACRS depreciation to avoid an AMT adjustment. If there is a limit on the 179 deduction or the taxpayer's circumstances dictate a slower write-off, a partial 179 deduction can be combined with the 150% declining balance method to avoid AMT.

What Depreciation Is NOT Refigured for the AMT? Do not refigure depreciation for the AMT for:

- Property for which an election was made to use the alternative depreciation system (ADS) of Section 168(g) for the regular tax.
- Property placed in service after 1998 that is depreciated for the regular tax using the 150% declining balance method or the straight-line method, including Section 1250 property (generally residential rental and nonresidential real property).
- Any part of the cost of any property for which the election was made under Section 179 to treat the cost of the property as a deductible expense. The reduction to the depreciable basis of Section 179 property by the amount of the Section 179 expense deduction is the same for the regular tax and the AMT.
- Motion picture films, videotapes, or sound recordings.
- Property depreciated under the unit-of-production method or any other method not expressed in a term of years.
- Qualified Indian reservation property.
- Property on which a first year bonus depreciation allowance was claimed if the depreciable basis for the property is the same for the AMT as it is for the regular tax; property eligible for bonus depreciation that is placed in service after 2015 whether or not the bonus allowance is claimed.

OTHER INFREQUENTLY ENCOUNTERED AMT ADJUSTMENT & PREFERENCE INCOME

The following are the other items that will impact the AMT. However they are usually attributable to pass through entities generally out of the control of the individual taxpayer. Thus, there are no strategies associated with the pass-through items.

- **Estates and Trusts K-1 (1041) Adjustments** – (Form 6251 – Line 2j) – This line accommodates flow through AMT adjustments from estates and trusts. The K-1 (on line 12j) should also indicate how much of the AMT preferences and adjustments is from exclusion items. This information is used in computing the AMT credit on the following year's Form 8801. See "Alternative Minimum Tax Credit" discussion below.

- **Passive Activities** – (Form 6251 – Line 2m) – Difference between regular and AMT income or loss. The same rules that apply for limiting deductions of passive losses for regular tax purposes also apply for AMT purposes. Indefinite carryover of disallowed losses is also allowed and full deduction is allowed in the year of a complete disposition of the activity. However, there was no phase in of the passive loss rule for AMT purposes. Just as with passive farm losses, the AMT adjustment may be reduced by the amount of a taxpayer's insolvency at the end of the year. AMT adjustment and tax preference items related to a passive loss activity should be accounted for when recomputing the passive activity loss and should be reflected on the passive activity loss lines of the AMT forms.

  When refiguring a possible loss activity for AMT, only items that are allowed for AMT should be deducted. For example, the passive loss is recomputed using straight-line depreciation. **Caution:** Those same adjustments and preference items should not be accounted for again on other lines of the AMT forms.

- **Loss Limitations** – (Form 6251 – Line 2n) – Difference between AMT and regular tax income or loss refigured for activities for which the taxpayer is not at risk or basis limitations are applicable. Generally applies to partnerships and S corporations. The difference takes into account all AMT adjustments and preferences that apply.

- **Circulation Costs** - (Form 6251 – Line 2o) – These are expenses of establishing, maintaining or increasing the circulation of newspapers and periodicals. They can be deducted in the year paid or incurred for regular tax purposes. The AMT adjustment is the difference between the amount allowed for regular purposes over the amount allowed by amortizing the costs ratably over a three-year period. If a taxpayer elects three-year, straight-line amortization of the costs for regular tax purposes, there is no AMT adjustment. This adjustment is rarely encountered for individual purposes except via pass through entities.

- **Long-Term Contracts** - (Form 6251 – Line 2p) – For purposes of computing alternative minimum taxable income, taxpayers must use the percentage-of-completion method of accounting for long-term contracts. For small construction contracts, under Code Sec. 460(e)(1), the percentage of the contract completed is determined by using the simplified method for allocating costs in Code Sec. 460(b)(3). This adjustment is rarely encountered for individual purposes except via pass through entities.

- **Mining Costs** – (Form 6251 – Line 2q) – Mining exploration and development costs are adjusted for AMT purposes. The following deduction is allowed: the amount that results from capitalizing mine exploration and development expenditures without regard to the Code Sec. 291(b)(1) 30% cutback and amortizing them on a straight-line basis over ten years. This adjustment is rarely encountered for individual purposes except via pass through entities.

- **Research and Experimental Costs** – (Form 6251 – Line 2r) – For regular tax purposes, research and experimental expenses may be deducted in the year paid or incurred, or they may be amortized on a straight-line basis over 10 years. If they are currently deducted, the AMT adjustment is the difference between that deduction and the ten-year amortization amount. This adjustment is rarely encountered for individual purposes except via pass through entities.

- **Income from Certain Installment Sales before 1987** - (Form 6251 – Line 2s) – The installment method does not apply for the AMT to any non-dealer disposition of property after August 16, 1986, but before January 1, 1987, if the "proportionate disallowance rule" applied to the installment sale. Under the proportionate disallowance rule that applied to certain pre-'88 installment sales, a portion of the taxpayer's outstanding indebtedness was treated as a constructive payment on the installment (receivables) obligation that the taxpayer held. This is an extremely rare adjustment that will generally only be encountered via pass through entities.

- **Intangible Drilling Costs Preference** – (Form 6251 – Line 2t) – This is the excess of the annual allowable expense deduction for intangible drilling and development costs in connection with oil, gas and geothermal wells, over the amount that would have been allowable had the costs been capitalized and straight-line recovery of intangibles used with respect to them. This adjustment is rarely encountered for individual purposes except via pass through entities.

- **Other Adjustments –** (Form 6251 – Line 3) – This is the catch-all entry for other rarely encountered adjustments not handled on other lines of the 6251 related to: depreciation figured using pre-1987 rules, patron's adjustment, pollution control facilities, tax shelter farm activities, charitable contributions of certain property, excess business loss limitation, business interest limitation, biofuel producer credit and biodiesel and renewable diesel fuels credit, net qualified disaster loss, large partnerships, and related adjustments. See Form 6251 instructions for details.

ALTERNATIVE MINUMUM TAX CREDIT

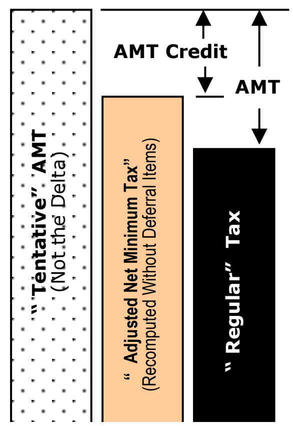
Overview

The Alternative Minimum Tax Credit is a frequently misunderstood and overlooked tax credit. Oversimplified, the alternative minimum tax credit is the result of incurring an alternative minimum tax in a prior year, which generates a credit that can be used to offset the excess of the taxpayer's regular tax over the alternative minimum tax in a subsequent year, with unused credit carried forward to future years.

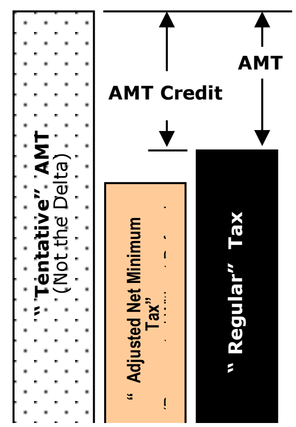
- The credit is generally a credit against regular tax, NOT the alternative minimum tax.
- The credit is computed in the year following a year in which there was an alternative minimum tax (or AMT credit carryover from some previous year).
- The AMT credit is computed on Form 8801 in the current year using data from the prior year 6251 and current year 1040.
- The amount of the credit is generally the excess of the AMT computed with deferral items of preference over the AMT computed without the deferral items of preference for the prior tax year.

AMT Credit - The AMT credit is the difference between the tentative AMT and adjusted net minimum tax (ANMT) but not exceeding the AMT itself. The ANMT is generally the AMT recomputed without deferral items of preference, which for most individuals means the AMT recomputed without the Incentive Stock Option (ISO) preference.

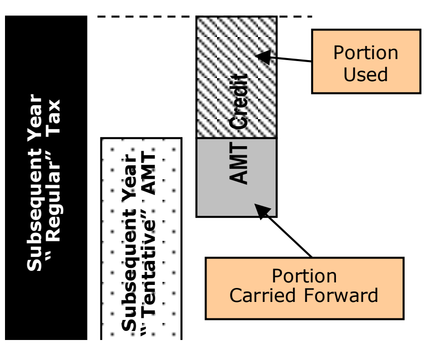
Adjusted Net Minimum Tax (ANMT) - For a non-corporate taxpayer, the ANMT for a tax year equals: (a) the alternative minimum tax (AMT) paid for that year; *less* (b) the amount of AMT that would have arisen if the only applicable preferences and AMT adjustments were "exclusion preferences" *plus* (c) the amount of any qualified electric vehicles credit not allowed solely by reason of the limitation on that credit that is a function of the taxpayer's tentative minimum tax.



Minimum Tax Credit
(Where ANMT is **Greater** Than the Regular Tax)



Minimum Tax Credit
(Where ANMT is **Less** Than the Regular Tax)



Using the Credit in a Subsequent Year
(Where the Regular Tax is **Greater** Than the Tentative AMT)

The two illustrations graphically illustrate how the AMT credit is determined where the ANMT is both greater than and less than the AMT.

Subsequent Year - Once the AMT Credit is determined, it is carried forward to subsequent tax years until used up. IRS Form 8801 – Credit for Prior Year Minimum Tax – is used to carry the credit forward.

DEFERRAL items of preference that can create an AMT Credit include:

- Qualified small business stock
- Incentive stock option preference
- Large partnerships adjustments
- Adjusted gain or loss
- Post-1986 depreciation adjustments
- Passive activities
- Loss limitations
- Circulation expenses differences
- Long-term contract preferences
- Mining cost differences
- Research and experimental costs
- Installment sales (pre-1987)
- Intangible drilling costs preferences
- Depreciation (pre-1987)

Strategies

Avoid AMT in a Subsequent Year - Since the AMT tax credit can only be used to reduce the regular tax to the AMT, it can never be used in a year where the taxpayer has an AMT. Therefore, the only way to obtain any benefit from this credit is to have a regular tax that is larger than the AMT. Where a taxpayer is marginally in the AMT or where transactions are creating an AMT, a taxpayer may be able to plan their income and deductions in such a way as to avoid the AMT in intervening years and take advantage of this credit.

Carryover & Preparation Software - Since the carryover credit is computed on Form 8801 for the year to which it is carried, it is frequently overlooked or lost in the transition and not continuously proformaed from year-to-year by preparation software. Some will only proforma the 8801 data from the immediately past year and not the information from other prior years. Therefore, it may be necessary to refer to Forms 8801 going back several years to make sure no credit is lost.

CALIFORNIA DIFFERENCES

With all the changes brought about by TCJA and the increases in the federal AMT exemption amounts combined with substantially higher income levels at which the exemption phases out, it is more likely taxpayers will incur a state AMT before incurring it on their federal return, which is the opposite of the situation before 2018. California's AMT calculation, done on **Schedule P (540),** is similar to the federal computation, with generally the same categories of adjustments and preferences, but often using different amounts that result from the frequent lack of conformity between federal and California law. Refer to the instructions to Schedule P for details about these differences. **The California AMT Tax rate has been 7% since 2011.**

AMTI Exclusion - The most significant difference between the federal and California AMT calculation—and a reason fewer taxpayers have been subject to California AMT—is that for California purposes a "qualified taxpayer" must exclude income, positive or negative adjustments, and preference items attributable to any trade or business when figuring AMTI.

Qualified Taxpayer - A "qualified taxpayer" is an owner of a trade or business with aggregate gross receipts, less returns and allowances, for the year of *less than $1 million from all of the taxpayer's trades or businesses*. If the taxpayer's ownership interest for any business is less than 100%, such as a partnership, then only the taxpayer's proportionate share of gross receipts for that business are included for the $1 million test. The threshold is not based on filing status, so it does not become $2 million for married taxpayers filing jointly.

If a qualified taxpayer's net trade or business income is a loss, the amount of the exclusion is zero.

AMT Exemptions and Phaseout – The California AMT exemption and the AMTI at which the exemption begins to phase out is adjusted annually for inflation. The adjacent tables show the exemption amounts and the phaseout start and end points for the current and prior several years.

CA AMT Exemptions

Filing Status	2016	2017	2018	2019
Joint & SS	87,627	91,793	95,373	
Single & HH	67,101	68,846	71,531	
MS	44,732	45,895	47,685	

CA AMT Exemptions Phaseout

Year	Single & HH	Joint & SS	MS
2019 Threshold			
Full Phase-out			
2018 Threshold	$268,237	$357,650	$178,822
Full Phase-out	$554,361	$739,142	$369,562
2017 Threshold	$258,168	$344,225	$172,110
Full Phase-out	$533,552	$711,397	$355,690
2016 Threshold	$251,626	$335,502	$167,749
Full Phase-out	$520,030	$693,370	$346,677

If any fields are blank, amounts were not available at publication date.
Full phase-out amounts equal exemption amount x 4 plus beginning phase-out amount.

KIDDIE TAX

Applies to child required to file a return who has unearned income over $2,200 (2019), if:

- **Under the age of 19 or**
- **Full Time Student over age 18 and under the age of 24**

Prior to 2018 and after 2025:

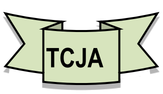
- Generally the child will be taxed on unearned income in excess of $2,100 (2017) at higher of own or parent's marginal tax rate.
- Instead may elect to include child's investment income on parent's return – depends on type of income

2018 through 2025:

- Generally, the child's unearned income in excess of $2,200 (2019) will be **taxed using the income tax rates for trusts and estates**.
- Child's taxable income attributable to earned income taxed using single rates for individuals.
- Tax computation not tied to parent's return (2018-2025)
- Instead may elect to include child's investment income on parent's return – depends on type of income

ALL YEARS:

- The basic **standard deduction** for a child, or any individual, who is or could be claimed as a dependent by another taxpayer, is limited to the **greater of the following two amounts** but not to exceed the regular standard deduction for the year ($12,200 for 2019).
    - The "**base amount**" which is $1,100 for 2019, or
    - The **dependent's earned income plus the "extra" amount** ($350 for 2019).
- If **neither parent is alive** on the last day of the year, the child's tax is at his/her own rate.
- If the child is **married and files JT**, child is taxed at his/her own rate.



The Act changes the way the "kiddie tax" is calculated for years 2018 through 2025, and removes from the computation any reference to the child's parent's return.

Related IRC and IRS Publications and Forms

- **Form 8814 -** Parents' Election To Report Child's Interest and Dividends
- **Form 8615 -** Tax for Certain Children Who Have Unearned Income
- **Pub 929** – Tax Rules for Children and Dependents
- **IRC Sec 1(g)**

<u>BASIC STANDARD DEDUCTION FOR CHILDREN (AND OTHER DEPENDENTS)</u>

The basic standard deduction for a child, or any individual, who is or could be claimed, as a dependent by another taxpayer is limited to the ***greater of:***

- The **"Base Amount"** (see table below), or
- The sum of the dependent's **Earned Income plus the "Extra" Amount** [(1)].

Note: Both the "base" and "extra" amounts are inflation-adjusted – see table below. Ignore the "earned income limit" column in the table for this calculation.

[(1)] However, the standard deduction can't be more than the regular standard deduction amount (including add-ons if age 65+ and/or blind) for the individual for whom it is computed.

Table 1

Year	Base Amount Sec 63(c)(5)(A)	Earned Income Limit	Earned Income Extra Amount
2016	1,050	2,100	350
2017	1,050	2,100	350
2018	1,050	2,100	350
2019	1,100	2,200	350
2020	1,100	2,200	350

If amount not shown it was not available at date of publication

KIDDIE TAX APPLIES TO

- Children **under Age 18**
- Children **Age 18 at end of Year** *(with Earned Income less than ½ of Support)*
- Full Time **Student over Age 18 and under Age 24** *(with Earned Income less than ½ of Support)*

Special rules apply for computing the tax on certain unearned income of a ***child meeting one of the age parameters listed above:***

1. Child's interest, dividends, and other unearned income total the "earned income limit" (see Table 1 above) or less: The child's income is taxed at the child's tax rates.

2. Child's interest, dividends, and other unearned income total more than the "earned income limit" (see Table 1 above): For years **before 2018 and after 2025**, part of that income may be taxed at the parent's tax rate instead of the child's tax rate. The computation of that tax is done on a return filed for the child.

   For years **2018 through 2025**, on the child's return the child's tax on the unearned income (investment income) will be taxed using the tax rates for estates and trusts (fiduciary) – shown below – both as to ordinary rates and capital gains rates. The child's taxable income attributable to earned income will be taxed at the single rates for individuals. The child's parent's tax rate will not affect the child's return.

3. Election by parents: A child's parent(s) may be able to choose to include the child's interest and dividend income (including capital gain distributions) on the parent's return rather than file a return for the child. If the child has income other than interest, dividends and capital gain distributions, this election is not allowed. See page 08.02.04 for the pros and cons of making the election.

CAUTION

If a child meets these requirements, the child is subject to the Kiddie Tax regardless of whether or not he/she qualifies as a dependent. A child can be a legally adopted child and a stepchild. If neither parent is alive on the last day of the child's tax year, the child's tax is determined at his/her own rate and the Kiddie Tax rules don't apply.

2019 Federal Tax Rate Schedule – Estates & Trusts

If your taxable Income is: Over -	But not over ---	the tax is:	of the amount over ---
$0	$2,600	10%	$0
2,600	9,300	$260.00 + 24%	2,600
9,300	12,750	1,868.00 + 35%	9,300
12,750		3,075.50 + 37%	12,750

2020 Federal Tax Rate Schedule – Estates & Trusts

If your taxable Income is: Over -	But not over ---	the tax is:	of the amount over ---
$0	$2,600	10%	$0
2,600	9,450	$260.00 + 24%	2,600
9,450	12,950	1,904.00 + 35%	9,450
12,950		3,129.00 + 37%	12,950

2018 through 2025:

- Generally, the child's unearned income in excess of $2,200 (2019) will be **taxed using the income tax rates for trusts and estates**.

Example – Kiddie Tax: *In 2019 Junior, age 10, has interest income of $3,000 from a bank account set up by his grandparents. He has no earned income and is a dependent of his father. Junior is subject to the kiddie tax because his unearned income exceeds $2,200. Junior's tax is determined as follows:*

- *Interest Income: $3,000*
- *Less Income Limit <2,200>*
- *Net taxable: $800*
- *The net is taxed at fiduciary rates = $80 ($800 x 10%)*

AMT EXEMPTION

The AMT exemption for 2019 for a child subject to the kiddie tax will be the lesser of (1) $7,750 (2019) plus the child's earned income, or (2) the regular 2019 AMT exemption for a single person of $71,700.

DEFINITIONS

Child - The term "child" includes a legally adopted child and a stepchild. The rules apply whether or not the child is a dependent. However, the rules don't apply if:

1. The child isn't required to file a tax return, or
2. Neither of the child's parents were living at the end of the tax year.

Unearned Income - For purposes of the Kiddie Tax, unearned income is generally all income other than salaries, wages, and other amounts received as pay for work actually done. It includes taxable interest (reduced by any penalty for early withdrawal of savings), dividends (including capital gain distributions), capital gains and losses, rents, royalties, etc. It also includes the taxable part of social security benefits, pension and annuity payments, taxable scholarship and fellowship grants not reported on Form W-2, unemployment compensation, taxable alimony, and income (other than earned income) received as the beneficiary of a trust.

Income subject to the kiddie tax includes amounts produced by assets the child obtained with earned income (such as interest on a savings account into which the child deposited wages).

Nontaxable unearned income, such as tax-exempt interest and the nontaxable part of social security and pension payments, is not included as unearned income. However, a child's unearned income includes income produced by property given as a gift to the child. This includes gifts to the child from grandparents or any other person and gifts made under the Uniform Gift to Minors Act.

Exception for income from qualified disability trusts – If a child is the beneficiary of a qualified disability trust (as defined in Code Sec. 642(b)(2)(C)(ii)), any amount distributed from the trust that is includible in the child's income is considered earned income for purposes of the Kiddie Tax computation.

Net Unearned Income – If the child is not itemizing deductions, subtract $2,200 (for 2019) from unearned income to figure net unearned income for purposes of the Kiddie Tax. If the child itemizes, the amount to subtract is the larger of $2,200, or $1,100 plus the portion of Schedule A deductions that are directly connected with producing the unearned income.

Itemized Deductions: For this computation, itemized deductions directly connected with the production of unearned income include expenses paid to produce or collect taxable income or to manage, conserve, or maintain property held for producing unearned income. These expenses also could include custodian fees and service charges on bank or brokerage accounts, service fees to collect taxable interest and dividends, and certain investment counsel fees. These expenses are claimed as Schedule A Tier 2 miscellaneous deductions subject to reduction by 2% of AGI. The deduction for these expenses is suspended for years 2018 through 2025, so it is highly unlikely that a child subject to the Kiddie Tax rules will be itemizing during this period.

PARENT'S ELECTION TO REPORT CHILD'S INTEREST AND DIVIDENDS

Parents may elect to include their child's interest and dividend income (including capital gain distributions) on their own tax return instead of the child filing a return of his/her own. If the child has other types of income, either earned or unearned, this election cannot be made. This provision was unchanged by the TCJA.

> **CAUTION:** This is an irrevocable election (Reg Sec. 301.9100-8(a)(4)(i)) and the child is treated as having no gross income and the child's income becomes the parent's income.

Child's Income Limit to File with Parent's Return – Table 2

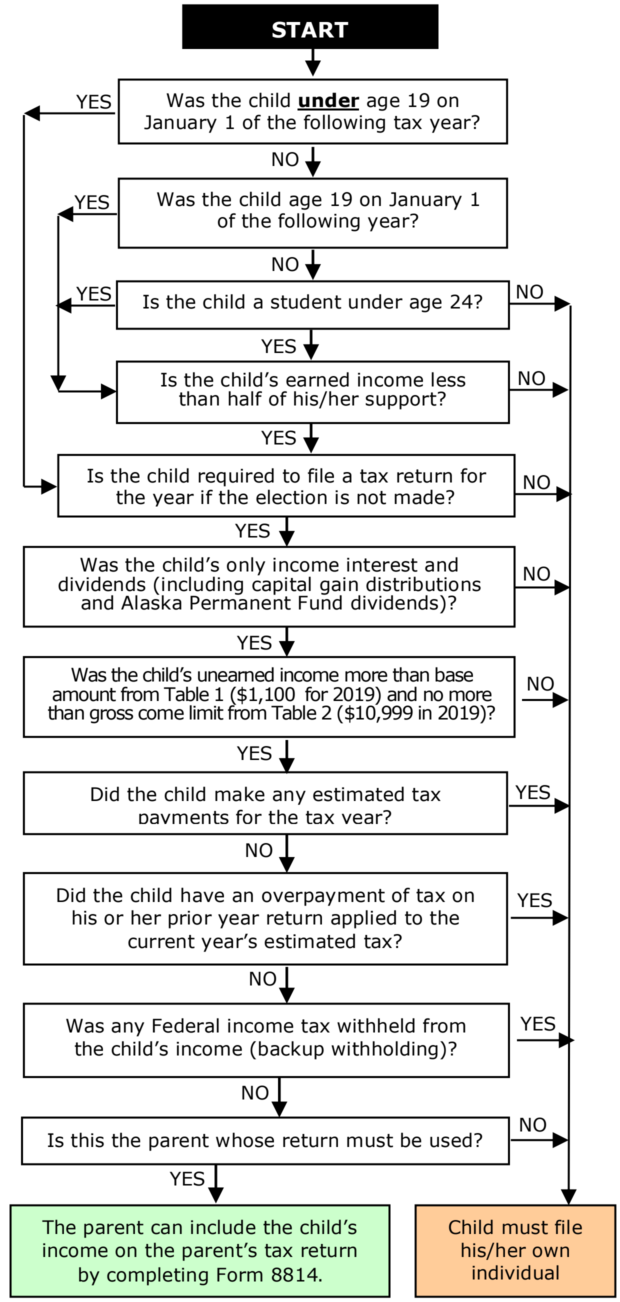
Year	2014	2015	2016	2017	2018	2019	2020
Limit(1)	9,999	10,499	10,499	10,499	10,499	10,999	10,999

(1) If the child's unearned income for any year is 10 times or more of the "base" amount (see Table 1) for that year, the child's income may not be included on the parent's return.

If amount not shown it was not available at date of publication.

Continue to next page.

Which Parent's Return? – When the parents aren't filing a joint return, it may not be readily apparent on which parent's return to make the election to include the child's interest and dividend income. Use the nearby flow chart and the following information to determine which return to use.



<u>Parents are married</u>: If the child's parents file separate returns, use the return of the parent with the greater taxable income.

<u>Parents not living together</u>: If a child's parents are married to each other but not living together, and the parent with whom the child lives (the custodial parent) is considered unmarried, use the return of the custodial parent. If the custodial parent is not considered unmarried, use the return of the parent with the greater taxable income.

<u>Parents divorced:</u> If a child's parents are divorced or legally separated, and the parent who had custody of the child for the greater part of the year (the custodial parent) has not remarried, use the return of the custodial parent.

<u>Custodial parent remarried</u>***:*** If the custodial parent has remarried, the stepparent (rather than the noncustodial parent) is treated as the child's other parent. Therefore, if the custodial parent and the stepparent file a joint return, use that joint return. Do not use the return of the noncustodial parent. If the custodial parent is a widow or widower who has remarried, the new spouse is treated as the child's other parent.

If the custodial parent and the stepparent are married, but file separate returns, use the return of the one with the greater taxable income. If the custodial parent and the stepparent are married but not living together, use the rule noted under "Parents not living together" previously.

<u>Parents never married</u>: If a child's parents did not marry each other, but lived together all year, use the return of the parent with the greater taxable income. If the parents did not live together all year, the rules explained under "parents divorced" (previously) apply.

How to make the election - Make the election to include the child's investment income on the parent's return by attaching Form 8814 to the parent's return. Attach a separate 8814 for each child for whom the election is made. *<u>The same election does not have to be made for all affected children</u>.*

Advantages and disadvantages of the election - Making the election can have certain advantages and disadvantages:

<u>Disadvantages</u>:

- ***Rates may be higher -*** By using Form 8814, the child's income may be taxed at a higher rate on the parent's return than it would be on the child's own return. Including the child's income could increase the parent's income to the point that it bumps the parents into the next higher tax bracket.
- ***Deductions lost -*** By making the Form 8814 election, parents can't take certain deductions the child would be entitled to on his or her return. For instance, the parents can't. . . .
  (1) Take the higher standard deduction if the child is blind,
  (2) Get a deduction for an interest forfeiture penalty on early withdrawal from the child's savings accounts, and
  (3) Deduct certain itemized deductions (such as the child's investment expenses (in years when Tier 2 miscellaneous deductions aren't suspended) or charitable contributions).
- ***Alternative Minimum Tax -*** If the child received tax-exempt interest from a private activity bond that is a tax preference item for alternative minimum tax (AMT) purposes, the parents must include it with their own tax preference items when figuring their AMT.

- ***3.8% Surtax on Net Investment Income (NII)*** – Electing to include the child's investment income on the parents' return could push the parents' modified AGI over the threshold at which the NII tax applies. If the parents are already subject to the NII tax, adding the child's investment income may increase the amount of NII tax the parents will pay.
- ***Reduced Deductions or Credits -*** The parent's increased adjusted gross income due to the child's income may reduce certain deductions or credits on their return, including:
  (1) IRA deductions;
  (2) Itemized deductions for medical expenses, casualty losses (only those in federally declared disaster areas for 2018-2025 are allowed), and in years when not suspended, certain miscellaneous expenses,
  (3) Total itemized deductions (in years when the overall itemized deduction phaseout applies),
  (4) Credit for child and dependent care expenses,
  (5) Saver's credit,
  (6) Child tax credit,
  (7) Personal exemptions (in years when exemption allowances are deductible and the amount must be phased due to "high" income), and
  (8) The earned income credit.

<u>Possible Advantages</u>:

- ***Deductible Investment Interest -*** If Form 8814 is used, a child's investment income is considered the parent's investment income. To figure the parent's limit on deductible investment interest expense, add the child's investment income to the parent's. However, if the child received capital gain distributions or Alaska Permanent Fund dividends, that income doesn't count as investment income.
- ***Simplification and Cost Savings –*** Including the child's income on the parent's return eliminates the need to file a separate return for the child, and may result in less overall tax preparation fees to the family.

FILING CHILD'S OWN RETURN WITH FORM 8615 (TAX YEARS 2018 THROUGH 2025)

With the decoupling of the parent's and child's returns, the Form 8615 has slimmed down from 18 lines on the 2017 version to 7 lines on the 2018 form. However, there is a 26-line computation worksheet in the instructions and special directions for the Schedule D Worksheet or Qualified Dividends and Capital Gain Tax Worksheet when one of them is being used. Fortunately, with accurate input, your tax program should make the computations for you.

FILING CHILD'S OWN RETURN WITH FORM 8615 (TAX YEARS BEFORE 2018 AND AFTER 2025)

If a parent does not or cannot choose to include their child's income on their return, and the child falls into the age or student categories noted above, the child's tax is figured using Form 8615 on the child's own return. The Form 8615 is necessary for 2017 only when the child's unearned income exceeds $2,100. To complete Form 8615 for the child, use the following steps:

- Figure the child's "net unearned income" (defined later).
- Figure the tentative tax on the net unearned income based on the parent's tax rate.
- Figure the child's tax.

Obtaining parent's information – In some situations, the information required for the parent's information may not be readily available.

<u>Using estimated information</u>: If the information needed from the parent's return is not known by the time the child's return is due, the return can be prepared using a reasonable estimate. Considered reasonable is using information from the previous year's return. However, if estimated amounts are used on Form 8615, write "Estimated" on the line next to the amount.

NOTE: When the correct information becomes available, an amended return must be filed for the child (provided the estimates are incorrect).

<u>Parent's return information not available</u>: If a child cannot get the required information about the parent's tax return, the child (or the child's legal representative) can request the necessary information from the IRS. Make the request with a signed, written request for the information sent to the Internal Revenue Service Center where the parent's return will be filed. The request needs to contain ALL of the following:

- A statement that the request is being made to comply with Section 1(g) of the Internal Revenue Code and that attempts have been made to get the information from the parent.
- Proof of the child's age - for example, a copy of the child's birth certificate.
- Evidence the child's unearned income exceeds the "earned income limit" amount (see Table 1) for the year (for example, a copy of the child's prior year tax return or copies of Forms 1099 for the current year).

- The name, address, social security number (if known), and filing status (if known) of the parent whose information is to be shown on Form 8615.

A child's legal representative making the request should include a copy of his or her Power of Attorney, such as Form 2848, or proof of legal guardianship.

The IRS cannot process the request before the end of the tax year. In fact, consider getting an extension of time to file the child's return, because there may be a delay in getting the information.

OTHER ISSUES

Deferring Income to Avoid the Kiddie Tax – A few years ago Congress raised the kiddie tax age from 14 to 18 (19 to 23 if a student) to prevent parents from transferring appreciated assets to their children to take advantage of the lower capital gains rates and especially the 0% rate.

Given the current age rule, a parent may want to reconsider any planned transfers of income-generating stocks, bonds, and other investments to children age 18, or those age 19-23 who are full-time students. However, placing or moving a child's funds into investments such as the following that produce little or no current taxable income, can help avoid the Kiddie Tax, at least in the years until the investments need to be sold or redeemed to pay for education expenses:

- **U.S savings bonds** – Interest can be deferred until the bonds are cashed.
- **Tax-deferred annuities** - Interest can be deferred until the annuity is surrendered.
- **Municipal bonds** – Generally produce tax-free interest income (may be taxable to the state).
- **Growth stocks** - Stocks that focus more on capital appreciation than current income.
- **Unimproved real estate** – That provides appreciation without current income.
- **Family employment** - If the family has a business, that family business could employ the child. The child's earned income is not subject to Kiddie Tax and will generate a deduction for the family business (assuming the wages are reasonable for work actually performed). The child's earned income can offset the standard deduction for a dependent and the excess income will be taxed at the child's rate (not the trust/estate tax rate). In addition, the child would also qualify for an IRA, which provides additional income shelter.

California conforms to the federal rules that children through age 18 and full-time students age 19 through 23 with the requisite amount of investment income are subject to the Kiddie Tax. However, California has not decoupled the child's and parent's returns. Use Form FTB 3800 for the tax computation of a child subject to Kiddie Tax.

California taxes the child's investment income over the limit (over $2,200 for 2019) at the parent's rate, if it is higher than the child's rate. In most cases, this income subject to the Kiddie Tax will be the same as the amount entered on federal Form 8615, line 1 (unearned income), except only income taxable by California should be included. Also include investment income that was not taxed on the child's federal tax return but is taxable under California law (for example, municipal bond interest from another state). California hasn't suspended the Tier 2 miscellaneous itemized deductions on Schedule A, so it is possible that a child with investment expenses could be using those itemized deductions in the computation of net investment income for calculating the state Kiddie Tax.

If the parents elect to report the child's income on their return, Form FTB 3803 is used; the computation parallels the federal, but the California tax rate is 1% on up to $1,100 (2019) of the child's first $2,200 of interest and dividend income instead of 10% as in the federal computation. Separate federal and state elections may be made.

Because California has no special capital gains rates, no special computations similar to the Federal Schedule D worksheets are necessary for the state.

NOTES

SELF-EMPLOYMENT TAX

RAPID FINDER

- Generally, income from self-employment is subject to SE Tax.
- **2019 Cap is $132,900 $16,479.60)** maximum tax @ **12.4%).**
- **$132,900** Cap is reduced for any FICA wages.
- Medicare element is **2.9%** with No Cap.
- Additional **0.9%** Medicare tax if SE income exceeds $200K/$250K/$125K threshold
- **$400** SE Income Threshold (no tax charges if total SE income is under $433 ($433 x 92.35% = $400)).
- **Self-Employment Income Generally Includes:**
  - Schedule C Income
  - Schedule F Income
  - SE Income from a Partnership K-1
  - Miscellaneous Income from a Regularly Conducted Trade or Business
  - Excluded Foreign Earned Income of self-employed person
  - Back Pay – At rates for year of payment
  - Professional Fiduciary
  - Agricultural Co-op Payments to Retired Farmers
  - Fishing Crew Member
- **Self-Employment Income Generally Does Not Include:**
  - Rental Income from Schedule E
  - Sub-chapter S K-1 Income (Taxpayer is supposed to take a reasonable wage on which FICA would be withheld.)
  - Miscellaneous Income from an Occasional Act or Transaction
  - Services performed as Notary Public
  - Non-Professional Fiduciary
  - Limited Partners' Share of Income
  - Newspaper Vendors under age 18
  - Termination Payments of Former Insurance Salespeople
  - Taxpayer's Child Employee under age 18
- **Non-Farm Optional Method**
  - Gross $8,160 or less (2019)
  - SE Net is less than $5,440 (2019)

RELATED IRC AND IRS PUBLICATIONS AND FORMS

- **Schedule SE (Form 1040)** – Self-Employment Tax
- **Form 8919** – Uncollected Social Security and Medicare Tax on Wages
- **Pub 225** – Farmer's Tax Guide
- **Pub 334** – Tax Guide for Small Business
- **Pub 517** – SS and Other Info for Clergy and Religious Workers
- **Pub 595** – Tax Highlights for Commercial Fishermen
- **IRC Sec 3101**

ACTIVITIES THAT CAN GENERATE SELF-EMPLOYMENT INCOME: Most taxpayers are considered self-employed if they are independent contractors or general partners in a partnership. A part-time business pursued in addition to a taxpayer's regular employment can generate self-employment income. Thus, a taxpayer with a Schedule C, Schedule F, and a partnership on Schedule E, could be subject to self-employment tax.

Note that IRS instructions to Form 1040 specify that self-employment income is not to be reported on the miscellaneous income line of the 1040; instead, the taxpayer must use Schedule C or F, as applicable, even if there are no expenses related to the income. See Chapter 3.09 for information on independent contractors.

TAX RATES

Lest we forget!

Tax Year	1990	2015★	2016★	2017★	2018★	2019★	2020★
SE Tax Rate	12.4	12.4	12.4	12.4	12.4	12.4	12.4
Inc Subject to Tax	51,300	118,500	118,500	127,200	128,400	132,900	
Maximum Tax	6,361.20	14,694.00	14,694.00	15,772.80	15,921.60	16,479.60	
Medicare Tax Rate	2.9	2.9	2.9	2.9	2.9	2.9	2.9

If values not shown they were not available ay publication date.
★Additional 0.9% (figured separately) applies if SE income exceeds thresholds – see below and Chapter 12.06

NET SELF-EMPLOYMENT INCOME: Net self-employment income includes all business income less business deductions related to that income. If a taxpayer has more than one trade or business which generates self-employed income, the income from all those sources is combined to determine the net; SE tax is computed using this net figure. (Even though all businesses are combined to compute net SE income, the taxpayer should be cautioned to keep separate records for each entity and report each non-farm sole proprietorship on a separate Schedule C. Also, the SE incomes and losses of spouses may not be combined for figuring SE tax of either spouse.) The Sec 199A deduction available in years 2018-2025 does NOT reduced self-employment income for the SE tax computation.

Example - Computing Net SE Income *- Jane owned a business from which the following data was obtained:*

Gross profit from sales	*$87,500*	*Miscellaneous expenses*	*1,900*
Salary paid to employees	*30,000*	*Gain on sale of equipment*	*350*
Rent	*6,000*	*Fire loss on store*	*1,200*
Utilities	*2,400*	*NOL carryover*	*1,000*

Jane's net self-employment income is computed as follows:

Gross profit from sales		*$87,500*
Expenses:		
Salaries	*$30,000*	
Rent	*6,000*	
Utilities	*2,400*	
Miscellaneous expenses	*1,900*	
Total expenses		*40,300*
Net profit from operations		*$47,200*

Jane's net SE earnings are $47,200; the equipment sale, fire loss, and NOL are not included in the calculation of net SE earnings.

FIGURING SE TAX: The SE tax rate is made up of two elements, the social security element and the Medicare Part A hospital insurance element. The Social Security tax rate has been 12.4% for a number of years (except for the 2011 and 2012 reduction to 10.4%). The tax has an annual cap based on a maximum wage subject to the tax (see the table above). The Medicare tax rate also has been stable at 2.90% for over 25 years. However, there is no cap on the Medicare portion of the SE tax.

SE TAX COMPUTATION DEDUCTION: 50% of the Social Security and Medicare taxes for employees are paid by the employer, while a self-employed person must pay both the employee and the employer portions. To compensate for this, tax law provides a deduction equal to 7.65% of net SE earnings. This deduction is allowed only for the purpose of figuring SE tax; the deduction is computed by multiplying net SE earnings by .9235 (100% less 7.65%) on Schedule SE. The computation does not include the additional 0.9 percent Medicare tax on the self-employment income of certain high-income taxpayers. (Code Sec. 1402(a)(12))

AFFORDABLE CARE ACT INCREASES SE TAX RATE FOR SOME

The effective rate of self-employment tax is 16.2% (12.4% + 3.8%) on any SE income above the following thresholds: $250,000 married joint, $125,000 married separate and $200,000 all others. The 3.8% rate is made up of the long-standing 2.9% (Medicare) Hospital Insurance (HI) tax plus an additional 0.9% enacted as part of the Affordable Care Act.

The SE tax computation deduction described just above does not include the 0.9% additional HI tax. The SE income in excess of the threshold amount that is subject to the 0.9% additional SE tax rate is reduced by the amount of wages, if any, that were also subject to the additional 0.9% tax for FICA purposes. Additional Medicare Tax, the computation for the additional 0.9% HI tax, is done on Form 8959 and not on Sch. SE. See Chapter 12.06 for details.

ADJUSTMENT FOR FICA AND MEDICARE TAXES PAID THROUGH WAGES: If a self-employed individual has both wages subject to FICA and SE income, the maximum amount subject to the Social Security portion of the SE tax is reduced by the wages subject to FICA. There is no adjustment for Medicare tax since there is ~~a~~ no cap.

FISCAL YEAR TAXPAYERS: Fiscal year taxpayers must use the SE tax rate and maximum income limit in effect at the beginning of their tax year, even if the rate and limit change during the tax year.

METHODS OF COMPUTING SE TAX: There are three methods a taxpayer may use to figure net SE earnings and SE tax: (a) the regular method; (b) the farm optional method; (c) the nonfarm optional method. All methods use Schedule SE for the computation. A taxpayer must have $433.13 or more of net SE earnings (before reduction by the 7.65% deduction) to be subject to the tax (.9235 x $433.13 = $400). No Schedule SE is required if net SE income is below the $433.13 amount (unless (b) or (c) above applies).

The Regular Method - Schedule SE allows the regular method computation of SE tax in either of two ways--use the Short Schedule SE (page 1 of the form) or the Long Schedule SE (page 2 of the form). Most taxpayers qualify to use the "short" method. Taxpayers required to use the "long" method are:

(a) Individuals whose total wages and tips subject to social security tax plus net SE earnings are more than "maximum subject to tax for the year";

(b) Ministers, members of religious orders, and Christian Science practitioners, who, by IRS consent, pay no SE tax on earnings from these sources but who owe SE tax on earnings from other sources;

(c) Employees receiving wages reported on Form W-2 of $108.28 (.9235 x $108.28 = $100) or more while working for a church electing out of social security taxes;

(d) Taxpayers with tip income subject to social security and Medicare tax that wasn't reported to their employers (the social security tax on this is computed on Form 4137), and

(e) Those who use one of the optional methods to figure SE tax.

Example - SE Tax Under the Regular Method - *Tom received $110,000 net SE income in 2019; he also received $10,000 in wages, which were subject to social security and Medicare taxes. Tom's SE tax is computed as follows:*

(1) Net SE income	*$110,000*	
(2) .9235 x LN1	*$101,585*	
(3) 2019 SS wage base	*132,900*	
(4) Wages	*10,000*	
(5) LN3 minus LN4	*122,900*	
(6) Lesser of LN2 or LN5	*101,585*	
(7) LN6 x .124 (social security portion of tax)		*12,596.54*
(8) LN2 x .029 (Medicare portion of tax)		*2,945.97*
Tom's total SE tax (ln 7 + ln 8) for 2019 is	*$15,542.51*	

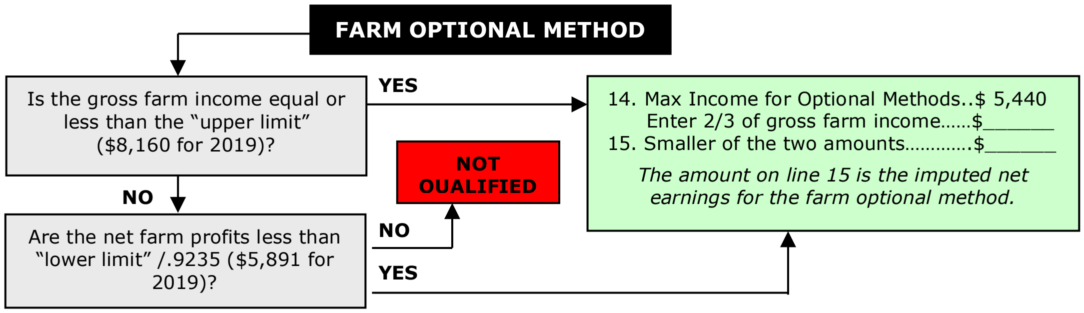
Farm and nonfarm optional methods - Use of these methods allows a taxpayer to continue SE tax coverage even in years when profits are small (or even when there is a loss). A taxpayer who uses one of the optional methods for figuring SE tax also uses the resulting imputed income when calculating the credit for child and dependent care expenses and the earned income tax credit. The "lower limit" and the "upper limit" for the optional methods are shown to the right:

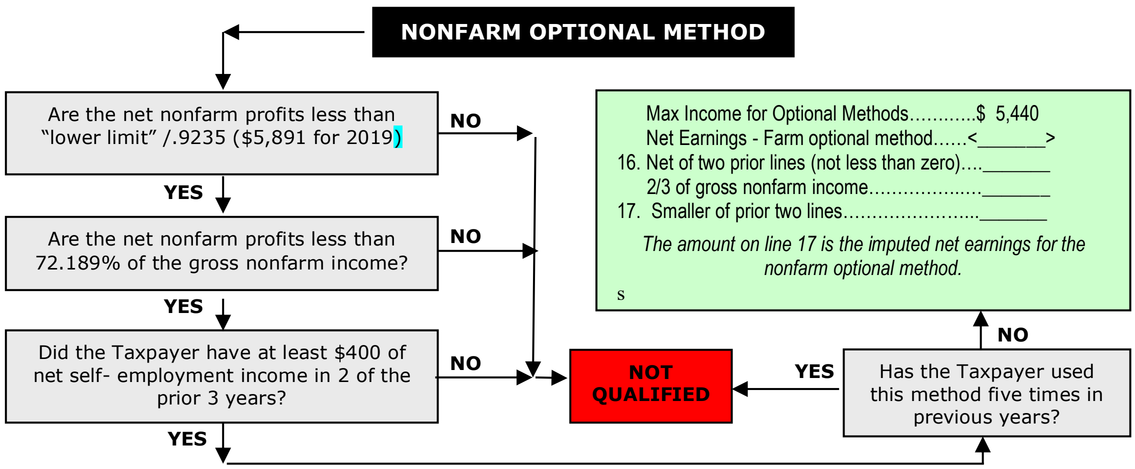
Year	2017	2018	2019	2020
Lower Limit	$5,200	$5,280	$5,440	
Upper Limit	$7,800	$7,920	$8,160	

If values not shown they were not available at publication date.

Note: *The lower limit is determined by multiplying the minimum earnings for a quarter's Social Security coverage (see chapter 2.03) by four. Thus for 2019 the lower limit is $5,440 ($1360 x 4). The upper limit is determined by multiplying the lower limit by 1.5 resulting in an upper limit for 2019 of $8,160 ($5,440 x 1.5).*

The following flow charts detail the qualifications for each method and the computations for both. The two optional methods can be applied in unison.





<u>SE TAX DEDUCTION</u>: A taxpayer can deduct one-half of the SE tax computed on Schedule SE for the year as a business expense that is deducted as an adjustment to gross income on Form 1040, Schedule 1, part II, line 14 of draft 2019 form. This deduction has no effect on the computation of net SE income or on the computation of SE tax.

Example: *Joshua's net self-employment income for 2019 is $130,000. He has no wage income. His combined SE and Medicare taxes total $18,369, and he is entitled to an above-the-line SE Tax deduction of $9,185, computed as follows:*

1. SE Income $130,000			
2. Line 1 times 92.35%	*120,055*		
3. Medicare tax Ln2 x 2.9%		*$ 3,482*	
4. Max. income for SE tax	*132,900*		
5. Smaller of Ln2 or Ln 4	*120,055*		
6. Line 5 times 12.4%		*<u>14,887</u>*	
7. Total SE & Medicare tax		*18,369*	
8. Line 7 times 50% = above-the-line SE Tax deduction			*$9,185*

<u>SPECIFIC SE ISSUES</u>

- ***Miscellaneous Income from an occasional act or transaction*** – Income from an occasional act or transaction, absent proof of efforts to continue those acts or transactions on a regular basis, isn't income from self-employment subject to the SE tax. (Rev Rul 58-112, 1958-1 CB 323; Rev Rul 55-431, 1955-2 CB 312; Rev Rul 55-258, 1955-1 CB 433) Regularity of activity, frequency of transactions, and the production of income are key elements in determining whether an activity will be considered a trade or business for SE tax purposes. Income from an occasional act or transaction, without proof of efforts to continue on a regular basis, may not be income from self-employment. In ***Langford, TC Memo 1988-300,*** an assistant professor who co-authored a textbook without any obligation to work on later revisions was found not to have trade or business income from the activity. Even though the professor did ultimately revise the book, he was not subject to SE tax.

- ***Notary public -*** The fees for the services of a ***notary public are exempt from the self-employment tax.*** However, the taxpayer has to prove the income came from notary public services. Merely having a notary seal isn't enough; the taxpayer must produce records of his or her notary public business or other evidence to show he or she isn't subject to the self-employment tax.

- ***Nonresident aliens and SE tax*** - Nonresident aliens don't pay self-employment tax. Residents of the Virgin Islands, Puerto Rico, Guam, or American Samoa, however, are subject to the tax. Nonresident and resident aliens employed in the U.S. by an international organization, a foreign government, or a wholly-owned instrumentality of a foreign government are not subject to SE tax. See also Chapter 6.03.

- ***Executors and administrators (fiduciaries)*** - A person who administers the estate of a deceased person (i.e., the fiduciary) is subject to SE tax if: (a) the person is a professional fiduciary; (b) the person is a nonprofessional fiduciary who manages an estate that includes an active trade or business. Nonprofessional fiduciaries are generally not treated as receiving income from a trade or business unless all of the following are met:
  - There is a trade or business among the assets of the estate.
  - The fiduciary actively participates in the operation of this trade or business.
  - The fees of the fiduciary are related to the operation of the trade or business.

  Example – Nonprofessional Executor - *Taxpayer, a nonprofessional fiduciary, is co-executor of an estate that includes a trade or business and is totally unfamiliar with the operation of the business and leaves the management of the business entirely in the hands of his co-executor. The fees received by the taxpayer aren't earnings from self-employment. (Rev Rul 58-5, 1958-1 CB 322)*

  Example – Managing a business - *A nonprofessional fiduciary receives a fee of $10,000 for acting as executor of an estate. The estate includes a business that the taxpayer manages during the period of administration. Under local law, an executor is entitled to a commission based on a percentage of the value of the assets. Based on the statutory allowance, the taxpayer would have been entitled to a commission of $7,500. However, the probate court allowed, and the taxpayer was paid, a commission of $10,000.*

  Since the statutory commission of $7,500 was attributable to the normal fiduciary duties, it isn't treated as income from a trade or business. The remaining $2,500 is treated as attributable to the operation of the estate's business and thus treated as self-employment income. (Rev Rul 58-5, 1958-1 CB 322)

  Example – Conservator nonbusiness assets *- A surviving spouse, on the death of her husband, was appointed successor conservator of the estate of a friend who was unable to manage her financial affairs. The estate consists solely of a residence occupied by the friend and income producing stocks, bonds, and depository cash accounts. IRS privately ruled that since the services provided by the surviving spouse as conservator didn't relate to any trade or business of the estate, a monthly allowance paid to the taxpayer-conservator wasn't self-employment income. (IRS Letter Ruling 8928030)*

  Example – Executor and Beneficiary *- A surviving spouse who operated a community property oil and gas lease as executrix of her husband's estate wasn't liable for self-employment tax on any part of the income from the lease, since she was the sole beneficiary of the estate. Beneficiaries don't realize self-employment income on business carried on by the estate. (Huval, Louisa, (1985) TC Memo 1985-568, PH TCM ¶85568, 50 CCH TCM 1452)*

- **Fiduciary of an estate on an isolated basis** - Those who serve in the capacity of fiduciary of an estate on an isolated basis (e.g., a friend or relative of the decedent) are not generally subject to SE tax on the fees they receive for their services.

- **Commissions allowed by the probate court** - Commissions allowed by the probate court under local law aren't considered self-employment earnings, but any excess is, on the ground that it represents a special payment for operating the business. *Rev Rul 58-5, 1958-1 CB 322*

- ***Limited Partners -*** A limited partner's share of partnership income is not subject to SE tax. IRS proposed regs define who are considered limited partners. The regs apply to all entities classified as partnerships for Federal tax purposes. Generally, an individual partner is treated as a limited partner unless he/she:
  - Has personal liability as a partner for debts of the partnership or claims against it;
  - Has authority to contract on the partnership's behalf under the law which the partnership is recognized; or
  - Participates in the partnership's trade or business for more than 500 hours during the tax year. If the partnership involved is a service partnership, anyone who provides more than de minimis amount of service isn't a limited partner.

- ***Newspaper vendors*** - The income newspaper vendors receive for selling newspapers directly to customers for a profit is not SE income if the vendor is under age 18; for those age 18 and over, it is SE income.

- ***Conservation Reserve Program Payments*** - Excluded from self-employment income are any Conservation Reserve Program payments made to individuals who are receiving Social Security retirement or disability payments.

- ***Corporate payments*** - Fees received for performances of services as a director of a corporation, including director meeting attendance, are SE income. A shareholder's portion of an S corporation's taxable income is not SE income.

- ***Partners*** - If a taxpayer is a member of a partnership that carries on a trade or business, his/her distributive share of the partnership's income is SE income. Guaranteed payments from the partnership should be included in net earnings from self-employment (in addition to the pass-through income for the year, if the partner is a general partner).

- ***Religious exemptions*** - Ministers, Christian Science practitioners, and members of religious orders who haven't taken a vow of poverty may get an exemption from self-employment tax on their earnings if certain requirements are met. To get the exemption, Form 4361 must be filed.

- ***Spouses May Elect Out of Partnership Rules -*** A husband and wife who file a joint return may elect out of the partnership rules. Thus, a joint venture between them is not treated as a partnership for tax purposes. ***(Code Sec. 761(f); Code Sec. 1402(a)(17))*** When this election is made, each spouse then files a Schedule C with their portion of the business' income and expenses, and each would be subject to SE tax. For more detail see Chapter 3.00.

- ***SE tax for termination payments of former insurance salespeople -*** The law provides that net earnings from self-employment don't include any amounts received from an insurance company for services performed by an individual as an insurance salesperson for the company if:
    1. The amount is received after the individual's agreement to perform services for the company ends;
    2. The person performs no services for the company after the agreement terminates and before the end of the tax year,
    3. A condition of the payments is that the salesperson does not compete with the company for at least one year after the end of the agreement, and
    4. The amount of the payment depends primarily on:
        - Policies sold by (or credited to the account of) the salesperson during the last year of the agreement, and/or
        - The extent to which the policies remain in force for some period after the agreement ends.

    The amount of payment can't depend on the length of service or overall earnings from services performed for the company. However, eligibility for payment can depend on length of service and/or overall earnings.

- ***Agricultural co-op payments to retired farmers*** – Although retired from daily farming activities, taxpayers who are still contractually obligated to supply an agricultural commodity to the agricultural cooperative of which they remain members are considered to be in a trade or business of producing, marketing, processing and selling the commodity. The "value-added" payments received from the co-op are subject to self-employment tax ***(Richard J. Bot, CA 8, 12/22/2003 92 AFTR 2d 2003-7385).***

- ***Rents paid in crop shares*** - are not subject to SE tax unless paid under an arrangement where the landowner (or tenant) materially participates in crop production or controls and directs the farming operation and pays the farmer at a fixed rate as his employee ***(Reg § 1.1402(a)-4(b))***.

- ***Real estate rental income*** – Rent from real estate and personal property leased with that real estate is not SE income if no services are provided with the rental. Rents received from a hotel or motel are considered SE income because services (e.g., maid service) are generally provided for the occupants. If substantial services are provided, the income is subject to SE tax. "Substantial" means that part of the rent is actually payment for services. For example, hotels, boarding houses, apartments which furnish hotel services, tourist homes or storage garages. ***(Reg 1.1402(a)-4(c)(2))***

- ***Trailer Park Owner - Rev Rule 83-139, CB 1983-2 150 -*** Monthly income of a trailer park owner who provided ***insubstantial services*** for tenants was not subject to SE tax. Provided were lots, a laundry facility, city sewer, and roadway to park. Owner cleaned and maintained premises daily and furnished hot water in the laundry. However, the ruling points out that an owner who provides additional services like a recreation hall, card area, pool room, kitchen, auditorium, stage and library would be subject to SE tax on income.

- *Fishing Crew Member - (Anderson, TC)* - In a case of first impression, the Tax Court held that a member of a fishing boat crew was self-employed because he was compensated solely from the proceeds of the sale of the boat's catch, even though operating expenses were subtracted from the proceeds before the crew's compensation was determined.

The taxpayer argued that the subtraction of the owner's expenses cause him to be classified as an employee due to the requirement in Reg. §31.3121(b)(20)-1(a) that a self-employed crew member's compensation must depend "solely" on the sales proceeds. However, Code Sec. 3121(b)(20) and its accompanying regulations reflected the tradition of compensating crew members with share of the profits from the sale of the catch. The history of the fishing industry, the relevant legislative history, the preamble and example contained in the regulation, and a logical and practical interpretation of the statute all indicated that "proceeds" refers to net proceeds after the subtraction of operating expenses, rather than the gross proceeds from the sale. A crew member qualifies as an employee only if the member is compensated with something other than a share of the catch, such as an hourly wage or a flat fee in excess of $100 for certain types of work.

- ***Income excluded under the foreign earned income exclusion*** - Even if excluded, if the income is for a self-employed person, it is subject to SE tax.
- ***Earnings passed through from an S corporation shareholder*** – This is not considered self-employment income. However, one case upheld the IRS assertion that dividends were subject to payroll taxes because the attorneys who owned the S corp. didn't take salaries. **IMPORTANT:** Active shareholders need to take a "reasonable salary," which of course, would be subject to FICA withholding. See Chapter 3.29 for more on reasonable compensation.
- ***Statutory Employees*** - Income received as an employee or statutory employee is not considered self-employed income.
- ***Taxpayer's Child Employee*** - A child under the age of 18, employed in their parent's unincorporated business, is not subject to FICA/Medicare payroll taxes and is not considered self-employed for purposes of SE tax (no social security tax is owed).

  A similar exemption applies for FUTA, which exempts earnings paid to a child under age 21 while employed by his or her parent.

  Note that there is no FICA or FUTA exemption for employing a child if the business is incorporated or a partnership that includes nonparent partners.

- **Misclassified as an independent contractor** – Where taxpayers feel they were incorrectly treated as independent contractors instead of employees and find themselves subject to a significant SE tax, they can file the Form SS-8 – "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding" – and see if they can get a determination letter from the IRS stating they are employees. (Of course, filing the SS-8 will not make the employer very happy.)

  Until a determination is made in their favor, they still have to pay the SE tax and amend for a refund when and if they receive a favorable opinion. Once the determination letter is in hand, a taxpayer can file an amended return to add Form 8919 (and the employee's share of the FICA taxes) and delete Schedule SE and the SE tax, resulting in a net refund equal to the employer's share of the SE tax. **Caution:** The client should file the SS-8 promptly as it does not extend the statute of limitations, and should the statute expire before the determination, there is no other recourse. The client should also be aware that filing the SS-8, especially if the IRS determines employee status, could result in "burning a bridge" with that employer.

- **Short Term Rentals & SE Tax –** Profit from a rental activity that is reported on Schedule E is not subject to self-employment (SE) tax. But what about short-term rentals reported on Schedule C – are they subject to SE tax? Even though Pub 527, Page 12, indicates taxpayers "may" have to pay self-employment tax on short-term rental income, the "may" applies to real estate dealers. To quote Pub 334, "You are a real estate dealer if you are engaged in the business of selling real estate to customers with the purpose of making a profit from those sales. Rent you receive from real estate held for sale to customers is subject to SE tax. However, rent you receive from real estate held for speculation or investment is not subject to SE tax." (IRC Sec 1402(a)(1))

CALIFORNIA DIFFERENCES

California has no equivalent tax. Nonetheless, California allows 50% of the SE tax to be claimed as an adjustment to gross income.

NOTES

MARGINAL TAX RATES

FEDERAL BRACKETS: The federal marginal tax brackets are annually adjusted for inflation. The historical table below indicates the end value for each bracket.

Filing Status		Single	HH	Joint	MS
2020	10.0%	9,875	14,100	19,750	9,975
	12.0%	40,125	53,700	80,250	40,125
	22.0%	85,525	85,500	171,050	85,525
	24.0%	163,300	163,300	326,600	163,300
	32.0%	207,350	207,350	414,700	207,350
	35.0%	516,400	518,400	622,050	311,025
	37.0%				
2019	10.0%	9,700	13,850	19,400	9,700
	12.0%	39,475	52,850	78,950	39,475
	22.0%	84,200	84,200	168,400	84,200
	24.0%	160,725	160,700	321,450	160,725
	32.0%	204,100	204,100	408,200	204,100
	35.0%	510,300	510,300	612,350	306,175
	37.0%				
2018	10.0%	9,525	13,600	19,050	9,525
	12.0%	38,700	51,800	77,400	38,700
	22.0%	82,500	82,500	165,000	82,500
	24.0%	157,500	157,500	315,000	157,500
	32.0%	200,000	200,000	400,000	200,000
	35.0%	500,000	500,000	600,000	300,000
	37.0%				
2017	10.0%	9,325	13,350	18,650	9,325
	15.0%	37,950	50,800	75,900	37,950
	25.0%	91,900	131,200	153,100	76,550
	28.0%	191,650	212,500	233,350	116,675
	33.0%	416,700	416,700	416,700	208,350
	35.0%	418,400	444,550	470,700	235,350
	39.6%				

FEDERAL MARGINAL TAX RATES: For the past few years, various Tax Acts altered the marginal tax rates from year to year. The table below summarizes the rates for the last 20+ years.

Tax Year	Federal Marginal Tax Rates						
94-00	N/A	15.0	28.0	31.0	36.0	39.6	
2001	Credit	15.0	27.5	30.5	35.5	39.1	
2002	10.0	15.0	27.0	30.0	35.0	38.6	
2003 – 2012	10.0	15.0	25.0	28.0	33.0	35.0	
2013 - 2017	10.0	15.0	25.0	28.0	33.0	35.0	39.6
2018 – 2025 (?)	10.0	12.0	22.0	24.0	32.0	35.0	37.0

<u>**BRACKETS**</u>**:** The California marginal tax brackets are annually adjusted for inflation. The historical table below indicates the <u>end value for each bracket</u>.

CAUTION - Mental Health Services Tax – A 1% additional Mental Health Services tax applies to all of the taxpayer's taxable income in excess of $1,000,000. This tax cannot be reduced by any tax credits other than the excess SDI credit.

Filing Status		Single/MS	HH	Joint
2019	1.00%			
	2.00%			
	4.00%			
	6.00%			
	8.00%			
	9.30%			
	10.30%			
	11.30%			
	12.30%			
2018	1.00%	8,544	17,099	17,088
	2.00%	20,255	40,512	40,510
	4.00%	31,969	52,224	63,938
	6.00%	44,377	64,632	88,754
	8.00%	56,085	76,343	112,170
	9.30%	286,492	389,627	572,984
	10.30%	343,788	467,553	687,576
	11.30%	572,980	779,253	1,145,960
	12.30%			
2017	1.00%	8,223	16,457	16,446
	2.00%	19,495	38,991	38,990
	4.00%	30,769	50,264	61,538
	6.00%	42,711	62,206	85,422
	8.00%	53,980	73,477	107,960
	9.30%	275,738	375,002	551,476
	10.30%	330,884	450,003	661,768
	11.30%	551,473	750,003	1,102,946
	12.30%			
2016	1.00%	8,015	16,040	16,030
	2.00%	19,001	38,003	38,002
	4.00%	29,989	48,990	59,978
	6.00%	41,629	60,630	83,258
	8.00%	52,612	71,615	105,224
	9.30%	268,750	365,499	537,500
	10.30%	322,499	438,599	644,998
	11.30%	537,498	730,997	1,074,966
	12.30%			

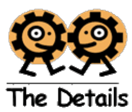
Strategy – To avoid the additional 1% Mental Health tax! Married taxpayers filing separately have the same threshold ($1,000,000) for the application of the 1% additional tax as any other filing status. Thus, a married couple with a taxable income in excess of $1,000,000 could file separately and eliminate or reduce this extra tax. **CAUTION** – Prepare and compare the results of the married separate and joint returns before making a final decision. There are other factors pertaining to married separate returns that could outweigh the savings. Generally, to file MFS for California, the MFS status also must be used for federal.

FARMERS & FISHERMEN INCOME AVERAGING

- Shift **current year's** farm or fishing income **to three prior (base) years**.
- Need not have been in the farming or fishing business in any of the "base" years
- **Includes all income**, gains, losses, and deductions **attributable to any farming or fishing business**
- All of the taxable income from farming or fishing need not be included
- Different filing status in different years OK.

RAPID FINDER	
AMT	8.05.01
Crewmembers	8.05.02
Farming Business	8.05.01
Filing Status	8.05.02
Fishing Business	8.05.01
Lessor, Vessel	8.05.02
Limitations	8.05.02
Liquidation	8.05.02
Property Sales	8.05.02
Rental, Farm	8.05.02
Taxable Income	8.05.02
Vessel	8.05.02
Who Can Use	8.05.01

Related IRC and IRS Publications and Forms
- **Pub 225** – Farmer's Tax Guide
- **Schedule J (1040)** – Income Averaging for Farmers and Fishermen
- **IRC Sec 1301**



A taxpayer engaged in a farming or fishing business may be able to average all or some of the current year's farm or fishing income by shifting it to the 3 prior years (base years).

<u>WHO CAN USE FARM OR FISHING INCOME AVERAGING</u>:

A taxpayer can elect to use farm or fishing income averaging if, in the year of the election, they are engaged in a farming or fishing business as an individual, a partner in a partnership, or a shareholder in an S corporation. They do not need to have been engaged in a farming or fishing business in any base year. Corporations, partnerships, S corporations, estates, and trusts cannot use this averaging method.

<u>DEFINITIONS:</u>

Farming Business - A farming business is the trade or business of cultivating land or raising or harvesting any agricultural or horticultural commodity. A farming business **INCLUDES**:
- Operating a nursery or sod farm;
- Raising or harvesting of trees bearing fruits, nuts, or other crops;
- Raising ornamental trees (but not evergreen trees that are more than 6 years old when severed from the roots);
- Raising, shearing, feeding, caring for, training, and managing animals; and
- Leasing land to a tenant engaged in a farming business, but only if the lease payments are based on a share of the tenant's production and not on a fixed amount.

A farming business **DOES NOT INCLUDE**:
- Contract harvesting of an agricultural or horticultural commodity grown or raised by another, or
- Merely buying or reselling plants or animals grown or raised by another.

Fishing Business - Fishing business is defined in section 1301(b)(4) as the conduct of commercial fishing as defined in section 3 of the Magnuson-Stevens Fishery Conservation and Management Act (Magnuson-Stevens Act), 16 U.S.C. 1802. The Magnuson-Stevens Act defines commercial fishing as fishing in which the fish harvested are intended to or do enter commerce through sale, barter, or trade. 16 U.S.C. 1802(4). Fishing is defined as the catching, taking, or harvesting of fish; the attempted catching, taking, or harvesting of fish; activities that reasonably can be expected to result in the catching, taking, or harvesting of fish; or any operations at sea in support of, or in preparation for, the catching, taking, or harvesting of fish. Fishing does not include any scientific research activity conducted by a scientific research vessel.

- **Fish** - is defined as: finfish, mollusks, crustaceans, and all other forms of marine animal and plant life, other than marine mammals and birds.

<u>OTHER ISSUES:</u>

AMT - The farm or fishing averaging cannot reduce the tax below the alternative minimum tax.

Farming Rental Income - The rental income of a landlord that is based on a share of a tenant's production is subject to fluctuations in the farm economy to the same extent as that of a farmer. Therefore, a landlord is engaged in a farming business if this arrangement is established in a written agreement before the tenant begins significant activities on the land.

Lessor of a Vessel - Regulations provide that a lessor of a vessel is engaged in a fishing business within the meaning of section 1301(b)(4) if the payment due to the lessor under the lease is based on a share of the lessee's catch (or a share of the proceeds from the sale of the catch) and the lease is a written agreement entered into before the lessee begins significant fishing activities resulting in the shared catch. A fixed lease payment is not eligible for income averaging.

Crewmembers - The income of crewmembers on vessels engaged in fishing also is subject to fluctuations in the fishing economy if the crewmembers' compensation is based on a share of the vessel's catch of fish or a share of the proceeds from the sale of the catch. Accordingly, the regulations provide that these crewmembers are engaged in a fishing business, whether or not they are treated as employees for employment tax purposes.

Taxable income from farming or fishing - Includes all income, gains, losses, and deductions attributable to any farming or fishing business. However, it does not include gain from the sale or other disposition of land. A taxpayer engaged in both a farming business and a fishing business must combine income, gains, deductions, and losses from both the farming and the fishing businesses to determine the maximum amount of income that is eligible for averaging. Generally, farm or fishing income, gains, losses, and deductions are reported on: Form 1040, line 1 (draft 2019), to the extent of wages and other compensation received as a shareholder in an S corporation engaged in a farming business; Schedule C; Schedule D; Schedule E, Part II**;** Schedule F; Form 4797; and Form 4835 – see Schedule J instructions for other potential income.

Not all income need be included - The elected farm or fishing income (EFI) is the amount of the taxable income from farming or fishing that the taxpayer elects to include. All of the taxable income from farming or fishing need not be included. It may be to the taxpayer’s advantage to include less than the full amount, depending on how the amount included affects the tax bracket for the current and prior 3 tax years.

Additional limitations

- The elected farm or fishing income cannot exceed the taxable income.
- The portion of the elected farm or fishing income treated as a net capital gain cannot exceed the **smaller** of the total net capital gain or the net capital gain attributable to farming or fishing business.
- If the elected farm or fishing income includes net capital gain, the taxpayer must allocate an equal portion of the net capital gain to each of the base years.
- If, for any base year, the taxpayer had a capital loss that resulted in a capital loss carryover to the next tax year, do not reduce the elected farm or fishing income allocated to that base year by any part of the carryover.

FILING STATUS:

Taxpayers are not prohibited from making a farm or fishing income averaging election solely because their filing status is not the same in an election year and the base years.

Example, if the taxpayer is married filing jointly in the election year, but filed as single in all of the base years, he or she may still elect to average farm or fishing income.

GAINS FROM THE SALE OR OTHER DISPOSITION OF FARM OR FISHING PROPERTY:

Gains from the sale or other disposition of farm or fishing property, other than land, can be designated as EFI if the taxpayer (or his/her partnership or S corporation) uses the property regularly for a substantial period in a farming or fishing business. Whether the property has been regularly used for a substantial period depends on all the facts and circumstances.

LIQUIDATION OF A FARMING OR FISHING BUSINESS:

If the taxpayer (or his/her partnership or S corporation) liquidates the farming or fishing business, gains on property sold within a reasonable time after operations cease can be designated as EFI. A period of one year after ceasing operations will be treated as a reasonable time. After that, what is “a reasonable time” depends on the facts and circumstances.

CALIFORNIA DIFFERENCES

California does not have an equivalent computation.

GENERAL BUSINESS CREDIT

Overview

Certain business incentive credits are combined into one "general business credit" for purposes of determining each credit's allowance limitation for the tax year. The general business credit generally is only allowed against the income tax (excluding the tax on self-employment income) for a particular tax year and is subject to an annual limitation based on tax liabilities. However, a taxpayer may use certain specified credits to offset all or part of the alternative minimum tax (AMT). See chapter for appropriate credit. A general business credit may generally be carried back one year and forward twenty years. "Carrying back" means, in most instances, amending the return of the year to which the credit is carried; if a return for that year had not been filed, then the carryback credit would be claimed on an original late-filed return for that year.

Over 40 different credits make up the general business credit. However, for small businesses, the 2019 general business credit is generally made up the following credits:

- Employer-provided child care facilities/services credit under Code Sec. 45F
- Alternative motor vehicles credit (business portion) covered by Code Sec. 30B(g)(1)
- New Qualified plug-in electric drive motor vehicles credit (business portion) NQPEDMVs Code Sec 30D
- 2-wheeled plug-in electric vehicles credit (business portion, carryforward only) QPEVs under Code Sec 30D
- The energy efficient home credit determined under Code Sec. 45L
- Employer social security credit under Code Sec. 45B(a)
- Indian employment credit under Code Sec. 45A
- Employee retention credit for employers affected by various hurricanes and disasters (carryforward only)
- Differential wage payment credit (for compensation paid to active duty military personnel)
- Small employer pension plan startup cost credit under Code Sec. 45E
- Small employer health insurance credit under Code Sec. 45R
- Building rehabilitation investment credit under Code Sec. 46
- Business energy investment credit for solar, geothermal, etc., under Code Sec. 46
- Work opportunity credit under Code Sec. 51(a)
- Research Credit Code Sec 41
- Disabled Access Credit Sec 44
- Family and Medical Leave Credit under Sec 45S

TCJA

Family and Medical Leave Credit (FAMLC) – Added by the TCJA, the FAMLC is available to eligible employers only for years 2018 and 2019. See chapter 9.17 for details.

Pubs

Forms

Related IRS Forms & Publications

- **Form 3800** – General Business Credit
- **Instructions for Form 3800**, General Business Credit

The Details

Limitation on general business credit based on tax liability - The general business credit (except for certain specified credits and the amount attributable to the sum of current year, carryforward and carryback credit amounts) for any tax year is subject to a limitation that is based on the taxpayer's tax liability. The credit must not exceed the excess (if any) of the taxpayer's "net income tax" (generally, the taxpayer's regular income tax and alternative minimum tax (AMT), reduced by most non-refundable credits other than the general business credit) over the greater of: (a) the taxpayer's "tentative minimum tax" for the tax year or (b) 25% of so much of the taxpayer's "net regular tax liability" as exceeds $25,000 ($12,500 for taxpayers filing married separate).

General carryback and carryover provisions – Unused credits can be carried back 1 year and forward 20 years.

Refer to Section 9 in the text for details related to each credit.

CREDITS MUST BE USED IN A SPECIFIC ORDER

When relevant, the components of the general business credit reported on Form 3800 arising in a single tax year are used in the following order.

- Investment credit (in the following order—
  - Rehabilitation credit,
  - Energy credit,
  - Qualifying advanced coal project credit,
  - Qualifying gasification project credit, and
  - Qualifying advanced energy project credit) (Form 3468).
- Qualifying therapeutic discovery project credit (carryforward only).
- Work opportunity credit (Form 5884).
- Biofuel producer credit (Form 6478).
- Credit for increasing research activities (Form 6765).
- Low-income housing credit (Form 8586, Part I only).
- Enhanced oil recovery credit (Form 8830).
- Disabled access credit (Form 8826).
- Renewable electricity, refined coal, and Indian coal production credit (Form 8835).
- Empowerment zone employment credit (Form 8844).
- Renewal community employment credit (carryforward only).
- Indian employment credit (Form 8845).
- Employer social security and Medicare taxes paid on certain employee tips (Form 8846).
- Orphan drug credit (Form 8820).
- New markets credit (Form 8874).
- Credit for small employer pension plan startup costs (Form 8881).
- Credit for employer-provided child care facilities and services (Form 8882).
- Qualified railroad track maintenance credit (Form 8900).
- Biodiesel and renewable diesel fuels credit (Form 8864)
- Low sulfur diesel fuel production credit (Form 8896).
- Credit for oil and gas production from marginal wells (Form 8904).
- Distilled spirits credit (Form 8906).
- Nonconventional source fuel credit (carryforward only).
- Energy efficient home credit (Form 8908).
- Energy efficient appliance credit (carryforward only).
- Alternative motor vehicle credit (Form 8910).
- Alternative fuel vehicle refueling property credit (Form 8911).
- Mine rescue team training credit (Form 8923).
- Agricultural chemicals security credit (carryforward only).
- Credit for employer differential wage payments (Form 8932).
- Carbon oxide sequestration credit (Form 8933).
- Qualified plug-in electric drive motor vehicle credit (Form 8936).
- Qualified plug-in electric vehicle credit (carryforward only).
- Credit for small employer health insurance premiums (Form 8941).
- Employee retention credit (Form 5884-A).
- Employer credit for paid family and medical leave (Form 8994).
- General credits from an electing large partnership (Schedule K-1 (Form 1065-B))

CALIFORNIA DIFFERENCES

The general business credits discussed in this chapter do not apply to California. See chapter 9.50 for a discussion of California Credits.

NOTES

CHILD & DEPENDENT CARE

- **Maximum Expense Limit** - $3,000 for one and $6,000 for two or more qualifiers.
- **Earned Income Limit –** Expenses limited to earned income.
- **Disabled or Full Time Student Monthly Imputed Income -** $250 for one; $500 for two or more qualifiers.
- **AGI Limitation –** 35% to 20% credit (see table)
- **AGI over $43,000 –** credit percentage equals 20%
- **Employer dependent care plans –** reduces qualified expenses
- **Married taxpayers must file jointly**
- **Qualifier**
  - Child under 13 (i.e., take credit for expenses up to date child turns 13);
  - A spouse or person - physically or mentally disabled lived with the taxpayer more than half the year (see details for more qualification rules);
- **Non-refundable, No carryover**
- **School Expenses** – under kindergarten
- **Day camps** – generally ok
- **Absences or part time employment** – prorate expenses.

RAPID FINDER

Related IRC and IRS Publications and Forms

- **Pub 503** – Child and Dependent Care Expenses
- **Form 2441** - Child and Dependent Care Expenses
- **Form W-10** – Dependent Care Provider's ID and Certification
- **IRC Sec 21** - Expenses for Household and Dependent Care Services Necessary for Gainful Employment
- **IRC Sec 129 –** Dependent Care Assistance Programs

A nonrefundable tax credit is available to some taxpayers for the expenses they incur for the care of a child, spouse, or other dependent while the taxpayer is gainfully employed (or is job seeking). In addition, employer dependent care assistance programs allow employees to exclude from income certain payments expended for child and dependent care. Tax return reporting is done on Form 2441, Child and Dependent Care Expenses.

EARNED INCOME LIMIT – The expenses allowable in computing the credit are limited to earned income. Generally, only taxable compensation is included in earned income. A taxpayer can elect to include nontaxable combat pay in earned income for dependent care credit purposes even if he chooses not to include it in earned income for purposes of the earned income credit or the exclusion for dependent care benefits. For taxpayers who file joint returns, the expense is limited to the EARNED INCOME of the lower paid spouse. Self-employed taxpayers use NET EARNINGS on Schedule C as earned income, even if the net is less than $400. Self-employed individuals who choose the optional method to figure self-employment tax may use the imputed income figured for the optional method as the amount of earned income.

Split Schedule C Strategy - When both spouses in a married couple are involved in the operation of an unincorporated business, it is fairly common – but incorrect – for all of that business's income to be reported on one spouse's Schedule C. In this case, the spouse not filing a Schedule C loses out on the chance to accumulate his or her own eligibility for Social Security benefits. In addition, to claim a child care credit, both spouses on a joint return must have earned income (or imputed income if one of the spouses is a full-time student or is disabled), so unless the non-Schedule C spouse has another source of earned income, the couple will not be allowed a child care credit.

There are ways to remedy this situation, however. One option is to file a partnership return for the activity, with each spouse receiving a K-1 for his or her share of the net profit. An approach that is probably less complicated is a qualified joint-venture election in which each spouse elects to file a separate Schedule C for his or her respective share of the business, giving them both self-employed income for the purposes of the self-employment tax and for claiming the child care credit.

A qualified joint venture refers to any joint venture involving the conduct of a trade or business if:

(1) The only members of the joint venture are husband and wife,
(2) Both spouses materially participate in the trade or business, and
(3) Both spouses elect to apply this rule.

Generally, to meet the material participation requirement, each spouse will have to participate in the activity for 500 hours or more during the tax year (Code Section 761(f)(2)(B)).

OBSERVATION: If the net income from the business exceeds the annual cap on income subject to the Social Security tax, the combined self-employment tax for the spouses with split Schedule Cs will exceed what a single spouse would have paid if he or she had filed a single Schedule C. In addition, when filing split Schedule Cs, be aware of the different allocation of income for purposes of retirement plans and the opportunity for both spouses to participate in IRAs and SE Retirement Plans.

THE COMPUTATION AND CREDIT LIMITS - The maximum expense limit is:

For one qualified person	$3,000
For two OR MORE qualified people	$6,000

- ***Limitation May Be in Unequal Proportions*** - The total amount of employment-related expenses that do not exceed the annual dollar limitation may be taken into account although the amount of employment-related expenses attributable to one qualifying individual exceeds 50 percent of the limitation. For example, a taxpayer with expenses of $4,000 for one qualifying individual and $1,500 for a second qualifying individual may take into account the full $5,500. *(Reg. 1.21-2(a)(3), IRS 2018 Form 2441, Instructions Page 3)*

  What comes as a surprise to many is that when there are 2 or more qualifying children, the $6,000 cap will apply to the expenses of all the qualifying children as a whole even if the expenses exceed $3,000 for any one of them.

  If you have been unaware of the application of the $6,000 expense limit in the past, as many are, and arbitrarily only entered expenses up to $3,000 for any one child or failed to enter a qualifying child simply because that child did not have any care expenses, you may have incorrectly limited your client's child care credit. If so, you may wish to review your returns that included child care credits to see if amended tax returns are in order.
- **Limit reduced by employer-provided dependent care assistance plans** - The limit must be reduced by the amount a taxpayer excludes from gross income under an employer-provided dependent care assistance plan (see more on this later in the chapter).
- **Tax year of credit -** Regardless of the taxpayer's method of accounting, the credit is allowable only in the tax year the services are provided or the tax year the expenses are paid, whichever is later.

AGI Adjusted Applicable Percentage

AGI Over	But Not Over	Applicable Percent	AGI Over	But Not Over	Applicable Percent
0	15,000	35	29,000	31,000	27
15,000	17,000	34	31,000	33,000	26
17,000	19,000	33	33,000	35,000	25
19,000	21,000	32	35,000	37,000	24
21,000	23,000	31	37,000	39,000	23
23,000	25,000	30	39,000	41,000	22
25,000	27,000	29	41,000	43,000	21
27,000	29,000	28	43,000	No Limit	20

REQUIREMENTS FOR THE CREDIT

- **Principal Place of Abode** - A qualifying individual must have the same principal place of abode as the taxpayer for more than half of the tax year.
- **Qualifying Individual** - A "qualifying individual" can be any of the following:
  1. A qualifying child who is the taxpayer's ***dependent and who is under age 13*** when care is provided;
  2. The taxpayer's spouse who was physically or mentally not able to care for himself or herself and lived with the taxpayer for more than half the year;
  3. A person who was physically or mentally not able to care for himself or herself, lived with the taxpayer for more than half the year, and either:
     a. Was the taxpayer's dependent, or
     b. Would have been the taxpayer's dependent except that:
        i. He or she received gross income of $4,200 (2019) or more,
        ii. He or she filed a joint return, or
        iii. The taxpayer, or the taxpayer's spouse if filing jointly, could be claimed as a dependent on someone else's return.
  4. The qualifying individual's name and social security number are required to be shown on Form 2441.
- **Special rule for children of separated or divorced parents** - In the case of a child of divorced or separated parents, only the custodial parent may claim the credit, even if the non-custodial parent may claim

the dependency for that child under Code Sec. 152(e). This is the case even if the custodial parent has waived the child's dependency to the non-custodial parent. Even if the child resides with the non-custodial parent for part of the year, the non-custodial parent is not eligible for any child care credit. Regulations define a custodial parent as the parent with whom a child shares the same principal place of abode for the greater portion of the calendar year. *(Reg. Sec. 1.21-1(b)(5)(ii))*

- **Definition of marital status -** The credit is not allowed for taxpayers who are married unless they file a joint return. Taxpayers who are separated under a decree of divorce or separate maintenance are not married for purposes of the child care credit.

QUALIFYING EXPENSES

Expenses are employment-related only if they are incurred to enable the taxpayer to be gainfully employed, or actively searching for gainful employment, and the expenses are for household services or for the care of a qualifying individual.

- **School Expenses** – Only school expenses for a child **below the level of kindergarten** are for the care of a qualifying individual, and may be employment-related.
- **Day Camp** - Expenses for day camp may be for the care of a qualifying individual, even if the camp specializes in a particular activity. Additionally, the cost of transportation provided by a dependent care provider may be an employment-related expense.
- **Part-Time Employment** - Taxpayers who work part-time must allocate expenses between days worked and days not worked. However, if a taxpayer who works part-time is required to pay for dependent care on a periodic basis that includes days worked and days not worked, the taxpayer is not required to allocate the expenses.
- **Payments to related individuals** - *A* credit is not allowed for any amount paid by the taxpayer to the taxpayer's spouse or the parent of the taxpayer's child who is a qualifying individual.
- **Agency and Application Fees** - The regulations clarify that indirect expenses such as application and agency fees may be employment-related expenses if the taxpayer is required to pay the expenses to obtain the care. Forfeited deposits do not qualify. *(Reg. Sec. 1.21-1(d)(11))*

SPECIAL SITUATIONS

- **Summer School, Tutoring, Day Camp**
    - Costs of summer school and tutoring programs are not qualifying employment-related expenses because they are educational in nature.
    - The rule that a dependent care center must comply with applicable state and local laws also applies to a day camp where more than six persons are cared for in return for a fee.
    - A day camp or similar program may constitute a qualifying employment-related expense, even though the camp specializes in a particular activity, such as soccer or computers.
        - The full amount paid for an education day camp that focuses on reading, math, writing, and study skills may be a qualifying expense.
        - No portion of the cost of an overnight camp is an employment-related expense.
- **Care Centers for Sick Children –** The IRS declined, in final regulations, to specify that payments to sick care centers were a qualifying expense. Instead, the matter is to be determined on a case by case basis as whether the expenses would be employment qualifying or a medical expense.
- **Absence from Work -** Generally, a taxpayer must allocate the cost of care on a daily basis if expenses are paid during a period in which a taxpayer is not employed or in active search of employment, but there is an exception for short, temporary absences. The final regulations eliminate the requirement that the temporary absence exception only applies to taxpayers who pay for care on a weekly, monthly, or annual basis.
    - Only those costs that a taxpayer is required to pay during the absence (e.g., while ill or on vacation) qualify for the exception.
    - A safe harbor for a short temporary absence is an absence of no more than two consecutive calendar weeks.
    - Cost of care while a taxpayer is on short- or long-term disability leave under the Family Medical Leave Act, paid medical leave, or paid maternity leave are not employment-related expenses.
- **Shift Workers** - Costs of overnight care and day care for parents who work at night and sleep during the day may be qualifying expenses.
- **Kindergarten Expenses -** Kindergarten is considered a non-qualifying educational cost regardless of whether a child attends part-time or full-time. Similarly, qualifying expenses do not include the cost of sending a child to a private school even though the taxpayer lives overseas in a place where public education is unavailable.

- **Live-In Caregivers –** The increase in the cost of utilities attributable to providing room and board to a caregiver may constitute a qualifying expense.
- **Care Outside the Home** - Costs for care outside the taxpayer's household of a qualifying individual who is a dependent or spouse incapable of self-care who regularly spends at least eight hours each day in the taxpayer's household may qualify for the credit.

DISABLED OR FULL-TIME STUDENT SPOUSE

The expenses allowable in computing the credit are limited to earned income of the lower paid spouse. For a disabled or full-time student spouse there is a special "imputed earned income" allowances of $250 per month. Thus, if the spouse qualified for the full 12 months of the year the earned income limit would be $3,000 (12 x $250) months if care is needed for 1 qualifying person and $6,000 (12 x $500) for the care if 2 or more qualifying persons. Any part of a month is treated as a whole month.

Example: *Joyce is a full-time student for 10 months of the year and in order for her to attend college she incurs child care expenses of $5,000 for the care of her dependent daughter. Her husband works full time and has earned income of $60,000. Joyce's dependent care credit is based upon the income of the lower earning spouse and since Joyce does not work and is a full-time student, she must use the imputed income of $250 per month for 10 months or $2,500. Her child care expenses were $5,000 but they are limited to $3,000 for one child. However, in her case the credit is based upon the lesser of the earned income (or imputed income) or the care expenses, which for one child are limited to $3,000. Since the imputed income of $2,500 is less than the $3,000 expense maximum, Joyce's dependent care credit is $500 ($2,500 x .2). The .2 was determine from the table on page 9.01.02 based on the couple's AGI.*

Both Spouses Disabled or a Full-time Student - If both spouses were full-time students or disabled (and not working) in any given month, then only one can be considered to have the imputed income for that month. A part of a month is treated as a whole month.

IMPUTED INCOME FOR DISABLED OR FULL-TIME STUDENT SPOUSE		
Qualifying Persons	One	Two
Imputed Income	$250	$500

Students at On-Line Institutions – In the case of a married taxpayer student the cost of child care while studying on-line at home is NOT a qualified expense for purposes of the deemed income rule. The statute requires that the educational organization have students in attendance at the place where its educational activities are regularly carried on. However, an individual who takes online courses at a school that has traditional classroom instruction as well as on-line course may be a student for purposes of the deemed earned income rule.

CAUTION - FOR CARE IN THE TAXPAYER'S HOME

The "sitter" is considered the taxpayer's EMPLOYEE. The taxpayer may need to pay FICA and file payroll returns; it's possible the IRS will check on this if auditing the credit. Of course, the payroll taxes paid by the taxpayer would qualify as child care expenses if the compensation paid to the provider is a qualified expense.

PROVIDER INFORMATION

Taxpayers claiming this credit must provide the name, address, and identification number of the child or dependent care provider unless the provider is a tax-exempt organization (e.g., a church). If the latter, the notation "tax-exempt" is made on the return instead of the ID number. The IRS may deny the credit when this information is not included on a return. ***Failure of a child or dependent care provider to furnish an ID number to a taxpayer without reasonable cause is subject to a $50 penalty. (Code Section 6109(a))***

Failure to provide the required information on a return can be excused if the taxpayer showed "due diligence." Due diligence is shown by keeping on file a copy of a provider's social security card, driver's license, provider's letterhead or invoice, IRS Form W-10 (Dependent Care Provider's Identification and Certification), Form W-4 (if provider is a household employee), or a statement of employer's dependent care assistance program.

DEPENDENT CARE BENEFITS

Employer Programs - Dependent care assistance programs are those that employers establish by a written plan to provide dependent care assistance for the exclusive benefit of employees. The payments received under the plan and used by employees to pay dependent care expenses are excludable from employees' income up to the lower of:

1. The employee's earned income (for married employees, this is the earned income of the lower paid spouse), or
2. $5,000 ($2,500 for married separate).

Dependent care assistance which exceeds the limits must be included in an employee's income in the year the dependent care is provided even though it is not paid to the employee until later.

Other Rules:

1. Compute the earned income limitation of a spouse who is incapacitated or a full-time student in the same manner as is done under the child care credit rules.
2. When dependent care is provided in-kind on the employer's premises at a facility maintained by the employer, employees using the facility exclude from income the value of the services provided.
3. There is no dependent care assistance exclusion where the care provider is the employee's dependent and/or child under age 19.

Who Is An Employee - For purposes of the exclusion, the term employee includes self-employed individuals (as defined in Code Section 401(c)(1)).

Self-employed individuals as "employees" eligible for the dependent care assistance exclusion - An "employee," for purposes of the dependent care assistance exclusion, includes a self-employed individual who can be covered under a self-employed retirement plan under Code Sec. 401(c)(1).

An advantage of a self-employed individual receiving dependent care assistance as a participant in a dependent care assistance program is that he would be able to deduct the cost of providing this benefit as a business expense. Also, if a self-employed individual provides dependent care facilities under a dependent care assistance program, he would be able to participate without disqualifying the program.

<u>However, if the self-employed individual participates in a dependent care assistance program, he will be taken into account in applying the nondiscrimination tests</u>.

Other Plan Requirements - A dependent care assistance plan must meet various requirements to be effective:

1. No more than 25% of the assistance the plan provides during the year may be paid on behalf of owners (including spouses and dependents) of more than 5% interest in the employer's business;
2. Employers must inform eligible employees about the availability of the plan;
3. Employees must receive a written statement of benefits they received during the year – usually provided on Form W-2;
4. The program cannot discriminate in favor of "highly-compensated" employees or their dependents.

W-2 Reporting of Dependent Care Exclusion Amounts - Form W-2, Box 10 shows the amount of dependent care benefits paid by the employer. The amount should not be included in Box 1 (Wages).

Example of Child Care Credit Computation - *Wage earners Dave and Danielle Drake filed a joint return. Their son, Derrick, and daughter, Darlene, lived with them all year and were their dependents. The children were ages 4 and 11, respectively. Mrs. Drake, an avid jogger, was injured during her morning run in mid-year; she required constant nursing care during July and August because of her injury. She was absent from her employment for that entire period. Other facts are:*

Dave's wages		*$26,200*
Danielle's wages		*3,900*
Dependent care assistance (Dave's employer)		*400*
The Drakes' AGI		*32,200*
Paid:	*Dropout Day Nursery (Derrick)*	*1,170*
	Dellie Duforth, part-time housekeeper (Oct.-Dec.)	*600*
	Donna Drew (Danielle's nurse)	*1,400*

Computation of the Drake's Childcare Credit*:*

1.	*Total dependent care benefits received*		*$ 400*	
2.	*Qualified expenses ($1,170 + $600 + $1,400)*		*3,170*	
3.	*Dave's earnings*	*26,200*		
4.	*Danielle's earnings ($3,900 +($500 x 2 months incapacitated))*	*4,900*		
5.	*Lesser of LN3 or LN4*		*4,900*	
6.	*Excluded benefit – Lesser of LN5 or LN1*		*400*	
7.	*Qualified expenses – LN2 less LN1*		*2,770*	
8.	*Limitation (2 or more people qualifying for care)*	*6,000*		
9.	*Excluded benefits from LN1*	*400*		
10.	*Subtract LN9 from LN8*		*5,600*	
11.	*Smallest of LN3, LN4, LN7 or LN10*		*2,770*	
12.	*Child Care Credit (LN11 x applicable % (26%))*			*$720*

SIMPLIFIED MEAL DEDUCTION FOR FAMILY DAY CARE PROVIDERS

Taxpayers that are in the business of providing family day care may deduct the ordinary and necessary expenses of their business, including the cost of providing meals and snacks to children in their care. (Code Sec. 162)

Because family day care providers often buy food for their own families and for their family day care business, they may have difficulty substantiating the family day care portion of their food costs. It's also burdensome for these taxpayers to keep receipts for all food bought during the year for both family day care and their own family's personal use.

Simplified Meal Deduction – Family Care Providers

Year	States	Breakfast	Lunch	Dinner	Snack
2016	Contiguous States	$1.32	$2.48	$2.48	$0.74
	Alaska	$2.11	$4.02	$4.02	$1.20
	Hawaii	$1.54	$2.90	$2.90	$0.86
2017	Contiguous States	$1.31	$2.46	$2.46	$0.73
	Alaska	$2.09	$3.99	$3.99	$1.19
	Hawaii	$1.53	$2.88	$2.88	$0.86
2018	Contiguous States	$1.31	$2.46	$2.46	$0.73
	Alaska	$2.09	$3.99	$3.99	$1.19
	Hawaii	$1.52	$2.88	$2.88	$0.85
2019	Contiguous States	$1.31	$2.46	$2.46	$0.73
	Alaska	$2.09	$3.99	$3.99	$1.19
	Hawaii	$1.53	$2.88	$2.88	$0.86
2020	Contiguous States	$1.33	$2.49	$2.49	$0.74
	Alaska	$2.12	$4.04	$4.04	$1.20
	Hawaii	$1.54	$2.92	$2.92	$0.87

If an amount not shown it was not available at publication date

To minimize disputes with family care providers about the amount of their meal deduction and the quality of their substantiation, IRS will allow them to use standard meal and snack rates to compute the deductible cost of food instead of deducting actual costs. Recordkeeping also is simplified if standard rates are used. (Rev Proc 2003-22)

The simplified deduction for each meal and snack bought and served to an eligible child during day care is equal to the US Department of Agriculture's Tier I Child and Adult Food Care Program (CAFCP) reimbursement rates for meals and snacks served in day care homes. The rates for each tax year are those Tier I rates in effect on the preceding Dec. 31.

The rates do not include the cost of nonfood supplies (e.g., utensils), which may be deducted separately. The number of meals per day per child is limited to a maximum of:

	Rate	2019 Max (contiguous states)
• One breakfast,	$1.31	$1.31
• One lunch,	$2.46	$2.46
• One dinner, and	$2.46	$2.46
• Three snacks	$0.73	$2.19
2019 Daily Max per qualified child		**$8.42**

If the provider receives some form of reimbursement or subsidy, they deduct only the part of the simplified rate that exceeds the reimbursed amount.

The rates may be used only by taxpayers (whether or not licensed, registered, or otherwise regulated) providing care in their homes to unemancipated children, and only with respect to children they are paid to care for and who don't reside in the home. (Rev Proc 2003-22, Sec. 3; Rev Proc 2003-22, Sec. 4)

Consistent Treatment - Family day care providers that use the simplified rates must use them to deduct meals and snacks for the entire tax year, but they can switch to deducting actual substantiated amounts in another tax year. *(Rev Proc 2003-22, Sec. 5.02)*

Substantiation - Family day care providers using the standard rates must keep records substantiating their computation of the total deductible amount. The records should include the name of each eligible child, dates and hours of attendance in the family day care and the type and quantity of meals and snacks served. Appendix to Rev Proc 2003-22 includes a suggested record Log. Users of this log will be treated as having met the substantiation requirements. (Rev Proc 2003-22, Sec. 5.03)

CALIFORNIA DIFFERENCES

The California child and dependent care credit is non-refundable based on the Federal credit. The credit is phased out for higher income taxpayers: The credit isn't available for taxpayers with Federal AGI over $100,000. Only care provided in California qualifies. The California credit may apply even if no federal credit is claimed, such as when federal tax liability is zero. The credit, calculated on FTB Form 3506, is based on a credit figured using the federal rules multiplied times the following factor:

If Federal AGI is:	Percent of Federal Credit:
$40,000 or less	50%
Over $40,000 but Not over $70,000	43%
Over $70,000 but Not over $100,000	34%
Over $100,000	0%

California allows a custodial parent who never married the child's other parent, and who doesn't qualify to claim the child as a dependent, to qualify for the child care credit. For purposes of the earned income limit when figuring this credit, "earned income" is limited to earned income (as defined under the federal credit provision) that is subject to California personal income taxation and includes compensation, other than pensions or retirement pay, received by a member of the armed forces for active services as a member of the armed forces, whether or not the member is domiciled in California.

Substantiation Requirements – Taxpayers must retain adequate records to prove entitlement to claim the credit, including documents that establish (1) the identity and age of the qualifying child/dependent, (2) the identity and taxpayer identification number of the care provider, and (3) the physical location of where the care was provided. If applicable, medical records that demonstrate the physical or mental incapacity of the qualifying child/dependent must be retained. The taxpayer must also retain proof of payment for the child/dependent care expenses. These substantiation requirements apply to tax years beginning on or after January 1, 2013.

DOCUMENTS THAT ESTABLISH IDENTITY
- U.S. Passport or Card
- U.S Driver's License
- Green Card
- Form I-551
- Foreign Passport w/I-551 Stamp
- Temp I-551 notation on Mach Readable Visa
- Form I-766*
- U.S. State Issued ID*
- School ID*
- Native American Tribal Document

** contains photograph*

DOCUMENTS THAT ESTABLISH TAXPAYER ID
- Social Security Card
- ITIN Card

DOCUMENTS THAT ESTABLISH PHYSICAL LOCATION
- California Driver's Lic.
- California ID
- Utility Bill

NOTES

CHILD & DEPENDENT TAX CREDIT

- **Maximum Credit** - $2,000 (2018 – 2025) per child
- **Qualifying Child**
  - Under age 17 at end of year
  - Meets relationship test
  - Is not self-supporting
  - Lived with taxpayer over ½ of the year
  - Claimed as the taxpayer's dependent
  - Has SSN before return due date
- **Dependent Credit (2018-2025)**
  - $500 per dependent not a qualifying child
  - Not for filer or spouse
  - Nonrefundable
  - SSN or ITIN acceptable
- **Phase-Out Thresholds (2018 – 2025) are:**
  - $400,000 for taxpayer filing married joint;
  - $200,000 for all others.
  - Not inflation-indexed.
- **Generally nonrefundable except for:**
  - Add'l child credit computation based on excess earned income
    - Excess Threshold: $$2,500
    - Excess EI %: 15%
  - Additional credit computation - 3 or more qualifying children
  - Maximum refundable: $1,400 per child
- **Offsets AMT** – The nonrefundable portion of the credit offsets AMT

RAPID FINDER

Related IRC and IRS Publications and Forms

- **Pub 972** – Child Tax Credit
- **Form 8812** – Additional Child Tax Credit
- **Form 8867 – Paid Preparer's Due Diligence Checklist**
- **IRC Sec 24**

TCJA CHANGES	See Page
Maximum Credit Increased	9.02.01
Higher Phase-out Thresholds	9.02.03
New Dependent Credit	9.02.02
SSN Requirement for Child	9.02.02
Lower Earned Income Threshold	9.02.03

The child tax credit (CTC) is made up of two credits, either or both of which may be claimed by a qualifying taxpayer. The two components include nonrefundable and refundable portions.

- The child tax credit (nonrefundable)
- The child tax credit – refundable portion computed using either:
  (1) A method based on earned income, or
  (2) The additional child credit for taxpayers with 3 or more children (Form 8812).

A new nonrefundable credit of $500 per dependent not qualifying for the child tax credit is available for years 2018 through 2025.

MAXIMUM CHILD TAX CREDIT

The maximum CTC amount per qualifying child in years 2018 through 2025 is **$2,000** (an increase from the pre-2018 maximum of $1,000). (IRC Sec 24(h)(2)) Up to $1,400 is refundable, and the $1,400 amount is subject to inflation-adjustment after 2018 but was unchanged for 2019. (IRC Sec 24(h)(5)) This higher CTC amount is designed by Congress to assist families that lost the suspended (repealed) exemption allowance for qualifying children as part of the TCJA changes.

QUALIFYING CHILD - A qualifying child for purposes of the child tax credit is a child who:

(1) Is the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, a grandchild),
(2) Was under age 17 at the end of the tax year,
(3) Did not provide over half of his or her own support for the tax year,
(4) Lived with the taxpayer for more than half of the tax year,
(5) Was a U.S. citizen, a U.S. national, or a resident of the United States,
(6) Was claimed as the taxpayer's dependent, and

TCJA (7) After 2017, has a Social Security number.

Adopted child **-** An adopted child is always treated as the taxpayer's own child. An adopted child includes a child lawfully placed with the taxpayer for legal adoption. If the taxpayer is a U.S. citizen or U.S. national and the adopted child lived with the taxpayer all year as a member of the taxpayer's household during the tax year, that child meets condition (5) above to be a qualifying child for the child tax credit.

Exceptions to "time lived with the taxpayer" condition **-** A child is considered to have lived with the taxpayer for all of the tax year if the child was born or died during the year and the taxpayer's home was this child's home for the entire time he or she was alive. Temporary absences for special circumstances, such as for school, vacation, medical care, military service, or business, also count as time lived with the taxpayer. There are also special rules for kidnapped and missing children.

Identification requirement **-** In order to claim the child tax credit, the taxpayer must include the qualifying child's name and, beginning with tax year 2018, the child's Social Security number on the tax return. The SSN must have been issued by the Social Security Administration prior to the return's due date. (IRC Sec 24(h)(7)) The SSN requirement applies only to the child; a taxpayer with an ITIN can qualify for the credit as long as the qualifying child has a SSN.

Birthdate on January 1 - For this credit, a child attains a given age on the anniversary of the date that the child was born ***(Rev. Rul. 2003-72)***. For example, a child born on January 1, 2002 attains age 17 on January 1, 2019 and would be a qualifying child for the child tax credit for 2018 but not for 2019.

Kidnapped child - If a taxpayer's child is presumed by law enforcement authorities to have been kidnapped by someone other than a family member, the taxpayer, if otherwise qualified can take the child into account in determining the taxpayer's eligibility for head of household or qualifying widow(er) filing status, the pre-2018 deduction for dependents, child tax credit, and the earned income credit (EIC).

Children of divorced or separated parents – Only one parent can claim the child tax credit with respect to a qualifying child, and that would be the parent who claims the child as a dependent. Most often this is the custodial parent unless the custodial parent has waived the dependency to the noncustodial parent. See Chapter 1.01 for the waiver rules.

Foreign Earned Income or Foreign Housing Costs Limitation - Effective for tax years beginning after December 31, 2014, a taxpayer who elects to exclude from gross income any amount of foreign earned income or foreign housing costs is prohibited for that year from claiming the refundable part of the child tax credit. (Trade Preferences Extension Act; IRC Sec 24(d)(5))

DEPENDENT CREDIT - NEW (IRC Sec 24(h)(4))

TCJA In conjunction with the increased CTC, for years 2018 through 2025 Congress added a new nonrefundable credit of $500 for each dependent who is not a qualifying child for the CTC. A dependent child who does not have an SSN, and therefore doesn't qualify for the CTC, but who has an IRS individual taxpayer identification number (ITIN) or IRS-issued ATIN (Adoption Taxpayer Identification Number) will be eligible for the nonrefundable $500 credit. This credit will also be available for a dependent child who reaches age 17 before the end of the tax year, as well as non-child dependents such as a parent.

Early versions of the proposal that eventually became the TCJA identified the $500 credit as a "family credit" and would have allowed it for the taxpayer and spouse, as well as other dependents, but the final bill did not include the taxpayer and spouse as qualifying for the credit.

PHASE OUT

The credit phases out for taxpayers with "modified adjusted gross income" above certain non-indexed thresholds, and applies to the child tax credit and the new dependent credit. The TCJA significantly increased the threshold amounts, which are not inflation-indexed and are shown below (IRC Sec 24(h)(3)):

Child & Dependent Tax Credits Phaseout Thresholds

Filing Status	Pre-TCJA Threshold	Threshold 2018 - 2025
Married joint	$110,000	$400,000
Married separate	$55,000	$200,000
All others	$75,000	$200,000

Phase-out computation: The credit is reduced by $50 for each $1,000 (or fraction of $1,000) of modified AGI over the thresholds.

*Modified AGI***:** "Modified AGI" is AGI increased by amounts excluded from gross income under Code Sections 911, 931, or 933 (the foreign exclusions).

Example – Phase Out of Regular Child Tax Credit - *Don and Mallory, a married couple, have an AGI of $402,001. They had no foreign income exclusions. They have one child eligible for the child credit.*

Modified AGI	*$402,001*
Threshold, Married Joint Taxpayers	*400,000*
Net Difference	*$ 2,001*
Divide Net Difference by $1,000 (Round up to next whole number)	*3 (A)*
Maximum credit per child	*$ 2,000 (B)*
Multiply (A) by $50	*$ 150 (C)*
Subtract (C) from (B)	*$ 1,850*

Don and Mallory get a maximum $1,850 child tax credit. Notice that modified AGI just $1 above an even $1,000 mark caused this couple to pay $50 additional tax.

CREDIT LIMITED TO TAX LIABILITY

In addition to being limited due to the AGI phase out, the child tax credit is also limited for most taxpayers by the taxpayer's total tax liability (both regular and AMT). However, when the credit is limited by the amount of tax liability, a portion of the credit may be refundable for certain taxpayers (see below). The child tax credit can be used to offset AMT.

REFUNDABLE CHILD TAX CREDIT

A taxpayer, who is unable to claim the full amount of the child tax credit because income tax liability is less than the credit amount, is allowed to take up to $1,400 of the tax credit as a refundable credit, referred to as the additional child tax credit. Form 8812 is used to claim the refundable child tax credit. The combined nonrefundable and refundable credits can't exceed the credit as computed after taking into account the adjustment for the modified AGI limitation. The $1,400 amount will be inflation-indexed in $100 increments after 2018. The amount remains $1,400 for 2019. (IRC Sec. 24(h)(5))

The amount of the refundable credit is based on an earned income computation. Taxpayers with 3 or more qualifying children also take into consideration the amount of Social Security and Medicare taxes they paid. Further, the additional child tax credit for these taxpayers will be limited by any earned income credit claimed by the taxpayer.

Combat Pay - Excluded combat zone pay of military taxpayers is treated as earned income for this computation.

Taxpayers with 1 or 2 Qualifying Children – The refundable child tax credit is the lesser of the balance of the child credit the taxpayer is otherwise entitled to or a percentage of taxable earned income (defined the same as for the earned income credit) in excess of a threshold amount. (IRC Sec 24(h)(6))

- The threshold amount is: **$2,500** ($3,000 before 2018)
- The percentage amount is: **15%**

Example – Refundable Child Credit – *Bob and Sara Scott file a married joint return for 2019 and claim their 9-year-old son as a dependent. The Scotts' AGI of $30,000 consists solely of Bob's wages (no modifications). Their income tax is $560 and child credit is $2,000. The first $560 of the credit is used to offset the tax to zero. The balance, $1,440 is greater than the maximum allowed of $1,400, so their refundable credit is limited to $1,400; it is less than the result using the earned income formula ((30,000 – 2,500) x 15% = $4,125).*

If, instead of $30,000 of wages, the Scotts' only income had been $30,000 of interest from investments, none of the child credit would be refundable. It would be limited to $560, the amount of their tax.

Worksheet – Child Credit – 2019
Refundable Computation if 1 or 2 Qualifying Children

1. Number of qualifying children…………………..…….. _________
2. Maximum credit per child …………………………..…. ____2,000
3. Total child credit (Line 1 times Line 2)*……………..……………… _________
4. Nonrefundable child credit claimed……………………………………… _________
5. Portion of credit available to be refunded (Line 3 less Line 4) _________
6. Enter taxpayer(s) earned income……………………………….……… _________
7. Taxpayer(s) earned income threshold ………..……………………. ____2,500
8. Subtract line 7 from line 6 (not less than zero)…………………... _________
9. Applicable percentage ……………..………….…... _____0.15
10. Limitation (Line 8 times Line 9)…………………..…. _________
11. **Refundable child credit** (smaller of Line 5 or Line 10)…..... _________

**But enter no more than the maximum credit available after adjusting for modified AGI phase out.*

Taxpayers with 3 or More Qualifying Children – The refundable child credit for a taxpayer with 3 or more qualifying children is limited to: the lesser of (a) the balance of the child credit the taxpayer is unable to claim as a nonrefundable credit or (b) the greater of:

- The earned income computation as explained above for taxpayers with fewer than 3 qualifying children, or
- The excess of the taxpayer's Social Security and Medicare taxes (including an amount equal to the above-the-line deduction of self-employment tax paid) over any earned income credit allowed.

> ***Example (6.2% FICA Rate)– Refundable Child Credit, 3 or More Children:*** *Rita has 3 qualifying children, wages of $50,020, $200 of interest income, and a total tax liability of $3,547. She was not eligible for any earned income credit. Rita paid $3,827 of Social Security and Medicare taxes. Her child credit based on 3 children x $2,000 would be $6,000 (no phase out for modified AGI required), but the nonrefundable credit is limited to her tax liability of $3,547. Rita can claim an additional, refundable, child credit of $2,453. It is the lesser of the credit she wasn't otherwise able to claim ($6,000 - $3,547 = $2,453) or the greater of her Social Security/Medicare taxes over EIC ($3,827 – $0 = $3,827) or her earned income in excess of $2,500 times 15% ($50,020 - $2,500 = $47,520 x 15% = $7,128). The $2,453 is also less than the refundable maximum of $1,400 per child (3 x $1,400 = $4,200).*

CHILD CREDIT AND THE FOREIGN TAX CREDIT LIMITATION

When computing the foreign tax credit limitation, the child credit is treated as not reducing the taxpayer's tax liability for purposes of computing the limitation.

INTEGRITY PROVISIONS

The PATH Act of 2015 added program integrity provisions, which in the case of the child tax credit prohibits an individual from retroactively claiming the child credit by amending a return, or filing an original return if he failed to file, for any prior year in which the individual or a child for whom the credit is claimed did not have a taxpayer identification number (PATH Act Sec 205).

DUE DILIGENCE REQUIREMENTS

Beginning with 2016 tax returns, the PATH Act of 2015 (Act Sec 207) adds the child tax credit in the paid preparer due diligence requirements that apply to the EITC, including the $500 due diligence penalty (indexed for inflation to $530 for 2019*). Form 8867 provides a 2-page due diligence checklist for EITC, AOTC and Child Tax Credit and the head of household filing status and must be completed by the paid preparer if the taxpayer claims any one of the credits or the taxpayer files as head of household. Form 8867 must be filed with the taxpayer's return. Of importance here is understanding that the $530 penalty applies to each credit and the H of H status, so if the taxpayer claims all three credits and H of H and the preparer has not met the due diligence requirements, the preparer's 2019* penalty could be as high as $2,120. *Returns filed in 2019 or 2020

Specific questions on Form 8867 relating to the child, additional child, and other dependent credit that the preparer needs to answer are whether the preparer:

a. Determined that each qualifying person for these credits is the taxpayer's dependent who is a citizen, national or resident of the U.S. (yes or no)

b. Explained to the taxpayer that the credit may not be claimed if the taxpayer didn't live with the child for over half the year, even if the taxpayer supported the child, unless the custodial parent released their claim to the child's exemption. (yes, no or not applicable)

c. Explained to the taxpayer the rules about claiming the credit for a child of divorced or separated parents, or parents who live apart, including the requirements to attach Form 8332 or similar statement to the return. (yes, no or not applicable)

TAXPAYER DISALLOWANCE PERIODS

Beginning with 2016 tax returns, the PATH Act of 2015 (Act Sec 208; IRC Sec 24(g)) adds a provision that where a taxpayer improperly claims the child tax credit (fraudulently or recklessly), a disallowance period applies during which no child credit is allowed. Where the improper claim is due to:

- Fraud - the disallowance period is 10 years.
- Reckless or intentional disregard of rules and regulations (not fraud) - the disallowance period is 2 years.

As part of these rules, the definition of underpayment has been modified to create a negative tax for when the underpayment is caused by a refundable credit. (IRC Sec 6664(a)). Consequently an underpayment amount for purposes of the underpayment penalty calculation is created. In addition, the standard for the reasonableness exception to imposition of the underpayment penalty has been increased from "reasonable basis" to "reasonable cause." (IRC Sec 6676(a)).

RECERTIFICATION OF CREDIT

Also added by the PATH Act, and applicable to tax years beginning after 2015, is that no child credit is allowed for any tax year after any tax year a taxpayer is denied the child credit as a result of deficiency procedures of the Code, unless the taxpayer provides information that IRS may require to demonstrate eligibility for the credit. That is, a taxpayer who has been denied the child credit as a result of deficiency procedures is ineligible to claim the credit in later years, unless the taxpayer provides evidence of eligibility that meets evidence requirements established by the IRS.

CALIFORNIA DIFFERENCES

California Exemption Credit - California continues to allow exemption credits for filer, spouse and each dependent even though TCJA suspended the federal exemption deductions for 2018 through 2025 – see Chapter 1.03 for details.

New Law & Stuff

Young Child Tax Credit - AB 91 (signed by the governor 6/27/2019) adds new R&TC Sec 17052.1 that, effective for years beginning on or after January 1, 2019, allows a refundable "young child tax credit." The credit is per taxpayer, not per child, and is $1,176 times the EITC adjustment factor, which is 85% for 2019. However, the credit cannot be greater than $1,000 for any year. Thus, the maximum credit for 2019 is $1,000 ($1,176 x .85 = $999.60 = $1,000).

The credit phases out when the taxpayer's earned income exceeds a threshold amount of $25,000. The phaseout rate is $20 per $100 or fraction thereof that the taxpayer's earned income exceeds $25,000. Therefore, the credit is fully phased out once earned income reaches $30,000 ($30,000 – $25,000 = $5,000/$100 = 50 x $20 = $1,000). The threshold amount will be annually adjusted beginning in the year after the year the minimum wage is set at $15 per hour, which is scheduled to be 2022 unless the scheduled increases are suspended by the governor (Labor Code Sec 1182.12).

To be eligible for the young child tax credit, the taxpayer must also be eligible for the CA EITC, have at least one qualifying child as defined for the EITC, and the child must be younger than 6 years old at the end of the tax year.

NOTES

EARNED INCOME CREDIT

The EIC is a refundable credit allowed to certain low-income workers.

Overview

# of Qual. Children:	None	One	Two	Three
Max Credit (2019)	$529	$3,526	$5,828	$6,557
Totally Phased Out				
Joint (2019)	$21,370	$46,884	$52,493	$55,952
Others (2019)	$15,570	$41,094	$46,703	$50,162

Disqualifying Income (2019) - $3,600

Related IRC and IRS Publications and Forms

Pubs Forms

- **Pub 596** – Earned Income Credit
- **Form 8867** - Paid Preparer's Due Diligence Checklist
- **Form 8862** – Information to Claim EIC After Disallowance
- **Schedule EIC** – Earned Income Credit
- **EIC Worksheet** – 1040 Instructions
- **IRC Sec 32**

The Details

Effect of Welfare Payments - The IRS has said that the credit has no effect on certain welfare benefits. The credit that a taxpayer receives isn't used to determine eligibility and amounts from such benefit programs as:

- Temporary assistance for needy families.
- Medicaid and supplemental security income (SSI).
- Food stamps and low-income housing.

EARNED INCOME REQUIREMENT

An "eligible individual" can get an EIC in an amount equal to the credit percentage (see below) of the part of the taxpayer's "earned income" for the tax year that isn't more than the specified earned income amount. Thus, a taxpayer who has no earned income can't get an EIC. However, the credit phases out for taxpayers whose adjusted gross income or "earned income" exceeds a phase-out limit. In addition, no credit is allowed if the taxpayer's "disqualified income" for the tax year exceeds a certain inflation-indexed dollar amount.

Year	Qualifying Children	Credit %	Earned Income	Maximum Credit
2017	None	7.65	6,670	510
	1	34.00	10,000	3,400
	2	40.00	14,040	5,616
	3	45.00	14,040	6,318
2018	None	7.65	6,780	519
	1	34.00	10,180	3,461
	2	40.00	14,290	5,716
	3	45.00	14,290	6,431
2019	None	7.65	6,920	529
	1	34.00	10,370	3,526
	2	40.00	14,570	5,828
	3	45.00	14,570	6,557
2020	None	7.65	7,030	538
	1	34.00	10,540	3,584
	2	40.00	14,800	5,920
	3	45.00	14,800	6,660

If amounts not shown they were not available at publication date.

RAPID FINDER

CREDIT RATES

The credit percentage, the earned income amount, and the maximum earned income credit depend on the number of "qualifying children" a taxpayer has (see table at left).

Rather than using formulas, the credit is actually determined under IRS tables that reflect the dollar amounts at which phase out begins and ends. The instructions to Form 1040 contain the tables and an earned income credit worksheet for determining the amounts to use with the tables. Alternatively, a taxpayer can have IRS figure the credit.

PHASE OUT OF THE CREDIT

The EIC can't exceed the excess (if any) of:

(a) The credit percentage times the earned income amount over

(b) The phase-out percentage times the amount by which the taxpayer's modified AGI (or, if greater, the taxpayer's earned income) exceeds the phase-out amount.

Phase-Out Percentage - The phase-out percentage, phase-out amount and completed phase-out level (level where the credit is totally phased out) depends on the number of "qualifying children" the taxpayer has. The amounts are shown in the adjacent table.

Credit Treated as Overpayment - If the amount allowable as an earned income credit exceeds the tax, the excess is considered an overpayment. Thus, a taxpayer eligible for the credit can get a refund that is actually more than the amount of tax withheld.

Year	Qualifying Children	Phase-out Percentage	Phase-out Threshold	Phase-out Complete
2017	None	7.65	13,930 – Joint 8,340 - Others	20,600 15,010
	1	15.98	23,930 – Joint 18,340 – Others	45,207 39,617
	2	21.06	23,930 – Joint 18,340 - Others	50,597 45,007
	3	21.06	23,930 – Joint 18,340 - Others	53,930 48,340
2018	None	7.65	14,170– Joint 8,490 - Others	20,950 15,270
	1	15.98	24,350– Joint 18,660 – Others	46,010 40,320
	2	21.06	24,350 – Joint 18,660 – Others	51,492 45,802
	3	21.06	24,350 – Joint 18,660 – Others	54,884 49,194
2019	None	7.65	14,450– Joint 8,650 - Others	21,370 15,570
	1	15.98	24,820– Joint 19,030 – Others	46,884 41,094
	2	21.06	24,820– Joint 19,030 – Others	52,493 46,703
	3	21.06	24,820– Joint 19,030 – Others	55,952 50,162
2020	None	7.65	14,680– Joint 8,790 - Others	21,713 15,832
	1	15.98	25,220– Joint 19,330 – Others	47,648 41,758
	2	21.06	25,220– Joint 19,330 – Others	53,330 47,440
	3	21.06	25,220– Joint 19,330 – Others	56,844 50,954

If amounts not shown they were not available at publication date.

Example – EIC Refundable - *Bill has no income tax liability but had $100 in Federal income tax withheld from wages. He qualifies for an earned income credit of $740. Bill's refund for the tax year is $840.*

CREDIT DISALLOWANCE - The credit is disallowed under certain circumstances:

Disqualifying Income: The credit isn't available to individuals when their "disqualified income" (i.e., investment income as defined below) is more than the amount in the adjacent table.

Year	2016	2017	2018	2019	2020
Disqualifying Income	3,400	3,450	3,500	3,600	3,650

If an amount is not shown it was not available at publication

Foreign Income Exclusion - If the taxpayer claims either the foreign earned income or foreign housing exclusion, they will not qualify for the earned income credit for the year.

Fraud or Reckless Disregard of Rules & Regulations - The credit is disallowed for 10 years for those who claimed it in an earlier year due to fraud or for 2 years due to reckless or intentional disregard of rules and regulations. These restrictions are in addition to any other penalty imposed, such as the accuracy-related penalty or the fraud penalty. In addition, no credit is allowed where the credit was denied in an earlier year because of IRS deficiency assessment procedures, unless the taxpayer is re-certified by IRS (see more below).

FEDERAL OFFSETS

The amount of any earned income credit otherwise refundable to a taxpayer may be reduced by that person's federal offsets. All or part of the overpayment shown on Form 1040 may be used (offset) to pay past-due federal offsets. Offsets for federal taxes are made by the IRS and all other offsets are made by the Treasury Department's Financial Management Service (FMS). The following are examples of offsets and the agencies that collect them:

- Back Taxes (IRS)
- Child Support (FMS)
- Spousal Support (FMS)
- Student Loans (FMS)

DEFINITIONS

Qualifying child – A qualifying child must be a qualifying child under the uniform definition of a child as it relates to the rules on personal exemptions, meaning the following tests must be met:

1. Relationship Test**:** The child must be the taxpayer's:
   - Son, daughter, stepson, or stepdaughter (or descendant of such individual);
   - Brother, sister, stepbrother, or stepsister (or descendant of any of these individuals – e.g., a niece or nephew);
   - Eligible foster child (an individual placed with the taxpayer by an authorized placement agency or by court order);
   - Adopted child who is legally adopted or lawfully placed with the taxpayer by an authorized placement agency for legal adoption by the taxpayer. ***Caution:*** A child with only an ATIN won't qualify - see "Identification Requirement" below.
2. Residency test**:** A qualifying child must live with the taxpayer in the U.S. for more than half the year. Temporary absence from home (such as to attend school) can still qualify as time spent at home. A child who was born or died during the taxable year is treated as having lived with the taxpayer the entire year if the taxpayer's home was the child's home the entire time he or she was alive during the year.
3. Age Test**:** The child must be under age 19 at the end of the tax year or be a full-time student under age 24 at the end of the tax year. The age test does not apply to a child who is permanently and totally disabled.
   - ***Full-time student*** - A full-time student is a student who is enrolled for the number of hours or courses a school considers full-time attendance during some part of each of 5 calendar months during the calendar year. The 5 calendar months need not be consecutive.
   - ***School -*** The term *"school"* includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade and mechanical schools. It does not include on-the-job training courses, correspondence schools and night schools (see night school below).
   - ***Vocational high school students*** - Students who work on "co-op" jobs in private industry as a part of a school's prescribed course of classroom and practical training are considered full-time students.
   - ***Night school*** - A child is not a full-time student while attending school only at night. However, full-time attendance at a school may include some attendance at night as part of a full-time course of study.
   - ***Permanently and totally disabled*** - A child is permanently and totally disabled if both the following apply:
     1) He or she cannot engage in any substantial gainful activity because of a physical or mental condition, and
     2) A doctor determines the condition has lasted or can be expected to last continuously for at least a year or can lead to death.
4. Additional Requirements**:**
   - **Joint Return** - The child will not be a qualifying child if he or she files a joint return, unless the return is filed solely to claim a refund.
   - **Younger than Credit Claimant** - A qualifying child must be younger than the taxpayer who is claiming the EIC. This means, for example, that a taxpayer cannot claim the credit for an older brother or sister.

Adjusted Gross Income **–** Use the regular AGI without modification.

Disqualified Income ***-*** means interest or dividends to the extent includible in gross income for the tax year plus the following income:

(1) Tax-exempt interest received or accrued during the tax year. Tax-exempt interest is defined by the rules requiring disclosure of the amount of tax-exempt interest on the return;

(2) The excess (if any) of gross income from nonbusiness rents or royalties over the sum of:
  * The noninterest deductions that are clearly and directly allocable to that gross income, and
  * The interest deductions properly allocable to the gross income;

(3) Capital gain net income (as defined in Code Section 1222) of the taxpayer for the year; and

(4) The excess, if any, of the aggregate income from all passive activities for the year (determined without regard to any amount otherwise included in earned income under Code Sec. 32(c)(2), or the other disqualified income described above) over the aggregate losses from all passive activities for the tax year. For purposes of this rule, "passive activity" has the same meaning as under the Code Section 469 passive activity rules.

Disqualified income doesn't include other unearned income such as social security benefits and pension income. Those items affect the right to the earned income credit only to the extent they increase the amount of adjusted gross income used to calculate the amount of the credit that's phased out.

CUSTODIAL PARENT RELEASES EXEMPTION

If a custodial parent releases a qualifying child's exemption to the non-custodial parent, the custodial parent still qualifies for the EIC if otherwise qualified to claim it.

TWO OR MORE INDIVIDUALS WITH THE SAME QUALIFYING CHILD

If an individual can be claimed as a qualifying child by two or more taxpayers for a tax year beginning in the same calendar year, that individual will be treated as the qualifying child of the taxpayer who is:

(1) A parent of the individual.

(2) If (1) does not apply, the taxpayer with the highest adjusted gross income for that tax year.

If the parents claiming the credit with respect to any qualifying child do not file a joint return together, that child will be treated as the qualifying child of:

(1) The parent with whom the child resided for the longest period of time during the tax year, or

(2) If the child resides with both parents for the same amount of time during that tax year, the parent with the highest adjusted gross income.

If a parent can claim the child as a qualifying child but does not do so, the child is treated as the qualifying child of the person who had the highest AGI for the year, but only if that person's AGI is higher than the highest AGI of any parent of the child.

Note: This is the same tie-breaker rule that applies under the uniform definition of a child for the purpose of the dependency exemption.

> ***Example – Unmarried parents living together –*** Where the unmarried parents of a qualifying child live together, the child would be the qualified child of the parent with the higher AGI and that parent would be the one to claim the EIC if otherwise qualified.

EARNED INCOME

A taxpayer must, of course, have earned income to qualify for the earned income credit. Earned income for purposes of the EIC includes only taxable earned income (items included in gross income). Nontaxable earned income items are not included as earned income for the EIC.

> ***NOTE:*** *If a taxpayer is married, filing as head of household (under the special rule for divorced or separated parents), and lives in a state that has community property laws, earned income for the credit does not include any amount earned by the taxpayer's spouse that is treated as belonging to the taxpayer under community property laws. That amount is not earned income for the credit, even though a taxpayer must include it in gross income on his/her tax return.*

The table indicates various types of earned and unearned income for purposes of the credit:

Earned Income Includes:	Earned Income Does NOT Include:
TAXABLE EARNED INCOME	Social security and railroad retirement benefits
Wages, salaries, tips	Pensions or annuities
Union strike benefits	Veterans' benefits (including VA rehab. pay)
Long-term disability benefits prior to minimum retirement age	Worker's compensation
Earnings from self-employment	Alimony
	Interest/Dividends
NONTAXABLE EARNED INCOME	Welfare
Housing allowance or rental value of a parsonage for the clergy	Child support
Excludable dependent care benefits	Unemployment
Voluntary salary reductions such as under a cafeteria plan	Taxable scholarship or fellowship grants that are not reported on Form W-2
Voluntary salary deferrals (e.g.: 401(K) or Gov. thrift plan)	Variable housing allowance for the military
Anything else of value received from someone for services even if it is not taxable	Earnings for work performed while an inmate at a penal institution
Combat zone excluded pay	Medicaid waiver payment excluded from income **But see Chp 2.01 regarding the *Feigh* case**
Basic quarters & subsistence allowances and in-kind quarters and subsistence for U.S. Military	Nontaxable disability benefits
Value of meals/lodging for convenience of employer	

AWARENESS

The IRS estimates that up to 1.5 million people who are receiving long-term disability retirement benefits are missing out on claiming the EITC. For those that qualify and missed the credit in prior years, they can still amend their past three years of tax returns if the amendment is filed within three years of the original April due date for the return.

SPECIAL RULES REGARDING EARNED INCOME

Household Employees - If a taxpayer was a household employee but did not receive Form W-2 because an employer paid less than $2,100 (2019), the EIC may still be available. Include the amount paid on the "wages, salaries, tips, etc." line of Form 1040 (line 1 on the draft 2019 version). Print "HSH" and the amount not reported on Form W-2 on the dotted line next to that entry.

Combat Pay Election - A taxpayer may elect to treat combat pay that is otherwise excluded from gross income as earned income for purposes of the EIC. Making this election for EIC purposes may or may not be advantageous.

If the taxpayer has earned income below the maximum amount of earned income on which the credit is calculated, including the combat pay will increase the credit amount. On the other hand, if the taxpayer's earned income is already in the phase-out range, electing to include combat pay as earned income will decrease the amount of credit that can be claimed.

Disability Benefits - If a taxpayer retired on disability, benefits received under an employer's disability retirement plan are considered earned income until the taxpayer reaches minimum retirement age. Minimum retirement age generally is the earliest age at which a taxpayer could have received a pension or annuity if he/she were not disabled. Beginning on the day after reaching minimum retirement age, payments a taxpayer receives are taxable as pensions and are not considered earned income. ***Note:*** Nontaxable disability income attributable to premiums paid by an employee is not "earned income" for purposes of the EIC. (Chief Counsel Advice 199916041; Eva B. Vellai-Palotay v. The United States, U.S. Court of Federal Claims; I6-125T, July 13, 2016.)

Taxpayer or Qualifying Child Dies During Tax Year - The fact that the taxpayer dies during the year, or that the dependent dies during the year, will not necessarily preclude the deceased taxpayer from claiming the EIC. The Service's position has long been that, if the child fails the more than half the year rule because the child died or was born during the year, the child will meet that rule if the child lived with the taxpayer for the entire time the child was alive for the year, including temporary absences (Pub 596). As for the death of the taxpayer, Section 32(e) provides as follows: taxable year must be a full taxable year - Except in the case of a taxable year closed by the reason of the death of the taxpayer. (PMTA 2007-01190)

Voluntary Salary Reductions Under Cafeteria Plans - A cafeteria plan is a benefit plan that allows choosing among two or more benefits consisting of cash and benefits that aren't taxed. If a taxpayer chooses a benefit that isn't taxed (such as accident and health insurance), the amount of the voluntary salary reduction is **NOT** earned income when figuring this credit.

Birth of a Qualifying Child During the Year - if the child fails the more than half the year rule because the child was born during the year, the child will meet that rule if the child lived with the taxpayer for the entire time the child was alive for the year, including temporary absences. (Pub 596)

Earnings While an Inmate - Amounts paid to inmates in penal institutions for their work are not earned income when figuring the earned income credit (IRC Sec 32(c)(2)(B)(iv)).

Earnings from Self-Employment - Earnings from self-employment are considered earned income for purposes of the credit.

* <u>Statutory employee's earnings</u>: If a taxpayer is a statutory employee, self-employment earnings is the amount on line 1 of Schedule C.

* <u>Other earnings</u>: Earnings from self-employment for services as a minister or member of a religious order, is earned income for the credit. Taxpayer must include these earnings in earned income even if net earnings are less than $400.

* <u>Losses from self-employment</u>: A loss from self-employment must be subtracted from other earned income.

* <u>Schedule SE</u>: Using the optional methods to figure SE tax on net earnings from self-employment may qualify a taxpayer for the earned income credit or give a larger credit if net earnings (determined without using the optional methods) are less than the year's "lower limit" (see Chapter 8.03). If a taxpayer uses the optional method, use the imputed income from the optional SE method calculation in lieu of the actual SE earnings, reduced by the SE tax deduction claimed as an adjustment to gross income on Form 1040 (line 14 of draft of 2019 Schedule 1).

  If Schedule SE isn't required (for example, because net earnings from self-employment are less than $400), and the optional method isn't used, earnings (or loss) from self-employment is the net profit or loss from self-employment activities. This is the amount that must be used to figure the EIC.

  If a taxpayer has an approved Form 4361 (exemption from Social Security tax for ministers), amounts received for performing ministerial duties as an employee are earned income. This includes wages, salaries, tips and other employee compensation. Other employee compensation includes nontaxable compensation such as housing allowances or the rental value of a parsonage that is received as part of pay for services as an employee. Amounts received from ministerial duties, but not as an employee, are not earned income. Examples include fees for performing marriages and honoraria for delivering speeches.

EIC ELIGIBILITY WITHOUT A QUALIFYING CHILD

A taxpayer without a qualifying child can qualify for EIC if all of the following are met:

* The individual's principal home is in the U.S.
* The individual (or spouse) must be 25 or over but under 65 before the end of the year.
* The individual (or spouse) must not be someone else's dependent.

DEFICIENCY PROCEDURES

If the IRS questions eligibility of the EIC for reasons other than a mathematical or clerical error, the IRS may send correspondence asking the taxpayer to provide information about eligibility for the credit. If they receive no response, or the information provided doesn't indicate that the taxpayer qualifies for the credit, the IRS may send a "notice of deficiency" (90-day letter) by certified or registered mail denying the credit.

INTEGRITY PROVISIONS

An individual is prohibited from retroactively claiming the EITC by amending a return or filing an original return if he or she failed to file, for any prior year in which the individual did not have a taxpayer identification number. (PATH Act Sec 206)

DENIAL OF EIC FOR FRAUD OR INTENTIONAL DISREGARD OF RULES

A taxpayer who fraudulently claims the EIC is ineligible to claim the credit for a later period of 10 years; a taxpayer who erroneously claims the credit due to recklessness or intentional disregard of rules or regulations is ineligible to claim the credit for a later period of 2 years. Specifically, no earned income credit is allowed for any tax year during a disallowance period. The disallowance period is:

1. The 10-tax-year period after the most recent tax year for which there was a final determination that the taxpayer's claim of the earned income credit was due to fraud, and
2. The 2-tax-year period after the most recent tax year for which there was a final determination that the taxpayer's claim of the earned income credit was due to reckless or intentional disregard of rules and regulations (but not due to fraud).

The disallowance period begins in the year after the year in which the credit was claimed improperly, even if the final determination isn't made until a later year.

> ***Example - Disallowance of EIC -*** *Bobbi claimed the EIC for each of Years 1 to 5. During Year 5, a court determines that Bobbi's claiming the credit for Years 1 and 2 was due to a reckless or intentional disregard of rules and regs. Her credit for Year 3 and Year 4 is disallowed retroactively.*

IRS AUTHORITY TO TREAT EIC CLAIM ON NONCUSTODIAL PARENT'S RETURN AS MATH ERROR

A mathematical or clerical error includes an entry on a return claiming the earned income credit with respect to a child if, according to the Health and Human Services' Federal Case Registry of Child Support Orders established under Section 453(h) of the Social Security Act, the taxpayer is a noncustodial parent of such child. *(Code Sec. 6213(g)(2)(M) as amended by 2001 Act §303(g))*

The IRS is authorized to use its math error authority to deny the earned income credit, if the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of the child with respect to whom the credit is claimed. *(Com Rept, see ¶5013)*

RECERTIFICATION OF THE CREDIT

No earned income credit is allowed for any tax year after any tax year a taxpayer is denied the earned income credit as a result of deficiency procedures of the Code, unless the taxpayer provides information that IRS may require to demonstrate eligibility for the credit. That is, a taxpayer who has been denied the EIC as a result of deficiency procedures is ineligible to claim the credit in later years, unless the taxpayer provides evidence of eligibility that meets evidence requirements established by the IRS.

> ***Example - Recertification of EIC -*** *Annie claimed the earned income credit for Year 1 and Year 2. IRS sent her a 90-day letter denying the credit for those years. She didn't file a Tax Court petition and didn't otherwise respond to the statutory notice. Therefore, IRS made the assessment and denied the credit. Annie can't claim an EIC for any year after Year 2, unless she provides the information required by IRS to recertify the credit.*

The recertification procedures can apply if a taxpayer is subject to the 2- or 10-year disallowance periods. However, recertification isn't required if IRS disallows all or part of the credit because of a mathematical or clerical error (such as claiming the credit based on self-employment earnings without paying the correct self-employment tax or claiming the credit after a previous denial as the result of deficiency procedures without becoming recertified). Recertification also isn't required if IRS denies the credit through the deficiency procedures, but the Tax Court (or an appellate court reviewing the Tax Court) decides the taxpayer is eligible to claim the credit.

IRS will send the taxpayer information about how to become recertified. If the taxpayer claims the credit without first being recertified, the claim will be automatically denied. Ineligibility for the earned income credit under the above rules is ***subject to review by the courts***.

FORM 8862

No EIC is allowed to a taxpayer who has lost the credit due to the deficiency procedures described above unless the taxpayer:

* Attaches Form 8862 showing they are again eligible for the credit.
* Is otherwise eligible for the credit.

Form 8862 asks a series of questions so that the IRS can determine whether or not the taxpayer is eligible for the credit. A taxpayer will be treated as ineligible for the credit if the form isn't complete (or if the form shows an inconsistency with an item on the taxpayer's return).

The expectation is that the IRS may require the taxpayer to provide documentary evidence in addition to Form 8862. Once a taxpayer shows that he/she is eligible for the credit, he/she doesn't have to submit Form 8862 with later returns unless deficiency procedures again occur.

If a taxpayer doesn't submit Form 8862 as required, the IRS can deny the credit based on mathematical or clerical error procedures. If an EIC is denied based on these procedures, the taxpayer must attach Form 8862 to the next return on which the EIC is claimed.

IDENTIFICATION REQUIREMENT

No credit is allowed to an individual who doesn't include his/her own ID number (and that of spouse if married) on the tax return. In addition, if basing the credit on one or more qualifying children, each qualifying child's name, age, and ID number must be included on the return. What is a taxpayer identification number for EIC rules?

The term "taxpayer identification number" is specially defined for purposes of:

* Code Section 32(c)(1)(E), which requires an individual claiming the earned income credit to include on the return the individual's, and if married the individual's spouse's, taxpayer identification number, and
* Code Section 32(c)(3)(D), which relates to the identification requirement for a qualifying child.

Solely for these purposes, a taxpayer identification number means a **Social Security number (SSN)**, other than one issued to an individual applying for or receiving Federally-funded benefits. Thus, the following numbers and designations are **not** acceptable for the above purposes:

1. Adoption taxpayer identification numbers (ATINs),
2. Individual taxpayer identification numbers (ITINs),
3. Temporary numbers, and
4. 'Applied for' or other designations.

The SSN must be issued by the Social Security Administration to a U.S. citizen or to a person who has permission from the Dept. of Homeland Security/U.S. Citizenship and Immigration Service (aka Immigration and Naturalization Service) to work in the U.S. The effect of requiring an individual's (and, if married, the individual's spouse's) SSN to be shown on the return is to bar individuals who haven't been authorized to work legally in the U.S. from claiming the earned income credit.

For returns (or amendments) filed after December 18, 2015, the SSN of the taxpayer, taxpayer's spouse and qualifying child or children must have been issued on or before the due date of the return or the credit will be denied. (IRC Sec 32(m)) The IRS says the due date for obtaining the SSN is the extended due date of the return (2018 Pub 17, page 222). An exception applies for original returns filed for tax years that include December 18, 2015, provided the return is timely filed. Some taxpayers may encounter legitimate difficulties in getting a taxpayer identification number within the time necessary for filing a tax return (e.g., where a child is being adopted). IRS says if the filing deadline is approaching and the taxpayer doesn't have an SSN, the taxpayer may request an automatic extension of time to file.

DUE DILIGENCE – PAID PREPARERS

Paid preparers of returns on which an earned income credit is claimed are expected to exercise due diligence in getting accurate information to determine eligibility and correctly computing the amount. **Failing to do so could result in a preparer penalty of $530 for a return or refund claim filed in 2020** ($520 for 2019 filings, $510 for tax years beginning in 2016 or 2017)**.** This penalty is inflation adjusted annually.

IRS due diligence requirements that preparers of returns and refund claims involving the earned income credit must meet to avoid imposition of this penalty are as follows (Reg § 1.6695-2(b)):

1. **Complete, submit and retain a copy of Form 8867** (or other such form as prescribed by the IRS), "Paid Preparer's Due Diligence Checklist." The completed Form 8867 or successor form must be included in the return that is filed. The data entered on the Form 8867 must be based on information provided by the taxpayer or otherwise reasonably obtained by the preparer. The preparer must retain for the period described in the Form 8867 instructions copies of any documents provided by the taxpayer and on which the preparer relied in completing Form 8867 and the EIC worksheet (described next).

IMPORTANT

The Form 8867 also includes the due diligence requirements for the Child Tax Credit/Additional Child Tax Credit/Other Dependent Credit, the American Opportunity Tax Credit, and starting with 2018 returns, the Head of Household filing status. The due diligence penalty applies to each credit and the H of H status. Thus if a Head of Household return was filed in 2019 and included EITC, AOTC and CTC, and the due diligence requirements were not met for all of these tax benefits, the penalty could be $2,080 (4 x $520). MAKE SURE YOU COMPLETE THE 8867.

2. **Complete and retain a copy of the EIC worksheet** (or other form and information prescribed by the IRS) or otherwise record in one or more documents in the tax return preparer's paper or electronic files the tax return preparer's EIC computation, including the method and information used to make that computation. All documents must be based on information provided by the taxpayer or otherwise reasonably obtained by the preparer.
3. The preparer **must not know, or have reason to know, that any information used by the tax return preparer in determining the taxpayer's eligibility for, or the amount of, the EIC is incorrect**.
4. The tax return **preparer may not ignore the implications of information furnished** to, or known by, the tax return preparer, and must make reasonable inquiries if the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete.
5. A tax return **preparer must make reasonable inquiries** if a reasonable and well-informed tax return preparer knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete.
6. The tax return preparer must also **contemporaneously document in the files the reasonable inquiries made** and the responses to these inquiries.

Thus, if the preparer receives conflicting information from two different taxpayers, the return preparer has an affirmative duty to request verification from both taxpayers to determine which information is correct and only file a return with the information the return preparer does not know or have reason to know is incorrect.

Example 1*: Lindsey is age 22. She tells her tax return preparer that she wants to claim two daughters, ages 10 and 11, as qualifying children for the EIC. The preparer must make additional reasonable inquiries regarding the relationship between Lindsey and the children because Lindsey's age appears inconsistent with the children's ages.*

Example 2*: Walter tells his tax return preparer that he has two children, has a Schedule C business in which he grossed $10,000 and had no expenses, and wants to claim the EIC. This information appears incomplete because it is very unlikely that a self-employed individual has no business expenses. The preparer must make additional reasonable inquiries regarding Walter's business to determine whether the information regarding both income and expenses is correct.*

Example 3: *Sara, an 18 year-old female taxpayer with an infant has $3,000 in earned income and states that she lives with her parents. Taxpayer wants to claim the infant as a qualifying child for the EIC. This information appears incomplete and inconsistent because the taxpayer lives with her parents and earns very little income. The preparer must make additional reasonable inquires to determine if the taxpayer (Sara) is the qualifying child of her parents and, therefore, ineligible to claim the EIC.*

CALIFORNIA DIFFERENCES

California initiated a refundable EITC in 2015. California and at least 29 other states plus the District of Columbia now offer an EITC. In the majority of these states, the credit is refundable. Most states set their EITC as a portion of the federal EITC, and most states conform to the federal EITC program in other aspects such as eligibility requirements and income levels.

The California EITC will only apply for taxable years for which an adjustment factor (see below) is specified in the state's annual Budget Act and if the Budget Act authorizes resources for the Franchise Tax Board (FTB) to oversee and audit returns associated with the EITC.

Overview

The California EITC will generally follow the eligibility requirements of the federal EITC. Additionally, the earned income limitations for the California EITC (the amount where the CA EITC will be fully phased-out) will be lower than those for the federal EITC.

Beginning for tax year 2017, the limitation of only allowing EITC for wage earners has been lifted and self-employment income will be allowed. This includes domestic workers whose income is not subject to withholding. The phase-out ranges also were substantially increased. It is estimated this change will more than double the number of individuals qualifying for California EITC. (SB 106)

2018 EITC TABLE				
Number of Children	**Credit Rate**	**Phaseout Starts**	**Phaseout Complete**	**Maximum Credit**
None	7.65%	$3,580	16,751	$232
One	34%	$5,376	$24,951	$1,554
Two	40%	$7,547	$24,951	$2,559
Three +	45%	$7,547	$24,951	$2,879

Eligible Individual Age Requirement – Beginning with tax year 2018, an individual (or if married, either the individual or their spouse) who does not have a qualifying child will be eligible for the California EITC if age 18 or older at the end of tax year. Previously, California followed the federal requirement that individuals without a qualifying child be age 25 through 64. (R&TC § 17052(c)(2), as amended by SB 855)

New Law & Stuff

As of 2020, if a taxpayer's earned income is $30,000 or more, the phaseout will reduce the California EITC to zero. (AB 91, signed by the governor 6/27/2019) The bill also makes other changes in the phaseout calculation, which will be reflected in the table provided by the FTB in the Form 540 instructions.

COMPARISONS

Credit Rates – The CA credit rates are the same as the federal: 7.65% without a qualifying child, 34% with one qualifying child, 40% with 2 qualifying children and 45% with three or more.

Earned Income – The maximum earned income amounts to which the credit rates apply for CA are less than the federal amounts, thus resulting in a lower credit amount for CA.

Phase Out – CA phases out in a manner similar to the federal, but at substantially lower AGI's.

Qualifications – To qualify for the California credit:

Taxpayer cannot have investment income in excess of $3,699 for 2018 (2019 amount not available at press date) – this is not the same amount as for the federal EITC;

- Cannot file as married filing separate;
- Cannot be a dependent of another;
- Have a qualifying child, or if no qualifying child, then for years before 2018, be age 25 or older, but under the age of 65 at the end of the year, or for 2018 or later years, be age 18 or older at year's end; and both the eligible individual and qualifying child must have their principal abode in CA for more than half the year.

Annual Adjustment Factor – CA has built a factor into it's computation that permits the state to limit the CA credit while still following the federal computation. For 2015 through 2019, that factor is 85%. Thus, a tentative credit is computed in the same fashion as the federal and then that amount is multiplied by the factor to determine the actual credit awarded. The EITC adjustment factor is set by the legislature in the annual Budget Act.

FTB Form – Form FTB 3514 is to be attached to the California return when claiming the California EITC. The instructions to the form include EITC Tables and worksheets. The form warns taxpayers "If you claim the EITC even though you know you are not eligible; you may not be allowed to take the credit for up to 10 years."

Preparer Due Diligence - A $500 penalty, in conformity with federal law except not adjusted for inflation, for failure to be diligent in determining eligibility for the earned income tax credit may be assessed by the state against the return preparer. (R&TC Sec 19167(f))

Underpayment of Estimated Tax - A waiver of the underpayment of estimated tax penalty will apply if the underpayment was attributable to the EITC adjustment factor for the year being less than the adjustment factor for the preceding year and applies to penalties imposed on or after January 1, 2016.

SB 106 also authorizes the FTB to prescribe regulations necessary or appropriate to carry out the purposes of this section, including regulations to prevent improper claims from being filed or improper payments from being made with respect to net earnings from self-employment. The FTB is considering a number of methods to ensure compliance, including requiring self-employed individuals to have business licenses or other documentation to support a claim of self-employment. Another possibility is to require the business to have been in existence in the prior two years and an expanded Form 3514 CA EITC due diligence form. Still another would require the taxpayer to prove they paid federal SE tax on the income.

Questionable Claims - According to the November 2017 *FTB Tax News*, if the FTB suspects the self-employment income on a return claiming the EITC could be fraudulent, they may need additional documentation to verify the business and related income or losses before issuing a refund. To obtain the additional information, the FTB will send a request to the taxpayer within 30 days of the tax return being filed and will need this information back before they can allow the credit and issue the refund. The request will come on form FTB 4502, Additional Documentation Required — Refund Pending. Items that the taxpayer may need to provide include:

- A profit and loss statement or schedule used to determine the business income and expenses reported on the tax return.
- Business bank statements and credit card statements supporting the business income (covering at least 2 months).
- Any certification, license, permit, or registration required for the business (taxicab, cosmetology, food service, contractor, vendor, etc.).
- Any federal Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., if partnership income is reported.
- If the taxpayer has claimed qualifying children, the FTB more than likely will also ask for documentation regarding these individuals.

PRIOR TO 2017 – Prior to 2017, because of the high federal EITC fraud rates (estimated to be in excess of 30%) and primarily attributable to phony self-employment income, California only allowed EITC for earned income subject to California withholding, including:

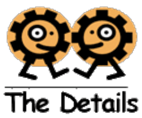
- W-2 wages,
- Salaries,
- Tips,
- Other employee compensation, and
- By election, the nontaxable military combat pay of the taxpayer (and/or the spouse/RDP if filing jointly), whether or not this election was made for federal purposes.

Not Included in Earned Income **–** Because of the requirement that the earned income for CA purposes be subject to withholding.

- **Self-Employment income** is not eligible.
- **Household employee income** is not specifically addressed by the FTB. However, generally it will not qualify for CA EITC. However, if the employee and employer have entered into a voluntary agreement to subject the employee's income to withholding as per CA Regulations, then the income would qualify for the EITC.
- **IHSS Payments** – Medicaid waiver payments, In Home Support Services (IHSS) payments and IHSS supplemental payments that are excluded for federal but included in CA wages are specifically excluded.

CLAIM OF RIGHT

Overview of Claim of Right – Cash basis taxpayers include amounts in gross income in the tax year received. If they must pay back the income amount in a later tax year, a deduction OR a tax credit may be allowed in the year of repayment--thus, the return for the year the income was originally claimed is not amended. However, return data from that previous tax year may be needed in order to compute the repayment year deduction or tax credit (whether to claim a deduction or credit, or for years 2018-2025 if certain deductions can be claimed, depends on which method produces the lower tax AND the amount of the repayment).

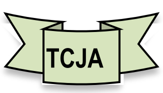


CLAIM OF RIGHT DOCTRINE: Code Section 1341 describes the Claim of Right doctrine which offers benefits to taxpayers who have included an amount in income in one tax year, but have had to repay all or part of it in a later year.

TRANSACTIONS COVERED BY THE DOCTRINE*:* The doctrine can apply to most any type of transaction in which a taxpayer receives income, other than one involving sale of inventory. Thus, required repayments of wages, commissions, alimony, social security, capital gain income, etc., can all be covered by the claim of right provisions.

DEDUCTION VS. TAX CREDIT IN THE REPAYMENT YEAR

- **Repayments of $3,000 or less** – If the amount repaid is $3,000 or less, deduct it from the taxpayer's income in the year the taxpayer repaid it. The repayment is generally deducted on the same form or schedule on which the income was previously reported. For example, if it was reported as self-employment income, deduct it as a business expense on Schedule C or Schedule C-EZ (Form 1040) or Schedule F (Form 1040). If reported as a capital gain, deduct it as a capital loss on Form 8949 (1040 Schedule D). If reported as wages, unemployment compensation, or other non-business income, it as a Schedule A Tier 2 miscellaneous itemized deduction. However, see below!



Years 2018-2025 – Tier 2 miscellaneous itemized deductions (those subject to the 2% of AGI reduction) are suspended by the TCJA starting with 2018 and through 2025. Therefore, during this period taxpayers making repayments of $3,000 or less that aren't related to a business or capital transaction are effectively prohibited from deducting these payments.

- **Repayments over $3,000** (no change by TCJA) - If the amount repaid was more than $3,000, the taxpayer can deduct the repayment as explained above (except as a Tier 1 (no 2% of AGI reduction) miscellaneous deduction if itemizing deductions) ***OR*** as a tax credit based on the difference in tax with or without the repaid income in the year the income was originally reported. Make both computations and select the one that provides the greater benefit.

THE CALCULATIONS FOR REPAYMENTS OVER $3,000

A. ***Computation - Repayment Year***

  - **Step I:** Compute the tax for the year in the usual manner without considering the repayment.
  - **Step II:** Deduct the repayment as a Tier 1 (not a Tier 2) itemized deduction and recompute the tax.
  - **Step III:** Subtract the tax computed in Step II from tax computed in Step I; the difference is the potential tax savings using the current-year deduction.

B. ***Computation - Year the income was originally reported -*** In this step, determine how much tax would have been saved if the repayment amount had never been included in income in the first place. To do this, recompute the tax for the year of income receipt without including the repaid amount. Subtract the result from the tax as originally reported. The difference is the amount of allowable tax credit potentially available in the repayment year.

C. ***Compare the results of (A) and (B).*** Determine which results in the lesser tax in the repayment year, claiming the deduction or the credit. There is no government form with which to make the computation or claim the credit, but when claiming the credit it should be claimed as part of payments made on Schedule 5 (2018) – the instructions to Schedule 5 say if claiming a credit for repayment of amounts you included in your income in an earlier year, include the credit on line 74. Check box d and enter "I.R.C. 1341" in the space next to that box. Based on drafts of the 2019 forms, the IRS is consolidating some of the 1040 schedules, with refundable credits now on Schedule 3. So instead of including the credit on line 74, it appears it would go to line 13 of Schedule 3.

Example - Claim of Right Computation - In 2019, James, a single taxpayer, was required to repay $5,000 he had reported as wages under claim of right in 2017. The following schedule compares his 2017 and 2019 tax liabilities, both with and without the repaid wages.

2017:	***With Wages***	***Without Wages***
Taxable Income	*$15,000*	*$10,000*
*Tax Liability **	*1,788*	*1,038*
Tax Savings (Credit Method)..	*$ 750*	

2019:	***Without Deduction***	***With Deduction***
Taxable Income	*$49,950*	*$44,950*
*Tax Liability **	*6,934*	*5,834*
Tax Savings (Deduction Method)....................................	*$ 1,100*	

** Using the Tax Tables for 2017 and the Tax Table for 2018 (because 2019 Tables not available at publication date)*

James was in the 15% tax bracket in 2017 and the 22% bracket in 2019. Thus, the deduction method, based on '19 rates, exceeds the credit method based on '17 rates. He will pay less tax by claiming a Tier 1 miscellaneous deduction for the repaid wages on his '19 return; the following worksheet shows James' computation.

Original Reporting Year: *2017*
Restoration Year: 2019

SECTION I - DEDUCTION METHOD - RESTORATION YEAR COMPUTATION *(Complete only if itemizing.)*

1. *Taxable income (w/o deduction) 49,950*
2. *Claim of right deduction .... <5,000>*
3. *Taxable income (with deduction) 44,950*
4. *Tax based on the amount of line 1.. 6,934*
5. *Tax based on the amount of line 3.. <5,834>*
6. *Tax savings this method (line 4 less line 5).. 1,100*

SECTION II - TAX CREDIT METHOD *- (Line 8 must exceed $3,000.)*

7. *Taxable income (as filed) 15,000*
8. *Claim of right adjustment... <5,000>*
9. *Modified taxable income (if negative, treat as zero) 10,000*
10. *Tax based on line 7 .... 1,788*
11. *Tax based on line 9 .... <1,038>*
12. *Tax savings this method (ln 10 less ln 11) 750*
    Line 12 is a refundable credit in the year of restoration if credit method is used
13. *Best tax savings (larger of ln 6 or ln 12).. 1,100*

METHOD USED: [X] Deduction Method [ ] Credit Method

Note: if a client is not itemizing, automatically use the credit method. But for 2018-2025, if repayment of non-business or non-investment income is $3,000 or less, neither a deduction nor a credit is available.

CALIFORNIA DIFFERENCES

California conforms to the provisions of Code Section 1341. No deduction or credit is allowed unless the repaid amount was previously taxed by California. Either the deduction or credit method is allowed, whichever creates the greater benefit. Deductions of $3,000 or less are subject to the 2% of federal AGI limit.

If claiming the credit for the repayment on the federal return, but deducting the repayment for California, enter the allowable deduction on Schedule CA, Part II, line 16, col. C (2018). If taking the credit instead of the deduction for California, enter the amount of the federal deduction on Part II, line 16, column B and add the credit amount on the total payment line of Form 540, and to the left of the total write "IRC 1341" and the amount of the credit.

SAVER'S CREDIT

Overview

- A credit for contributions made by eligible low income taxpayers to a qualified plan (IRAs and elective deferrals).
- **Eligible Individual** – 18 Years of age or older except:
  - (1) Dependent of Another.
  - (2) Full-time Student.
- **Amount of Credit** – Applicable % x (up to first $2,000 of contribution)
- **Eligible Contributions** – must be reduced by certain distributions made during 2 year, 9.5 months testing period
- **Joint Return** - Credit Available to both spouses.
- **Applicable %** - Based on AGI and can be 50%, 20% or 10%
- **2019 AGI Limits:** Jt = $64,000, HH = $48,000, and Others = $32,000
- **Credit** – Non-refundable.
- **AMT** – Allowed against AMT

RAPID FINDER

Pubs
Forms

Related IRC and IRS Publications and Forms

- **Form 8880** - Credit for Qualified Retirement Savings
- **IRC Sec 25B**

WHO IS ELIGIBLE FOR CREDIT

The term "eligible individual" will mean any individual who has reached age 18 as of the close of the tax year *(Code Sec. 25B(c)(1)*, except an individual in either of the following situations:

The Details

- **Dependent of Another** - an individual with respect to whom a dependency is allowed to another taxpayer for a tax year beginning in the calendar year in which the individual's tax year begins *(Code Sec. 25B(c)(2)(A)).*
- **Full-Time Student** - a student, as defined in *Code Sec. 151(c)(4) (Code Sec. 25B(c)(2)(B))* (generally, a full-time student during each of 5 months in the tax year at an educational organization or an individual pursuing a full-time course of institutional on-farm training).

AMOUNT OF CREDIT

In the case of an eligible individual (defined above), a tax credit is allowed equal to the applicable percentage (below) of up to the first $2,000 of the individual's qualified retirement savings contributions (defined below). *(Code Sec. 25B(a))* In the case of married taxpayers, each can qualify for the full credit. The applicable percentage is determined under the following table: (*Code Sec. 25B(b))*

2017 Phase-outs

Modified Adjusted Gross Income						Applicable percentage
Joint return		Head of household		Others		
Over	Not over	Over	Not over	Over	Not over	
$ 0	$37,000	$ 0	$27,750	$ 0	$18,500	50
37,000	40,000	27,750	30,000	18,500	20,000	20
40,000	62,000	30,000	46,500	20,000	31,000	10
62,000		46,500		31,000		0

2018 Phase-outs

Modified Adjusted Gross Income						Applicable percentage
Joint return		Head of household		Others		
Over	Not over	Over	Not over	Over	Not over	
$ 0	$38,000	$ 0	28,500	$ 0	19,000	50
38,000	41,000	28,500	30,750	19,000	20,500	20
41,000	63,000	30,750	47,250	20,500	31,500	10
63,000		47,250		31,500		0

2019 Phase-outs

Modified Adjusted Gross Income						Applicable percentage
Joint return		Head of household		Others		
Over	Not over	Over	Not over	Over	Not over	
$ 0	$38,500	$ 0	$28,875	$ 0	$19,250	50
38,500	41,500	28,875	31,125	19,250	20,750	20
41,500	64,000	31,125	48,000	20,750	32,000	10
64,000		48,000		32,000		0

2020 Phase-outs

Modified Adjusted Gross Income						Applicable percentage
Joint return		Head of household		Others		
Over	Not over	Over	Not over	Over	Not over	
$ 0	$39,000	$ 0	$29,250	$ 0	$19,500	50
39,000	42,500	29,250	31,875	19,500	21,250	20
42,500	65,000	31,875	48,875	21,250	32,500	10
65,000		48,750		32,500		0

If amounts are not shown, they were not available at publication date.

Modified AGI - Adjusted gross income will be determined without regard to Code Sec. 911 (foreign earned income exclusion and foreign housing exclusion or deduction), Code Sec. 931 (exclusion of income from American Samoa, Guam, or the Northern Mariana Islands), and Code Sec. 933 (exclusion of income from Puerto Rico). *(Code Sec. 25B(e))*

CREDIT IS NONREFUNDABLE; OFFSETS MINIMUM TAX

The credit will be nonrefundable and will offset alternative minimum tax liability as well as regular tax liability.

> ***Example*** *– Eric and Heather are married, both age 25, and filing a joint return. Eric contributed $3,000 through his 401(k) plan at work, and Heather contributed $500 to her IRA account. Their modified AGI for 2019 was $28,000. The credit is computed as follows:*
> *Eric's 401(k) contribution was $3,000, but only the first $2,000 can be used $2,000*
> *Heather's IRA contribution was $500, so it can all be used…………………………. 500*
> *Total Qualifying contributions……………………………………………………………….. $2,500*
> *Credit percentage for a Jt AGI of $28,000 from the table……………………………. X .50*
> ***Saver's credit****……………………………………………………………………………….. **$1,250***

CONTRIBUTIONS QUALIFYING FOR THE CREDIT

Subject to the reduction for distributions (discussed below), "qualified retirement savings contributions" will equal the sum of elective contributions to a:

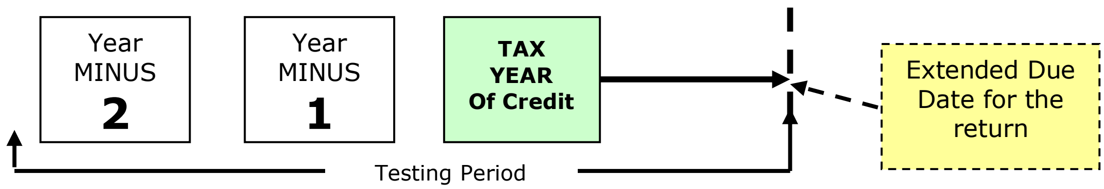
- Code Sec. 401(k) plan,
- Code Sec. 403(b) annuity (TSA), or eligible deferred compensation arrangement of a state or local government (a "Code Sec. 457 plan"),
- Tax-exempt employee-funded pension plan (typically a union plan),
- SIMPLE IRA or salary reduction SEP,
- Traditional or Roth IRA, and
- Voluntary after-tax employee contributions to a qualified retirement plan.

CERTAIN DISTRIBUTIONS WILL REDUCE AMOUNT ELIGIBLE FOR CREDIT

With the exceptions listed below, an individual's qualified retirement savings contributions eligible for the credit will have to be reduced (but not below zero) by the sum of:

- Any taxable distribution from any of the types of plans for which eligible contributions could be made (see list above) received by the individual during the testing period (defined below), and *(Code Sec. 25B(d)(2)(A).*
- Any distribution from a Roth IRA or a Roth account, received by the individual during the testing period that isn't a qualified rollover contribution (as defined in Code Sec. 408A(e)) to a Roth IRA or a rollover (under Code Sec. 408A(c)(8)(B)) to a Roth account. *(Code Sec. 25B(d)(2)(A))*

Testing period - The "testing period" will include the tax year for which the credit is claimed, the two preceding tax years, and the period after the tax year and before the due date (including extensions) for filing the taxpayer's return for that tax year. *(Code Sec. 25B(d)(2)(B))*



Pension Distributions during the Testing Period can be Costly!
Distributions taken from qualified plans by taxpayers who are eligible for the credit are potentially very costly. Not only may the distribution itself be taxable, but it may also cause the loss of a tax credit worth 10, 20, or even 50 cents on the dollar. Further, the credit may be lost not only in the current year, but for the next two years as well.

Distributions received by spouse - Distributions received by an individual's spouse will be treated as received by the individual, if the individual and spouse filed a joint return both in the tax year for which the credit is claimed and the tax year during which the spouse received the distribution. *(Code Sec. 25B(d)(2)(D))*

Strategies

***Example – Plan Ahead to Avoid the Testing Period** - Mary will turn age 70 on June 26, 2020 and thus becomes age 70.5 on December 26, 2020. She cannot contribute to an IRA in the year she turns 70.5, so 2019 is the last year that she could contribute to her IRA. If Mary will qualify for the saver's credit for 2019, she should be sure that she doesn't take her 2020 required minimum distribution from her IRA until after the extended due date of her 2019 return (generally Oct. 15, 2020). Otherwise, if she withdraws her IRA distribution prior to that date, the distribution will be within the testing period for her 2019 return, and depending on the amount of the distribution, the worst case is she won't be allowed any saver's credit for 2019, and the best case is that only part of the credit will be lost.*

DISTRIBUTIONS THAT DON'T REDUCE THE CREDIT

The following distributions won't reduce the amount of qualified retirement savings contributions:

- Loans to a plan participant or beneficiary from a qualified employer plan that are treated as distributions under Code Sec. 72(p);
- Distributions of excess contributions to a cash or deferred arrangement (401(k) plan) under Code Sec. 401(k)(8);
- Distributions of excess aggregate contributions under Code Sec. 401(m)(6);
- Distributions of excess deferrals under Code Sec. 402(g)(2);
- Dividends paid on employer securities under Code Sec. 404(k);
- Distributions of IRA contributions returned before the due date of the taxpayer's return under Code Sec. 408(d)(4) *(Code Sec. 25B(d)(2)(C)(i))*; and
- Rollovers from a Traditional IRA to a Roth IRA to which Code Sec. 408A(d)(3) applies. *(Code Sec. 25B(d)(2)(C)(ii)*

CREDIT IN ADDITION TO ANY PENSION DEDUCTION

The credit is in addition to any deduction or exclusion that would otherwise apply for a contribution and offsets AMT as well as regular tax liability.

CALIFORNIA DIFFERENCES

California has no comparable credit.

NOTES

ADOPTION EXPENSE CREDIT

RAPID FINDER

Overview

- **"Eligible child"** is:
  - either a person **under the age of 18** or
  - a person **physically or mentally incapable of self-care**
- **Maximum Credit Amount** – 2019 = $14,080
- **Special Needs Child** – Full credit without expenses.
- **Foreign adoption** - Credit only in the year the adoption is final.
- **Phase-out (2019)** – all filing statuses
  - Threshold $211,160
  - Complete $251,160
- **AMT** – Allowed against AMT
- **Carryover**
  - Years after 2011 (non-refundable) – 5-year carryover

Pubs Forms

Related IRC and IRS Publications and Forms

- **Form 8839** – Qualified Adoption Expenses
- **Instructions** – Form 8839
- **Form 1040** – Cannot use 1040A (pre-2018)
- **IRC Sec 23**

The Details

ELIGIBLE CHILD

An "eligible child" is either a person under the age of 18 at the time a qualified adoption expense is paid or incurred, or a person physically or mentally incapable of taking care of himself or herself. ***(Code Sec 23(d)(2)(A) and (B))***

A child who turned 18 during the year is an eligible child for the part of the year he or she was under age 18. A child attains a given age on the anniversary of the date the child was born. ***(Rev Rul 2003-72, 2003-33 IRB)***

Child Born Jan 1 - *A child born on Jan. 1, 2001 attains the age of 18 on Jan. 1, 2019.*

CREDIT AMOUNT

An individual is allowed an income tax credit for qualified adoption expenses. ***(Code Sec. 23(a)(1))*** The total expenses that can be taken as a credit for all tax years with respect to an adoption of a child is an annually inflation adjusted amount as illustrated in the table below.

Special Needs Child - In the case of an adoption of a child with special needs, the full credit limit will be allowed for the tax year in which the adoption becomes final, regardless of whether the taxpayer has qualified adoption expenses. ***(Code Sec.23(a)(3))***

Year	2017	2018	2019	2020
Max Credit	$13,570	$13,810	$14,080	$14,300
Phase-out:				
Threshold	$203,540	$207,140	$211,160	$214,250
Complete	$243,540	$247,140	$251,160	$254,250
If values not shown, not available at publication date				

In the case of a taxpayer adopting a U.S. child with special needs, the taxpayer may be able to exclude up to $14,080 (2019) and claim a credit for additional expenses up to $14,080 (minus any qualified adoption expenses claimed for the same child in a prior year). The exclusion may be available, even if the taxpayer or the taxpayer's employer didn't pay any qualified adoption expenses, provided the employer has a written qualified adoption assistance program (for further details and the definition of a special needs child, see the instructions for Form 8839).

PHASE OUT

The credit is phased out if the taxpayer's adjusted gross income (as computed without the foreign income exclusions of Code Sections 911, 931 and 933) exceeds the inflation adjusted threshold amount and is fully eliminated when AGI reaches the threshold cap. The table above includes both beginning and ending phase out amounts. ***(Code Sec. 23(b)(2))*** Note that the phase-out range is the same for all filing statuses.

QUALIFIED ADOPTION EXPENSES

Reasonable and necessary adoption fees, court costs, attorney fees, expenses required by a state as a condition of adoption, and other expenses that are directly related to and the principal purpose of which is the taxpayer's legal adoption of an eligible child are qualified adoption expenses. ***(Code Sec. 23(d)(1)(A))*** Expenses that violate state or federal laws, are incurred while carrying out a surrogate parenting arrangement, or those related to adoption of a spouse's child are not eligible. ***(Code Sec. 23(d)(1)(B); 23(d)(1)(D))***

When Expenses Are Paid

- Paid in a year before adoption is final **-** The credit for an expense paid or incurred before the tax year in which the adoption becomes final is allowed for the tax year following the tax year during which it is paid or incurred. ***(Code Sec. 23(a)(2)(A))***
- Paid in the year the adoption is final - For an expense paid or incurred during the tax year in which the adoption becomes final, the credit is allowed for the tax year in which it's paid or incurred. ***(Code Sec. 23(a)(2)(B))***
- Paid in a year after the adoption is final - For an expense paid or incurred after the tax year in which the adoption becomes final, the credit is allowed for the tax year in which it's paid or incurred. ***(Code Sec. 23(a)(2)(B))***

  Example *- A taxpayer pays or incurs $2,000 of qualified adoption expenses in Year 1, $1,000 in Year 2, nothing in Year 3 when the adoption becomes final, and $4,000 in Year 4, the year after the adoption becomes final. The $2,000 of expenses paid or incurred in Year 1 would be allowed in Year 2. The $1,000 of expenses paid or incurred in Year 2 would be allowed in Year 3. The $4,000 paid or incurred in Year 4, would be allowed in Year 4, the year in which paid or incurred, for a total of $7,000.*

Failed Adoption of a U.S. Child - Qualified adoption expenses paid or incurred in an unsuccessful attempt to adopt an eligible U.S. child before successfully finalizing the adoption of another eligible child are eligible for the credit. The unsuccessful/successful adoptions are treated as one effort for each eligible child for purposes of the dollar limit on the credit. Even expenses paid in connection with an unsuccessful attempt to adopt a U.S. child where no later adoption is successful are eligible; treat them the same way as expenses paid for adoptions that aren't final by the end of year. (IRS 2018 Form 8839 Instructions, pages 3 and 6)

FOREIGN ADOPTION

For a foreign adoption, the credit is allowed only in the year the adoption becomes final ***(Code Sec. 23(e)(2)),*** and no credit is allowed if the adoption doesn't become final. ***(Code Sec. 23(e)(1))*** However for expenses paid or incurred in a tax year after the adoption becomes final, the credit may be taken in the year the expenses are paid or incurred.

- **Safe Harbor – Finality – Foreign Adoptions** – **Revenue Procedure 2010-31** provides safe harbors for determining when foreign adoptions are final for purposes of the adoption credit and the exclusion of employer reimbursements for qualifying adoption expenses with respect to adoptions covered by the Hague Convention on Protection of Children and Co-operation in Respect of Intercountry Adoptions ("Convention"). The safe harbors are:
  - The IRS will not challenge the taxpayer's treatment of an adoption that is finalized in another country that is party to the Convention (the sending country) as final if the sending country enters a final decree of adoption, or the U.S. Secretary of State issues a Hague Adoption Certificate (IHAC).
  - If the adoption is finalized in the U.S., the IRS won't challenge the taxpayer's treatment of an adoption of a child who has entered the U.S. for the purpose of adoption as final in the taxable year that a state court enters a final decree of adoption if the Secretary of State has issued a Hague Custody Certificate (IHCC).

    General information about foreign adoptions and the Convention can be accessed through the Department of State website at http://www.adoption.state.gov. Determining finality of foreign adoptions from countries not party to the Hague Convention is covered in Rev. Proc. 2005-31, 2005-1 C.B. 1374.
- **IR visa** - is a visa issued to an orphan if (1) a simple adoption occurs in the foreign-sending country, or (2) the competent authority of the foreign-sending country grants legal guardianship or custody either to the prospective adoptive parent or parents or to an individual or agency acting on behalf of the prospective adoptive parent or parents.

SUBSTANTIATION REQUIREMENTS

Taxpayers claiming the adoption credit for 2012 or later years are not required to attach a copy of substantiating documentation to their returns. Instead, the documentation should be retained by the taxpayer. The following documents are the types of documents that an adopting taxpayer should retain in case of IRS inquiry:

For domestic and foreign adoptions that have been finalized:

- If finalized in the United States, an adoption order or decree.
- For a foreign adoption governed by the Hague Convention and finalized in another country, (1) a Hague Adoption Certificate (Immigrating Child), (2) an IH-3 visa, or (3) a foreign adoption decree, translated into English.
- For a foreign adoption from a country that is not party to the Hague Convention, (1) a foreign adoption decree (translated into English), or (2) an IR-2 or IR-3 visa.

Information to be included – An order or decree should include information that establishes that the taxpayer's adoption of the eligible child has been finalized and the date finalized. Redaction of sensitive personal information is permitted, but the IRS may require an unredacted copy of the document if needed to substantiate the claim for the credit.

Adoptions of special needs children – In addition to the documentation listed above, a taxpayer adopting a special needs child should retain a copy of the state determination of special needs for that child. Redaction is permitted but IRS may still require an unredacted copy.

For domestic adoptions that are not final – one of the following:

1. An adoption taxpayer identification number (ATIN), obtained by the taxpayer for the child, included on the taxpayer's return,
2. A home study completed by an authorized placement agency,
3. A placement agreement with an authorized placement agency,
4. A document signed by a hospital official authorizing the release of a newborn child from the hospital to the taxpayer for legal adoption,
5. A court document ordering or approving the placement of a child with the taxpayer for legal adoption, or
6. An original affidavit or notarized statement signed under penalties of perjury from an adoption attorney, government official or other person, stating that the signor (a) placed or is placing a child with the taxpayer for legal adoption, or (b) is facilitating the adoption process for the taxpayer in an official capacity, summarizing the facilitation.

OTHER ISSUES

- ***Re-adoption expenses as QAE***.- Many adoptive parents pay or incur expenses in connection with home state re-adoptions of their foreign-born children for practical reasons, such as obtaining a birth certificate issued in English, rather than because re-adoption is required by law. Otherwise qualified expenses paid or incurred in connection with a re-adoption do not fail the requirement that QAE must be "reasonable and necessary."
- ***Employer-reimbursed expenses*** - A taxpayer can't claim a credit for any employer-reimbursed adoption expense. ***(Code Sec. 23(b)(3)(A))***
- ***Adoptive child ID number*** - The taxpayer must include (if known) the name, age and taxpayer identification number (TIN) of the child on the return. ***(Code Sec. 23(f)((2)(A))*** Prospective adoptive parents who have had a child placed in their household by an "authorized placement agency" and meet certain other requirements may apply (use Form W-7A) for a temporary (two-year) adoption taxpayer identification number (ATIN) for the child (unless the child is an alien eligible to get an ITIN) to satisfy filing requirements, but not for earned income credit. ***(Reg § 301.6109-3)*** For a taxpayer to be eligible for the earned income credit and child tax credit/additional child tax credit, the qualifying child must have a Social Security number issued before the extended due date of the return for the year for which the credit is being claimed. However, an ATIN is an acceptable number for claiming the "other dependent credit" that was created as part of the TCJA. (Pub 972, 2018, page 2)

MARRIED TAXPAYERS

To get the credit, married individuals must file jointly (except as noted below) ***(Code Sec 23(f)(1))***

Married Persons Filing Separate Returns **–** A married individual filing a separate return is able to take the credit or exclusion if all of the following apply (per 2018 Form 8839 Instructions page 2).

- Their modified AGI is less than the top of the phaseout threshold for the year or they have a qualifying adoption credit from a prior year.
- They report the required information about the eligible child.
- They lived apart from their spouse during the last 6 months of the year.
- The eligible child lived in their home more than half of the year.
- They provided over half the cost of keeping up their home.

ALTERNATIVE MINIMUM TAX

The adoption credit is not subject to the §26(a) limitation. Thus, the post-2011 credits are allowed against the alternative minimum tax.

CREDIT CARRYOVER

> **Note:** There can be no carryovers from a year prior to 2012 since credit for 2010 and carryover from prior years were refundable in the 2010 return, and the credit for 2011 was also fully refundable.

Post-2011 Carryovers – If the adoption credit allowable for the tax year exceeds the limitation in effect for that year, the excess credit can be carried to the next tax year and added to the adoption credit allowable for that year.

But no adoption credit can be carried forward to any tax year following the fifth tax year after the tax year in which the credit arose. For purposes of this five-year limit, credits are treated as used on a first-in, first-out (FIFO) basis.

Credit amounts carried forward from a previous tax year are not subject to the income phaseout rules in subsequent tax years. However, a carryforward amount is still subject to the carryforward year's dollar limitation and the limitation that the credit taken cannot exceed the taxpayer's tax liability for the year. (***Code Sec. 23(b)(2)(A***))

EFFECT OF ADOPTION CREDIT ON FOREIGN TAX CREDIT LIMITATION:

The total amount of the foreign tax credit that a taxpayer may claim is limited based in part on the amount of U.S. tax against which the credit is taken. For individuals, this amount is reduced by any allowable nonrefundable personal credits for the tax year.

CALIFORNIA DIFFERENCES

California Credit for Child Adoption Costs — Credit Code 197
For the year in which an order of adoption is entered, the taxpayer may claim a credit for 50% of the cost of adopting a child who is a citizen or legal resident of the United States and who was in the custody of a California public agency or a California political subdivision. Include the following costs if directly related to the adoption process:

- Fees of the Department of Social Services or a licensed adoption agency;
- Medical expenses not reimbursed by insurance; and
- Travel expenses for the adoptive family.

Qualifying costs that were paid or incurred in any year prior to the year in which the order of adoption is entered may be included in determining the credit for the year the credit is allowed.

This credit does not apply when a child is adopted from another country or another state, or was not in the custody of a California public agency or a California political subdivision.

Note: Any deduction for the expenses used to claim this credit must be reduced by the amount of the child adoption costs credit claimed. Use the worksheet to figure this credit. If more than one adoption qualifies for this credit, complete a separate worksheet for each adoption. The maximum credit is limited to $2,500 per minor child. California does not have a separate adoption credit form.

CA ADOPTION WORKSHEET

1. Enter qualifying costs for the child.......................... __________
2. Credit percentage — 50%.. .50
3. Credit amount. Multiply Line 1 by Line 2.
   Do not enter more than $2,500................................ __________

Carryover: The allowable credit is limited for a tax year to $2,500 per minor child. The excess credit can be carried over to future years until the credit is used up.

CA RDP Issues – See chapter 1.12 for Federal and Adoption credit issues related to RDPs.

PENSION PLAN START-UP COSTS CREDIT

- **Credit amount – 50%** of administrative and retirement-education expenses for a new plan.
- **Credit Limit** - $500 per year (3 years)
- **Eligible Employer** – Employs **100 or fewer employees** who received in excess of **$5,000** in compensation in prior year.
- **Three Year Look Back** – No plans established
- **Non-Highly Compensated Employee** – At least one
- **General Business Credit** – Credit is part of the General Business Credit. Thus, unused credit can be carried back one year and any excess then carried forward 20 years.

RAPID FINDER

Disallowance	9.09.02
Elect Out	9.09.02
Eligible Employer	9.09.01
Eligible Plan	9.09.02
First Credit Year	9.09.02
General Business Credit	9.09.02
Limitations, Credit	9.09.02
Look Back Period	9.09.01
Start-Up Costs	9.09.02
Three-Year Look-back	9.09.01

Related IRC and IRS Publications and Forms

- **Form 8881** - Credit for Small Employer Pension Plan Startup Costs*
- **Form 3800** – General Business Credit
- **IRC Sec 45E**

*An individual whose only source of this credit is from a partnership or S corporation is not required to complete Form 8881. Instead, the credit is reported directly on Form 3800.

Sec 45E provides for a nonrefundable income tax credit for 50% of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a Code Sec. 401(k) plan), SIMPLE plan, or simplified employee pension ("SEP")).

ELIGIBLE EMPLOYER

An "eligible employer" will have the same meaning as that term has in *Code Sec. 408(p)(2)(C)(i)* which defines the types of employers that are eligible to adopt SIMPLE IRA plans (i.e., an employer that employs 100 or fewer employees who received in excess of $5,000 of "compensation" from the employer for the preceding year).

THREE YEAR LOOK-BACK

An employer won't be eligible for the credit if, during the three-tax year period immediately preceding the first tax year for which the small employer pension plan start-up costs credit is otherwise allowable for a qualified employer plan of the employer, the employer or any member of any controlled group including the employer (or any predecessor of either) established or maintained a qualified employer plan with respect to which contributions were made, or benefits were accrued, for substantially the same employees that are in the qualified employer plan. *(Code Sec. 45E(c)(2))*

QUALIFIED START-UP COSTS DEFINED

For purposes of the credit, qualified start-up costs mean any ordinary and necessary expenses of an eligible employer which are paid or incurred in connection with: *(Code Sec. 45E(d)(1)(A))*

- The establishment or administration of an eligible employer plan (defined below), or *(Code Sec. 45E(d)(1)(A)(i))*
- The retirement-related education of employees with respect to the eligible employer plan. *(Code Sec. 45E(d)(1)(A)(ii))*

Examples of eligible expenses include consulting fees, set-up fees for the investments into which the plan's funds are deposited, and costs to modify payroll systems.

At least one non-highly compensated participant - Qualified start-up costs won't include any expense in connection with a plan that doesn't have at least one employee eligible to participate who is not a highly-compensated employee. The code does not define a highly compensated employee, but presumably refers to the definition included in the anti-discrimination rules of IRC § 414(q) which states:

414(q)(1) In general - The term "highly-compensated employee" means any employee who:

(A) Was a 5-percent owner at any time during the year or the preceding year, or

(B) For the preceding year:

(i) Had compensation from the employer in excess of $80,000*, and

(ii) If the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.

** The $80,000 amount is inflation-indexed and for 2019 it is $125,000 (up from 120,000 for years 2015 through 2018).*

Also, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees of the employer who have worked with the employer for at least three months.

ELIGIBLE EMPLOYER PLAN DEFINED

For purposes of the credit, an eligible employer plan will include:

- Any qualified pension, profit-sharing, or stock bonus plan which includes an exempt trust,
- A qualified annuity plan,
- A simplified employee pension, and
- Any simple retirement account (i.e., any SIMPLE IRA).

$500 LIMITATION

The amount of the credit for any tax year can't exceed:

- $500 for the first credit year and each of the two tax years immediately following the first credit year (defined below), and *(Code Sec. 45E(b)(1)).*
- Zero for any other tax year. (*Code Sec. 45E(b)(2))*

Thus, the credit will apply to 50% of the first $1,000 in administrative and retirement-education expenses for the plan for each of the first three years of the plan. *(Com Rept.)*

FIRST CREDIT YEAR DEFINED

For purposes of the dollar limitation, the "first credit year" is:

(1) The tax year which includes the date that the eligible employer plan (defined above) to which the qualified start-up costs relate becomes effective, or *(Code Sec. 45E(d)(3)(A)).*

(2) At the election of the eligible employer (defined above), the tax year preceding the tax year referred to in (1) above. *(Code Sec. 45E(d)(3)(B))*

DISALLOWANCE OF DEDUCTION IF THE CREDIT CLAIMED

No deduction will be allowed for that portion of the qualified start-up costs paid or incurred for the tax year which is equal to the small employer pension plan start-up cost credit. *(Code Sec. 45E(e)(2))*

ELECTION OUT OF THE CREDIT

The credit will not apply to a taxpayer for any tax year if the taxpayer elects to have the credit not apply for that tax year. *(Code Sec. 45E(e)(3))* The election out of the credit is done simply by not filing Form 8881 with the employer's return.

In most cases, it will be advantageous for employers to claim the credit (rather than electing out of the credit). But, a taxpayer subject to the alternative minimum tax (AMT) might reduce his overall tax liability by electing out of the credit, because the credit will be part of the general business credit and can't be used against the AMT.

CREDIT IS PART OF THE GENERAL BUSINESS CREDIT

In the case of an eligible employer (as defined above), the small employer pension plan start-up costs credit will be part of and subject to the general business credit rules, including carryback and carryforward of unused credit when tax liability is less than the credit amount. See chapter 9.00 for details of the general business credit.

CALIFORNIA DIFFERENCES California has no equivalent credit.

HOMEOWNER SOLAR ENERGY CREDIT

Overview

NOTE: Residential Energy Property Credit – Sec 25C – Expired after 2017 after being extended by the Tax Technical Corrections Act of 2018 (P.L. 115-141). This was the $500 (lifetime) home energy efficient credit.

Residential Energy Efficient Property Credit (REEP credit)– Sec 25(D)

- Taxpayer's Main or Second Home (Except for Fuel Cell)
- Credit Percentages (no limit on credit amount):
  - Qualified **Solar Electric and Solar Water Heating Systems** 30% through 2019
    - 26% for 2020
    - 22% for 2021
- **Non-refundable Personal Credit –** The energy credits offset AMT. Carryover available.

Pubs
Forms

Related IRC and IRS Forms & Publications

- **Sec 25D** – Credit for residential energy generation property
- **Form 5695** – Residential Energy Credits

RAPID FINDER

SOLAR CREDIT (Sec 25D)

This is a personal tax credit available for the purchase of residential energy efficient property that uses solar power, to create electricity. Other types of alternative energy property eligible for the Sec 25D credit are listed below but not otherwise covered in this material.

Effective Dates:

- Qualified **Solar Electric and Solar Water Heating Systems –** The PATH Act extended this credit through 2021 and phased it out. There is no annual dollar cap on the credit for these systems. The credit percentages are:
  - Through 2019: 30%
  - 2020: 26%
  - 2021: 22%
- Qualified **Fuel Cell** Property (Expires after Dec. 31, 2021*)
- Qualified **Small Wind Energy Property** (Expires after Dec. 31, 2021*)
- Qualified **Geothermal Heat Pumps** (Expires after Dec. 31, 2021*)

  *Extended by the Bipartisan Budget Act of 2018 (P.L. 115-123)

Definitions:

- **Qualifying solar water heating property –** Qualifies if used in a dwelling unit located in the U.S. that is used by the taxpayer as a main or second residence where at least half of the energy used by the property for such purpose is derived from the sun. Heating water for swimming pools or hot tubs does not qualify for the credit. The property must be certified for performance by the Solar Rating Certification Corporation or a comparable entity endorsed by the state government where the property is installed.
- **Qualified solar electric property -** is property that uses solar energy to generate electricity for use in a dwelling unit located in the U.S. and used as a main or second residence by the taxpayer.

Other aspects of the credit:

- **Limited Carryover** - the credit is subject to Code Sec. 26, which limits the amount of various nonrefundable personal credits that are allowed in a tax year. However, the portion of the credit that is not allowed because of this limitation may be carried to the next tax year and added to the credit allowable under Code Sec. 25D for that year. (Code Sec. 25D(c))

  Caution: The code infers that any credit carryover can be added to the Sec 25D credit allowed in the subsequent year. However, what is unclear is whether any carryover will be allowed to 2022 once the credit expires at the end of 2021.
- **Installation Costs** - expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit, and for piping or wiring connecting the property to the residence, are expenditures that qualify for the credit. (Code Sec. 25D(e)(1))

  Roof - Expenditures relating to a solar panel or other property installed as a roof (or portion thereof) are treated as installation costs even though it constitutes a structural component of the structure on which it is installed (Sec 25D(e)(2)).

  Ground-mounted – IRS Notice 2013-70 (Sec. 5.02, Q&A 25) states that the Sec 25D credit may be claimed for solar panels that are not directly located on the taxpayer's home if they are used to generate electricity for the home. Although there is no specific IRS guidance related to onsite preparation and structural components for ground-mounted solar arrays, it would appear that those costs would qualify as installation costs for the credit (IRS Letter Ruling 201536017).
- **Swimming Pool** - expenditures that are properly allocable to a swimming pool, hot tub, or any other energy storage medium having a function other than the function of such storage are **NOT** taken into account for purposes of the credit. (Code Sec. 25D(e)(3))

SPECIAL ISSUES:

Basis Adjustment - The basis of the property is increased by the amount of the expenditure and reduced by the amount of the credit. (Code Sec. 1016(a)(34); Code Sec. 1016(a)(35)). This will generally create a different basis for federal and state purposes where the state does not provide a credit or it differs from the federal credit amount.

Association or Cooperative Costs – A taxpayer who is a member of a condominium management association for a condominium he or she owns, or a tenant-stockholder in a cooperative housing corporation, is treated as having paid his or her proportionate share of any qualifying costs of such association or corporation.

Mixed-Use Property - If less than 80% of the property is used for non-business purposes, only that portion of expenditures that is used for non-business purposes is taken into account. (Code Sec. 25C(e)(1); Code Sec. 25D(d)(7)) Thus, if the business use of a dwelling unit is 20% or less, the full amount of the expenditures is eligible for the credit.

NOTE: The 80% rule would come into play with residences that have a home office or other business use.

Timing and Treatment of Expenditures - The expenditures are treated as made when the original installation is completed, except that expenditures in connection with the construction or reconstruction of a structure are treated as made when the taxpayer's original use of the constructed or reconstructed structure begins. (Code Sec. 25C(e)(1); Code Sec. 25D(e)(8))

Multiple Installations – The credit is available for multiple installations. For instance, after the initial installation, if a taxpayer adds additional panels to increase capacity or adds batteries for storing electricity, these would be treated as original installations and the credit would apply. On the other hand, if a taxpayer had to replace damaged panels, inoperative batteries or perform other maintenance on the system, these items would not be an original system and their costs would not qualify for the credit.

Who Gets the Credit – The taxpayer need not own the property to qualify for the credit, as the taxpayer need only be a "resident" of the home. For the Residential Energy Efficient Property Credit, the code does not specify that an individual has to own the home, only that it is the taxpayer's residence.

IRC Sec. 25D(b)(2) - Qualified solar electric property expenditure - *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*.

Example*: Son lives with his mother who owns the home. Son pays to have the solar system installed. The son gets the credit.*

Newly Constructed Homes – Sec 25D credits can be taken for newly constructed homes if the costs of the residential energy efficient property can be separated from the home construction and the required certification documents are available (Sec 25D(e)(8)(B)).

Second Home - A taxpayer may claim a Sec 25D credit for other qualifying properties described in §25D that are not fuel cell properties installed in or on a dwelling unit used as a second home or a vacation home by the taxpayer. But a taxpayer may not claim the §25D credit for expenditures for improvements made to an investment property, such as rental property, that is not also used as a residence by the taxpayer. Thus, presumably if a taxpayer has multiple second homes the credit will apply to all of them as long they are located in the United States and used as a residence by the taxpayer.

HERO Program Financing and Deductions - The HERO program originated in Riverside County in Southern California – the purpose being to provide financing for energy related improvements to a taxpayer's home with principal and interest payments added to the taxpayer's property tax bill for the year. The HERO program has since spread to almost all counties in CA and even some areas outside of California.

The HERO loans – sometimes referred to as PACE (Property Assessed Clean Energy) loans – are used primarily to finance high cost energy improvements such as home solar energy property. The complication here is that the annual loan payments are added to the home's property tax bill leading many to believe the payments are deductible as property taxes. This includes a number of real estate agents with websites making this claim.

The truth of the matter is the payments are loan payments and NOT deducible as property tax. The interest portion of the separately stated payments is deductible as home acquisition debt interest and the principal portion is not deductible at all. The principal portion, however, may add to the home's basis to the extent not used to determine an energy related credit.

The HERO program will have provided your client with a loan amortization statement, which allows you to determine what portion of the payment is home acquisition debt interest. As an additional minor complication, the loan amortization schedule provided by the HERO program administrator is on a fiscal year, and the income tax reporting is on a calendar year, requiring you to make an adjustment. Generally, you can approximate the interest for the calendar year by adding the interest amounts for the two fiscal years including the calendar and dividing by 2.

In addition, the interest is not being reported on a 1098 so there will be mismatch with IRS's computer.

Comment: If you are providing clients with guidance in financing their home energy improvements, be sure to make them aware of the very high interest rates associated with HERO loans, in excess of 8%. Other sources of funds should be explored first, although the HERO loan qualifications are very liberal.

Residential Rentals – Although a tax credit for installation of solar equipment on a residential rental isn't allowed under Sec 25D, a credit may be available under Sec 48 – Energy Credit as part of the general business credit of Sec 38. Property eligible for the general business credit is tangible property for which depreciation is allowed, and this would include solar equipment installed in a residential rental property. (Sec 48(a)(5)(D)) The solar system must be used to generate electricity or to heat or cool a structure, but not for heating a swimming pool. (Sec 48(a)(3)(A)(i)) While Sec 50(b)(2) generally prohibits a business credit for property used primarily to furnish lodging, this prohibition doesn't apply to "any energy property". (Sec. 50(b)(2)(D)) The same credit rates and phaseouts apply under Sec 48 as under Sec 25D.

CALIFORNIA DIFFERENCES

California has no equivalent credit. Therefore, the basis of property on which the federal credit is claimed will be different for federal and California.

NOTES

BUSINESS ENERGY CREDITS

One of the credits that is included in the business investment credit component of the general business credit is a credit for investments in alternative energy sources. Although the credit includes a wide range of energy sources, many of them apply to big businesses and are not covered here. This chapter is an overview of the credits that might apply to small trades or businesses.

Related IRS Publications and Forms

- **Form 3468 –** Investment Credit
- **Form 3800 –** General Business Credit
- **Form 8582-CR** – Passive Activity Credit Limitations
- **Form 8810** – Corporate Passive Loss and Credit Limitations.
- **IRC Sec 48**

A taxpayer can claim (on Form 3468) the following energy credits (in each case, the percentage applies to the basis of eligible energy property placed in service during the year). The results from Form 3468 – Investment Credit are transferred to Form 3800 – General Business Credit (see chapter 3.00)

- *Solar Energy Property* - (Form 3468-Line 12b) This credit is for solar energy property (i.e., equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for) a structure, or to provide solar process heat, but not for heating a swimming pool), the construction of which begins before Jan. 1, 2022 subject to the phaseouts below. (Code Sec. 48(a)(3)(A)(i))

SOLAR ENERGY PROPERTY PHASE-OUT		
Date Construction Begins	Placed in Service	Credit
Before 1/1/2020	Before 1/1/2024	30%
1/1/20 - 12/31/20	Before 1/1/24	26%
1/1/21 - 12/31/21	Before 1/1/24	22%
Before 1/1/22	On or after 1/1/24	10%
On or after 1/1/22	Any	10%

- *Fiber-Optic Solar Energy Property* - (Form 3468-Line 12b) This credit is for fiber-optic solar energy equipment which uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight, the construction of which begins before Jan. 1, 2022 subject to the phaseouts below. (Code Sec. 48(a)(3)(A)(ii))

FIBER-OPTIC SOLAR ENERGY PROPERTY PHASE-OUT		
Date Construction Begins	Placed in Service	Credit
Before 1/1/2020	Before 1/1/2024	30%
1/1/20 - 12/31/20	Before 1/1/24	26%
1/1/21 - 12/31/21	Before 1/1/24	22%
Before 1/1/22	On or after 1/1/24	0%
On or after 1/1/22	Not Applicable	0%

- *Small Wind Energy Property* - This is a credit for qualified small wind energy property the construction of which begins before 2022, subject to the phaseouts below. (Code Sec. 48(a)(3)(A)(vi))

SMALL WIND ENERGY PROPERTY PHASE-OUT		
Date Construction Begins	Placed in Services	Credit
Before 1/1/2020	Before 1/1/2024	30%
1/1/20 - 12/31/20	Before 1/1/24	26%
1/1/21 - 12/31/21	Before 1/1/24	22%
Before 1/1/22	On or after 1/1/24	0%
On or after 1/1/22	Not Applicable	0%

- *Fuel Cell Property* – (Form 3469–Line 12c) This is a credit for qualified fuel cell property, the construction of which begins before Jan. 1, 2022, subject to the phaseouts below. The credit is not to exceed an amount equal to $1,500 for each 0.5 KW of capacity. (Code Sec. 48(a)(2)(A)(i)(I))

FUEL CELL ENERGY PROPERTY PHASE-OUT		
Date Construction Begins	Placed in Service	Credit
Before 1/1/2020	Before 1/1/2024	30%
1/1/20 - 12/31/20	Before 1/1/24	26%
1/1/21 - 12/31/21	Before 1/1/24	22%
Before 1/1/22	On or after 1/1/24	0%
On or after 1/1/22	Not Applicable	0%

QUALIFICATIONS:

1. Meet the performance and quality standards, if any, that have been prescribed by regulations and are in effect at the time the property is acquired;
2. Be property for which depreciation (or amortization in lieu of depreciation) is allowable; and
3. Be property either:
   a. The construction, reconstruction, or erection of which is completed by the taxpayer; or
   b. Acquired by the taxpayer if the original use of such property commences with the taxpayer. Energy property doesn't include any property acquired before February 14, 2008, or to the extent of basis attributable to construction, reconstruction, or erection before February 14, 2008, that is public utility property, as defined by section 46(f)(5) (as in effect on November 4, 1990), and related regulations.

OTHER REQUIREMENTS:

- The basis of energy property must be reduced by 50% of the energy credit determined.
- The basis of energy property used for figuring the credit must be reduced by any amount attributable to qualified rehabilitation expenditures.
- Energy property that qualifies for a grant under section 1603 of the American Recovery and Reinvestment Tax Act of 2009 isn't eligible for the energy credit for the tax year that the grant is made or any subsequent tax year.

WHAT ABOUT RENTALS?

Property that is eligible for the general business credit is tangible property for which depreciation is allowable (Sec. 48(a)(5)(D)). Solar panels installed on a residential rental would meet that requirement.

But, as noted in the Form 3468 instructions and per the code, business credits are generally not available for property that is used predominantly to furnish lodging (Sec. 50(b)(2)). However, there is an exception: Sec. 50(b)(2)(D) provides the restriction to property used predominantly to furnishing lodging does not apply to the energy credit. Thus, rental property would qualify.

One more hurdle: because rentals are considered passive activities for purposes of the Sec 48 energy credits, before the credit from the 3468 can pass onto the Form 3800, the credit must first pass through Form 8582-CR – Passive Activity Credit Limitations or Form 8810 – Corporate Passive Loss and Credit Limitations.

CALIFORNIA DIFFERENCES

CA has no equivalent credit but these repealed California energy credits have carryover provisions:

- Commercial Solar Energy – Credit Code 181
- Energy Conservation – Credit Code 182
- Solar Energy – Credit Code 180

NOTES

WORK OPPORTUNITY TAX CREDIT (WOTC)

RAPID FINDER

Overview

- **Credit:** generally, 40% of first year wages (25% for short-term employment (120 to 400 hours)) + 50% of 2nd year wages for L-T family assistance recipients
- **Max Wage for Credit:** generally, $6,000
  - $12,000 to $24,000 for qualified veterans
  - $10,000 for L-T family assistance recipients
- **Certification –** Form 8850 **filed within 28 days**
- **Sunset Date:** Extended by the PATH Act of 2015. Eligible individuals must begin work before 01/01/20

Pubs

Forms

Related IRS Code, Publications and Forms

- **Form 3800 –** General Business Credit
- **Form 5884 –** Work Opportunity Credit
- **Form 5884-C** – WOTC for Tax-Exempt Org Hiring Qualified Veterans
- **Form 8850 –** Cert. Request for WOTC
- **Form 9062 –** Conditional Certification Form (Dept. of Labor form)
- **Form 9061 –** Individual Characteristics Form (Dept. of Labor form)
- **IRC Sec 38 –** General Business Tax Credit
- **IRC Sec 51 -** WOTC

The Details

CREDIT AMOUNT

Employers may elect to claim a WOTC for 40% of first-year wages, up to $6,000 (more for certain targeted groups) per employee, for hiring workers from one of several targeted groups. Thus except for those targeted groups with higher allowable creditable wages, the maximum credit is $2,400 (40% of $6,000). First-year wages are wages paid during the tax year for work performed during the one-year period beginning on the date the target group member begins work for the employer.

For the full credit (40%), the targeted employee must work for a minimum of 400 hours in the first year. For those that work between 120 and 399 hours the credit percentage is reduced to 25%.

Targeted groups after 2015 include:

- **Veterans** - A qualified veteran is a veteran who is certified by the designated local agency as falling within one of the following categories:
  - *Veteran Who is a Member of a Family Receiving Food Stamps for at least Three Months* - The individual is a member of a family receiving assistance under a food stamp program under the Food and Nutrition Act of 2008 for at least three months, all or part of which is during the 12-month period ending on the hiring date. The maximum qualifying first-year wage taken into account is $6,000. **Thus the maximum WOTC is $2,400 (.4 x $6,000)** (*Code Sec. 51(d)(3)(A)(i)*)
  - *Veteran Entitled to Compensation for a Service-Connected Disability Hired Within First Year after Separation from Service* - The veteran must be entitled to compensation for a service-connected disability and have a hire date that isn't more than one year after having been discharged or released from active duty. The maximum qualifying first-year wage taken into account is $12,000. **Thus, the maximum WOTC is $4,800 (.4 x $12,000)** *(Code Sec. 51(d)(3)(A)(ii)(I))*
  - *Veteran Entitled to Compensation for a Service-Connected Disability with Six Months of Unemployment in the Year Preceding the Hire Date* - The veteran has aggregate periods of unemployment during the 1-year period ending on the hiring date that equal or exceed six months. The maximum qualifying first-year wage taken into account is $24,000. **Thus the maximum WOTC is $9,600 (.4 x $24,000)** *(Code Sec. 51(d)(3)(A)(ii)(II))*

- *Veteran Has Aggregate Periods of Unemployment Exceeding Four Weeks in the year Preceding the Hire Date* - The veteran has aggregate periods of unemployment during the 1-year period ending on the hiring date which equal or exceed four weeks (but less than six months). The maximum qualifying first-year wage taken into account is $6,000. Thus, the **maximum WOTC is $2,400 (.4 x $6,000)** *(Code Sec. 51(d)(3)(A)(iii))*
- *Veteran Has Aggregate Periods of Unemployment Exceeding Six Months in the Year Preceding the Hire Date* - The veteran has aggregate periods of unemployment during the 1-year period ending on the hiring date which equal or exceed six months. The maximum qualifying first-year wage taken into account is $14,000. Thus, the **maximum WOTC is $5,600 (.4 x $14,000)** *(Code Sec. 51(d)(3)(A)(iv))*

- **Recipients of Temporary Assistance for Needy Families** (TANF) program – The assistance must be received for any 9 months during the 18-month period ending on the hiring date. The maximum qualifying first-year wage taken into account is $6,000, and thus the **maximum WOTC is $2,400 (.4 x $6,000)**.
- **Long-Term Family Assistance (TANF) Recipients** - The first-year wages considered for this group is $10,000 with a maximum credit of $4,000 per employee. In addition, this group qualifies for second year credit equal to 50% of up to $10,000 of the second-year wages. A qualified individual is one who is a member of a family that:
  - Has received temporary assistance for needy families (TANF) payments for at least 18 consecutive months ending on the hiring date, or
  - Receives TANF payments for any 18 months (whether or not consecutive) beginning after August 5, 1997, and the earliest 18-month period beginning after August 5, 1997, ended during the past 2 years, or
  - Stopped being eligible for TANF payments because federal or state law limits the maximum period such assistance is payable, and the individual is hired not more than 2 years after such eligibility ended.

For the following groups, unless noted otherwise the maximum qualifying first-year wage taken into account is $6,000, and thus the maximum WOTC is $2,400 (.4 x $6,000):

- **Long-term unemployed individuals** (unemployed 27 consecutive weeks) hired after 2015.
- **Qualified ex-felon -** An individual who has been convicted of a felony under any federal or state law and is hired not more than 1 year after the conviction or release from prison for that felony.
- **Vocational rehabilitation referral -** An individual who has a physical or mental disability resulting in a substantial handicap to employment and who was referred to the employer upon completion of (or while receiving) rehabilitation services by a rehabilitation agency approved by the state, an employment network under the Ticket to Work program, or the Department of Veterans Affairs.
- **Summer youth employee -** An individual who:
  - Performs services for the employer between May 1 and September 15,
  - Is age 16 but not yet age 18 on the hiring date (or if later, on May 1),
  - Has never worked for the employer before, and
  - Lives within an empowerment zone.

  The maximum amount of qualified first-year wages that may be taken into account for a summer youth employee is $3,000, and thus the maximum WOTC is $1,200 if the employee works 400 hours or more.
- **Supplemental Nutrition Assistance Program (SNAP) recipient.** An individual who:
  - Is at least age 18 but not yet age 40 on the hiring date, and
  - Is a member of a family that—
    a. Has received SNAP benefits for the 6-month period ending on the hiring date or
    b. Is no longer eligible for such assistance under section 6(o) of the Food and Nutrition Act of 2008, but the family received SNAP benefits for at least 3 months of the 5-month period ending on the hiring date.
- **SSI recipient -** An individual who is receiving supplemental security income benefits under title XVI of the Social Security Act (including benefits of the type described in section 1616 of the Social Security Act or section 212 of Public Law 93-66) for any month ending during the 60-day period ending on the hiring date.
- **Designated community residents** - These are individuals certified by the designated local agency as having attained age 18 but not age 40 on the hiring date, and as having their principal place of abode within an empowerment zone, enterprise zone, renewal community or rural renewal county. Wages that qualify for the WOTC don't include wages paid or incurred for services performed while the individual's principal place of abode is outside an empowerment zone or rural renewal county. Code Sec. 51(d)(1) and Code Sec. 51(d)(5))

Qualified Zones, Communities and Counties - Refer to the list of designated areas available in the instructions to IRS Form 8850 or go to: https://www.hud.gov/program_offices/comm_planning/economicdevelopment/programs/rc/tour.

Certification Process - To be eligible to claim a WOTC, an employer files Form 8850 (Pre-Screening Notice and Certification Request for the Work Opportunity Credit) with the State Workforce Agency (SWA) **no later than the 28th day after the potentially eligible employee begins work**. Then, after the worker is state-certified as being a member of a targeted group and puts in sufficient hours, the employer claims the WOTC on Form 5884 (Work Opportunity Credit).

Fast-tracked Certification For Veterans **-** A veteran will be treated as certified by the designated local agency as having aggregate periods of unemployment meeting the requirements of:

- Code Sec. 51(d)(3)(A)(ii)(II) or Code Sec. 51(d)(3)(A)(iv), if he or she is certified by the local agency as being in receipt of unemployment compensation under State or Federal law for not less than six months during the 1-year period ending on the hiring date.
- Code Sec. 51(d)(3)(A)(iii), if he or she is certified by the local agency as being in receipt of unemployment compensation under State or Federal law for not less than four weeks (but less than six months) during the 1-year period ending on the hiring date.

Other Issues:

- No credit is allowed for an employee who is related to the employer or to certain owners of the employer, or who is a dependent of the employer.
- Claiming the WOTC may also impact the availability of certain other employment related tax credits.
- The credit is generally not available for employment of prior employees or replacements for employees on strike or locked out and employees who are receiving federally funded on-the-job-training.
- This credit is part of the general business credit and subject to its limitations and carryover provisions. See chapter 9.00 for details of the general business credit

Tax-exempt employers qualify for the credit - A tax-exempt employer may claim a credit for the WOTC it could claim for hiring qualified veterans if it were not tax-exempt. The credit is claimed by completing Form 5884-C, Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans, filed separately from any other return.

- *Credit Limited To OASDI* - The credit is allowed against the OASDI (Social Security) tax that the exempt employer would otherwise have to pay on the wages of *all* its employees during the one-year period beginning with the day he or she goes to work for the tax-exempt organization and cannot exceed the OASDI tax for that one year period.
- *Other limits applicable to tax-exempt employers*:
    - The general credit percentage of qualifying first-year wages is 26% (instead of 40%).
    - The credit percentage of qualifying wages is 16.25% (instead of 25%) for a qualified veteran who has completed at least 120, but less than 400, hours of service for the employer.
    - The tax-exempt employer may only take into account wages paid to a qualified veteran for services in furtherance of the activities related to the purposes or function constituting the basis of the organization's Sec. 501 exemption.

CALIFORNIA DIFFERENCES

While California does not conform to the federal WOTC, the state does have its own version of hiring incentives that are explained in Chapter 9.50.

NOTES

2008 FIRST-TIME HOMEBUYER CREDIT RECAPTURE

CREDIT RECAPTURE RULES – HOMES PURCHASED IN 2008

The Details

Regular recapture rule - The credit for new homebuyers is recaptured ratably over fifteen years, with no interest charge, beginning in 2010 and continuing through 2024. For each tax year of the 15-year recapture period, the credit is recaptured as an additional income tax amount equal to 6 2/3% of the amount of the credit, using IRS Form 5405. (Code Sec. 36(f)(1); Code Sec. 36(f)(7))

Example: *Frank and Mary Smith, eligible taxpayers with modified AGI below the phaseout limits, bought a $200,000 principal residence in August of 2008. They claimed a first-time homebuyer credit of $7,500 on their 2008 income tax return (lesser of $20,000 (10% of the $200,000 cost of the home) or $7,500). On their income tax return for 2010 the Smiths paid an additional income tax amount equal to $500 (6 2/3% of $7,500). They also will pay an additional income tax of $500 on their income tax returns for each tax year 2011 through 2024 (assuming they own the home and use it as a principal residence for that period).*

Accelerated recapture rule - If a taxpayer who claimed the credit for new homebuyers sells the home (or he or his spouse no longer uses it as a principal residence) before complete repayment of the credit, any remaining credit repayment amount is paid with the tax return for the year in which the home is sold (or ceases to be used as the principal residence).

SERVICE MEMBERS SPECIAL EXTENSION AND RECAPTURE WAIVER

Recapture Waiver – In the case of a disposition of a principal residence by an individual (or a cessation of use of the residence that otherwise would cause recapture) after Dec. 31, 2008, in connection with Government orders received by the individual (or the individual's spouse) for qualified official extended duty service, no recapture applies by reason of the disposition of the residence, and any 15-year recapture with respect to a home acquired before Jan. 1, 2009, ceases to apply in the tax year of the disposition. (Code Sec. 36(f)(4)(E))

OTHER DETAILS:

- **Taxpayer's Death** - Neither the regular nor the accelerated recapture rules apply to any tax year ending after the taxpayer's death.
- **Involuntary Conversion** - If the home is involuntarily converted (e.g., it's destroyed in a storm), and the taxpayer buys a new principal residence within a two year period beginning on the date of the disposition or the date the home ceases to be the principal residence, (1) the accelerated recapture rule does not apply, but (2) the regular recapture rule applies to the replacement principal residence during the recapture period in the same way as if the replacement principal residence were the converted residence. (Code Sec. 36(f)(4)(B))
- **Divorce** - In the case of a transfer of the residence to a spouse or to a former spouse incident to divorce, the accelerated recapture rule won't apply to the transfer, but both the regular and accelerated recapture rules will apply to the transferee spouse (and not the transferor spouse) who will be responsible for any future recapture.
- **Bankruptcy** – Courts have ruled that credit debt is pre-petition debt for bankruptcy purposes, so it qualified for discharge. (Betancourt, BK court, MO)
- **Credit Recapture Limited to Gain** - The credit repayment amount can't exceed the gain from the sale of the residence to an **UNRELATED** person. For this purpose, gain is determined by reducing the home's basis by the amount of the credit to the extent not previously recaptured. (Code Sec. 36(f)(2), Code Sec. 36(f)(3))
- **Joint Returns** – If the credit was allowed on a joint return, half of the credit is treated as having been allowed to each individual filing the return for recapture purposes. (Code Sec. 36(f)(5))

IRS LOOK-UP TOOL

IRS has a tool at IRS.gov that will allow taxpayers to look up information about their original first-time homebuyer credit amount, annual repayment amount, amount already repaid and balance owed. To use the tool, a taxpayer needs their Social Security number, date of birth and complete address.
www.irs.gov/Individuals/First-Time-Homebuyer-Credit-Account-Look-up

CALIFORNIA DIFFERENCES

A California credit was available for certain homes purchased May 1, 2010 through April 30 2011. The circumstances under which such credit would need to be recaptured have expired.

NOTES

ELECTRIC VEHICLE CREDIT

This credit is allocated by qualifying vehicle and only the first 200,000 vehicles sold per manufacturer qualify for the credit. To find out what amount of credit a vehicle qualifies for, visit the following website page: http://www.irs.gov/Businesses/Qualified-Vehicles-Acquired-after-12-31-2009

- **Four Wheeled Electric Drive Vehicles** (QPEDMV)
  - Credit: $2,500 + $417 (if battery capacity not less than 5 KWH) + $417 per KWH in excess of 5 KWH Maximum Credit: KWH component limited to $5,000; overall limit $7,500
  - Qualifying Vehicle: 4-Wheel highway vehicle that draws propulsion using a rechargeable battery with at least 4 kilowatt hours of capacity. Must have a gross weight of less than 14,000 pounds
  - Effective: **2010 through 200,000 vehicle sales phase-out process**
- **The following are expired after 12/31/2017:**
  - Qualified Fuel Cell Motor Vehicle Credit
  - 2-Wheeled (Motorcycle) Vehicle Credit (QPEV)
  - Alternative Fuel Vehicle Refueling Property Credit

*Extended by the Bipartisan Budget Act of 2018 (P.L. 115-123)

RAPID FINDER

Related IRC and IRS Forms & Publications

- **Form 8936 –** Qualified Plug-in Electric Drive Motor Vehicle Credit
- **Form 3800** – General Business Credit
- **Instructions 3800** – Instructions for General Business Credit
- **IRC Sec 30D**

4-WHEELED PLUG-IN ELECTRIC VEHICLE CREDIT (Code Sec 30D)

These vehicles are also referred to as "Qualified Plug-in Electric Drive Motor Vehicles" (QPEDMV).

The Credit Amount – The <u>per-vehicle</u> credit will be the sum of the following: (Code Sec. 30D(b)(1))

(1) $2,500; plus

(2) for a vehicle which draws propulsion energy from a battery with not less than 5 kilowatt hours of capacity, $417, plus an additional $417 for each kilowatt hour of capacity in excess of 5 kilowatt hours, but not in excess of $5,000. For this purpose, battery capacity, with respect to any battery is the quantity of electricity that the battery is capable of storing, expressed in kilowatt hours, as measured from a 100% state of charge to a zero percent state of charge.

Thus, the maximum credit is $7,500.

Important – In case you missed the underline above, this credit is a per vehicle credit not a per taxpayer credit. Thus, if a taxpayer purchases multiple electric vehicles the taxpayer is entitled to the credit for all of the vehicles subject to the non-refundable provisions for the personal credit and subject to the general business credit provisions for the business portion of the credit.

Credit Phase-Out – The credit phases out beginning in the second calendar quarter following that in which a manufacturer sells its 200,000th plug-in electric drive motor vehicle for use in the U.S. The applicable percentage phase-out is:

- 50% for the first two calendar quarters of the phaseout period,
- 25% for the third and fourth calendar quarters of the phaseout period, and
- 0% for each later calendar quarter.

YOU MUST GO TO THE IRS WEBSITE TO DETERMINE IF THE CREDIT IS PHASING OUT FOR A PARTICULAR VEHICLE

The IRS is tracking the cumulative sales by manufacturer on its web site:]https://www.irs.gov/businesses/irc-30d-new-qualified-plug-in-electric-drive-motor-vehicle-credit

VEHICLES BEGINING PHASEOUT IN 2019							
Date Acquired >>> VEHICLE	**Before 2019**	**Jan - Mar 2019**	**Apr - June 2019**	**July - Sept 2019**	**Oct – Dec 2019**	**Jan – Mar 2020**	**Apr – June 2020**
Tesla (all qualifying models)	$7,500	$3,750	$3,750	$1,875	$1,875	$0	$0
Chevrolet (all qualifying models)	$7,500	$7,500	$3,750	$3,750	$1,875	$1,875	$0
Cadillac (all qualifying models)	$7,500	$7,500	$3,750	$3,750	$1,875	$1,875	$0

Credit Sunset – There is **no specific sunset date for this credit** other than the per manufacturer quantity phase-out.

"Motor Vehicle" Definition - A "motor vehicle" is any vehicle manufactured primarily for use on public streets, roads and highways (not including a vehicle operated exclusively on a rail or rails) and that has at least four wheels.

"Qualified plug-in electric drive motor vehicle" (QPEDMV) defined - A "qualified plug-in electric drive motor vehicle" (QPEDMV) is a "motor vehicle" that satisfies the requirements listed below:

(1) The original use of the vehicle begins with the taxpayer.

(2) The vehicle is acquired for use or lease by the taxpayer and not for resale. "Acquired" is defined as the date on which title to the vehicle passes under state law (*Notice 2009-89*).

(3) The vehicle is made by a "manufacturer" (defined below).

(4) The vehicle is treated as a motor vehicle for purposes of title II of the Clean Air Act.

(5) The vehicle has a gross vehicle weight rating of less than 14,000 pounds.

(6) The vehicle is propelled to a significant extent by an electric motor that draws electricity from a battery that has a capacity of at least 4 kilowatt hours and is capable of being recharged from an external source of electricity.

(7) The vehicle is in compliance with the provisions of the Clean Air Act (or state law in certain cases) applicable for the make and model year of the vehicle and motor vehicle safety provisions of sections 30101 – 30169 of title 49, US Code.

Certification - A taxpayer may rely on a manufacturer's certification concerning the vehicle and the amount of the credit allowable for the vehicle (including in cases in which the certification is received after the purchase of the vehicle) provided the taxpayer meets the other requirements for the credit. (IRS Notice 2009-58). The IRS web site includes a list of certified vehicles and the amount of the available credit – search "Plug-in Electric Vehicle Credit (IRC 30D)" on the IRS web site.

Other Issues:

Allocation Between Business and Personal Use – The credit is allocated between a personal credit (personal use) and general business credit (business use).

- **Personal Credit** – The personal portion of the credit is a non-refundable personal credit that will off-set the AMT. Thus, any excess not used in the year of purchase is lost.
- **Business Credit** – The business use portion of the credit becomes part of the general business credit (Form 3800) with its normal carryback and carryforward provisions.
- **Basis** – Both the personal and **depreciable basis of the vehicle** must be reduced dollar for dollar for the amount of the credit claimed for the purchase of the vehicle. No credit is allowed for any portion of the vehicle expensed under Sec 179.

Foreign Use Property **–** The credit is not allowed to foreign use property.

Elect Out **-** The credit for QPEDMVs won't be allowed for a vehicle if the taxpayer elects to not have the credit apply to that vehicle (an election out).

Manufacturer **–** The term manufacturer for purposes of these credits has the same meaning as in regulations prescribed by the Administrator of the Environmental Protection Agency for purposes of administering title II of the Clean Air Act (42 U.S.C. 7521 et seq).

Recapture - IRS is required to issue regulations that provide for recapturing the benefit of any credit allowable for QPEDMVs with respect to any property that stops being property eligible for the credit.

Who Gets the Credit **–** The purchaser or lessee of the vehicle that originally places the vehicle in service claims the credit!

Off-Road Vehicles & Golf Carts - Vehicles manufactured primarily for off-road use, such as for use on a golf course, do not qualify for the credit.

CALIFORNIA DIFFERENCES

California has no equivalent tax credit. **Caution:** business vehicles where the credit is taken for federal purposes will have a different CA basis since there is a federal basis adjustment in the amount of the credit but no CA basis adjustment

California Clean Vehicle Rebate Project (CVRP) - The Clean Vehicle Rebate Project (CVRP) California created by Assembly Bill 118 establishes rebates available for the purchase or lease of a qualified plug-in electric vehicle or a zero emissions vehicle. The program is dependent on annual funding by the Legislature. More information is available at the following web site: https://cleanvehiclerebate.org/eng.

NOTE:
This rebate has nothing to do with the preparation of clients' tax returns. It is all handled through the sales transaction and online.

NOTES

RESEARCH CREDIT

Caution – This chapter is an overview (awareness) of what can be a very complex tax credit and generally only includes information related to small businesses.

Overview

The Internal Revenue Code (Sec 41) provides a tax credit of up to 20% of qualified expenditures for businesses that develop, design or improve products, processes, techniques, formulas or software and similar activities. The credit has been made permanent and modified by the PATH Act of 2015.

The credit is calculated on the basis of increases in research activities and expenditures. Its purpose is to reward businesses that pursue innovation by continually increasing investment. Even so, an alternative simplified method allows taxpayers to claim research credits if research costs remain the same or even decline when compared with prior years.

RAPID FINDER

Pubs Forms

Related IRC and IRS Publications and Forms

- **Form 6765** – Research Credit
- **Form 8975** - Qualified Small Business Payroll Tax Credit for Increasing Research Activities
- **Form 3800** – General Business Credit
- **Instructions for Form 3800**, General Business Credit
- **IRC Sec 41**
- **IRC SEC 38 –General Business Credit**
- **IRC SEC 52(c)(2) – Tax-Exempts Employing Vets**
- **IRC Sec 3111(f) – Payroll Credit Election**

The Details

The research credit equals the sum of: (1) 20% of the excess (if any) of the qualified research expenses for the tax year over a base amount (unless the taxpayer elected an alternative simplified research credit); (2) the university basic research credit (i.e., 20% of the basic research payments); and (3) 20% of the taxpayer's expenditures on qualified energy research undertaken by an energy research consortium.

For years after December 31, 2015:

- Small businesses (average of $50 Million or less in gross receipts in the prior three years) can claim the credit against the alternative minimum tax (PATH Act Sec 121(b)). **Note:** The TCJA repealed the AMT for corporations, effective for tax years beginning after December 31, 2017.
- For years after December 31, 2015, small businesses (less than $5 Million in gross receipts for the year the credit is being claimed and no gross receipts for any taxable year before the 5-taxable-year period ending with the taxable year) can claim up to $250,000 per year of the credit against their employer FICA tax liability (PATH Act Sec 121(c)). See details beginning on page 9.16.02

Computation Methods - The two methods used to compute the credit are the regular method that provides for the 20% credit, or the simplified method which is easier to document but results in reduced credit amounts.

- *Regular Method* - Under the regular research credit method, the credit equals 20% of qualified research expenditures for a tax year over a base amount established by the taxpayer in 1984–1988 or by another method for companies that started up subsequently. This method may be best for companies that can document a low base amount.
- *Simplified Method* - The alternative simplified method credit equals 14% (12% for years prior to 2009) of qualified research expenses over 50% of the average annual qualified research expenses in the three immediately preceding tax years. If the taxpayer has no qualified research expenses in any of the three preceding tax years, the alternative simplified method credit may be 6% of the tax year’s qualified research expenses. This method may be the best choice for taxpayers with incomplete records from the mid-1980s, those complicated by mergers and acquisitions, or taxpayers with a high base amount from that period.

Base Amount - The base amount is a fixed-base percentage of taxpayer's average annual gross receipts from a U.S. trade or business (including any foreign sub's gross receipts), net of returns and allowances, for the 4 tax years before the credit year, and can't be less than 50% of the year's qualified research expenses. The fixed base percentage for a non-startup company is the percentage (not exceeding 16%) that taxpayer's total qualified research expenses is of total gross receipts for tax years beginning after '83 and before '89. (Code Sec. 42(c))

Except when a taxpayer elects the alternative simplified research credit the Code assigns a fixed-base percentage of 3% in making the base amount computation for each of its first 5 tax years in which a "startup company" has qualified research expenses. (Code Sec. 41(c)(3)(B)(ii)(I)) For the second 5 tax years, the fixed-base percentage is a specified amount of the ratio or percentage that is increased annually during this second 5 year period and is determined by dividing qualified research expenses by gross receipts.

Qualified Research - The term "qualified research" means research which is undertaken for the purpose of discovering information which is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and relates to:

- A new or improved function,
- Performance, or
- Reliability or quality.

Certain purposes that are not qualified include style, taste, cosmetic, or seasonal design factors. The definition is relatively broad and encompasses such activities as:

- Developing new or improved products, processes or formulas;
- Developing prototypes or models; Developing or applying for patents;
- Certification testing; Developing new technology;
- Environmental testing; Developing or improving software technologies;
- Building or improving manufacturing facilities; and Streamlining internal processes.

Qualified research expenses (QREs) - are amounts the taxpayer pays or incurs during the tax year "in carrying on any trade or business" (including certain start-up costs) of the taxpayer for: in-house research expenses, which consist of certain wages and supplies, and contract research expenses, i.e., 65% of amounts paid to certain nonemployees, and 100% of the taxpayer's expenditures to eligible small businesses, universities, and federal laboratories for qualified energy research. (Code Sec. 41(b); Reg § 1.41-2)

Note: No deduction is allowed for that portion of the qualified research expenses or basic research expenses otherwise allowable as a deduction for the tax year, which is equal to the amount of the research credit determined for the tax year (Code Sec. 280C(c)(1)). In other words, a taxpayer must reduce his deduction for research or experimental expenditures (or qualified research expenses or basic research payments) by 100% of the amount of the research credit determined for the year.

Similarly, if the taxpayer capitalizes, rather than deducts the expenditures, the amount chargeable to the capital account is reduced by 100% of the amount of the credit for the tax year over the amount allowable as a deduction for qualified research expenses or basic research expenses (determined without regard to the reduced deduction, discussed above).

> **Example:** X has in the current year credit-eligible research expenditures totaling $100,000. Assume that the allowable credit is $8,000. The amount X must deduct, amortize or capitalize may not exceed $92,000 (i.e., $100,000 – $8,000).

Taxpayers may make an annual irrevocable election to claim a reduced research credit and avoid having to reduce their research expense deductions or capital expenditures. (Code Sec. 280C(c)(3)(A)) Under the election, the amount of the research credit is reduced by the product of the research credit computed in the regular manner and the maximum corporate tax rate. The election must be made on an original return filed not later than the extended due date of the election-year's return. Effective for tax years ending on or after July 27, 2011, the election is made on Form 6765.

TCJA

Research and experimental expenditures paid or incurred in tax years beginning after December 31, 2021, generally must be amortized over five years (15 years for research expenditures outside the U.S.), beginning at the mid-point of the tax year when the expenditures are paid or incurred (June 30 for calendar year taxpayers). (IRC Sec. 174, as amended by the TCJA, §13206(a)). This means the provision allowing taxpayers to currently deduct research and experimental expenditures is eliminated after 2021. The amount capitalized and otherwise eligible for amortization must be reduced by the excess (if any) of the research credit allowed for the tax year and the amount allowable as a deduction for the tax year as qualified research expenses or basic research expenses. (IRC Sec. 280C(c), as amended by the TCJA, §13206(a)).

Limitations - The R&D credit is also subject to limitations of the general business credit. Its total and others included in the general business credit are limited to 25% of the taxpayer's net tax liability over $25,000. To the extent that a research credit is not available for use in the current year or immediate prior year, unused credits have a 20-year carry forward.

QUALIFIED SMALL BUSINESS PAYROLL ELECTION

Beginning for tax years after December 31, 2015, a qualified small business may elect to apply a portion of its research credit, but no more than $250,000, against the employer's share of the employees' FICA withholding requirement (the 6.2 percent payroll tax).

Qualified Small Business - A qualified small business (QSB) for this purpose is a C corporation, S corporation or a partnership provided:

- It does not have gross receipts in any year before the fourth preceding year (Code Sec. 41(h)(3)(A)(i)(II)). However this rule does not require a taxpayer to be in existence for five years. Thus the payroll credit can only be taken in the first 5 years of the entity's existence,
- The gross receipts of the entity for the year the credit is elected are less than $5 million as determined under Code Sec. 448(c)(3), and
- It is not a tax-exempt organization.

Any person (other than a corporation or partnership) is a qualified small business if the person meets the requirements of the first 2 bullets above taking into account the person's aggregate gross receipts received in carrying on **all** the person's trades or businesses. (Notice 2017-23, Section 3.02)

> ***Example*** *- The taxpayer is a calendar year individual with one business that operates as a sole proprietorship. The taxpayer has gross receipts of $4 million in 2019. For years 2015, 2016, 2017 and 2018, the taxpayer had gross receipts of $1 million, $7 million, $4 million, and $3 million and did not have any gross receipts for any taxable year prior to 2015. The taxpayer is a qualified small business for 2019 because he has less than $5,000,000 in gross receipts for 2019 and did not have gross receipts before 2015 (before the 5-taxable-year period ending with 2019). The taxpayer's gross receipts in years 2015-2018 are not relevant in determining whether he is a qualified small business in taxable year 2019. Because the taxpayer had gross receipts in 2015, the taxpayer is not a qualified small business for 2020, regardless of his gross receipts in 2020.*

Payroll Tax Portion of the R&D Credit - The payroll tax portion of the research credit is equal to the smallest of the following:

1. The amount specified by the taxpayer in its election to claim the credit, but not exceeding the $250,000 maximum;
2. The research credit determined for the tax year (determined without regard to the payroll tax election made for the tax year); or
3. In the case of a qualified small business other than a partnership or S corporation, the amount of the business credit carryforward for the tax year of the election (determined without regard to the payroll tax election made for the tax year).

Note: Determining the amount of the #3 limitation is quite complicated! Since the R&D credit is part of the general business credit, it must first be added to the general business credit for the year and used to offset any regular tax liability and any AMT liability. Then, the general business credit must be carried back one year. Any excess after the carryback is carried forward to the year after the year for which the credit was computed. The payroll credit is limited to the amount of the business credit carryover. See the steps outlined below:

Current Year:
1. Determine the R&D credit
2. Add the R&D Credit to the General Business Credit (GBC)
3. Offset any current regular or AMT tax with the GBC
4. Carry any excess back to preceding year

Preceding Year:
5. Offset any preceding year taxes
6. Determine credit remaining that could be carried over if payroll credit wasn't claimed

Current Year:
7. The payroll credit is limited to carryover from the preceding year.

Next Year:
8. Adjust the R & D credit carryforward by the amount of the payroll tax credit claimed

Example *– Taxpayer, operating as a Schedule C sole proprietor, has a $35,000 general business credit in 2018 2019, which includes a $25,000 research credit computed without regard to the payroll tax credit. The taxpayer's regular and AMT tax liability in 2019 is $15,000. The taxpayer's 2018 regular and AMT tax liability was $5,000. After offsetting 2019 and 2018 tax liabilities, the taxpayer has a $15,000 general business credit carryforward to 2020 without regard to the election to claim a payroll tax credit. The maximum payroll tax credit that may be claimed in 2019 is $15,000 since this amount is less than the $250,000 maximum and the $25,000 research credit determined for the year of election without regard to the payroll tax credit. The taxpayer elected to use all of the $15,000 as a 2019 payroll tax credit, and therefore will have only $10,000 of the $25,000 R&D credit to carry forward to 2020.*

Electing the Payroll Tax Credit – Complete Section D of Form 6765 – Credit for Increasing Research Activities to make the election to claim the payroll credit. Then complete Form 8974 - Qualified Small Business Payroll Tax Credit for Increasing Research Activities and attach it to each quarterly payroll tax return (generally Form 941) until the credit is used up. See the Form 8974 instructions for additional guidance.

CAUTION: The election cannot be made if the taxpayer made an election for five or more preceding years. Code Sec. 41(h)(4)(B)

CALIFORNIA RESEARCH CREDIT

The California version of the research credit for increasing the research activities of a trade or business is claimed on Form FTB 3523, Research Credit, which is also used to claim pass-through research credits from S corps, partnerships, limited liability companies and trusts. The credit is nonrefundable but unused credit may be carried forward.

The California credit is 15% of the excess of qualified research expenses for the taxable year over the base period research expenses. Corporations are allowed the 15% credit amount plus credit for 24% of the basic research payments.

- Taxpayers may elect the alternative incremental credit in which taxpayers are assigned a smaller three-tiered fixed-base percentage and a reduced three-tiered credit rate (1.49%, 1.98%, and 2.48%).
- The CA credit can be claimed whether or not the federal research credit is claimed.
- California conforms to the federal definition for qualified research expenses under IRC Section 41(b).
- Qualified research expenses do not include any amounts paid for tangible personal property eligible for the exemption from sales or use tax under R&TC Section 6378. The eligible property is tangible personal property used primarily for the following:
    1. In teleproduction or other postproduction services.
    2. To maintain, repair, measure, or test any property described in item 1.
- The basic and qualified research must have been conducted within California.
- For business conducted both within and outside of California, for purposes of determining the base amount, gross receipts are the receipts from the sale of property that is held primarily for sale to customers (in the ordinary course of a trade or business) and that is delivered or shipped to customers in California.
- If a taxpayer owns an interest in a disregarded business entity [a Single Member Limited Liability Company (SMLLC) not recognized (disregarded) by California and for tax purposes is treated as a sole proprietorship owned by an individual or a branch owned by a corporation], the amount of the credit that can be utilized is limited to the difference between the taxpayer's regular tax computed with the income of the disregarded entity, and the taxpayer's regular tax computed without the income of the disregarded entity. If the disregarded entity reports a loss, the taxpayer may not claim the credit for the loss year but can carry over the credit amount received from the disregarded entity. For more information on disregarded business entities, get Form 568, Limited Liability Company Tax Booklet.
- The credit cannot reduce the minimum franchise tax (corporations and S corporations), annual tax (partnerships and QSub), alternative minimum tax (corporations , exempt organizations, individuals, and fiduciaries), built-in gains tax (S corporations), or excess net passive income tax (S corporations).
- This credit can reduce regular tax below tentative minimum tax (TMT). Get Schedule P (100, 100W, 540, 540NR, or 541), Alternative Minimum Tax and Credit Limitations, for more information.

NOTES

CREDIT FOR PAID FAMILY AND MEDICAL LEAVE

For two years, 2018 and 2019, TCJA added a provision that allows employers a general business credit for wages paid to employees while they are on paid family or medical leave. The credit is variable and only applies where the leave wages are at least 50% of what is normally paid to the individual. The credit percentage is 12.5% and increases by 0.25%, up to a maximum of 25%, for each percentage point that the rate of payment exceeds 50%.

Related IRC and IRS Publications and Forms

- **Code Sec 45S(a)**
- **Form 8994** - Employer Credit for Paid Family and Medical Leave
- **Instructions - Form 8994**
- **General Business Credit** – Chapter 9.00
- **Notice 2018-71 –** Guidance on Sec 45S in Q&A format

The Credit - For wages paid in tax years beginning after 2017 and before 2020, a general business credit may be claimed equal to 12.5% of the amount of wages paid to a qualifying employee during any period in which the employee is on family and medical leave if the rate of payment is at least 50% of the wages normally paid to the employee, for up to a maximum of 12 weeks of leave with respect to any employee for the tax year. (Sec. 45S(b)(3)) The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

Example: *ABC, Inc. has a qualifying written policy to pay an employee 70% of their normal wage while on family or medical leave. 70% is 20 percentage points above the 50% credit threshold. The credit is increased by 5 percentage points (.25 x 20) which when added to the base credit of 12.5% results in a credit percentage of 17.5%. Assuming the leave wages paid for the year were $15,000, the credit would be $2,625 (.175 x $15,000).*

Leave that is paid by a state or local government or is required by state or local law is not included in the amount of paid family and medical leave provided by the employer.

Qualifying Employer - To qualify for the credit, an employer must have a written policy containing certain requirements, and all "qualifying" full-time employees must be given at least two weeks of annual paid family and medical leave (all less-than-full-time qualifying employees must be given a commensurate amount of leave on a pro rata basis).

Qualifying Employee – To be a qualifying employee, the individual must have been employed by the employer for one year or more, and, for the preceding year, had compensation not in excess of an amount equal to 60% of the "highly compensated employee" threshold. $120,000 is the "highly compensated" amount for years 2015 through 2018, and $125,000 is the inflation-adjusted amount for 2019. Thus, to be a qualifying employee in 2018 or 2019, an employee must have earned no more than $72,000 (60% of $120,000) in compensation in the *preceding year*.

Credit or Deduction – The employer can't take both a credit and a deduction for amounts for which the paid family and medical leave credit is claimed. Claiming the credit is an election.

Employer Policy - The employer's policy, at a minimum, must provide

(A) that:

1. A qualifying employee who is **not a part-time employee**, generally one who works 30 hours or more a week is provided no less than two weeks of annual paid family and medical leave, and
2. A qualifying employee who **is a part-time employee**, generally one who works less than 30 hours a week, is provided an amount of annual paid family and medical leave that is not less than an amount which bears the same ratio to the amount of annual paid family and medical leave that is provided to a qualifying employee who is not part time (works 30 or more hours a week) as
    a. The number of hours the employee is expected to work during any week, bears to
    b. The number of hours an employee who is not a part time is expected to work during the week.

(B) The policy requires that the rate of payment under the program is not less than 50% of the wages normally paid to that employee for services performed for the employer.

Form 8994 – The IRS developed Form 8994 to be used when claiming the paid family and medical leave credit. The instructions to Form 8994 provide details as to eligible employers, qualifying employees, what constitutes family and medical leave, minimum paid leave requirements, the applicable percentage, and how to compute the credit, including worksheets. Preparers are encouraged to read the instructions carefully before claiming the credit on a client's return and to make sure the various requirements noted in the instructions for the employer's written policy have been satisfied.

CALIFORNIA DIFFERENCES

California does not have a similar credit.

NOTES

CALIFORNIA TAX CREDITS

Overview

- **California Credits Covered Elsewhere in This Text**
  - Ch 9.03 **– Earned Income Tax Credit**
  - Ch 9.08 **– Adoption Credit**
  - Ch 9.02 **– Child & Dependent Care Credit**
  - Ch 9.16 **– Research credit**
  - Ch 1.03 **– Exemption Credits**
- **California Credits Included in This Chapter**
  - **Renters Credit**
  - **Employer Child Care Contribution Credit** – Carryover only
  - **Senior Head of Household Credit**
  - **Joint Custody Head of Household Credit**
  - **Credit for Dependent Parent Credit**
  - **Manufacturers Investment Credit** – Carryover only
  - **Natural Heritage Preservation Credit**
  - **Film Credits**
  - **New Jobs Credit**
  - **New Employment Credit**
  - **California Competes Credit**
  - **College Access Tax Credit**
  - Overview of other credits
  - Credit Reference & Carryover Table

RAPID FINDER

NONREFUNDABLE RENTER'S CREDIT

This nonrefundable credit is:

- $120 for Joint, HH and SS filers, and
- $60 for all others.

AGI Limit

Filing Status	2016	2017	2018	2019
Joint, HH and SS	78,125	80,156	83,282	
Others	39,062	40,078	41,641	

If blank, the amounts are not available at publication date

Qualifications - To claim renter's credit, a taxpayer must meet the following conditions:

- Be a resident of California for the entire year.
- AGI must be below annual limit. Use California AGI for this test.
- Must pay rent for at least half of the tax year on property (including a mobile home that the taxpayer owned on rented land) in CA that was the taxpayer's principal residence.
- The rented property is not exempt from property taxes.
- For not more than half the year, the taxpayer did not live with, or was not a minor under the care of a parent, foster parent, or legal guardian who claimed the taxpayer as a dependent.

  (1) Military personnel *- A military person, who is not a legal resident of California, does not qualify for this credit. However, the military person's spouse may claim this credit if he or she was a California resident, did not live in military housing, and is otherwise qualified.*

  (2) Form 540NR – *Some 540NR filers may qualify if they were residents of California at least six months during the tax year.*

EMPLOYER CHILD CARE CONTRIBUTION CREDIT

This credit is not available after 2011. However, any unused credit can be carried over until used up.

CREDIT FOR SENIOR HEAD OF HOUSEHOLD

A taxpayer can claim this credit (without qualifying as head of household in the current year) if they:

- Were 65 years of age or older on December 31 of the tax year;
- Qualified as head of household in one of the two preceding tax years by providing a household for a qualifying individual who died during one of the two preceding tax years; and
- Did not have adjusted gross income over annually inflation adjusted AGI limit (see adjacent table).

AGI & Credit Limits

Tax Year	2016	2017	2018	2019
AGI	71,370	73,226	76,082	
Max Credit	1,345	1,380	1,434	

If blank, the amounts were not available at publication date

The credit is the lesser of:

- 2% of the taxpayer's California taxable income for the year, or
- The credit limit for the year (see adjacent table).

CREDIT FOR JOINT CUSTODY HEAD OF HOUSEHOLD

This credit IS NOT available to taxpayers filing as head of household or qualifying widow(er). The credit IS available to taxpayers who:

- Are unmarried at the end of the tax year, or
- If married, lived apart from their spouse for the entire tax year and are filing as married filing separate, and
- Furnished more than one-half the household expenses for a home that also served as the home of the taxpayer's child, stepchild, or grandchild for at ***least 146 days but not more than 219 days (between 40% and 60%)*** of the taxable year. If the child is married, the taxpayer must be entitled to claim a dependent exemption credit for the child.

The custody arrangement for the child must be part of a decree of dissolution or separate maintenance or must be part of a written agreement between the parents where the proceedings have been initiated, but a decree of dissolution or separate maintenance has not yet been issued.

The credit is the lesser of:

- 30% of the tax (less the tax on accumulation trusts) less exemptions credits but before credits and AMT.
- The credit limit for the year (see table).

Tax Year	2016	2017	2018	2019
Max Credit	440	451	469	

If blank, the amount was not available at publication date

CREDIT FOR DEPENDENT PARENT: This credit is available to taxpayers who:

- Were married at the end of the tax year and used the married filing separate filing status;
- The taxpayer's spouse was not a member of the household during the last six months of the year; and
- The taxpayer furnished over one-half the household expenses for a dependent mother's or father's home, whether or not they lived in the taxpayer's home.

The credit is computed in the same manner as the Joint Custody Head of Household credit.

The credit is the lesser of:

- 30% of the tax (less the tax on accumulation trusts) less exemption credits but before other credits and AMT.
- The credit limit for the year (see table).

Tax Year	2016	2017	2018	2019
Max Credit	440	451	469	

If blank, the amount was not available at publication date

NATURAL HERITAGE PRESERVATION CREDIT – FUNDED 1/1/10 – 6/30/20

Funding for the Natural Heritage Preservation Credit is available beginning January 1, 2010, until June 30, 2020. FTB Form 3503 is used to claim this credit. In 2014, Senate Bill No. 355 was passed by the Legislature and approved by the Governor. The bill extended the period for when a qualified contribution is made for which a tax credit would be allowed to June 30, 2020. The bill also extended the carryover period to 15 years for a qualified contribution made on or after January 1, 2015. All other aspects of the Program remain unchanged.

The credit is:

- ***55% of the appraised fair market value*** of pre-qualified land (fee title or conservation easement) and/or water or water rights contributed to state/local governments or nonprofit organizations. Application for approval of the contribution must be made to the California Wildlife Conservation Board.
- ***Not refundable but available for carryforward*** until exhausted, but for no more than **8 years** (15 years for post-2014 contributions), if the credit exceeds net tax.
- ***In lieu of any other state tax credit or deduction*** the taxpayer may otherwise claim for the donated property.

Eligibility Criteria - To be considered by the Board to be an eligible donation, the property must meet one or more of the following criteria (*Public Resources Code § 37015*):

a. The property will help meet the goals of a habitat, multispecies or natural community conservation plan, or any other subsequently statutorily authorized similar plan designed to benefit native species of plants, including, but not limited to, protecting forests, old growth trees, or oak woodlands, and animals and development.

b. The property will provide corridors or reserves for native plants and wildlife that will help improve the recovery possibilities of listed species or will help avoid the listing of species as endangered, or protect wetlands, waterfowl habitat, or river or stream corridors, or promote the biological viability of important California species.

c. The property interest is a perpetual conservation easement over agricultural land, or is a permanent contribution of agricultural land, that is threatened by development and is located in an unincorporated area that is zoned for agricultural use by the county.

d. The property interest is a water right, or land with an associated water right, and the contribution of the property:
   - Will help improve the recovery chances of a listed species,
   - Will reduce the likelihood that any species of fish or other aquatic organism will be listed,
   - Will improve the protection of listed species, or
   - Will improve the viability and health of fish species of economic importance to the state.

   The donee receiving the water right, or land with an associated water right, must ensure that it will retain title to the water right, and that the water is used to fulfill the intended purposes for which it is being accepted. Assurances must be made that no harm will result to any legal user of the water if a water right includes a diversion or place of use change.

e. The property will be used as a park or open space or will augment public access to or enjoyment of existing regional or local park, beach, or open-space facilities, or will preserve archaeological resources.

In addition to meeting one or more of the above criteria, the proposed donation must satisfy the requirements for a "qualified contribution" of IRC § 170. If only a portion of a proposed conveyance of property satisfies the requirements for a "qualified contribution," or if the property is sold for less than fair market value, only that portion, or the amount representing the difference between the amount paid by the donee and the fair market value, is eligible for the tax credit. The donor must not receive any other valuable consideration for the donation of property subject to the tax credit.

A donation will **not** qualify if it is proposed to satisfy a condition imposed upon the donor by any lease, permit, license, certificate, or other entitlement for use issued by a public agency, including mitigating significant effects on the environment of a project per an approved environmental impact report.

For additional information on qualifying donations and the mechanics of obtaining approval by the Wildlife Conservation Board, see the Board's Website at www.wcb.ca.gov.

FILM CREDITS

Section 17053.85 of the Revenue and Taxation Code provides a nonrefundable income tax credit to a qualified taxpayer for qualified expenditures attributable to the production of a qualified motion picture, independent film, television show, etc., in California that is allocated and certified by the California Film Commission (CFC). Annually, the CFC is required to provide the FTB with a list of qualified taxpayers and the tax credit amounts allocated to each qualified taxpayer by the CFC. The original program was revised and extended five years by legislation (AB 1839) approved by the governor in September 2014. New R&TC 17053.95 covers the revised rules and is effective January 1, 2016 through June 30, 2020. Among the changes are increased funding of the program from $100 million to $330 million per fiscal year; expanded eligibility to big-budget feature films, 1-hr TV series (for any distribution outlet) and TV pilots; elimination of budget caps for studio and independent films; and use of a ranking system based on jobs and other criteria rather than a lottery system to select recipients of the credits. Below is a summary of the credit amounts under the law that's effective through June 30, 2020 (the California Film & Television Tax Credit Program 2.0):

Eligible for 20% Non-Transferable Tax Credit (plus 5% Uplift*):
- Feature Films: $1 million minimum budget; credit allocation applies only to the first $100 million in qualified expenditures.
- Movies-of-the-Week and Miniseries: $500,000 minimum budget
- New television Series for any distribution outlet; $1 million minimum budget per episode (at least 40 minutes per episode, scripted only)
- TV Pilots: $1 million minimum budget (at least 40 minutes)

Eligible for 25% Transferable Tax Credit (maximum credit is 25%, uplifts do not apply):
- Independent Projects: $1 million minimum budget; credits apply only to the first $10 million of qualified expenditures. (Only independent projects may sell their tax credits.)
- Relocating TV Series, any episode length, that filmed its most recent season outside California; $1 million minimum budget. (Additional seasons are eligible for 20%.)

5% Credit Uplift (bonus credit):
- Filming outside the Los Angeles 30-mile zone + 5%
- Music Scoring and music track recording expenditures + 5%
- Visual Effects expenditures (minimum spend required) + 5%

*Note: The above uplifts cannot be combined. The maximum credit a production can earn is 25%.

Form FTB 3541 is used to claim the credit (file separate Forms 3541 to report the old and new credits). Any credit unused in a taxable year because it is in excess of the taxpayer's tax liability can be carried over for six taxable years. The credit may not be used to reduce any CA AMT liabilities.

Qualified taxpayers may elect to split the credits and apply a portion to their income tax liability and a portion to their sales & use taxes. However, only one Credit Certificate will be issued to the taxpayer. Under the new program, which began July 1, 2016, the certificate numbering will begin with 5000.

For credits attributable to an independent film with a qualified expenditure budget of $10 million or less, the qualified taxpayer is permitted to sell a credit to an unrelated party. Proceeds from selling the credit are includible in income.

Productions interested in applying for the tax credits should refer to the CFC's website for the available application dates and application submission procedures: http://www.film.ca.gov/incentives.htm.
The FTB web site includes Q&As about the credit: http://film.ca.gov/tax-credit/faqs/

Credit Code Numbers:
- New Credit: 237
- Old Credit: 223

Film Credit Extension - SB 871, signed by the governor on June 27, 2018, establishes film credits similar to those currently allowed, effective for taxable years beginning on or after January 1, 2020, to be allocated by the California Film Commission on or after July 1, 2020, and before July 1, 2025. This is the so-called California Film & Television Tax Credit Program 3.0. The credit will be 20% or 25% of qualified expenditures for the production of a qualified motion picture in CA, with additional credit amounts allowed, including for amounts equal to specified qualified expenditures and qualified wages relating to original photography outside the Los Angeles zone. The aggregate amount of these new credits to be allocated in each fiscal year is limited to $330,000,000 plus additional specified amounts. Subject to a computation and ranking of applicants based on a jobs ratio, the California Film Commission will be required to allocate credit amounts subject to specified categories of qualified motion pictures in 2 or more allocation periods per fiscal year beginning on or after July 1, 2020, and issue credit certificates. Applicants for the credit will be required to include in their application their written policy against unlawful harassment and a summary of the applicant's voluntary programs to increase the representation of minorities and women in certain job classifications. As under current law, the newest version of the credit also will allow the credit amount to be applied against qualified state sales and use taxes in lieu of being used as an income tax credit. Highlights of other changes:

- Creates a pilot program for training Californians from under-served communities for careers in the skilled craft occupations in motion picture and television productions. Program is funded by a fee accessed on approved applicants.
- Reduces proportion of credits for the relocating TV category (from 20% to 17%), increases the amount of credits for the independent film category (from 5% to 8%), and splits the independent film "pot" into two categories – under $10 million and over $10 million budgets.
- Allows an additional 5% credit on wages paid to individuals who live and work on qualified productions outside the Los Angeles 30-mile zone.
- Requires applicants to provide statistics on the gender, racial, and ethnic status of individuals whose wages are not qualified (directors, producers, writers, actors).
- Eliminates "facility" (sound stage) from bonus point consideration.
- Eliminates the additional 5% credit for music scoring wages; includes music wages as a bonus point factor.
- Extends the date by which principal photography must begin from 180 days to 240 days for projects with budgets over $100M qualified spend.
- Jobs Ratio overstatement penalty threshold of independent productions has been reduced to match non-independent productions.

NEW EMPLOYMENT CREDIT IN CERTAIN AREAS (SB 90)

Effective January 1, 2014 and through 2025 (extended from 2020 by SB 855, signed into law 6/27/2018), a New Employment Credit (NEC) will be available to qualified businesses located in (1) a former enterprise zone (EZ) or former local agency military base recovery area (LAMBRA), (2) a newly created Designated Census Tract, and (3) designated areas of high unemployment. These areas are collectively referred to as designated geographic areas (DGA). Pilot areas are areas within the DGA that have been designated by the Governor's Office of Business and Economic Development (GO-Biz). Up to five pilot areas may be designated for a period of four calendar years. On April 24, 2014, GO-Biz designated 3 pilot areas:

- Fresno Pilot Area, consisting of the former Fresno City Enterprise Zone, except within census tracts with the lowest unemployment and poverty;
- Merced Pilot Area that includes the former Merced Enterprise Zone, except within census tracts with the lowest unemployment and poverty; and
- Riverside Pilot Area made up of Census tracts 303, 401.01, 402.03, 429.04, and 467 in Riverside County.

These pilot area designations expired December 31, 2017. Although the pilot area designation may be extended for an additional period of up to three calendar years by GO-Biz, no extensions were given to the above areas.

The special tax benefits that have been available in the following types of economic development areas have been eliminated after December 31, 2013: EZs, targeted tax areas (TTAs), manufacturing enhancement areas (MEAs), and LAMBRAs. However, employers who are eligible for credits for hiring qualified employees under prior law will continue to receive credits for 60 months, and carryover periods for prior credits will remain.

Ineligible Businesses - The following types of businesses are **not** allowed to claim the NEC unless they meet the definition of a small business: Food service, retail, casinos, temporary employment agencies, bars and adult live entertainment (such as night clubs and strip clubs). A qualified small business is a trade or business that has aggregate gross receipts, less returns and allowances reportable to California, of less than two million dollars ($2,000,000) during the previous taxable year. However, a small business that is involved in a sexually oriented business is ineligible for the credit.

Qualifying Employees - The credit factors in the net increase in jobs not including replacements for current employees. Eligible hires, who generally must be hired for full-time work and paid at least 150% but not over 350% of minimum wage, include: individuals who have been unemployed for at least 6 months, veterans separated from the service within 12 months of the hire date, individuals receiving the federal earned income credit for the previous tax year, ex-felons, and recipients of CalWORKs or general assistance (welfare).

Credit Amount and Annual Certification - For eligible employers, who must make a tentative credit reservation with the FTB within 30 days of the date the Employment Development Department's new-hire reporting requirements are met, the credit is 35% of qualified wages. Unused credits can be carried over for 5 years.

Employers must annually certify continued employment of the qualified employees and their wages (by March 15 for calendar year businesses). The credit may only be claimed on an original, timely filed return, and the employer's name, amount of credit claimed, and number of new jobs created by the employer will be published on the FTB's web site. The annual certification is done online at the FTB web site:

https://www.ftb.ca.gov/file/business/credits/new-employment-credit/annual-certification.asp

Form 3554 is used to calculate the credit.
See the Franchise Tax Board's web site for additional information:

- https://www.ftb.ca.gov/file/business/credits/new-employment-credit/index.html
- Map look-up for Designated Geographic Areas: http://maps.gis.ca.gov/gobiz/dga/default.aspx

THE CALIFORNIA COMPETES TAX CREDIT

Available for tax years beginning on and after January 1, 2014, and before January 1, 2030 (was 1/1/2025 prior to extension by SB 855, signed into law 6/27/2018), this is an income or franchise tax credit available to businesses that come to California or stay and grow in California. Tax credit agreements will be negotiated by the Governor's Office of Business and Economic Development (GO-Biz) and approved by a statutorily created "California Competes Tax Credit Committee." The committee consists of:

- Director of GO-Biz (Chair).
- State Treasurer.
- Director of the Department of Finance.
- One appointee each by the Speaker of the Assembly and Senate Committee on Rules.

The California Competes Credit only applies to state income or franchise tax. Taxpayers awarded a contract by the committee will claim the credit on their income or franchise tax returns using credit code 233. The credit can reduce tax below tentative minimum tax (TMT). Any credits not used in the taxable year may be carried forward up to six years.

Since 2014, $1 Billion of the California Competes Tax Credits have been allocated to 1,029 companies, projected to create more than 100,000 new jobs and make $19.5 billion in new investments. (GO-Biz News Release, July 20, 2019) SB 855 set the amount to be allocated to the credit at $180 million in each fiscal year from 2018-19 to 2022-23, inclusive.

For fiscal year 2018-19, GO-Biz will accept applications for the California Competes Tax Credit during the following periods:

- July 29, 2019, through August 2019 $90 million available)
- January 6, 2020, through January 27, 2020 ($75 million available)

- March 9, 2020, through March 30, 2020 ($71.8 million plus any remaining unallocated amounts from the previous application periods)

Applications for the credit will be accepted at www.calcompetes.ca.gov. Go to **business.ca.gov** for more information on the California Competes Tax Credit.

THE CALIFORNIA COLLEGE ACCESS TAX CREDIT

For tax years beginning on or after January 1, 2014, and through 2022, a California credit is available for individuals and business entities, and for tax years 2017 through 2022 for insurance company entities also. The credit is allowed for cash contributions made to the College Access Tax Credit Fund ("Fund"), which is a specially created fund that will be used to provide additional Cal Grants to eligible students.

There is no explicit limit on the amount a taxpayer may contribute, but the contributions must be made in cash. "Cash" for this purpose means cashier's check, money order, or Electronic Fund Transfer. For business entities only, checks written on the business entity's business account will be considered as cash. Electronic Fund Transfer only includes wire transfer and Automated Clearing House.

Taxpayers who receive a certificate from the California Educational Facilities Authority (CEFA) may claim the credit on their income or franchise tax returns using credit code 235. The awardable credits are:

- For the 2014 taxable year, 60% of the amount contributed, as allocated and certified by the California Educational Facilities Authority ("CEFA").
- For the 2015 taxable year, 55% of the amount contributed, as allocated and certified by CEFA.
- For the 2016 through 2022 taxable years, 50% of the amount contributed, as allocated and certified by CEFA.

https://www.ftb.ca.gov/file/personal/credits/college-access-tax-credit.html

Carryovers: Any unused credit is carried forward for up to six years.

Charitable Deduction: No deduction will be allowed on the state tax return for amounts taken into account in calculating the credit. However, the taxpayer is entitled to take a federal charitable deduction if itemizing on their federal return.

IRS Regs Reduce Deduction - The IRS issued final regulations in June 2019 that are aimed at overcoming the credit programs some states developed that were meant to be work-arounds to the TCJA itemized deduction limitation of $10,000 that applies to state and local taxes. (See page 7.04.01 for details.) These regulations also apply to contributions made after August 27, 2018 to pre-existing *quid pro quo* programs when the credit claimed on the state return is greater than 15% of the contribution. The California College Access Tax Credit Fund is such a program.

> ***Example:*** *Alyssia makes a payment of $1,000 to the California College Access Fund on October 1, 2019. In exchange for the payment, she receives or expects to receive a state tax credit of 50% of the contribution. Under the regulations, Alyssia's federal charitable contribution deduction is reduced by $500 (50% x $1,000). Thus, Alyssia's federal charitable contribution deduction for the $1,000 payment is $500.*

Credit Must Be Applied For: The maximum aggregate amount of tax credits that can be allocated and certified for each calendar year 2014-2016 is $500 million in addition to the amount of any unallocated and uncertified tax credits in the previous calendar year. The cumulative amount of credits allocated and certified for 2014 through 2018 was just over $25.5 million. For 2018 and 2019, the yearly maximum amount of credits that can be allocated and certified is $500 million (per SB 81, signed into law June 24, 2015). The California Educational Facilities Authority's (CEFA) deadline for applications for credits for 2019 is 5:00 p.m. January 2, 2020. The application can be downloaded at: https://www.treasurer.ca.gov/cefa/catc/index.asp. The completed application can be faxed to 916-653-2179 or mailed to **CEFA**, **915 Capitol Mall, Room 435, Sacramento, CA 95814, Attention: Operations Manager**.

CA AMT – SB81 passed in 2015 allows the credit to be used against the California AMT. The legislation is also retroactive to 2014, and allows CA taxpayers who were approved for the credit, claimed the credit on their 2014 tax return and had the credit limited by the AMT to amend the 2014 return and claim the credit against the AMT.

Continue to Next Page for Credit Reference Table

OTHER CURRENT CREDITS NOT SPECIFICALLY COVERED ELSEWHERE IN THE TEXT

Credit	Code	Abbreviated Description
AMT (prior year) Credit – FTB 3510	188	Determined in a manor similar to the Federal AMT credit; reduces regular tax; not refundable.
Disabled Access for Eligible Small Businesses FTB Form3548	205	Similar to the Federal credit but limited to $125 based on 50% of qualified expenditures that do not exceed $250.
Donated Agricultural Products Transportation FTB Form 3547	204	50% of the costs paid or incurred for the transportation of agricultural products donated to nonprofit charitable orgs.
Enhanced Oil Recovery – FTB 3546	203	One third of the similar Federal credit and limited to qualified enhanced oil recovery projects located in CA.
Low-Income Housing – FTB 3521	172	Similar to the Federal credit but limited to low-income housing in California.
New Donated Fresh Fruits or Vegetables - FTB 3814	238	15% of the qualified value of the donated item, based on weighted average wholesale price for contributions to CA food banks 2017-2021; unused credit carried forward 7 years.
Prison Inmate Labor - FTB 3507	162	10% of wages paid to prison inmates.

CREDIT REFERENCE TABLE

CREDIT	FORM NUMBER	CREDIT NUMBER
California Competes	FTB 3531	233
Child Adoption	Worksheet	197
Child and Dependent Care Expenses	FTB 3506	232
College Access	FTB 3592	235
Dependent Parent	Worksheet	173
Disabled Access for Eligible Small Businesses	FTB 3548	205
Donated Agricultural Products Transportation	FTB 3547	204
Earned Income Tax	FTB 3514	None
Enhanced Oil Recovery	FTB 3546	203
Enterprise Zone Hiring,	FTB 3805Z	176
Joint Custody Head of Household	Worksheet	170
Local Agency Military Base Recovery Area Hiring	FTB 3807	198
Low-Income Housing	FTB 3521	172
Natural Heritage Preservation	FTB 3503	213
New CA Motion Picture & Television Production	FTB 3541	237
New Donated Fresh Fruits or Vegetables	FTB 3814	238
New Employment	FTB 3554	234
Nonrefundable Renter's	Worksheet	None
Other State Tax	Schedule S	187
Prior Year Alternative Minimum Tax	FTB 3510	188
Prison Inmate Labor	FTB 3507	162
Research	FTB 3523	183
Senior Head of Household	Worksheet	163

EXPIRED OR REPEALED CREDITS – Carryover may still be available.

Agricultural Production	175
California Motion Picture & TV Prod	223
Commercial Solar Electric System	196
Commercial Solar Energy	181
Community Dev Fin Institution Investment	209
Donated Fresh Fruits & Vegetables	224
Employer Childcare Contribution	190
Employer Childcare Program	189
Employee Ridesharing	194
Employer Ridesharing (Large)	191
employer Ridesharing (Small)	192
Employer Ridesharing (transit passes)	193
Energy Conservation	182
Enterprise Zone Sales or Use Tax	176
Environmental Tax	218
Farm Worker Housing	207
Local Agency Military Base Recovery	198
Low-Emission Vehicles	160
Manufacturing Enhancement Area Hiring	211
New Jobs	220
Orphan Drug	185
Political Contributions	184
Recycling Equipment	174
Residential Rental & Farm Sales	186
Rice Straw	206
Ridesharing	171
Salmon & Steelhead Habitat Restoration	200
Solar Energy	180
Solar Pump	179
Targeted Tax Area Sales or Use Tax	210
Water Conservation	178
Young Infant	161

NOTES

FEDERAL TAX PENALTIES

Overview

Late filing: 4-1/2 % per month; 22-1/2% max

- **Late paying:** 1/2% per month; 25% max. (combined with late filing 1st 5 mo.)
- **Late filing minimum:** smaller of $330 (2020) or 100% of tax due
- **Failure to report tips:** 50% of the SS tax on tips
- **Dishonored payment:**
    - Less than $1,250 – lesser of $25 or the amount of the check
    - $1,250 or more – 2% of the check amount
- **Excessive Claim Penalty:** 20% of the excessive amount
- **Fraud:** 75% of the unpaid tax due to fraud
- **Negligence** (accuracy related)**:** 20% of the underpayment, 40% if attributable to undisclosed foreign financial asset
- **Paying late:**
    - Each month – ½ %
    - After notice to levy – 1% per month
    - Maximum 25%
    - If paying in installments – ¼% per month
- **Missing ID Number:** $50 each
- **Late filing because of fraud:** 15% per month
    - Maximum 75%
- **Failure to report foreign gifts:** 25% (See chapter 1.13)
- **Failure to report ownership of or transactions with foreign trusts**: Greater of $10,000 or 35% (See chapter 1.13)
- **Failure to report foreign assets (Form 8938):** $10,000 for 1st 90 days and $10,000 for each subsequent 30 days (See chapter 1.13)
- **Failure to report Foreign Accounts (FBAR):** $10,000 (non-willful), $100,000 or 50% of account balance if willful (See chapter 1.13)

RAPID FINDER

New Law & Stuff

CHANGES MADE BY THE TAXPAYER FIRST ACT OF 2019

Penalty for Failure to File - Effective for returns required to be filed after Dec. 31, 2019, the late filing minimum penalty is increased to $330 (adjusted for inflation after 2020) and is substituted for the inflation-adjusted $215 penalty that was to apply to returns required to be filed in 2020. (Code Sec. 6651(a) and Code Sec. 6651(j), as amended by the Taxpayer First Act - Sec. 3201)

Pubs Forms

Related IRS Publications and Forms

- **Form 1040 Instructions**
- **Pub 17** - Your Federal Income Tax
- **Form 4868 Instructions** – Application for Automatic Extension
- **Notice 746**–Information About Your Notice, Penalty and Interest

The Details

PENALTIES - The following is a listing of the penalties that are most commonly assessed by the IRS. The codes which the IRS uses on its penalty notices are also included.

Filing and Paying Late (Code 01) - These penalties are assessed because a taxpayer did not timely file and did not pay the tax owed. The combined penalty is 5% of the unpaid tax for each month or part of a month the return is late, but not for more than 5 months. The late filing penalty is reduced by the late payment penalty. Thus, the 5% includes a 4 1/2% penalty for filing late and a 1/2% penalty for paying late. (IRC 6651).

The 25% combined maximum penalty includes 22 1/2% for filing late and 2 1/2% for paying late. The 1/2 % penalty for paying late is not limited to 5 months. This penalty will continue to increase to a maximum of 25% until the taxpayer pays the tax in full. The maximum 25% penalty for paying late is in addition to the maximum 22 1/2% late filing penalty for a total penalty of 47 1/2%.

If a taxpayer didn't file a return within 60 days of the due date, the minimum penalty is the lesser of 100% of the tax due or $330 for returns required to be filed 2020 (Taxpayer First Act). Historical penalties shown in the table below.

Year	Before 2009	2009-2015	2016	2017-2018	2019*
Penalty	$100	$135	$205	$210	$330

If amount not shown it was not available at publication date.
**Technically, applies for returns required to be filed in 2020, which generally would be 2019 returns*

Extensions – IRM 20.1.2.2.3.1.1 (03-19-2019) – Extension of Time to File Not Found - provides guidance to IRS employees when a taxpayer claims to have filed an extension, but the extension has not been posted on the IRS system. It requires the IRS agent to check if the extension filed was erroneously posted to another account. It also requires the IRS to examine the facts of each case and apply the more likely than not criteria. The following is an excerpt from the Revenue Manual:

> *. . . if all the known facts would lead a reasonable person to presume that it is more likely than not, that a valid, and timely, extension request was submitted, then the* ***more likely than not*** *criteria has been met. Examples would include a certified mail receipt along with a copy of the extension; or a list of extensions filed by a tax professional where most extensions on the list have been received and posted; or a payment posted to the account that was mailed with the extension request. (This list is not all-inclusive.)*
>
> *A history of approved extensions alone, a mere statement that an extension request was filed, or even a copy of the extension request that was* allegedly *filed, are not in and of themselves* evidence of filing *an extension for the current year. However, collectively with other facts, such as the reason the taxpayer would have had for filing an extension, the earlier mentioned facts could be sufficient to meet the* more likely than not *criteria. Additionally, Facts can be used collectively to show that it was reasonable for the taxpayer to* believe *that an extension had been requested and approved. For example, a list of extensions allegedly filed by a tax professional, where most extensions on the list have not been received and processed, still may be used to show that it was reasonable for the taxpayer to* believe *that an extension of time to file had been requested and approved.*

Extension Precautions

Many practitioners take filing extensions far too lightly and are unaware of, or ignore, the nuances of properly completing an extension and the potential penalties. Properly and timely filing the Form 4868 extends the individual income tax return filing due date for a calendar-year filer to October 15 (or the next business day if October 15 falls on a weekend or holiday) and avoids the 5% per month (or part of a month) failure-to-file penalty.

Properly Estimate the Tax Liability – The 4868 instructions clearly indicate that to have a valid extension, a taxpayer must:

(1) Properly estimate their tax liability using the information available to them, and
(2) Enter their total tax liability on line 4 of the 4868 and
(3) File the extension by the regular due date for their return.

This requirement was reinforced in Tax Court (*Laidlaw v. Commissioner*) where the court determined the extension was invalid because the taxpayer (through their tax preparer) did not make a bona fide and reasonable estimate of their tax liability or attempt to secure the information necessary to complete a valid estimate. They had merely entered a zero for the estimated tax liability without making a proper estimate of the liability.

Underpayment of Estimated Tax (Code 02) - If a taxpayer owes tax of $1000 or more for the tax year, the taxpayer must prepay the tax by having tax withheld or by making estimated tax payments. Failure to do so will result in the taxpayer being subject to the current published interest rates for underpayment of estimated taxes. See chapter 10.03 on estimated taxes and safe harbor rules. (IRC Sections 6654, 6621)

Dishonored Check Payment (Code 04) - A penalty is charged if a taxpayer's payment is dishonored and returned from a financial institution. The penalty is the greater of $25 or 2% of the payment amount. For checks of less than $1,250, the penalty is the lesser of $25 or the amount of the check. (IRC Section 6657)

Fraud (Code 05) - This penalty is 75% of the tax unpaid due to fraud. (IRC Section 6663)

Negligence (Code 06) - This "accuracy-related" penalty is 20% of the tax underpayment that is due to negligence or tax valuation misstatements (IRC Section 6662(a)). Substantial understatement is the greater of 10% (5% if the Sec 199A deduction is claimed) of the tax shown on the return or $5,000. (IRC Section 6662(d)(1)) A 40% accuracy-related penalty is imposed for underpayment of tax that is attributable to an undisclosed foreign financial asset understatement (IRC Sec. 6662(j)).

Paying Late (Code 07) - The penalty is 1/2% of the unpaid tax for each month or part of a month the tax is unpaid. If the IRS issues a Notice of Intent to Levy and the taxpayer doesn't pay the balance within 10 days, the penalty increases to 1% per month. The penalty can't be more than 25% of the tax paid late. The late payment penalty is reduced to 1/4% per month for those paying in installments. (IRC Section 6651)

Missing ID Number (Code 08) - This penalty is $50 for each missing number. This penalty is charged when a taxpayer doesn't provide a social security number (SSN) for self, dependent, or another person or doesn't provide his/her SSN to another person when required. The penalty can't exceed $100,000 in any calendar year. (IRC Section 6723)

Penalty on Tips (Code 27) - This penalty is charged if a taxpayer didn't report tips to his/her employer. It equals 50% of the social security tax on the unreported tips. (IRC Section 6652(b))

"Excessive" Claim Penalty - If a claim for refund or credit for income tax (other than a claim for refund or credit relating to the earned income credit that was made prior to December 16, 2015) is made for an "excessive amount," the person making the claim is liable for a penalty equal to 20% of the excessive amount. (Code Sec. 6676(a), as amended by the PATH Act of 2015) The "excessive amount" is the amount by which the amount of a person's claim for refund or credit for any tax year exceeds the amount of the claim allowable under the Code for that tax year. (Code Sec. 6676(b))

The penalty doesn't apply if it is shown that the claim for the excessive amount is made with reasonable cause. For claims filed on or before December 18, 2015, the penalty applies to claims filed without a reasonable *basis*. (Code Sec. 6676(a)) The penalty also does not apply if any portion of the excessive amount or credit is subject to an accuracy-related penalty imposed under Code Sec. 6662 or Code Sec. 6662A or under the Code Sec. 6663 fraud penalty. (Code Sec. 6676(c))

Frivolous return - In addition to any other penalties, the law imposes a penalty of $5,000 for filing a frivolous return. A frivolous return is one that does not contain information needed to figure the correct tax or shows a substantially incorrect tax because the taxpayer takes a frivolous position or desire to delay or interfere with the tax laws. This includes altering or striking out the preprinted language above the space where the taxpayer signs. For a list of positions identified as frivolous, see Notice 2010-33, I.R.B. 2010-17, April 7, 2010, which modifies and supersedes Notice 2008-14, 2008-4, IRB 310, both of which are available at: www.irs.gov/irb. (Code Sec 6702) Under limited circumstances the IRS may reduce the penalty from $5,000 to $500; see Rev. Proc. 2012-43, 2012-49 IRB 643 for details.

Minimum Penalty for Failure to Report on Foreign Trust - For notices and returns required to be filed after Dec. 31, 2009, the initial penalty for failing to report under Code Sec. 6048 is the greater of $10,000 or 35% of the gross reportable amount (5% for U.S. persons treated as owners of the trust). (Code Sec. 6677(a)) Thus, an initial penalty of $10,000 is imposed even where IRS has insufficient information to determine the gross reportable amount. The additional $10,000 penalty for every additional 30 days of delinquency continues to apply. The penalty applies if the required information or return is not filed by the due date, does not include all required information or includes incorrect information.

Failure to File Information Returns –A payer who, without reasonable cause, fails to timely file a required information return in the required manner, or fails to include all of the information required to be shown on the return, or includes incorrect information, is subject to a penalty of $100 for each return required to be filed on or before December 31, 2015, with a maximum penalty of $1.5 million for each calendar year. For a correct information return filed late, but on or before 30 days after the required filing date, the penalty amounts are reduced to $30/$250,000; returns filed after the 30th day after the due date but on or before August 1 have a reduced penalty of $60/$500,000. The maximum penalty is reduced to $75,000 (corrected within 30 days) or $200,000 (corrected by Aug. 1) if average gross receipts is $5 million or less. For tax years beginning in 2015, the penalty amounts are increased and inflation-adjusted (see tables below). Income is determined by averaging the gross annual receipts of the most recent three tax years. (Code Sec 6721)

	Year	Penalty Per Return	Calendar Year Maximum Average Gross Receipts $5 Million or Less	Calendar Year Maximum Average Gross Receipts More Than $5 Million
General Rule	2018 2019* 2020	$270 $270 $280	$1,091,500 $1,113,000 $1,130,500	$3,275,500 $3,339,000 $3,392,000
Corrected by 30th day after due date	2018 2019* 2020	$50 $50 $50	$191,000 $194,500 $197,500	$545,500 $556,500 $565,000
Corrected after 30th day but on or before August 1	2018 2019* 2020	$100 $110 $110	$545,500 $556,500 $565,000	$1,637,500 $1,669,500 $1,696,000
Per Rev Proc	2018 2019* 2020	2018-18 2018-57		

*Return required to be filed in 2020

De Minimis Failures - An otherwise correctly filed information return required to be filed **after 2016** that has one or more incorrect dollar amounts does not need to be corrected in some cases. It is treated as having been filed or provided with all correct required information, if no single incorrect dollar amount differs from the correct amount by more than $100; and no single amount reported for tax withheld on any information return differs from the correct amount by more than $25. (Code Sec. 6721(c)(3)) However, if the person receiving the payee statement elects out of the exception, and elects to receive a corrected payee statement, this safe-harbor rule won't apply.

Restitution Collection - The IRS is allowed to assess and collect the amount of restitution under an order made pursuant to title 18 USC § 3556 for failure to pay any tax imposed under the Code, in the same manner as if the restitution amount were the tax itself (Code Sec. 6201(a)(4)(A)). In other words, IRS can assess and collect restitution owed by defendants in criminal tax cases as if it were a tax. An assessment of such a court-ordered restitution amount won't be made before all appeals of the order are concluded and the right to make all those appeals has expired. (Code Sec. 6201(a)(4)(B))

W-4 Falsification – A penalty of $500 may be assessed if excessive allowances are claimed to reduce the withholding and there is no reasonable basis for doing so. There is also a $1,000 criminal penalty or one year of imprisonment, or both, if convicted of willfully providing fraudulent information in order to reduce withholding. (Code Section 6682)

Overstatement of Non-Deductible IRA Contributions - $100 for each overstatement unless due to reasonable cause.

Failure to file Form 8606 – Non-Deductible IRA - $50 unless due to reasonable cause. (Form 8606 Instructions)

Failure to Provide TIN to Payer of Alimony - $50 (IRS Pub 504).

Penalty Relief Application Chart

Reproduction of IRM Exhibit 20.1.1-1 (07/2019)

IRC Section	Type of Penalty	Reasonable Cause Relief	Other Relief
6039E	Failure to Provide Information Concerning Resident Status	Yes	Yes
6651(a)(1)	Failure to File Tax Return	Yes	Yes
6651(a)(2)	Failure to Pay Tax When Due	Yes	Yes
6651(a)(3)	Failure to Pay Within 10 Days of Notice of Additional Tax Due (notices issued prior to 1/1/1997)	Yes	Yes
6651(a)(3)	Failure to Pay Within 21 Days of Notice of Additional Tax Due (10 business days if amount is $100,000 or more) (notices issued after 12/31/1996)	Yes	Yes
6651(f)	Fraudulent Failure to File	No	No
6652(a)(1)	Failure to File Certain Information Returns	Yes	Yes
6652(c)(1)	Failure to File Annual Return by Exempt Organization	Yes	Yes
6652(c)(2)	Failure to File Returns Under IRC 6034 or IRC 6043(b))	Yes	Yes
6652(d)(2)	Notification of Change in Status of a Plan	Yes	Yes
6652(e)	Information Required in Connection With Certain Plans of Deferred Compensation—Form 5500	Yes	Yes
6652(h)	Failure to Give Notice to Recipients of Certain Pension, Etc., Distributions	Yes	Yes
6652(i)	Failure to Give Written Explanation to Recipients of Certain Qualifying Rollover Distributions	Yes	Yes
6652(j)	Failure to File Certification With Respect to Certain Residential Rental Projects	Yes	Yes
6654	Estimated Tax Penalty on Individuals	No	Yes
6655	Estimated Tax Penalty on Corporations	No	No
6656(a)	Failure to Deposit	Yes	Yes
6657	Bad Checks	Yes	Yes
6662	Accuracy-Related Penalty on Underpayments	Yes*	Yes
6662A	Accuracy-Related Penalty on Understatements With Respect to Reportable Transactions	Yes*	Yes
6663	Fraud	No	No
6676	Erroneous Claim for Refund or Credit	Yes	No
6692	Failure to File Actuarial Report	Yes	Yes
6698	Failure to File Partnership Return	Yes	Yes
6699	Failure to File S Corporation Return	Yes	Yes
6721	Failure to File Correct Information Reporting Returns	Yes	Yes
6722	Failure to Furnish Correct Payee Statements	Yes	Yes
6723	Failure to Comply With other Information Reporting Requirements	Yes	Yes
	* Reasonable cause does not apply to any portion of the underpayment (IRC 6662) or understatement (IRC 6662A) attributable to an IRC 6662(b)(6) transaction (transactions lacking economic substance within the meaning of IRC 7701(o), or failing to meet the requirements of any similar rule of law).		

REASONABLE CAUSE FOR PENALTY REMOVAL

The penalties described in this chapter may generally be reduced or removed if a taxpayer shows reasonable cause.

What Constitutes "Reasonable Cause"?

- The IRS Penalty Handbook defines reasonable cause as ***those reasons deemed administratively acceptable*** to the Service for justifying the nonassertion or abatement of applicable penalties against taxpayers. "Reasonable cause relief is generally granted when the taxpayer exercises ordinary business care

and prudence in determining their tax obligations but is unable to comply with those obligations." The Handbook also says, "Each case must be judged individually based on the facts and circumstances at hand."

CFR Section 301.6651 requires a written statement containing a declaration that is made under penalty of perjury and signed by the taxpayer or a representative having power of attorney. A request from a taxpayer's representative is considered a request by the taxpayer if:

a. The taxpayer's representative is an attorney, certified public accountant, enrolled agent, or any person permitted to represent the taxpayer before the IRS; and
b. The representative has been given a properly signed power of attorney.

- The Internal Revenue Manual contains this recommendation of the documentary evidence to support a reasonable cause request: "Taxpayers should be advised to submit documentation supporting the claim. Supporting documentation might include death certificates, doctor's statements, insurance statements, or other objective evidence."
- **Internal Revenue Code Section and Regulations References**
  1. Neither the accuracy-related penalty nor the fraud penalty is imposed with respect to any portion of an underpayment if it is shown that the taxpayer had reasonable cause for an underpayment and acted in good faith. *(Code Sec. 6664(c))*
  2. This standardized reasonable cause exception was designed to provide greater scope for judicial review of IRS penalty determinations.
  3. For example, under the former waiver provision, the Tax Court held that it could overturn an IRS determination of the substantial understatement penalty on reasonable cause and good faith grounds only if it found that the IRS abused its discretion in asserting the penalty.
  4. Code Sec. 6664(c) was intended to apply the same standard of review to the accuracy-related penalty as applies to the review of additional taxes assessed by the IRS (House Committee Report, Revenue Reconciliation Act of 1989). Frivolous challenges to the regulations remain subject to the penalty.
  5. The meanings of the terms "reasonable cause" and "good faith" are unchanged from those applicable under the former penalty structure. Whether a taxpayer has reasonable cause and good faith is a facts and circumstances determination made on a case-by-case basis. The most important factor is the extent of the taxpayer's effort to assess proper tax liability. *(Reg. §1.6664-4(b))*
- **Guidance for IRS employees in evaluating reasonable cause request, summarized from the Internal Revenue Manual, Section 20, Penalty Handbook**
  1. The burden of proof to establish reasonable cause is generally upon the taxpayer.
  2. Each reasonable cause request must be evaluated on its own merit.
  3. The merits should be determined based on the events or parties involved and whether or not the taxpayer exercised ordinary business care and prudence, but due to circumstances or events beyond the taxpayer's control, he/she was unable to meet the tax requirement.
  4. Determine if the taxpayer's reason addresses the penalty imposed. To show reasonable cause, the dates and explanations should clearly correspond with events on which the penalties are based.
  5. In determining whether or not ordinary business care and prudence were used, review available IRS information. Check previous periods for payment patterns and penalty history. The same penalty previously assessed may indicate that the taxpayer is not exercising ordinary business care to meet tax obligations.
  6. Consider the length of time between the event cited as a reason for the noncompliance and subsequent compliance.
  7. Consider whether or not the taxpayer could have anticipated the event that caused the noncompliance.

PROVING REASONABLE CAUSE

Reasonable cause has been defined as that which would prompt an ordinarily intelligent person to act under similar circumstances as did the taxpayer. The following have been used as grounds for reasonable cause in requesting penalty removal (they may or may not be favorable grounds):

(1) Reliance on IRS advice or publications;
(2) Expert tax advice;
(3) Delegating filing of tax return to attorney or accountant;
(4) Oversight of the taxpayer or an employee;
(5) Ignorance or misunderstanding of law by a nonexpert;
(6) Missing information;
(7) Unavailability of books and records;
(8) Essential parties to the situation unavailable;
(9) Overwork, stress, or health problems of the taxpayer;
(10) Unresolved dispute with IRS or other litigation;
(11) Disputes or misunderstandings between spouses;
(12) Financial hardship;
(13) Problems with U.S. postal service;
(14) Normal business practice.

Reasonable cause requests for nonassessment or abatement of penalties:

1. The law allows IRS to remove, reduce, or not assess penalties for late filing and/or late payment if the taxpayer is able to show "reasonable cause". IRS procedures require that in most cases where the penalty is being asserted, reasonable cause criteria should be discussed.
2. Appeals has jurisdiction to hear penalty cases prior to full payment.

Reasonable cause not established - If the taxpayer's request does not establish reasonable cause, the IRS will determine whether additional information is needed to evaluate the request. If the request is then rejected, the IRS will provide written notification to the taxpayer of the denial and of the taxpayer's appeal rights. The notice should include a complete explanation for the denial, instructions on how to submit a written protest and power of attorney information.

FIRST TIME ABATEMENT (FTA) PENALTY RELIEF

The Internal Revenue Manual (IRM 20.1.1.3.3.2.1 (11-21-2017) provides a one-time administrative abatement of **late filing** and **late payment** penalties where the taxpayer has:

- Not previously been granted relief under this provision, and
- Has been compliant in the three prior years.

The IRS is supposed to automatically apply this relief but frequently does not. If the taxpayer qualifies for the relief, a call to taxpayer services will usually trigger the relief. If the penalty has already been paid, file Form 843.

<u>Note</u>: where the taxpayer also qualifies for some other form of penalty relief, the IRM requires the FTA to be applied first.

According to IRS policy, the FTA penalty relief option does not apply if the taxpayer has not filed all returns and paid, or arranged to pay, all tax currently due. For example, the taxpayer is considered current if they have an open installment agreement and are current with their installment payments.

The FTA relief only applies to a single tax period for a taxpayer. For example, if a request for penalty relief is being considered for two or more periods of a taxpayer, and the earliest period meets the FTA criteria, FTA would apply only to the earliest period, and not for all periods.

Penalty relief under the first-time abatement provision does not apply to returns with an event-based filing requirement, such as Form 706, 709, 1120 or 1120S (not an all-inclusive list). For the S Corporation if, in the prior three years, at least one Form 1120S was filed late but not penalized, penalty relief under FTA will not apply.

The IRS said it would base decisions on removing any future failure to file, failure to pay or failure to deposit penalties on any information taxpayers provide that meets reasonable cause criteria.

Taxpayers who have been billed for penalty charges who feel they have reasonable cause, should send their explanations with their bill to their service center or call the IRS at (800) 829-1040 for assistance. Taxpayers may also use Form 843, Claim for Refund and Request for Abatement.

RELIANCE ON INFORMAL IRS ADVICE

Informal advice does not represent an official ruling. While it is usually most helpful in indicating the IRS viewpoint on a question, the taxpayer relies on it "at his peril" (United Block Co v. Helvering, (1941, CA2) 28 AFTR 399).

PENALTIES AND ADDITIONS TO TAX ATTRIBUTABLE TO RELIANCE ON ERRONEOUS WRITTEN ADVICE OF IRS

IRS must abate any portion of any penalty or addition to tax that is attributable to erroneous written advice furnished by an officer or employee of IRS (acting in an official capacity) to a taxpayer. (Code Sec. 6404(f); Reg. § 301.6404-3(a)) The abatement applies only if:

(1) The written advice was reasonably relied upon by the taxpayer,

(2) The written advice was in response to a specific written request of the taxpayer (Code Sec. 6404(f)(2)(A)), and,

(3) The portion of the penalty or addition to tax did not result from a failure by the taxpayer to provide adequate or accurate information. Thus, no abatement is allowed with respect to any portion of any penalty or addition to tax that resulted because the taxpayer requesting the advice did not provide IRS with adequate and accurate information. IRS need not verify or correct information that the taxpayer submits.

To have the penalty removed because of erroneous written advice from the IRS, a taxpayer should complete Form 843, Claim for Refund and Request for Abatement. Attach a copy of the taxpayer's written request for advice from the IRS. Also attach a copy of the IRS reply and the notice assessing the penalty.

HOW TO REQUEST ABATEMENT OF CIVIL PENALTIES FOR RESONABLE CAUSE

Taxpayers have the right to challenge the assertion or assessment of a penalty, and generally may do so at any stage in the penalty process. Taxpayers may request:

- A review of the penalty prior to assessment (e.g. deficiency procedures),
- A penalty abatement after it is assessed and either before or after it is paid (post-assessment review), or
- An abatement and refund after payment - claim for refund Form 843. Taxpayers may indicate their disagreement with IRS verbally, in writing, or if paid, by filing a claim for refund (IRS Form 843) or credit.

If agreement cannot be reached at the district or service center, the taxpayer may request a conference with the employee's immediate manager or in most cases the taxpayer may request that the case be forwarded to Appeals. Taxpayers should provide a written request for consideration by Appeals.

The taxpayer may also file suit in court. Depending on the procedural circumstances of the taxpayer's case, the taxpayer may petition the Tax Court or file a complaint with either the district court having jurisdiction or the Court of Federal Claims, as appropriate. ***(Internal Revenue Manual)***

To request abatement of a penalty after assessment, the taxpayer must submit a written request to IRS. ***(Internal Revenue Manual)***

Appeals officers have the authority to resolve appeals of assessed penalties. In order to expedite processing, each service center has a penalty appeal coordinator. Appeals officers should generally dispose of small penalty cases (resources permitting) within 90 days of receipt of the written protest and file from the service center or district office. Large penalty cases, or cases with more complex issues, could take additional time to complete. ***(Internal Revenue Manual)***

Internet access to the Internal Revenue Manual is: **http://www.irs.gov/irm**

STATUTE OF LIMITATIONS

- Section 6501(a)-The general statute of limitation within which the IRS must assess is 3 years from the due date of the return or the date the return is actually filed (state of California is 4 years);
- Section 6501(e) – contains the 6-year statute for the underreporting of income of more than 25%

Section 6501(c)(1), (2), & (3) provides for an unlimited statute for fraud, attempt to evade,and failure to file.

CALIFORNIA DIFFERENCES

CALIFORNIA PENALTIES OVERVIEW

- **Late filing**: 25% of the tax due if filed after the Oct 15 due date
- **Late filing Minimum**: Lesser of $135 or 100% of the refund.
- **Late paying**: 5% of the tax due plus 1/2% per month

UNDERPAYMENT OF ESTIMATED TAXES – See chapter 10.03

MANDATORY E-FILE E-PAY PENALTY – See chapter 10.03

LATE FILING OF RETURN

The maximum total penalty is 25% of the tax not paid if the tax return is filed after October 15. The minimum penalty for filing a tax return more than 60 days late is $135 or 100% of the balance due, whichever is less.

LATE PAYMENT OF TAX

If the total tax liability is not paid by the original due date, generally April 15 of the year following the tax year, a taxpayer will incur a late payment penalty plus interest. If at least 90% of the tax shown on the return is paid by the original due date of the tax return, the FTB will waive the penalty based on reasonable cause. However, the imposition of interest is mandatory. The penalty is 5% of the tax not paid when due plus 1/2% for each month, or part of a month, the tax remains unpaid.

MINIMUM LATE PAYMENT PENALTY

California amount is $135 (FTB Pub 1140, internet version updated as of 6/26/19).

INTEREST:

Interest will be charged on any late filing or late payment penalty from the original due date of the return to the date paid. In addition, if other penalties are not paid within 15 days, interest will be charged from the date of the billing notice until the date of payment. Interest compounds daily and the interest rate is adjusted twice a year. The FTB website has a chart of interest rates in effect since 1976. For the current and historical interest rates go to: https://www.ftb.ca.gov/pay/penalties-and-interest/interest-and-estimate-penalty-rates.html.

COST RECOVERY FEES:

The FTB charges cost recovery fees if they must take collection action to resolve a taxpayer's filing and payment delinquencies. Cost recovery fees may include a filing enforcement fee, a collection fee, a lien fee, and fees to cover the cost of seizing and selling property. Enforcement fees vary from year to year based on legislation and are set for a fiscal year July 1 through the following June 30. (R&TC Sections 19254, 19209, 19221, 19233, and 19234)

Fiscal Year:	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Individual, LLC, Partnership, LLP							
Enforcement Fee	$78	$76	$79	$81	$84	$88	$85
Collection Fee	$170	$194	$226	$226	$287	$317	$317
Corporation, LLC Treated as a Corp							
Enforcement Fee	$96	$96	$92	$100	$85	$81	$93
Collection Fee	$278	$310	$334	$365	$374	$382	$355

If the taxpayer's financial institution does not honor a payment to the Franchise Tax board that the taxpayer made by check, money order, or electronic funds transfer, a penalty of 2% of the payment amount is assessed. However, if the payment is less than $1,250 the penalty is $25 or the payment amount, whichever is less.

DEMAND TO FILE PENALTY

If the Franchise Tax Board issues a demand to file an income tax return or to provide information, and the taxpayer does not comply, the FTB will impose a penalty of 25% of the tax on the assessment, without reduction of payments and credits. This may result in a taxpayer owing penalties and interest even if the return shows a refund due.

NEST PENALTY

California's non-economic substance transaction understatement penalty (NEST), imposes a **20 percent penalty** for understatements attributable to non-economic substance transactions (Revenue and Taxation Code (R&TC) Section 19774). The penalty increases to **40 percent for transactions that are not adequately disclosed.**

A transaction lacks economic substance either because:

1. It lacks an economic benefit or,
2. There is no bona fide, non-tax California business purpose for entering into the transaction.

In cases where the taxpayer has received a final federal audit report, the FTB may assess the NEST penalty in lieu of the accuracy-related penalty assessed on the audit report if both of these criteria are met:

- The federal adjustment was from a transaction lacking economic substance.
- Tax benefits from this same transaction were reported on the California tax return.

This penalty is imposed on a Notice of Proposed Assessment. To dispute the NEST penalty, the taxpayer should file a protest of the penalty within the required 60-day time period (R&TC Section 19041), and also file a request for Chief Counsel to Relieve Penalties (form FTB 626).

The factors relating to whether the penalty was properly imposed will be developed during the protest process. The Chief Counsel relief process (R&TC Section 19774(d)) is the mechanism for determining whether to withdraw or reduce the NEST penalty. The Chief Counsel's determination will consider all grounds raised in the dispute of the penalty, including substantive arguments concerning economic substance and business purpose.

The Chief Counsel will issue a determination on the Request for Penalty Relief. The taxpayer cannot appeal or challenge the Chief Counsel's refusal to compromise the penalty before the Office of Tax Appeals or in court. A Notice of Action will be issued on the remaining issues which are the subject of the protest.

The taxpayer may also contest the penalty after paying the full amount and filing a claim for refund with FTB, and may appeal to the Office of Tax Appeals or file an action in court after the refund claim is denied or deemed denied.

FRIVOLOUS SUBMISSION PENALTY

The Franchise Tax Board (FTB) will begin imposing a penalty of $5,000 on or after July 20, 2009 for specified frivolous submissions as provided for in R&TC Section 19179. The penalty will not apply if the person withdraws the submission in writing within 30 days of FTB's notice that states the submission is a "specified frivolous submission." The FTB has adopted the list of frivolous positions in IRS Notice 2008-14. A "specified frivolous submission" is a submission that includes material that meets either of the following definitions:

- Is based on a position FTB identifies as frivolous.
- Reflects a desire to delay or impede the administration of federal income tax laws determined by the IRS, or California income or franchise tax laws determined by FTB.

Relief Available - Either or both of the following methods may be used to contest the frivolous submission penalty:

- Request relief from the penalty by submitting form FTB 626, Request for Chief Counsel to Relieve Penalties.
- After paying the penalty in full, the taxpayer can also file a claim for refund within the statute of limitations (R&TC Section 19306).

FRIVOLOUS RETURN PENALTY

A penalty applies for filing a frivolous return and is determined in accordance with Section 6702 of the Internal Revenue Code, except as otherwise provided. (R&TC Section 19179) The frivolous return penalty is $5,000 for California and is imposed if all of the following apply:

• The taxpayer submits what is purported to be a required return.
• The purported return does not contain sufficient information to judge the substantial correctness of the self-assessment or contains information that, on its face, indicates that the self-assessment is substantially incorrect.
• The purported return is based on a frivolous position or reflects an attempt to delay or impede administration of the tax laws.

Relief from Frivolous Return Penalty – The same methods apply as those for relief from the frivolous submission penalty. FTB's penalty reference chart: http://www.ftb.ca.gov/forms/misc/1024.pdf or https://www.ftb.ca.gov/forms/misc/1024.html

FIRST TIME ABATEMENT PENALTY RELIEF

California DOES NOT have a first-time abatement penalty relief provision similar to the IRS. The FTB maintains that it does not have administrative authority to abate penalties, but may abate certain penalties if reasonable cause is proven. The fact that the IRS abated a penalty under the FTA policy, or that the taxpayer has a good compliance history with the state, is not by itself sufficient to establish reasonable cause.

PENALTIES AND REASONABLE CAUSE RELIEF

Some of these penalties may be abated if a taxpayer can demonstrate reasonable cause. "Reasonable cause" in the context of penalties means that the taxpayers exercised ordinary business care and prudence in meeting their tax obligations but nevertheless failed to comply. Taxpayers may go to ftb.ca.gov and search for "reasonable cause" for law summaries which describe the circumstances that generally constitute reasonable cause.

Penalties imposed on taxpayers that can be abated for "reasonable cause" include:

- Delinquent/Late Filing Penalty - R&TC Section 19131.
- Late Payment Penalty - R&TC Section 19132.
- Notice and Demand/Failure to Furnish Information Penalty - R&TC Section 19133.
- Accuracy-Related Penalty - R&TC Section 19164.
- Electronic Fund Transfer (EFT) Penalty - R&TC Section 19011.
- Dishonored Payment Penalty - R&TC Section 19134.
- Withholding Liability for Tax and Withholding Penalties - R&TC Section 18668.
- Partnership/S-Corporation late filing penalties - R&TC Sections 19172 and 19172.5.

Reasonable Cause Abatement Request Forms - The FTB has two forms with instructions regarding reasonable cause and statute of limitations:

- FTB 2917, Reasonable Cause – Individual and Fiduciary Claim for Refund
- FTB 2924, Reasonable Cause – Business Entity Claim for Refund

The FTB recommends using these two forms for a quicker response but will continue to accept and process handwritten reasonable cause abatement requests.

NOTES

PREPARER PENALTIES

Overview

- Greater of $1,000 or 50% of the Preparation Fee – **Unreasonable position**
- Greater of $5,000 or 75% (50% prior to 2016) of the Preparation Fee – **Willful or Reckless Conduct**
- $530* – Per check - **Negotiating a refund check**
- $250/$1,000– Each - **Improper return information disclosure**
- $530* – Each failure to comply with **Head of Household**, **EIC, Child Tax Credit & AOTC due diligence**.
- $50 – Each failure ($26,500* max) to…
  - Furnish a completed **copy of the return**.
  - **Keep a copy of the return** (or keep list).
  - Reflect **preparer's ID number on return**.
  - **Sign a return**.
  - **File correct information returns**
  - Retain and make available a record of preparers employed, plus $50 for each failure to include a required item in that record.

*Amount applies to returns or refund claims filed in 2020 (i.e., generally 2019 returns)

RAPID FINDER	
Adequate Disclosure	10.02.01
Copy of Tax Return	10.02.01
Did Not Sign Return	10.02.03
Failure to E-File	10.02.01
Fraudulent Prep	10.02.03
Preparer Penalties	10.02.02
Unreasonable	10.02.01
Willful & Reckless	10.02.01
Did Not Sign Return	10.02.03

TCJA

Head of Household Due Diligence – Effective with 2018 returns, a paid preparer is subject to due diligence requirements in determining a client's eligibility for the head of household filing status. (IRC Sec 695(g), as amended by Sec 11001(b) of the TCJA) For returns filed in 2020, the penalty for failing to exercise due diligence with respect to the head of household status is $530 ($520 for filings in 2019). IRS has revised Form 8867, Paid Preparer's Due Diligence Checklist, to add a section for this new requirement.

New Law & Stuff

CHANGES MADE BY THE TAXPAYER FIRST ACT OF 2019

Improper Disclosure by Return Preparers - Effective with respect to disclosures or uses made on or after the date of enactment, the Act increases the civil penalty for the unauthorized disclosure or use of information by tax return preparers from $250 to $1,000 for cases in which the disclosure or use is made in connection with a crime relating to the misappropriation of another person's taxpayer identity ("taxpayer identity theft"). The Act also increases the calendar year limitation from $10,000 to $50,000 in identity theft situations. The calendar year limitation is applied separately with respect to disclosures or uses made in connection with taxpayer identity theft. (Code Sec. 6713(b), as amended by Act Sec. 2009(a)(2))

The Act also increases the criminal penalty for knowing or reckless conduct to $100,000 in the case of disclosures or uses in connection with taxpayer identity theft. (Code Sec. 7216(a), as amended by Act Sec. 2009(b))

Pubs Forms

Related IRS Publications and Forms

- **Form 8275** - Disclosure Statement
- **Form 8275-R** – Regulation Disclosure Statement
- **Form 14157** – Complaint: Tax Return Preparer
- **Form 14157**-A - Tax Return Preparer Fraud or Misconduct Affidavit

The Details

DEFINITION OF A TAX RETURN PREPARER

The definition of a tax preparer includes preparers of income, estate, gift, employment, excise tax, and exempt organization returns. (Code Sec. 7701(a)(36)

DUTIES OF A RETURN PREPARER TO RETAIN RETURN COPIES

- Return must contain ***preparer's full address***.
- Copy of completed return must be ***furnished to taxpayer*** at time of preparation completion.
- A return preparer must either keep a ***copy of the return*** on file or keep a list including name and taxpayer ID number of each return prepared. The record should indicate the type of return prepared. If multiple

preparers are in an office, the name of the preparer needs to also be in the record. This record information must be kept on file for ***3 years*** after close of the return period during which the return was given to the taxpayer (or 3 years from the return's due date if it is due (including extensions) after the return period in which it was presented for signature). The return period for this purpose is the 12-month period ending July 1 of each calendar year. *(Sec. 6107(d))*

- The ***IRS has jurisdiction*** to request the preparer's list or copies of returns without violating the preparer's rights.
- In an employment arrangement, only the ***employer has the obligation*** to retain return copies or a list.
- A ***computerized service*** is excused from retaining copies--e.g., a service bureau.
- When a ***preparer sells a business***, he/she retains the obligation to keep copies of returns. However, the preparer can transfer the retained returns to the buyer under an arrangement that recognized the record-retention requirement; the seller remains liable should the buyer fail to keep the records. **Note:** The seller should retain a list of the clients sold--this meets the IRS requirement for record retention.

FAILURE TO E-FILE (MAGNETIC MEDIA): Sec 6011(e)(3) requires a "specified" tax return preparer who prepares and files any individual, trust or estate return to file it by magnetic media (e-file). "Specified" tax return preparers are all preparers except an individual who reasonably expects to file 10 or fewer individual income tax returns in a calendar year. **There is no monetary penalty for not e-filing**, but Circular 230, Sec 10.51 states that willful disregard of e-filing rules is classified as disreputable conduct.

UNREASONABLE POSITION - A tax return preparer who prepares a return or refund claim for which any part of a tax liability understatement is due to an "unreasonable position" (defined below) must pay a penalty for each return or claim equal to the **greater** of:

- **$1,000** or
- **50% of the income derived** (or to be derived) by the tax return preparer for preparing the return or claim (Code Sec. 6694(a)(1))

A position is "unreasonable" if:

- The tax return preparer knew (or reasonably should have known) of the position,
- There was not a reasonable belief that the position would more likely than not be sustained on its merits, and
- The position was not disclosed as provided in Code Sec. 6662(d)(2)(B)(ii), or if the position was disclosed, there was no reasonable basis for the position. (Code Sec. 6694(a)(2))

WILLFUL OR RECKLESS CONDUCT - A tax return preparer who prepares a return or refund claim for which any part of a tax liability understatement is due to an "unreasonable position" (defined below) must pay a penalty for each return or claim equal to the **greater** of:

- **$5,000** or
- **75% of the income derived** (or to be derived) by the tax return preparer for preparing the return or claim (Code Sec. 6694(a)(1)). The 75% component of the penalty calculation was increased from **50%**, in effect for returns prepared for years before December 18, 2015.
- If the unreasonable position penalty was also imposed, the willful or reckless conduct penalty is reduced by the unreasonable position penalty.

"Willful or reckless conduct" is conduct by the tax return preparer which is a:

- Willful attempt to understate the tax liability on the return or claim, or
- Reckless or intentional disregard of rules or regulations. (Code Sec. 6694(b)(2))

Limitation Periods for Assessing & Refunding Sec 6694 Penalties – In Chief Counsel Advice Memorandum 201514008, the IRS said:

1. The limitation period for making an assessment of the return preparer penalty under Sec 6694 for preparing a return or claim for refund with an understatement of tax liability must be within 3 years of the date the underlying tax return or claim for refund is filed.
2. Any claim for refund of an overpayment of a penalty assessed under Sec 6694(a) must be filed within 3 years of the date the penalty was paid to the IRS.

Sec 6694 Penalties when Return Not Signed, Not Filed or Filed Late - For purposes of the penalties under Code Sec. 6694, a return or claim for refund is deemed prepared on the date it is signed by the tax return preparer, but if a signing tax return preparer (as defined in Reg. § 301.7701-15(b)(1)) fails to sign the return, the return or claim for refund is deemed prepared on the date the return or claim is filed. Chief Counsel Advice 201519029 concludes that Sec 6694 penalties apply where an amended return was signed by the preparer and never filed, and if an amended return was filed but IRS disallowed the refund. On the other hand, the Chief Counsel ruled that this penalty, as well as the penalties for understatement of tax and aiding or abetting an understatement of tax, is not to be assessed if the preparer made and filed a claim for refund after the period for claiming a refund had expired.

WHAT IS ADEQUATE DISCLOSURE? Disclosure under Sec. 6694(a) with regard to the unreasonable position penalty is adequate if made on a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, attached to the return, amended return or refund claim, or pursuant to the annual revenue procedure (see, for example, Rev Proc 2019-9, which applies to any income tax return filed on 2018 tax forms for a tax year beginning in 2018 and to any income tax return filed in 2019 on 2018 tax forms for short taxable years beginning in 2019). For similar revenue procedures for other recent years see Rev Procs 2018-11, 2016-13, 2015-16, 2014-15, 2012-51, and 2012-15). The $1,000/50% of preparation income penalty will not be imposed if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

PREPARER PENALTIES: In addition to the penalties described above, the following penalties may be assessed against return preparers (amounts apply to returns or refund claims filed in 2020 unless otherwise noted):

- **$530 ($505** for tax years beginning in 2015, **$510** for tax years 2016 and 2017, $520 for filings in 2018) (per check) if the preparer endorses or ***negotiates any income tax check*** issued to the taxpayer.
- **$250** for each improper disclosure of return information, i.e., where the information is used for a purpose other than preparation of the return or **$1,000** for cases in which the disclosure or use is made in connection with a crime relating to the misappropriation of another person's taxpayer identity ("taxpayer identity theft"). The calendar year limitation is $10,000 ($50,000 for instances related to taxpayer identity theft). The calendar year limitation is applied separately with respect to disclosures or uses made in connection with taxpayer identity theft. (Code Sec. 6713(b)) The monetary penalty increases relating to a taxpayer identity theft crime apply to disclosures or uses on or after June 1, 2019, the date of the enactment of the Taxpayer First Act.
- Additionally, a criminal penalty of up to $1,000 ($100,000 in the case of a disclosure or use that involves taxpayer identity theft) and/or imprisonment of up to one year may be imposed.
- **$530 ($505** for tax years beginning in 2015, **$510** for tax years 2016 and 2017, $520 for 2018 filings) for each failure to comply with due diligence requirements in determining ***eligibility for the Head of Household filing status, EITC, Child Credit, and AOTC (child credit and AOTC effective for returns filed after 12/31/2016); HoH effective for tax years beginning after 12/31/2017).***
- In addition, the following **$50** penalties can be assessed unless reasonable cause is shown:
    - Each failure to furnish a ***completed copy*** of the return.
    - Each failure to keep a ***copy of the return*** (or keep list).
    - Each failure to reflect preparer's ***ID number*** on return.
    - Each failure to ***sign a return***.
    - Failure to retain and make available a record of preparers employed (the name, taxpayer identification number, and principal place of work during the return period of each preparer employed), plus $50 for each failure to include a required item in that record. (IRC Sec 6695(e); Sec 6060; Reg. 1.6060-1)

PREPARER NOT LIABLE WHERE HE DID NOT SIGN OR HELP PREPARE RETURNS: A district court has determined on summary judgment that a return preparer who owned a tax preparation business was not liable for Code Sec. 6694 penalties (understatement of taxpayer's liability by return preparer) with respect to returns that he didn't sign or help prepare. The court found that IRS failed to show that the preparer had any involvement with those returns or that liability could nonetheless be imposed on the basis that he employed the preparers. However, the court denied the preparer's motion for summary judgment with respect to the returns signed by him, stating that whether he acted willfully under Code Sec. 6694 was a factual issue to be decided by a jury. Lowery v. U.S., (DC NC 9/26/2018)

REPORTING FRAUDULENT PREPARERS: If you encounter work performed by another preparer that is clearly fraudulent, and you feel the need to report the practitioner's violations of Circular 230 provisions or tax law to the IRS, Form 14157 and its companion Form 14157-A are used for this purpose.

CALIFORNIA DIFFERENCES

California Preparer Penalties include the following:

- **$50 penalties** - California preparers are subject to a $50 per failure penalty for:
  - Not furnishing a completed copy of a return or claim. *R&TC 19167(a).*
  - Not including the identifying number of the preparer, employer or both on the return or claim. *R&TC 19167(b)*
  - Not retaining a completed copy of the return for 3 years (or keeping a list). *R&TC 19167(c)*
  - Failing to file returns electronically if subject to R&TC Sec. 18621.9. *R&TC 19170*
- **Negotiating taxpayer's check -** $250 for each endorsement or negotiation of a check. *R&TC 19169, 20645.7*
- **Penalty for not registering with CTEC** (California Tax Education Council) when required - $2,500 for first failure to register; $5,000 for other than first failure. *R&TC 19167(d)(1) and (2)*
- **Understatement of a taxpayer's liability by a tax preparer:**
  - Willful or reckless conduct - The greater of $5,000 or 50% (75%, effective for returns prepared for years ending after December 18, 2015) of the income derived (or to be derived) for each return or claim. *R&TC 19166(a)*
  - Unreasonable position – Greater of $250 or 50% of the income derived (or to be derived) for each return or claim. Applies if the taxpayer's understatement is due to a position for which there was not reasonable belief that the tax treatment was more likely than not the proper treatment, the preparer knew or should have known of the position, and the position was not disclosed or there was no reasonable basis for the tax treatment of that item. *R&TC 19166(a)*

See FTB penalty chart at https://www.ftb.ca.gov/forms/misc/1024.pdf for more details about penalties.

NOTES

UNDERPAYMENT OF ESTIMATED TAXES

- **De minimis Tax Due Amount**: $1,000
- **Safe Harbors**
  - **General rule**
    - 90% of the current year's tax, or
    - 100% of the previous year's tax.
  - **High income** – AGI prior year over $150,000 ($75,000 MS)
    - 90% of the current year's tax, or
    - 110% of the previous year's tax.
  - **Farmers & Fishermen**
    - 66 2/3% (.6667) of their total tax for the year, or
    - 100% of the total tax shown on the prior full year.

CAUTION
When preparing estimates don't overlook the 3.8% surtax on net investment income for higher income taxpayers!

Related IRC and IRS Publications and Forms

- IRC Section 6654
- 2019 Form W-4 – Employee's Withholding Allowance Certificate
- 2020 Form W-4 – Employee's Withholding Allowance Certificate
- 2020 Form W-4 – Instructions
- Pub 505 – Tax Withholding & Estimated Tax
- Pub 15 – Circular E, Employer's Tax Guide
- Pub 15-T – Federal Income tax Withholding Methods

2020 DRAFT W-4 RELEASED (A reproduction of the 2020 W-4 appears at the end of this chapter)

The Internal Revenue Service has released a draft of their proposed 2020 Form W-4 that is supposed to make accurate withholding easier for employees starting for 2020. The revised form implements changes made by the TCJA. and no longer uses the concept of withholding allowances, which was previously tied to the amount of the personal exemption.

The 2020 draft Form W-4 supposedly reflects important feedback from the payroll community and others in the tax community. The primary goals of the new design are to provide simplicity, accuracy and privacy for employees while minimizing burden for employers and payroll processors.

The IRS expects to release a near-final draft of the 2020 Form W-4 later in 2019 to give employers and payroll processors the tools they need to update systems before the final version of the form is released in November.

The IRS has also released early drafts of new Publication 15-T, Federal Income Tax Withholding Methods, for tax year 2020 with the related instructions for employers and instructions for Form W-4 for employees completing the new form. The instructions are about 10 pages and include worksheets for deductions, credits and multiple job situations. The IRS encourages the use of its online withholding calculator, which is supposed to be "easier and more accurate."

The new Form W-4 is not for current use but is a draft of the form to be used starting in 2020. For 2019, taxpayers should continue using the current Form W-4 (PDF).

There are several avenues available to avoid interest penalties for underpayment of estimated taxes.

DE MINIMIS EXCEPTION: The de minimis exception applies when the tax liability less withholding is less than **$1,000**.

ESTIMATED TAX SAFE HARBOR - ***General rule -*** To avoid an underpayment penalty, individuals whose annual tax obligation won't be met through income tax withholding must make timely payments (generally four equal payments) of estimated tax. The general rule requires annual payments of the lesser of:

- 90% of the current year's tax, or
- 100% of the previous year's tax.

High income safe harbor: If AGI for the previous year is over $150,000 ($75,000 if filing married separate), the required payment is the smaller of:

- 90% of the current year's tax, or
- 110% of the previous year's tax.

Amended return – The tax amount to use for the safe harbor test when the prior year return is amended depends on when the amendment is filed. Use the tax amount shown on the:

- Amended return if it is filed by the due date of the original return.
- Original return if the amended return is filed after the original return's due date. (*Exception:* if spouses originally filed timely separate returns and then file a joint return after the due date to replace the separate returns, use the tax on the joint return to figure the required estimated tax payments.)

Special Exceptions - Farmers and Fishermen - If at least two-thirds of the taxpayer's gross income for the prior year or the current year is from farming or fishing, the following special exceptions and rules apply:

- The estimated tax underpayment penalty won't apply if the tax return of the farmer or fisherman is filed, and all tax due is paid, by March 1 (calendar year filers).
- Any penalty owed is figured from the January 15 installment date.
- The taxpayer's required annual payment is the smaller of:
  1) 66-2/3% (.6667) of their total tax for the year, or
  2) 100% of the total tax shown on the prior year provided the prior year was for a full 12 months.

Separate Returns – Separate Estimates - If the taxpayer and spouse made separate estimated tax payments for the year and file separate returns, they can take credit only for their own payments.

Separate Returns – Joint Estimates - If the taxpayers made joint estimated tax payments, they must decide how to divide the payments between the returns. One can claim all of the estimated tax paid and the other none, or they can divide it in any other way they agree on.

If they cannot agree, they must divide the payments in proportion to each spouse's individual tax as shown on their separate returns for the year.

> ***Example -*** *James and Evelyn Brown made joint estimated tax payments totaling $3,000. They file separate returns and cannot agree on how to divide estimates. James' tax is $4,000 and Evelyn's is $1,000.*
> *James' share = 4,000/5,000 x 3,000 = $2,400*
> *Evelyn's share = 1,000/5000 x 3,000 =$ 600*

Divorced Taxpayers - If the taxpayers made joint estimated tax payments for the year and were divorced during the year, either spouse can claim all the payments or they each can claim part of them. If the taxpayers cannot agree on how to divide the payments, they must divide them in proportion to each spouse's individual tax as shown on their separate returns for the year.

NO TAX LIABILITY LAST YEAR - The taxpayer is exempt from the underpayment penalty if they had no tax liability in the prior year and they were a U.S. citizen or resident for the whole year. For this rule to apply, the tax year must have included all 12 months of the year.

2018 SPECIAL UNDERPAYMENT WAIVERS

The changes brought about by TCJA and the ensuing W-4 debacle and concerns that taxpayers may have under- withheld or under-prepaid estimated tax through no fault of their own prompted several members of Congress to apply pressure on the IRS to provide special relief from the penalty for underpayment of estimated taxes for 2018.

The IRS capitulated and initially provided an 85% safe harbor. This safe harbor, unlike the 90% quarterly statutory safe harbor only required that the taxpayer had made payments at any time during the year to satisfy the 85% requirement. However, because of the lateness of TCJA, the 2018 Form 2210 was already released and did not provide for the special 85% safe harbor. As a result, the IRS issued special instructions to check Box A in Part II of the 2210 and write "85% Waiver" next to Box A, and file page 1 of Form 2210 with the tax return to request the waiver.

However, after doing all this several Congressional leaders did not believe 85% was sufficient relief and urged the IRS to further reduce the safe harbor. The IRS subsequently, towards the end of February, reduced the safe harbor to 80% (Notice 2019-25).

> ***Example****: Susan's 2018 tax liability is $10,000; She had paid estimated tax installments totaling $8,100; no tax withheld. Thus, Susan was under paid by $1,900, so the $1,000* de minimis exception did not apply. *However, she had paid in 81% ($8,100/$10,000) of her tax liability, and since she prepaid more than 80% but less than 90%, the taxpayer is eligible for the penalty waiver due to tax reform. Had the taxpayer's ES payments been only $$7,900 (79% of $10,000), neither the 90% safe harbor nor the 80% tax reform waiver would apply, and the taxpayer would be subject to a Form 2210 penalty.*

Bottom line is some taxpayers, depending upon when they filed their return may have paid too high of an underpayment penalty and are due a refund.

Automatic Penalty Refund - In mid-August 2019 the IRS announced that it is automatically waiving the estimated tax penalty for the more than 400,000 eligible taxpayers who already filed their 2018 federal income tax returns but did not claim the waiver. The IRS will apply this waiver to tax accounts of all eligible taxpayers, so there is no need to contact the IRS to apply for or request the waiver. The IRS will be sending out CP21 notices advising taxpayers that they qualify for the waiver, followed by a refund check about three weeks after the CP21 is sent. The whole process could take several months. (IR-2019-144)

Refund Not Received - If you later determine your client is due a refund of some part or all of the penalty and did not receive an automatic refund, they can claim a refund of estimated tax penalties paid by filing Form 843, Claim for Refund and Request for Abatement. Most of the lines of the form are self-explanatory with the exception of the following:

- **Line 3** – Check "income" tax
- **Line 4** - Enter IRC Sec 6654
- **Line 5** – Leave blank
- **Line 7** – Include the statement "80% Waiver of estimated tax penalty" on line 7 and if the entire penalty is not refundable explain the circumstances.

Form 843 can't be filed electronically.

Special Waiver for Farmers and Fishermen – Anticipating that tax reform changes that affect farmers and fishermen would mean that some farmers and fishermen would have difficulty accurately determining and paying their 2018 tax liability by March 1, 2019 (see "Special Exceptions - Farmers and Fishermen" above), the IRS provided relief to individual taxpayers who are farmers or fishermen by waiving the underpayment of estimated tax penalty for any qualifying farmer or fisherman if their 2018 income tax return was filed and tax due was fully paid by April 15, 2019 (April 17, 2019 for those living in Maine or Massachusetts) and Form 2210-F was attached to the return with box A in Part I checked.

WAIVER OF PENALTY - The IRS will, under certain circumstances, waive the underpayment penalty. The following are the conditions and procedures for penalty waiver.

Conditions - The IRS can waive the penalty for the following circumstances:

1. The taxpayer retired (after reaching age 62) or became disabled in the year previous to the computation year or the computation year and both the following requirements are met.
   a. The taxpayer had a reasonable cause for not making the payment, and
   b. The underpayment was not due to willful neglect.
2. The taxpayer did not make payment because of one of the following situations and it would be inequitable to impose the penalty:
   a. Casualty
   b. Disaster, or
   c. Other unusual circumstance

Procedure - To request a waiver, complete Form 2210 and write the requested waiver amount next to line 17 (or the last line of Part IV if using the regular method).

a. **Requesting waiver of the entire penalty**
   i. Check ***Box A*** of ***Part II*** of the 2210
   ii. Attach a statement with an explanation and verification documentation.

b. **Requesting a partial waiver**
   i. Check ***Box B*** of ***Part II*** of the 2210
   ii. Complete Form 2210 through:
      1. Line 16 if using the short method or
      2. The next to last line of Part IV if using the long method.
      3. Subtract the amount being requested to be waived from the penalty calculated as if no waiver was requested and enter the balance on line 17 (short method) or the last line of Part IV (long method).
   iii. Attach a statement with an explanation and verification documentation

Verification –

a. **Retirement or Disability** - If the taxpayer is requesting a waiver due to retirement or disability, attach documentation that shows the taxpayer's retirement date and age on that date or the date the taxpayer became disabled.
b. **Casualty, Disability or Unusual Circumstances** - If the taxpayer is requesting a waiver due to a casualty, disaster, or other unusual circumstance attach documentation such as copies of police and insurance company reports.

ANNUALIZED INCOME EXCEPTION (REGULAR METHOD): If the de minimis and the safe harbor exceptions do not apply, use IRS Form 2210 to compute the underpayment penalty using the annualized method.

The worksheet annualizes the tax at the end of each period based on actual income, deductions, and other items relating to events that occurred since the beginning of the tax year through the end of the period. If this exception is used, Form 2210 must be attached to the tax return.

Strategies

WITHHOLDING STRATEGY: Wage withholding is considered paid evenly throughout the year regardless of when during the year it was withheld. Thus where a taxpayer's withholding and estimated tax payments are less than what is required to avoid a penalty, the taxpayer can increase his or her withholding at any time during the year and make up for the shortfall from earlier in the year.

CALIFORNIA DIFFERENCES

California estimated tax installment rules front load the estimate installments by requiring the payments to be 30%, 40%, 0% and 30%, respectively, of the annual payment due.

New Law & Stuff

2018 Penalty Waivers – California does not conform to the lowered safe harbor percentage for 2018 returns because the FTB felt the TCJA had no general impact to the amount of state income tax an individual would owe and thus it wasn't necessary for California to provide relief similar to the special federal waiver. However, California will waive the estimated tax penalty for farmers and fishermen who were unable to file and pay their 2018 taxes by March 1, 2019, if they filed and paid their 2018 taxes by April 15, 2019. For details see the FTB web site at:
https://www.ftb.ca.gov/about-ftb/newsroom/public-service-bulletins/2019-09-farmers-and-fishermen-relief.html

California and Federal estimated tax payment requirements are different. Use Form 5805 (5805F for farmers/fishermen) for the California computation of the underpayment penalty.

De minimis exception - The de minimis exception applies when the current or prior year's California tax liability (including AMT and the mental health services tax but excluding lump-sum distribution tax) less withholding and credits is less than **$500 ($250 if MS)**.

Annualized Exception – California law deems that a taxpayer's withholding is allocated in the same manner as the estimated payments. Thus, the withholding would be allocated as 30% paid in the 1st quarter, 40% in the second, none in quarter three and 30% in the last quarter.

General rule – The same as the Federal rule - Individuals must make timely payments of estimated tax. The general rule requires annual payments of the lesser of: (1) 90% of the current year's tax or (2) 100% of the prior year's tax.

High income safe harbor – The same as the Federal rule for most filers **-** If California AGI for the **previous year** is over $150,000 ($75,000 if filing married separate), the required payment (does not apply to farmers or fishermen) is the lesser of: (1) 90% of their current year's tax, or (2) 110% of the prior year's tax liability.

> *Exception for Extra-High-Income Taxpayers* – The prior-year-tax safe harbor cannot be used by taxpayers with an AGI of $1 million or more ($500,000 married separate). Instead, to avoid an underpayment of estimated tax penalty for California, these taxpayers' estimated payments must be at least 90% of their expected current year tax.

Farmers and fishermen - with at least two-thirds of their gross income for the prior year or the current year from farming or fishing, they may:

- Pay all of their estimated tax by Jan 15th (4th quarter due date); or
- File their tax return on or before March 1st and pay the total tax due.

The required estimated tax payment for farmers and fishermen is the lesser of 66 2/3% of the current year's tax or 100% of the prior year's tax.

General Exceptions - Underestimated penalties are not assessed by California if:

- 90% or more of the current year's tax will be paid by withholding; or
- There was no tax liability for the prior year and the prior year's return was for a full 12 months, or would have been if the taxpayer had been required to file; or
- The taxpayer's tax for the prior year (after subtracting withholding and credits) was less than the *de minimis* amount.

Law change exception – The underpayment of estimated tax penalty does not apply for California to the extent the underpayment of an installment was created or increased by any provision of law that is enacted during and operative for the tax year of the underpayment. (This exception does not apply to federal law changes that may create a state tax underpayment.) Request a waiver of the penalty on Form 5805 (Form 5805F for farmers and fishermen).

Mandatory e-pay required for high-income individual taxpayers - Beginning January 1, 2011 personal income taxpayers must send the payment electronically if either of the following conditions exists:

- **Tax liability is greater than $80,000**, or
- An **estimated tax or extension payment that exceeds $20,000** is made.

Once either of the above conditions is met, all payments regardless of type, amount, or tax year must be remitted electronically.

> ***Example*** *– On April 15, 2019, a taxpayer makes an estimated tax payment of $25,000 by paper check. Any payment made after that (for example, a bill payment from a previous year, the second quarter estimated tax payment or payments for future years) must be made electronically.*

Electronic payment methods include: (1) Electronic Withdrawal (EFW) when e-filing a return, (2) WebPay (at ftb.ca.gov), or (3) credit card (call 800.272.9829). There is a fee for using a credit card. There is also a pay-by-phone option but the taxpayer must register in advance to use this method by completing Form FTB 4073, *Mandatory e-pay Pay-by-Phone Authorization Agreement for Individuals*, and submitting it to the FTB. See the FTB web site for more details.

A payment made using a bank's online bill payment system is not an electronic payment because the bank mails a paper check to FTB, which does not meet the requirement to pay electronically.

While a taxpayer must make tax payments electronically if the e-pay criterion is met, there is no requirement that the tax return must be e-filed.

If required payments are not remitted electronically, there is a **one percent penalty** of the amount paid, unless the failure to pay electronically was for reasonable cause and not willful neglect. Taxpayers whose tax thresholds subsequently fall below the mandatory e-pay amounts may request to discontinue making electronic payments by using FTB Form 4107, *Mandatory e-pay Election to Discontinue or Waiver Request*.

Form **W-4**

Department of the Treasury
Internal Revenue Service

Employee's Withholding Allowance Certificate

▶ **Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay.**
▶ **Give Form W-4 to your employer.**
▶ **Your withholding is subject to review by the IRS.**

OMB No. 1545-0074

2020

Step 1: Enter Personal Information

1a First name and middle initial | Last name | **1b Social security number**

Home address (number and street)

City or town, state, and ZIP code

▶ **Does your name match the name on your social security card?** If not, to ensure you get credit for your earnings, contact SSA at 800-772-1213 or go to *www.ssa.gov*.

1c ☐ **Single or Married filing separately** ☐ **Married filing jointly**
☐ **Head of household** (Check only if you're unmarried and pay more than half the costs of keeping up a home for yourself and a qualifying individual.)

Complete Steps 2 through 4 if they apply to you; otherwise, skip to Step 5. See instructions on page 2.

Step 2: Account for Multiple Jobs

Caution: The correct amount of withholding depends on income earned from all jobs in the household. If you:
- Hold more than one job at a time, or
- Are married filing jointly and both you and your spouse work,

account for this below or you may owe additional tax when filing your tax return.
(If you and/or your spouse have income from self-employment, see page 2.)

2 **Multiple jobs.** Do **only one** of the following.
- Use the calculator at *www.irs.gov/W4App* for most accurate withholding; **or**
- Use Worksheet 1 on page 3 and enter the result on line 4c below for roughly accurate withholding; **or**
- If there are only two jobs in your household, you may check here. Do the same on Form W-4 for the other job. With this option, more tax than necessary may be withheld from your wages, but you generally won't have too little tax withheld . . . . ▶ ☐

Complete lines 3 through 4b on Form W-4 for only one job in the household. (Your withholding will be most accurate if you do this on the Form W-4 for the highest paying job.)

Step 3: Claim Dependents

3 **Dependents.** If your income will be $200,000 or less ($400,000 or less if married filing jointly) (see instructions):
- Multiply the number of qualifying children under age 17 by $2,000 ▶ $
- Multiply the number of other dependents by $500 . . . . . ▶ $

Add the amounts above and enter the total here . . . . **3** $

Step 4: Other Adjustments (optional)

4a **Other income.** If you want tax withheld for other income you expect this year that will not have withholding, enter the amount of other income here. This may include interest, dividends, and retirement income. You should not include income from any jobs . . **4a** $

b **Deductions.** If you expect to claim deductions other than the standard deduction and want to reduce your withholding, use Worksheet 2 on page 3 and enter the result here **4b** $

c Enter any additional amount you want withheld each **pay period** . . . . **4c** $

d **Exemption.** You can claim exemption from withholding for 2020 if:
- For 2019, you had **no** federal income tax liability; **and**
- For 2020, you expect to have **no** federal income tax liability.

If you meet both of these conditions, certify by writing "Exempt" here . . . . . ▶ **4d**

Step 5: Sign Here

Under penalties of perjury, I declare that this certificate, to the best of my knowledge and belief, is true, correct, and complete.

▶ **Employee's signature** (This form is not valid unless you sign it.) ▶ **Date**

Employers Only

5 Employer's name and address | **6** First date of employment | **7** Employer identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 2. Cat. No. 10220Q Form **W-4** (2020)

NOTES

INJURED SPOUSE RELIEF

Overview

- **Definition**
  - Share of refund used to pay spouse's separate past debts:
    - Federal taxes
    - Child and spousal support
    - Student loans
- **Qualifications**
  - Injured spouse not liable for the past due amounts
  - Injured spouse received and reported income on a joint return
  - The joint return had withholding, estimated tax paid, or credits attributable to the injured spouse
- **Community Property States**
  - Application of community property law may negate injured spouse claims

RAPID FINDER

Child Support	11.01.01
Community Prop States	11.01.01
Conditions	11.01.01
Five Step Process	11.01.02
Form 8379	11.01.02
Injured Spouse	11.01.01
Past Federal Taxes	11.01.01
Risk	11.01.01
Spousal Support	11.01.01
Student Loans	11.01.01

Pubs
Forms

Related IRC and IRS Publications and Forms

- **Form 8379** – Injured Spouse Allocation (used to request refund)
- **Rev Rul 74-611**

DEFINITION OF INJURED SPOUSE

The Details

Don't confuse joint taxpayer relief ***(innocent spouse)*** with an ***injured spouse claim.*** The two are very different. The innocent spouse rules are covered in Chapter 11.02. A taxpayer is an injured spouse if his/her share of a refund on a joint return was (or may be) applied against his/her spouse's legally enforceable separate ***past-due debts*** such as:

- Federal and/or state income taxes,
- State unemployment compensation,
- Child or spousal support payments, or
- Student loans.

ELIMINATE THE RISK

Where appropriate, clients might consider filing separate returns so that the non-liable spouse's refund is protected, and therefore that spouse would no longer be "injured."

CONDITIONS FOR INJURED SPOUSE RELIEF

Injured spouse relief is available if all three of the following apply:

1. Taxpayer (injured spouse) isn't required to pay the past due amount.
2. The injured spouse received and reported income on the joint return.
3. The joint return had withholding, estimated tax, or a refundable credit (e.g., EIC) attributable to the injured spouse.

COMMUNITY PROPERTY STATES

Important for Community Property States - If the injured spouse resides in a community property state, Form 8379 may be filed if only Item 1 above applies. Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin***.*** Overpayments involving community property states are allocated by the IRS according to state law of the state of residence.

In a series of revenue rulings, the IRS explains how the amount of an overpayment reported on a joint return may be applied against a spouse's separate tax liability for taxpayers domiciled in community property states. These rulings make assumptions about the operation of state community property laws, which are highly dependent on facts and circumstances. Therefore, check current law and apply it to the particular facts of a specific taxpayer after reviewing the applicable revenue ruling. These rulings and the states they cover are:

State of Domicile	Revenue Ruling
Arizona, Wisconsin	2004-71
California, Idaho, Louisiana	2004-72
Nevada, New Mexico, Washington	2004-73
Texas	2004-74

Each of these rulings explains a 5-step process for determining how much of a joint overpayment the IRS can use to offset the separate tax liability of one spouse. The five steps are:

- **Step 1**: Identify the underlying source of the overpayment (i.e., income tax withholding, estimated tax payments and other credits). Note: If earned income credit is a source of the overpayment, see Rev. Rul. 87-52.
- **Step 2**: Characterize the underlying source of the overpayment as either separate or community property or a combination of separate and community property. An overpayment will be characterized in the same manner as the source of the overpayment.
- **Step 3**: Offset the liable spouse's share of the joint overpayment from a community property source against the liable spouse's separate tax liability.
- **Step 4**: Determine whether, under state law, the IRS may reach the non-liable spouse's share of the overpayment from a community property source.
- **Step 5**: Determine whether the IRS may, under state law, reach a portion of the overpayment from a separate property source of the liable spouse or the non-liable spouse.

Example – Determining Offset if Domiciled in California: *In 2017 Larry Smith is single and incurs a tax liability of $20,000, which he does not pay. In 2018 Larry marries Nancy. In 2020 they file a joint return for 2019, reporting an overpayment of $1,000 that results from Larry and Nancy's wages in 2019. They are domiciled in California for all relevant years. The IRS determines that the entire $1,000 overpayment may be used to offset part of Larry's 2017 tax liability, and thus Nancy would have no injured spouse claim. The IRS's analysis is as follows:*

Step 1: *The overpayment is from income taxes withheld in 2019 from Larry's and Nancy's wages.*

Step 2: *California law presumes that all property acquired during marriage by either spouse or both spouses, including wages, is community property. The overpayment results from income tax withholding from the Smiths' wages, so the entire overpayment is assumed to be from a community property source.*

Step 3: *Under California law, each spouse has an equal interest in all community property, so the IRS may offset Larry's $500 share of the overpayment, which is from a community property source, against his separate tax liability.*

Step 4: *Under California law, a creditor may reach all of the community property to satisfy a debt incurred by a spouse before or during marriage. Therefore, the IRS may offset the remaining $500 of the overpayment.*

Step 5: *Under California law, a creditor may reach all of Larry's separate property to satisfy his separate tax liability, but a creditor may not reach any of Nancy's separate property to satisfy Larry's separate tax liability. Since no part of the overpayment is a separate property source, there is no separate property that the IRS may offset against Larry's separate tax liability.*

FORM 8379: Injured spouses may be entitled to refunds for their own share of the tax on a joint return. Form 8379, Injured Spouse Allocation, is used to request this refund.

- Filing Form 8379 separate from Form 1040: If a taxpayer has already filed a joint return, either a paper or electronic version, Form 8379 is mailed by itself to the IRS Service Center for the taxpayer's residence at the time the return was originally filed. With the form, include copies of all W-2s and W-2Gs (for both spouses) and Forms 1099-R or other 1099 series forms that show tax withheld.
- Filing Form 8379 with Form 1040 (paper version): If a taxpayer is filing Form 8379 with his/her joint return, simply attach the form with the return in the order of its sequence number. Write "Injured Spouse" in the upper left corner of the return. **NOTE:** A taxpayer filing Form 8379 can't ask for a direct deposit of a refund into more than one account *(Form 8888 Instructions).*

CALIFORNIA DIFFERENCES

California does not have an "injured" spouse provision (Form FTB 705 instructions).

"INNOCENT SPOUSE" RULES

Tax Liability Relief for Joint Filers

Overview

When married taxpayers file jointly, they become JOINTLY AND INDIVIDUALLY responsible (often referred to as ***"jointly and severally liable"***) for the tax and interest or penalty due on their returns. <u>This is true even if they later divorce</u>.

Joint filers remain ***"jointly and severally liable"*** even if a divorce decree states that a former spouse is responsible for any amounts due on previously filed joint returns. One spouse may be held responsible for all the tax due, even if all the income was earned by the other spouse. However, a spouse may in certain cases be relieved of responsibility for tax, interest, and penalties on a joint return under special relief rules. Fairly recent tax law changes make it easier for a taxpayer to qualify for such relief.

RAPID FINDER

Pubs Forms

Related IRC and IRS Publications and Forms

- **Form 8857** – Request for Innocent Spouse Relief
- **Pub 971** – Innocent Spouse Relief
- **IRC Sec 66(c)**
- **IRC Sec 6015**
- **Rev. Proc. 2013-34**

The Details

<u>INNOCENT SPOUSE VS. INJURED SPOUSE</u>:

Don't confuse the label "innocent spouse" with "injured spouse". The two are very different. ***Innocent spouse*** refers to the possible relief for one spouse from joint and individual tax liability on a jointly filed return. On the other hand, a spouse may become an ***injured spouse*** when he/she marries someone owing a debt for taxes, child support, student loans, etc., incurred prior to the marriage. The injured spouse rules are covered in Chapter 11.01.

<u>USE FORM 8857 TO REQUEST JOINT TAX LIABILITY RELIEF</u>:

A spouse can be relieved of unpaid tax, interest, and penalties on a joint tax return. The request is made on **Form 8857**, **Request for Innocent Spouse Relief**.

The ***"innocent spouse"*** files **Form 8857** after becoming aware of a tax liability he/she believes belongs only to the other spouse. This could occur due to an audit or because of an IRS notice. Send the form to: **Internal Revenue Service, P.O. Box 120053, Covington, KY 41012** – send it to this address even if prior communications have occurred with the IRS because of an examination, appeal or collection action. Alternatively, the form and attachments can be faxed to the IRS at 855-233-8558.

Time Limitations for Requesting Relief - The IRS, in Notice 2011-70 and proposed regulations in Notice 2012-8 provide that equitable relief requests must be filed before the expiration of the period of limitation for collection of tax (generally 10 years from the time tax is assessed), or if applicable, the period of limitation for credit or refund. If the taxpayer has received an IRS notice of deficiency, a petition should be filed with the Tax Court within 90 days, and innocent spouse relief should be raised as a defense for the deficiency in the petition so as to preserve the taxpayer's rights in case the IRS doesn't process the request before the end of the 90-day period.

Rev Proc 2013-34 notes that if the requesting spouse is applying for relief from a liability or a portion of a liability that remains unpaid, the request for relief must be made on or before the Collection Statute Expiration Date, or the date the period of limitation on collection of the income tax liability expires, as provided in section 6502. "Generally, that period expires 10 years after the assessment of tax, but it may be extended by other provisions of the Internal Revenue Code."

Abused Spouse Requesting Relief - Rev Proc 2013-34 also provides that if the nonrequesting spouse abused the spouse who is requesting relief from the IRS, or maintained control over the household finances by restricting the requesting spouse's access to financial information, and because of the abuse or financial control, the requesting spouse was not able to challenge the treatment of any items on the joint return, or to question the payment of the taxes reported as due on the joint return or challenge the nonrequesting spouse's assurance regarding payment of the taxes, for fear of the nonrequesting spouse's retaliation, then the abuse or financial control will result in satisfying the factor needed for a streamlined determination even if the requesting spouse knew or had reason to know of the items giving rise to the understatement or deficiency, or knew or had reason to know that the nonrequesting spouse would not pay the tax liability

Note that under ***Rev. Rul. 2003-36 (2003-18 IRB 849),*** an ***estate executor*** can file **Form 8857** on behalf of a deceased ***"innocent spouse"*** as long as the decedent had satisfied the applicable requirements while alive. The ruling also concluded that if a spouse made a claim before death, an executor may pursue the claim following that spouse's death.

RELIEF FROM JOINT AND SEVERAL TAX LIABILITY:

Three types of relief are available:

- Innocent spouse relief
- Separation of liability
- Equitable relief

Table Comparing the 3 Relief Types (further discussion later in the chapter)

Factor	If innocent spouse relief	If separation of liability relief	If equitable relief
Type of liability	Must have filed joint return that had "understatement" of tax due to an erroneous item of non-innocent spouse.	Must have filed joint return with an "understatement" of tax liability due in part to an item of non-innocent spouse.	Must have filed a joint return that has either "understatement" or "underpayment" of tax.
Marital status		Must be no longer married, legally separated, or have not lived with spouse for whole year before filing for relief.	
Knowledge	Must show that at the time joint return was filed did not know, and had no reason to know, that there was an "understatement" of tax.	If IRS shows that taxpayer actually knew of the item causing the understatement, taxpayer isn't entitled to relief to extent of the actual knowledge (except where domestic abuse existed).	
Other qualifications			(1) Available where taxpayer doesn't qualify for innocent spouse relief or separation of liability. (2) No fraud involved.
Unfairness	The standard of unfairness may be applied in granting relief.		The standard of unfairness may be applied in granting relief.
Refunds	Request can generate a refund.	Relief available only for unpaid liabilities resulting from "understatement" of tax; refunds not authorized.	May be entitled to this relief in form of a refund in limited cases (Notice 2012-8).

INNOCENT SPOUSE RELIEF

To qualify for innocent spouse relief, a taxpayer:

1) Must have filed a joint return with an ***"understatement of tax"*** (i.e., the difference between the amount of tax that should have shown on a return vs. the tax actually shown) that was due to ***"erroneous items"*** of his/her spouse;
2) Must establish that at the time he/she signed the joint return, he/she ***didn't know*** (and had no reason to know) that there was an understatement; and
3) Accounting for all the facts and circumstances, it would be ***unfair*** (i.e., inequitable) to hold the taxpayer liable for the understatement of tax.

"Erroneous Items" are either:

- Unreported income that was received by the non-innocent spouse and isn't reported on the return.
- Incorrect deductions, credits, or basis claimed by the non-innocent spouse which are improper or for which there is no basis in fact or law.

The following are examples of erroneous items:

a. ***Deducted amount was never paid -*** *Delta's spouse claimed $10,000 for advertising expense on Schedule C, but never paid for advertising.*
b. ***Deducted expense does not qualify -*** *Sheri claimed a business fee of $10,000 that actually was for the payment of a nondeductible state penalty.*
c. ***No factual argument to support deduction*** *- Mac claimed $4,000 for security costs related to a home office. The costs were for veterinary fees and food costs for Buster, the family dog.*

"Indicators of Unfairness" are determined based on the facts and circumstances of each individual case. To decide unfairness, the IRS checks factors like these:

- ✓ Whether the "innocent spouse" received ***significant direct or indirect benefit*** from the understatement of tax. A significant benefit is one which is excessive in terms of normal support.

  Example—Significant Benefit: *In March 2019, Jenna received $20,000 from Terence, her spouse of 10 years. The funds were traced to Terence's lottery winnings in 2017. No winnings were reported on the couple's joint 2017 federal return. The couple's normal monthly household operating budget was around $4,000. More than likely, the IRS would rule that Jenna had received a significant benefit due to the $20,000 gift, even though it was received in a year other than the one in which the unreported income occurred.*

- ✓ ***Desertion*** of the innocent spouse by the non-innocent spouse.
- ✓ ***Divorce or separation*** of the spouses.
- ✓ Innocent spouse received a ***benefit on the return*** from the understatement.

RELIEF BY SEPARATION OF LIABILITY: To file a claim for this type of relief the understatement of a joint tax liability (including interest and penalty) must be allocated (separated) between spouses (or former spouses). Since this form of relief is for ***unpaid liabilities*** resulting from understatements of tax, **the relief doesn't generate refunds**.

To request relief by separation a taxpayer must have filed a joint return and meet either of the following when ***Form 8857*** is filed:

- ***Be divorced or legally separated*** from the spouse with whom the joint return was filed (***widowed*** counts the same as divorced or legally separated), OR
- ***Not be a member of the same household*** as the spouse with whom the joint return was filed during the 12-month period ending on the date Form 8857 is filed. **Note:** The reason for living apart must be due to estrangement, not temporary absence.

Limitations For Relief By Separation - Innocent spouse relief by separation won't be granted in these situations:

1. IRS proves that the spouses transferred assets to each other ***fraudulently***.
2. IRS shows that the "innocent spouse" had ***actual knowledge*** of erroneous items at the time of signing the joint return. **NOTE:** A victim of domestic abuse who had actual knowledge of errors may still qualify for relief if the abuse happened before signing the joint return and fear prevented the abused spouse from challenging treatment of return items.
3. The "non-innocent" spouse transfers property to the "innocent" spouse to ***avoid taxes***. A transfer to avoid tax is presumed if made within 1 year before the date on which the IRS sent its ***first letter*** of proposed deficiency. However, this presumption doesn't apply if the transfer is made under a divorce decree or separate maintenance agreement nor does it apply where a taxpayer can establish that the main purpose of the transfer was not tax avoidance.

EQUITABLE RELIEF: If a taxpayer doesn't qualify for the two other forms of innocent spouse relief, the IRS will ***automatically*** consider whether equitable relief is suitable to the situation.

A taxpayer may qualify for ***equitable relief*** if all of the following are met:

1. The taxpayer ***doesn't qualify under one of the other forms*** of relief (e.g., separation of liability);
2. The spouses ***didn't transfer assets*** to each other fraudulently or for the purpose of avoiding tax payment;
3. The taxpayers' return ***wasn't fraudulently filed***;

4. The taxpayer ***did not pay the tax owed*** (although a refund may be available for the taxpayer's portion of the joint overpayment from another tax year that was applied to the joint tax liability to the extent the taxpayer establishes providing funds for the overpayment (Notice 2012-8));
5. The taxpayer can establish that it would be ***unfair (inequitable)*** to hold him/her responsible for the tax liability;
6. The income ***tax*** from which the taxpayer seeks relief ***is attributable to the "non-innocent" spouse,*** unless one of the following exceptions applies:
   a. The item is partly or totally attributable to the taxpayer under community law.
   b. An item titled in the taxpayer's name is attributable to the taxpayer unless rebutted by facts and circumstances.
   c. The taxpayer had no knowledge, or reason to know, that the "non-innocent" spouse misappropriated the funds that were intended to pay the tax.
   d. The taxpayer establishes being an abuse victim before signing the return, and because of prior abuse, didn't challenge the treatment of items on the return for fear of retaliation by the spouse.

UNDERPAYMENT OF TAX VS. UNDERSTATEMENT OF TAX: Unlike limitations in innocent spouse or separation of liability relief situations, with equitable relief, a taxpayer can be entitled to either relief from an ***underpayment*** or ***understatement*** of tax. ***Definitions:***

Understatement of tax - This is generally the difference between the total tax that should have been shown on a return and the amount of tax actually shown on the return. This difference is due to erroneous items on the return.

> ***Example -*** *A joint return shows a tax liability of $5,000, all of which was paid. When the return is audited, the IRS finds that $10,000 of one spouse's income was unreported. The additional tax on this income is $1,500 for a total tax liability of $6,500. The understatement of tax is $1,500.*

Underpayment of tax - This is the amount of tax reported on the taxpayer's return but which hasn't been paid. For instance, if spouses file jointly owing a total tax liability of $6,000 and they pay only $4,000 with their return, their underpayment of tax is $2,000.

INDICATORS OF UNFAIRNESS

The IRS considers all facts and circumstances to determine if it is unfair to hold the innocent spouse responsible for an underpayment or understatement of tax. The degree of importance of each factor varies depending on the requesting spouse's circumstances and the factual context of the marriage. The factors are designed to be guides, and no one factor or a majority of factors necessarily determines the outcome. *(Notice 2012-8)* Examples of factors considered include:

Favorable Factors:

- ***Separation or divorce*** of the involved spouses.
- ***Economic hardship***
- ***Abuse***
- ***Lack of knowledge*** of the innocent spouse
- Non-innocent spouse's ***obligation under a divorce decree*** to pay the tax.
- The ***tax owed is attributed to the non-innocent spouse***.

Unfavorable Factors:

- ✓ Innocent spouse had ***knowledge*** of the understated items.
- ✓ Innocent spouse received ***significant benefit*** from the unpaid tax.
- ✓ ***Lack of good faith effort to comply with tax law*** by the innocent spouse.
- ✓ ***Innocent spouse has obligation to pay*** the tax under a divorce decree.
- ✓ ***Tax*** for which relief request is made is ***attributable to the innocent spouse***.

> ***Example—Applying the Unfairness Factors:*** *Nathan and his spouse Rae filed a joint 2019 return which showed a tax liability of $10,000. Nathan wanted to pay half the liability with funds he had saved prior to marriage and the other half with loan proceeds of $5,000. He made the necessary financial arrangements for these transactions and received two $5,000 checks which he gave to Rae to pay the 2019 taxes. However, unknown to Nathan, Rae paid only $5,000 with the tax return and used the $5,000 loan proceeds to go on a shopping spree for herself at Saks Fifth Avenue. The IRS later billed for the unpaid $5,000 and flabbergasted Nathan hurried to his accountant for advice. His accountant recommended seeking relief from the tax liability due under the innocent spouse rules so Nathan filed Form 8857.*

<u>Economic Hardship</u> – The IRS, in Rev. Proc. 2013-34, has set out criteria for quantifying this factor by providing minimum standards based on income, expenses, and assets, for determining whether the requesting spouse would suffer economic hardship if relief is not granted. An economic hardship exists if satisfaction of the tax liability in whole or in part will cause the requesting spouse to be unable to pay reasonable basic living expenses, taking into consideration the requesting spouse's current income and expenses and the requesting spouse's assets. The Service will compare the requesting spouse's income to the Federal poverty guidelines for the requesting spouse's family size and will determine by how much, if at all, the requesting spouse's monthly income exceeds the requesting spouse's reasonable basic monthly living expenses. For example, this factor will weigh in favor of relief if the requesting spouse's income is below 250% of the Federal poverty guidelines, unless there are assets from which the requesting spouse can make payments towards the tax liability and still adequately meet reasonable basic living expenses. The lack of a finding of economic hardship does not weigh against relief, as it did under Rev. Proc. 2003-61, and instead will be neutral.

Worksheet for Allocating the Understatement of Tax

(Not to be filed with the IRS. Keep with the taxpayer's records.)

			(a) Innocent Spouse Items	**(b) Joint Items**
1.	Enter the <u>net</u> income and deductions (1) taken into account in computing the understatement of tax **AND** (2) allocated to taxpayer or allocated jointly to taxpayer and spouse.		1.____________	1.____________
1.	Enter net amount of all income & deductions taken into account in computing understatement of tax.*	2.__________		
2.	Divide line 1 by line 2. Enter the result as a decimal rounded to at least 3 places.		3.____________	3.____________
3.	Enter the understatement of tax.*	4.__________		
4.	Enter the credits & other taxes taken into account to compute the understatement of tax.**	5.__________		
6.	Subtract line 5 from line 4.	6.__________		
7.	Multiply line 6 by line 3.		7.____________	7.____________
8.	Enter the credits & other taxes (1) taken into account in computing the understatement of tax & (2) allocated jointly to the spouses.***		8.____________	8.____________
9.	Add lines 7 & 8. The total of columns (a) and (b) is the understatement of tax the innocent spouse is responsible for.		9.____________	9.____________

NOTE: Subtract total from line 4 to get the understatement of tax that qualifies for relief.

* This should be shown on the IRS notice or audit report.

** Enter the part of the understatement of tax that came from an adjustment to a credit. Also include adjustments to alternative minimum tax, household employment taxes, self-employment taxes, penalties on IRA or pension distributions, among other taxes.

*** Enter in column (b) credits & other taxes allocated jointly to the spouses. Don't enter them in column (a). Such items could include a child's liability reported on the joint return or household employment taxes.

<u>ALLOCATING AN UNDERSTATEMENT OF TAX</u>

Once a taxpayer files Form 8857, the IRS will figure the part of the tax, interest, and penalty that belongs to each spouse. Alternatively, the allocation can be made for the taxpayer using the worksheet above.

<u>NOTES ON THE ALLOCATION WORKSHEET:</u>

Important Reminder: Community property laws aren't taken into account to determine whether an item belongs to the innocent or non-innocent spouse.

LINE 1, Column (a)

1. Allocate income and deductions to compute understatement of tax in the same manner that would have been used if separate returns had been filed.
2. Generally, enter items allocable to the innocent spouse in column (a).
3. Allocate wages to the spouse who performed the underlying services. Business income should be allocated to the spouse who owned the business. This rule also applies to capital gains. If spouses own property together, allocate according to each one's ownership interest.

4. To allocate items subject to different tax rates, first separate erroneous items into categories according to tax rate. Then use a separate worksheet for each category.

EXAMPLE—Allocating Items Subject to Differing Tax Rates: *Dan and Holly filed a joint tax return in 2017 but were divorced in 2018. In 2019, the IRS audited the 2017 return and found that the couple owed $4,780 additional income tax. Of that amount, $1,500 was tax on an unreported net capital gain of $10,000 (15% tax rate). The remaining $3,280 was assessed due to unreported interest and nonqualified dividend income of $10,000 (33% tax rate). This is the breakdown of the erroneous items attributable to each spouse.*

	15% RATE	**33% RATE**
Dan	Capital gain--$4,000	Interest--$7,000
Holly	Capital gain--$6,000	NQ Dividends--$3,000

Holly decides to ask for relief by separation of liability. She will complete 2 worksheets, one for each different tax rate. On the first worksheet (for 15% rate items) on line 1, she will enter $6,000 in column (a); $10,000 on line 2; .60 on line 3, column (a); and $1,500 on line 4. The remainder of the worksheet will be completed as appropriate.

On the second worksheet (for 33% rate items) on line 1, column (a), she will enter $3,000; $10,000 on line 2; .30 on line 3 column (a); and $3,280 on line 4. The remainder of the worksheet will be completed as appropriate.

5. If there is income subject to special limits on separate returns (like social security), figure the income on a joint return basis and allocate it between the spouses.

EXAMPLE—Allocating Income with Special Separate Return Limits: *Belle and Riordon filed their 2019 return jointly. Riordon received social security income in that year but it was not taxable because the couple's total income was under the base amount of $32,000 for joint filers. Eventually, the couple received an IRS notice advising them that they hadn't reported certain interest income. The notice recomputed their 2019 tax based on this increased income and also showed that half of Riordon's social security was taxable because total income was over the $32,000 base amount. Had Riordon filed a separate return for 2019, 85% of his social security would have been taxable. When figuring his separation of liability, Riordon allocates only half of the social security. This is true even though 85% would have been taxable had he and Belle filed separately.*

LINE 1, Column (b) - Income and deductions allocated jointly to the spouses need to be entered in Column (b), including items of the non-innocent spouse which created a tax benefit for the innocent spouse and erroneous items the innocent spouse knew about.

EXAMPLE—Tax Benefit Items Allocated to Innocent Spouse: *Terry's joint return shows his wages of $50,000 and $15,000 gross self-employment income allocated to his spouse. An audit disallowed $20,000 in expenses of the self-employed spouse. Only $15,000 of the disallowed expense offset the spouse's income. The remaining $5,000 must be allocated to Terry because the amount offset his income.*

LINE 5 - Enter the part of the understatement of tax that came from an adjustment to a credit. In addition, enter adjustments to a child's tax that the taxpayer chose to report on a joint return and any tax other than income tax. Examples of the latter could be:

a) Alternative minimum tax,
b) Net investment income tax,
c) Household employment taxes,
d) Recapture of investment, low-income housing, qualified electric vehicle, Indian employment, or new markets credits,
e) Recapture of federal mortgage subsidy,
f) Self-employment tax,
g) Social security and Medicare tax on unreported tips,
h) Premature retirement account distribution penalties,
i) Additional taxes on Coverdell education savings accounts,
j) Tax on excess contributions to IRAs, education savings accounts, or Archer MSAs,
k) Tax on golden parachute payments,
l) Tax on accumulation distribution of trusts, and
m) Uncollected social security and Medicare or RRTA tax on tips or group-term life insurance.

LINE 8, Column (a) - Generally, allocate credits and other taxes in the same manner as if the spouses had filed separate returns.

> ***EXAMPLE—Allocating Credits, Taxes, Etc., to the Innocent Spouse:*** *Alice reported $800 in self-employment tax on her return. In an audit, the IRS concluded that she owed $1,200 in self-employment tax. Since all of this tax applies to Alice, she would enter the increase in self-employment tax of $400 ($1,200 less $800) in column (a) of the worksheet.*

If a ***child's tax liability*** is reported on the joint return (using Form 8814), include the tax attributable to the child's income in Column (a) only if the child is the innocent spouse's and hasn't been legally adopted by the non-innocent spouse.

In addition, enter the innocent spouse's share of ***alternative minimum tax*** in Column (a) using the following formula to figure it:

$$\frac{\text{Innocent spouse's share of alternative minimum taxable income (AMTI) as recomputed by the IRS}}{\text{Total AMTI as recomputed by IRS}} \times \text{Understatement of tax due to AMT}$$

Credits that wouldn't be allowed had the innocent spouse filed separately should be figured as on a joint return and then allocated between the spouses. Examples of this might be child and dependent care credits, adoption or education credits and the EIC.

> ***EXAMPLE—Allocating Credits between Spouses:*** *Fred and Alta claimed an $860 child care credit on their joint tax return. However, $360 of the credit was disallowed in audit. Had the couple filed separate tax returns, none of the credit would have been allowed. However, they are entitled to $500 for purposes of figuring separation of tax liability. The amount allocated between Fred and Alta on the Worksheet is actually the $360 disallowed portion.*

Line 8, Column (b) - Credits and other taxes allocated jointly to the spouses need to be entered in Column (b) on this line. They should not be entered in Column (a). The following are examples of items to be listed in Column (b):

- ***Credits*** allocable to the non-innocent spouse that created a tax benefit for the innocent spouse;
- ***Erroneous items*** the innocent spouse was aware of;
- ***A child's tax liability*** reported by filing Form 8814. However, if one spouse is the child's step-parent, enter this liability in Column (b) only if the step-parent legally adopted the child;
- ***Household employment taxes***.

FILLED IN ALLOCATION WORKSHEET EXAMPLE

FACTS - Denise and William filed jointly in 2016, but they were divorced in 2018. On April 30, 2019, the IRS issued a collection notice to the couple in regard to their 2016 tax return. The notice cited four adjustment items:

- An unreported 1099-MISC for William showing $2,400 non-employee compensation from Showtime Consulting;
- $339 assessed for self-employment tax on the $2,400 1099-MISC;
- An adjustment to income of $170 for half of the $339 self-employment tax;
- An unreported 1099-INT from Bank of New York for Denise in the amount of $600.

After consulting with her accountant, Denise decided to file Form 8857 to request relief under separation of liability provisions. With her accountant's help, she fills out an allocation worksheet. The following table shows the allocated items:

Items to Allocate	Denise	William
1099-MISC		$2,400
1099-INT	$600	
½ self-employment tax adj		$170
Self-employment tax		$339

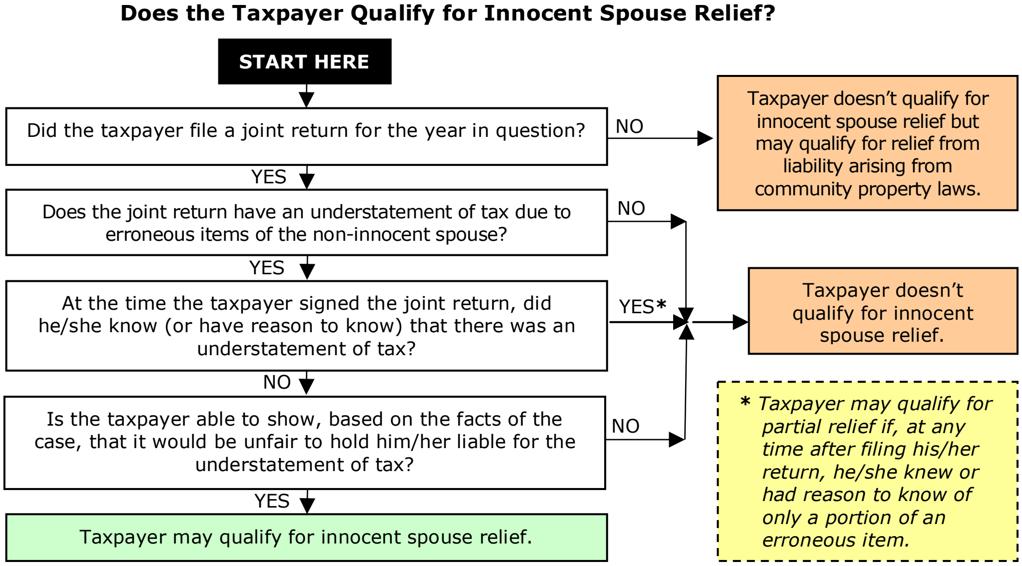
Continue to next page for worksheet

Worksheet for Allocating the Understatement of Tax
(Not to be filed with the IRS. Keep with the taxpayer's records.)

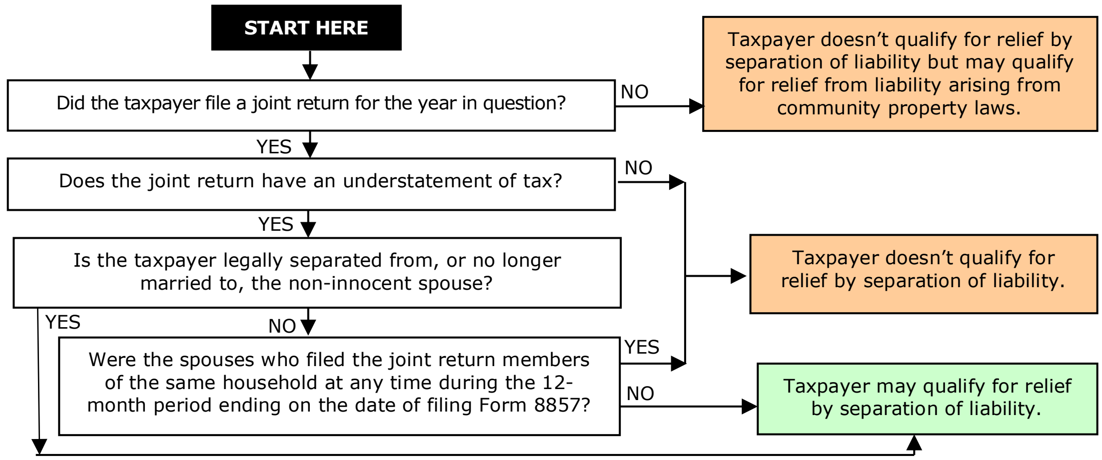
			(a) Innocent Spouse Items	(b) Joint Items
1.	Enter the <u>net</u> income and deductions (1) taken into account in computing the understatement of tax **AND** (2) allocated to taxpayer or allocated jointly to taxpayer and spouse.		1. 600	1. ____
2.	Enter net amount of all income & deductions taken into account in computing understatement of tax.*	2. 2,830	(2,400 + 600 – 170)	
3.	Divide line 1 by line 2. Enter the result as a decimal rounded to at least 3 places.		3. .212	3. -0-
4.	Enter the understatement of tax.*	4. 750	(from IRS notice)	
5.	Enter the credits & other taxes taken into account to compute the understatement of tax.**	5. 339		
6.	Subtract line 5 from line 4.	6. 411		
7.	Multiply line 6 by line 3.		7. 87	7. -0-
8.	Enter the credits & other taxes (1) taken into account in computing the understatement of tax & (2) allocated jointly to the spouses.***		8. -0-	8. -0-
9.	Add lines 7 & 8. The total of columns (a) and (b) is the understatement of tax the innocent spouse is responsible for.		9. 87	9. -0-

NOTE: Subtract total from line 4 to get the understatement of tax that qualifies for relief.

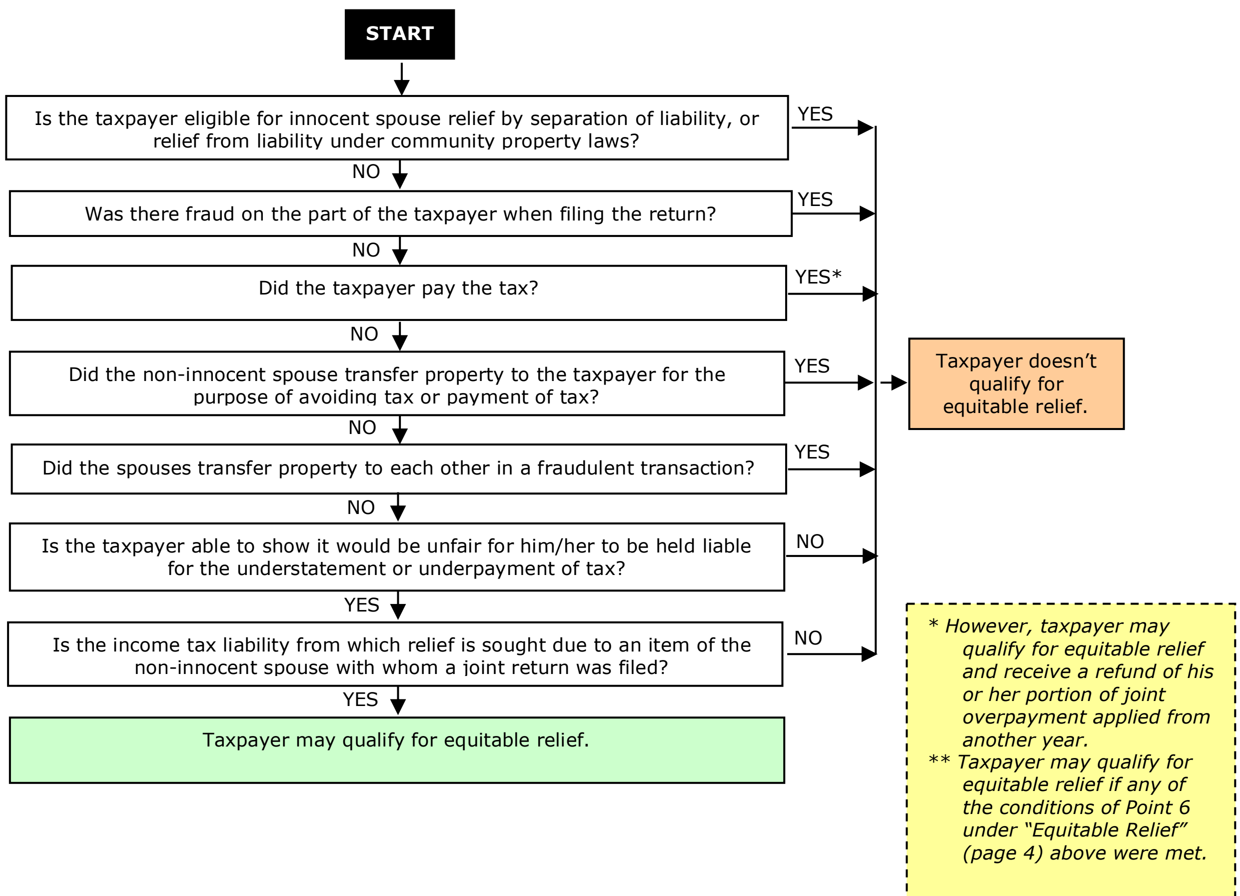
Does the Taxpayer Qualify for Innocent Spouse Relief?



Does the Taxpayer Qualify for Relief by Separation of Liability?



Determine If a Taxpayer May Qualify for Equitable Relief



TAX PLANNING CONSIDERATIONS

Meeting the time limits to request relief. A spouse, other than one requesting equitable relief, must request relief generally within 10 years from the time tax is assessed, or if applicable, the period of limitation for credit or refund.

A ***request for relief can be made before start of collection activity -*** For example, it can be made in connection with an audit. However, NO REQUEST CAN BE MADE BEFORE RECEIPT OF AN AUDIT OR OTHER NOTICE FROM THE IRS WHICH INDICATES THERE MAY BE AN OUTSTANDING TAX LIABILITY FOR A GIVEN YEAR.

What type of relief should a taxpayer request? When making a request for relief from joint tax liability on Form 8857, the request should not be made only for "equitable relief." The reason for this is that the IRS won't grant relief under the other provisions if only equitable relief is originally requested and not granted (i.e., no "innocent spouse relief" or "relief by separation of liability" will be available). However, if Form 8857 requests either "innocent spouse relief" or "relief by separation of liability" and the IRS finds that the requesting spouse might qualify for relief under one of these provisions, they will give the requester an opportunity to amend his/her original claim to request relief under an additional provision.

Suspension of the Statute of Limitations - A request for "innocent spouse relief" or "relief by separation of liability" results in the suspension of the Statute on collection. This is not so with "equitable relief."

Effect of Offer-in-Compromise - A spouse can't get joint tax liability relief for any tax year for which he/she has entered into an Offer-in-Compromise.

In Divorce Situations - Tax preparers may be asked to review tax allocations of estranged spouses as part of divorce proceedings. Of course, such allocations can be closely related to the innocent spouse rules and the possibility that one spouse may be considering requesting relief from a joint tax liability. For that reason, preparers may want to discuss the following questions and other specifics for consideration of the divorcing spouses:

- Have the parties specified how tax liabilities and refunds are to be allocated in their separation or divorce agreement? Remember that the parties' allocation agreement isn't enforceable on the IRS. Therefore, the agreement should provide for how the spouses are to proceed if the IRS allocates a tax liability contrary to the couple's agreement.
- Are there net operating losses being carried forward? How will they be shared between the spouses?
- In case of tax audits that occur in later years, what procedures are in place for selection of a representative and payment of professional fees?

OTHER RELATED ISSUES:

Joint return election: The election to file a joint tax return may be revoked only before the due date of a return, including extension. However, an executor may revoke a joint return election made by a surviving spouse within one year of the due date of the return including extension.

Validity of joint returns signed under duress: A signature made involuntarily or under duress is not a valid signature. Thus, if a spouse claims he/she signed a joint return under duress, the election to file a joint return may not be valid and the person claiming duress may not be held jointly or severally liable for the tax on the return. This circumstance, in effect, makes the relief provisions of ***§6015*** inapplicable. To establish that a return is signed under duress, the ***Internal Revenue Manual (IRM) 25.15.1.2.3 (06-26-2017)*** states that a taxpayer must show that he/she:

- Was unable to resist demands to sign the return; and
- Would not have signed the return except for the constraint applied by the other party.

If one spouse is able to prove duress, the IRS is instructed to adjust the return to reflect married separate returns being filed by both spouses. ***Question***—Will the taxpayer who proves duress save tax dollars? Much depends on the income of each spouse on the joint return, the use of certain credits not available on married separate returns, etc. Number crunching with married separate calculations should be part of the planning procedure. The IRM states that a requesting spouse who raises the issue of duress and later determines more tax would be owed if he or she filed separately, may choose not to pursue the issue of duress.

Forged Signatures: Where a spouse establishes forgery of his/her signature on a joint return (and there was no implied consent by that spouse to the return as filed), the joint return election is invalid. As with signature under duress, the relief provisions of ***§6015*** don't apply. The return will be adjusted to a married separate filing status. A married separate return may also be needed for the spouse claiming the forgery, depending on whether that spouse had income. The ***IRM 25.15.1.2.4 (06-26-2017)*** advises IRS auditors to consider referring the individual who forged the signature to the Criminal Investigation Division. Professional legal help should be advised.

EFFECTS OF RELIEF PROVISIONS ON THE "NON-INNOCENT SPOUSE"

Once a spouse (the requesting spouse) asks for innocent spouse relief, the other spouse (the non-requesting spouse) must be given the chance to participate in the proceedings ***(King v. Comm, 115 T.C. 118 (2000))***. In ***Corson v. Comm, 114 T.C. 354 (2000)***, for example, the IRS and the requesting spouse had reached an agreement, but the Court denied relief until the non-requesting spouse had the chance to participate in the proceedings.

The non-requesting spouse is entitled to file a written protest and receive an Appeals conference in regard to the IRS' decision to grant relief to a requesting spouse ***(Rev. Proc. 2003-19, 2003-5 IRB 371).*** Note, however, that the non-requesting spouse isn't entitled to file an independent petition with the Tax Court ***(Maier v. Comm, 119 T.X. 267 (2002), aff'd, No. 03-4509 (2d Cir., 02/26/04). Also see "Rev. Proc. 2003-19" below.***

To ensure that the non-requesting spouse gets the opportunity to participate in proceedings, the IRS must send notice to that spouse's last known address. In addition, information provided by one spouse may be shared with the other at the request of either spouse.

Rev. Proc. 2003-19 does not grant the non-requesting spouse the right to appeal to the Tax Court a decision by IRS to grant or deny relief to the requesting spouse. Thus, the non-requesting spouse generally has no recourse once IRS makes a final innocent spouse determination. If a spouse requesting innocent spouse relief petitions the Tax Court, however, the Court's rules allow the non-requesting spouse to become a party to the proceeding.

Procedures:

1) The non-requesting spouse must request an Appeals conference, in writing, within 30 calendar days of the mailing date of the notification letter. Such a request suspends further processing of the requesting spouse's claim for relief pending its outcome.
2) If only the non-requesting spouse files a written protest requesting an Appeals conference, IRS will notify the requesting spouse of the non-requesting spouse's request. If after the Appeals conference with the non-requesting spouse IRS proposes to change the preliminary determination, the requesting spouse will have an opportunity to request an Appeals conference before the final determination.
3) If only the requesting spouse files a written protest requesting an Appeals conference, IRS will notify the non-requesting spouse of the requesting spouse's protest and hold an Appeals conference with the requesting spouse. If Appeals proposes to increase the relief recommended, the non-requesting spouse will have an opportunity to request an Appeals conference.
4) If both spouses file written protests requesting Appeals conferences, IRS will notify each of the other's request and hold separate Appeals conferences with each spouse, with both spouses permitted to submit information. However, IRS may hold a joint Appeals conference instead of separate ones.

TIMEFRAME FOR PROCESSING FORM 8857

Form 8857 claims may move slowly through the IRS system due to the following:

- ✓ The taxpayer's account must be researched, administrative files retrieved and additional information secured from the taxpayer.
- ✓ The legal requirement to notify the non-innocent party of the claim. This party is given a "reasonable time" to respond. The IRS considers 60 days reasonable time.
- ✓ Denied claims, 30-day appeal letters, and 90-day determination letters slow down the process. IRS may use ***Form 870 IS, Waiver of Collection Restrictions in Innocent Spouse Cases*** to help reduce the time needed to resolve these matters.

All in all, it could take 8 months to complete processing in optimal circumstances.

California's innocent spouse relief provisions are in conformity with the comparable Federal income tax provisions in ***IRC §6015***. To this end, any Federal regulations interpreting IRC ***§6015*** are applicable for California purposes so long as there is no conflict with state law or regulations. **NOTE:** Except for cross-references and agency names, it largely repeats the language of IRC ***§6015*** word-for-word. The California rules also apply to registered domestic partners.

Ways to Qualify for State (CA) Innocent Spouse Relief

Basic Requirements - To qualify, a taxpayer must meet these three tests. First, he/she must have filed a joint tax return for any year that he/she is seeking relief. Second, the taxpayer must prove eligibility for relief based on one of the methods described below. Third, the taxpayer must request the relief in writing. The written request should include taxpayer's name, address, social security number, the years in question, a statement explaining why the taxpayer believes that he/she qualifies for relief, and if applicable, a copy of his/her court order.

Form FTB 705, Request for Innocent Spouse Relief, is the California equivalent to ***IRS Form 8857*** for making the request and can be found on the FTB web site at: https://www.ftb.ca.gov/forms/misc/705.pdf. The FTB has a short brochure on this topic, available on their web site at: https://www.ftb.ca.gov/forms/misc/714.html
The FTB web site has other information on this topic, which can be accessed at:
https://www.ftb.ca.gov/file/personal/filing-situations/tax-debt-relief-for-spouse.html

Submit requests for innocent spouse relief to:

State of California
Innocent Spouse Unit MS A452
Franchise Tax Board
P.O. Box 2966
Rancho Cordova, CA 95741-2966
Telephone: (916) 845-7072

Relief by Court Order - Revenue and Taxation Code Section 19006(b) – As part of a divorce/termination of registered domestic partnership from a spouse/RDP, the court may have issued an order relieving the taxpayer of unpaid tax due from a joint liability. For a court order to be effective, **ALL** the following requirements must be met:

- The court order must have been entered after January 1, 1977.
- The court order must specify which California income tax years the taxpayer has been relieved from paying.
- The tax due on the income that the taxpayer earned, managed, or controlled is paid.
- The tax due for which the taxpayer is requesting relief is **not** already paid. (If it is already paid, there is nothing of which to be relieved.)
- The Franchise Tax Board issued a Tax Revision Clearance Certificate* if, for the tax years of requested relief:
  -The taxpayer's joint gross income was more than $150,000[(1)], or
  -The taxpayers jointly owe more than $7,500[(1)] in state tax.

***** *A Tax Revision Clearance Certificate, Form FTB 2572, can be obtained from the Franchise Tax Board upon written request. Once issued, the Certificate must be filed with the court and incorporated into the taxpayer's court order for divorce. A confirmed copy of the certificate and decree must be returned to the Franchise Tax Board to obtain relief.*

[(1)] *For divorce court orders issued before 1/1/2003, the amounts were $50,000 and $2,500, respectively.*

Relief Automatic if Federal Relief Granted - SB 1065 enacted Sept. 27, 2010, requires that the FTB grant innocent spouse relief when the IRS has granted relief under the same facts and circumstances. This law is effective on January 1, 2011, and applies to requests for state relief that are based on an IRS request for similar relief made on or after January 1, 2009 and for requests for equitable relief received by the FTB on or after January 1, 2011. *(R&TC § 18533)* Copies of notices and correspondence from the IRS should be included with FTB 705 when requesting relief.

General Statute of Limitations for Refunds Applies - Assembly Bill 1748, enacted October 8, 2007, amends existing law (R&TC § 18533) to more closely conform to federal law by **applying the general statute of limitations for claims for refund** to *complete/partial relief* and by **disallowing any claims for refund** for *separate allocation relief*. Thus, such claims for relief made after the statute of limitations would be disallowed for claims for refunds to *complete/partial relief*. This act is effective January 1, 2008, and applies to requests for relief filed on or after that date.

NOTES

OFFER IN COMPROMISE

Overview

Our U.S. tax system is built on the premise that all taxpayers are expected to report their tax liabilities accurately and pay them on time. However, the Internal Revenue Code ***(§7122)*** gives the IRS the authority to "compromise" (i.e., settle based on a taxpayer's adverse economic circumstances) a tax liability for less than its stated amount at certain times when:

- Doubt exists as to the liability;
- Doubt exists as to the liability's collectibility; or
- It would advance effective tax administration to settle the liability.

Note: Although the IRS may compromise any civil or criminal case arising under the Internal Revenue Code, once IRS sends a case to the Department of Justice, the latter gains jurisdiction over its outcome.

According to ***IRS Policy Statement P-5-100*** goals of the OIC program are:

1) The IRS will accept an offer in compromise when it is unlikely that the tax can be collected in full and the amount offered reasonably reflects the collection that is probable.
2) An offer in compromise is a justifiable alternative to declaring a case currently not collectible or making it the subject of a long, drawn-out installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the government.
3) In cases where an offer appears to be a possible solution to a tax delinquency, IRS personnel assigned to the case will discuss the compromise alternative with the taxpayer and assist as needed in preparing the required forms. The taxpayer is held responsible for starting the first specific proposal for compromise.
4) Ensuring success of the compromise program requires: (a) taxpayers to make adequate compromise proposals consistent with their ability to pay along with reasonable documentation to verify this ability, ***AND*** (b) the IRS to make prompt and reasonable decisions in compromise cases.
5) The ultimate goal of the program is a compromise that is in the best interest of both the taxpayer and the government. Acceptance of an adequate offer is meant to result in a fresh start for the taxpayer to comply with future filing and payment requirements.

New Law & Stuff

The Taxpayer First Act signed into law on July 1, 2019, amends IRC Sec 7122(c) by waiving the offer-in-compromise application fee for an individual with AGI for the most recent tax year for which information is available that doesn't exceed 250% of the applicable poverty level.

The amendment applies to offers-in-compromise submitted after July 1, 2019, the date of enactment of the Act. It appears that the IRS has built in this provision in the Low-Income Certification portion of Form 656 with revision date of August 2019.

Related IRC and IRS Publications and Forms

Pubs Forms

- **Form 656** – Offer in Compromise
- **Form 656-B** – Form 656 Booklet
- **Form 656-L** - Doubt as to Liability
- **Form 656-PPV** – Offer in Compromise Periodic Payment Voucher
- **IRC Sec 7122**
- **Internal Revenue Manual**– Section 5.8

RAPID FINDER

Fresh Start Initiative - The IRS expanded its "Fresh Start" initiative to offer more flexible terms in its Offer-in-Compromise (OIC) program (IR-2012-53). This enables a larger number of financially distressed taxpayers to clear up their tax problems faster than in the past. While resolving tax problems might previously have taken four or five years, taxpayers may now be able to resolve their problems in as little as two years. Changes incorporated by the IRS affect how the taxpayer's future income is calculated, allow taxpayers to repay their student loans, allow taxpayers to pay state and local delinquent taxes, and expand the allowable living expense allowance category and amount.

The IRS determines a taxpayer's reasonable collection potential, based on the taxpayer's income and assets, to determine if the liability can be paid in full as a lump sum or through a payment agreement. When calculating this potential, the IRS now looks at only one year of future income for OICs paid in five or fewer months, and two years of future income for OICs paid in six to 24 months. Form 656, Offer in Compromise, and Form 656-B (revised August 2019), Offer in Compromise booklet, reflect the most up-to-date computations and recovery periods.

When conducting financial analysis to evaluate a taxpayer's ability to pay, the IRS applies allowable living expense standards that incorporate average expenditures for basic necessities for people in similar geographic areas. These standards are used when evaluating installment agreements and OIC requests. The miscellaneous allowance portion of the standards includes items such as credit card payments and bank fees and charges. The IRS has clarified that it will allow payments for student loans for post-high school education, if the loans are guaranteed by the federal government. Further, payments for delinquent state and local taxes may be allowed based on a percentage basis of tax owed to the state and the IRS.

USE PRE-QUALIFIER TO TEST FOR ELIGIBILITY

The IRS encourages taxpayers to use the Offer in Compromise Pre-Qualifier on the IRS' web site at http://irs.treasury.gov/oic_pre_qualifier/ to confirm eligibility to make an offer and prepare a preliminary proposal.

ALL REQUIRED RETURNS MUST BE FILED FIRST

OIC applications received by the IRS on or after March 27, 2017 will be returned without being considered by the IRS if the taxpayer has not filed all required tax returns. In such cases, the application fee will be returned but any required initial payment submitted with the Offer will be applied to outstanding tax debt. This policy doesn't apply to current year tax returns if there is a valid extension on file.

APPLICATION FEE

Offers require a $186 application fee. EXCEPTION: If the applicant is an individual or is operating as a sole proprietorship and their household gross income meets the low income (as defined below under "waivers") guidelines, the application fee is not required to be paid.

PARTIAL PAYMENTS REQUIRED WITH OFFER SUBMISSIONS

The IRS has adopted some tough procedures associated with the submission of an offer-in-compromise (OIC) - IR 2006-106; Fact Sheet 2006-22.

Taxpayers submitting offers must make a nonrefundable, up-front payment to IRS while the service considers the merits of the offer. According to the instructions in the Form 656-B (August 2019) booklet, the payment options are:

- **For Lump-sum Offers** – 20% paid with the offer and the balance paid in five or fewer installments within 5 or fewer months of the offer's acceptance.
- **For Periodic Payment Offers** – Requires the first payment with the offer and the remaining balance paid, within 6 to 24 months, in accordance with the proposed offer terms. Under this option, the taxpayer must continue to make monthly payments while the IRS is evaluating the offer. If these payments aren't made, the IRS will return the offer. There is no appeal. Total payments must equal the total offer amount.

Individuals meeting the Low-Income Certification guidelines will not be required to send the initial payment or make the required monthly payments while their offer is being considered.

Failure to submit up-front payments - will produce the following actions:

- **For lump-sum offers** – where no up-front payment is submitted the offer will be returned to the taxpayer as being unprocessable. If less than the 20% up-front payment is submitted, the IRS will ask the taxpayer to pay the remaining balance in order to avoid having the offer returned. If it isn't paid, IRS will return the offer and retain the $186 application fee.
- **For periodic payment offers** – failure to submit the first proposed installment with the offer will result in the offer being returned to the taxpayer as being unprocessable.

Application of the up-front payments – The up-front payments are not refundable and are considered payments on tax. Thus, if the offer is rejected the up-front payments will be applied to the taxpayer's liability. A taxpayer can specify the application of any payment made under the above rules to the assessed tax or to other amounts at the submission of the offer. If a taxpayer fails to specify then the IRS will apply the payments in the best interest of the government. However, the applicant may make a deposit (see Form 656, Section 5), which may be returned. If the offer is accepted, the payments made during the offer process, including any money designated as a deposit, will be applied to the offer amount.

Specification Strategy - The application of any partial payment won't matter if the offer is accepted, but it might if the offer is rejected. To prepare for that possibility, if the offer is being made with respect to more than one tax year, the taxpayer should consider applying any payments made under the offer to more recent years, rather than to those nearing the expiration of the limitation period for collection. This will avoid having the payments credited to a tax liability that might be rendered uncollectible by the running of the statute of limitations.

Up-front Payment Waivers Possible - Taxpayers qualifying as low-income or filing an offer based solely on doubt as to liability can receive a waiver of the partial payment requirements.

- ***Low-income taxpayer Offers*** *- A low-income taxpayer is an individual whose income falls below poverty levels based on guidelines established by the U.S. Department of Health and Human Services. Taxpayers claiming the low-income exception should use the worksheet and low-income guidelines in the Form 656-B booklet to determine if they qualify.*
- ***Doubt as to Liability Offers*** *- An offer is considered to be submitted solely on the basis of doubt as to liability if the taxpayer submits the offer on Form 656-L, Offer in Compromise (Doubt as to Liability), or if the offer is submitted on Form 656, Offer in Compromise, it is clear on the face of the form that the only basis on which the taxpayer relies in making the offer is doubt as to liability.*

Offers are submitted using Form 656, Offers in Compromise. Form 656-B, Offer in Compromise Booklet, provides detailed instructions for completing the offer and includes all of the necessary financial forms and worksheets. When submitting Form 656, taxpayers must include an application fee unless they qualify for the low-income exemption or are filing a doubt-as-to liability offer. The application fee will be applied to the assessed tax or other amounts due.

Deemed Acceptance - If an offer is not withdrawn, returned or rejected within 24 months of the date received by IRS, it is deemed to be accepted. Time periods during which a liability included in the offer is the subject of a dispute in court proceedings will be disregarded by the IRS when calculating the 24-month time frame. **(Code Sec 7122(f)**)

DEFINING THE 3 OIC FUNDAMENTAL CONCEPTS

1) ***"Doubt as to liability"***—Doubt as to liability exists when there is ***a real dispute about the existence or amount of the correct tax liability of a taxpayer***.

   Such doubt doesn't exist, though, if the liability has been settled by a final court decision or judgment concerning the genuineness or amount of the liability. But an offer under the "doubt as to liability" category can't be rejected just because the IRS can't locate the taxpayer's return or information to verify the liability **(IRC 7122(d)(3)(B))**. The IRS indicates it will consider an offer based on doubt as to liability if it reasonably reflects the amount the IRS could expect to get by going to court. Since trying to predict the outcome of a court case is far from an exact science, the IRS relies on "discretion" in determining what it will consider as a reasonable offer **(Rev. Proc. 2003-71, 2003-2 C.B. 517)**.

2) ***"Doubt as to collectibility"***—Doubt as to collectibility may be present in any case when a taxpayer's assets and income are less than the full amount of the assessed liability. To determine doubt as to collectibility, the IRS considers the ***taxpayer's ability to pay***. In settling such a case, the taxpayer must be allowed to preserve sufficient funds to pay for his/her basic living expenses. To determine settlement, IRS considers expenses only to the extent they are necessary for health and welfare of the taxpayer and family or are needed to produce income **(Rev. Proc. 2003-71)**.

   In general, the IRS won't consider an offer based on doubt as to collectibility if the ability of the government to collect the tax is not in doubt. This kind of offer is considered appropriate when liquidation of assets or maximum levy of income isn't enough to pay the tax. The assets of a non-liable spouse generally aren't considered to determine a taxpayer's ability to pay unless those assets have been conveyed to the spouse in order to defraud creditors (or unless state law makes the spouse's assets available to creditors, such as in community property states). However, action against the spouse's assets must be weighed against how such action will affect the standard of living of the taxpayer and family.

   The IRS publishes schedules of national and local living expense standards to help evaluate family needs **(Publication 1854, How to Prepare a Collection Information Statement (Form 433-A))** - https://www.irs.gov/pub/irs-pdf/p1854.pdf. They use these standards based on the individual facts and circumstances of each individual case. The standards aren't used if the amounts they prescribe would deprive a taxpayer of adequate support for basic living needs. Be sure to use the most recent version (February 2019) of the publication and form to ensure the current amount is used for living expense standards. The IRS has detailed discussions about the various standards and the current amounts on its web site– enter "living expense standards" in the search box.

3) ***"To promote effective tax administration"***—If the IRS finds no grounds to compromise based on the two previously described categories, they may enter into a compromise to promote effective tax administration.

This could happen when collection of a full tax liability creates economic hardship. Alternatively, it could result where detrimental public policy or unfairness to the taxpayer provide basis for a compromise. Although acceptance of a compromise under this standard may occur where full collection would undermine public confidence in the tax law, a compromise would not be accepted if it would undermine compliance with the tax laws by taxpayers.

Congressional intent with this provision was that the IRS would take into account factors like equity, hardship, and public policy in the tax administration process. Factors that may be considered in determining hardship might include serious illness that depletes a family's financial resources ***(Reg. Section 301.7122-1(c)(3)(i)(A))***. On the other hand, a compromise of a tax shelter liability would be one that could undermine rather than promote compliance within the tax system.

OIC PROCEDURES AND REQUIRED FORMS

IRS' authority to compromise a tax liability is established by ***Code Section 7122***. The IRS' authority to enter a valid agreement exists only when the statute is carefully and strictly administered. A very old case states that without such administration a compromise agreement is not binding on either the IRS or the taxpayer ***(Botany Worsted Mills v. U.S., 278 U.S. 282 (1929))***. However, just because an Offer is made doesn't mean the IRS will accept it. For example, during FY 2016 taxpayers proposed 63,000 OICs but the IRS accepted only 27,000 of the Offers., an acceptance rate of 42.86% (IRS 2016 Data Book), while the acceptance rate for FY 2017 went down to 40.52% (IRS 2017 Data Book). For FY 2018 taxpayers submitted 59,000 offers and the IRS accepted 24,000 of them yielding and acceptance rate of 40.6%, slightly down from 2017.

The procedures for submitting an offer in compromise are outlined in ***Rev. Proc. 2003-71***. This procedure applies to all offers to compromise a civil or criminal liability submitted to the IRS, except for those offers going directly to Appeals. In addition, it doesn't apply to offers that have been referred to the Department of Justice.

Submit offers (based on other than doubt as to liability) on ***Form 656, Offer in Compromise***. **NOTE:** The latest version of the form available (August 2019 at this writing) MUST ALWAYS be used and none of the standard language of the form may be stricken or altered. The form needs to be signed under penalty of perjury.

The offer should include:

- All tax liabilities to be covered by the compromise;
- The legal grounds for the compromise;
- The amount the taxpayer is proposing to pay: and
- The payment terms (including amounts and due dates of payments).

The taxpayer needs to submit ***Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals,*** or ***Form 433-B, Collection Information Statement for Businesses***, along with any other backup information as required by the IRS. The information sent to the IRS must be current, reflecting the taxpayer's financial situation for the 3 months just before the date of submitting the offer. **Forms 433-A and 433-B must be filled out COMPLETELY. This means that items that don't apply to the taxpayer should be notated with N/A (not applicable).**

If the basis of an offer is ***doubt as to liability***, the taxpayer should submit ***Form 656-L*** (latest version when this material was updated is dated January 2018)***,*** which includes a detailed description of why the taxpayer believes he/she doesn't owe the tax liability.

Taxpayers submitting offers on Form 656 must make a nonrefundable, up-front payment to IRS (in addition to the application fee) while the service considers the merits of the offer, unless waived because the taxpayer meets the low-income exception noted above. (See "Partial Payments Required with Offer Submissions" above for amounts.) The up-front payments are not refundable and are considered payments of tax. Thus, if the offer is rejected the up-front payments will be applied to the taxpayer's liability. A taxpayer can specify the application of any payment made under the above rules to the assessed tax or to other amounts at the submission of the offer. If a taxpayer fails to specify then the IRS will apply the payments in the best interest of the government.

If an offer is accepted under the "effective tax administration" or "doubt as to collectibility" categories and collection of an amount more than that offered would create economic hardship, then the taxpayer may ask for the user fee to either be refunded or applied against the offer amount. The IRS ***won't refund the fee*** to the taxpayer if the offer is accepted, rejected, withdrawn, or returned as non-processable after acceptance for processing. However, they won't charge an additional fee if a taxpayer resubmits an offer the IRS determines it has rejected in error or returned in error after acceptance for processing ***(Reg. Section 300.3(b))***. Other limitations on submitting the fee include:

- If making an offer on a liability owed jointly with another person, only one Form 656 is needed and one application fee.
- If making an offer individually (e.g., for employment tax liability) and for other liabilities with another person (e.g., income tax), but only one of the individuals is submitting an offer, all liabilities are listed on Form 656 and one application fee is submitted.
- If a taxpayer makes an offer individually and another jointly, then the taxpayer shows all tax liabilities on Form 656 and submits one application fee. The other joint filer files Form 656 showing only the joint tax liability but must also submit an application fee.

The following table shows the number of Forms 656 and application fees needed in specific OIC filing situations:

Type of Situation	**# of Forms 656 Needed**	**# of Application Fees Needed**
Taxpayer & spouse submitting 1 offer for same joint liability.	1	1
Taxpayer & spouse submitting separate offers for same joint liability (including divorced, separated, or living apart).	2	2
Divorced, separated or spouses living apart submitting offer on a joint liability.	1	1
Married couple owing 1 joint liability plus one spouse owes another individual (non-joint) liability.	2	2
Married couple owing a joint liability, plus one spouse owes an individual year liability with a prior spouse and a business liability. Other spouse also owes another individual year liability with a prior spouse.	2*	2*
An individual owes tax and also owes a partnership debt as a general partner (or a corporate debt from a closely held corporation).	2	2

One spouse will file one offer listing the joint income tax, the individual year tax and the business liability. The other spouse will file an offer listing the joint income tax liability and the individual year liability. Each will attach a single application fee with their offer.* ***Note:* *It does not matter that the joint liability appears on both offers.*

<u>OIC PROCESSING PROCEDURES:</u>

When the IRS receives an OIC, if all required returns have been filed, an offer examiner evaluates the offer and, if necessary, requests additional documentation to verify the taxpayer's financial and other information. The examiner will then make a decision on whether to accept or reject the offer, or whether a larger offer amount is needed to justify acceptance of the offer. If the latter is the case, the taxpayer gets an opportunity to amend the offer. When a compromise is under consideration, the IRS:

- Usually defers collection proceedings provided the government's interests aren't in jeopardy due to the delay;
- Is prohibited from collecting the tax by levy (but may file a Notice of Federal Tax Lien); and
- Is prohibited from collecting the tax by levy during the 30 days after rejection of an offer where an appeal of the rejection is being considered.

Note that an offer in compromise isn't under consideration just because it is received. It must be ***accepted for processing*** by the IRS. In fact, an offer is considered accepted for processing by the IRS only when the taxpayer receives acceptance notification from the IRS **IN WRITING**. According to ***Rev. Proc. 2003-71***, acceptance for processing occurs when the IRS finds that:

- An offer has been submitted with the correct Form 656 version;

- The most current version of Form 433-A and/or Form 433-B has been submitted, as appropriate to the situation;
- The taxpayer isn't in a bankruptcy situation (the courts and the IRS differ on the issue of whether the IRS should accept offers for processing from taxpayers in bankruptcy proceedings);
- The taxpayer has complied with all filing and payment requirements;
- The application fee has been paid, if required; and
- The offer meets any other minimum requirements the IRS establishes.

If it turns out that the taxpayer has not filed all tax returns that were legally required to be filed, the IRS will apply any initial payment sent with the offer to the tax debt and return both the offer and application fee to the taxpayer. This decision cannot be appealed.

Barriers to offer processability that may cause its return to a taxpayer include:

1. The offer doesn't meet the minimum requirements;
2. Insufficient information is sent with the offer so that it can't be evaluated effectively;
3. The taxpayer didn't supply additional data requested by the IRS within a reasonable time frame;
4. The offer by the taxpayer was submitted simply to delay collection;
5. The taxpayer failed to file a return or pay a liability;
6. The taxpayer filed for bankruptcy;
7. The offer was accepted for processing in error in the first place.

An offer won't be completely processed if the taxpayer's estimated tax payments for the current year aren't paid up to date. If the IRS finds that estimated payments for the current year aren't up to date, the taxpayer will get a single opportunity to make the required payments before the offer is returned. If an offer is returned because estimates aren't made, the application fee is forfeited.

To avoid a breakdown of the compromise process, a taxpayer should respond promptly to IRS requests for additional information during the period an offer is being evaluated.

Keep in mind that the return of an offer in compromise isn't a rejection; the taxpayer doesn't have the right to appeal it. But if the IRS begins collection activity after the offer is returned, the taxpayer can appeal under the collection due process rules.

The IRS may require extension of the statute of limitations on assessment as a condition of their accepting an offer in compromise. They must, however, let the taxpayer know of the right to refuse to extend or to limit the extension to particular issues or time periods.

What happens when an offer is withdrawn or determined non-processable?

- It will be returned to the taxpayer.
- Any amounts the taxpayer paid when making the offer including the up-front payments are not refundable and are considered payments on tax. Thus, if the offer is rejected the up-front payments will be applied to the taxpayer's liability. A taxpayer can specify the application of any payment made under the above rules to the assessed tax or to other amounts at the submission of the offer. If a taxpayer fails to specify then the IRS will apply the payments in the best interest of the government.
- The application fee of $186 generally won't be refunded unless the offer was accepted for processing through error.

Procedures for Withdrawing an Offer in Compromise

- A taxpayer may withdraw an OIC at any time before its acceptance.
- The withdrawal request may be made in person or by mail. In such cases, the withdrawal becomes effective when the IRS receives it.
- A withdrawal request may also be made by fax or telephone. In such case the withdrawal request becomes effective when the IRS mails (or personally delivers) acknowledgement of the request.
- Once an offer is withdrawn, collection activities can proceed.

Notes Regarding Rejected/Accepted Offers:

Rejected offers

- An OIC isn't considered rejected until the IRS issues written notice of the rejection ***(Rev. Proc. 2003-71)***. Written notice to the taxpayer must be "prompt."
- An offer can't be rejected until an independent administrative review of the proposed rejection is complete.

- The taxpayer can ask for a meeting to discuss acceptable alternative solutions with the office handling a rejected offer. If no agreement is reached at this meeting, the taxpayer has 30 days to file a protest with Appeals.
- In rejecting an offer, the IRS will also notify the taxpayer by mail, giving the taxpayer a reason for the rejection. They will not return the application fee. However, the taxpayer has a right to appeal the rejection or submit another offer (and another application fee).

NOTE: The statute of limitations is suspended during the period an OIC is pending, during the 30 days following a rejection of an offer, and during the time of any appeal of an offer's rejection.

Accepted Offers

- If the IRS accepts the taxpayer's offer, they send written notice of this decision by mail. Prompt payment and compliance with offer terms by the taxpayer are needed to prevent default on the offer. Once the payment terms are met by the taxpayer, the IRS will release all Notices of Federal Tax Lien against the taxpayer.
- If an offer involving more than $50,000 is accepted, a written opinion of the IRS Chief Counsel is required. The opinion includes the reason for acceptance, the amount of tax, interest, and penalties assessed, and the amount to be paid according to the terms of the compromise.
- Accepted offers in compromise become public information.
- If an offer is not withdrawn, returned or rejected within 24 months of the submission date, it is deemed to be accepted. Time periods during which a liability included in the offer is the subject of a dispute in court proceedings will be disregarded by the IRS when calculating the 24-month time frame.

Which IRS Personnel Handle Offers in Compromise?

IRS Collections has the responsibility for processing the following OICs:

- All offers based on doubt as to collectibility, including proposed liabilities still subject to settlement in Audit or Appeals;
- All offers based on effective tax administration;
- All offers under doubt as to liability for either trust funds recovery penalty (employment taxes) or personal liability for excise tax assessment.

Examination (Audit) has responsibility for processing these functions related to OICs:

- Processing and investigation of offers based on doubt as to liability (except those cited above under IRS Collections);
- Backup to Collections for recommendations on offers based on effective tax administration with public policy/equity issues.

Appeals handles OICs as necessary from both Collection and Audit cases.

Expedited Processing (IRM 5.8.4.26 (07-18-2017): Taxpayers may ask that their OIC be expedited due to an emergency situation. Such situations might be:

a. A taxpayer's time-sensitive contract that requires resolution of a tax liability as a condition of agreement;
b. Availability of funding for the offer is time-sensitive; or
c. A taxpayer's terminal illness affecting ability to complete payment terms.

Offers requesting expedited processing are referred to IRS management personnel for decisions on the requests. The **Form 656** should be clearly labeled "Emergency Processing Requested". Target for completed processing of these requests is 90 days from receipt.

FILLING OUT FORMS 656/433-A/433-B:

For joint filers, if only one spouse has tax liability, but both have income, only the spouse responsible for the tax debt needs to prepare the forms. In this case, the responsible spouse should include only his/her assets and liabilities when filling out the forms. **Important:** The income and expenses of the whole household are required, including income of spouse, domestic partner, significant other, children and others that may contribute to the household.

In community property states, the forms are required from both spouses.

When completing forms, remember that offers based on doubt as to collectibility or effective tax administration must include all unpaid tax liabilities and periods for which the taxpayer is liable. For instance, if a taxpayer submits an offer to compromise income tax liabilities, but also owes business liabilities for his/her sole proprietorship, both the income tax and business liabilities must be included in the taxpayer's offer. On the other hand, doubt as to liability offers should only include the tax year in question, and other tax periods that the taxpayer owes on shouldn't be included in the offer ***(IRM 5.8.1.7 (01-01-2016))***.

Coverage of Offers: A compromise is effective for a taxpayer's assessed liability for tax, penalties and interest for the years or periods covered by the offer. When a compromise is accepted, all questions of tax liability for the years covered by the agreement are settled. Neither the taxpayer nor the IRS can reopen a compromised tax year unless there was falsification of documents or some other concealment or mutual mistake in the case.

The following table gives an overview of acceptable amounts and documents needed for OICs:

Type of Offer	**Documents/Fees Required**	**Acceptable Offer Amt**	**Special Circumstances**
Doubt as to Collectability	Form 656, Form 433-A and/or 433-B. $186 Application Fee unless low income guidelines met.	Must be equal to or more than t/p's reasonable collection potential amt (RCP)*.	Offer of less than RCP will be considered when based on t/p's unusual circumstances such as life-threatening illness, advanced age, or other. *
Doubt as to Liability	Form 656-L including explanation showing why tax is not owed. No application fees.	Taxpayer's corrected computation of tax, penalty and interest amounts.	N/A
Effective Tax Administration	Form 656, Form 433-A and/or 433-B. $186 Application Fee unless low income guidelines met	No specific guidelines.	T/p must give Explanation of Circumstances to show tax payment would cause economic hardship or be unfair to t/p if req'd to be paid. Attach documents of support for exceptional circumstances.

*RCP equals the net equity of a taxpayer's assets (asset current value less unpaid loan amounts) plus the amount that could be collected from his/her future income.

OIC Definitions (useful in preparing offers based on "doubt as to collectibility" or "effective tax administration"):

Current value of assets is the amount a person could reasonably expect to get from the sale of an asset at a given point in time. In filling out OIC forms, determine current value of various assets by checking, for example, with realtors, used car dealers, newspaper advertisements, etc.

With the ups and downs of the housing market, the IRS recognizes that the real estate valuations used to assess ability to pay may not be accurate. So, in instances where the accuracy of local real estate valuations is in question or other unusual hardships exist, the IRS will do a second review of the information to determine if accepting an offer is appropriate. ***(IR-2009-2, Jan. 6, 2009)***

California RDP's Assets Considered in OIC - The IRS Chief Counsel's Office has determined that in considering the reasonable collection potential of a California taxpayer who files an offer in compromise (OIC), the IRS may consider the community property assets owned by the taxpayer's registered domestic partner. This is so even though the RDPs are not allowed to file a joint federal return.

In community property states, of which California is one, the IRS' position is that the assets of both owners of community property (the owner submitting the offer and the non-offering owner) should be considered in the offer.

The Internal Revenue Manual (Section 25.18.4.4 06-05-2017) provides that if under applicable state law, all or part of the non-offering owner's share of community property and community property income would be available to satisfy the tax liability at issue, these items should be considered in the offer in compromise. Since California registered domestic partners share an equal interest and liability in community property in the State of California, the Chief Counsel concluded that the IRS can consider the assets of the taxpayer's RDP in determining whether to accept the taxpayer's OIC. *(CCA 201021049)*

Future income is the amount the IRS figures they could collect by subtracting a taxpayer's necessary living expenses from his/her monthly income over a set period of time.

Necessary expenses are payments a person makes to support the health and welfare of himself/herself and his/her family. Necessary expenses can also be those for items used in the production of income for the taxpayer.

IRS to be More Flexible with OICs from Unemployed Taxpayers - The IRS announced that its employees will be permitted to consider a taxpayer's current income and potential for future income when negotiating an offer in compromise. Normally, the standard practice is to judge an offer amount on a taxpayer's earnings in prior years. This new step provides greater flexibility when considering offers in compromise from the unemployed.

The IRS may also require that a taxpayer entering into such an offer in compromise agree to pay more if the taxpayer's financial situation improves significantly. *(IR-2010-29, 3/9/2010)* Note: Commenting on this change, the National Taxpayer Advocate raised concerns that "procedures do not clearly instruct IRS employees to apply flexibility and good judgment when calculating future income." (*Taxpayer Advocate Service, Fiscal Year 2011 Objectives* report to Congress, page 22)

Living expenses generally NOT allowed by IRS as "necessary expenses" include school (including college) tuition, charitable gifts, voluntary retirement contributions, cable TV charges and the like. Such expenses can only be claimed as necessary when the taxpayer shows they are vital to the health and welfare of his/her family or needed for the production of income. The IRS in IR-2012-53 has revised their necessary expenses to include payments on federally guaranteed student loans for post-secondary education.

Quick Sale Value (QSV) is the amount a person can reasonably expect from the sale of an asset if it had to be sold in 90 days or less.

Realizable Value is QSV less any amount owed to a secured creditor on the asset.

POSSIBLE PAYMENT PLANS AVAILABLE FOR AN OIC:

Doubt as to collectability -

- ***Lump Sum Cash payment*** - 20% of the lump sum cash offer must be paid with the offer and the remaining balance paid in 5 or fewer installments within 5 or fewer months of the date the offer is accepted.
- ***Periodic payment*** - The first payment must be made with the offer and the remaining balance paid monthly starting the month after the offer is submitted and fully paid off within 6 to 24 months, in accordance with the proposed offer terms. Under this option, the taxpayer must continue to make monthly payments while the IRS is evaluating the offer. If these payments aren't made, the IRS will return the offer. There is no appeal. Total payments must equal the total offer amount.

  NOTE: A Notice of Federal Tax Lien (lien) gives the IRS a legal claim to the taxpayer's property as security for payment of their tax debt. The IRS may file a Notice of Federal Tax Lien during the offer investigation. However, unless a jeopardy situation exists, a request for a Notice of Federal Tax Lien will usually not be made until a final determination has been made on the offer. IRS will not file a lien on any individual shared responsibility payment debt (i.e., the penalty for failing to have health insurance). *(Form 656-B rev 8-2019)*

Doubt as to liability - The offer must be $1.00 or more and payable within 90 days of the notification of acceptance, unless an alternative term is approved at the time the offer is accepted. *(Form 656-L rev 1-2018)*

Note: The IRS may file a Notice of Federal Tax Lien to protect the Government's interest during the offer investigation. If the offer is accepted, the tax lien will be released when the terms of the offer agreement are satisfied.

WHERE TO FILE AN OIC:

For residents of: Alabama, Arkansas, Florida, Georgia, Hawaii, Idaho, Kentucky, Louisiana, Mississippi, Nevada, New Mexico, North Carolina, Oklahoma, Oregon, Tennessee, Texas, Washington, or Wisconsin:

Memphis IRS Center COIC Unit
PO Box 30803, AMC
Memphis, TN 38130-0803

For residents of: Alaska, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Illinois, Indiana, Iowa, Kansas, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, Utah, Vermont, Virginia, West Virginia, Wyoming, or have a foreign address:

Brookhaven IRS Center COIC Unit
PO Box 9007
Holtsville, NY 11742-9007

GUIDELINES FOR IRS FINANCIAL ANALYSIS OF A TAXPAYER'S OFFER

As outlined in the ***Internal Revenue Manual 5.8***: In processing an OIC, the IRS will perform a detailed analysis of the submitting taxpayer's financial condition. The taxpayer submits financial information on ***Form 433-A, Collection Information Statement for Wage-earners and Self-employed Individuals,*** or ***Form 433-B, Collection Information Statement for Businesses.***

The IRS primarily uses National and Local Standards as their guideline in determining the necessary expense levels to be allowed in finalizing an offer. The standard amounts are designed to account for the basic living expenses of the taxpayer according to income level. Sometimes, based on a taxpayer's circumstances or possible economic hardship, the Service may diverge from the standard amounts in determining basic expense levels. A taxpayer must provide reasonable substantiation of all expenses that exceed the standard amounts, including bank statements, canceled checks, credit card receipts, rent/lease receipts and agreements, payment coupons, court orders, contracts, future events that may increase expenses (e.g., birth of a child).

Auditors are instructed that analysis and verification of the Forms 433-A or -B should take place shortly after the forms are received. The ability to pay determination based on the analysis should be given to the taxpayer within "a reasonable amount time." The forms the taxpayer submits should reflect data no older than the prior 6 months. If, during the IRS investigation time, the data becomes older than 12 months, the personnel working the case will ask for updated information. At times, they may even request a new ***Form 433.***

A face-to-face conference with the taxpayer (and/or his/her representative) is the IRS preferred method for reviewing the ***Form 433*** information. Telephone and mail contact may be used to secure some information.

The expectation of the IRS in coming to an agreeable compromise amount is this: The taxpayer is expected to be able to pay a tax liability equal to that over and above necessary (or not allowable conditional) expenses.

IRS Analysis of a Taxpayer's Financial Information: The goal of the IRS analysis is, of course, to determine the amount of disposable income (gross income less all allowable expenses) available to apply to the tax liability.

Allowable expenses include those expenses that meet a **necessary expense test**. This necessary expense test defines expenses that are essential to provide for a taxpayer's and his/her family's health and welfare and/or for production of income. The expenses must be reasonable. The total of the necessary expenses will establish the minimum a taxpayer and family needs to live.

The guidelines use 3 standards for determining necessary expense based on a taxpayer's income level:
- **National standards**
- **Local standards**
- **Other**

See the IRS web site for links to the most current standards: https://www.irs.gov/businesses/small-businesses-self-employed/collection-financial-standards

National Standards: These expense standards come from the Bureau of Labor Statistics Consumer Expenditure Survey. They establish standards for what are considered reasonable amounts for five types of expenses. The expenses include:

1. Food (all meals, home and away),
2. Housekeeping supplies (including laundry and cleaning supplies, other household products, paper products, lawn and garden supplies, postage, stationary, and miscellaneous supplies),
3. Apparel and services (including shoes, clothing, laundry, dry cleaning, shoe repair),
4. Personal care products and services (including hair care costs, barber and beautician services, oral hygiene products, shaving needs, cosmetics, perfume bath preparations, deodorants, feminine hygiene products, electric personal care appliances, personal care services, and repair of personal care appliance),
5. Miscellaneous (a discretionary amount established by the IRS rather than Labor Statistics).

Local Standards: Local standards apply to 2 types of expenses:

A. Housing (all utilities [including gas, electricity, water, fuel, oil, other fuels, trash collection, telephone, cell phone, cable television and internet services], mortgage/rent, property taxes, interest, parking, maintenance, home insurance, homeowner dues),

B. Transportation (vehicle insurance, vehicle payments and repairs, fuel, vehicle registration, parking, tolls, driver's license, public transportation). Transportation costs not required to produce income or ensure health of taxpayer and family aren't considered necessary.

Taxpayers are allowed the lesser of: the local standard or the amount actually paid by the taxpayer. **Note:** The IRS has established a housing cost level for each county in the U.S.

Other: Other expenses than those cited under National and Local Standards may be allowed if they meet the necessary expense test. Such expenses must provide for the health and welfare of the taxpayer and family or be for the production of income and are based on the discretion of the IRS.

Conditional Expenses: These expenses don't meet the necessary expense test. However, they may be allowable as necessary if the tax liability, including projected accruals, can be fully paid within 5 years. In addition, under a 1-year rule, a taxpayer has up to one year to modify or eliminate excessive necessary or not allowable conditional expenses if the tax liability, including projected accruals, cannot be fully paid within 5 years.

Note: National and local expense standards are guidelines. If it is determined a standard amount is inadequate to provide a specific taxpayer's basic living expenses, the IRS is instructed to allow divergence from the standards.

> ***Example—Applying National Standards for Expenses:*** *Charlie had the following monthly expenses: Housekeeping supplies, $150; clothing $160; food, $600, miscellaneous, $400. In all, his total monthly expenses were $1,310. The Bureau of Labor Statistics National Standard for these expenses is $1,100, based on Charlie's income level. The taxpayer would be allowed $1,100 as his necessary expense amount unless he could substantiate and justify to the IRS's satisfaction the need for the additional amount.*

Worksheet – The worksheet included in the 656-B (booklet) can be completed using data from Form 433-A. It is useful in determining how much a taxpayer's Form 656 compromise offer should be.

CALIFORNIA OFFER IN COMPROMISE PROGRAM

California has an offer in compromise program for taxpayers who do not have the income, assets or means to fully pay their state tax liability currently or in the foreseeable future. However, the FTB will not accept a zero-dollar offer; the offer must represent the most the FTB can expect to collect over a reasonable period of time. The factors used by the FTB in considering the offer include the taxpayer's ability to pay, present and future income and expenses, the amount of equity in the taxpayer's assets, the potential for changed circumstances and whether the offer is in the best interest of the state.

Application Processing and Options - For the Franchise Tax Board to process an OIC application, the taxpayer must have:

- Filed all required tax returns.
- Fully completed the OIC application (***FTB 4905PIT*** for personal income tax, ***FTB 4905BE*** for business income tax) and provided all supporting documentation (see list in 4905 booklet). According to the FTB web site the booklet and forms are only available by request. By providing the FTB with an email address they will email the information to the requestor.
- Agreed with the FTB as to the amount of tax owed.
- Authorized the FTB to obtain the taxpayer's consumer credit report, and to investigate and verify the information provided on the application.

If an OIC was accepted by the IRS, it does not mean that the OIC made to the FTB will be accepted automatically. The FTB does a separate evaluation from the federal offer.

If the taxpayer owes tax to the Employment Development Department, California Department of Tax and Fee Administration, and Franchise Tax Board (or any one or combination of these agencies), ***Form DE 999CA***, OIC Multi-Agency Application, can be used instead of FTB 4905PIT or FTB 4905BE.

No Installment Payments – Unlike the federal OIC program which allows installment payments of the compromised tax amount, the FTB requires a lump sum payment of the offered amount, which must be submitted by cashiers check or money order. The offered funds should not be sent in with the application but should only be sent to the FTB after the offer is accepted and the taxpayer has been notified to send payment.

Collateral Agreement May be Required – If the offer is approved, the FTB may require a "collateral agreement" for a term of 5 years. A collateral agreement is a contractual agreement between the taxpayer and the Franchise Tax Board in which the taxpayer agrees to pay to the FTB a percentage of future income that exceeds an agreed upon threshold. Generally, if the taxpayer is on a fixed income or has limited potential for increased earnings, a collateral agreement will not be required.

NOTES

HOUSEHOLD EMPLOYEES

Overview

Not all individuals hired to work in a taxpayer's home are considered household employees. For example, a taxpayer may hire a self-employed gardener who handles the yard work for the taxpayer and others in the taxpayer's neighborhood.

RAPID FINDER

The gardener supplies all tools and brings in other helpers needed to do the job. Under these circumstances, the gardener isn't an employee and the person hiring him/her isn't responsible for paying employment taxes.

Whether a household worker is considered an employee depends a great deal on circumstances and the amount of control the person hiring has over the job and the hired person. Ordinarily, when someone has the last word about telling a worker what needs to be done and how the job should be done, then that worker is an employee. Having a right to discharge the worker and supplying tools and the place to perform a job are primary factors that show control.

Contrast the following example to the self-employed gardener described earlier: The Smith family hired Lynn to clean their home and care for their 3-year old daughter, Lori, while they are at work. Mrs. Smith gave Lynn instructions about the job to be done and how the various tasks should be done; she, rather than Lynn, had control over the job. Under these circumstances, Lynn is a household employee and the Smiths are responsible for withholding and paying certain employment taxes for her.

Pubs Forms

Related IRS Publications and Forms

- **Pub 926** - Household Employer
- **Form SS-4** – Application for EIN
- **Form W-9** – Request for Taxpayer ID Number
- **Schedule H** – Form 1040

Warning!

It is illegal to knowingly hire or to continue to employ an alien who is not legally eligible to work in the U.S. When hiring a household employee who works on a regular basis, Form I-9, Employment Eligibility Verification, must be completed by the employer and employee. The employer must examine documents presented by the employee that establish the employee's identity and employment eligibility. The employer retains the completed Form I-9; it is not submitted to IRS. Form I-9 is not an IRS form; it can be downloaded from the U.S. Customs and Immigration Services web site: https://www.uscis.gov/sites/default/files/files/form/i-9.pdf

The Details

Social Security and Medicare Taxes (FICA) - A household employer must withhold both social security and Medicare taxes from a household employee's cash wages if they equal or exceed the threshold for the year – see adjacent table.

Tax Year	2014-15	*2016-17*	2018-19	2020
Threshold	$1,900	$2,000	$2,100	

If no entry, amount not available at the date of publication

The employer must match from his/her own funds, the FICA amounts withheld from the employee's wages. Wages paid to a ***household employee, who is under age 18*** at any time during the year, are exempt from social security and Medicare taxes unless household work is the employee's principal occupation.

The value of food, lodging, clothing or other noncash items given to household employees isn't subject to FICA taxes. However, cash given in place of these items is subject to such taxes.

Income Tax Withholding - A household employer doesn't have to withhold income taxes on wages paid to a household employee, but if the employee requests such withholding, the employer can agree to it. If income taxes are to be withheld, the employer can have the employee complete Form W-4 and base the withholding amount on the data the employee provides. Circular E provides the federal income tax and FICA withholding tables.

Wages subject to withholding – This includes salary, vacation pay, bonuses, clothing and other noncash items, meals and lodging. Meals are not subject to income tax withholding if they are furnished for the employer's convenience and on the employer's premises. The same goes for lodging if one additional requirement applies--that the employee lives on the employer's premises. Reimbursement for (a) transit passes, up to $265 per month for 2019 used by the employee to commute to the employer's premises, or (b) commuting-related parking, up to $265 per month for 2019 are not counted as wages See chapter 2.01 other year rates.

In lieu of withholding the employee's share of FICA taxes from the employee's wages, some employers prefer to pay the employee's share themselves. In that case, the FICA taxes paid on behalf of the employee are treated as additional wages for income tax purposes.

Federal Unemployment Tax (FUTA) - A household employer who pays more than $1,000 in cash wages to household employees in any calendar quarter of either the current or the prior year, is liable for FUTA tax. There is a credit against this tax for payments made to a state unemployment fund.

Employer Identification Number – A household employer is required to have an employer identification number (not the same as a Social Security number). It is used on any employment tax forms required to be filed. Use Form SS-4, Application for Employer Identification Number, to request an EIN (or one can be obtained by completing an on-line application at the IRS' web site; enter "EIN" in the search box). A household employer who has had an EIN as the sole proprietor of a business should use that number.

Reporting and Paying Employment Taxes for Household Workers: Household employers will **generally** report and pay employment taxes on household employee wages as part of their Form 1040 filing. This includes social security, Medicare, withholding and FUTA taxes. Schedule H is used for this purpose and is attached to Form 1040 when paying the taxes. To avoid an underpayment of estimated tax penalty, the household employer should be sure that his or her own income tax withholding or estimated tax payments is sufficient to cover the Schedule H taxes as well as regular income tax.

If the employer runs a sole proprietorship with employees, the social security, Medicare, and income tax withholding for any household employees may be included on Form 941, Employer's Quarterly Federal Tax Return, filed for the business. In that event, FUTA tax for the household employees is included on the business' Form 940 or 940-EZ, Employer's Annual Federal Unemployment Tax Return. Some employers may be required to file Form 944, Employer's ANNUAL Federal Tax Return, instead of Form 941. ***Caution:*** when preparing the proprietor's Schedule C, care should be taken to make sure that the wages and related payroll taxes of the household employee aren't included as a business expense on the Schedule C.

Form W-2 and Form W-3 - Household employers must provide W-2s to their household employees for whom they paid social security and Medicare taxes. The W-2 is due in the employee's hands by January 31 of the year following the one in which the wages were paid (unless that date falls on a holiday or weekend; then it's extended to the next working day). Beginning in 2017, the W-2s and Form W-3 that are filed with the Social Security Administration are due by January 31 also. In past years the government's copies of the W-2s weren't due until the last day of February of the year following the payment of the wages.

> ***Example - Household Employees and Employment Taxes –*** *In 2019 Sherri hired Ruby White to clean her house once a week. Ruby is to receive a gross amount of $70 weekly. Sherri expects to pay Ruby an amount in excess of the tax threshold during the tax year, so she withholds social security and Medicare tax from each of Ruby's paychecks. Unfortunately, Ruby experienced family problems and was forced to resign her job. Up to that point, Sherri had paid Ruby $910 in gross wages and she had withheld social security and Medicare tax. Sherri must refund the withheld amounts to Ruby. She is not required to give Ruby a W-2.*
>
> *Sherri hired a new house cleaner, Kathy, to replace Ruby. Kathy worked the remainder of the year and received gross wages of $2,730 on which Sherri withheld $208.85 in social security and Medicare taxes. By Jan. 31, 2020 Sherri must give Kathy a W-2 showing the gross wages and the withheld tax amounts, and provide a copy of the W-2, along with transmittal Form W-3, to the government.*
>
> *Then when Sherri files her own tax return, she will include Schedule H with her 1040 and pay a total of $417.70 (Kathy's share and Sherri's employer share of social security and Medicare tax) in employment taxes on Kathy's behalf. (For 2019, the employee's rate and the employer's rate for Social Security tax is 6.2%; each pays 1.45% Medicare tax.) Sherri will owe no FUTA tax, because she did not pay $1,000 or more in cash wages to household employees in any calendar quarter during the tax year or in the previous year.*

Grossing up wages - Frequently a household employer will not withhold employment taxes from the household employee's payments. When this happens, the employer must then pay the taxes and include the taxes in the employee's wages (W-2). This is referred to as grossing up the wages. In other words, the payments to the employee are treated as if they were net payments after withholding the required amounts for FICA and, if applicable, state payroll payments.

<u>*Gross up with both federal and state payroll taxes*</u> - In this example we use California SDI payments. The gross-up calculation shown is for *2019*.

$$\text{Gross-Up Factor} = \frac{1}{(1 - .0765^{(1)} - 0.01^{(2)})}$$

$$= 1/0.9135.$$
$$= 1.09469$$

(1) The amount used here is the federal withholding rate for the year (6.2% FICA plus 1.45% HI).

(2) The amount used here is for a state payroll tax withholding. If not applicable enter zero or the amount applicable to the state. For this example, the California SDI rate of 1% for 2019 is used.

Example – Proof:

Net payment = $200 *Grossed up payment = $200 X* 1.09469 = 218.94

W-2 Wage =	218.94
FICA (.0765) =	*<16.75>*
SDI (.01) =	*< 2.19>*
Net Check =	*200.00*

<u>*Gross up with only federal payroll taxes*</u> –

$$\text{Gross-Up Factor} = \frac{1}{(1 - .0765)}$$

$$= 1/0.92350.$$
$$= 1.08283$$

Thus, for wages subject just to FICA and HI withholding, the Factor is 1.08283

Hiring Household Help through an Agency - Hiring household employees through an agency may be a way for a taxpayer to avoid becoming an employer for these purposes. When help is hired through an agency or service, the agency/service is considered the employer; the taxpayer pays the agency, which, in turn, pays the employee.

Nursing Services - Wages and other amounts, such as the employer's portion of employment taxes, paid for nursing services can be included in medical expenses. Services need not be performed by a nurse as long as the services are of a kind generally performed by a nurse. This includes services connected with caring for the patient's condition, such as giving medication or changing dressings, as well as bathing and grooming the patient. These services can be provided in the home or another care facility.

Generally, only the amount spent for nursing services is a medical expense. If the attendant also provides personal and household services, these amounts must be divided between the time spent performing household and personal services and the time spent for nursing services. However, certain maintenance or personal care services provided for qualified long-term care can be included in medical expenses.

Part of the amounts paid for that attendant's meals are also included in medical expenses. Divide the food expense among the household members to find the cost of the attendant's food. If additional amounts for household upkeep were paid because of the attendant, include the extra amounts with the medical expenses. This includes extra rent or utilities paid, because a larger apartment or house was needed to provide space for the attendant.

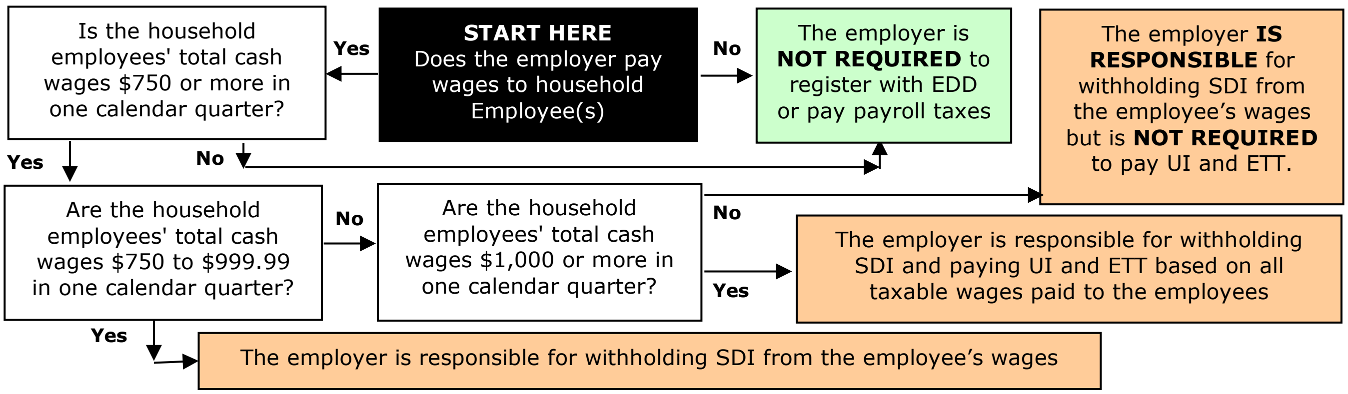
Additionally, certain expenses for household services or for the care of a qualifying individual incurred to allow the taxpayer to work may qualify for the child and dependent care credit – but the same expense can't be used both as a medical expense and for the child and dependent care credit. The employer's share of employment taxes paid on eligible expenses may be included when figuring the credit.

CALIFORNIA DIFFERENCES

California's employment taxes consist of unemployment insurance (UI) and employment training taxes (ETT) – paid by the employer – and state disability insurance (SDI) and state income taxes – paid by the employee through wage withholding. The California Employment Development Department (EDD) administers employment taxes. California does not allow household employers to pay their state employment taxes as part of their income tax filings. Instead, separate quarterly or annual employment tax returns and payments must be filed with the EDD. Household employers must register with the EDD when payments to one or more employees for household services reach $750 in cash wages in a calendar quarter.

Once $1,000 or more in cash is paid in a calendar quarter to household employees, the UI and EDD taxes apply to the current and following year. The threshold at which SDI withholding applies to domectic services in a private home is

$750 of cash wages paid in a calendar quarter for household services. California has the same rule as federal regarding income tax withholding (not required, but can be done if requested by the employee).
For information on the forms required to be filed, due dates and other details, please see EDD Pub. 8829 – 2019 Household Employer's Guide, available at: https://www.edd.ca.gov/pdf_pub_ctr/de8829.pdf



Meals and lodging - Cash wages include both checks and cash. Noncash wages, such as meals and lodging, are not included when calculating whether the $750-in-cash-wages threshold is met. Meals and lodging are included once the cash limit of $750 is reached. See examples on page 5 of the DE 8829 - Household Employer's Guide

E-File and E-Pay Requirement - California Assembly Bill (AB 1245) (Chapter 222, Statutes of 2015) requires all employers, including household employers, to electronically submit employment tax returns, wage reports, and payroll tax deposits to the EDD. Depending on the number of employees, the requirement is phased-in as follows:

- January 1, 2017 - Employers with 10 or more employees were required to electronically submit employment tax returns, wage reports, and payroll tax deposits.
- January 1, 2018 - All remaining employers are required to electronically file and pay.

Penalties - Filing paper returns instead of electronically filing when required will result in the following penalties for household employers:

- Employer of Household Worker(s) Annual Payroll Tax Return (DE 3HW) - $50 per return
- Employer of Household Worker(s) Quarterly Report of Wages and Withholdings DE (3BHW) - $20 per wage item
- Payroll Tax Deposit (DE 88) – 15% of the amount due.

Waiver - Employers may request a waiver from the electronic filing mandate due to:

- Lack of automation,
- Severe economic hardship,
- Current exemption from the federal government, or
- Other good cause.

The E-file and E-pay Mandate Waiver Request (DE 1245W) can be downloaded at: www.edd.ca.gov/pdf_pub_ctr/de1245w.pdf

Waiver requests, which cannot be filed retroactively, must be received by the final filing date of the quarter for which the taxpayer is requesting that the waiver begin. Requests received after the due date for the quarter requested will be processed for the subsequent quarter. An approved waiver will be valid for four consecutive quarters beginning with the effective quarter, and to avoid a non-compliance penalty when the waiver expires, an employer must start to electronically file and pay, or submit a new waiver request.

2019 California Payroll Tax Chart

Payroll Tax	Who Pays	Taxable Wages	Tax Rate	Maximum Tax
Unemployment Insurance (UI) For more Info., refer to Information Sheet: CA System of Experience Rating (DE 231Z) available online at www.edd.ca.gov/pdf_pub_ctr/de231z.pdf	**Employer**	First $7,000 of wages per employee, in a calendar year.	New employer tax rate is 3.4 percent (.034) for a period of two to three years. Following this period, the tax rate is calculated annually based on each employer's previous UI experience and the condition of the UI Fund.	$434 per employee, per year [calculated at the highest UI tax rate of 6.2 percent (.062)]. The maximum UI tax amount will be less if the UI rate is less than 6.2 percent.
Employment Training Tax (ETT)	**Employer**	First $7,000 of wages per employee, in a calendar year	Set by law at 0.1 percent (.001) of UI taxable wages for employers with positive UI reserve account balances.	$7 per employee, per year.
State Disability Insurance (SDI) Disability Insurance (DI) and Paid Family Leave (PFL) are components of the SDI Program and are included in the SDI employee contributions.	**Employee** Employer withholds SDI from employee wages; employers are responsible for SDI not withheld from employee wages. If the employer pays SDI for employee(s), those payments increase wages.	First $118,371 of wages per employee, in a calendar year.	The 2019 withholding rate is 1 percent (.01). Set by law, the SDI rate may change each year. The EDD notifies employers of the new rate each December.	$1,183.71 per employee, in a calendar year.
California Personal Income Tax (PIT)	**Employee**. Household employers are not required to withhold PIT from employee wages unless **both** the employer and employee agree to withhold the tax. However, the employee is still responsible for reporting wages and paying any PIT due to the FTB.	Normally, all PIT wages (cash and noncash)	PIT is withheld based on each *Employee's Withholding Allowance Certificate* (Form W-4 or DE 4) and the withholding schedules provided in the *California Employer's Guide* (DE 44)	No maximum

NOTES

GIFT PLANNING

Overview

- Annual Gift Tax Exclusion (2019): $15,000
- Lifetime Gift Tax Exclusion (2019): $11.40 Million
- Top Gift Tax Rate: 40%
- Estate Tax Exclusion (2019): $11.40 Million

Pubs Forms

Related IRC and IRS Publications and Forms

- **Form 709** – U.S. Gift Tax Return
- **Form 3520 -** Annual Return To Report Transactions
- **Form 8892** – Automatic Extensions to File Form 709
- **Form 8971 –** Information Regarding Beneficiaries Acquiring Property from a Decedent
- **Pub 950** – Estate & Gift Taxes
- **IRC Sec 2501** – Imposition of Tax
- **IRC Sec 2503** – Taxable Gifts
- **IRC Sec 6075** – Time for Filing Estate & Gift Tax Returns

RAPID FINDER

Foreign Gifts & Inheritances

The question frequently arises regarding reporting requirements for gifts or inheritances received from a foreign source. Gifts and inheritances are income-tax free to a U.S. citizen or resident alien. However, if the amount is received from a nonresident alien individual or foreign estate and is more than $100,000, the recipient must file Form 3520. Complete Page 1 and Part IV of Form 3520. The form is due on the same date as the taxpayer's tax return (including extensions). See form instructions for current filing address. Gifts valued at more than $16,388 (2019 amount, adjusted annually for inflation) from foreign corporations or foreign partnerships (including foreign persons related to the foreign corporations or foreign partnerships) also must be reported on Form 3520.

CAUTION – If the taxpayer has income from a foreign trust see the instructions for Form 3520, as there may be some tax liability. Also, if the beneficiary leaves the funds in the foreign country, he will have to comply with the reporting requirements for having a foreign financial (bank) account (FBAR).

See Chapter 1.13 for more detail related to foreign gift and accounts reporting.

The Details

Gift transactions are one of the primary techniques used to reduce estate taxes. In this section, we review the basics of gifts and how they are taxed.

GIFT & ESTATE EXCLUSION UNIFICATION

There is a single graduated rate schedule for both the estate and gift taxes, and the single lifetime exclusion can be used for gifts and/or bequests.

GIFT TAX RULES - Lifetime gifts currently are subject to a gift tax imposed at the same tax rates that apply for the value of estates at the time a taxpayer dies, with some exceptions, as explained next.

ANNUAL PER DONOR PER DONEE GIFT LIMIT (Without Tax Consequences)

Year	Prior to 2000	2002-05	2006-08	2009-12	2013-17	2018-20
Amount	$10,000	$11,000	$12,000	$13,000	$14,000	$15,000

If amount is not shown, it was not available at publication date.

Annual Exclusion **-** Gifts of up to the annual per donor per donee (recipient) per year limit amount may be made without tax consequences (Sec. 2503(b)). The gift must be a gift of a present interest. Direct gifts (including UGMA gifts) qualify, as do gifts to 2503(c) trusts and Crummey withdrawal trusts.

1. 2503(c) trusts are those that meet the following requirements:
   - The property and the income may be expended by or for the benefit of the donee before age 21.
   - To the extent the property is not so expended, it will pass to the donee at age 21.
   - If the donee dies before age 21, the property will be payable to the donee's estate or as the donee may appoint under a general power of appointment.

NOTE: *Many clients hesitate to use 2503(c) trusts, because they do not want the child to receive the trust at age 21.*

2. Crummey trusts take their name from the case of ***Crummey v. Comm, 397 F.2d 82 (9th Cir. 1968).*** In that case, a gift to a trust qualified as a present interest (and thus an annual exclusion), because the donee had a present (though short-term) right to withdraw the gift to the trust.

Tuition/Medical Exclusion **-** In addition to the annual exclusion, a donor may make gifts that are totally excluded from the gift tax in the following circumstances:

- Payments made **directly** (Sec 529 plans are not direct) to an educational institution for tuition. This includes college and private primary education. It does not include books or room and board.
- Payments made directly to any person or entity providing medical care for the donee.

In both cases, it is critical that the payments be made directly to the educational institution or health care provider. Reimbursement paid to the donee will not qualify. The tuition/medical exclusion is often overlooked, but these expenses can be quite significant. Parents and grandparents interested in estate reduction should strongly consider these gifts.

Gift Splitting **-** A husband and wife can each make annual exclusion gifts, thereby increasing the exclusion from *$15,000* to *$30,000* per year (2019 and 2018 amounts). However, only one of the spouses may have available property to give. Code Section 2513 allows the spouses to elect (on a Form 709) to treat a gift made by one spouse as being made by both spouses. Gift splitting can be used for annual exclusion gifts, lifetime exclusion gifts, and gifts above the lifetime exclusions.

Example - Gift Splitting - *John and Jane are married and have two children. In a year when the annual exclusion limit is $15,000, they would like to exclude $60,000 ($15,000 x 2 donors x 2 donees) in gifts. Jane received a large inheritance some years back; John has only a modest estate. Jane gives the children $30,000 each. Then the couple elects to gift split so that the $30,000 gift is treated as given one-half by Jane and one-half by John (or $15,000 each). The gifts all qualify for the annual exclusion.*

Even if both spouses have sufficient resources to make gifts, gift splitting is useful when the husband and wife have different estate planning goals.

Example - Gift Splitting Where Spouses Have Different Estate Planning Goals - *Steve has a large estate and a daughter, Ryan, from a prior marriage. He would like to make maximum annual exclusion gifts to her. Sharon, Steve's wife, can afford to make annual exclusion gifts to Steve's daughter, but is not inclined to do so, since she has other beneficiaries of her own to plan for. Steve gives $30,000 to Ryan in a year when the annual exclusion limit is $15,000. He and Sharon elect to gift split, so the gift is treated as given one-half by each. As long as the property given is properly valued and supportable on audit, the gift split helps Steve and Ryan, yet it costs Sharon nothing. Sharon's financial and tax ability to make gifts to others is not reduced by the gift split.*

For clients in community property states, if community property is given, gift splitting is not necessary. Regardless of who holds the record title, or who "makes" the gift, the property is owned one-half by each and is therefore given one-half by each.

Due Date for Gift Tax Returns (Form 709) **–** When required to be filed, gift tax returns generally are due by April 15 of the year following the gift. A calendar year taxpayer who requests an extension of time on Form 4868 for his or her income tax return also extends the due date of the gift tax return to the extended due date of the 1040. However, if the taxpayer will owe a gift tax, payment voucher Form 8892-V should be completed and sent with payment to the IRS by the original due date, since the extension is only for the time to file and not for paying the tax. If the donor isn't filing Form 4868, an automatic 6-month extension to file the gift tax return can be obtained by filing Form 8892 on or before the due date of the gift tax return.

Estate, Generation Skipping and Gift Tax Tables

Year	Estate Tax Exclusion	Top Estate Tax Rate	GST Exclusion	Top GST Tax Rate	Lifetime Gift Exclusion	Top Gift Tax Rate
2006	$2 Million	46%	$2 Million	46%	$1 Million	46%
2007	$2 Million	45%	$2 Million	45%	$1 Million	45%
2008	$2 Million	45%	$2 Million	45%	$1 Million	45%
2009	$3.5 Million	45%	$3.5 Million	45%	$1 Million	45%
2010	$5.0 Million	35%	$5.0 Million	0%/35%	$1 Million	35%
2011	$5.0 Million	35%	$5.0 Million	35%	$5 Million	35%
2012	$5.12 Million	35%	$5.12 Million	35%	$5.12 Million	35%
2013	$5.25 Million	40%	$5.25 Million	40%	$5.25 Million	40%
2014	$5.34 Million	40%	$5.34 Million	40%	$5.34 Million	40%
2015	$5.43 Million	40%	$5.43 Million	40%	$5.43 Million	40%
2016	$5.45 Million	40%	$5.45 Million	40%	$5.45 Million	40%
2017	$5.49 Million	40%	$5.49 Million	40%	$5.49 Million	40%
2018	$11.18 Million	40%	$11.18 Million	40%	$11.18 Million	40%
2019	$11.40 Million	40%	$11.40 Million	40%	$11.40 Million	40%
2020	$11.58 Million	40%	$11.58 Million	40%	$11.58 Million	40%

If amount is not shown, it was not available at publication date.

No Tax Deduction – The value of gifts made, other than those to charitable organizations, is not deductible by the donor.

Example - Gift Tax Computations - *Neil Moneybags, a single father, gives $5,505,000 to his daughter in 2019. Neil has not made previous taxable gifts. The gift tax is computed as follows:*

Value of gift	*$5,505,000*
Annual exclusion	*<15,000>*
Taxable gift	*$5,490,000*
Tax per rate schedule	*$2,141,800*
Unified credit used	*< 2,141,800>*
Tax due	*$ 0*

Of course, this gift may cause an increase in estate taxes upon Neil's death or a later gift. Neil's 2019 unified credit of $4,505,800 has been reduced to 2,364,000, which remains to be used against future taxable gifts and/or his estate tax when he dies. The available future unified credit amount may be more or less at his date of death depending whether he's made additional gifts in excess of the annual exclusion amount that used up more of the lifetime amount and what the lifetime exclusion (and unified credit) is for the year of his death.*

Post-2012 Gift & Estate Tax Rate Schedule

COLUMN A Taxable Amount over	COLUMN B Taxable Amount over	Tax on amount in Column A	Rate of tax on excess over amount in Column A
---------	$10,00	---------	18%
$10,000	$20,000	$1,800	20%
$20,000	$40,000	$3,800	22%
$40,000	$60,000	$8,200	24%
$60,000	$80,000	$13,000	26%
$80,000	$100,000	$18,200	28%
$100,000	$150,000	$23,800	30%
$150,000	$250,000	$38,800	32%
$250,000	$500,000	$70,800	34%
$500,000	$750,000	$155,800	37%
$750,000	$1,000,000	$248,300	39%
$1,000,000	---------	$345,800	40%

** The unified credit is determined by computing the tax on the $11.4 million exclusion for 2019.*

Gifts in Excess of Lifetime Exclusion - Once the annual exclusion and the lifetime exclusion are used up, any further gifts generate a gift tax.

HOW WILL THE TCJA-INCREASED GIFT TAX EXCLUSION AFFECT POST-2025 ESTATES?

The lifetime gift and estate tax exclusion, starting in 2018, was more than doubled by the TCJA and continues to increase each year with inflation adjustments. Barring Congressional action, the higher exclusion amount returns to its inflation adjusted former amount after 2025. This caused concerns related to what the tax consequences might be for post-2025 estates where the decedent, while alive, had made gifts during the 2018 through 2025 period utilizing the higher unified gift-estate exclusion. Would that cause a claw back due to the reduced exclusion? Fortunately, the IRS has proposed taxpayer-friendly regulations that address the issue.

Proposed Regulation 20.2010-1(c), which will be effective when the finalized regulation is published, provides a special rule that allows the estate to compute its estate tax credit using the higher of the basic exclusion amount applicable to gifts made during life or the basic exclusion amount applicable on the date of death. As a result, individuals planning to make large gifts before 2026 can do so without concern that they will lose the tax benefit of the higher exclusion level once it decreases after 2025. (IR 2018-229; NPRM REG-106706-18)

LIFE ESTATE

A frequently encountered issue is when an elderly parent turns the title of his or her home over to a child or other beneficiary and continues to reside in the home. This situation raises important questions: How is a future sale of the home treated if it is sold before the parent's death (will Sec 121 apply?), and is a gift tax return required? Or if the parent passes away while still residing in the home, does the beneficiary use a gift basis or the FMV on the date of death? What is the tax result if the parent moves out of the home?

Completed Gift or Life Estate? – Per Sec 2036, the value of a decedent's estate shall include the value of all property in which the decedent has transferred any interest (except for a *bona fide* sale) that the decedent has retained for his or her life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death. Thus, an individual who transfers a title and retains the right to live in a home for his or her lifetime has established a de facto life estate, and as such, when the individual dies, the value of the home is included in the decedent's estate and no gift tax return is applicable. As a result, the beneficiary's basis would be the FMV at the date of the decedent's death.

Even though a de facto life estate may be intended, without written documentation the giver takes the risk of having the home sold out from under him by the new titleholder.

On the other hand, if the elderly parent does not continue to reside in the home after transferring the title, a gift has occurred since no life estate has been established; a gift tax return would be required, and the child's (gift recipient's) basis would be the parent's adjusted basis in the home at the date of the gift. In addition, if the child were to sell the home, the Sec 121 home sale exclusion would not apply unless the child met the Section 121 qualifications.

Partial Interests - Section 121 applies to sales of partial interests, so if the parent has simply added the child's name to the title, retaining a partial interest, and the home is subsequently sold, the parent would be able to apply the Sec 121 exclusion to his or her portion of the gain provided he or she met the Sec 121 qualifications. A gift tax return would be required for the year the child's name was included on the title, and the child's basis would be the portion of the parent's adjusted basis transferred to the child. The Sec 121 exclusion would not apply to the child unless the child separately met the Sec 121 qualifications.

Although "parent" and "child" were used throughout this analysis, the same rules would apply to unrelated individuals.

PORTABILITY OF UNUSED ESTATE TAX EXCLUSION

The executor of a deceased spouse's estate may transfer any unused exclusion to the surviving spouse for estates of decedents dying after December 31, 2010. A Form 706 (Estate Tax Return) must be timely filed to obtain the portability. (Code Sec. 2010(c)(2)) **But see special extension of time to file Form 706, below, where the form is being filed for portability only and is not otherwise required to be filed.**

The applicable exclusion amount is the sum of:

(1) the "basic exclusion amount" and

(2) in the case of a surviving spouse, the "deceased spousal unused exclusion amount."

The basic exclusion amount is $11.4 million for deaths in 2019.

The "deceased spousal unused exclusion amount" is *the lesser of:*

(1) the basic exclusion amount, or

(2) the excess of the applicable exclusion amount of the last deceased spouse dying after Dec. 31, 2010, of the surviving spouse, over the amount on which the tentative tax on the estate of the deceased spouse is determined. (Code Sec. 2010(c)(4))

A surviving spouse (for convenience we'll assume it is the wife in this discussion) may use the deceased spousal unused exclusion amount in addition to her own basic exclusion for taxable transfers (i.e., gifts) made during life or her estate may use it on the estate tax return at her death.

> ***Example -*** *Husband dies in 2014, having made taxable transfers of $3 million and having no taxable estate. His unused exclusion amount in 2014 was $2.34 Million $5.34 million - $3 million). An election is made on his estate tax return to permit Wife to use his deceased spousal unused exclusion amount. Wife has made no taxable gifts in his year of death or later and has had no other husbands. Wife's applicable exclusion amount for 2019 is $13.74 million (her $11.40 million basic exclusion amount plus $2.34 million deceased spousal unused exclusion amount from Husband), which she may use for lifetime gifts or for transfers at death. (Committee Report)*

If a surviving spouse is predeceased by more than one spouse, the amount of unused exclusion that is available for use by the surviving spouse is limited to the lesser of the applicable exclusion amount (for example, *$11.40* million if the spouse died in *2019*) or the unused exclusion of the last deceased spouse. (Code Sec. 2010(c)(4))

For the surviving spouse or her estate to use the deceased spouse's unused exclusion amount, the predeceased spouse's estate must make an election – referred to as the portability election – on a timely filed estate tax return (Form 706) that includes a computation of the unused exclusion amount. To make the portability election, Form 706 must be filed even if the value of the gross estate is not enough to otherwise require filing an estate tax return. See regulations § 20.2010-2 for detailed rules and guidance on the portability election.

CAUTION – Possible Repercussions for Not Filing the Portability Election!
Where a surviving spouse's estate is expected to be valued at less than the estate tax exclusion amount when he or she passes, it may seem to be a waste of time, effort and money to file a 706 Estate Tax Return for the pre-deceased spouse. However, in making that decision, one should consider the possibilities of the surviving spouse receiving inheritances, hitting the lotto or for Congress to reduce the estate tax exemption some time in the future. Any of these potential events could result in substantial estate tax considering the current tax rate on taxable estates is 40%. **Who will get the blame? You the tax preparer of course! If the executor refuses to file the 706 then get a signed statement to that affect.**
SEE SUGGESTED STATEMENT FOR EXECUTOR SIGNATURE AT END OF CHAPTER

Special Extension for Portability Only – In Revenue Procedure 2017-34, IRS has provided a permanently available simplified method for estates to obtain an extension of time to make the estate tax portability election. The simplified method is only available to estates that are not required to file an estate tax return based on the value of the gross estate and is effective June 9, 2017. In order to qualify for the automatic extension, the following requirements must be met:

1. The taxpayer is the executor of the estate of a decedent who:
    a. has a surviving spouse;
    b. died after Dec. 31, 2010; and
    c. was a citizen or resident of the U.S. on the date of death;
2. The taxpayer is not required to file an estate tax return based on the value of the gross estate and adjusted taxable gifts, without regard to the need to file for portability purposes;
3. The taxpayer did not file an estate tax return within the time prescribed for filing an estate tax return required to elect portability;
4. The executor must file a complete and properly prepared Form 706 **on or before the later of Jan. 2, 2018, or the second annual anniversary of the decedent's date of death**;
5. The executor filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER Code Sec. 2010(c)(5)(A)."

Thus, the Rev Proc allowed additional time to those who failed to previously file a Form 706 to elect portability as long as they did so by Jan. 2, 2018. In addition, executors of other estates that do not otherwise have a Form 706 filing obligation but need to file only to make the portability election, will have 2 years from the decedent's date of death to file for portability.

The simplified method of this revenue procedure is not available to the estate of a decedent whose executor already timely filed an estate tax return because the executor either will have elected portability on that return or will have affirmatively opted out of portability.

INCOME TAX BASIS

Lifetime Gifts: If property is given during a donor's lifetime, the donee (gift recipient) keeps the same basis as the donor for gain property. *Sec. 1015(a)* For loss property, the donee's basis is the fair market value *[Sec. 1015(a)]*, which prevents the donee receiving tax benefits from the economic losses which occurred while the donor owned the property. Basis is also increased by the amount of gift tax paid, if any. *Sec. 1015(c)*

Inherited Assets – see Chapter 11.07.

TAX BENEFITS OF GIFTS

Annual Exclusion Gifts - As covered earlier in this section, for 2019 a donor can make annual exclusion gifts of up to $15,000 per donor, per donee, per year. These gifts are totally exempt from estate and gift taxes, as well as all future income and appreciation on the property given. A $15,000 gift may not sound that impressive, but with multiple beneficiaries and multiple years, the estate reduction could be significant.

Example - Annual Exclusion on Gifts - *Bob and Millie have two children and two grandchildren. They make maximum annual exclusion gifts for 15 years.* ***Assume for this example that the annual exclusion was $15,000 and was not increased by inflation during this period****. During that time, the gifted property appreciates 5% per year. The results are impressive:*

Annual exclusion	$15,000
Donors (2) x Donees (4) x Years (15)	*x 120*
	$1,800,000
*5% compounded growth over 15 years**	*$789,428*
Value in hands of donees (and out of donor's estate)	*$2,589,428*

*The estate reduction is accomplished without any reduction in Bob and Millie's unified credit. They still can give away $11.40 million more each during their lifetimes (through 2019). *assumes gifts made at end of each year and does not account for any income tax paid on the earnings*

Lifetime Exclusion Gifts (Unified Credit Gifts) - A client may wish to make gifts beyond the annual exclusion. If so, the client begins using up the unified credit. Using up a part or all of the unified credit means that the portion so used will not be available to reduce estate tax. So, lifetime exclusion gifts do not have a current tax cost, but they will have a future tax cost.

Nevertheless, clients may still desire to make lifetime exclusion gifts because all of the future income and appreciation on the gifted property will not be included in their estate. Thus, they use up their lifetime exclusion at today's values rather than the values at date of death.

Gifts Beyond Lifetime Exclusion - A client may wish to make gifts beyond the annual and lifetime exclusions. These gifts are subject to current year gift tax. Even clients who can afford to part with the property may be reluctant to do anything that accelerates payment of transfer (gift or estate) taxes. However, it might be to their advantage to do so.

- First, all of the income and appreciation escapes the donor's estate taxes.
- Second, gift and estate taxes are computed differently. With estate taxes, the tax is computed on the gross estate, before payment of estate tax. Thus, in effect, a tax is paid on the tax.

With gift taxes, the tax is computed only on the amount the donee receives. So, the gift tax is really a lower tax.

DOs AND DON'Ts OF SELECTING ASSETS TO GIVE

A. Give assets producing higher taxable income rather than those with lower or no taxable income.
B. Give assets likely to grow in value.
C. Give high-basis rather than low-basis assets. This limits the impact of the tax on capital gains when the donee sells the asset and leaves the low-basis assets available for the step-up in basis at the time of the owner's death.
D. Don't give an asset with a value less than its basis. Don't hold until death either. In either case, the loss will be wasted.
E. Don't give to a trust, property subject to an encumbrance for which the donor is personally liable. This will cause grantor trust treatment and estate inclusion. See Regs Sec. 1.677(a)-1(d) and 20.2036-1(b)(2).
F. Don't give property with a debt in excess of basis. The excess will be realized income. See Regs Sec. 1.1001-2(B)(4)(iii).
G. Be careful in making gifts of business interest or of farm, ranch or business real estate. Doing so could result in a disqualification from the benefits of Secs. 303, 2032A or 6166.
H. Do make minority interest gifts to qualify for discounts.
I. Don't give installment obligations. This will cause acceleration of gain under Sec. 453B. Be careful in making gifts of S corporation stock so that the recipient is a permitted shareholder.

GIFT RECIPIENTS

Gifts can, of course, be given to individuals. However, for various reasons, a donor may not want the donee to own the gifted property outright. The donee may be a minor. The donee may be a young adult, legally competent but immature and not responsible. The donor may be reluctant to give up full control. The donor may want some of the protections afforded by other gift vehicles even for a mature and responsible donee.

UGMA/UTMA - All states have adopted some form of the Uniform Gifts to Minors Act or the Uniform Transfer to Minors Act. In general, these statutes allow for a simple method to create an informal trust-type arrangement with a custodian holding property for the minor.

Advantage: The chief advantage is that the transaction and set up is very simple and usually does not require an attorney. The transfer constitutes a completed present interest gift that qualifies for the annual exclusion. Income on the property is taxed to the minor (subject to the "kiddie tax").

Disadvantages:
a. The property must be distributed to the child when the child reaches the age provided for in the UGMA/UTMA statute, typically either 18 or 21.
b. The property will be includible in the donor's gross estate if the donor is acting as custodian at the time of the donor's death.
c. Depending on the state's law, some types of property may not be owned in UGMA/UTMA form.

Sec. 2503(c) Trusts - The advantage of these trusts is easy qualification for the annual exclusion. The disadvantage is that the property in trust passes to the donee at age 21.

Crummey Trusts

Advantage:
a. Qualifies for annual exclusion, though in a convoluted manner.
b. Trust does not have to end at age 21; it can last for the entire lifetime of the beneficiary and beyond.
c. Allows for generation-skipping.
d. Can probably qualify as a spendthrift trust and be exempt from the reach of some or all of the beneficiary's creditors.

Disadvantages:
a. Complexity.
b. Beneficiary has a right to withdraw trust property for some specified period of time.
c. The lapse of a withdrawal right has tax consequences to the beneficiary, e.g., income tax, Sec. 678(a), Sec. 2541(e) and estate tax, Sec. 2041(b)(2).

NonCrummey Trusts - Though not often used, a client could also draft a trust for adult beneficiaries that does not grant Crummey withdrawal rights. Gifts to the trust would not be eligible for the annual exclusion. Possible situations when such a trust might be appropriate:

1. Gifts of the lifetime exemption. (Of course, a Crummey withdrawal right could be granted and the gift made in the amount of the exemption amount plus the annual exclusion amount.) Similarly, gifts in excess of the lifetime exclusion might also be given to a non-Crummey trust.
2. The donor's annual exclusions are already being used up under some other portion of the estate plan (other trusts, FLPs, etc.)
3. The donor desires to avoid the tax consequences to the beneficiary arising from a lapse of a withdrawal right.

Generation-Skipping Trusts - If a client is forward-looking enough, he/she can achieve impressive results by structuring a trust through at least the next generation's lifetime (and often to the end of the third or fourth generation's lifetime).

Under a traditional plan, the parents would provide in the will or trust for assets not to be distributed to a child while the child is young. At some designated age, say 30 or 35, the trust would terminate, and the trust assets would be distributed to the child. As an alternative, the trust might provide for staggered distributions, say one-third at each of ages 25, 30 and 35, with total termination and distribution occurring at age 35.

Under a generation-skipping plan, the trust would not terminate at any given age. Instead, the trust will last for the entire lifetime of the beneficiary, and often beyond. The child (and often his or her children) will be the trust beneficiaries, usually with an objective distribution standard relating to health, education, maintenance and support in accordance with the beneficiaries' accustomed standard of living.

If the parents so desire, the child can be given the right to appoint himself or herself as the trustee after attaining a pre-set age or some other objective benchmark.

If a child is both the primary beneficiary and the trustee, and if the distribution standard is health, education, maintenance and support, the child is basically in the same position as a surviving spouse in a typical bypass trust.

The trust has the following advantages over an outright distribution to an adult beneficiary:

<u>Transfer Tax Savings:</u>

a. Unless a prior lapsed withdrawal right causes a portion of the trust to be included in the beneficiary's gross estate, the trust will probably not be subject to estate taxes on the beneficiary's death.
b. If sufficient GST exemption is allocated to the trust by the donor/decedent, the trust will also be exempt from the generation-skipping tax on the beneficiary's death.
c. The GST exemption for 2019 is $11.40 million ($22.8 million for a couple). Certain lifetime gifts may also be eligible for a $15,000 (2019) GST annual exclusion (under rules that are far more restrictive than the gift tax annual exclusion).

   Therefore, if a family plans properly, it is possible to exempt over $22 million of property (plus income and appreciation) from the U.S. transfer tax system (gift, estate and generation-skipping taxes) on the death of the second generation.

   If the trust extends through the lifetime of the third generation, the same result occurs at that generation's death.

   Contrast that result with an outright gift to a mature adult child. The child will own the property outright and will be able to transfer it to his or her children only by subjecting it to the estate and gift tax system. The likely result is that the property (which was already taxed at Mom and Dad's deaths) will be subject to estate tax all over again.
d. If generation-skipping is to be attempted, it is best to segregate GST exempt property and GST nonexempt property. This usually requires 2 sets of trusts. While being cumbersome, it structures the family wealth so that the trustees can maximize the benefit of the GST exemption. The trustee can simply make all distributions to the second generation out of nonexempt trusts and let the exempt trust grow in value.
e. Over 2 or 3 decades of managing the trusts in that manner, the growth of the exempt assets versus the nonexempt assets can be quite dramatic.
f. It is also a good idea to build a mechanism into the nonexempt trust to make sure that on the child's death, the trusts are subject to estate taxes if the estate tax rates are lower than the GST rate. An easy approach is to provide for generation-skipping trusts only up to the amount of the GST exemption. More sophisticated formula provisions are possible and are commonly used. Currently the top estate tax rate and the GST rate are the same, so this provision may no longer be appropriate.

<u>Creditor Protection</u>*:* The trust would usually include "spendthrift" provisions that would prevent most of the beneficiary's creditors from reaching the trust's assets. If the assets are distributed to the beneficiary outright they would be far more likely to be reached by a creditor. Many of our clients have a great concern over runaway damages and excessive lawsuits. Many of them take great pains to structure their own affairs to limit the reach of creditors. With the generation-skipping trust, they can easily do the same for their children and grandchildren.

<u>Divorces</u>*:* The spendthrift provisions and the general lack of the beneficiary's ownership of the trust assets will probably greatly reduce the chance of losing the property in a divorce. If the child owned the assets outright, the assets would be more reachable by the child's spouse.

Family Limited Partnership (FLP) - A family limited partnership (or LLC, or LLP) can be a means of giving property to children (limited partnership interest) in order to shift future appreciation to children, with the parent (as general partner) retaining control indefinitely. This type of arrangement can be viewed as a substitute for a transfer of property to an irrevocable trust for the benefit of the children. This technique's details are not included in this material.

Gifting encumbered property - When an individual makes a gift of encumbered property, the amount of the gift reported on Form 709 – U.S. Gift Tax Return is the FMV of the property less the amount of the encumbrance. The recipient of the gift assumes the giver's adjusted basis. When a mortgage on property exceeds the giver's basis, the giver recognizes a capital gain in an amount equal to the excess of the mortgage over basis.

Example: *Parents wish to gift an investment property to their son. The FMV of the property is $500,000, the mortgage on the property, which the son will be assuming, is $230,000. The parents' adjusted basis in the property is $200,000. Thus, the parents' gift amount is $270,000 ($500,000 - $230,000), the son assumes his parents' basis in the property of $200,000 and the parents have long-term capital gain equal to the excess of the mortgage over basis, which in this example is $30,000 ($230,000 - $200,000).*

CALIFORNIA DIFFERENCES

California does not have a gift, estate or inheritance tax. Because there is no longer a pick-up tax equal to the state death tax credit (since no such credit is now available on the federal Form 706), Form ET-1 is no longer required to be filed to the state of California.

STATEMENT
ESTATE PORTABILITY ELECTION

The executor of the estate of an individual who was married at the date of death ("deceased spouse") may transfer any unused estate tax exclusion to the surviving spouse for estates of decedents dying after December 31, 2010. (Code Sec. 2010(c)(2)) This provision is referred to as the portability election.

Example – *A spouse dies, having made taxable transfers (taxable gifts) and a taxable estate totaling $6 million. The unified gift and estate tax exclusion for the year is $11.40 million[1]. The executor of the estate can make an election whereby the unused portion of the deceased spouse's estate tax exclusion can be passed on to the surviving spouse for use in the future. So in this example $5.40 million ($11.40 million less $6 million) would be added to the surviving spouse's estate tax exemption when he or she dies, or during the surviving spouse's lifetime it can be applied to taxable gifts made by the surviving spouse.*

To make the portability election, a Form 706 (Estate Tax Return) must be timely filed. The Form 706 is a complicated and costly return to prepare.

Where the presumption is that the surviving spouse would never have the need for the unused estate tax exemption of the deceased spouse, and where there is no filing requirement, the estate executor may decide it is a waste of time, effort, and expense to file a 706 for the deceased spouse.

That decision can be costly in the future since any taxable estate of the surviving spouse can be taxed at rates as high as 40% [1]. The surviving spouse's estate could increase through inflation, inheritances, winnings and investments. Congress could also reduce the estate tax exemption in the future.

I have read and understand the foregoing and elect not to file a 706 and not to make the portability election for the estate of: ____

_______________________________________ _______________

Estate Executor Date

[1] *Values shown are for 2019. Exclusion is annually inflation adjusted.*

BASIS

Overview

The "basis" of an asset can be thought of as the amount a taxpayer has invested in the property. Without knowing the basis, deductions for depreciation, casualties, or depletion, etc., could not be determined, and gains or losses on the disposition of assets could not be established.

Pubs Forms

Related IRS Publications and Forms

- **Pub 551** – Basis of Assets
- **Form 8594** – Asset Acquisition Statement

The Details

COST AND BASIS:

The basis of purchased property is usually its cost. The whole purchase price includes:

- Cash,
- Mortgages and other liabilities (new, assumed, "subject to," recourse and nonrecourse),
- The basis of property given in exchange for the property,
- Back taxes or interest that were the liability of the previous owner, but were paid by the present owner, and
- Freight and installation charges.

The basis DOES NOT include interest, other than described in the fourth item above.

BASIS OF GIFTS

A donee's original or unadjusted basis (that is, the basis before adjustments made while the donee owned it) for property the donee acquires by gift is the same as the property's adjusted basis in the hands of the donor, or in the hands of the last preceding owner who didn't acquire the property by gift. But if the property's fair market value (FMV) at the date of the gift is lower than that adjusted basis, then the property's basis for determining *loss* is its FMV on that date. (Code Sec. 1015(a))

PURCHASE OF SEVERAL ITEMS FOR ONE LUMP SUM

When several items are bought for one lump sum (e.g., a business, or real property along with personal property), the basis must be separated among the various properties.

Exception - If a taxpayer buys several assets to get just one, the whole price is allocated to the one.

> ***Example – multiple assets purchased to acquire one*** *- When a taxpayer who buys land and a building intending to tear down the building, the whole cost of the property goes to the land, none to the building.*

Real Property Purchases - Allocate to each item according to FMV, e.g., the basis of building A equals the FMV of A divided by the total FMV of all the assets, times total purchase price.

FAIR MARKET VALUE AS BASIS

In certain instances, basis is determined by the FMV of the property. Examples include:

- Property acquired in a taxable exchange.
- Property acquired from a decedent (except for deaths in 2010 in some cases). FMV is determined as of date of death (or estate alternate valuation date). This means that if the heirs sell inherited property soon after the decedent's death, the result will usually be little or no gain. FMV will be used to figure depreciation, as well as for figuring gain or loss on sale.

Valuation of inherited property is generally taken from the estate tax return (if any), and if FMV was used to determine the value for estate tax purposes, the same value must be used by the beneficiary. See "Basis of Assets Inherited," below. If there is no estate tax return, probate papers may provide an "inventory" showing values of items in the estate.

<u>Property acquired from a decedent</u> - Property acquired by bequest, devise, or inheritance which includes:

(1) Items required to be in the decedent's gross estate (whether or not an estate tax return is filed).

(2) Gifts from the decedent within three years of death, ONLY IF these items are required to be included in the estate tax return.

(3) It can include joint tenancy and community property. If COMMUNITY PROPERTY, the whole property is acquired by inheritance; if JOINT TENANCY, only the decedent's part that is required to be included in the gross estate is inherited property. However, if the joint tenancy is between spouses and the property would otherwise be community property, it may be possible to establish that the property is actually community property for this purpose.

However, it does not include:

(1) Appreciated property received as a gift by a decedent within one year of death, if the property passes back to the donor or spouse of the donor. Basis of this kind of property is the same as the decedent's basis immediately before death.

(2) Payments received by the heirs from sales of property which were reported on the installment basis by the decedent.

Property Jointly Owned with Spouse - Where the decedent jointly owned property with a spouse, basis of the inherited property will generally include the surviving spouse's share of the adjusted cost basis and the decedent's share at FMV (except for deaths in 2010 when the estate chose the "no tax" option, in which event the decedent's share would be adjusted basis unless the executor chose to increase the basis to FMV as part of the $1.3 million general or $3 million spousal adjustment). However, this might not be true if the property is held as community property. When held as community property, the basis of the entire property is adjusted.

Example – Spousal Joint Tenants: *Ross and Rachel, who are married to each other, own a rental property as joint tenants that they bought for $200,000. Ross contributed $120,000 (60%) to the purchase and Rachel paid $80,000 (40%). When Ross died, the property's FMV at his date of death was $300,000. Prior to Ross' death they had claimed depreciation of $70,000. After his death, Rachel's basis in the rental will be $215,000:*

50% of the original basis ($200,000 x 50%)	*$100,000*
Inherited basis from Ross ($300,000 x 50%)	*150,000*
Less 50% of depreciation of $70,000	*<u>< 35,000></u>*
Rachel's new basis	*$215,000*

Regardless of the amount of each spouse's contribution to the purchase price of the asset, 50% of the FMV of joint tenancy property held by a married couple is included in the gross estate of the first spouse to die.

Example – Community Property *– If Rachel and Ross had owned the rental as community property, Rachel's basis after Ross' death would be $300,000, the fair market value at his DOD. No adjustment is required for prior depreciation claimed.*

<u>Property Jointly Owned with Non-spouse</u> – In the case of unmarried joint tenants, when the first joint tenant dies, the presumption is that the entire value of a joint tenancy asset is included in the decedent's estate. However, if the surviving joint tenant can prove what amount he or she contributed toward purchasing the property, the surviving joint tenant's basis is stepped up by an amount equal to the amount included in the decedent's estate. Add the surviving tenant's original basis to the value of the property that was included in the decedent's estate and subtract any depreciation or depletion allowed to the surviving joint tenant.

Example – Non-Spouse Joint Tenants *– If Ross and Rachel from the prior example had not been married, and the value of the rental included in Ross' estate was $180,000 (60% of the FMV), Rachel's new basis would be $225,000, figured as follows:*

Rachel's original basis (40% of $200,000)	*$ 80,000*
Inherited from Ross (60% of $300,000)	*180,000*
Less 50% of depreciation (50% x $70,000)	*<u>< 35,000></u>*
Rachel's new basis	*$225,000*

EASEMENT BASIS ADJUSTMENT

Consideration received for the granting of an easement constitutes the proceeds from the sale of an interest in real property and should be applied as a reduction of the cost or other basis of the portion of the land subject to the easement. (Rev. Rul. 68-291 clarifying Rev. Rul. 59-121) If it is impossible or impractical to separate the basis of the part of the property on which the easement is granted, the basis of the whole property is reduced by the amount received. Any amount received that is more than the basis to be reduced is a taxable gain. IRS Pub 544, Pg 3.

CAUTION: If the easement is for a specific period of time, then it is generally treated as rental income. (Wineberg, William, (1961) TC Memo 1961-336), but see GCM 35492 (9/73) for a different outcome).

CARRYOVER (SUBSTITUTED) BASIS

Under the carryover basis rules, the BASIS OF THE OLD PROPERTY (with certain adjustments) is used for:

(1) Property acquired in a TAX-DEFERRED" EXCHANGE (Sec 1031).

(2) Vehicles acquired in a TRADE-IN transaction. Basis is the adjusted basis of the trade-in plus unrecognized loss or minus unrecognized gain, plus cash given. This can be complicated when accounting for part personal, part business use. ***Note:*** Effective with exchanges completed after 2017, only exchanges of real property will qualify for Sec 1031 treatment.

(3) Replacement property in an INVOLUNTARY CONVERSION (Sec. 1033).

(4) REPLACEMENT RESIDENCE (Sec. 1034). Code Sec 1034 was repealed, effective for sales and exchanges after 5/6/1997. Prior to repeal, it allowed the seller to postpone gain on the sale of a principal residence if a replacement residence was acquired within a specified time, and the new residence's cost was at least as much as the adjusted sales price of the old residence. The basis in the new residence was reduced by the amount of the postponed gain.

(5) PROPERTY ACQUIRED FROM A DECEDENT DYING IN 2010 (where the estate opts for the "no tax" method) that is not increased to FMV by the $1.3 million general adjustment or the $3 million spousal adjustment.

(6) GIFTS: The previous owner's adjusted basis (plus all or some of the gift tax paid – see #7 next) is generally used for gifts. BASIS FOR GAIN equals the donor's basis. BASIS FOR LOSS equals the smaller of the donor's basis or the FMV at the date of the gift. Notice, though, that the BASIS WILL BE THE FMV AT DATE OF DEATH if the gift was required to be included in the decedent's estate (may not be so for deaths in 2010).

(7) For gifts after 1976, only the gift tax attributable to the appreciation is added to basis. For gifts before 1977, the whole Federal gift tax is added. In either case, adding the gift tax cannot increase the total basis to more than the FMV.

EXAMPLE – Carryover Basis - *Stella received a gift of property from her mother. FMV at the time of the gift was $50,000, but her mother's adjusted basis was $20,000. Gift tax on the property was $9,000. Stella's basis is figured as follows:*

FMV		*$50,000*
Less: adjusted basis		*-20,000*
Appreciation		*30,000*
Gift tax	*9,000*	
Multiply by: ($30,000/$50,000)	*x 60%*	
Gift tax due to appreciation		*5,400*
Adjusted basis		*20,000*
Stella's basis		*$ 25,400*

Where there is carryover of basis, there is generally a carryover of holding period as well.

TRANSFERS BETWEEN SPOUSES

Property retains the same basis in the hands of the recipient that it had in the hands of the couple or other spouse.

MISCELLANEOUS TRANSACTIONS

(1) For property CONVERTED FROM PERSONAL USE to business use (e.g., a personal residence converted to a rental), basis is the LESSER OF COST OR FMV AT THE DATE OF CONVERSION. Generally, this will be cost for real estate (but real estate purchased at the peak of the early- and mid-2000s boom market may be an exception to the general rule, at least until the real estate market fully recovers). Figure the COST of land from the original tax bill, if possible. Add all building improvements to building cost for depreciation.

(2) STOCK basis is original cost or other basis and might be adjusted for items like TAX-FREE DISTRIBUTIONS (this reduces total basis), STOCK DIVIDENDS AND SPLITS (spreads out the current basis over the new number of shares, making no change in the total basis, but the basis per share is reduced), and REINVESTED

(3) DIVIDENDS (if the dividends are taxable, the amount included in income becomes the basis of the new shares; for pre-1986 excluded public utility dividends, basis of the new shares is zero).

(4) ASSESSMENTS FOR LOCAL IMPROVEMENTS (e.g., streets and sidewalks) are usually added to basis rather than deducted as taxes.

ADJUSTED BASIS

When there is a sale of property, it may be necessary to make various adjustments to the basis so that an accurate gain or loss can be determined. Some of the many possible additions and subtractions from basis:

INCREASES TO BASIS:

- Improvements made to the property after purchase
- Legal fees paid to protect property title
- Zoning costs
- Escrow costs
- Recapture of some credits

DECREASES TO BASIS:

- Depreciation, amortization, depletion, etc.
- Section 179 deductions
- Casualties
- Easements
- Energy, investment, and rehabilitation credits

BASIS OVERSTATEMENT AND THE STATUTE OF LIMITATIONS

A six-year, rather than three-year, statute of limitations for assessment of tax applies if a taxpayer omits from gross income an amount in excess of 25% of the gross income amount stated in the return. Controversy existed between the IRS and taxpayers, and various courts, as to whether overstatement of basis could result in a gross income omission that would extend the statute of limitations to six years, for example where gross income was understated as a result of an asset's sale where the basis was overstated. The Supreme Court resolved a split among federal appeals courts by concluding that an overstatement of basis does not result in an omission of income for statute of limitation purposes. *(United States v. Home Concrete & Supply, LLC, SCt, 2012-1 USTC ¶50,315)* **However,** Congress overrode the Supreme Court by providing a provision in the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (H.R. 3236) that the 6-year limitation period applies where any overstatement of basis results in a substantial omission (over 25%) of gross income stated in the return. This legislation is effective for returns for which the normal assessment period was open on July 31, 2015 (date of enactment) and for all returns filed after July 31, 2015.

BASIS OF ASSETS INHERITED

Decedent Died in 2010 - Under the Tax Act of 2010, the estate tax was retroactively reinstated for 2010 with an exception for 2010 permitting an election to choose no estate tax and a modified carryover basis for inherited assets. If the no estate tax election was chosen, the basis of the inherited property will be determined by a complicated formula and the basis must be provided by the executor of the estate. Most likely, for estate's valued at less than $5 million, the executor will have opted for the estate tax and step-up/down basis rules rather than the modified carryover basis method. Consult the estate executor if in doubt. See chapter 1.05 for more information related to the modified carryover basis!

Decedent Died in Other than 2010 – Generally, a beneficiary who inherits an asset is allowed to use the asset's fair market value on the date the deceased owner died as his or her tax basis in the asset. This is commonly referred to as the "step-up or step down" basis. (Sometimes an alternate valuation, determined as of the date six months after the date of death, is used – but only if doing so reduces the total value of the estate and estate tax is paid.) Note: Basis adjustment does not apply to items that would have been taxable to the deceased as income such as Traditional IRAs, pensions, installment notes, etc.

Inherited Property Basis Consistency - The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 imposed a new basis consistency standard – in general, the basis of property received by reason of death under Code Sec. 1014 must equal the value of that property for estate tax purposes. This basis consistency rule only applies to a property whose inclusion in the decedent's estate increases the estate's federal estate tax liability (reduced by credits allowable against such tax). (Code Sec. 1014(f)(2)) It applies whenever the beneficiary reports to the IRS a taxable event with respect to the property and continues to apply until the property is sold, exchanged, or otherwise disposed of in one or more transactions that result in the recognition of gain or loss. (Prop. Reg. §1.1014-10(a)(1)) This provision does not apply to property that is disposed of prior to distribution to beneficiaries or income in respect of a decedent. (Prop. Reg. §1.6035-1(b))

Effective for property with respect to which an estate tax return is filed after July 31, 2015, the basis of any property to which Code Sec. 1014(a) applies (i.e., the rules for determining basis of property acquired from a decedent), can't exceed:

(A) In the case of property, the final value of which has been determined for purposes of the tax imposed by estate tax on the estate of the decedent, such value, and

(B) In the case of property not described in (A), above, and with respect to which a statement has been furnished under new Code Sec. 6035(a) (see basis reporting below) identifying the value of such property. (Code Sec. 1014(f)(1), as amended by Act Sec. 2004(a))

For purposes of Code Sec. 1014(f)(1), the basis of property has been determined for purposes of the estate tax if:

- The value of such property is shown on a return required under Code Sec. 6018 (i.e., an estate tax return filed on Form 706, 706-NA, or 706-A) and that value is not contested by IRS before the expiration of the time for assessing a tax under the estate tax rules;
- In a case not described in (A), above, the value is specified by IRS and that value is not timely contested by the executor of the estate; or
- The value is determined by a court or pursuant to a settlement agreement with IRS.

IRS may by regulations provide exceptions to the application of Code Sec. 1014(f).

Inherited Basis Information Reporting - The information reporting requirement is designed to ensure that the basis consistency standard is met.

Under the Act, effective for property with respect to which an estate tax return is filed after July 31, 2015, the following new information reporting requirements apply to inherited property (Code Sec. 6035(a), as added by Act Sec. 2004(b)(1)):

(1) The executor of any estate required to file a return under Code Sec. 6018(a) must furnish to IRS and to each person acquiring any interest in property included in the decedent's gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on the estate tax return and such other information with respect to such interest as IRS may prescribe.

(2) Each person required to file a return under Code Sec. 6018(b) (returns by certain beneficiaries) must furnish to IRS and to each other person who holds a legal or beneficial interest in the property to which such return relates a statement identifying the information described in (1), above.

The statements required under (1) and (2), above, must be furnished as prescribed by IRS, but not later than the earlier of the date which is:

- 30 days after the date on which the estate tax return was required to be filed (including extensions, if any), or
- 30 days after the date the estate tax return is actually filed. (Code Sec. 6035(a)(3)(A))

Form 8971 - In proposed regulations, the IRS has designated Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent, and its Schedule A, as the statement an executor is to use to satisfy the reporting requirements. Form 8971 is a separate filing requirement from the estate's Form 706, 706-NA, or 706-A, and should not be attached to the respective estate tax return. Where there is an adjustment to the information required to be included on the 8971 and/or Schedule A after it has been filed, a supplemental 8971 and Schedule A must be filed not later than the date which is 30 days after the adjustment is made (Code Sec. 6035(a)(3)(B)).

Schedule A of Form 8971 - All property acquired (or expected to be acquired) by a beneficiary must be listed on that beneficiary's Schedule A. If the executor has not determined which beneficiary is to receive an item of property as of the due date of the Form 8971 and Schedule(s) A, the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be filed once the distribution to each such beneficiary has been made.

Other issues associated with filing the Schedule A*:*

- Generally, any property that qualifies for a marital deduction or a charitable deduction will not generate estate tax, and "No" should be indicated in Column C of the Schedule A.
- A form or schedule filed with IRS without entries in each field will not be processed. A form with an answer of "unknown" will not be considered a complete return.

- The executor is to provide each beneficiary only with their own Schedule A, not those of other beneficiaries.
- Beneficiaries could conceivably receive revised Schedule As years after their original returns were filed if the IRS examines the estate tax return, does not agree with the FMV claimed on that return and the executor chooses to litigate the issue.

Since the executor of the estate must certify that copies have been provided to all beneficiaries it would be prudent for the executor to retain a proof of mailing, proof of delivery, acknowledgment of receipt, or other information relevant for the estate's records.

Failure to File Penalty - Failing to follow the information reporting requirements is subject to the failure-to-file penalty of $270 for returns required to be filed in 2020 or 2019, ($260 for years 2015-2018), per return (Code Sec. 6721(a)). The 8971 and the Schedule A are considered a single filing for purposes of the penalty.

Inconsistency Penalty - Beneficiaries who report basis in property that is inconsistent with the amount on the Schedule A may be liable for a 20% accuracy-related penalty under Code Sec 6662. However, adjustments to the basis of property post-death, such as capital improvements, will not cause a beneficiary to be subject to the accuracy-related penalty if the basis of property claimed on a return exceeds its final value as determined under Code Sec. 1014(f). (Prop. Reg. §1.1014-10(a)(2))

8971 Not Required if 706 Filed Just to Make Portability Election

Prop. Reg. 1.6035-1(a)(2) states that the Form 8971 filing requirement does not apply to estate tax returns filed solely for the purposes of making a portability election (or a generation-skipping transfer tax election or exemption allocation). When the proposed regs are published as final in the Federal Register, they will apply to property acquired from a decedent or by reason of the death of a decedent whose required estate tax return is filed after July 31, 2015. These rules may be relied on before the date of publication of the Treasury Decision adopting these rules as final in the Federal Register.

CALIFORNIA DIFFERENCES

California is a community property state and the method of establishing basis will depend in part upon how title was held at the time of the decedent's death.

Current law generally allows a married couple the following options to hold title:

- **Joint Tenancy** - The benefits of this status include a guarantee that the surviving spouse will inherit the property with little or no transfer cost. The survivor is also assured of inheriting the decedent's share, since a secret will cannot divest a joint tenancy interest. The survivor receives a step-up or step-down in basis of only 50 percent of the FMV at the time of the decedent's death. The remaining 50 percent retains the survivor's original (adjusted) basis.
- **Community Property** - This form of title provides a 100 percent step-up or step-down of the property's basis. In other words, both the decedent's and the survivor's halves get a new basis of the FMV upon the death of the first spouse. Unlike joint tenancy, each spouse can will his or her share of the community property to anyone at all. However, changing title when the first spouse dies requires a "spousal property petition" action that can require the survivor to incur legal expenses to remove the deceased spouse's name. This process can also take six to eight weeks.
- **General Presumption of Community Property** – There is a general presumption that all real property in California and all personal property wherever situated, that is acquired by a spouse during marriage, is community property (Family Code Sec 760). The presumption may be overcome (rebutted) by certain types of evidence to prove that the property is actually separate. Some property acquired during marriage is specifically excluded from the community property presumption (Family Code Sec. 802 and 803). The general community property assumption specifically applies to:
  - All real property (including leased) that is located in California and acquired during marriage by a spouse while domiciled in California (Family Code Sec 760).
  - All personal property, wherever located that is acquired during marriage by a person while domiciled in California (Family Code Sec 760).
  - All community property transferred by husband and wife to a trust pursuant to Family Code Sec 761.

- **Community Property with Right of Survivorship** Beginning July 1, 2001, a married couple may hold title as "Community Property with Right of Survivorship". Doing so will: Allow the double step-up or -down in basis; require that the surviving spouse inherit the property; and allow property to pass to the surviving spouse without court action.

Inherited Basis of Property of Decedent's Dying in 2010 – California does not conform to the federal inherited basis rules for 2010, so for California purposes, the inherited basis of assets of a decedent dying in 2010 is fair market value on the date of death (R&TC 18031, 18035.6). This is true even if, for federal purposes, the no estate election was made and the federal basis was determined by modified carryover basis.

NOTES

ASSET BASIS WORKSHEET

Asset Description: ____

Date Acquired.. ____/____/____

Method of Acquisition: ❒ Purchase ❒ §1031 ❒ Repossession ❒ Inherited ❒ Gift

Starting Basis (based upon acquisition method above)... __________

Acquisition Expenses (total of expenses below) .... __________

Purchase expenses	_______	Telephone.............................	________
Legal expenses..........................	_______	________________________......	________
Title expenses...........................	_______	________________________......	________
Postage, fax, etc.......................	_______	________________________......	________

Auto Travel (to acquire, hold and dispose of property - total $ from below)... __________

Yr(s)	Rate*	Miles	$	Yr(s)	Rate*	Miles	$

**See chapter 3.11 for historical mileage rates by year.*

Other Travel (to acquire, hold and dispose of property - total of expenses below)................................ __________

Out-of-town lodging	_______	Air fare.................................	________
Overnight meals pre-'86 (100%)….	_______	Train/bus...............................	________
Overnight meals '86-'93 (80%)…..	_______	________________________......	________
Overnight meals post-'93 (50%)….	_______	________________________......	________
Local transportation......................	_______	________________________......	________

Additional & Improvement Expenses (total of expenses below).. __________

Association dues..........................	_______	Sewer assessments..................	________
Brush clearing.............................	_______	Street assessments..................	________
Insurance....................................	_______	Telephone..............................	________
Lighting assessments....................	_______	Water assessments..................	________
Management fees.........................	_______	________________________......	________
Office supplies.............................	_______	________________________......	________

Disposition Expenses (total of expenses below)... __________

Appraisal......................................	_______	Telephone..............................	________
Commission..................................	_______	Title......................................	________
Escrow...	_______	________________________......	________
Inspection....................................	_______	________________________......	________
Legal..	_______	________________________......	________
Postage..	_______	________________________......	________

TOTAL ASSET ADJUSTED BASIS.. __________

INSTALLMENT AGREEMENTS

Overview

- **Simplified Method –** Pay full amount in 120 days – Arrange at 800-829-1040
- **Streamlined Approval Process**
  - Amount owed does not exceed $50,000 and Taxpayer will pay it off within 72 months
- **Terms**
  - Make all payments on time and in full
  - All required tax returns must have been filed
  - File all future tax returns on time
  - Have enough withholding or estimated tax payments so no tax is due with timely filed future returns
  - User Fee: Ranges from $31 to $225 depending on application and payment methods – see pg. 11.08.02
- **Guaranteed Installment Agreement**
  - Does not owe more than $10,000
  - During the prior five years
    - Filed and paid tax timely
    - Did not enter into an installment agreement
  - Cannot pay the tax in full when due
  - Agree to pay balance in three years
- **Interest** - Current rate compounded daily
- **Penalties** – Late payment reduced to 0.25% per month

RAPID FINDER

Pubs Forms

Related IRC and IRS Publications and Forms

- **Form 9465** – Installment Agreement (liability up to $50,000)
- **Form 433-A** – Collection Information Statement for Wage Earners and Self-Employed
- **Form 433-F** – Collection Information Statement
- **Form 2159** – Payroll Deduction Agreement
- **Form 13844** - Application for Reduced User Fee for Installment Agreements.
- **IRC Sec 6159**

The Details

Certain taxpayers who cannot pay the full tax due may qualify for an installment plan that permits monthly payments. A streamlined approval process is available if:

- **The amount due does not exceed $50,000*, and**
- **The taxpayer will pay it within a six-year (72 months) period.**

** Amounts over $50,000 do not qualify for the streamlined process. However, installment agreements can still be requested for amounts over $50,000 provided a Form 433-A or Form 433-F Collection statement is completed and submitted with the request.*

Individuals are eligible for the streamline process regardless of the type of tax owing. There are additional limits for businesses: (1) defunct businesses (other than sole proprietorships, which fall into the "individual" category) are limited to tax owed of no more than $25,000 (any type of tax) and (2) operating businesses (Form 1120) are limited to income tax liabilities of up to $25,000. A separate program is available for small businesses owing trust fund taxes – see details below.

TERMS

By requesting an installment agreement, a taxpayer agrees to:

- Make sure installment payments are made in full and on time.
- File all future tax returns on time.
- Have enough withholding or estimated tax payments so no tax is due with timely filed future returns.

Taxpayers with liability over $25,000 and up to $50,000 must enroll in a Direct Debit Installment Agreement.

USER FEE

Effective January 1, 2017, when setting up an installment agreement there is a $31 to $225 fee, with the amount dependent on the method used to apply for the installment plan and whether the taxpayer makes the payments by direct debit from a bank or other financial institution checking account (see table below). The fee is not to be included with the installment agreement request. The IRS will bill the taxpayer for the fee with the first payment. The IRS will generally respond within 30 days.

A taxpayer may be qualified for a fee at the low end of the range if their income is below a certain level, as shown in the accompanying table. If a taxpayer receives an installment agreement acceptance notice from the IRS but not a reduced user fee, even though they believe they should qualify for one, request a reduced fee by completing Form 13844. The qualifications depend upon family size and whether they reside in the continental US, Hawaii or Alaska.

Reduced Fee Income Table (Form 13844 rev. 7-2018*)

Family Size	Cont US	Alaska	Hawaii
One	$30,150	$37,650	$34,650
Each Additional Person	(1)	(2)	(3)

(1) Add $10,450 each for persons 2-7; $10,480 for person 8; $10,450 each for any additional
(2) Add $13,075 each for any additional persons
(3) Add $12,025 each for any additional persons
* Based on 2017 US Dept of Health & Human Services Poverty Guidelines, Federal Register, Document Citation 82 FR 8831, January 26, 2017, pp. 8831-8832. Also note that the reduced fee is supposed to be based upon 250% of poverty level, but the form, at date of publication has not been updated for the 2019 poverty rates. See user fee waivers and reimbursements below.

USER FEES EFFECTIVE JAN 1, 2017

Type of Agreement	User Fee
Regular installment agreement paid by check, money order, or credit card	$225
Regular direct debit installment agreement	$107
Online payment agreement	$149
Direct debit online payment agreement	$31
Restructured or reinstated installment agreement	$89
Low-income rate - AGI 250% or below of poverty rate	$43
Low-income rate – direct debit	$31

User Fee Waivers and Reimbursements – For installment agreements entered into **on or after April 10, 2018** by taxpayers whose AGI for the most recent year for which such information is available is at or below 250% of the federal poverty rate (low-income taxpayers), the IRS will waive the user fee if the low-income taxpayer agrees to make electronic payments through a debit instrument by entering into a direct debit installment agreement. For a low-income taxpayer who is unable to make electronic payments through a debit instrument by entering into a direct debit installment agreement, the IRS will reimburse the user fee that the taxpayer paid for the installment agreement upon completion of the installment agreement. (Form 9465 instructions, rev. Dec. 2018)

GUARANTEED INSTALLMENT AGREEMENT - A taxpayer's request for an installment agreement cannot be turned down if the tax they owe is not more than $10,000 and **all three** of the following apply.

1. During the past 5 tax years, the taxpayer (and spouse if making a request for a joint tax return) have timely filed all income tax returns and paid any income tax due and did not enter into an installment agreement for payment of income tax.
2. The IRS determines that the taxpayer cannot pay the tax owed in full when it is due, and the taxpayer provides the IRS any information needed to make that determination.
3. The taxpayer(s) agree to pay the full amount they owe within 3 years and to comply with the tax laws while the agreement is in effect.

SIMPLIFIED ARRANGEMENT FOR FULL PAYMENT – A taxpayer who may not have the funds to pay their tax liability when it is due, but who can pay the full amount owed within 120 days, may call the IRS at 1-800-829-1040, or apply online, to establish their request to pay in full. This avoids paying the fee to set up an installment payment plan. Interest and late payment penalties continue to apply until the entire balance is paid.

PAYMENTS BY PAYROLL DEDUCTION – A taxpayer who wishes to make the installment agreement payments by payroll deduction may indicate that on the completed Form 9465 but must also complete and attach a signed Form 2159, Payroll Deduction Agreement. The employer must also complete their portion of the 2159. The user fee for this payment method is $225 (but could be $43 if qualified for the reduced fee on Form 13844), and the taxpayer cannot file Form 9465 electronically.

IN-BUSINESS TRUST FUND EXPRESS INSTALLMENT AGREEMENTS

Small businesses that currently have employees can qualify for an In-Business Trust Fund Express Installment Agreement (IBTF-Express IA). These installment agreements generally do not require a financial statement or financial verification as part of the application process.

To qualify for an IBTF-Express IA:

- The taxpayer can owe no more than $25,000 at the time the agreement is established. If more than $25,000 is owed, the taxpayer may pay down the liability before entering into the agreement in order to qualify.
- The debt must be fully paid within 24-months or prior to the Collection Statute Expiration Date, whichever is earlier.
- The taxpayer must enroll in a Direct Debit installment agreement if the amount owed is between $10,000 and $25,000.
- The taxpayer must be compliant with all filing and payment requirements.

To Request an IBTF-Express IA call the phone number on the bill received from IRS or complete IRS Form 9465, Installment Agreement Request and send it to the address on the bill, or if the taxpayer does not have a bill, to the address in the 9465 instructions.

INTEREST

Taxpayers will also be charged interest at the current rate, compounded daily.

PENALTIES

The late payment penalty, usually 0.5% of the balance due per month, is reduced to 0.25% when the IRS approves the agreement for an individual taxpayer who timely filed the return and did not receive a levy notice.

PROCESS

- ***Automatic bank withdrawal*** – The bank statement becomes the record of payment. The IRS will provide a statement at the beginning of each year with the amount the taxpayer owes at the beginning of the year, all payments made during the year, and the amount at the end of the year.
- ***Manual payments*** – After each payment, the IRS will send the taxpayer a letter showing the remaining amount owed and the due date and amount of the next payment.

REFUNDS FROM FUTURE YEARS

Any refund due the taxpayer in a future year will be applied against the amount the taxpayer owes.

AGREEMENT DEFAULT

In making the agreement, a taxpayer agrees to keep all future years current. If the taxpayer does not make payments on time **OR** has an outstanding past due amount in a future year, they will be in default of their agreement and the IRS has the option of taking enforcement actions to collect the entire amount owed.

IMPACT ON THE 10-YEAR STATUTE FOR COLLECTIONS

Code Sec 6502 puts a 10-year limit on how long the IRS can pursue the collection of a tax debt. When an installment agreement is in effect and not in dispute, the statute of limitation is not tolled and continues to run.

WHERE TO FILE THE REQUEST

- ***1040 Just Being Filed*** - Attach Form 9465 to the front of the return to be filed.
- ***Already Filed*** - File Form 9465 by itself with the Internal Revenue Service Center where the taxpayer's 1040 is filed.

CALIFORNIA DIFFERENCES

California also provides installment agreements. The agreement terms are generally the same as the Federal with the following differences:

- CA only accepts electronic transfer payments (minimum $25 – no manual payments allowed).
- CA requestors use Form 3567, filed separately from the tax return, or apply online for balances of $25,000 or less that will be paid in full in 60 months. The payment period for a business is usually 12 months.
- There is no specified payment formula (except for online requests) - proposed payment amounts and duration are at the discretion of the FTB.
- If the tax liability owed exceeds $10,000, **or** the installment agreement period for payment exceeds 36 months, **or** both, then the taxpayer must certify that he or she has a financial hardship. (In cases of financial hardship, installment agreements are subject to periodic review.)
- Employees must confirm that the withholding rates for Forms DE-4 and W-4 on file with their employer is correct, or if incorrect, take steps to change the forms.
- The taxpayer cannot be subject to a current wage garnishment.
- There is a $34 charge for setting up an installment agreement for an individual, $50 for a business.
- Changes in installment amount can be requested by calling (800) 689-4776.
- A business that needs to request an installment payment plan should call the FTB at (888) 635-0494 to make arrangements.

Form FTB 3561C – The FTB developed FTB 3561C, Financial Statement (rev. 2-2018), to be used when required to provide current financial information necessary to help the FTB to determine how a taxpayer can satisfy an outstanding tax liability. If the taxpayer submitted an IRS Form 433-A or 433-F, dated within the previous 12 months, to the IRS, that form may be used in lieu of the FTB 3561.

Generally, a taxpayer will be required to complete a Financial Statement under the following circumstances (FTB Tax News, May 2018):

1. When the total balance is greater than $25,000; or
2. An Installment Agreement will not pay in full within 60 months; or
3. Taxpayer claims they do not have the ability to pay (financial hardship); or
4. To return/release of assets seized by Warrant; or
5. The taxpayer has a demonstrated history of non-compliance.

NOTES

PATIENT PROTECTION AND AFFORDABLE CARE ACT (ACA)

(An Overview)

Signed into law in March 2010, various pieces of legislation, often collectively referred to as Obamacare or the ACA, created fundamental reforms to the health care system of the United States. The success of the Health care plan is predicated on having everyone insured by one means or the other. Thus, the overall plan includes a variety of provisions, most of which are phased in over time and many that affect taxpayers' income tax returns. In addition, there have been modifications to the plan since its inception.

PROVISIONS

2009

- Med Student Loan COD Income Forgiveness
- Investment Credit For Therapeutic Discovery

2010

- Small Employer HC Credit
- Child Age 26 Excludable HC Benefits
- Child Age 26 SE Health Insurance
- Refundable Adoption Credit
- Tanning Services 10% Tax

2011

- Non-Qualifying Distribution Penalty Archer & MSA - 20%
- No Over-the-Counter Med Reimbursement from HRA, FSA, HSA and MSA Plans
- Simple Cafeteria Plans < 100 employees

2012

- Employer Provided HC Benefits Reported on W-2

2013

- Increased HI Tax (0.9% on earned income > than $200K ($250 MFJ) threshold.
- 3.8% surtax on Net Investment Income High Income Taxpayers AGI>$200K ($250 for MFJ)
- FSA Maximum Annual Medical Expense Limited to $2,700 (2019)
- Medical Itemized Deduction Threshold Raised to 10%*
- $2 per life Patient-Centered Outcomes Research Fee on Self-Insured Health Plans

2019

- Penalty for not being insured repealed

20202

- Excise Tax on High Cost Employer Plans

*Reduced to 7.5% for 2017, 2018

2014

- Premium Assistance Credit
- Individual Penalty for Not Being Insured
- Employee Notices Re: Insurance Exchanges Options

2015

- Large Employer (100 employees) HC Mandate Excise Tax
- Employer and Insurer Reporting Requirement

2016

- Midsize Employer (50-99 employees) HC Mandate Excise Tax

2017

- Small Employer HRA Less Than 50 EFT Employees. Avoids the Sec 4980D $100/day Penalty.

Related IRS Publications and Forms

- **Pub 5093** – Health Care Law On-Line Resources
- **Pub 5187** – Affordable Care Act: What You and Your Family Need to Know
- **IRS web site** – IRS.gov/aca

The various provisions are highlighted below and where appropriate covered in more detail, as noted, in separate sections (chapters) following this chapter.

2009

STUDENT LOAN FORGIVENESS FOR HEALTH PROFESSIONALS

The law was amended to include amounts received by an individual in tax years beginning after Dec. 31, 2008; the gross income exclusion for amounts received under the National Health Service Corps loan repayment program or certain State loan repayment programs is modified to include any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas as determined by the State. (Code Sec. 108(f)(4))

The Tax Cuts and Jobs Act (TCJA) of 2017 includes a provision that the discharge of an eligible student loan in 2018 through 2025 because of the student's death or total and permanent disability does not result in discharge of debt income. (Code Sec. 108(f)(5)(A))

2010

TANNING SERVICES EXCISE TAX

For indoor tanning services performed **on or after July 1, 2010**, a 10% excise tax is imposed on the amount paid for any indoor tanning service, whether paid for by insurance or otherwise. The tax is imposed on tanning service recipients, although the service provider is liable for the collection and payment of the tax; thus service providers are liable if they fail to collect the tax. (Code Sec. 5000B(a), as added by Health Care Act Sec. 10907(b)) Form 720 (IRS #140 in Part II) is used to compute the tax.

EXCLUDABLE MEDICAL REIMBURSEMENTS FOR OLDER CHILDREN

Effective **on Mar. 30, 2010**, the general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan is extended to any child of an employee who hasn't attained age 27 as of the end of the tax year (Code Sec. 105(b)). This change is also intended to apply to the exclusion for employer-provided coverage under an accident or health plan for injuries or sickness for such a child including health savings accounts (HSA), health flexible spending arrangements (FSA) and voluntary employees' beneficiary associations (VEBAs).

This change also applies to Sec 401(h) benefits for sickness, accident, hospitalization, and medical expenses of retired employees, their spouses and their dependents.

SELF-EMPLOYED HEALTH INSURANCE DEDUCTION

Effective **on March 30, 2010**, the older children provision of the health care reform law also applies to a self-employed individual's child under the age of 27 as of the end of the year. No other requirements apply so long as they meet the definition of a child and have not reached age 27 by the last day of the year. Even a married child is included by this definition! The child is not required to be a dependent.

TAX CREDITS FOR SMALL EMPLOYERS OFFERING HEALTH COVERAGE

A 35% (25% for non-profit organizations) credit was available for eligible small employers that provide nonelective health insurance to their employees and employ 25 or fewer equivalent full-time employees with average annual full-time wages of $50,000 or less. The credit increases to 50% (35% for non-profits) as of 2014, but the number of years the credit is available is limited to two. See chapter (section) 12.08 for further details.

2011

INCREASED TAX ON NONQUALIFYING HSA OR ARCHER MSA DISTRIBUTIONS

The additional tax for HSA withdrawals for other than qualified medical expenses before age 65 is increased from 10% to 20% (Code Sec. 223(f)(4)(A)), and the additional tax for Archer MSA withdrawals for other than qualified medical expenses is increased from 15% to 20% (Code Sec. 220(f)(4)(A)). Distributions after age 65 are not subject to the penalty.

OVER-THE-COUNTER MEDICATION RESTRICTION FOR EMPLOYER PLANS

Beginning in 2011, over-the-counter medications, except for doctor prescribed over-the-counter medication and insulin will no longer qualify for reimbursement. This restriction applies to health reimbursement accounts (HRAs), health flexible spending accounts (FSAs), health savings accounts (HSAs), and Archer medical savings accounts (MSAs).

SMALL EMPLOYER SIMPLE CAFETERIA PLANS

For years beginning after Dec. 31, 2010, small employers (average of 100 or fewer employees on business days during either of the two preceding years) may provide employees with a "simple cafeteria plan." (Code Sec. 125(j)) See chapter (section) 12.07 for details.

2012

EMPLOYER W-2 REPORTING RESPONSIBILITIES

Certain employers are required to disclose the aggregate cost of the benefit provided by them for employer-sponsored health insurance coverage on the employee's annual Form W-2. This amount is reported in Box 12 using code DD.

2013

ADDITIONAL HOSPITAL INSURANCE TAX – HIGH-INCOME TAXPAYERS

The Hospital Insurance (HI) tax rate (currently at 1.45%) is increased by 0.9 percentage points on individual taxpayer earnings (wages and self-employment income) in excess of compensation thresholds for the taxpayer's filing status. (Code Sec. 3101(b)(2)) See chapter (section) 12.06 for details.

NET INVESTMENT INCOME TAX (IRC Sec. 1411)

A new surtax called the Net Investment Income Tax is imposed on individuals, estates, and trusts. For individuals, the surtax is 3.8% of the lesser of (1) the taxpayer's net investment income or (2) the excess of modified adjusted gross income over a threshold amount ($250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all others). Threshold amounts are not inflation-adjusted. See chapter (section) 12.05 for further details.

EMPLOYER HEALTH FLEX-SPENDING PLAN CONTRIBUTIONS LIMITED

In order for a health FSA to be a qualified benefit under a cafeteria plan, the maximum amount available for reimbursement of incurred medical expenses of an employee, the employee's dependents, and any other eligible beneficiaries with respect to the employee, under the health FSA for a plan year (or other 12-month coverage period) cannot exceed $2,500 (adjusted for inflation: $2,550 for 2015 and 2016, $2,600 for 2017, $2,650 for 2018 and $2,700 for 2019). (Code Sec. 125(i)) An employer has the decision to establish a cap less than $2,500 for employer's plan.

The limitation is on an employee-by-employee basis. That is, $2,700 is the maximum amount that an employee may contribute in 2019, regardless of the number of individuals (e.g., spouse or dependents) whose medical expenses may be reimbursed under the plan. However, if two people are married, and each has the opportunity to participate in a health FSA, whether through the same employer or through different employers, each may contribute up to the annual limit.

IRS Relaxes Use it or Lose it Rules - This modification permits § 125 cafeteria plans to be amended to allow up to $500 of unused amounts remaining at the end of a plan year in a health FSA to be paid or reimbursed to plan participants for qualified medical expenses incurred during the following plan year, provided that the plan does not also incorporate the grace period rule. (Notice 2013-71)

MEDICAL ITEMIZED DEDUCTIONS LIMITED

The itemized deduction for medical expenses is limited in the following manner (Code Sec. 213):

- *AGI Threshold* – The AGI threshold percentage for claiming medical expenses on a taxpayer's Schedule A is currently 10%, which is the same as the threshold percentage for alternative minimum tax (AMT) purposes. See accompanying table for the percentages for other years.

Year	Pre-2013	2013-16	2017-18	Post-2018
Under age 65	7.5%	10%	7.5%	10%
Either Spouse 65 or over	7.5%	7.5%	7.5%	10%
AMT Threshold	10%	10%	7.5%	10%

FEE ON SELF-INSURED HEALTH PLANS - PATIENT-CENTERED OUTCOMES RESEARCH FEE (PCORI)

Section 4376 imposes a fee (see below) multiplied by the average number of lives covered under the plan. The fee amount will be adjusted for inflation for policy and plan years beginning after September 30, 2015. The amount used to calculate the fee imposed for policy years and plan years that end on or after October 1, 2018 and before October 1, 2019 is $2.45, up from $2.39 for the 2017-2018 period. The fee is paid using Form 720, Quarterly Federal Excise Tax Return, which is due on July 31 of the year following the last day of the policy year or plan year. Payment is due at the time Form 720 is due. The PCORI fee is imposed on an issuer of a specified health insurance policy and a plan sponsor of an applicable self-insured health plan. Fees are based on the average number of lives covered under the policy or plan. Generally, plan sponsors of applicable self-insured health plans must use one of the following three alternative methods to determine the average number of lives covered under a plan for the plan year.

1. Actual count method.
2. Snapshot method.
3. Form 5500 method.

This excise tax (fee) is due for policy years or plan years ending after Sept. 30, 2012, and before Oct.1, 2019. **Thus, these fees don't apply to policy years ending after September 30, 2019.**

EMPLOYEE NOTICES

Beginning January 1, 2014 (October 1, 2013 for existing employees), certain employers must provide written notice to employees about health insurance coverage options available through the Marketplace (insurance exchanges).

- **Notices must be provided by employers** to whom the Fair Labor Standards Act applies. Generally, means an employer that employs one or more employees who are engaged in, or produce goods for, interstate commerce. For most firms, this rule doesn't apply if they have less than $500,000 in annual dollar volume of business.
- Employers must provide a notice **to each employee**, regardless of plan enrollment status (if applicable), or of part-time or full-time status. Employers do not have to provide a separate notice to dependents or other individuals who are, or may become, eligible for coverage under any available plan, but who are not employees.
- The notice must be provided in writing in a manner calculated to be understood by the average employee. The notice must include information regarding the existence of a new Marketplace, inform the employee that the employee may be eligible for a premium tax credit if the employee purchases a qualified health plan (QHP) through the Marketplace, and (2) include a statement informing the employee that if the employee purchases a QHP, the employee may lose the employer contribution (if any) to any health benefits plan offered by the employer, and that all or a portion of such contribution may be excludable from income for federal income tax purposes. Model language notices are available on the Department of labor's EBSA's website at https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/health-plans (under "Plan Administration and Compliance" click on "health plans" and then expand the "model notices & disclosures" section to find one model for employers who do not offer a health plan, and another model for employers who offer a health plan to some or all employees).
- *Timing and delivery of notice.* Employers must provide the notice to each new employee at the time of hiring.

2014

AMERICAN HEALTH BENEFIT EXCHANGES (MARKETPLACES)

By 2014, each state was required to establish an exchange (also termed a Marketplace) to help individuals and small employers obtain coverage. Residents of a state that chose not to set up its own Marketplace used the Marketplace set up by the Federal government. Benefit options for policies offered through the Marketplace are in a standard format and a single enrollment form is used for all policies. Plans offered through an exchange must provide minimum essential health benefits, limit cost sharing (i.e., the amount that the insured pays for medical care), and provide specified accrual benefits (i.e., the percentage amount paid by the insurer). Out-of-pocket deductibles are limited to the same amounts as the caps for Health Savings Accounts and further limited in the small group market.

SHARED RESPONSIBILITY PAYMENT (Penalty For an Individual Not Being Insured) (Code Sec 5000A)

Nonexempt U.S. Citizens and legal resident taxpayers will be penalized for failing to maintain at the least the minimum essential health coverage. The penalty phased in beginning in 2014 and was fully implemented in 2016.

The Tax Cuts and Jobs Act of 2017 effectively repealed this penalty as of 2019 by setting the penalty percentage and fixed dollar amount penalty at 0% and $0, respectively. See Chapter (section) 12.03 for full details.

CALIFORNIA DIFFERENCES

NOTE: California has decided to pick up where the Feds left off with one intervening year. So, for 2019 neither CA nor the Federal return will include a penalty. But beginning in 2020 CA will begin imposing an individual mandate on Californians generally following the former Federal Guidelines. See Chapter 12.03 for details.

PREMIUM ASSISTANCE CREDIT (Code Sec. 36B)

Tax credits are available for lower-income individuals who purchase health insurance coverage with a qualified health plan (QHP) through an exchange (Marketplace). Generally, these are individuals whose household income is at least 100%, but not more than 400% of the federal poverty line and who don't receive health insurance under an employer plan, Medicaid, Medicare, or other acceptable coverage. See chapter (section) 12.02 for full details.

CALIFORNIA DIFFERENCES

SB 78, signed by the governor 6/27/2019, created a California Individual Market Assistance program that is authorized to provide health care coverage financial assistance, including advanced premium assistance subsidies, to California residents with household incomes below 600% of the federal poverty level. The program will run from 2020 through 2022, after which it is repealed and no new financial assistance or other subsidies are to be provided. See chapter 12.02 for details.

2015

LARGE EMPLOYER HEALTH COVERAGE EXCISE TAX

Large employers, generally those with 50 or more full-time employees in the prior calendar year, that:

- Do not offer coverage for all its full-time employees,
- Offer minimum essential coverage that is unaffordable (employee contribution is more than 9.5% (subject to inflation adjustment) of the employee's household income), or
- Offer minimum essential coverage where the plan's share of the total allowed cost of benefits is less than 60%, will be required to pay a penalty if any of its full-time employees were certified to the employer as having purchased health insurance through an individual Marketplace and qualified for either tax credits or a cost-sharing subsidy discussed previously. (Code Sec. 4980H(a))

Eligible employers with between 50 and 99 full-time employees were not subject to shared responsibility payment assessments for 2015. See eligibility requirements in the “2016” section below.

Final regulations provide a "phase-in" rule for applicable large employers (ALE) under which an employer won't owe a penalty for failing to offer health coverage so long as it offers coverage to at least 70% of its full-time employees in 2015, and 95% for 2016 and later years. See chapter (section) 12.09 for full details.

INSURER & EMPLOYER REPORTING

The Affordable Care Act (ACA) provides for mandatory employer and insurer reporting requirements. Under Sec. 6055(a) health insurers are required to file information returns reporting each individual for whom minimum essential coverage is provided. In addition, each employer is also required to provide information related to each employee covered under the employer’s plan and details about the employer’s plan that will allow the government to determine whether the employer offers minimum essential care or not and whether they are subject to large employer excise penalties for not providing minimum essential coverage.

The return must include, among other things:

- Certification that the employer offers its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan.
- The number of full-time employees of the employer for each month during the calendar year;
- The name, address, and taxpayer identification number of each full-time employee employed by the employer during the calendar year and the number of months, if any, during which the employee (and any dependents) was covered under a plan sponsored by the employer during the calendar year.

This reporting requirement was initially scheduled for 2014. However, it was delayed by the administration to give Treasury time to develop ways to simplify the new reporting requirements consistent with the law, and provide time to adapt health coverage and reporting systems. The first required filing was in 2016 covering 2015 information. IRS developed Forms 1095-B (Health Coverage) and 1095-C (Employer-Provided Health Insurance Offer and Coverage) to meet the reporting requirements.

2016

MID-SIZED EMPLOYER HEALTH COVERAGE EXCISE TAX

A mid-sized employer, generally with 50 to 99 full-time employees in the prior calendar year, that:

- Does not offer coverage for all its full-time employees,
- Offers minimum essential coverage that is unaffordable (employee contribution is more than 9.5% (subject to inflation adjustment) of the employee's household income), or
- Offers minimum essential coverage where the plan's share of the total allowed cost of benefits is less than 60%,

will be required to pay a penalty if any of its full-time employees were certified to the employer as having purchased health insurance through a government health exchange (marketplace) and qualified for either tax credits or a cost-sharing subsidy discussed previously. (Code Sec. 4980H(a)) Implementation of the tax was delayed until 2016 provided the mid-sized employer met certain requirements, summarized next.

No penalty applied for a mid-sized employer for any month during 2015, or for any month in 2016 where a non-calendar year plan began in 2015 for the months of the plan occurring in 2016, if the employer met the following conditions:

(a) The employer must employ on average at least 50 full-time employees (including full time equivalents (FTEs)), but fewer than 100 full-time employees (including FTEs) on business days during 2014.

(b) From February 9, 2014, through December 31, 2014, the employer had not reduced the size of its workforce or the overall hours of service of its employees in order to satisfy the workforce size condition set forth at (a) above.

(c) The employer did not eliminate or materially reduce the health coverage, if any, it offered as of February 9, 2014. There are exceptions to this rule.

(d) The employer certifies on a prescribed form that it meets the eligibility requirements set forth in paragraphs (a) through (c) above. **Without this certification, starting Jan. 1, 2015, the employer mandate will be imposed on businesses with 50 full-time employees in 2014.**

See chapter 12.09 - Large Employer Health Coverage Excise Tax.

2017

The "21st Century Cures Act" (H.R. 34), passed in late 2016, includes a provision allowing small employers to reimburse their employees under a health reimbursement arrangement (HRA) for medical expenses without being liable for a $100 per day draconian penalty (IRC Sec 4980D) for violating the Affordable Care Act (ACA)'s rules. See chapter 12.10 – Small Employer HRA

2019

The Tax Cuts and Jobs Act effectively repealed the individual shared responsibility payment (penalty for not being insured) by setting the penalty percentage and fixed dollar amount penalty at 0% and $0, respectively for years after 2018. See Chapter (section) 12.03 for full details.

2022

EXCISE TAX ON HIGH-COST EMPLOYER-SPONSORED HEALTH COVERAGE

Originally, beginning in tax year 2018, a 40% nondeductible excise tax on insurance companies and plan administrators was supposed to apply for any health coverage plan where the premiums exceed the amounts shown in the list that follows. However, the effective date was delayed to years after 2021 and the law was amended to permit employers to deduct the tax they pay. (Consolidated Appropriations Act, 2016, signed into law December 18, 2015)

Single Coverage:	$10,200
Single Coverage, high-risk employment or retired age 55 and older:	$11,850
Family coverage:	$27,500
Family coverage high-risk employment or retired age 55 and older:	$30,950

***Note:** these amounts will subsequently be adjusted for inflation when implemented in 2022.*

The tax will apply to self-insured plans and plans sold in the group market, but not to plans sold in the individual market (except for coverage eligible for the deduction for self-employed individuals). Stand-alone dental and vision plans would be disregarded in applying the tax. The dollar amount thresholds may be later adjusted for inflation.

There is considerable bipartisan support in Congress to repeal this tax before a penny of it is collected. In fact the House has overwhelmingly passed a bill to repeal it, and there's a chance the Senate will take it up in the fall of 2019.

CALIFORNIA DIFFERENCES

California developed its own marketplace, called "Covered California". Covered California announced in mid-July 2019 that the 2020 statewide weighted average change in premiums will be up by only 0.8%, down from 2019's increase of 8.7%. This is the lowest premium increase since 2014. Some parts of the state will see lower rates or no increase, and Californians who shop on the marketplace and switch to the lowest-cost plan in the same metal tier could lower their premiums. The average rate changes and potential savings by shopping and switching do not reflect the additional savings available from the new state subsidies that begin in 2020 (see Chapter 12.02). Covered California estimates 922,000 consumers will be eligible to receive the new subsidies. Covered California's 2020 Rate Booklet is available at: https://www.coveredca.com/pdfs/CoveredCA_2020_Plans_and_Rates.pdf

The open enrollment period for 2019 was October 15, 2018 and through January 15, 2019. (https://www.healthforcalifornia.com/covered-california-enrollment/open-enrollment). The open enrollment period for 2020 is not posted on the Covered California web site as of the date this chapter was updated.

https://www.coveredca.com/newsroom/news-releases/2019/07/19/covered-california-releases-regional-data-behind-record-low-0-8-percent-rate-change-for-the-individual-market-in-2020/

NOTES

PREMIUM TAX CREDIT

(Code Sec. 36B)

Overview

The 2010 Patient Protection and Affordable Care Act ("ACA") creates a refundable premium tax credit for eligible individuals and families to subsidize the purchase of health insurance through a government Marketplace.

Pubs Forms

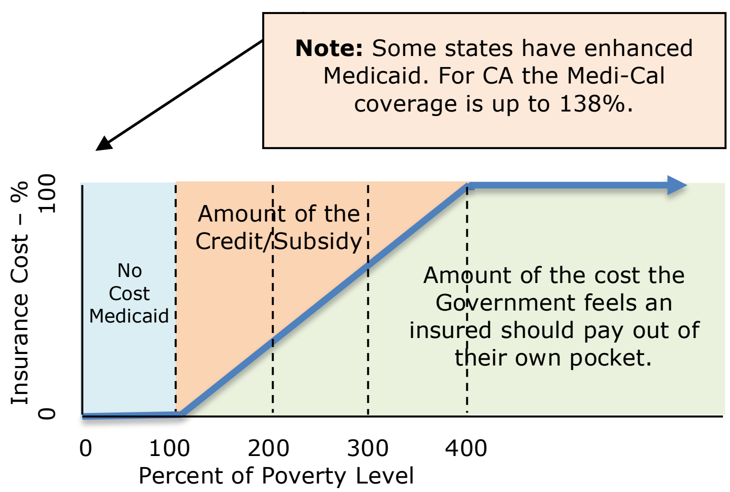
Related IRC and IRS Publications and Forms –

- **Form 8962** – Premium Tax Credit
- **Form 1095-A** – Health Insurance Marketplace Statement
- **Pub 974 – Premium Tax Credit**
- **IRC Sec 36B**

WHAT IS THE PREMIUM TAX CREDIT (PTC)?

The premium tax credit is a refundable credit available to lower income taxpayers to help them offset the cost of purchasing their health insurance. **It is only available to individuals who purchase their health insurance through a government insurance Marketplace and whose income is between 100 and 400 percent of the federal poverty level.** The credit, which is claimed on Form 1040, can also be claimed in advance to reduce current premiums.

If the taxpayer's advance premium tax credit (APTC) exceeds the PTC the taxpayer may be required to pay back part of the credit. On the other hand if the PTC exceeds the APTC, then the excess becomes a refundable credit.



Failure to Pay the Difference – When the advance premium tax credit used as a subsidy payment of the premium is not sufficient to cover the total premium, individuals who fail to pay all or part of the remaining premium amount will be given a mandatory **three-month grace period** before an involuntary termination of their participation in the plan.

ELIGIBLE INDIVIDUALS (Applicable Taxpayer)

The refundable premium tax credit is available to individuals:

RAPID FINDER

1. Whose household income for the taxable year is at least 100% (133% in states with expanded Medicaid) but not more than 400% of the federal poverty level ("FPL"),
2. Who purchase qualified health care insurance through a government-sponsored Marketplace (the insurance **MUST** be purchased through a Marketplace to qualify for the credit).
3. Who **CANNOT** be claimed as a dependent by another,
4. Who are **NOT** eligible for minimum essential coverage through Medicaid, Medicare, employer-sponsored insurance, or other acceptable types of coverage (Preamble to Prop Regs, 8/17/2011). Solely for purposes of determining whether an individual is eligible for government plans such as Children's Health Insurance Program (CHIP) or Medicaid, Notice 2013-41 provides the following guidance:
   - If an individual loses CHIP coverage and is locked out for a period of time (lockout period) due to failure to pay premiums, the individual is treated as eligible for CHIP and eligible for qualified health plan coverage subsidized by the premium tax credit during the lockout period.
   - An individual who may not enroll in CHIP during a pre-enrollment waiting period is treated as not eligible for CHIP coverage during the waiting period. Accordingly, the individual may be eligible for qualified health plan coverage subsidized by the premium tax credit during this period.
   - An individual who is terminated from Medicaid or CHIP for failure to pay premiums is treated as eligible for Medicaid or CHIP during any period for which the individual would be eligible for Medicaid or CHIP except for the failure to pay premiums.
5. Who, if married, must file a joint tax return (but see special rules for victims of domestic violence), and
6. Who are **NOT** employees that are offered minimum essential coverage under an employer-sponsored plan. An individual is eligible for employer-sponsored minimum essential coverage only if the employee's share of premiums is "affordable" (9.56% of household income in 2015, 9.66% in 2016, 9.69% in 2017, 9.56% in 2018, and 9.86% in 2019), and provides "minimum value".

IMPORTANT

How Does One Determine if the Employer Offered the Employee Affordable Minimum Essential Health Insurance? Well, all you need to do is look at the Form 1095-C, Part II, Line 14 codes. (See chapter 12.09 for a description of the offer codes 1A through 1H.) **For months they were offered coverage, they are not qualified for the premium tax credit.** Be sure to review the 1095-C before completing the return to avoid IRS notices.

SPECIAL SITUATIONS RELATED TO ELIGIBILITY

Post-employment coverage (COBRA) - A former employee (including a retiree), or an individual related to a former employee, who may enroll in eligible employer-sponsored coverage or in continuation coverage required under Federal law, or a State law that provides comparable continuation coverage, is eligible for minimum essential coverage under this coverage only for months that the former employee or related individual is enrolled in the coverage (Reg 1.36B-2(c)(3)(iv)). Thus if a former employee does not take the COBRA coverage and is otherwise qualified, he or she would be eligible for the PTC.

Individuals who are incarcerated or not lawfully present - Individuals who are not lawfully present in the United States or are incarcerated (other than pending disposition of charges, for example, awaiting trial) are not eligible to enroll in a qualified health plan through a Marketplace. However, these individuals may be applicable taxpayers and claim the PTC for the coverage of an individual in their tax family who is eligible to enroll in a qualified health plan.

Married taxpayers - A taxpayer who is married generally must file a joint return with their spouse to take the PTC. However, the taxpayer is treated as unmarried for federal income tax purposes if the taxpayer is divorced or legally separated according to state law under a decree of divorce or separate maintenance.

Married taxpayer filing as head of household – Where a married taxpayer qualifies to file as head of household, they can take the PTC if they otherwise qualify. A married taxpayer can file as head of household if he or she: (a) lived apart from their spouse at least the last six months of the year and (b) paid more than one-half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one-half the year of a child, stepchild or eligible foster child for whom the taxpayer may claim a dependency exemption. (Nondependent child qualifies only if the taxpayer gave written consent to allow the dependency to the non-custodial parent, or the non-custodial parent has the right to claim the dependency under a pre-'85 divorce agreement).

Victims of Domestic Abuse or Spousal Abandonment **-** If the taxpayer is a victim of domestic abuse or spousal abandonment, they can take the PTC on a married filing separately return if they meet all of the following (Regs 1.36B-2(b)(2)(ii))

- They are living apart from their spouse at the time they file their tax return.
- They are unable to file a joint return because they are a victim of domestic abuse or spousal abandonment.
- They certify on their return that they meet the criteria for claiming the PTC using the married filing separate filing status.

A taxpayer is considered a victim of spousal abandonment for a tax year if, taking into account all facts and circumstances, the taxpayer is unable to locate his or her spouse after reasonable diligence. (Reg. § 1.36B-2(b)(2)(iv))

The taxpayer may claim this exception to the requirement that married taxpayers must file jointly to claim the PTC for no more than **three consecutive taxable years**. (Reg. § 1.36B-2(b)(2)(v))

Domestic abuse includes physical, psychological, sexual, or emotional abuse, including efforts to control, isolate, humiliate, and intimidate, or to undermine the victim's ability to reason independently. All the facts and circumstances are considered in determining whether an individual is abused, including the effects of alcohol or drug abuse by the victim's spouse. Depending on the facts and circumstances, abuse of the victim's child or other family member living in the household may constitute abuse of the victim. A taxpayer is a victim of spousal abandonment for a tax year if, taking into account all facts and circumstances, the taxpayer is unable to locate his or her spouse after reasonable diligence.

Taxpayers self-certify they qualify for an exception by checking the "Relief" box in the top right-hand corner of Form 8962. No documentation should be attached to the return but it should be kept with the taxpayer's tax return documents. For examples of what documentation to keep, see Pub. 974.

Married filing separately – Generally, a married taxpayer filing separately (MFS) who does not qualify as a victim of domestic abuse or spousal abandonment cannot take the premium tax credit (PTC) and thus must repay all advance premium tax credit (APTC) received (Sec 36B(c)(1)(C)). However, when an individual has obtained insurance through the marketplace, received APTC, and subsequently files as MFS, the amount of APTC that must be paid back may be limited based on the taxpayer's household income relative to the federal poverty level (Sec 36B(f)(2)(B)(i)). See page 12.02.10 for maximum paybacks based upon federal poverty level.

This exception effectively allows MFS taxpayers to obtain some amount of the PTC when they have obtained insurance through the marketplace and are not offered affordable insurance by their employers. In addition, MFS spouses are splitting their incomes by filing separately, thus reducing their individual household incomes and potentially dropping them into a lower poverty level. This, in turn, can reduce the amount of APTC they have to pay back.

ADVANCED PTC TO OFFSET PREMIUMS OR 1040 CREDIT?

The PTC can be:

- Taken in advance to supplement the monthly Marketplace insurance premiums,
- Claimed as a refundable credit on the 1040 tax return, or
- Some combination of both.

This points up the importance of cautioning clients about the significance of notifying the Marketplace of family and income changes to make sure the advance credit is not excessive and creating a future liability for those who can least afford it.

Taxpayers with the changes in circumstances such as the following should report them to the Marketplace:

- Changes in household income.
- Birth or adoption.
- Marriage or divorce.
- Move to a different address.
- Gaining or losing eligibility for other health care coverage.
- Changes to employment – new or additional job, loss of job, becoming self-employed, etc.

DETERMINING POVERTY LEVEL

The advance premium tax credit (APTC) provided to a family is dependent upon their poverty level as determined from the federal poverty guidelines. The lower their **family income** and corresponding percentage of the federal poverty guidelines, the greater their APTC will be. Families with income between 100% and 400% of the federal poverty level qualify for an APTC provided they purchase their insurance from a Marketplace. Families below 100% of the federal poverty level qualify for Medicaid. Note: Some states have enhanced Medicaid and individuals may qualify for Medicaid at higher percentages of the poverty level.

Poverty Guidelines - The Federal Poverty Guidelines are posted annually in the Federal Register and reflect the income representing 100% of the poverty level in the continental U.S., Alaska and Hawaii and an add-on amount for each additional individual in the tax family.

IMPORTANT NOTE
Because open enrollment on the Marketplaces begins in the year prior to the coverage, the prior year poverty guidelines are used in determining a taxpayer's poverty level. Thus for the 2019 year, the 2018 poverty guidelines are used.

Use for 2019

Year	Individuals	Continental U.S.	Alaska	Hawaii
2018 Poverty Levels USED **FOR PREPARING 2019 RETURNS** *Dept of Health & Human Services notice 2018-00814*	One.................... Each Additional	12,140 4,320	15,180 5,400	13,960 4,970
2017 Poverty Levels USED **FOR PREPARING 2018 RETURNS** *Dept of Health & Human Services notice 2017-02076*	One.................... Each Additional	12,060 4,180	15,060 5,230	13,860 4,810
2016 Poverty Levels USED **FOR PREPARING 2017 RETURNS** *Federal Register, January 25, 2016, pp. 4036-4037*	One.................... Each Additional	11,880 4,140	14,840 5,180	13,670 4,760
2015 Poverty Levels USED **FOR PREPARING 2016 RETURNS** *Federal Register, January 22, 2015, pp. 3236 -3237*	One.................... Each Additional	11,770 4,160	14,720 5,200	13,550 4,780

Example: *Suppose you wanted to determine the income that represented the 200% of the federal poverty level for a family size of four in the continental U.S for 2019. You would add $12,140 for the first individual and $4,320 for each of the 3 additional individuals for a total of $25,100 ($12,140 + (3 x $4,320)). The $25,100 represents 100% of the federal poverty level for a family size of 4, so to determine 200% of the federal poverty level for a family with 4 members, multiply $25,100 by 200%, which is $50,200.*

We have done the math, and developed the table below, which represents a variety of poverty levels and family sizes. However, this is for illustration purposes and the actual percent of poverty level must be computed using the values from the table above.

2018 Federal Poverty Guidelines by Family Size & Family Income

USED FOR PREPARING 2019 RETURNS

Family Size	100%	138%	150%	200%	250%	300%	400%
1	12,140	16,753	18,210	24,280	30,350	36,420	48,560
2	16,460	22,715	24,690	32,920	41,150	49,380	65,840
3	20,780	28,676	31,170	41,560	51,950	62,340	83,120
4	25,100	34,638	37,650	50,200	62,750	75,300	100,400

Determining the Family Poverty Level – When determining a family's percentage of the federal poverty level, the income level for 100% of the federal poverty level must be determined from the table above, based on family size, and then that income is divided into the family's household income to find the actual poverty level percentage (this computation is performed in Part 1 of Form 8962).

Family Size - The family size is the same as the number of individuals for which the taxpayer would have been allowed an exemption deduction for the tax year if the TCJA hadn't eliminated the deduction. Generally, this is the taxpayer, the taxpayer's spouse if filing jointly, and the taxpayer's dependents.

Household Income – The term household income includes the modified adjusted gross income (MAGI) of the taxpayer plus the sum of MAGIs of all individuals that were taken into account when determining the taxpayer's family size **and were required to file a tax return**. For this purpose, the determination of whether there is a filing requirement is based solely on the taxpayer's standard deduction (and prior to 2018 and after 2025, allowable filer exemption amounts).

> ***Example:*** *Qualifying child in 2019 has a part time job at a burger joint and makes $16,000. The child files his or her own return and since the earned income exceeds the standard deduction of $12,200 the child is required to file a return. The child's MAGI is included in household income for the PTC computation.*
>
> ***Example:*** *Same as the previous example but the child only made $3,000 at the burger joint. The child is not required to file a return. Therefore, the child's MAGI is not included in household income for purposes of the PTC.*
>
> ***Example:*** *In this example, the child has $3,000 of 1099-MISC income. The child is required for tax purposes to file a return and pay the SE tax on the $3,000. However, for purposes of computing household income the child is not required to file and the child's MAGI is excluded from household income for PTC purposes.*

Modified Adjusted Gross Income (MAGI) – The term MAGI for purposes of this credit means adjusted gross income increased by any foreign earned income exclusion, the excluded portion of Social Security and Railroad Retirement benefits, and tax-exempt interest income. (IRC Sec 36B(d)(2)(B))

> ***Example:*** *In 2019, Family of three lives in the continental U.S and has a household income of $34,000. From the table for 2018 poverty levels used for 2019 returns, we determine that 100% of the poverty level income is $12,140 plus $4,320 for each additional family member. Thus, for our example, the income at 100% of the poverty level would be $20,780 $12,140 + $4,320 + $4,320). The poverty level used for Form 8962 is then determined by dividing the family's household income of $34,000 by the income for their family size at 100% of the poverty level, $20,780, multiplied by 100 to convert to a percentage. Thus, the family's percentage of the federal poverty level is 164 (($34,000/$20,780) x 100), rounded to the nearest whole percentage.*

Special rounding rules – As if things are not complicated enough, the instructions to Form 8962 require that when computing the poverty level, if the result is less than 1.00 or more than 3.99, round the result as follows:

- For any amount less than 1.00, round **down** to the nearest whole percentage. For example, for .996, use 99.
- For any amount between 3.99 and 4.00, round **down** to 399.
- For any amount more than 4.00 but no more than 9.99 round up to the nearest whole percentage, for example for 4.004 use 401.
- For an amount more than 9.99 enter the result as 999. For example, for 10.456 use 999.

Gambling Winnings May Impact Health Insurance Costs

Gambling winnings, even if there's a net loss for the year, and game show winnings can increase the cost of health insurance premiums for low-income individuals or families who obtain their insurance through the Marketplace and, in some cases, those enrolled in Medicare coverage.

We all know that taxpayers, except under very special circumstances, cannot net their winnings and losses on their tax returns. The total gambling winnings are included in the adjusted gross income (AGI) for the year, while the losses are deducted as an itemized deduction and limited to an amount not exceeding the reported winnings for the year.

Thus, whether or not a taxpayer itemizes deductions and deducts their gambling losses, the full amount of the gambling winnings is included in their AGI; their AGI is used to determine their household income, which in turn is used to determine the amount of premium tax credit (PTC) to which the taxpayer is entitled. The higher the income, the lower the PTC, and the lower the PTC, the higher the insurance premiums. Similarly, if a taxpayer wins goods on a game show, the taxpayer may also receive a W-2G, adding to their AGI for the year. Even if they give some or all of the goods to charity, that would, like gambling losses, be an itemized deduction.

Although impacting very few, the scenario also applies to taxpayers on Medicare. An individual's Medicare B and D premiums are based on their AGI from two years prior. Thus, a taxpayer who had gambling winnings from two years back could see increases in both their monthly Medicare B premiums and supplement for the Medicare D (prescription drug coverage).

Spousal Issues Under an Employer Plan – The employer insurance mandate does not require an employer to provide insurance coverage to a spouse of the employee. However, in some cases employers do include spousal coverage.

- *Spousal Coverage Not Offered* – An unemployed spouse or spouse whose employer does not offer affordable coverage must obtain coverage elsewhere to avoid the penalty for not being insured. One of those options is the Marketplace and the spouse will qualify for the PTC if the spouse otherwise qualifies for the credit.
- *Spousal Coverage Offered* – If an employer offers coverage for both the employee and the employee's spouse, and the cost of the employee's coverage for 2019 does not exceed 9.86% (up from 9.56% in 2018) of the taxpayer's household income, then no matter the cost of the spouse's coverage the taxpayer will not be eligible for the PTC. This is because the affordability test is based upon the employee's self-only coverage premiums for purposes of the 9.86% (9.56% in 2018) of household income test, and if affordable for the employee then it is considered affordable for all members of the taxpayer's tax family offered coverage under the employer plan. If an individual's coverage offered by an employer is considered affordable then the taxpayer is not eligible for a PTC. (Example Reg 1.36B-2(c)(3)(v)(D)) This is commonly referred to as the "family glitch."

Child Under 26 Issues Under an Employer Plan - If a child under 26 can be covered under a parent's policy, can the child get lower costs on Marketplace insurance based on income if they apply themselves? It depends on whether the child is a dependent in the parent's tax household. (Q&A Healthcare.gov).

- *If the under-26 child is included as a dependent in the parent's tax household* - and if they have access to a parent's job-based coverage – they aren't eligible for lower costs on a Marketplace plan. This is because they have access to job-based coverage.
- *If the child files taxes themselves* - they may be eligible for lower costs on a Marketplace plan based on their income. This is true even if they have access to a parent's job-based coverage. But if the child is **enrolled** in a parent's job-based coverage, they aren't eligible for lower costs on a Marketplace plan.

Child Receiving Social Security Benefits – A child receiving SS benefits and no other income is likely not required to file a return. Thus, their MAGI that includes the non-taxable SS benefits is not required to be added to the family's household income. However, should the child have a part time job and make over the standard deduction amount, they would be required to file a return and their non-taxable SS benefits would have to be added to their MAGI and their MAGI added to the family's income.

Where a child has earned income, and the earned income puts them over the filing requirement, the child could contribute to a traditional IRA and possibly reduce their income below the required filing level (remember, for the PTC, filing requirement for 2019 is based solely on standard deduction).

A child providing over half of his/her own support, would not be a qualifying child for dependency purposes, so then the child would file their own return and the child's income wouldn't be considered with the parents' MAGI when figuring the PTC. However, the child would still need to have health care coverage or be subject to penalty, and if bought through a Marketplace, would be eligible for a PTC (unless below poverty level and Medicaid would kick in). Parents could still include the child on a policy purchased thru the employer but would not be eligible for the PTC because the plan was not bought thru the Marketplace.

DETERMINING THE CREDIT

Overview: The credit is actually the difference between what the government thinks a family should pay towards their own health insurance premiums, based upon their poverty level, and the cost of the insurance. A simplistic view without the details is:

The family's cost of insurance purchased through a Marketplace:	$ XXXX
What government thinks a family should pay towards own insurance:	< XXXX>
Premium Tax Credit:	$ XXXX

The cost of the insurance used for the determination is the second lowest cost of a Silver plan of insurance (SLCSP). It is also referred to as the benchmark premium. This cost is determined by the Marketplace and reported on Form 1095-A, a copy of which goes to the IRS and the insured.

What the government thinks the family should pay towards their insurance is a percentage of the family's household income based upon their poverty level. This percentage, referred to as the "applicable percentage" is determined from a table provided by the government based upon the family's poverty percentage.

Family's responsibility towards their insurance premiums – Below is a table showing the "applicable percentage" (termed "applicable figure" on line 7 of Form 8962) for various poverty levels. For example, the "applicable %" value of 0312 is actually 3.12%. This table is included in the Form 8962 instructions. **Note:** The table shown below is for 2018; the 2019 table was not available at publication date. Consult the Form 8962 instructions for 2019 for the 2019 table once it is released.

Applicable Percentage Table for 2018 Returns
(Percentage of Household Income That Must Be Paid Towards Own Insurance)

less than 133	0.0201	175	0.0519	218	0.0697	261	0.0842
133	0.0302	176	0.0523	219	0.0701	262	0.0845
134	0.0308	177	0.0528	220	0.0704	263	0.0848
135	0.0314	178	0.0532	221	0.0708	264	0.0851
136	0.0320	179	0.0537	222	0.0711	265	0.0854
137	0.0326	180	0.0542	223	0.0715	266	0.0857
138	0.0332	181	0.0546	224	0.0718	267	0.0860
139	0.0338	182	0.0551	225	0.0722	268	0.0863
140	0.0344	183	0.0555	226	0.0726	269	0.0865
141	0.0350	184	0.0560	227	0.0729	270	0.0868
142	0.0355	185	0.0565	228	0.0733	271	0.0871
143	0.0361	186	0.0569	229	0.0736	272	0.0874
144	0.0367	187	0.0574	230	0.0740	273	0.0877
145	0.0373	188	0.0579	231	0.0743	274	0.0880
146	0.0379	189	0.0583	232	0.0747	275	0.0883
147	0.0385	190	0.0588	233	0.0750	276	0.0886
148	0.0391	191	0.0592	234	0.0754	277	0.0889
149	0.0397	192	0.0597	235	0.0757	278	0.0892
150	0.0403	193	0.0602	236	0.0761	279	0.0895
151	0.0408	194	0.0606	237	0.0764	280	0.0898
152	0.0412	195	0.0611	238	0.0768	281	0.0901
153	0.0417	196	0.0616	239	0.0771	282	0.0903
154	0.0421	197	0.0620	240	0.0775	283	0.0906
155	0.0426	198	0.0625	241	0.0778	284	0.0909
156	0.0431	199	0.0629	242	0.0782	285	0.0912
157	0.0435	200	0.0634	243	0.0785	286	0.0915
158	0.0440	201	0.0638	244	0.0789	287	0.0918
159	0.0445	202	0.0641	245	0.0792	288	0.0921
160	0.0449	203	0.0645	246	0.0796	289	0.0924
161	0.0454	204	0.0648	247	0.0799	290	0.0927
162	0.0458	205	0.0652	248	0.0803	291	0.0930
163	0.0463	206	0.0655	249	0.0806	292	0.0933
164	0.0468	207	0.0659	250	0.0810	293	0.0936
165	0.0472	208	0.0662	251	0.0813	294	0.0938
166	0.0477	209	0.0666	252	0.0816	295	0.0941
167	0.0482	210	0.0669	253	0.0819	296	0.0944
168	0.0486	211	0.0673	254	0.0822	297	0.0947
169	0.0491	212	0.0676	255	0.0825	298	0.0950
170	0.0495	213	0.0680	256	0.0828	299	0.0953
171	0.0500	214	0.0683	257	0.0830	300 thru 400	0.0956
172	0.0505	215	0.0687	258	0.0833		
173	0.0509	216	0.0690	259	0.0836		
174	0.0514	217	0.0694	260	0.0839		

Example: *Assume the family's poverty percentage is 167 and the family's income is $34,000. From the table above the percentage of their income that they should pay towards their own insurance is .0482 (4.82%). Thus, the amount the government expects them to pay towards their own insurance is $1,639 (.0482 x $34,000)*

Determining the premium tax credit – Depending upon whether the Marketplace reporting using Form 8962 is on an annual basis or a monthly basis, the credit will have to be computed in the same manner. For purposes of explaining how the computation works, the following explanation is based upon an annual computation.

1. Taxpayer's **family size –** (line 1 Form 8962); defined earlier in this chapter.
2. Taxpayer's **household income** (line 3 Form 8962); defined earlier in this chapter.
3. From the table determine the income that is equal to 100% of the federal poverty level based on the taxpayer's family size (line 4 Form 8962).
4. **Family's poverty level** - Divide the amount from line 2 by the amount determined at line 3, rounded to the nearest whole percentage (line 5 Form 8962), keeping in mind the special rounding rules noted above.
5. From the **applicable percentage** table determine the percentage of family income the taxpayer is expected to pay towards purchasing their own health insurance (line 7 Form 8962).
6. **Multiply line 5 times line 2**. This is the amount of health insurance premium the taxpayer is expected to pay towards their own health insurance (line 8a Form 8962).
7. Enter the annual premium for the **second lowest cost Silver plan** (SLCSP). The Marketplace provides this number on Form 1095-A (line 33A for annual computations).
8. Subtract Line 6 from line 7. This amount, not exceeding the cost of the insurance, is the premium tax credit.

Example*: Married couple with one child who live in the continental U.S. Couple has an AGI of $27,000. Child, a teenager, has a part time job and has an AGI of $7,000. Their **2018** premium tax credit is determined as follows.*

1. *Taxpayer's **family size: 3***
2. *Taxpayer's **household income: $34,000** ($27,000 + $7,000)*
3. *From the table of 2017 poverty levels used for 2018 returns, determine the income that is equal to 100% of the federal poverty level for the taxpayer (line 4 Form 8962): $20,420 (100% of poverty level for family of 3 = $12,060 plus $4,180 x 2)*
4. ***Family's poverty level -** Divide the amount from line 2 by the amount determined at line 3, rounded to the nearest whole percentage: **167%** (($34,000/$20,420) x 100)*
5. *From the **applicable percentage** table determine the percentage of family income the taxpayer is expected to pay towards their own health insurance: .0482 taken from the IRS table shown above based on the poverty level.*
6. ***Multiply line 5 times line 2**. This is the amount of health insurance premium the taxpayer is expected to pay towards their own health insurance: **$1,639 (.0482 x $34,000)***
7. *Enter the annual premium for the **second lowest cost Silver plan** (SLCSP). The Marketplace provides this number on Form 1095-A: **$6,310:** (Estimated by the author in order to provide this example).*
8. *Subtract Line 6 from line 7. This amount, <u>not exceeding the cost of the insurance</u>, is the premium tax credit: **$4,671 ($6,310- $1,639).***

Form 8962 – Premium Tax Credit (PTC) - is used to determine the premium assistance credit that the taxpayer is entitled to and to reconcile that credit with the advance credit paid through the insurance Marketplaces.

Example – Completing 8962 - Married couple with one teenage child who works part time with $7,000 of earned income. Parents' AGI is $27,000. Tax year 2019. Annual premium for the second lowest cost Silver plan is $6,348. Actual policy premium is $5,200. APTC paid is $5,016.

Line 1: Family size = 3
Line 2a: Taxpayer's AGI = $27,000
Line 2b: Child's AGI = $7,000
Line 3: $34,000 ($27,000 + $7,000)
Line 4: $20,780 (100% poverty level - family of 3)
Line 5: 164% (($34,000/$20,780) x 100)
Line 6: Yes
Line 7: .0468 is the applicable percent of income that the taxpayer is expected to pay towards own insurance. Taken from IRS table in Form 8962 instructions based on the value of line 5. *Caution: Value is from 2018 table; 2019 table not available at publication.*
Line 8: Taxpayer's annual contribution towards own insurance = $1,591 (.0468 x 34,000)
Line 9: Taxpayer's monthly contribution towards own insurance = $1,591/12 rounded up = $133.

Form 8962 – Part 1

Form **8962** — Department of the Treasury, Internal Revenue Service

Premium Tax Credit (PTC)

▶ Attach to Form 1040, 1040A, or 1040NR.
▶ Information about Form 8962 and its separate instructions is at *www.irs.gov/form8962*.

OMB No. 1545-0074 — 2019 — Attachment Sequence No. **73**

Name shown on your return | Your social security number | Relief (see instructions) ☐

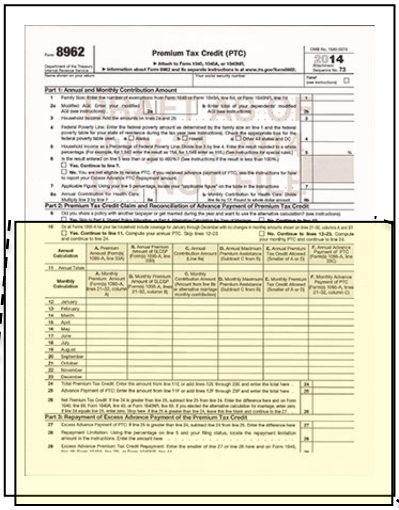
Part 1: Annual and Monthly Contribution Amount

1	Family Size: Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d	1	3
2a	Modified AGI: Enter your modified AGI (see instructions)	2a	27,000
b	Enter total of your dependents' modified AGI (see instructions)	2b	7,000
3	Household Income: Add the amounts on lines 2a and 2b	3	34,000
4	Federal Poverty Line: Enter the federal poverty amount as determined by the family size on line 1 and the federal poverty table for your state of residence during the tax year (see instructions). Check the appropriate box for the federal poverty table used. a ☐ Alaska b ☐ Hawaii c ☒ Other 48 states and DC	4	20,780
5	Household Income as a Percentage of Federal Poverty Line: Divide line 3 by line 4. Enter the result rounded to a whole percentage. (For example, for 1.542 enter the result as 154, for 1.549 enter as 155.) (See instructions for special rules.)	5	164 %
6	Did you enter 401% online 5? (See instructions if you entered less than 100%) ☒ **No.** Continue to line 7. ☐ **Yes**. You are not eligible to receive PTC. If advanced payment of the PTC was made, see the instructions ow or How to report your excess advance PTC repayment amount.		
7	Applicable Figure: Using your line 5 percentage, locate your "applicable figure" on the table in the instructions	7	.0468
8a	Annual Contribution for Health Care: Multiply line 3 by line 7	8a	1,591
b	Monthly Contribution for Health Care: Divide line 8a by 12. Round to whole dollar amount	8b	133

Part 2: Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

DRAFT AS OF JULY 24 2014 DO NOT FILE

Form 8962 – Part 2 & 3



EXAMPLE CONTINUED

Assuming all information was provided on an annual basis
11A = Cost of Insurance from **1095-A (33A)**
11B = Benchmark insurance cost from **1095-A (33B)**
11C = TP's Share of Insurance from **Part I, Line 8a**
11D = $4,757 (6,348 – 1,591)
11E = $4,757 (Smaller of $5,200 or $4,757)
11F = Amount of Advance PTC paid from Form **1095-A (33C)**
27 = 259 ($5,016 - $4,757)
28 = $600 (Amount from maximum repayment table - see Page 12.02.12)

Multiply line 3 by line 7 . . . . . 8a | line 8a by 12. Round to whole dollar amount 8b

Part 2: Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Did you share a policy with another taxpayer or get married during the year and want to use the alternative calculation? (see instructions)
☐ **Yes.** Skip to Part 4, Shared Policy Allocation, or Part 5, Alternative Calculation for Year of Marriage. X☐ **No. Continue to line 10.**

10 Do all Forms 1095-A for your tax household include coverage for January through December with no changes in monthly amounts shown on lines 21–32, columns A and B?
X☐ **Yes. Continue to line 11.** Compute your annual PTC. Skip lines 12–23 and continue to line 24.
☐ **No. Continue to lines 12–23.** Compute your monthly PTC and continue to line 24.

Annual Calculation	**A.** Premium Amount (Form(s) 1095-A, line 33A)	**B.** Annual Premium Amount of SLCSP (Form(s) 1095-A, line 33B)	**C.** Annual Contribution Amount (Line 8a)	**D.** Annual Maximum Premium Assistance (Subtract C from B)	**E.** Annual Premium Tax Credit Allowed (Smaller of A or D)	**F.** Annual Advance Payment of PTC (Form(s) 1095-A, line 33C)
11 Annual Totals	5,200	6,348	1,591	4,757	4,757	5,016

Monthly Calculation	**A.** Monthly Premium Amount (Form(s) 1095-A, lines 21–32, column A)	**B.** Monthly Premium Amount of SLCSP (Form(s) 1095-A, lines 21–32, column B)	**C.** Monthly Contribution Amount (Amount from line 8b or alternative marriage monthly contribution)	**D.** Monthly Maximum Premium Assistance (Subtract C from B)	**E.** Monthly Premium Tax Credit Allowed (Smaller of A or D)	**F.** Monthly Advance Payment of PTC (Form(s) 1095-A, lines 21–32, column C)
12 January						
13 February						
14 March						
15 April						
16 May						
17 June						
18 July						
19 August						
20 September						
21 October						
22 November						
23 December						

24	Total Premium Tax Credit: Enter the amount from line 11E or add lines 12E through 23E and enter the total here .	24	4,757
25	Advance Payment of PTC: Enter the amount from line 11F or add lines 12F through 23F and enter the total here .	25	5,016
26	Net Premium Tax Credit: If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27 .	26	

Part 3: Repayment of Excess Advance Payment of the Premium Tax Credit

27	Excess Advance Payment of PTC: If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here	27	259
28	Repayment Limitation: Using the percentage on line 5 and your filing status, locate the repayment limitation amount in the instructions. Enter the amount here	28	600
29	Excess Advance Premium Tax Credit Repayment: Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44	29	259

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37784Z Form **8962** (2014)

CAUTION: There will be occasions where one individual may have attested to the Marketplace that they would be the one claiming an exemption allowance for a spouse or dependent, and end up not claiming the exemption, and therefore not having the responsibility for that individual. In such cases the benchmark premium amount and the advance premium assistance credit attributable to that individual or individuals can be allocated to other taxpayers on page 2 of the 8962.

TAX RETURN RECONCILIATION

The law requires that any advance payment of the credit be made in the form of an advance payment that **is paid directly to the insurer**. When receiving the credit in the form of an advance payment, a taxpayer is required, when filing their individual income tax return, to reconcile the actual credit that he or she is due with the amount that has actually been subsidized by the government through a Marketplace. Form 8962, Premium Tax Credit, has been developed by the IRS for this purpose. A taxpayer who receives an advance premium tax credit is required to file a tax return so that the reconciliation can be done, even if the taxpayer otherwise would not be required to file.

Credit (PTC) Exceeds Advance Payments (ATPC) - If the calculated credit amount exceeds the advance premium tax credit amount made monthly to the insurer on the taxpayer's (and family's) behalf, **the excess is a refundable tax credit** for the taxpayer, and will be entered on Form 1040, Schedule 3, Part II, line 9 (draft 2019).

Example: *During the open enrollment period at the end of 2018, Jake enrolls in a qualified health plan through a Marketplace and determines his premium tax credit for the upcoming year (2019) is $3,500. He chooses not to have his premium reduced by the premium tax subsidy. Jake's 2019 tax liability, before application of the credit, is $3,000. The credit reduces his tax to zero. In addition, he will receive a $500 refund ($3,500 credit – $3,000 tax) when he files his 2019 return.*

Example: *Michael enrolls in a qualified health plan through a Marketplace and opts to have the premiums reduced by the estimated credit subsidy. During the year, $2,000 of subsidy is applied to reduce his insurance premiums. At the end of the year, and based on his family income and family size, Michael's actual premium tax credit is determined to be $3,500. On his 1040 for the year, reducing the computed credit by the subsidy, he will have a refundable credit balance of $1,500 ($3,500 - $2,000). If his tax liability for the year was $1,000, he would receive a refund of $500 ($1,500 – $1,000).*

Advance Payments (APTC) Exceed Credit (PTC) - If the advance premium tax credit used as monthly premium subsidies exceeds the credit computed on the individual's income tax return, the taxpayer is required to repay the excess as an additional tax on their tax return, **subject to a maximum liability** explained below. The amount of the repayment is entered on Form 1040, Schedule 2, Part I, line 2 (draft 2019).

While the Affordable Care Act prevents the IRS from using liens and levies to collect the individual shared responsibility payment (penalty for individuals who are uninsured that applied before 2019) from taxpayers, the same is not true for repaying the excess premium subsidy. The IRS can use all of the collection efforts in its arsenal for situations where a taxpayer's premium subsidy (advance premium tax credit) exceeds the actual credit and the resulting additional tax has not been paid, and the unpaid amount could be subject to penalty and interest charges as well.

Example: *Michael in the previous example computes his credit at the end of the year and determines it to be $1,250. Because his subsidy payments of $2,000 exceed his credit he will be liable for repayment of a portion of the credit, subject to the maximum liability discussed below.*

Information Reporting (1095-A) – The health insurance Marketplace where the taxpayers acquire their health insurance is required to provide them a Form 1095-A showing which family members were covered, and for which month(s), and the amount of subsidy received, providing the tax preparer with the information required to determine the taxpayer's actual credit amount. This information is used to determine if the taxpayer has a premium credit refund or must repay part of the subsidy.

COMPUTING THE MAXIMUM CREDIT REPAYMENT

If the advance premium tax credit provided by an insurance *Marketplace* exceeds the amount the taxpayer qualifies for, then the difference is reconciled on the taxpayer's return (Form 8962) for the year and the excess repaid on the tax return. However, for taxpayers with household income less than 400% of the poverty level, the maximum repayment is limited to the amount determined from the table below. The amounts are inflation adjusted in $50 increments. (IRC 36B(f)(2)(B)) There is no repayment limit for taxpayers whose household income is 400% or more of the poverty level.

Household Income (Expressed as a % of poverty line)	Maximum Repayment Amount			
	2019		2020	
Filing Status	Single	Other	Single	Other
Less than 200%	$300	$600	$325	$650
At least 200% but less than 300%	$800	$1,600	$800	$1,600
At least 300% but less than 400%	$1,325	$2,650	$1,350	$2,700
400% or more	Entire Amount of Excess			

***Example – Computing the Maximum Credit Repayment** – Jack is married with one child and the family's household income for 2019 is $56,000. Jack purchased his family's health insurance through his state's insurance Marketplace. Using his family's household income, we find from the poverty guideline chart that Jack is in the "at least 200% but less than 300%" category. Therefore, Jack's maximum repayment would be $1,660 for 2019. If the Marketplace credited Jack's insurance carrier with $2,000 more than Jack qualified for, then Jack, instead of having to repay the $2,000, would only be liable for $1,660 on his tax return.*

***Example – No Cap on Credit Repayment Amount** – Let's say that Jack from the previous example received a year-end bonus that caused his income to increase so that his actual household income for 2019 ended up at 405% of the poverty level. In this case Jack's repayment of the excess credit would be $2,000, since he does not benefit from the repayment limitation rule because his household income was 400% or more of the poverty level.*

CONTINUE TO NEXT PAGE

DEFINITIONS AND OTHER ISSUES:

Household income below 100% (133% in states that have enhanced Medicaid) of the Federal poverty line – If the computed Federal poverty level (line 5 of Form 8962) is less than 100%, the taxpayer will still qualify for the PTC if:

- The taxpayer or an individual in the taxpayer's tax family enrolled in a qualified health plan through a Marketplace;
- The Marketplace estimated at the time of enrollment that the household income would be between 100% and 400% of the Federal poverty line for the taxpayer's family size for the tax year;
- APTC is paid for the coverage for one or more months during the tax year; and
- The taxpayer otherwise qualifies as an applicable taxpayer (without taking into account the Federal poverty line percentage).

Alien lawfully present in the United States - Certain aliens with household income below 100% of the Federal poverty line are not eligible for Medicaid because of their immigration status. Such a taxpayer will qualify for the PTC even if their household income is less than 100% of the Federal poverty level if all of the following requirements are met.

- The taxpayer or an individual in the taxpayer's tax family enrolled in a qualified health plan through a Marketplace.
- The enrolled individual is lawfully present in the United States **and** is not eligible for Medicaid.
- The taxpayer otherwise qualifies as an applicable taxpayer (without taking into account the Federal poverty line percentage).

Household income above 400% of the Federal poverty line - If the computed Federal poverty level (line 5 of Form 8962) is more than 400, the taxpayer cannot take the PTC and must repay the APTC paid for all individuals in their tax family. This is so even if the Marketplace apparently provided incorrect information and allowed the taxpayer to purchase their insurance through the Marketplace using APTC to pay part of the premiums when their income exceeded 400% of the poverty line (Carol Sue Walker and Theodore Paul Walker v. Commissioner., U.S. Tax Court, T.C. Summary Opinion 2017-50).

Minimum essential health coverage - As currently defined by ACA, includes government sponsored programs, eligible employer sponsored plans, plans in the individual market, certain grandfathered group health plans and other coverage recognized by the Department of Health and Human Services (HHS). A taxpayer cannot claim the PTC for any individual in the taxpayer's tax family for any month when that individual is eligible for minimum essential coverage, except for coverage purchased through the individual market. Other types of minimum essential coverage include:

- Most government-sponsored programs (including comprehensive Medicaid, Medicare parts A or C, and the Children's Health Insurance Program (CHIP)).
- Most employer-sponsored coverage (if the premiums are affordable and the deductibles and co-pays are no more than a certain amount).
- Other health coverage the Department of Health and Human Services designates as minimum essential coverage.
- Coverage purchased in the individual market outside the Marketplace is minimum essential coverage, but it does not qualify for the PTC.

For more details on minimum essential coverage, see *Minimum essential coverage* in Pub. 974 or check *www.irs.gov/uac/Individual-Shared-Responsibility-Provision* for future updates about types of coverage that are recognized as minimum essential coverage.

Child born, adopted or placed with taxpayer for foster care during the month - If a taxpayer enrolls a newborn child (or a child newly adopted or placed for foster care) in a qualified health plan, the child is treated as enrolled as of the first day of the month the child was born, adopted, or placed for foster care. The child is included in the coverage family for the month of birth, adoption, or foster care placement.

Qualified health plan - For purposes of the PTC, a qualified health plan is a health insurance plan or policy purchased through a Marketplace at the Bronze, Silver, Gold, or Platinum level. Plans sold as "catastrophic" coverage and plans purchased through the Small Business Health Options Program (SHOP) do not qualify a taxpayer to take the PTC.

Enrollment premiums - The enrollment premiums are the total amount of the premiums for the month for one or more qualified health plans in which any individual in the taxpayer's tax family enrolled. Form 1095-A, Part III, Column A, reports the enrollment.

Failure to pay premiums – A taxpayer is not allowed a monthly credit amount for the month if the portion of the enrollment premium for that month has not been paid by the unextended due date of the taxpayer's tax return (Reg. §1.36B-3(c)(1)(ii)).

Failure to file a return – If a taxpayer qualified for APTC and does not file a return, then the taxpayer will not be qualified for APTC or cost-sharing reductions in subsequent years. Example: Does not file a 2018 return, not qualified for APTC in 2019 or future years. (IRS Q&A 23).

SLCSP – Refers to the "second lowest cost silver plan". The premiums for the SLCSP are used to calculate the PTC. See also "Determining the Proper SLCSP Premiums," below.

Form 8962 Must Be Filed – If:

- APTC was paid for the taxpayer or any member of the taxpayer's family.
- APTC was paid for an individual for whom the taxpayer told the Marketplace they would claim a personal exemption, if no one else claims a personal exemption for that individual.

SHARED POLICY ALLOCATION

Certain marital, custodial and family groupings can create situations where the PTC must be divided between multiple taxpayers, and thus requiring those taxpayers to allocate the APTC, SLCSP, and actual premiums reported by the Marketplace on Form 1095-A. This generally occurs when a taxpayer's family Marketplace health plan covers at least one individual that should not have been included in the taxpayer's tax family or the family has split up.

Situations requiring allocations include children leaving the nest, including someone on the Marketplace policy that is not a dependent, separated taxpayers not filing jointly, and divorced taxpayers.

FORM 8962 INSTRUCTIONS

The instructions for line 9 of Form 8962 include a table that guides you through a series of "if – then" steps to determine if a Shared Policy Allocation is required. The instructions to Part IV, Allocation of Policy Amounts, have a variety of examples for specific situations.

The following is an example where allocations are required using part 4 IV of Form 8962.

Example 1 – Divorced Couple **-** *Al and Janice were divorced in June and will not be filing jointly for the year. Both Al and Janice and their dependent son, Dan, are insured on their family policy with the Marketplace. They notified the Marketplace of their divorce and Marketplace provided separate policies for them beginning in July. The Marketplace will issue a 1095-A for the first six months that will have to be allocated, and Janice and Al will each receive a separate 1095-A for the last half of the year. They will combine their separately reported 1095-A information with the allocated amounts when reconciling the PTC on their own returns.*

When making an allocation and there are other family members on their policy, they must first do a per capita allocation for the family members based upon who is claiming the dependency for the family member. The remainder can be allocated in any way they can agree upon or if they cannot agree, 50-50.

Note: Although the allocations are referred to as percentages, the form instructions require that they be entered as decimals. For example, 67% would be entered as 0.67.

Form 8962 (2014) Page 2

Part 4: Shared Policy Allocation

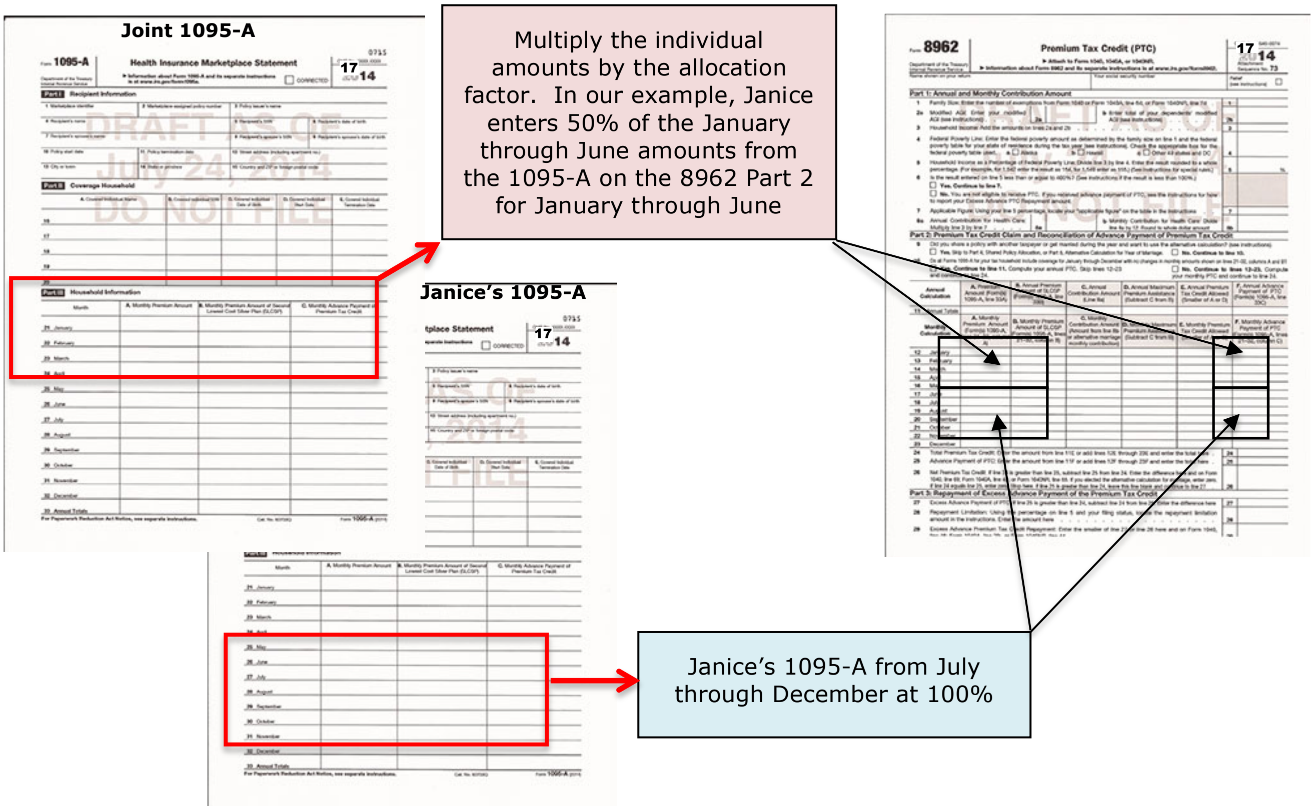
Complete the following information for up to four shared policy allocations. See instructions for allocation details.

Shared Policy Allocation 1

	a Policy Number (Form 1095-A, line 2)	b SSN of taxpayer sharing allocation	c Allocation start month	d Allocation stop month
30	ACA4236534	Appropriate SSN	January	June

Allocation percentage applied to monthly amounts	e. Premium Percentage	f. SLCSP Percentage	g. Advance Payment of the PTC Percentage
	0.50	0.50	0.50

Continuing with our example, we must now transfer the allocated 1095-A data to Part II of the 8962. We will use Janice's reporting for this example. Since they were divorced mid-year and reported that change in status to the Marketplace, they will receive a joint 1095-A for the part of the year they were married and individual 1095-As for the period of time after the divorce. Thus, they must allocate the APTC, SLCSP premiums, and actual premiums paid and reported on the joint 1095-A. They agreed to allocate 50% to each. Therefore, Janice will use 50% of APTC, SLCSP premiums, and actual premiums reported on the joint 1095-A and 100% of the ones on her 1095-A for the last half of the year. See illustration below.



The Form 8962 instructions include a large list of possible scenarios requiring Form 1095-A allocations. However, one need only remember the following rule to determine when allocations are required:

If the 1095-A includes APTC for individuals not included on the same tax return, allocations are required!

<u>Example 2 – Divorced Couple</u> **-** *Using Al and Janice from example 1, except that they failed to notify the Marketplace of their divorce and as a result the coverage continued as family coverage for the entire year including the last half of the year when they were divorced. When this occurs, there must be two allocations, one for the first half of the year as done in example 1 and another for the last half of the year using the rules for "**policy shared with an individual for whom another person claims a personal exemption**". Under those rules Al and Janice can allocate the 1095-A amounts for the last part of the year in any manner they can agree upon provided the APTC, SLCSP premiums, and actual premiums reported by the Marketplace are allocated proportionately. If they cannot agree, the allocation percentage is the number of exemptions claimed by the taxpayer divided by the total number enrolled in the policy. Thus, Al and Janice will do two separate allocations using different rules for the periods of the year they were married and the part they were divorced.*

<u>Example 3 - Taxpayers married at year end but filing separate returns</u> **-** *If the taxpayers are married at the end of the year but are filing separate returns, either or both may meet the qualifications to file as single* or head of household instead of married filing separately. If filing as single* or head of household, that taxpayer may qualify to take the PTC since they have separate tax families and are not filing as married separate. The total enrollment premiums and APTC (<u>but not the applicable SLCSP premiums</u>) are **allocated equally** between the spouses for the months when one qualified health plan covers at least one individual for each tax family, which may be any of the following.*

- *The policy covers both spouses.*
- *The policy covers the taxpayer and one or more dependents of the spouse.*
- *The policy covers one or more of the taxpayer's dependents and the spouse.*
- *The policy covers one or more dependents of both spouses.*

If none of the above applies, all enrollment premiums and APTC are allocated to the spouse whose tax family had one or more of the covered individuals.

If one or both spouses do not qualify to file as single or head of household then he or she must file as married filing separately and is not eligible to take the PTC. APTC allocated to this spouse must be repaid subject to the limitations described on page 12.02.12.*

**May apply only if filing Form 1040NR – see instructions to Form 1040NR for requirements*

CAUTION: *If a taxpayer in example 3 is able to file as single* or head of household as described, the coverage family may change, in which case a new applicable SLCSP premium will be needed to calculate the credit. If the Marketplace was not notified, the amount reported on Form 1095-A may not be correct. See Pub. 974 for information on determining the correct SLCSP premium needed to compute the credit.*

TIP: Keep in mind that community property (income) rules will apply when determining family income since it includes the taxpayer's MAGI.

Example 4 – Victim of domestic abuse or spousal abandonment* -** *If a taxpayer is married at the end of the year but is filing a return as married filing separately because the taxpayer is a victim of domestic abuse or spousal abandonment, the taxpayer may still qualify for the PTC. The total enrollment premiums and APTC (but not the applicable SLCSP) are* ***allocated equally between the spouses *for the months when at least one individual in each taxpayer's tax family is enrolled in the same qualified health plan, which may be any of the following.*

- *The policy covers both spouses.*
- *The policy covers the taxpayer and one or more dependents of the spouse.*
- *The policy covers one or more of the taxpayer's dependents and the spouse.*
- *The policy covers one or more dependents of both spouses.*

If none of the above applies, all enrollment premiums and APTC are allocated to the spouse whose tax family had one or more of the covered individuals. This will occur when only individuals in the taxpayer's family are included in the Marketplace policy and therefore no allocation is required.

Victims of domestic abuse must check the box at the top right of page 1 of the 8962.

Caution: *The taxpayer claiming to be the victim of domestic abuse or abandonment will generally have a change in family size and will have to use an applicable SLCSP premium different from the one reported on the 1095-A. See Pub 974 for information on determining the correct applicable SLCSP premium.*

***Example 5 – Policy shared with an individual for whom another taxpayer claims* -** *If the taxpayer or another person in the taxpayer's tax family was enrolled in a Marketplace qualified health plan with an individual (for example, the taxpayer's child) whom another taxpayer claims as a dependent (for example, a former spouse), an allocation of the APTC, insurance premiums and applicable SLCSP premium is required on Form 8962, Part IV. The taxpayer claiming the dependent may be able to take the PTC for the child's coverage. The taxpayer and the person claiming the dependent may agree on any allocation percentage between zero and one hundred percent. If they cannot agree on an allocation percentage, the allocation percentage is equal to the number of individuals enrolled by the taxpayer whom the other person claims as a for the tax year divided by the total number of individuals enrolled in the same policy as the individual. The allocation percentage is the percentage of the total that applies to the amounts the person claiming the must use to compute PTC and reconcile it with APTC. The taxpayer uses the remaining amounts to compute PTC and reconcile the APTC.*

***Example 6 - A taxpayer is credited with APTC for Marketplace qualified coverage for an individual whom no taxpayer claims as a* -** *The taxpayer is responsible for reporting and reconciling the APTC.*

Example 7 – Policy shared with two or more tax families - *If the taxpayer enrolled in a single qualified health plan with one or more other tax families and APTC was credited to the policy, the enrollment premiums may have to be allocated among the families. Each applicable taxpayer covered by the plan can claim the PTC, if otherwise allowable. Both taxpayers must each use the premium for the applicable SLCSP coverage for their family. Each must compute their respective contribution amounts using the Federal poverty line percentage for the household income and family size reported on their individual Form(s) 8962. The enrollment premiums are allocated in proportion to the premiums for the applicable SLCSP for each taxpayer's coverage family.*

- ***If no APTC is paid*** - for this qualified health plan, the Marketplace may furnish only one Form 1095-A. In this situation, the taxpayer receiving the Form 1095-A should provide a copy to the other taxpayers. The taxpayers must complete only column e on the appropriate line in Part IV to allocate the enrollment premiums to each family.
- ***If APTC was paid*** - for each tax family in a shared policy and no family had any unreported changes in their respective coverage family during the tax year, and each family received their own Form 1095-A, the taxpayer need not complete Part IV of this form. The Marketplace will allocate the enrollment premiums and APTC on Form 1095-A.

More Than Four Allocations Required – If more than four allocations are required for the taxpayer, check the "no" box at line 34 and attach a supplemental statement. Then follow the instructions for the yes box, but include the amounts from the supplemental statement.

Alternative Calculation for Year of Marriage - In the year of marriage, and in the months before marriage, one or both of the newlyweds may have been covered by a Marketplace policy. They may have had their own individual Marketplace policies or they may have been on their family's Marketplace policy. Whatever their pre-marriage circumstances, they will have to account for any APTC based upon their married status at the end of the year, which could result in them having excess APTC when they file since their family size is now at least two and their household income includes the incomes of both spouses. To compensate for that, an elective alternative calculation for the year of marriage is provided. Worksheets and detailed instructions are included in Pub. 974 under "Alternative Calculation for Year of Marriage."

Generally, the alternative calculation allows the couple to split the household income in half and use the appropriate family size to compute their individual PTCs. Family size would normally be one unless one of the couple has other dependents. However, when using this method, if the alternative method computation results in additional PTC as a consequence of the marriage, the PTC is capped at the amount computed using the regular method. Thus the alternative method can only reduce the amount owed, but cannot increase the refund.

CAUTION – The alternative method will only work if 50% of their combined household income is below the 400% poverty level. If over 400%, all the APTC must be repaid.

DETERMINING THE PROPER SLCSP PREMIUMS

When family situations change, and the 1095-A must be allocated, the SLCSP amounts included on the 1095-A may not apply to the changed family size. In those cases, the taxpayer needs to determine the SLCSP for their family circumstances.

Only the Marketplaces are able to provide SLCSP premiums. The Federally-facilitated Marketplace and most state Marketplaces have provided online SLCSP premium tools, which can be used to look up the SLCSP premium that applies to the taxpayer's coverage family for each month.

PREMIUM TAX CREDIT INTERACTION WITH MEDICAID

We have had several questions related to PTC and its interaction with Medicaid (Medi-Cal in California). In virtually all of the cases, a spouse, child or dependent applied for and received free Medicaid coverage. In order to do that they would have had to indicate they were not in another family or did not have another family member with household income that they neglected to include in the application. As a result they received free Medicaid coverage that they were not entitled to. What are the repercussions, if any?

Penalty For Not Being Insured – Section 5000A imposes a "shared responsibility payment" for anyone who is not "covered under minimum essential coverage" (Section 5000A(a) & (f)). Medicaid is a "qualified health plan" so if all the family members are covered by Medicaid and other qualified health insurance, there is no uninsured penalty. For years after 2018, the TCJA set the penalty at $0, so it is no longer an issue anyway.

Medicaid & Premium Tax Credit (PTC) – To qualify for the PTC, the health insurance must be insurance obtained through a government Marketplace. Thus, Medicaid does not qualify for PTC.

However, assume another member of the tax family obtained coverage through the Marketplace. Then that family member would qualify for the PTC. The amount of the PTC is dependent on family size and household income. The fact that some members of the tax family were on Medicaid makes no difference. If only one member of the tax family qualifies for the PTC it will be the same as if all members of the family qualified. **There is no adjustment needed or allowed**.

> ***Example -*** *Mother and daughter manage to get coverage through Medicaid. Mother files jointly with father and they claim daughter as a dependent. Father, using his correct household income (too high for Medicaid), obtains his insurance through the Marketplace. Since the family size is three, the family's federal poverty level percentage is lower, and thus the PTC is higher, even though the mother and daughter had insurance through Medicaid. FREE insurance and higher PTC…but that's the way it works out!*

Household Income Stated Above Medicaid Threshold **–** To avoid repayments of advance credit payments for taxpayers who experience an unforeseen decline in income, the existing regulations provide that if an Exchange (Marketplace) determines at enrollment that the taxpayer's household income will be at least 100% but will not exceed 400% of the applicable federal poverty level (FPL), the taxpayer will not lose his or her status as an applicable taxpayer (i.e., one who is eligible for the PTC) solely because household income for the year turns out to be below 100 percent of the applicable FPL. (Reg. Sec. 1.36B–2(b)(6))

The regulations provide that a taxpayer whose household income is below 100 percent of the FPL for the taxpayer's family size is **not treated as an applicable taxpayer** if the taxpayer provided incorrect information to an Exchange for the year of coverage with intentional or reckless disregard for the facts. A reckless disregard of the facts occurs if the taxpayer makes little or no effort to determine whether the information provided to the Exchange is accurate under circumstances that demonstrate a substantial deviation from the standard of conduct a reasonable person would observe. A disregard of the facts is intentional if the taxpayer knows the information provided to the Exchange is inaccurate. (Reg 1.36B-2(b)(6)(ii))

Exchange Determines Taxpayer Ineligibility for Medicaid or CHIP **-** Similar to the rule for taxpayers who received the benefit of advance credit payments but ended the taxable year with household income below 100 percent of the applicable FPL, the existing regulations do not require a repayment of advance credit payments for taxpayers with household income within the range for eligibility for certain government-sponsored programs if an Exchange determined or considered the taxpayer or a member of the taxpayer's family to be ineligible for those programs.

To reduce the likelihood those individuals who recklessly or intentionally provide inaccurate information to an Exchange will benefit from an Exchange determination, the regulations provide that:

1. A taxpayer whose household income is below 100 percent of the FPL for the taxpayer's family size is NOT treated as an applicable taxpayer if, the taxpayer intentionally or reckless disregarded the facts, and provided incorrect information to an Exchange for the year of coverage, and
2. An individual who was determined or considered by an Exchange to be ineligible for Medicaid, CHIP, or a similar program (such as a Basic Health Program) may be treated as eligible for those coverages and therefore ineligible for PTC if the individual (or a person claiming the individual as a dependent) provided incorrect information to the Exchange with intentional or reckless disregard for the facts (defined the same as above). (Reg 1.36B-2(c)(2)(v))

ELIGIBILITY FOR EMPLOYER-SPONSORED COVERAGE FOR MONTHS DURING A PLAN YEAR

The regulations under section 36B provide that an individual is eligible for minimum essential coverage through an eligible employer-sponsored plan if the individual had the opportunity to enroll in the plan and the plan is affordable and provides minimum value. The Treasury Department and the IRS are aware that in some instances individuals may not be allowed an annual opportunity to decide whether to enroll in eligible employer-sponsored coverage. This lack of an annual opportunity to enroll in employer-sponsored coverage should not limit an individual's annual choice from available coverage options through the Marketplace with the possibility of benefitting from the premium tax credit.

The regulations clarify that if an individual declines to enroll in employer-sponsored coverage for a plan year and does not have the opportunity to enroll in that coverage for one or more succeeding plan years, for purposes of section 36B, the individual is treated as ineligible for that coverage for the succeeding plan year or years for which there is no enrollment opportunity and as such would be eligible for Marketplace coverage and the PTC.

Note: In general, an applicable large employer will not be treated as having made an offer of coverage to a full-time employee for a plan year if the employee does not have an effective opportunity to elect to enroll in the coverage at least once with respect to the plan year. For this purpose, a plan year must be twelve consecutive months, unless a short plan year of less than twelve consecutive months is permitted for a valid business purpose.

EXCEPTED BENEFITS

The regulations clarify that for purposes of section 36B an individual is considered eligible for coverage under an eligible employer-sponsored plan only if that plan is minimum essential coverage. Accordingly, an individual enrolled in or offered a plan consisting solely of excepted benefits is not denied the premium tax credit by virtue of that excepted benefits offer or coverage.

INSURANCE OPT-OUT ARRANGEMENTS

Employers occasionally provide their employees with opt-out programs. An opt-out payment is a payment that:

(1) is available only if the employee declines coverage (which includes waiving coverage in which the employee would otherwise be enrolled) under the employer-sponsored plan, and

(2) cannot be used to pay for coverage under the employer-sponsored plan.

Proposed Regulations - Prop Reg 1.36B-2(c)(3)(v)(A)(7) defines an "eligible opt-out arrangement" as an arrangement under which the employee's right to receive the opt-out payment is conditioned on:

(1) The employee declining to enroll in the employer-sponsored coverage and

(2) The employee providing reasonable evidence that the employee and all other individuals that the employee reasonably expects to claim as a dependent for the tax year or years that begin or end in or with the employer's plan year to which the opt-out arrangement applies (employee's expected tax family) have or will have minimum essential coverage (other than coverage in the individual market, whether or not obtained through the Marketplace) during the period of coverage to which the opt-out arrangement applies. For example, if an employee's expected tax family consists of the employee, the employee's spouse, and two children, the employee would meet this requirement by providing reasonable evidence that the employee, the employee's spouse, and the two children, will have coverage under the group health plan of the spouse's employer for the period to which the opt-out arrangement applies.

CALIFORNIA DIFFERENCES

NOTE

The following does not take effect until 2020, so it is not something you need to be concerned about for over a year (i.e., for 2020 returns), and by that time the state should have the forms and procedures in place.

New Law & Stuff

Individual Market Assistance (Government Code Sec 100800-100825) - SB 78, signed by the governor 6/27/2019, created a California Individual Market Assistance program that is authorized to provide health care coverage financial assistance, including advanced premium assistance subsidies, to California residents with household incomes below 600% of the federal poverty level. The program will run from 2020 through 2022, after which it is repealed and no new financial assistance or other subsidies are to be provided. (Gov Code Sec 100825(b))

A California individual taking advantage of the advanced assistance from the state will be required to file a California income tax return, even if their income is below the income-based filing requirement, to reconcile the advances with the actual amount allowed based on household income, family size, etc., and to repay any excess advances (up to a limit to be determined by the program) or receive a refund if the actual subsidy allowed exceeds the advances.

To be eligible for a premium assistance subsidy from the California program, a California resident must be eligible for the federal premium tax credit authorized under IRC Sec 36B, except that premium assistance subsidy shall not be subject to the income requirements of Sec 36B.

It is the Legislature's intent that the regulations promulgated under IRC Section 36B as of January 1, 2019, shall apply to the extent that those regulations do not conflict with CA law or regulations issued by the Exchange (Covered California) or Franchise Tax Board.

NOTES

IMPORTANT

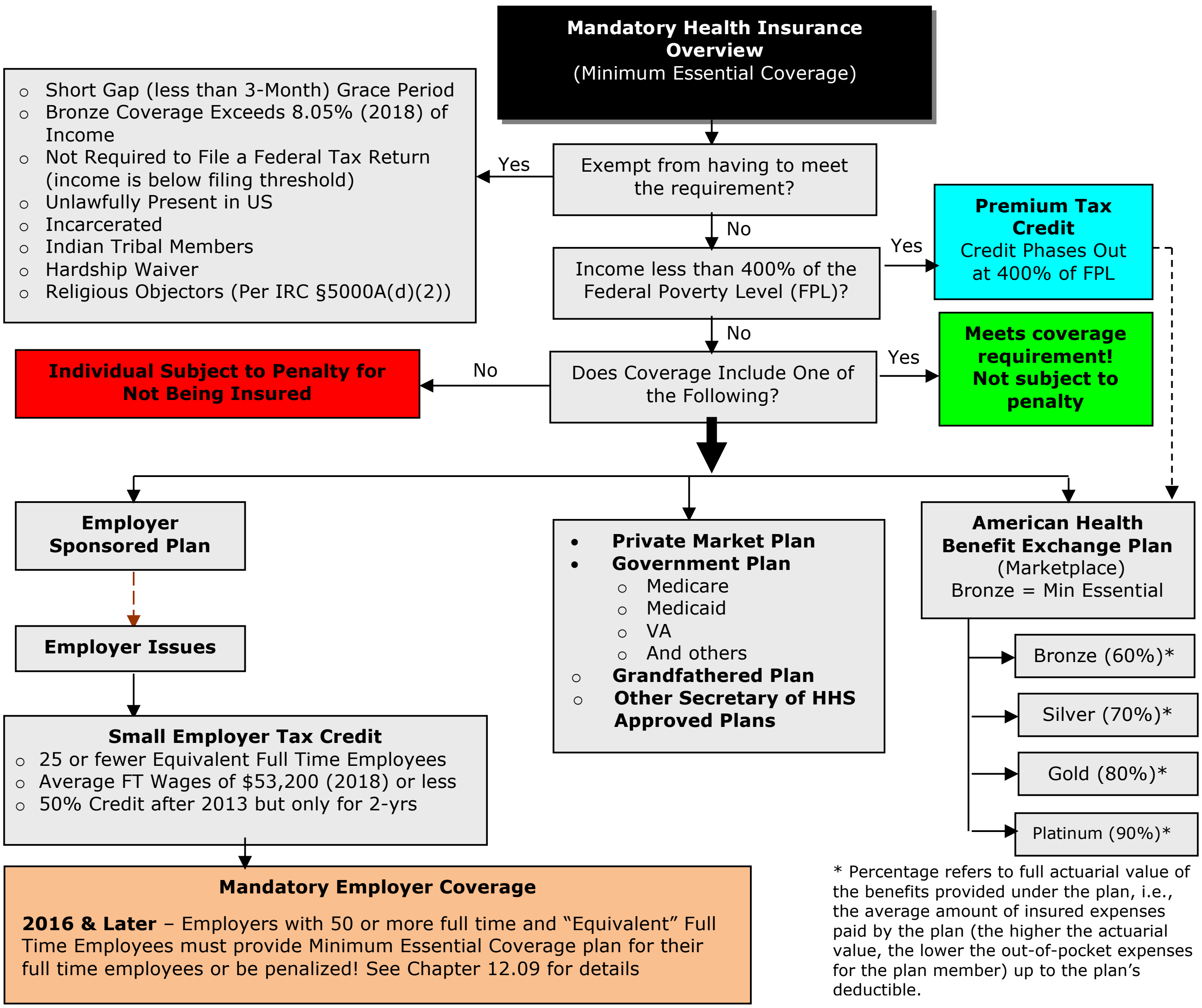
The federal "shared responsibility payment" (penalty for not being insured) **NO LONGER APPLIES after 2018**. However, this chapter is being retained to provide the information and exceptions for prior years. For **California preparers**, the state is reintroducing the penalty beginning for 2020 tax year and will generally following these federal rules, See details at the end of this chapter.

SHARED RESPONSIBILITY PAYMENT
(Penalty for Not Having Health Insurance)

Overview

Individuals are liable for a penalty tax under Code Sec. 5000A for not carrying health insurance. Rather than calling it a penalty, which it is, Congress chose the name "Shared Responsibility Payment", we assume, to gloss over the issue.

And who do you think gets to compute the penalty? You guessed it – you the tax preparer are becoming a part of the health care industry.



* Percentage refers to full actuarial value of the benefits provided under the plan, i.e., the average amount of insured expenses paid by the plan (the higher the actuarial value, the lower the out-of-pocket expenses for the plan member) up to the plan's deductible.

Related IRC and IRS Publications and Forms –

- **Form 8965 –** Health Coverage Exemptions
- **Form 1095-**A – Health Insurance Marketplace Statement
- **Form 1095-B** – Health Coverage
- **Form 1095-C** – Employer-Provided Health Insurance Offer and Coverage
- **IRC Sec 5000(A)** – Shared Responsibility Payment
- **Treas. Decision T.D. 9632** (Reg §§1.5000A-0 – 1.5000A-5)
- **Pub 5156** – Facts about the Individual Shared Responsibility Provision.
- **Pub 5172** – Facts about Health Coverage Exemptions

TCJA has eliminated the shared responsibility payment effective in 2019. Congress didn't *actually* repeal this penalty; instead, it *effectively* repealed it by tweaking the law so that the percentage of household income used in the penalty calculation is 0%, and the flat dollar amount is $0, which causes the amount of the penalty to be $0.

Affordability Exception to Penalty - For purposes of the affordability exception to the shared responsibility penalty, the IRS in Notice 2017-74, states that if an individual resides in a rating area served by a Marketplace that does not offer a bronze plan, the lowest cost metal-level plan available in the Marketplace serving the rating area in which the individual resides should be used. Applies for tax years ending after December 31, 2016.

SHARED RESPONSIBILITY PAYMENT

The Affordable Care Act (ACA) refers to the penalty for not being insured as the Shared Responsibility Payment, based on the legislation's premise that everyone should be insured. The Shared Responsibility Payment will be referred to as a penalty in this publication.

Nonexempt U.S. Citizens and legal resident taxpayers will be penalized for failing to maintain at the least the minimum essential health coverage, which includes:

- Government-sponsored programs (e.g., Medicare, Medicaid, Children's Health Insurance Program),
- Eligible employer-sponsored plans,
- Plans in the individual market, and
- Certain grandfathered group health plans and other coverage as recognized by Health and Human Services (HHS) in coordination with IRS.

The penalty was phased in beginning in 2014 and fully implemented in 2016 through 2018.

Penalty (Sec 5000A(c)) - The penalty for noncompliance is the **lesser** of:

(A) The sum of the **monthly penalty amounts** for months in the taxable year during which 1 or more such failures occurred, or

(B) An amount equal to the national average premium for qualified health plans which have a **bronze level of coverage**, provide coverage for the applicable family size involved, and are offered through Exchanges (Marketplaces) for plan years beginning in the calendar year with or within which the taxable year ends.

National Average Cost of Bronze Coverage

Family Size	1	2	3	4	5 or More
2016 Per Month	$223	$446	$669	$892	$1,115
Full Year	$2,676	$5,352	$8,028	$10,704	$13,380
2017 Per Month	$272	$544	$816	$1,088	$1,360
Full Year	$3,264	$6,528	$9.792	$13,056	$16,320
2018 Per Month	$283	$566	$849	$1,132	$1,415
Full Year	$3,396	$6,792	$10,188	$13,584	$16,980

Monthly Penalty Amounts **–** The monthly penalty amount is an amount equal to 1/12 of the **greater of** the following amounts:

Year	2014	2015	2016-18
Flat Dollar Amounts (annual)			
Adult……………………..	$95.00	$325.00	$695.00
Individual Under 18….	$47.50	$162.50	$347.50
Percentage of Income Rate:	1.0%	2.0%	2.5%

(A) Flat dollar amount – (See computation of the flat dollar amount below)

(B) Percentage of income - An amount equal to the applicable percentage for the year (see table) multiplied by the taxpayer's household income for the year exceeds the taxpayer's income tax filing threshold.

Flat Dollar Amount – The flat dollar amount is the **lesser of**:

1. The sum of the applicable dollar amounts (see table above) for all individuals who were not covered for the month *or*
2. 300% of the per adult penalty (maximum $2,085 in 2018).

Example - Unmarried taxpayer without minimum essential coverage *- In 2018, Gil is an unmarried individual, under age 65, with no dependents who doesn't have minimum essential coverage for any month in 2018. Gil's household income is $120,000 and his applicable filing threshold is $12,000. The annual national average bronze plan premium for Gil is $3,264 (Note: we are using the 2017 value since the 2018 value was not available at the time this chapter was updated.) For each month in 2018, from the table, Gil's applicable dollar amount is $695.*

- *Gil's flat dollar amount is* ***$695*** *(the lesser of $695 or $2,085 ($695 x 3)).*
- *Gil's percentage of excess household income amount is* ***$2,700*** *(($120,000-$12,000) x 0.025).*
- *The monthly penalty is 1/12 of the greater of foregoing amounts. Therefore, the monthly penalty amount is $225 ($2,700/12)). Of course the sum of the* ***monthly penalty amounts*** *is ($2,700, unless Gil qualifies for the short coverage gap grace period (explained later in this chapter).*
- *The penalty is the lesser of the sum of the monthly penalty amounts (($2,700) and the cost of the bronze coverage ($3,264). Thus the penalty is $2,700.*

Why Are Monthly Amounts & Annual Amounts Determined?

As you went through the example above you probably asked yourself, why do I compute an annual amount and then divide it by 12 and then turn around and multiply it by 12 again to get the annual amount? There is a logical reason. Even though the percentage of income calculation is based upon annual household income less the filing threshold amount times a fixed percentage, the flat dollar amount could change during the year due to marriage, death, children, etc. Thus if the dollar amount turns out to be the greater amount, the sum of those dollar amounts will be used and each month may be different.

If an applicable individual has not attained the age of 18 as of the beginning of a month, the "applicable dollar amount" for the month will be equal to one-half of the amount shown in the table divided by 12.

NOTE: The 1040 includes a check box, for example on line 61 on the 2017 form (1040-EZ, line 11; 1040-A, line 38) that indicates "Full Year" coverage. If that box is checked it is presumed that the taxpayer is not subject to a shared responsibility payment for the year and the penalty computation is not required.

Penalty Computation Form: The following is a reproduction of the shared responsibility payment (penalty) worksheet taken from the instructions for Form 8965. There is no penalty form that is included with the return. The penalty is computed on the worksheet and transferred directly to line 61 of the 1040

PENALTY EXEMPTIONS

The following table is based on the instructions for Form 8965. (See next page)

Coverage Exemption	Granted By Marketplace	Claimed On Return	Code For Exemption
Income below the filing threshold — Taxpayer's gross income or household income was less than the taxpayer's applicable minimum threshold for filing a tax return.		√	No Code
Coverage considered unaffordable — The minimum amount the taxpayer would have paid for premiums is more than 8.16% of the taxpayer's household income.		√	A
Short coverage gap — Taxpayer went without coverage for less than 3 consecutive months during the year.		√	B
Citizens living abroad and certain noncitizens — Taxpayer was: • A U.S. citizen or resident alien physically present in a foreign country or countries at least 330 full days during any period of 12 consecutive months; • A U.S. citizen who was a bona fide resident of a foreign country or U.S. territory for an uninterrupted period that includes an entire tax year; • A bona fide resident of a U.S. territory; • A resident alien who was a citizen or national of a foreign country with which the U.S. has an income tax treaty with a nondiscrimination clause, and was a bona fide resident of a foreign country for the entire tax year; • Not lawfully present in the U.S and not a U.S. citizen or U.S. national. For more information about who is treated as lawfully present for purposes of this coverage exemption, visit healthcare.gov; or • A nonresident alien, including (1) a dual-status alien in the first year of U.S. residency and (2) a nonresident alien or dual-status nonresident alien who elects to file a joint return with a U.S. spouse. This exemption not applicable for a nonresident alien who for the year met certain presence requirements and elected to be treated as, a resident alien. more information see Pub 519.		√	C
Members of a health care sharing ministry — The taxpayer was a member of a health care sharing ministry.		√	D
Members of Indian tribes — Taxpayer was either a member of a Federally recognized Indian tribe, including an Alaska Native Claims Settlement Act (ANCSA) Corporation Shareholder (regional or village), or was otherwise eligible for services through an Indian health care provider or the Indian Health Service.	*	√	E
Incarceration — The taxpayer was in a jail, prison, or similar penal institution or correctional facility after the disposition of charges.		√	F
Aggregate self-only coverage considered unaffordable — Two or more family members' aggregate cost of self-only employer sponsored coverage was more than 8.16% of household income, as was the cost of any available employer sponsored coverage for the entire family.		√	G
Resident of a state that did not expand Medicaid — The taxpayer's household income was below 138% of the federal poverty line based on family size and at any time in 2017 the taxpayer resided in a state that didn't participate in theedicaid expansion under the Affordable Care Act.		√	G
Member of tax household born or adopted during the year — The months before and including the month that an individual was added to the taxpayer's tax household by birth or adoption. Claim only if also claiming another exemption on Form 8965.		√	H
Member of tax household died during the year – The months after the month that a member of the tax household died during the year. Claim this exemption only if taxpayer is also claiming another exemption on Form 8965.		√	H
Members of certain religious sects — The Marketplace determined that the taxpayer is a member of a recognized religious sect.	√		ECN Required
Ineligible for Medicaid based on a state's decision not to expand Medicaid coverage — The Marketplace found that the taxpayer would have been determined ineligible for Medicaid solely because the state in which taxpayer resided didn't participate in Medicaid expansion under the ACA.	√		ECN Required
General hardship — Marketplace determined taxpayer experienced a hardship that prevented him/her from obtaining coverage under a qualified health plan.	√		ECN Required
Coverage considered unaffordable based on projected income — Marketplace determined taxpayer didn't have access to coverage that is considered affordable based on taxpayer's projected household income.	√		ECN Required
Certain Medicaid programs that are not minimum essential coverage —Marketplace determined taxpayer was (1) enrolled in Medicaid coverage provided to a pregnant woman that is not recognized as minimum essential coverage; (2) enrolled in Medicaid coverage provided to a medically needy individual (also known as Spend-down Medicaid or Share-of-Cost Medicaid) that is not recognized as minimum essential coverage; or (3) enrolled in Medicaid coverage provided to a medically needy individual, and was without coverage for other months because the spend-down had not been met.	√		ECN Required
The coverage exemptions for members of Indian tribes, is no longer granted by the Marketplace, except in Connecticut. See the instructions for Part 1, later, to claim the exemption.			

ADDITIONAL EXPLANATIONS FOR EXEMPTIONS

Line 7a Check Box – Household income below filing requirement - Taxpayers with household income below the income tax filing threshold are automatically exempt from the shared responsibility penalty. If the individual taxpayer qualifies under this exemption then everyone in the taxpayer's tax household is exempt for the entire year. If for some reason the taxpayer wishes to file a return, the 8965 must be attached and the "yes" box checked on line 7a. Of course the household gross income includes the taxpayer's MAGI and the MAGIs of all members of his or her tax family that are required to file a return.

2017 Filing Thresholds

Single <65:	$10,400	MFJ both under 65:	$20,800	SS <65:	$16,750
Single 65+:	$11,950	MFJ one 65+:	$22,050	SS 65+:	$$18,000
HH <65:	$13,400	MFJ both 65+:	$23,300		
HH 65+:	$14,950	MFS:	$4,050		

2018 Filing Thresholds

Single <65:	$12,000	MFJ both under 65:	$24,000	SS <65:	$24,000
Single 65+:	$13,600	MFJ one 65+:	$25,300	SS 65+:	$25,300
HH <65:	$18,000	MFJ both 65+:	$26,600	MFS <65:	$5
HH 65+:	$19,600			MFS 65+:	$5

Code A - Coverage considered unaffordable – For 2018 this exemption applies to individuals who cannot afford coverage because their required contribution for employer-sponsored coverage or the lowest cost "bronze plan" in the local Insurance Marketplace exceeds 8.05% (8.16% in 2017) of household income. If self-only coverage is affordable to an employee, but family coverage is unaffordable, the employee is subject to the penalty if he does not maintain minimum essential coverage. However, any individual eligible for employer coverage due to a relationship with an employee (e.g. spouse or child of employee) is exempt from the penalty if that individual does not maintain minimum essential coverage because family coverage is not affordable (i.e., exceeds 8.05% of household income). The final regulations provide that, when determining whether an individual is exempt based on inability to afford coverage, the taxpayer's household income is increased by the portion of the required contribution made through a salary reduction arrangement and excluded from gross income.

Code B - Short Coverage Gap Grace Period – No penalty is assessed for individuals who do not maintain health insurance for a continuous period of **less than three** full calendar months that is the first short coverage gap of the tax year. If an individual exceeds the gap limit during the taxable year, the penalty for the full duration of the gap during the year is applied. If there are multiple gaps in coverage during a calendar year, the exemption from penalty applies only to the first such gap in coverage.

> ***Example –*** *Della has minimum essential coverage in 2018 from Jan. 1 through March 2, when she quits her job and loses coverage under her employer's plan, and again beginning June 15 when she starts work with a new employer and has coverage under the new employer's plan. Thus Della has the required coverage for Jan., Feb., March and June through December. Her continuous period without coverage is two months, April and May, so she's eligible for penalty exemption under the short coverage gap exception. If Della's coverage with the new employer wasn't effective until July 1, she would have had a 3-month continuous period without coverage (April, May, June), which would not be considered a short gap in coverage and she would be subject to penalty for those 3 months. (based on Reg 1-5000A-3(j)(2) and (4), Examples 1 and 2)*

The following example illustrates the rule provided in Reg 1-5000A-3(j)(3) for gaps spanning two years:

> ***Example*** *- Fay, an unmarried individual with no dependents, has minimum essential coverage for the period January 1 through October 15, 2017. Fay is without coverage until enrolling in an eligible employer-sponsored plan effective February 15, 2018. She files her tax return for 2017 on March 10, 2018. Under the regulations, November and December of 2017 are treated as a short coverage gap. However, November and December of 2017 are included in the continuous period that includes January 2018. The continuous period for 2018 is not less than 3 months and, therefore, is not a short coverage gap.*

Code C – Citizens living abroad and certain noncitizens – No penalty is assessed on an individual who is a U.S. citizen or resident alien who was physically present in a foreign country or countries for at leas 330 full days during any period of 12 consecutive months or a U.S. Citizen who is a bona fide resident of a foreign country or U.S Territory or is neither a U.S. citizen or U.S. national nor an alien lawfully present in the U.S.

Code D – Members of a health care sharing ministry – IRC Sec. 5000A(d)(2) provides religious exemption from the penalty for being insured for members of health care sharing ministries. As defined in that section of the code, a "health care sharing ministry" is a 501(c)(3) organization that is exempt from taxation under section 501(a), and its members:

- Share a common set of ethical or religious beliefs,
- Share medical expenses among members in accordance with those beliefs and without regard to where a member resides or whether or not he or she is employed, and
- Retain membership even after they develop a medical condition.

Furthermore, the organization or a predecessor must have been in existence at all times since December 31, 1999; medical expenses of its members must have been shared continuously and without interruption since at least December 31, 1999; and an annual audit must be performed by an independent certified public accounting firm in accordance with generally accepted accounting principles and made available to the public upon request.

Christian Healthcare Ministry applied for and was granted an exemption in a letter issued January 14, 2014, from the Department of Health and Human Services (HHS) under 5000A. However, the letter also stated that although HHS was granting the exemption, it did not reflect any decision by the IRS as to Christian Healthcare Ministry's compliance with the Internal Revenue Code. So while they are technically not covered by health care insurance, participants in this health care cost-sharing program are eligible for exemption from the shared responsibility penalty.

For the penalty exception, use Code D in Part III of the Form 8965 for any month that the taxpayer and any member of the taxpayer's household were members of the Christian Healthcare Ministry's health care cost-sharing program. Enter the code in column (c), and identify the months to which the coverage exemption applies. For a full year, check Column (e). If not a full year, check the months covered in columns (d) through (p) (Form 8965 instructions). Part I and II of the 8965 would generally be left blank.

Code E – Members of Federally recognized Indian Tribes – Taxpayers that are members of a Federally recognized Indian Tribe are exempt and may have been provided an ECN by the Marketplace. If so, complete Part I of the 8965. If an ECN was not provided the exemption can still be claimed by completing Part III of the 8965.

Code F – Incarcerated Individuals - Taxpayers that are in a jail, prison, or similar penal institution or correctional facility after the disposition of charges are exempt The exemption can be claimed by completing Part III of the 8965.

Code G - Self-only employer-sponsored coverage is more than 8.05% in 2018 (DOWN from 8.16% in 2017) of household income - Two or more family members' aggregate cost of self-only employer-sponsored coverage is more than 8.05% of household income, as is the cost of any available employer-sponsored coverage for the entire family. Note this exception requires the completion of the *affordability worksheet* included in the instructions for the 8965.

Code G - Resident of a state that did not expand Medicaid — Taxpayer's household income was below 138% of the federal poverty line for the taxpayer's family size and at any time in 2018 the taxpayer resided in a state that didn't participate in the Medicaid expansion under the Affordable Care Act.

Code H - Member of tax household born, adopted, or died — During 2018 a child was added to the taxpayer's tax household by birth or adoption, or a member of the tax household died during the year and the full-year coverage checkbox on the tax return can't be checked. For births and adoptions, the exemption applies to the months before and including the birth or adoption, and for deaths, the exemption applies for the months after the month the family member died. These exemptions only apply if also claiming another exemption on the 8965.

ECN Number Required - Members of certain religious sects — In order for a taxpayer to claim an exemption as a member of a recognized religious sect he or she must obtain an exemptions certificate number (ECN) from the marketplace. A recognized religious sect is a religious sect in existence since December 31, 1950, that is recognized by the Social Security Administration as conscientiously opposed to accepting any insurance benefits, including Medicare and social security.

Part I – ECN Number Required – General hardship – See discussion below.

Part I – ECN Number Required – No access to coverage based on household income - Taxpayer does not have access to affordable coverage based on his or her projected household income. This exception requires completing Part I of the 8965 and requires an exemption certificate number (ECN).

Part I – ECN Number Required – Certain Medicaid programs that are not minimum essential coverage — Taxpayer was enrolled in:

(1) Medicaid coverage provided to a pregnant woman that is not recognized as minimum essential coverage;

(2) Medicaid coverage provided to a medically needy individual (also known as Spend-down Medicaid or Share-of-Cost Medicaid) that is not recognized as minimum essential coverage; or

(3) Medicaid, and received minimum essential coverage for one or more months of the year by meeting a spend-down, but not in other months because the spend-down had not been met.

APPLYING FOR EXEMPTIONS WHERE ECN NUMBERS ARE REQUIRED

Self-Certifying - As a result of President Trump's very first executive order, the Centers for Medicare & Medicaid Services (CMS) announced on September 12, 2018 that consumers can claim a hardship exemption for not purchasing health insurance and avoid the shared responsibility penalty (penalty for not being insured) by either:

- Obtaining an ECN through the existing application process, or
- Simply entering the hardship code on their federal income tax return (self-certify).

However, CMS cautioned that consumers should keep with their other tax records any documentation that demonstrates qualification for the hardship exemption.

Applying For An ECN - A number of exemptions require approval in the form of one or more exemption certificate numbers (ECN). ECNs are obtained by filing an application available at www.healthcare.gov. Here are the appropriate links:

Application Form: http://marketplace.cms.gov/applications-and-forms/hardship-exemption.pdf

Hardship Exemptions - The following is a full list of situations (for 2017) that qualify for a hardship exemption and the documentation required. (See next page)

Hardship Number	Category	Documentation Required
1	Homeless	None
2	Evicted in the past 6 months or were facing eviction or foreclosure.	Copy of eviction or foreclosure notice
3	Received a shut-off notice from a utility company	Copy of shut-off notice from a utility company
4	Recently experienced domestic violence.	None
5	Recently experienced the death of a close family member.	Copy of death certificate, copy of death notice from newspaper, or copy of other official notice of death
6	Experienced a fire, flood, or other natural human-caused disaster that caused substantial damage to taxpayer's property.	Copy of police or fire report, insurance claim, or other document from government agency, private entity, or news source documenting event
7	Filed for bankruptcy in the last 6 months	Copy of bankruptcy filing
8	Had medical expenses the taxpayer couldn't pay in the last 24 months.	Copies of medical bills
9	Experienced unexpected increases in necessary expenses due to caring for an ill, disabled, or aging family member.	Copies of receipts related to care
10	Expect to claim a child as a tax dependent who's been denied coverage in Medicaid and the Children's Health Insurance Program (CHIP) for 2017, and another person is required by court order to give medical support to the child. (Penalty for child is waived in this case.)	Copy of medical support order AND copies of eligibility notices for Medicaid and CHIP showing that the child has been denied coverage
11	As a result of an eligibility appeals decision, the taxpayer is eligible either for: 1) Enrollment in a qualified health plan (QHP) through the Marketplace, 2) Lower costs on your monthly premiums, or 3) Cost-sharing reductions for a time period when the taxpayer wasn't enrolled in a QHP through the Marketplace in 2016.	Copy of notice of appeals decision
12	Taxpayer was determined ineligible for Medicaid because his/her state didn't expand eligibility for Medicaid in 2017 under the Affordable Care Act.	Copy of notice of denial of eligibility for Medicaid
13	Taxpayer received a notice saying that his/her "grandfathered" individual health insurance plan (that taxpayer had since 3/23/2010 or before) was cancelled because it doesn't meet the ACA requirements, and taxpayer believes other Marketplace plans are unaffordable.	Copy of notice of cancellation
14	Taxpayer experienced another hardship in obtaining health insurance.	Please submit documentation if possible

Hardship exemptions usually cover the month before the hardship, the months of the hardship and the month after the hardship, but the Marketplace may provide for a longer exemption period, up to a full calendar year.

Family Glitch Issue

The term "family glitch" refers to how some low-to-moderate-income families may be locked out of receiving financial assistance to purchase health coverage through the health insurance Marketplaces. It is based on two facts:

(1) The term "affordable" is based solely on individual coverage and does not take into consideration cost of family coverage.

(2) If an employer offers affordable coverage to the employee, the affordable criteria has been met and thus the family is not qualified for the premium tax credit.

As a result, even though the insurance is affordable for the employee, the other members of the family cannot get an insurance subsidy through the Marketplace. If they do, it will have to be repaid when they file their return.
This situation does qualify for an exemption to the penalty, and if the family income is below 133% of the federal poverty level, the children should qualify for free or low cost CHIP coverage.

TRANSFERRING THE COVERAGE EXEMPTIONS TO THE PENALTY WORKSHEET

Where a family member has an exemption for the month or the year, **DO NOT** check the corresponding months for that individual on the penalty worksheet.

OTHER ISSUES & DEFINITIONS

Minimum Essential Coverage – The following are types of minimum essential coverage. Individuals could be enrolled in more than one type of coverage for the year, so it is important to consider all coverages when determining how many qualifying months of coverage an individual has:

Employer Sponsored Coverage:

- Group health insurance coverage for employees under—
  - A governmental plan, such as the Federal Employees Health Benefit program
  - A plan or coverage offered in the small or large group market within a state
  - A grandfathered health plan offered in a group market
- A self-insured health plan for employees

- COBRA coverage
- Retiree coverage
- Coverage under an expatriate health plan for employees

Individual Health Coverage:
- Insurance purchased directly from an insurance company
- Health insurance purchased through the Marketplace
- Health Insurance provided through a student health plan
- Catastrophic plans
- Coverage under an expatriate health plan for non-employees such as students and missionaries

Government Sponsored Plans:
- Medicare Part A coverage
- Medicare Advantage plans
- Most Medicaid coverage*
- Children's Health Insurance Program (CHIP)
- Most types of TRICARE coverage
- Comprehensive health care programs offered by the Department of Veterans Affairs
- Health coverage provided to Peace Corps volunteers
- Department of Defense Nonappropriated Fund Health Benefits Program
- Refugee Medical Assistance
- Coverage through a Basic Health Program (BHP) standard health plan

Other Minimum Essential Coverage: See list of plans whose coverage has been recognized as Minimum Essential Coverage (MEC) through the Centers for Medicare & Medicaid Services (CMS) application process at: https://www.cms.gov/CCIIO/Programs-and-Initiatives/Health-Insurance-Market-Reforms/Downloads/MEC_PublicList_for-508_FINAL_02-01-17.pdf

**Medicaid programs that provide limited benefits generally don't qualify as minimum essential coverage. However, a hardship exemption may be obtained from HHS for individuals with certain types of limited-benefit Medicare coverage.*

DEFINITIONS & OTHER ISSUES:

CHIP - is short for the Children's Health Insurance Program – free or low cost insurance to uninsured children and teens (up to age 19) of low-income families who are not eligible for or enrolled in Medical Assistance. Generally, eligibility for CHIP coverage applies for families with incomes up to 200% of the federal poverty level.

CHIP Buy-in Programs - In Notice 2015-37, the IRS has determined that individuals who qualify and enroll in Children's Health Insurance (CHIP) "buy-in" programs that HHS has designated as minimum essential coverage are treated as eligible for minimum essential coverage (and thus eligible for the premium tax credit and avoid the penalty for not having coverage).

In certain states, certain individuals in households with income exceeding eligibility levels for CHIP may enroll in coverage resembling coverage under the state's CHIP program. These programs, commonly called CHIP "buy-in" programs, generally require the payment of premiums with little or no government subsidy.

TRICARE - is a health benefit program for all seven uniformed services. Individuals must be listed by the Defense enrollment Eligibility Reporting System as being eligible for military health care benefits.

Definition of a Month for Coverage - For any calendar month, an individual is treated as having minimum essential coverage if the individual is enrolled in and entitled to receive benefits under a qualifying program or plan for at least one day. (Reg. § 1.5000A-1(b))

Liability for Dependent Coverage – Under Code Sec 5000A, nonexempt individuals are subject to the penalty for any dependent that **may** be claimed on their tax return not just those that they actually claim. The penalty applies regardless of whether or not the the potential dependent is claimed (Reg Sec 1.5000A-1(c)).

This will prove to be a problem in divorce situations where one parent has custody of a child and claims the child as a dependent, but the noncustodial parent is required by the divorce decree to pay for medical insurance, and has not done so or has purchased coverage that does not meet the minimum essential coverage requirement. The final IRS regulations make no exception for these circumstances and the custodial parent is liable for the penalty. However, Health and Human Services (HHS) has addressed this situation in guidance that permits Exchanges (Marketplaces) to grant a hardship exemption under 45 CFR 155.605(g)(1) to the custodial parent for a child in this situation if the child is ineligible for coverage under Medicaid or the Children's Health Insurance Program (CHIP). See HHS Center for Consumer Information & Insurance Oversight, Guidance on Hardship Exemption Criteria and Special Enrollment Periods (June 26, 2013). (T.D. 9632, Summary of Comments and Explanation of Revisions)

If an individual may be claimed as a dependent by more than one taxpayer in the same year, the taxpayer who properly claims the individual as a dependent is liable for the shared responsibility payment attributable to the individual. If more than one taxpayer may claim an individual as a dependent in the same year but no one claims the individual as a dependent, the taxpayer with priority under the dependency tie-breaker rules to claim the individual as a dependent is liable for the individual's shared responsibility payment. (Reg 1.5000A-1(c)(2))

Family Size - For computing a taxpayer's shared responsibility payment with respect to any nonexempt individual included in the taxpayer's shared responsibility family, the final regs clarify that the applicable family size involved for purposes of identifying the appropriate bronze level plan includes only the nonexempt members of the taxpayer's shared responsibility family who do not have minimum essential coverage. (Reg. § 1.5000A-4)

Household Income - Household income is the sum of the modified adjusted gross incomes (MAGIs) of the taxpayer and all individuals accounted for in the family required to file a tax return for that year. A taxpayer's family means the individuals for whom the taxpayer properly claims a deduction for a personal exemption under Sec 151 for the taxable year (this would only apply for years 2014 – 2017 since the TCJA suspended the exemption deduction for 2018). Modified AGI means AGI increased by all tax-exempt interest and excluded foreign earned income (Code Sec. 5000A(c)(4)). **Note:** Even though an individual is liable for the penalty for dependents they may claim (even if they don't), they are only required to include in household income the MAGI of the dependents they actually claimed.

Kiddie Tax - If a parent makes the election to include the child's income on their return, household income includes the child's gross income included on the parent's return and the child is treated as having no gross income (Reg. 1.5000A-1(d)(10)(ii)).

Drop Dependents? Based on the regulations, even if a dependent is not claimed, a taxpayer who could claim the exemption is still stuck with the penalty. However, under those same regulations, only the MAGI of a dependent actually claimed and who is required to file a return is counted in determining the penalty under the percentage of income method.

Before dropping a dependent, one must consider the tax benefits lost by not claiming a child, such as exemption amount (pre-2018), child credit, childcare deduction, EITC, etc. To make things further complicated, even if the benefits outweigh the additional penalty, the refund may be taken to pay the penalty.

Adopted Children - Special rules apply to individuals who are adopted or placed in foster care during a tax year. (Reg. § 1.5000A-1(c)(2)(ii)) In general, if a taxpayer legally adopts a child and is entitled to claim the child as a dependent for the tax year when the adoption occurs, the taxpayer is not liable for a shared responsibility payment attributable to the child for the month of the adoption and any preceding month. Conversely, if a taxpayer who is entitled to claim a child as a dependent for the tax year places the child for adoption during the year, the taxpayer is not liable for a shared responsibility payment attributable to the child for the month of the adoption and any following month.

Penalty Enforcement - For a joint return, the individual and spouse are jointly liable for any penalty payment. Under Sec 5000A(g) the penalty for failing to carry health insurance "shall be paid upon notice and demand by the Secretary, and shall be assessed and collected in the same manner as an assessable penalty" under Code Sec. 6671 through 6725. Thus the IRS will not be permitted to:

(i) file a notice of lien with respect to any property of a taxpayer by reason of any failure to pay the penalty, or

(ii) levy on any property of a taxpayer with respect to such a failure.

However, the authority to offset refunds or credits is not so limited. Noncompliance with the personal responsibility requirement to have health coverage is not subject to criminal or civil penalties under the Code and interest does not accrue for failure to pay such assessments in a timely manner. (Committee Report) Therefore enforcement is generally limited to seizing a refund.

CALIFORNIA DIFFERENCES

NOTE: California has decided to pick up where the Feds left off with one intervening year. So, for 2019 neither CA nor the Federal return will include a penalty. But beginning in 2020 CA will begin imposing an individual mandate on Californians generally following the former Federal Guidelines. See the details below.

INDIVIDUAL MANDATE

While the TCJA essentially repealed the federal requirement for individuals to have health insurance coverage or be penalized, effective 2019, California's legislature enacted SB 78 (signed by the governor 6/27/2019) that created new Title 24 in the Government Code (sections 100700 – 100725) imposing an individual mandate on Californians. For each month beginning on or after January 1, 2020, a California resident must be enrolled in and maintain minimum essential coverage for that month for him- or herself, spouse, and dependents except in the situations listed below:

(1) An individual who has in effect a certificate of exemption for hardship or religious conscience issued by the Exchange (Covered California) for that month.

(2) An individual who, for that month, is a member of a health care sharing ministry defined the same as in IRC Sec 5000A(d)(2)(B) on January 1, 2017.

(3) An individual who is incarcerated for that month, other than incarceration pending the disposition of charges.

(4) An individual who is not a citizen or national of the United States and is not lawfully present in the United States for that month.

(5) An individual who is a member of an Indian tribe, as defined in IRC Sec 45A(c)(6), during that month.

(6) An individual for whom that month occurs during a period when the individual's tax home is in a foreign country (i.e., meets either the bona fide resident or substantial presence test of IRC Sec 911).

(7) An individual who is a bona fide resident of a possession of the United States, as determined under IRC Sec 937(a), for that month.

(8) An individual who is a bona fide resident of another state for that month.

(9) An individual who is enrolled in limited or restricted scope coverage under the Medi-Cal program or another health care coverage program administered by and determined to be substantially similar to limited or restricted scope coverage by the State Department of Health Care Services for that month.

Individuals, other than those listed above who fail to have minimum essential coverage, or who qualify for one of the exceptions noted below, will be subject to an individual shared responsibility penalty (new R&TC Sec 61015), calculated in much the same way as the federal penalty was. The penalty is the lesser of:

(a) The sum of the monthly penalty amounts (defined below) for months in the taxable year during which one or more of the failures occurred, or

(b) An amount equal to one-twelfth of the state average premium for qualified health plans that have a bronze level of coverage for the applicable household size involved, and are offered through the Covered California for plan years beginning in the calendar year with or within which the taxable year ends, multiplied by the number of months in which a failure occurred.

The monthly penalty amount is one-twelfth of the greater of (1) or (2) below:

(1) An amount equal to the lesser of either of the following:

(a) The sum of the applicable dollar amounts for all applicable household members who failed to enroll in and maintain minimum essential coverage. The applicable dollar amount is $695 ($347.50 for individuals under age 18 as of the beginning of the month) and is subject to inflation adjustment.

(b) 300% of the applicable dollar amount determined for the calendar year during which the taxable year ends.

(2) An amount equal to 2.5% of the excess of the responsible individual's applicable household income for the taxable year over the amount of gross income that would trigger the responsible individual's requirement to file a state income tax return (the applicable filing threshold), for the taxable year.

If an individual who is subject to the state's shared responsibility penalty fails to timely pay it, the individual is not subject to a criminal prosecution or penalty with respect to that failure and the FTB may not place a lien on or levy any real property of the individual. (R&TC 61025(b)(1) and (2)) Otherwise, the individual would be subject to the usual FTB notice and collection actions.

Exceptions to the Penalty – No penalty applies if:

- The responsible individual's required contribution, determined on an annual basis, for coverage for the month exceeds 8.3% (as adjusted for inflation) of that responsible individual's applicable household income for the taxable year.
- The responsible individual's applicable household income for the taxable year containing the month is less than the amount of adjusted gross income or gross income specified for that taxable year for the return filing requirement.
- The last day of the month occurred during a period in which the applicable household member did not maintain minimum essential coverage for a continuous period of three months or less.

NOTES

CASE STUDIES

CASE STUDY #1 - (Married Couple – Employer Does or Does Not Offer Coverage) – 2019 Return

In this case we will look at the various possibilities for Jack, who is married to Jill, and works for ABC Manufacturing. Jill does not work. Here are the facts of Jack's situation:

- Jack & Jill's annual household income: **$31,930**
- Number in household is: **2**
- Poverty level (2018 poverty table used for **2019** returns; page 12.02.04) is: **194% ($31,930/(12,140 + 4,320))**
- Applicable percentage (table page 12.02.07 – using 2018 table since 2019 table not available) is: **.0606**
- Jack & Jill's monthly baseline premium is: **161.25** (($31,930 x .0606) /12).

> **161.25** is the monthly amount the government feels Jack and Jill should pay towards their own insurance.

Assume the cost of Jack & Jill's insurance, second lowest cost Silver *(SLCSP),* from an Exchange is: **$450 per month.**

- Then Jack and Jill's monthly Premium Tax Credit (or Advance PTC) is: **$288.75** (450 – 161.25).

> The credit (or subsidy) is the difference between the cost of the Silver *(SLCSP)* level of coverage, **$450** per month, less the amount that the government feels they should pay towards their own insurance, **161.25** per month, or **$288.75** per month.

- The national average premium for Bronze coverage for a couple (page 12.03.02) is: **$566 per month** (using the 2018 amount for this example since the 2019 amount wasn't available at publication time)
- If Jack & Jill are uninsured in 2019 there is no penalty since TCJA set the penalty amounts to zero**.**

Scenario A: - If **<u>ABC DOES NOT offer a health care plan OR does not offer an affordable plan:</u>**

(1) ***<u>Jack and Jill</u>*** may choose to purchase a health plan through an Insurance Exchange (Marketplace), and regardless of the level of coverage they select, they will qualify for the **$288.75** per month premium tax credit (PTC). The premiums for health insurance purchased through an exchange are based upon coverage, the insured's ages and location of residence. The credit can be taken as an advance premium tax credit (APTC), or as credit on their tax return, or some of both. But it will be reconciled on the tax return for the year and if the APTC exceeds the PTC, some portion of it must be paid back. For example if they chose the Silver coverage at $450 per month, and the APTC, Jack and Jill's monthly out-of-pocket **premium cost would be $161.25** ($450.00 - $288.75) .

(2) ***<u>Jack and Jill</u>*** could choose not to have the advance payment (subsidy) applied to their monthly premium and instead claim a tax credit of $3,465 ($288.75 x 12) when they file their 2019 return. The amount of the credit that exceeds their tax is refundable. Generally most taxpayers who are eligible utilize the advance payment to subsidize their premium and have less to pay each month for their insurance coverage.

(3) ***<u>Employer Consequences</u>*** –If Jack's employer, ABC, had fewer than 50 employees in the prior year there are no consequences for ABC.

- If ABC had 50 or more equivalent employees in the prior year, and Jack or another full-time employee is enrolled in and qualifies for the advance premium tax credit (subsidy), then the employer will be subject to the large employer excise tax for not offering affordable health care.

Scenario B: - **<u>ABC is a large employer and DOES offer an affordable health care plan:</u>**

(1) **Jack and Jill** can purchase their insurance through ABC's plan. Concerns: (1) If ABC offers affordable minimum essential coverage, Jack and Jill DO NOT qualify for the premium tax credit (PTC) or advance PTC. (2) Jack's employer may or may not supplement the cost of Jack's insurance. (3) The premiums paid by ABC

for Jack and Jill's health insurance are excludable from Jack's W-2. (4) To be classified as affordable only the portion of the premiums for Jack's coverage needs to meet the affordable criteria.

(2) If the premiums for Jack's coverage alone through ABC's plans meet the affordable criteria, then Jack is not qualified for the premium tax credit. This is true even if ABC's coverage for Jack and Jill together does not meet the affordable criteria. In such a case, Jack would not qualify for the PTC or APTC through an Exchange, but **Jack** could purchase his coverage through his employer's plan and benefit from any employer subsidy while **Jill** could purchase insurance through an Exchange and qualify for the PTC and could choose an advance PTC (subsidy).

> **PROBLEM:** In this case, Jack and Jill probably wish Jack's employer did not offer qualified affordable health care insurance, since that fact disqualifies Jack from the PTC and APTC and could actually make their insurance coverage more expensive.

(3) **Jack and Jill** can choose not to have insurance. The TCJA made the penalty $0 for individuals who don't have health insurance coverage, effective for 2019 and later years.

(4) ***Employer Consequences:***

a. If for 2019 ABC has 25 or fewer employees with an average wage of $54,200 or less and pays at least 50% of the cost of the employee's coverage, ABC would qualify for the small employer health insurance credit, provided ABC purchases the insurance through an Insurance Exchange and ABC hasn't claimed the credit in two prior years. These Exchanges are not the same ones that individuals will use to purchase health insurance. The Exchanges for small employers are covered under the Small Business Health Options Program (SHOP) – see Chapter (section) 12.08 and https://www.healthcare.gov/what-is-the-shop-marketplace/ for additional information.

b. If for 2019 ABC has fewer than 50 employees in the prior year and does not qualify for the small employer credit then there are no consequences.

c. If for 2019, ABC has fewer than 50 employees (under a provision of the "21st Century Cures Act" beginning for 2017) ABC may reimburse its employees under a health reimbursement arrangement (HRA) for medical expenses without being liable for a $100 per day draconian penalty (IRC Sec 4980D) for violating the Affordable Care Act (ACA)'s rules. See chapter 12.10.

d. If ABC has 50 or more employees in the prior year and provides affordable health care for all of its employees, there are no consequences.

e. If ABC has 50 or more employees and provides health care coverage, but has a wide range of pay scales, it is conceivable the coverage would meet the affordable criteria for some employees but not all. In those cases, should one or more of the employees go to an Exchange for insurance and qualify for a PTC/APTC the employer would be subject to the employer penalty.

CASE STUDY #2 - (Single Individual –Advance Credit-Payback) –

2019 Return - In this case we will look at the various possibilities for Mary who is employed at XYZ Industries. She is single with no dependents. Her employer does not offer health coverage. Here are the facts of Mary's situation for **2019:**

- Mary's estimated annual household income for 2019: **$34,500**
- Number in household is: **1**
- Her 2019 poverty level (from table on page 12.02.07) is: **284%** (($34,500/12,140) x 100)
- Her applicable percentage (Using 2018 amounts) is: **.0909**
- Mary's monthly baseline premium is: **$261.34** (($34,500 x .0909)/12)

> **$261.34** is the monthly amount the government feels Mary should pay towards her own insurance.

- Assume the cost of Mary's insurance (**Silver**) from an Exchange is: **$290 per month**
- Then Mary's monthly Advance Premium Tax Credit (or Subsidy) is: **$28.66** (290 – 261.34)

> The PTC is the difference between the cost of the Silver *(SLCSP)* level of coverage, **$290** per month, and the amount that the government feels Mary should pay towards her own insurance, **$261.34** per month, or **$28.66** per month.

If Mary is uninsured in 2019 there is no penalty since TCJA set the penalty amounts to zero**.**

Scenario A: Mary chooses to purchase a health plan through an Exchange, and regardless of the level of coverage she selects, and based upon her household income, she will qualify for a **$28.66** per month PTC. Mary chooses Silver coverage with a monthly premium of $290.00 per month. She also decides to take the PTC as an APTC so she pays a premium of **$261.34** (290.00 – $28.66) per month. When she has her tax return prepared her household income is the same as projected so she receives no additional premium tax credit nor does she have to repay any of the advance PTC (subsidy).

Scenario B: Same as scenario A, except Mary chooses not to utilize the advance premium tax credit so she pays a premium of $290.00 per month. When she has her tax return prepared her household income is the same as projected so she receives a premium tax credit of $343.92 ($28.66 x 12, rounded).

Scenario C: Same as scenario A, except Mary loses her job and doesn't notify the exchange of her change in income. Her actual household income for the year is only $23,340. That makes her estimated poverty level percentage 192% (($23,340/12,140) x 100). instead of the projected 290%. As a result, her applicable percentage (using 2018 values) is .0597. That changes her monthly baseline premium to $116.12 ((23,340 x .0597/12). Subtracting that from the cost of Silver coverage from the exchange we find that Mary's actual premium tax credit for the year is $2,086.56 ((290.00 – $116.12) x 12). She used $343.92 ($28.66 x 12) as an APTC, so she is entitled to the difference, $1,742.64 ($2,086.56 – $343.92), as a refundable credit on her tax return for the year.

Scenario D: Same as scenario A, except Mary receives a raise and a bonus that bring her household income for the year to $50,000. As a result Mary's income is above the 400% of poverty level limit, and she does not qualify for the PTC. Since she chose to utilize the APTC to offset her premiums based upon her projected household income and does not actually qualify for the credit based upon her actual household income, she must repay the APTC when she files her return for the year. Thus she would have to repay the full $344 APTC.

CASE STUDY #3 - (Divorced or Separated Parents) – **2019** Return

Marilee is divorced and has a child age 10. Her ex-husband, John, pays her taxable alimony of $2,000 a month and child support payments of $600 per month. She has no other income. She files as head of household in 2019.

- Marilee's annual household income for 2019: **$24,000** ($2,000 x 12)
- Number in household is: **2**
- Her poverty level from table on page 12.02.04 is: **146%** ((($24,000/(12,140 + 4,320)) x 100)
- Her applicable percentage (Using 2018 amounts) is: **.0379**
- Marilee's monthly baseline premium is: **75.80** (($24,000 x .0379)/12)
- Assume the cost of Marilee's insurance (**Silver**) from an Exchange is: **$310 per month**
- Then Marilee's monthly Premium Tax Credit (or APTC) is: **$234.20** (310 – 75.80)

If Marilee is uninsured in 2019, there is no penalty since TCJA set the penalty amounts to zero**.**

Scenario A: Marilee is unemployed and claims their child as a dependent. Since Marilee claims the child, Marilee is the one that may claim the premium tax credit for the health insurance premium she pays for her child (if the insurance is bought through an Exchange). The monthly cost of Silver coverage for her and her child is $310. Her premium tax credit is $234.20 (310 – 75.80) per month. So, Marilee's coverage will cost her 75.80 per month ($$909.60 per year), and she could lower that even further by selecting Bronze coverage instead of the Silver plan. However, under a Bronze plan her co-pays, the portion of the bills she has to pay for prescription drugs and hospital stays, plus the overall amount she could be out-of-pocket for the year generally will be higher than for a Silver plan. So Marilee will need to weigh the monthly savings of a Bronze plan against the potential extra total costs of the Bronze plan. There are no repercussions to John with respect to providing healthcare coverage for his child.

Scenario B: Same as scenario A except Marilee decides not to procure insurance. There is no penalty since TCJA set the penalty amounts to zero. There are no repercussions to John with respect to providing healthcare coverage for his child.

Scenario C: Same as scenario A, with Marilee purchasing insurance for her child through an Exchange, but pursuant to their divorce decree, John pays the premiums for the child's coverage. Because Marilee claims the child, and acquires the insurance through an Exchange, any premiums paid by John are treated as paid by Marilee and she gets the premium tax credit. Marilee could have the premiums reduced by using the APTC and only have John pay the difference. If by some chance, it turns out the APTC was excessive, then Marilee would be liable for any repayment. She could choose not to utilize the APTC and instead claim the premium tax credit on her tax return. Whether she would reimburse John for any of the credit would be at Marilee's discretion or by court order.

Scenario F: Same scenario as A except Marilee receives only $1,000 per month alimony and has no other income. Her annual Household income is $12,000 and for a family of two that is below 100% (138% in states with enhanced Medicaid) of the federal poverty level and Marilee does not qualify for the premium tax credit. Instead she qualifies for Medicaid (Medi-Cal in CA).

CASE STUDY #4 - (Young Adult – Student – Self-Supporting – Independent) – **2019 Return**

Susan, age 22, is a full-time student attending University in 2019.

Scenario A: She has no income and her parents pay all her education expenses. Because Susan is under the age of 24, is a full time student and is not self-supporting she would be a qualifying child of her parents. If her parents file a joint return, and provide minimum essential health insurance for Susan they may qualify for a premium tax credit and an APTC depending on the amount of their household income and what percentage of the poverty level it is. If they don't provide any insurance for Susan, there is no penalty for the parents or Susan since TCJA set the penalty amounts to zero.

Scenario B: Susan uses student loans to pay her tuition and school expenses and has part-time employment with an employer that does not have an affordable health care plan. Her household income consists of her employment income of $10,000. No one else contributes to Susan's support so she is self-supporting. Since her income is below 100% (138% in states with enhanced Medicaid) of the federal poverty level, Susan will not qualify for the premium tax credit. Susan would qualify for Medicaid (Medi-Cal in CA).

Scenario C: Same as scenario B except Susan makes $18,000 from her part-time employment. Her employer does not offer an affordable healthcare plan. Her income is 148% of the federal poverty level. As a result she qualifies for the PTC and APTC.

- 2019 poverty level is: **148%** ((18,000/12,140) x 100)
- Her applicable percentage (Using 2018 amounts, Page 12.02.07) is: **0.0391**
- Susan's monthly baseline premium is: **$58.65** (($18,000 x .0.0391)/12)
- Assume the cost of Susan's insurance (**Silver**) from an Exchange is: **$190 per month**
- Then Susan's monthly Premium Tax Credit (or APTC) is: **$131.35** (190 – **$58.65**)

Thus Susan' monthly insurance premium through an exchange is $58.65 for Silver coverage or less if she selects a **$175** per **month Bronze coverage**

If Susan does not buy the insurance there is no penalty since TCJA set the penalty amounts to zero**.**

Scenario D: Other things that could impact Susan's results would be non-qualified distributions from Sec 529 plans, non-qualified distributions from Coverdell accounts, and taxable scholarships which will add to her AGI and household income.

CASE STUDY #5 - (Retired Couple)

Charlie, age 66, and Joyce, age 60, are retired. The year is **2019.**

Scenario A: Charlie is covered under Medicare that qualifies as minimum essential coverage. Joyce is too young for Medicare. Charlie and Joyce's only income is $2,000 per month from Social Security. Their household income for the year is $24,000 (all of the SS is included in household income) For 2019 and later years there is no penalty if they choose not to have health insurance coverage for Joyce.

Scenario B: Same as scenario A, except Charlie takes a taxable distribution from his Traditional IRA account of $35,000. Thus $8,550 of the SS becomes taxable. The $35,000 taxable IRA distribution added to the $24,000 of SS income results in a household income of $59,000 for PTC purposes.

- **2019** poverty level is: **358%** (59,000/(12,140 + 4,320)) x 100
- Their applicable percentage (Using 2019 amounts, Page 12.02.07) is: **.0956**
- Joyce's baseline premium is: **470.03** (($59,000 x .0956)/12)
- Assume the cost of Joyce's insurance (**Silver**) from an Exchange is: **$325 per month**
- Then Joyce's monthly Premium Tax Credit (or APTC) is: **$0.00** (325 – **470.03**)

Thus Joyce's monthly insurance premium through an exchange is $325 for Silver coverage or less if she selects **Bronze coverage**. If Joyce does not buy the insurance there is no penalty since TCJA set the penalty amounts to zero.

CASE STUDY #6 - (Employee – With and Without Affordable Employer Plan)

Tricia, age 40, is self-supporting and works full time for an accounting firm. She has one 16-year-old daughter Carmen that she claims as a dependent and who qualifies Tricia to file as head of household. The daughter has a part-time job and earns $3,000. Tricia's AGI is $31,000. Because Carmen's income is below the filing threshold, Carmen's income is not included in Tricia's household income.

- Tricia's annual household income is: **$31,000**
- Number in the household: **2**
- 2019 poverty level is: **188%** (31,000/(12,140 + 4,320)) x 100
- Her applicable percentage (Using 2018 amounts, Page 12.02.07) is: **.0579**
- Tricia's monthly baseline premium is: **$149.58** (($31,000 x .0579)/12)
- Assume the monthly cost of Tricia's Silver coverage from the Exchange is: **$310**
- Then Tricia's monthly premium tax credit (or APTC) is: **$160.42** (310 – $149.58)

Scenario A: Tricia's employer does not provide a health care plan. Tricia purchases insurance for Carmen and herself through the Exchange and elects the APTC. **Her health insurance will cost her $160.42 per month $1,925 per year).** If she itemizes her deductions, she can include her out-of-pocket cost as part of her medical expenses. The premiums and the other medical expenses may end up not being deductible because of the 10% of AGI rule.

Scenario B: Tricia's employer does provide affordable health care insurance for Tricia and Carmen and supplements Tricia's premiums by $100 per month. Assuming Tricia's premiums under the employer plan are the same as in scenario A, but without APTC ($310 per month), the cost of **Tricia's health insurance is $210.00 ($310 minus the employer supplement of $100) per month ($2,520 per year).** Since Tricia's employer offers an affordable care plan Tricia does not qualify for the premium tax credit. Not considering the benefits and co-pays, Tricia's cost of insurance would be less if the employer did not have a plan and she was able to qualify for the PTC/APTC.

These comparisons show some inequities in the application of the premium tax credit, and why the government is trying to get individuals covered under employer plans by offering incentives for the small employers and penalties to large employers.

NOTES

NET INVESTMENT INCOME TAX

For Individuals the Surtax is **3.8%** of the **lesser of**:

- Taxpayer's net investment income, or
- Excess MAGI over the threshold amount.

Threshold Amounts for Individuals (not inflation adjusted):

- $125,000 for MFS
- $200,000 for S and HH
- $250,000 for MFJ and SS

For an estate or trust, the surtax is **3.8%** of the **lesser of:**

- Undistributed net investment income or
- The excess of AGI over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

Related IRC and IRS Publications and Forms

- **Code Section 469** – Passive Activities
- **Code Section 1411 –** Net Investment Income Tax
- **Final Regulations** §1.1411-1 – §1.1411-10
- **Proposed Regulations** §1.1411-7
- **Publication 550** – Investment Income and Expense
- **Form 4952** – Investment Interest Expense Deduction
- **Form 8960**
- **Form 1040 Schedule A**

The surtax has come to be referred to as the "Net Investment Income (NII) Tax." Although passed as part of the Affordable Care Act, the tax goes to the government's general fund. This tax is imposed on individuals, estates and trusts.

For years 2018 through 2025, investment expenses are not deductible. Thus investment expenses are not deductible in determining NII for those years and not being able to deduct investment expenses in determining NII will essentially increase NII and as a result the surtax on NII.

TAX COMPUTATION

Individuals **-** For individuals, the surtax is 3.8% of the **lesser** of:

1. The taxpayer's **net** investment income or
2. The excess of modified adjusted gross income over the threshold amount ($250,000 for a joint return or surviving spouse, $125,000 for a married individual filing a separate return, and $200,000 for all others). Note: These amounts will **not** be indexed for inflation.

Example 1: *A single taxpayer has net investment income of $100,000 and MAGI of $220,000. The taxpayer would pay a NII tax only on the $20,000 amount by which his MAGI exceeds his threshold amount of $200,000, because that is less than his net investment income of $100,000. Thus, the taxpayer's NII tax would be $760 ($20,000 × 3.8%).*

Example 2: *Married taxpayers filing jointly have net investment income of $100,000, the husband has wages of $300,000, and their MAGI is $375,000. The taxpaying couple would pay a NII tax of $3,800 ($100,000 x 3.8%) since their MAGI exceeds the MAGI threshold by more than their net investment income ($375,000 – 250,000 = $125,000). Of special note: In addition to paying the net investment income tax of $3,800, the taxpayers would also pay an additional HI (Medicare) tax of $450 ($50,000 x 0.9%) on his wages in excess of $250,000 (as explained in chapter 12.06).*

Estates & Trusts **-** For an estate or trust, the surtax is 3.8% of the lesser of (Sec. 1411(a)(2)):

1. Undistributed net investment income or
2. The excess of AGI over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

2019 TRUST & ESTATE INCOME TAX RATES

Over	Taxable Income But Not Over	Pay	Plus	Of the Amount Over
-0-	$2,600	-0-	10%	-0-
$2,600	$9,300	$260.00	24%	$2,600
$9,300	$12,750	$1,868.00	35%	$9,300
$12,750		$3,075.50	37%	$12,750

Highest Bracket Threshold

***Example 3:** In 2019 a trust has undistributed net investment income of $20,000. The highest tax bracket for a trust in 2019 begins at $12,750. The trust's AGI is $30,000. The excess of the AGI over the initiation point of the highest tax bracket is $17,250. Since $17,250 is less than the $20,000 of undistributed NII, the surtax will be $655.50 (3.8% of $17,250).*

Generally Won't Apply to Simple and Grantor Trusts
Simple trusts require all income to be distributed and don't provide for charitable contributions. Income from grantor trusts is taxable to the owner (grantor) of the trust.

Estates and trusts not subject to the Net Investment Income Tax - The following trusts are not subject to the Net Investment Income Tax:

- Trusts that are exempt from income taxes imposed by Subtitle A of the Internal Revenue Code (e.g., charitable trusts and qualified retirement plan trusts exempt from tax under section 501, and Charitable Remainder Trusts exempt from tax under section 664).
- A trust or decedent's estate in which all of the unexpired interests are devoted to one or more of the purposes described in section 170(c)(2)(B).
- Trusts that are classified as "grantor trusts" under sections 671-679.
- Trusts that are not classified as "trusts" for federal income tax purposes (e.g., Real Estate Investment Trusts and Common Trust Funds).
- Electing Alaska Native Settlement Trusts.
- Perpetual Care (Cemetery) Trusts.

DEFINITIONS

Modified Adjusted Gross Income (MAGI) - Is the taxpayer's adjusted gross income (AGI) - increased by the amount excluded from income as foreign earned income under Code Sec. 911(a)(1) (net of the deductions and exclusions disallowed for the foreign earned income). (Code Sec. 1411(d))

Net investment income - "Net" investment income (NII) is investment income reduced by investment expenses allowed which are allocable to the investment income.

Investment income – (Explained in more detail later in the chapter) Investment income includes gross income from:

- Interest, dividends, non-qualified annuities, and royalties,
- Rents (other than derived from a trade or business),
- Capital gains (other than derived from a trade or business),
- Trade or business income that is a passive activity with respect to the taxpayer, and
- Trade or business income with respect to trading financial instruments or commodities.
- Prorated state and local income tax refunds - *Since prorated taxes are allowed as a deduction against NII, then appropriate refund of those taxes must be allocated to NII in the year the refund is received.*

Exclusions from Gross Income - For surtax purposes, gross income doesn't include excluded items, such as **interest on tax-exempt bonds**, veterans' benefits, and excluded gain from the sale of a principal residence (Code Sec 1411(d)).

Investment Expenses – Expenses allowable in computing NII include deductions that are properly allocable to items of Gross Investment Income. Examples include (IRS Q&A 12):

- Investment interest expense[(1)],
- Investment advisory and brokerage fees[(1)],
- Expenses related to rental and royalty income, and
- State and local income taxes properly allocable to items included in Net Investment Income[(2)].

[(1)] *For years before 2018 and after 2025, these items are included in a taxpayer's itemized deductions. The amounts allowed are after the reduction of miscellaneous deduction by 2% of AGI and after the Pease limitation (phase out of itemized deductions) for Schedule A deductions for higher income taxpayers. If a taxpayer claims the standard deduction, investment income may **not** be reduced by these expenses when computing NII.*

[(2)]*State and local income taxes are deductible as an itemized deduction but are not part of the Tier 2 miscellaneous deductions.*

If a credit is claimed for foreign income taxes, those foreign taxes are not deductible in computing net investment income.

TCJA

CAUTION

Per TCJA, investment expenses includible as Tier 2 miscellaneous deductions are not deductible for years 2018 through 2025. Thus these investment expenses are not deductible in determining NII for those years.

Net Investment Income for Most Taxpayers

Thus, for taxpayers that don't engage in passive activities or a commodities trading business, net investment income will include non-business income from interest, dividends, annuities, rents, and capital gains less allowed deductions.

The surtax does not apply to (explained in more detail later in the chapter):

- Income from other trades or businesses conducted by a sole proprietor, partnership, or S corporation (Committee Report). However, income, gain, or loss on working capital isn't treated as derived from a trade or business and thus is subject to the tax (Code Sec. 1411(c)(3)).
- A nonresident alien,
- A trust of all the unexpired interests in which are devoted to charitable purposes,
- A trust that's tax-exempt under Code Sec. 501,
- A charitable remainder trust tax-exempt under Code Sec. 664 or
- Distributions from qualified retirement plans (qualified pension, stock bonus or profit sharing plans; qualified annuity plan; tax-sheltered annuity plan; traditional and Roth IRAs; Sec. 457(b) plans of state and local governments and tax-exempt organizations).
- Self-employment income for such taxable year on which the 0.9% HI surtax tax is imposed.

NET INVESTMENT INCOME

Net investment income is investment income less allowed investment expenses. Reg. Section 1.1411-4(a)(1) breaks the definition of "net investment income" into three subparagraphs:

(i) Gross income from interest, dividends, annuities, royalties, rents, substitute interest payments, and substitute dividend payments (as defined in Reg. Section 1.1411-1(d));

(ii) Other gross income derived from a trade or business described in Reg. Section 1.1411-5; and

(iii) Net gain attributable to the disposition of property (as described in Reg. Section 1.1411-4(d)).

The term that the tax community has begun to use in defining net investment income in the three categories above is "one little i income", "two little i income", and "three little i income."

Categories of Net Investment Income

ONE LITTLE I
Interest (including substitute)
Dividends (including substitute)
Annuities
Royalties
Rents

TWO LITTLE I
Gross income derived from a trade or business as described in Reg 1.1411-5.

THREE LITTLE I
Gain Attributable to the disposition of property.

ONE LITTLE I INCOME

This category includes income from interest, dividends, annuities, royalties, rents, substitute interest payments, and substitute dividend payments. In general, the definitions in this category are fairly straightforward with the following exceptions:

Gross income from dividends includes: corporate dividends; constructive dividends; amounts treated as distributions under Section 1248(a), relating to the gain from the sale of stock in a controlled foreign corporation; and amounts distributed by an S corporation that are treated as a dividend by virtue of the fact that the distribution is deemed to have come from earnings and profits accumulated in prior C corporation years. In the preamble to the proposed regulations, the IRS clarified that capital gain dividends from mutual funds and real estate investment trusts (REITs) are to be included as net gain "three little i income," not as dividend income.

Annuity income (other than from qualified plans) of any type, including from annuities purchased pre-2013, is subject to the tax. However, a deduction is allowed for the Code Sec 72(b)(3) unrecovered basis in a decedent's annuity (Reg. Section 1.1411-4(f)(3)(iv)).

Exceptions to being classified as investment income – there are four exceptions to being classified as investment income in this category:

1. Tax-exempt interest earned on state and local tax-exempt bonds.
2. Distributions from qualified pension plans.
3. Interest paid to an employee by an employer under a nonqualified deferred compensation plan.
4. Income earned in the ordinary course of a trade or business.

Example 4A: *Your client is in the mortgage loan business and earns interest on the loans. The interest income earned is income earned in the course of a trade or business and is* ***NOT*** *subject to the tax on investment income.*

Example 4B: *Your client is in the business of selling furniture. He also earns interest on the business' bank accounts. Since the client is not in the business of lending money, the interest income from the business accounts* ***IS*** *subject to the tax on investment income.*

Example 4C: *If your client in Example 4B also sold furniture on time and carried back the paper, then the interest earned on the notes would be income earned in the course of a trade or business and* ***IS NOT*** *subject to the tax on investment income.*

Rental Income as One Little I income – Before the proposed regulations for Sec 1411 were released many believed that qualifying as a real estate professional and materially participating in a rental activity would shield the rental income from the 3.8% unearned income tax. However, that is not enough. According to the preamble of the regulations, to be excluded **each** rental must meet the following criteria:

a) Is engaged in a trade or business under the meaning of the tax law (measured at the business level).

b) The income must be earned in the ordinary course of the trade or business (measured at the business level).

c) The income must not be passive to the individual owner (determined at the owner level).

Being a real estate professional satisfies requirements b) and c) but what about a), the requirement to be engaged in a trade or business?

Definition of a Trade or Business

There is no bright line definition of a trade or business in the over 70,000 pages of the tax code. The IRS in the final regulations relies in part on Sec 162 – Trade or Business Expenses – to help define a Trade or Business. The determination can be subjective and the regulations generally leave the determination to the taxpayer (or his preparer) to get it right. We will encounter this issue throughout the study of net investment income.

In order for a rental activity to rise to the level of a trade or business, the taxpayer's involvement in the activity must be regular, continuous, and substantial. Key factual elements that may be relevant in determining if the rental rises to the level of a trade or business include, but are not limited to, the following, according to the IRS in the preamble to the final regulations:

- Type of property (commercial real property versus a residential condominium versus personal property, for example);
- Number of properties rented;
- Day-to-day involvement of the owner or his agent;
- Type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease)

CAUTION

The IRS concedes in the preamble to the final regulations that a single rental could require **regular and continuous** involvement such that the rental activity is a trade or business under Sec 162. But the **IRS warns** that not every single property rises to the level of a trade or business as a matter of law. In addition, the IRS, in cases where other Code provisions use a trade or business standard that is the same or substantially similar to the Section 162 standard adopted in the final regulations, indicates they will closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of Section 1411, but not a trade or business for such other provisions. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of Section 1411, the IRS will take into account the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by section 6041.

Example 1 – Taxpayer rents a single-family residence and just collects a monthly rental check. That clearly does not rise to the level of a trade or business, and therefore the rents from that rental are subject to the 3.8% tax. But remember the tax is on the net investment income so you can deduct expenses.

Example 2 – Taxpayer owns a 20-tenant commercial rental that produces $1,000,000 in annual income. The taxpayer’s involvement in the activity is regular, continuous, and substantial. As a result, the rental activity is clearly a trade or business and not subject to the Sec 1411 tax.

Note: When the properties are sold, the gain from the property in example #1 will be subject to the 3.8% tax while the gain from the property in example #2 will not.

<u>*Limited Liability Company (LLC)*</u> – It is increasingly common for rental properties to be held in separate LLCs. The proposed regulations require that the determination of whether an activity rises to the level of a trade or business must be done at the *entity* level.

Example *– Jay owns 5 commercial properties through separate LLCs. He also owns two residential rental properties through separate LLCs. The trade or business determination must be made at the entity level, and for Sec 1411 purposes, the fact that Jay qualifies as a real estate professional and has grouped all the properties for purposes of the material participation test has no effect on the determination of whether the entity rises to the level of a trade or business. In Jay’s situation the commercial properties probably meet the trade or business requirement while the two residential rentals do not. Thus, the income from the commercial properties can be excluded from net investment income for purposes of the 3.8% surtax, while the income from the residential rentals cannot.*

Passive Income versus Trade or Business Income – Making the allocation between passive and trade or business activities in order to avoid the 3.8% tax can have some unexpected ramifications that should be carefully considered. The IRS failed to provide a bright line definition of a trade or business, and is relying on the provisions related to Sec 162 – Trade or Business Expenses.

- Because non-passive income cannot be offset by passive losses, treating profitable rental activities as a trade or business to avoid the tax on investment income will also deny them any offsetting passive losses from other passive rental activities and passive loss carryovers. It might be that passive losses will offset passive income and not create an investment tax problem in the first place.
- But treating rental activities that could be treated as a trade or business as passive in order to net passive gains and losses could have an unintended result when a rental is sold, since the gain from the sale of a passive activity is also subject to the 3.8% tax.

<u>TWO LITTLE I INCOME</u>

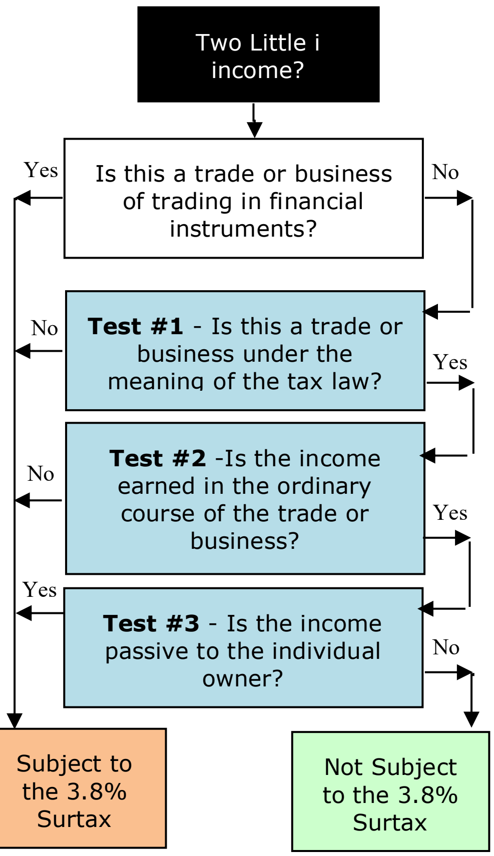
Subparagraph “two little i” of Reg. Section 1.1411-4(a)(1) operates by reference to Reg. Section 1.1411-5, stating that net investment income includes <u>all other gross income derived from a trade or business described within that regulation section which is:</u>

1. ***The trade or business of trading in financial instruments or commodities*** – this includes any and all income earned from the trading in financial instruments or commodities, regardless of whether the individual owner materially participates in the business. The regulations define “financial instruments” as stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of these items, such as a short position or partial units of these items.

2. ***A passive activity*** - Under this provision, all of the income allocated to an individual owner from a business – even if the income represents normal, operating income rather than items that we normally associate with investment income, such as dividends and interest – will be included in net investment income if the activity is passive to the individual. Thus income from an S-Corporation, a partnership and a sole proprietorship will be treated as investment income unless all three of the following tests are met:
   a) The entity or sole proprietorship is engaged in a trade or business under the meaning of the tax law (measured at the business level).
   b) The income must be earned in the "ordinary course of the trade or business" (measured at the business level).
   c) The income must not be passive to the individual owner (determined at the <u>owner</u> level).

   In general, the regulations under Section 469 provide that an activity is passive to an individual unless that individual "materially participates" in the activity.

   Note: rental activities are treated as passive regardless of an individual's level of participation, unless the "real estate professional" standard is met.



<u>Material Participation</u> - The following tests determine material participation (only one test needs to be met to qualify a taxpayer as a material participant):

<u>Time Tests</u> **-** A taxpayer is a material participant in an activity if the taxpayer:

(1) Participates **500 HOURS** or more during the tax year;

(2) Provides "**SUBSTANTIALLY ALL THE PARTICIPATION"** in the activity;

(3) **SPENDS MORE THAN 100 HOURS** on the activity and nobody spends more time than this on the activity; or

(4) **SPENDS AGGREGATE TIME** over 500 hours on all "significant participation activities" (SPA's). A SPA is an activity in which the taxpayer spends over 100 hours during the year, but cannot meet one of the three other time tests.

<u>Prior participation tests</u> **-** A taxpayer may be a material participant based on prior participation rather than TIME. The taxpayer may meet either of these criteria:

(5) Participate in the activity "materially" **IN <u>ANY</u> 5 OF THE LAST 10 TAX YEARS**; or

(6) TAXPAYER is in a **PERSONAL SERVICE BUSINESS** and **WAS** a **MATERIAL PARTICIPANT IN ANY 3 PREVIOUS TAX YEARS**.

<u>SPECIAL RULE FOR LIMITED PARTNERS</u>
Limited partners are generally not treated as material participants. If a taxpayer wishes to rebut the presumption, only tests 1, 5, and 6 above may be used. The other tests are not available.

Example*: Jack and his son Junior each own 50% of the stock of an S corporation, a retail car dealership that has been in business for the last four years. Both Jack and Junior received wage income appropriate to the time and activities they performed for the S corporation. Jack is almost retired and only worked 100 hours during the year while his son Junior worked full time at the business putting in over 2,080* *hours during the year. The S corporation earns $800,000 from selling cars. Jack and Junior's respective K-1s each show $400,000 of ordinary income on line 1. The business certainly rises to the level of a trade or business so it passes test a) above and the income was earned from the conduct of the trade or business of selling cars so it passes test b). However, test c) provides different results for the father and son. For Jack the income is passive because he did not materially participate in the business, and as a result, his passive income is treated as investment income subject to the 3.8% tax. Junior, on the other hand, meets test c) since he materially participated, and so the $400,000 passed through on Junior's K-1 is not subject to the 3.8% tax.*

Grouping Activities to Meet the Material Participation Rules - Meeting the material participation requirements for one business may be quite simple, but what if the taxpayer owns an interest in several businesses and even though he or she works full time at all of them cannot meet the 500 hour requirement for each?

Regulation Section 1.469-4 allows individuals to "group" certain activities for purposes of passive activity rules. Unfortunately the regulations do not provide a bright line rule but rather provide subjective guidance to grouping activities. It suggests the greatest weight in determining whether activities can be grouped is based upon the following factors:

- Similarities and differences in types of trades or businesses;
- The extent of common control;
- The extent of common ownership;
- Geographical location; and
- Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

The following examples are taken from the regulations:

Example (1) - Taxpayer C has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. In this case, after taking into account all the relevant facts and circumstances, there may be more than one reasonable method for grouping C's activities. For instance, depending on the relevant facts and circumstances, the following groupings may or may not be permissible: a single activity; a movie theater activity and a bakery activity; a Baltimore activity and a Philadelphia activity; or four separate activities.

Example (2) - Taxpayer B, an individual, is a partner in a business that sells non-food items to grocery stores (partnership L). B also is a partner in a partnership that owns and operates a trucking business (partnership Q). The two partnerships are under common control. The predominant portion of Q's business is transporting goods for L, and Q is the only trucking business in which B is involved. Under this section, B appropriately treats L's wholesale activity and Q's trucking activity as a single activity.

<u>*Grouping rental activity with a trade or business*</u> - A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit, and

- The rental activity is insubstantial in relation to the trade or business activity;
- The trade or business activity is insubstantial in relation to the rental activity; **or**
- Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case <u>the portion of the rental activity that involves the rental of items of property for use in the trade or business activity</u> may be grouped with the trade or business activity.

Example (1) - H and W are married and file a joint return. H is the sole shareholder of an S corporation that conducts a grocery store trade or business activity. W is the sole shareholder of an S corporation that owns and rents out a building. Part of the building is rented to H's grocery store trade or business activity (the grocery store rental). The grocery store rental and the grocery store trade or business are not insubstantial in relation to each other.

However, because they file a joint return, H and W are treated as one taxpayer (§1.469-1T(j)). Therefore, the sole owner of the trade or business activity (taxpayer H-W) is also the sole owner of the rental activity. Consequently, each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. Accordingly, the grocery store rental and the grocery store trade or business activity may be grouped together since the rental activity involves renting to the grocery trade or business.

Example (2) - Attorney D is a sole practitioner in town X. D also wholly owns residential real estate in town X that D rents to third parties. D's law practice is a trade or business activity. The residential real estate is a rental activity and is insubstantial in relation to D's law practice. Under the facts and circumstances, the law practice and the residential real estate do not constitute an appropriate economic unit. Therefore, D may not treat the law practice and the residential real estate as a single activity.

Prohibited Groupings – Certain groupings are prohibited:

- The grouping of real property rentals and personal property rentals is prohibited (Reg §1.469-4(d)(2)).
- Generally limited partner ownerships cannot be grouped with other activities. See Reg §1.469-4(d)(3) for exceptions.

Changing a Grouping - If an individual groups activities into appropriate economic units, the individual must continue using that grouping in subsequent taxable years unless a material change in the facts and circumstances makes it clearly inappropriate.

Grouping Fresh Start Allowed for Taxpayers Subject to the 3.8% Surtax

Because of the enactment of Sec 1411, the regulations include amendments to the Sec 469 regulations to permit taxpayers to elect to regroup their activities for passive activity loss purposes in the first taxable year that they become subject to the 3.8% surtax. (Reg. Section 1.469-11(b)(3)(iv)) Without permitting regroupings, taxpayers would be bound by their original grouping decisions – some of which may be more than two decades old. Any regrouping must comply with the disclosure and reporting requirements of Reg. 1.469-4(e) and Rev. Proc. 2010-13. A taxpayer may regroup activities only once under this provision, and the regrouping will apply to the taxable year for which the regrouping is done and all subsequent years.

Amending to Regroup **-** Taxpayers may regroup activities in the first year they are subject to the NII tax. Taxpayers who are not subject to the §1411 NII tax because they do not have *both* net investment income and MAGI in excess of the applicable threshold may not elect to regroup their activities. But, if the taxpayer, while the statute of limitations period is still open, subsequently amends a post-2012 return and, therefore, becomes subject to the NII tax (or an IRS adjustment creates NII tax), the taxpayer may use the regrouping election on the amended return.

THREE LITTLE I INCOME

Gains from the sale of property are covered separately under Reg. Section 1.1411-4(a)(1)(iii). Included in this category of income are long-term and short-term capital gain, Section 1231 gain, Section 1245 ordinary income recapture, and unrecaptured Section 1250 gain. Exempt from this category of income are gains derived from a trade or business.

Capital Gains – The final regulations allow the net Schedule D loss up to the amount of the **$3,000 ($1,500)** loss limitation to be deductible against NII. This includes losses incurred before the imposition of the NII tax (carryover losses). Except, losses attributable to a trade or business are not subject to the NII tax.

Because Sec. 1411(c)(1)(A)(iii) uses the term net gain (which contemplates a positive number), the regulations provide that the amount of net gain included in net investment income may not be less than zero. Although capital losses in excess of capital gains are not recognized for purposes of Sec. 1411, losses allowable under Sec. 1211(b)(1) and (2) are permitted to offset gain from the disposition of assets other than capital assets that are subject to Sec. 1411. (Sections 1211(b)(1) and (2) cover the annual loss limit deduction and carryover.)

Example 1 *– Fred has wages of $300,000, earned $5,000 of interest income and has a capital loss of $40,000 from the sale of XYZ stock and a capital gain of $10,000 from selling ABC stock. For regular tax purposes Fred has a capital loss of $30,000, of which he can deduct $3,000 against his other income and carry over the remaining $27,000 to future years. For purposes of Sec. 1411, his $10,000 capital gain is reduced by the $40,000 capital loss, so his net gain is zero. He may reduce the $5,000 investment income by the $3,000 of excess capital losses over capital gains and has a capital loss carryover of $27,000.*

Example 2 *– In Year 2, Fred has a $30,000 capital gain on the sale of PDQ stock. For income tax purposes, Fred can reduce the $30,000 gain by the Year 1 $27,000 capital loss carryover. For the Sec. 1411 surtax purposes, Fred's $30,000 gain may also be reduced by the $27,000 capital loss carryover from Year 1. Therefore, in Year 2, Fred has $3,000 net gain for both regular tax and the 3.8% surtax.*

Capital Loss Carryover can be used in subsequent years to offset gain and where applicable create an up to $3,000 ($1,500) loss that can be deducted against NII. Except, losses attributable to a trade or business not subject to the

NII Tax can't be used. Thus every year, whether or not the taxpayer is subject to the NII tax, the capital loss carryover will have to be divided and split between carryover that can be used against NII and that which cannot. This requires the additional computation annually.

Impact of home sales - Where there is a home sale gain, after taking the Sec 121 exclusion, the remaining gain is reported on Form 8949 (Schedule D) and will end up in the computation for net investment income. As a result, in cases where there is a taxable home sale gain and the taxpayer's MAGI exceeds the threshold amount, then some or all of the taxable home sale gain profit could be subject to this surtax. On the other hand, the entire gain from the sale of a second home or one held strictly for investment purposes would be included in the investment income computation.

> ***Example*** *- Jay & Emily sell their home that they have owned and lived in for 35 years for $900,000 (net of selling expenses). Their basis in the home is $200,000. Their gain from the sale is $700,000 and they are able to exclude $500,000 under Sec 121. That leaves them with a $200,000 taxable gain that will also be included in the computation of the net investment income for purposes of the 3.8% surtax.*

Exclusion for Certain Gains - Gain from the sale of property will *not* be included in net investment income, if:

1. The property was held in a "trade or business",
2. The trade or business is not the trade or business of trading in financial instruments, and
3. The trade or business is not passive to the taxpayer.

This exclusion has a dramatic effect on the owners of sole proprietorships, S corporations, or partnerships, as it may serve to remove a wide array of gains that otherwise would be included within net investment income:

> ***Example*** *- A owns 100% of S Co., an S corporation. S Co. is engaged in a trade or business that is not the trading of financial instruments, and A materially participates in the business. S Co. sells an asset used in its business, generating a $20,000 Section 1231 gain that is allocated to A on his Schedule K-1.*
>
> *Because the $20,000 gain allocated to A was held in a trade or business, the trade or business was not the trading of financial instruments or commodities, and the activity is not passive to A, A may exclude the $20,000 gain from his net investment income computation and tax.*

Intangibles & Goodwill - The regulations make it clear that this exclusion includes the gain from the sale of intangible assets, such as self-created goodwill, provided the goodwill was created by a trade or business that is neither the trading of financial instruments nor passive to the taxpayer. The 2013 Prop. Reg. Section 1.1411-4 contains information related to goodwill and partnership distributions. This issue was "reserved" in the final regulations.

Installment Sales - Gain deferred under the Sec 453 installment sale rules is not subject to the surtax in the year of the sale.

Tax Deferred Exchanges - Gain deferred under Sec 1031 is not subject to the surtax to the extent it is deferred into another property.

RENTALS & NII TAX

The intent behind the 3.8-percent net investment income (NII) tax was principally to impose surtax on unearned, passive-type income. However, the statutory language and lengthy regulations have unfortunately turned this straightforward goal into a complex maze of layered rules. Among the areas of particular concern that have developed has been the determination of when rental income is subject to the NII tax. Unfortunately, the final regulations did not provide a definitive bright line solution. **This means we have to navigate some very complex rules that in some cases will require you to make judgment calls.**

> **The basic rule is**: To be **exempt** from the 3.8% NII tax the rental activity must rise to the level of a trade or business and cannot be passive.

Rental Income in Trade or Business - Determining whether rental income or gain is derived in the ordinary course of a trade or business is a key element in determining whether rental income is subject to NII tax. If rental income or gain is not derived in the ordinary course of a trade or business, it is NII irrespective of the passive activity of the taxpayer.

- Direct case law or inferred guidance on the issue of what constitutes a trade or business within the context of rental real estate for NII tax purposes is vague at best. Field Service Advice Memorandum 200120036, in connection with an earned income credit issue, noted that, "Where it is clear from the facts that real estate is devoted to rental purposes, the courts have repeatedly held that such use constitutes use of property in a trade or business, regardless of whether or not it is the only property so used."

- In contrast, however, Example 1 of final Reg. §1.1411-5(b)(2) presents a rental activity of a single commercial building that does not involve the conduct of a trade or business under Code Sec. 162. However, case law holds that the rental of a single property may constitute a trade or business under various provisions of the Code. The IRS is clearly taking the position that the facts and circumstances of each situation will determine if the rental activity rises to the level of a trade or business.

Rental Income and Passive Activity Rules - With respect to rental income and its exposure to the NII tax by way of the passive activity loss (PAL) rules, two tests have been suggested:

- If the rents are not derived in the ordinary course of a trade or business, then the rents constitute NII (under Category (i)). Whether rents are derived in the ordinary course of a trade or business should be determined under applicable authority, including case law interpreting Code Sec. 162 – Trade or business expenses. (Why Sec. 162? According to the preamble of the Dec. 2012 proposed regulations, "the most established definition of trade or business is found under section 162(a), which permits a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a trade or business." Thus, to facilitate administration of Sec. 1411, the regulations refer to Sec. 162 for purposes of determining whether an activity is a trade or business for Sec. 1411.)

- If the rents are derived in the ordinary course of a trade or business, then the rents constitute income from a passive activity included in NII unless Code Sec. 469 – Passive Activity Losses – excludes the rents from passive income.

  Code Sec. 469(c)(2) and (4) lay down the general rule that passive activity includes any rental activity without regard to whether the taxpayer materially participates in the activity. Code Sec. 469(c)(7) carves out exceptions to this general rule for real estate professionals.

Single Rental - A single rental could require **regular and continuous** involvement such that the rental activity is a trade or business under Sec 162. But the **IRS warns** that not every single property rises to the level of a trade or business as a matter of law.

Consistent Treatment – **From the Regulations' preamble** - In cases where other Code provisions use a trade or business standard that is the same or substantially similar to the Section 162 standard adopted in these final regulations, the IRS will closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of Section 1411, but not a trade or business for such other provisions. <u>For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of Section 1411, the IRS will take into account the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by section 6041.</u>

Self-Rented Property Recharacterization - The self-rented property rule under Reg. §1.469-2(f)(6) recharacterizes from passive to non-passive a taxpayer's income from renting property to a trade or business activity in which the taxpayer materially participates. Under the self-rented rule, the taxpayer's net rental income from the rental of property for use in a trade or business in which the taxpayer materially participates is treated as not from a passive activity. How should this income be treated for the NII tax?

The final regulations provide that in the case of rental income that is treated as nonpassive by reason of Reg. §1.469-2(f)(6), or because the rental activity is properly grouped with a trade or business activity under §1.469-4(d)(1) and the grouped activity is a nonpassive activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business. Thus, that rental income would escape the NII tax. Furthermore, in both of these instances, the final regulations provide that any gain or loss from the assets associated with that rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

Developer's Recharacterization - The developer rule under Reg. §1.469-2(f)(5) similarly recharacterizes from passive to non-passive a taxpayer's gain from disposing of rented property if the taxpayer had materially or significantly participated in the trade or business activity of developing the property. If the taxpayer sold the property within 12 months after rental commenced, the gain is generally non-passive. §1.1411-5(b)(2) of the final regulations provides that, to the extent that income or gain from a trade or business is subject to a net income recharacterization rule described in §1.469-2(f)(5), the gross income or gain treated as "not from a passive activity" will be considered derived from a trade or business for purposes of the net investment income tax.

Real Estate Professionals Exception – A **safe harbor** test applies for a **real estate professional** (within the meaning of Sec. 469(c)(7)) who participates in one or more rental real estate activities for more than 500 hours per year (or 500 hours per year in 5 of the prior 10 years). In such cases, the rental income associated with that activity is deemed to be derived in the ordinary course of a trade or business, and not subject to the NII tax. Any "grouping" election (under §1.469-9) to aggregate all of a taxpayer's rental activities is respected for this 500-hour test. (Reg. 1.1411(4)(g)(7))

NET OPERATING LOSSES

NOL Deductions per the original proposed regulation were not deductible at all against the NII. The final regulation (§1.1411-4(f)(2)(iv) and (h)) allows a pro-rated deduction. However, no portion of an NOL incurred in a tax year beginning before 2013 is permitted to reduce net investment income.

Because NOLs are computed and carried over year-by-year, a separate ratio must be determined for each year. Thus, the final regulations provide that taxpayers may deduct a portion of an NOL deduction in determining their net investment income. The portion of an NOL deduction for a taxable year that may be deducted for section 1411 purposes is calculated by:

(A) First determining the applicable portion of the NOL for each loss year. The applicable portion of the NOL is the lesser of:

(1) the amount of the NOL for the loss year that the taxpayer would have incurred if only items of gross income that are used to determine net investment income and only properly allocable deductions were taken into account in determining the NOL in accordance with section 172(c) and (d), or

(2) the amount of the taxpayer's NOL for the loss year.

(B) Next, the amount of the NOL carried from each loss year and deducted in the taxable year is multiplied by a fraction. The numerator of this fraction is the applicable portion of the NOL for the loss year as determined above. The denominator of the fraction is the total NOL for the loss year. A separate fraction is determined for each loss year. The result of this multiplication is the amount of the NOL deduction from the loss year that is allowed as a deduction in the taxable year, referred to as the section 1411 NOL amount. The sum of the amounts for each NOL carried to and deducted in the taxable year, referred to as the total section 1411 NOL amount, is the amount of the NOL deduction for the taxable year that is properly allocable to net investment income.

The amount of the NOL deduction included in AGI, regardless of the year in which the NOL originated and whether any portion of the NOL is investment-income related, is allowed when determining modified AGI for the NIIT threshold test. For losses arising in years beginning after 2017, the TCJA limits the NOL deduction to 80% of the taxpayer's taxable income computed without the NOL. In this case, the limited NOL deduction amount would be the amount to use in (B) above for post-2017 NOLs.

ALLOCABLE ITEMIZED DEDUCTIONS

As noted earlier in this chapter, the three categories of investment income can be reduced by "properly allocable deductions" that were paid or incurred to produce the income and allowed as a deduction. These expenses include the deductions related to rental and royalty income, the early withdrawal of savings penalty, and ordinary and necessary trade or business deductions. In addition, certain itemized deductions, such as investment interest and taxes are allowed. However, investment expenses included as a Tier 2 miscellaneous itemized deduction are not allowed when computing NII for years 2018 through 2025.

OTHER ISSUES

Tax refunds – Since prorated taxes are allowed as a deduction against NII, then any subsequent refund of those taxes must be appropriately allocated to NII in the year the refund is received.

Self-charged interest - can be recharacterized as passive interest and offset by passive interest expense.

Guaranteed Payments to Partners (Section 707(c) payments) **–** If for services (subject to SE taxes), the payments are not subject to NII tax. Otherwise the IRS believes guaranteed payments for use of capital has the characteristic of interest and is subject to the NII tax.

Partner Liquidating Distributions (Sec 736 payments) – Sec 736 applies to distributions to a retiring or deceased partner's entire interest. The distributions must be segregated into those subject and not subject to the NII tax through some complicated Reg. Sec. 1.469-2(e)(2)(iii) allocations.

SE Income – Any income subject to self-employment tax will not be subject to the 3.8% tax. The same income cannot be subject to both taxes (Reg. Section 1.1411-9).

Kiddie Tax - The amounts of Net Investment Income that are included in a taxpayer's income by reason of Form 8814 are included in calculating the taxpayer's Net Investment Income for the surtax. But NII does not include (a) amounts excluded due to the threshold amounts on Form 8814 and (b) amounts attributable to Alaska Permanent Fund Dividends.

Common Trust Funds (CTF) **-** Proposed §1.1411-4(e)(3) includes a rule that provides income or loss from a CTF is net investment income or deduction to the extent that such amount would have been net investment income or deduction if the participant had made directly the investments of the CTF.

REMIC Residual Interests – A REMIC is not considered as being in a trade or business. The 2013 proposed regulations provide that a holder of a residual interest in a REMIC takes into account the daily portion of taxable income (or net loss) under section 860C in determining net investment income. (Proposed Regs 1.1411-4(g)(13)) This issue was "reserved" in the final regulations.

Working Capital Investment – Generally the working capital of a company is invested in short-term income producing assets. The NII rules reference the working capital rules in Code Sec. 469. Any income from the investment of working capital is treated as not derived in the ordinary course of a trade or business and is treated as investment income.

Hobby Loss and At Risk Rules are not considered when making the determination of a trade or business for purposes of the NII tax.

Disposition of Partnership or S-Corporation Interests – Proposed Reg §1.1411-7(b) ("reserved" in the final regulations) provides a calculation to determine how much of the gain or loss that must be recognized is investment gain or loss. This definition recognizes that the items of property inside the passthrough entity that constitute Section 1411 property might vary among transferors because a transferor may or may not be "passive" with respect to the property. The proposed regulations include two methods, the primary method and the optional simplified method for certain smaller dispositions.

- *Primary Method* – Requires a **materially participating** transferor to determine what part, if any, of the gain represents the sale of investment property and therefore subject to the NII tax. To determine what part of gain represents the sale of investment property, a deemed (hypothetical) sale of the investment assets at FMV must be computed and the lesser of the resulting deemed-sale gain or the amount of gain recognized for regular income tax purposes is subject to the NII tax. The balance of the sale is not subject to the NII Tax. Gain with respect to passive or trading activities would also be subject to the NII Tax.
- *Simplified Method* - The optional simplified method relies on historic distributive share amounts received by the transferor from the passthrough entity to extrapolate a percentage of the assets within the passthrough entity that are passive with respect to the transferor for purposes of section 1411(c)(4). Generally, to qualify under the simplified method:
  - A transferor's investment income is 5% or less of the total of all investment income allocated to the transferor during the Section 1411 Holding Period,(1) and the transferor's recognized gain is $5 million (including multiple dispositions) or less, **or**
  - A transferor's share of the gain is $250,000 (including multiple dispositions) or less.
  - There are several exceptions when the simplified method does not apply even if it otherwise qualifies, including:
    - If the transferor did not hold the interest for 12 months prior to the disposition.
    - If the transferor transferred Section 1411 Property to or received a distribution of property (other than Section 1411 Property) from the entity in the 12 month period prior to the disposition.
    - The entity's Section 1411 property increased or decreased more than 25% during the Section 1411 holding period.
    - If the S-Corporation was a C-Corporation during the Section 1411 holding period.

  (1) Section 1411 Holding Period is defined to mean the year of disposition and the transferor's two taxable years preceding the disposition or the time period the transferor held the interest, whichever is less.

Deferral or Disallowance Provisions - used in determining AGI to apply to the determination of NII, including:

- Limitation on investment interest (Sec 163(d)), or
- Passive activity loss limitations (Sec 469(b)).

A deduction carried over to a tax year under certain provisions and allowed for that year in determining AGI is also allowed for the determination of NII, whether or not the year from which the deduction is carried precedes the surtax effective date.

Individuals - the term "individual" for this surtax purpose is any natural person, except those who are nonresident aliens—in other words, any citizen or resident of the U.S.

U.S. Citizen Married to a Non-resident Alien:

- **Filing MS** - The U.S. Citizen or resident spouse will be subject to the $125,000 threshold and the non-resident alien is exempt.
- **Filing Joint** (Sec 6013(g) Election) – Couple is subject to the surtax on their combined worldwide income and use the $250,000 threshold.

Residents of U.S. Territories:

- Residents of **Guam, the Northern Mariana Islands, and the U.S. Virgin Islands** generally will not be subject to the surtax if they fully comply with their territory's tax laws.
- Residents of **American Samoa and Puerto Rico** may be subject to the surtax if they have U.S. reportable income that gives rise to both NII and MAGI exceeding the threshold amount. However, if the bona fide resident is also a nonresident alien individual with respect to the U.S, then the surtax doesn't apply.

Short Tax Years - The threshold amount generally isn't prorated in the case of an individual's short tax year, such as in the case of death. (Reg § 1.1411-2(d)(2)(i)) A special rule applies for individuals who have a short tax year resulting from a change of annual accounting period and who must annualize taxable income. For these taxpayers, the applicable threshold amount is prorated. (Reg § 1.1411-2(d)(2)(ii))

Grantor Trusts - Items of income, deduction, and credit attributed accordingly is taxed to the owner. Thus these amounts are taken into account in calculating the owner's NII. (Reg § 1.1411-3(b)(1)(v))

Charitable Remainder Trusts (CRTs) - CRTs are subject to special computational rules. The trust itself isn't subject to the surtax, but the annuity and unitrust distributions may constitute NII to a noncharitable recipient. (Reg § 1.1411-3(d))

Bankruptcy Estates - A bankruptcy estate of a debtor who is an individual is treated as an individual for purposes of the surtax. Under Code Sec. 1398, which provides the rules for the taxation of Chapter 7 and 11 bankruptcy estates where the debtor is an individual, the bankruptcy estate computes its tax in the same manner as an individual, and the rate is the same as that imposed on a married taxpayer filing separately. Accordingly, regardless of the debtor's actual marital status, the bankruptcy estate is treated as married filing separately for purposes of the thresholds and the $125,000 threshold applies. (Reg § 1.1411-2(a)(2)(v))

NIIT TAX PLANNING TECHNIQUES

MAGI Management – Since the net investment income tax (NIIT) only applies to individuals whose MAGI exceeds the taxation thresholds, careful management of MAGI becomes an important tool in minimizing the NIIT both in current and future years since, what you defer now will generally impact MAGI at a future date or to heirs.

Net Investment Income Management – Since NIIT is a function of both MAGI and net investment income (NII) careful management of investment income and strategies to recharacterize income as non-investment come into play.

Non-Dividend Paying Stocks - Higher-income taxpayers can minimize the NIIT by including in their investment portfolio non-dividend paying growth stocks, which do not **currently** increase MAGI or create investment income, but will affect MAGI and NII in the **future** when sold.

Tax-deferred Annuities - Tax-deferred annuities and related investments will also minimize **current** liability for the NIIT, but also consider what impact they might have in **future** years when the income is taken.

Tax-Exempt State and Local Obligations - Tax-exempt income is not included in either MAGI or NII, providing a way to avoid the NIIT altogether.

Tax Deferred Exchange – Section 1031 exchanges are a way of deferring **current** taxable NII to **future** years.

Installment Sales – Where allowed, installment sales provide a means of deferring and spreading investment income from investment capital gains over multiple years. Thus **current** year income can be reduced and **future** income spread over multiple years. Caution: Buyers may pay off the note early and defeat part of this strategy, plus there are the inherent risks of the obligor defaulting.

Retirement Plans - Because distributions from qualified retirement plans are not included in net investment income, the NIIT provides taxpayers with additional incentive to maximize retirement plan contributions to minimize current NIIT liability. However, distributions from these plans, including RMDs, will impact the MAGI in the future.

Roth IRAs – Roth IRAs generally provide no current protection from NIIT, but do not add to MAGI when distributions are taken in the future and not at all if left to heirs. Taxpayers whose future distributions from regular IRAs and qualified plans could cause their MAGI to exceed the threshold amount may want to consider conversions to Roth accounts before RMDs are required, but done over time so that current MAGI isn't bumped above the threshold amount.

Passive Activity Loss Planning - Passive income is investment income for purposes of the NIIT. Classifying income as passive is generally advantageous for taxpayers with sufficient passive losses to offset the passive income. For taxpayers with net passive income, however, the NIIT increases the tax rate on passive income.

Estate Planning - The NIIT provides higher-income taxpayers with an incentive to consider the use of family limited partnerships and related estate planning techniques. Investment income transferred from parents with significant MAGI and investment income to children with MAGI below the applicable threshold amount through the use of family limited partnerships will not be subject to the NIIT.

Tax Planning for Estates and Trusts - Estates and trusts with undistributed net investment income will be subject to the NIIT whenever their adjusted gross income exceeds the dollar amount at which the top marginal tax rate begins ($12,750 for 2019). Because the top marginal rate for estates and trusts begins at a relatively small amount of income, the NIIT is of particular concern to estates and trusts and should be considered in both distribution and investment decisions

Estimated Tax – The NIIT needs to be included when determining estimated tax payment requirements and the estimated tax penalty. (IRC Sec. 6654(f), as amended by the 2010 Reconciliation Act)

NET INVESTMENT INCOME TAX – FORM 8960

The draft of the 2019 Form 8960 has been released at press time, but not the draft of 2019 instructions. The instructions for the 2018 version are 20 pages long and include various worksheets. The instructions can be accessed at: https://www.irs.gov/pub/irs-pdf/i8960.pdf.

CALIFORNIA DIFFERENCES

California has no similar tax. Since Federal taxes are not deductible in computing the CA tax, this federal tax will have no impact on the CA tax computation.

NOTES

ADDITIONAL HOSPITAL INSURANCE TAX

Additional HI Tax: **0.9% (0.009)**
To Extent Wage/SE Income on a Return Exceeds:

- S and HH: $200,000
- JT and SS: $250,000
- MS: $125,000

Related IRC and IRS Publications and Forms

- **Sec 3101(b)**
- **Sec 1401(b)**
- **Form 8959** – Additional Medicare Tax
- **Instructions Form 8959**

RAPID FINDER

WITHHOLDING RATES:

The Hospital Insurance (HI) (aka Medicare) tax rate (currently at 1.45%) will be increased by 0.9 percentage points on individual taxpayer earnings (wage withholding and SE tax) in excess of compensation thresholds for the taxpayer's filing status; see table below. (Code Sec. 3101(b)(2))

All wages currently subject to Medicare tax will be subject to the additional Medicare tax, if they are paid in excess of the applicable threshold amount. The same is true of Railroad Retirement Tax Act (RRTA) compensation.

No special rules apply for nonresident aliens and U.S. citizens living abroad. Wages, other compensation, and self-employment income that are subject to Medicare tax will also be subject to additional Medicare tax after the threshold is reached.

Wage Withholding – An employer must withhold additional Medicare tax from wages it pays to an individual in excess of $200,000 in a calendar year, without regard to the individual's filing status or wages paid by another employer. Thus, an employee's wage withholding HI rate will be 1.45% on the first $200,000 of wages paid by his employer and 2.35% (1.45 + 0.9) on amounts in excess of $200,000. An individual may owe more than the amount withheld by the employer, depending on the individual's filing status, wages, compensation, and self-employment income.

SE Tax – The HI component of the SE tax rate will be 2.9% up to the income threshold and 3.8% (2.9 + 0.9) on amounts in excess of the threshold.

Additional Hospital Insurance Tax Compensation Thresholds	
Married Taxpayers Filing Jointly	$250,000
Married Taxpayers Filing Separately	$125,000
All Others	$200,000

These amounts are not adjusted for inflation

All Income Combined for Purposes of the Threshold
For purposes of determining the additional HI tax, all wage and self-employment income is combined. For married taxpayers, the spouses' wages and self-employment incomes are combined.

Married Taxpayers - Where both spouses work, their wages are combined for purposes of determining whether they as a couple filing a joint return are responsible for the additional HI tax.

Multiple Employers – Employers will not consider income from other employers when determining the amount to be withheld UNLESS the employers utilize a common paymaster. This will create under-withholding for employees with multiple employers whose wages from all employers exceed the filing status threshold.

Spouses Both Working – Where both spouses work, even though their wages must be combined for purposes of determining whether they as a couple are responsible for the additional HI tax, employers withhold only on the wages of the individual who is their employee. Even though a couple may work for the same employer, the wages of each spouse are considered separately by the employer.

Excess Medicare Withholding – If the employer over-withholds the Medicare tax, the excess can be claimed as additional income tax withholding when the taxpayer files his or her return. After completing Form 8959 and determining that the taxpayer's Medicare tax is over-withheld, the excess Medicare tax is combined with the taxpayer's income tax withholding for the year for entry on Form 1040, line 17 (draft 2019).

Employer Fails to Withhold Additional Amount - An employer that does not deduct and withhold Additional Medicare Tax as required is liable for the tax unless the tax that it failed to withhold from the employee's wages is paid by the employee. Even if not liable for the tax, an employer that does not meet its withholding, deposit, reporting, and payment responsibilities for additional Medicare tax may be subject to all applicable penalties.

Tips - To the extent that tips and other wages exceed $200,000, an employer applies the same withholding rules for additional Medicare tax as it does currently for Medicare tax. An employer withholds additional Medicare tax on the employee's reported tips from wages it pays to the employee.

Employer Matching - An employer is not required to make a matching contribution.

Self-Employment Income:

The following details pertain to payment of the additional HI SE tax:

- The self-employed taxpayer will be responsible for the additional 0.9% HI tax. And, like an employer, will not be liable for a matching amount.
- The SE tax computation deduction continues to be computed using half the sum of the OASDI tax rate and only the regular HI tax rate (i.e., 7.65%), without regard to the additional 0.9% HI tax. In other words, the 0.9% additional tax is not taken into account for purposes of the SE tax deduction. (Code Sec. 1402(a)(12)(B)

SE Income and Wages - Individuals with wages subject to FICA tax and self-employment income subject to self-employment tax calculate their liabilities for additional Medicare tax in three steps:

Step 1 - Calculate additional Medicare tax on any wages in excess of the applicable filing status-based threshold, without regard to whether any tax was withheld.

Step 2 - Reduce the applicable threshold for the filing status by the total amount of Medicare wages received, but not below zero.

Step 3 - Calculate additional Medicare tax on any self-employment income in excess of the reduced threshold.

> ***Example – Joint Filers***: Don and Etta are married and file jointly. Don has $150,000 in wages and Etta has $175,000 in self-employment income.
>
> 1. Don's wages are not in excess of the $250,000 threshold for joint filers, so they are not liable for additional Medicare tax on Don's wages.
>
> 2. Before calculating the additional Medicare tax on Etta's self-employment income, the $250,000 threshold for joint filers is reduced by Don's $150,000 in wages, resulting in a reduced SE income threshold of $100,000.
>
> 3. Don and Etta are liable for additional Medicare tax on $75,000 of self-employment income ($175,000 in self-employment income minus the reduced threshold of $100,000).

SE Income and Railroad Retirement Tax Act (RRTA) Wages - The Affordable Care Act, in which the additional Medicare tax was enacted, did not provide for a reduction in the self-employment income threshold amounts by the amount of any RRTA compensation taken into account in determining liability for the additional Medicare tax. Therefore, an individual who receives both RRTA compensation and SE income does not reduce the self-employment income threshold amounts by the amount of RRTA compensation taken into account in determining the additional Medicare tax liability. (Reg. 1.1401-1(d)(2))

Underpayment of Estimated Tax:

A taxpayer cannot request additional withholding specifically for the additional Medicare tax but can request that his or her employer withhold an additional amount of income tax. Estimated tax rules apply to the additional Medicare tax, but the individual need not identify the payments as being specifically for that tax.

CALIFORNIA DIFFERENCES

California has no equivalent tax. It does, however, allow 50% of the self-employment tax to be deducted as an adjustment to gross income, but since the 0.9% additional tax is not computed as part of the SE tax on 1040 Schedule SE, no part of the additional tax is deductible on the California (or federal) return.

SMALL EMPLOYER SIMPLE CAFETERIA PLANS

RAPID FINDER

Overview

Small employers (average of 100 or fewer employees on business days during either of the two preceding years) may provide employees with a "simple cafeteria plan." (Code Sec. 125(j))

Under such a plan, the employer is provided with a safe harbor from the nondiscrimination requirements for cafeteria plans as well as from the nondiscrimination requirements for specified qualified benefits offered under a cafeteria plan–

- including group term life insurance,
- benefits under a self-insured medical expense reimbursement plan, and
- benefits under a dependent care assistance program.

The Details

Once the Simple Cafeteria plans have been established, the employer is deemed as having met the small employer requirement until such time as the average number of employees exceeds 200 on business days during any year preceding any such subsequent year.

Simple Cafeteria Plan – For purposes of the provision, a simple cafeteria plan is a plan that:
(1) Is established and maintained by an eligible employer,
(2) Meets prescribed contribution requirements, and
(3) Meets prescribed eligibility and participation requirements.

Contribution Requirements – To create a simple cafeteria plan, the employer will have to make contributions to provide qualified benefits under the plan on behalf of each qualified employee (without regard to whether a qualified employee makes any salary reduction contribution) in an amount equal to:
(1) a uniform percentage (not less than 2%) of the employee's compensation for the plan year, or
(2) an amount which is not less than the lesser of
(a) 6% of the employee's compensation for the plan year, or
(b) twice the amount of the salary reduction contributions of each qualified employee.

The requirements of (2) above are not met if, under the plan, the rate of contributions with respect to any salary reduction contribution of a highly compensated or key employee at any rate of contribution is greater than that with respect to an employee who is not a highly compensated or key employee.

Qualified Employee – Does not include highly compensated or key employees.

Highly-Compensated Employee - is any employee who:
(1) was a five percent owner at any time during the year or the preceding year or,
(2) for the preceding year, received compensation from the employer in excess of $125,000 ($120,000 (for 2016, 2017, 2018), and, if the employer elects, was in the top-paid group of employees for the preceding year. The employer can make the election annually, without the consent of IRS. An employee is in the top-paid group of employees for any year if such employee is in the group consisting of the top 20 percent of the employees when ranked on the basis of compensation paid during such year (Code Sec. 414(q)(1)(B)(ii)).

Key Employee - In general, the term "key employee" (Sec 416(i)) means an employee who, at any time during the 2019 plan year, is an officer of the employer having an annual compensation greater than $180,000, or a 5-percent owner of the employer, or a 1-percent owner of the employer having annual compensation from the employer of more than $150,000.

Minimum Eligibility & Participation Requirements - The minimum eligibility and participation requirements will be met with respect to any year if, under the plan,

(a) all employees who have at **least 1,000 hours** of service for the preceding plan year are eligible to participate, and
(b) each employee eligible to participate in the plan may, subject to terms and conditions applicable to all participants, elect any benefit available under the plan.

However, an employer will be able to **elect to exclude** under the plan employees:

(1) who have not attained the age of 21 before the close of a plan year (plan may provide for a younger age),
(2) who have less than one year of service with the employer as of any day during the plan year (plan may provide for a shorter period of service),
(3) who are covered under an agreement which the Secretary of Labor finds to be a collective bargaining agreement, if there is evidence that the benefits covered under the cafeteria plan were the subject of good faith bargaining between employee representatives and the employer, or
(4) who are described in Code Sec. 410(b)(3)(C) (relating to nonresident aliens working outside the U.S.)

Employee Revoking Coverage - In Notice 2014-55, the IRS permits a Small Employer Cafeteria Plan to allow an employee, during a period of coverage, to revoke his or her election for coverage under the employer's group health plan (other than a flexible spending arrangement (FSA)) in order to purchase a qualified health plan through a competitive Marketplace established under the Patient Protection and Affordable Care Act (ACA). Revocation is allowed in two situations:

- **Reduction in hours of service -** The first situation involves a participating employee whose hours of service are reduced so that the employee is expected to average less than 30 hours of service per week, but for whom the reduction doesn't affect the eligibility for coverage under the employer's group health plan.
- **Enrollment in a qualified health plan -** The second situation involves an employee participating in an employer's group health plan who would like to cease coverage under the group health plan and purchase coverage through a Marketplace without that resulting either in a period of duplicate coverage under the employer's group health plan and the coverage purchased through a Marketplace or in a period of no coverage.

For details and qualifications refer to Notice 2014-55.

NOTES

SMALL BUSINESS HEALTH INSURANCE TAX CREDIT

Overview

- Only Available to Eligible Small Employers (ESEs) that provide nonelective health insurance to their employees and:
  - Employ **25 or fewer equivalent full-time employees** (FTEs)
  - With average annual full-time **wages** (AAEW) **of $54,200 (2019) or less**
  - Pay at least **50%** of the Insurance Costs
- Credit Percentage for 2014 and later is 50% (35% for non-profits) and is available for only two years.
- Credit (except for non-profits) is claimed on the 1040
- **Credit reduced** when:
  - Number of **FTEs exceeds 10** and
  - **AAEW exceeds $27,100 (2019)**

RAPID FINDER

Pubs

Forms

Related IRC and IRS Citations, Forms & Pubs

- **Form 8941** – Credit for Small Employer Health Insurance Premiums
- **Instructions for Form 8941**
- **Benchmark Premiums –** Included in the 8941 Instructions
- **Form 990-T** - Exempt Organization Business Income Tax Return
- **Form 3800** – General Business Credit
- **Instructions for Form 3800**, General Business Credit
- IRS Website: https://www.irs.gov/affordable-care-act/employers/understanding-the-small-business-health-care-tax-credit
- **IRC 45R**

New Law & Stuff

IRS provides relief for employers that were unable to qualify for credit because the principal place of business is located in a county where a QHP through a SHOP Exchange isn't available. See Page 12.08.06 for details

The Details

The Affordable Care Act provides a tax credit for an eligible small employer (ESE) for nonelective contributions to purchase health insurance for its employees. (Code Sec. 45R)

NO DOUBLE BENEFIT

ESEs considering establishing a health plan for their employees need to understand that they can deduct the cost incurred for their plan as a business deduction or qualify for the credit. If they choose the credit they can still deduct the portion of the expenses not used in the computation or phased-out because of too many employees or too high of an average wage.

Tax Years after 2013 - An ESE is entitled to a deduction under Code Sec. 162 equal to the amount of the employer contribution minus the dollar amount of the credit.

EMPLOYER NONELECTIVE CONTRIBUTION

The term "nonelective contribution" means an employer contribution other than an employer contribution pursuant to a salary reduction arrangement.

An ESE is required to make a nonelective contribution on behalf of each employee who enrolls in a qualified health plan offered to employees by the employer in an amount equal to a uniform percentage **(not less than 50 percent)** of the premium cost of the qualified health plan.

CREDIT PERCENTAGES POST-2013

- Eligible Small Employers (ESE): **50%**
- Tax-Exempt 501(c) Organizations: **35%**

CAUTION
When counseling a client related to this credit, make sure the client understands this credit is for two years only.

CREDIT QUALIFICATION

For tax years after 2013, eligible small employers who purchase coverage through the Insurance Exchange may be eligible for a tax credit up to 50% (35% for tax-exempt ESEs) of the lesser of (1) the amount of nonelective contributions the employer made on behalf of its employees or (2) the amount the employer would have paid if the employees were enrolled in a qualified health plan with a premium equal to the average premium for the small group market in the rating area where the employee enrolls. The latter amount is referred to as the benchmark amount and will be determined by the Secretary of Health and Human Services. These premiums are listed by county in the Form 8941 Instructions for the year of the credit.

Note that:

- The insurance **MUST** be purchased through the state insurance Exchange, also referred to as the Small Business Health Options Program (SHOP). See Page 5 for information about SHOP.
- The coverage must be uniform and not less than 50% of the premium cost. (Committee Report)
- The credit is only available for a maximum coverage period of **two consecutive tax years** beginning with the first year in which the employer or any predecessor first offers one or more qualified plans to its employees through SHOP coverage offered by the Marketplace. (Sec 45R(e)(2)).

ELIGIBLE SMALL EMPLOYER (ESE)

An ESE generally is an employer with no more than 25 full-time equivalent employees (FTEs) employed during its tax year, and whose employees have annual full-time equivalent wages that average no more than (see upper line of table below), Code Sec. 45R(d).

The credit percentage that can be claimed varies with the number of employees and average wages. The full amount of the credit is available only to an employer with 10 or fewer FTEs and whose employees have average annual full-time equivalent wages (AAEW) from the employer of less than (see lower line of table below), (Code Sec. 45R(c)).

Average Full Time Equivalent Wages

Year	2015	2016	2017	2018	2019	2020
ESE is an employer with no more than:	$51,600	$51,800	$52,400	53,200	54,200	55,200
Full credit available with AAEW less than:	$25,800	$25,900	$26,200	26,600	27,100	27,600

CALCULATING THE CREDIT AMOUNT

The credit is equal to the **lesser of the following two amounts** multiplied by an applicable tax credit percentage and subject to the phase-outs discussed later:

(1) The amount of contributions the ESE made on behalf of the employees during the tax year for the qualifying health coverage.

(2) The amount of contributions that the employer would have made during the tax year if each employee had enrolled in coverage with a small business benchmark premium. (Code Sec. 45R(b)) Contributions under this method are determined by multiplying the benchmark premium by the number of employees enrolled in coverage and then multiplied by the uniform percentage that applies for calculating the level of coverage selected by the employer. (Committee Report)

COMPUTING THE CREDIT PHASE-OUT

The full credit is only available to ESEs with 10 or fewer full-time equivalent employees (FTEs) with an average annual full-time equivalent wage (AAEW) of $25,000 (adjusted for inflation after 2013 and shown in the table above) or less. If either or both of these thresholds are exceeded, then the credit is reduced.

There is no credit reduction if there are 10 or fewer FTEs with an AAEW of $27,100 (2019) or less.

There is no credit if the FTEs exceed 25 or the AAEW exceeds $54,200 (2019).

To figure the reduction of credit when the limits are exceeded, the number of the employer's full-time equivalent employees (FTE's) and average annual full-time equivalent wages (AAEW) for the year must be determined.

Figuring the number of FTEs - An employer's FTEs is determined by dividing the total hours the employer pays wages during the year (but not more than 2,080 hours per employee) by 2,080. (Code Sec. 45R(d)(2)) The result, if not a whole number, is then rounded down to the next lowest whole number if any. However, if the resulting number is less than one, round up to one FTE. (Prop. Reg. 1.45R-2(e)) Also see "Excluded Employees" below.

An employee's hours of service for a year include each hour for which an employee is paid, or entitled to payment, for (a) the performance of duties for the employer; and (b) for vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence (except that no more than 160 hours of service are required to be counted for an employee on account of any single continuous period during which the employee performs no duties). (Notice 2010-44, Sec. II.C.) (Prop. Reg. 1.45R-2(d)(1))

In calculating the total number of hours of service that must be taken into account for an employee for the year, the employer may use any of three methods:

(1) Determine actual hours of service from records of hours worked and hours for which payment is made or due (payment is made or due for vacation, holiday, illness, incapacity, etc.);

(2) Use a days-worked equivalency where the employee is credited with 8 hours of service for each day for which he would be required to be credited with at least one hour of service under (1), above; or

(3) Use a weeks-worked equivalency where the employee is credited with 40 hours of service for each week for which he would be required to be credited with at least one hour of service under (1), above. (Notice 2010-44, Sec. II.C.) (Prop. Reg. 1.45R-2(d)(2))

$$\textbf{FTE} \text{ (rounded down to next whole number)} = \frac{\text{Total Hours for Year (but no more than 2,080 per employee)}}{2{,}080}$$

Calculating average annual wages (AAEW) - Average annual wages is determined by dividing the employer's total FICA wages (without regard to the wage base limitation) for the tax year by the number of the employer's FTEs for the year (rounded down to the nearest $1,000) (Code Sec. 45R(d)(3)(A); Prop. Reg. 1.45R-1(a)(22))

$$\textbf{AAEW} \text{ (rounded down to the nearest \$1,000 if need be)} = \frac{\text{Total FICA Wages (without regard for wage base limitations)}}{\textbf{FTE}}$$

Credit reduction - If the number of FTEs exceeds 10 **or** if AAW exceed $27,100 (2019), the amount of the credit is reduced (but not below zero). Both reductions can apply at the same time!

- **FTE Reduction** - If the number of FTEs exceeds 10, the reduction is determined as follows:

$$\textbf{FTE Reduction} = \frac{(\text{FTEs} - 10)}{15} \times \text{Tentative Credit}$$

- **AAEW Reduction** - If average annual wages exceed $27,100 (2019), the reduction is determined as follows:

$$\textbf{AAEW Reduction} = \frac{(\text{AAEW} - 27{,}100)}{27{,}100} \times \text{Tentative Credit}$$

Example *– Joe owns a small California wood working business and has 12 employees, not counting himself or family members. The total FICA wages (without regard for wage base limitations) for 2019 were $309,000 and total hours worked by his employees during the year were 24,400. None of his employees worked more than 2,080 hours during the year. Joe made non-elective contributions to purchase health insurance for his employees in the amount of $49,800 for the year. Joe's credit is determined as follows:*

- *Small Business Benchmark Premium (estimated for this example. In actual practice the benchmark premiums are included in the instructions for Form 8941) = 12 x 5,345 = $64,140*

- *Smaller of actual premium paid or Benchmark premium = $49,800*
- *Tentative credit = $49,800 x 0.50 = $24,900*
- *Full-time equivalent employees (FTEs) = 24,400/2080= 11.7 rounded down = 11*
- *Average annual full-time equivalent wages (AAEW) = 309,000/11 = $28,091 rounded down = $28,000*
- *FTE Reduction = ((11-10)/15) x $24,900 = $1,660*
- *AAEW Reduction = ((28,000-27,100)/27,100) x $24,900 = $827*
- ***Joe's health insurance tax credit** = $24,900 - $1,660 - $827 = **$22,413***

Other Issues:

- Aggregation rules apply in determining the employer. (Code Sec. 45R(b); Prop. Reg. 1-45R-2(b))
- The credit is available for a domestic (household) employee of a sole proprietor of a business, and there's a special rule to prevent sole proprietorships from receiving the credit for the owner and their family members. (IRS Notice 2010-82)
- The credit is available for tax liability under the alternative minimum tax. (Prop. Reg. 1-45R-5(b))

EXCLUDED EMPLOYEES

Owners, Shareholders, and Self-employed Individuals - Self-employed individuals, including partners and sole proprietors, 2% shareholders of an S corporation, and 5% owners of the employer are not treated as employees for purposes of the small employer health insurance credit. Thus, the wages and hours of these business owners and partners, and of their family members and dependent members of their household, are disregarded in determining full-time equivalent (FTE) employees and average annual wages, and the premiums paid on their behalf are not counted in determining the amount of the credit (Notice 2010-44) (Prop. Reg. 1-45R-1(a)(4)(iii)).

Ministers - A minister performing services in the exercise of his or her ministry is treated as self-employed for Social Security and Medicare tax purposes. However, for the small employer health insurance credit, whether a minister is an employee or self-employed is determined under the common law test for determining worker status (Notice 2010-82). Thus, under the common law test, a self-employed minister would not be taken into account for this credit. On the other hand, if under the test a minister is an employee, the minister would be taken into consideration. (Prop. Reg. 1-45R-1(a)(4)(v))

Leased Employees - A leased employee is an individual who is not an employee of the service recipient, but who provides services to the recipient under an agreement with a leasing organization. For purposes of the definition of a full-time equivalent (FTE) employee, the definition of an eligible small employer (ESE), and the phaseout rules that apply to the small employer health insurance credit, an employee includes a leased employee. However, no provision of Code Sec. 45R supports attributing to the service recipient the leasing organization's payment of premiums. Therefore, premiums for health insurance coverage paid by a leasing organization for a leased employee are not taken into account by the service recipient in computing the service recipient's credit (Code Sec. 45R(e)(1)(B)) and Notice 2010-82)

Seasonal Employees - The number of hours of service worked by, and wages paid to, a seasonal worker of an employer are not taken into account in determining the FTE employees and average annual wages of the employer unless the worker works for the employer on **more than 120 days** during the tax year (Code Sec. 45R(d)(5)(A)). Health insurance premiums paid on behalf of seasonal workers can be counted in determining the amount of the credit (Notice 2010-44). There is no minimum number of hours of service that a worker has to work in a day before that day is taken into account for purposes of the 120-day test.

GENERAL BUSINESS CREDIT

The credit is a general business credit, can be carried back for one year and carried forward for 20 years, and can offset alternative minimum tax. (Code Sec. 38(b), Code Sec. 39(a)), Code Sec. 38(c)(4)(B)(vi)) However, because an unused credit amount cannot be carried back to a year before the effective date of the credit, any unused credit amounts for taxable years beginning in 2010 can only be carried forward (Notice 2010-44). See chapter 9.00 for details of the general business credit.

WHERE TO CLAIM

IRS Form 8941 is used to calculate the credit by both small businesses and tax-exempt organizations. A small business will include the amount of the credit as part of the general business credit on its income tax return. Tax-exempt organizations will claim the small business health care tax credit on Form 990-T.

TAX EXEMPT ORGANIZATIONS AS QUALIFIED SMALL EMPLOYERS

Any organization described in section 501(c), which is exempt under section 501(a) that otherwise qualifies for the small business tax credit is eligible to receive the credit. However, for tax-exempt organizations, the applicable percentage for the credit, for taxable years beginning in years after 2013, is limited to 35 percent. The small business tax credit is otherwise calculated in the same manner for tax-exempt organizations that are qualified small employers as the tax credit is calculated for all other qualified small employers.

Tax-exempt organizations are eligible to apply the tax credit against the organization's liability as an employer for payroll taxes for the taxable year to the extent of: (1) the amount of income tax withheld from its employees under section 3401(a); (2) the amount of hospital insurance tax withheld from its employees under section 3101(b); and (3) the amount of the hospital tax imposed on the organization under section 3111(b). However, the organization is not eligible for a credit in excess of the amount of these payroll taxes.

SMALL BUSINESS HEALTH OPTIONS PROGRAM (SHOP)

The Marketplace provides a health insurance marketplace for small businesses, those with 50 or fewer full-time equivalent employees. The Small Business Health Options Program (SHOP), even though offered through the various state Exchanges, is a different program from the individual Exchanges. Starting with the 2014 tax year, to be eligible for the Small Business Health Insurance Credit, the insurance must be purchased through the SHOP.

- ***Application Process*** - SHOP offers a single universal online application form. Business owners can, on their own, or with the help of an agent, broker, or other assister, compare price, coverage, and quality of plans in a way that's easy to understand.
- ***Who Uses SHOP*** – Starting in 2016, an employer with at least 50 and fewer than 100 equivalent full-time employees **must offer** coverage to all **full-time** employees–generally those working 30 or more hours per week on average–or be subject to a penalty. For employers with fewer employees, coverage is not mandatory. Initially SHOP will not be available to employers who must offer coverage or be penalized. Employers eligible to use the SHOP marketplace generally will find more plans offered than if they don't use SHOP, thus providing more plan options for their employees. Employers who qualify for the Small Business Health Insurance Credit based on the number of employees and average wage criteria, **must purchase the insurance through the SHOP marketplace to be eligible for the credit starting in 2014**.
- ***Work Site*** – The employer must have an office or employee work site within the SHOP's service area to use that particular SHOP.
- ***Coverage*** – The employer can select the desired coverage and how much the employer will contribute to the employee premiums, if any. Employees can then select higher or lower cost plans, but the employer's cost will not change.
- ***Self-Employed Individuals Without Employees*** – Self-employed individuals with no employees (independent contractors are not considered employees for this purpose), are considered self-employed, but not an employer and cannot acquire insurance through SHOP. They must instead use the individual Marketplace.
- ***Self-Employed Individuals With Employees*** – Self-employed individuals who have employees (generally, workers whose income is reported on a W-2 at the end of the year) is considered an employer. In that case the self-employed individual can get coverage for himself or herself and the employees through the SHOP Marketplace.
- ***Enrollment*** – In many states at least 70% of the employees offered coverage must enroll in order to buy insurance through the SHOP.
    - Employees with coverage through another employer plan, Medicare, Medicaid, the military, or veterans' programs are **not** included in the calculation.
    - Employees with individual non-group private coverage **are** included in the calculation.

Example *– An employer has 14 full-time employees, and of them two have coverage through a spouse's employer, one is covered by Medicare and one is covered by TRICARE[1]. Thus 10 employees count toward the 70% requirement and at least 7 of the 10 employees must enroll.*

[1]TRICARE® is the health care program serving Uniformed Service members, retirees and their families worldwide.

Employees Are Not Eligible for Premium Tax Credit: Employees covered under an employer plan are not eligible for the premium assistance subsidy/credit even though they would otherwise be qualified. This is one of the catch-22 provisions of the premium assistance subsidy/credit. Thus, where an employer provides a plan but does not supplement the employee's cost, the employee is stuck with the cost of the employer plan even though his out-of-pocket insurance premiums may be substantially less through the individual Exchange if he qualified for the premium assistance subsidy/credit.

For more information go to these websites:

- California: https://www.healthcare.gov/marketplace/shop/#state=california
- Federal: https://www.healthcare.gov/contact-us/#

SHOP COVERAGE NOT AVAILABLE

IRS has provided relief for eligible small employers who properly claim Code Sec. 45R credit in any part of the 2016 tax year but then find they can't offer employees a qualified health plan (QHP) for any part of remaining two-year credit period because the principal place of business is located in a county where QHPs through the SHOP Exchange isn't available. Employers in this situation may calculate the Code Sec. 45R credit by treating health insurance coverage provided for a later health plan year as qualifying for credit, provided that such coverage would have qualified for credit under rules applicable before 1/1/2014. IRS also notes that guidance doesn't affect ad hoc transitional relief provided through earlier Notices. (Notice 2018-27)

QUALIFICATION DETERMINATION WORKSHEET (2019)
Credit for Small Employer Health Insurance Premiums

Determine the Number of Full Time Employees:

1. Enter the number of employees who worked 2,080 hours or more during the year……………………………………………………………………………………….. _______
2. Multiply Line 1 by 2,080 ……………………………………………………………………………. _______
3. Enter the total hours worked by all employees who worked less than 2,080 hours during the year……………………………………………………………………… _______
4. Enter the total of lines 2 and 3……………………………………………………………………… _______
5. Divide line 4 by 2,080……………….……………………………………………………………… _______
6. **Number of full time equivalent employees** (round down line 5 to the next whole number (if the number is less than one, enter 1)………………………..….… ☐

CAUTION: IF LINE 6 IS 25 OR MORE, STOP – CREDIT NOT AVAILABLE

Determine the Average Annual Wage:

7. Enter the total of all wages paid to employees during the tax year……………………... _______
8. Divide Line 7 by the number of equivalent full time employees (Line 6)……………….._______
9. **Average annual wage** (round down the amount on line 8 to the next lower $1,000)……. ☐

CAUTION: IF LINE 9 IS $54,200 OR MORE, STOP – CREDIT NOT AVAILABLE

If line 6 is less than 25 and line 9 is less than $54,200, the taxpayer qualifies for the credit!
Enter the amount from Line 6 on Line 2 of Form 8941 and
Enter the amount from Line 9 on Line 3 of Form 8941 and complete the form for the credit.

California has no equivalent credit.

LARGE EMPLOYER
HEALTH COVERAGE EXCISE TAX

Overview

All applicable large employers (ALE), must offer at least 95% of its full-time employees and their dependents (but not spouse) affordable minimum essential health care coverage or be subject to a penalty.

- An applicable large employer is one with 50 or more equivalent full time employees.
- Even though part-time employees can drive the equivalent full-time employee count above the 50 threshold, the employer need only offer affordable minimum essential coverage to its full-time employees.
- Excise tax (penalty) applies to those applicable large employers (ALEs), that:
  - Do not offer coverage for all its full-time employees (and their dependents),
  - Offer minimum essential coverage that is unaffordable (employee contribution for 2019 is more than 9.86%) (up from 9.56% in 2018) of the employee's household income), or
  - Offer minimum essential coverage where the plan's share of the total allowed cost of benefits is less than 60% (i.e. less than the bronze coverage)

Pubs Forms

Related IRC and IRS Publications and Forms

- **1094-C** – Transmittal
- **1095-B** – Insured Statement
- **1095-C** - Employee Statement
- **Code Sec 4980H** - Shared responsibility for employers
- **Reg §54.4980H-4 -** Assessable payments (Sec 4980H(a))
- **Form 8928** - Return of Certain Excise Taxes

CAUTION

Who is an "employee" and who is an "Applicable Large Employer" (ALE) are governed by some very complex and lengthy regulations (Reg. § 54.4980H). The regulations include an abundant number of special rules. This material covers many of the more common situations **but not all**. Practitioners providing advice to their clients related to this excise tax are cautioned to review and familiarize themselves with the entire regulation before rendering any services. Full text of the regulations can be accessed in the Federal Register at: http://www.gpo.gov/fdsys/pkg/FR-2014-02-12/pdf/2014-03082.pdf

ACRONYMS - The following acronyms are used throughout this chapter:

ALE – Applicable Large Employer – those subject to the employee insurance mandate.
FTE – Full-time employees – generally those working 30 hours or more per week.
EFTE – The equivalent full-time employees taking into account the hours worked by part-time employees.
Small – Refers to employers with fewer than 50 EFTE
Large – Refers to employers with 50 or more EFTE

RAPID FINDER

DETERMINING IF AN EMPLOYER IS AN ALE

Generally an employer is a "large employer" if it employs 50 or more EFTEs during the preceding calendar year. Seems simple, right? Well it is not all that simple, because a number of issues come into play in determining what constitutes a FTE. What else would you expect? Consider this to be an overview of the issues that does not necessarily cover all the intricacies that apply.

Taxpayer Advocate Service Online Estimator

The IRS' Taxpayer Advocate Service has developed an Employer Shared Responsibility Provision (ESRP) Estimator to help employers determine the number of their full-time and full-time equivalent employees and make an estimate of the *maximum* amount of the potential liability for the employer shared responsibility payment that could apply if they fail to offer coverage to their full-time employees. The estimator can be accessed at: https://taxpayeradvocate.irs.gov/estimator/esrp/

Employee Categories Not Considered FTEs - The final regulations provide clarifications regarding whether employees of certain types or in certain occupations are considered full-time, including:

- *Volunteers:* Hours contributed by bona fide volunteers for a government or tax-exempt entity, such as volunteer firefighters and emergency responders, will not cause them to be considered FTEs.
- *Educational Employees:* Teachers and other educational employees will not be treated as part-time for the year simply because their school is closed or operating on a limited schedule during the summer.
- *Seasonal Employees:* Those in positions for which the customary annual employment is six months or less generally will not be considered FTEs.
- *Student Work-study Programs:* Service performed by students under federal or state-sponsored work-study programs will not be counted in determining whether they are FTEs.
- *Adjunct Faculty:* In general, employers of adjunct faculty are instructed to use a method of crediting hours of service for those employees that is reasonable in the circumstances and consistent with the employer responsibility provisions. For this purpose, the regulations specify that crediting an adjunct faculty member with 2.25 hours of service per week for each hour of teaching or classroom time is reasonable.
- *Work Performed Outside the U.S.:* In determining whether an employer is an ALE, an employer generally takes into account only work performed in the United States. Thus, employees working only abroad, whether or not U.S. citizens, generally will not be taken into account for purposes of determining whether an employer is an ALE.
- *Veterans:* Shall not be taken into account as a FTE for any month the individual has medical coverage under Tricare or the Veterans Administration (Transportation Act of 2015).

Methods of Determining FTE Status - An employer's number of FTE matters for purposes of whether the Employer Shared Responsibility provisions apply to the employer. An employer identifies its FTEs based on each employee's hours of service. An employee is a FTE for a calendar month if he or she averages at least 30 hours of service per week. Under the final regulations, for purposes of determining FTE status, 130 hours of service in a calendar month is treated as the monthly equivalent of at least 30 hours of service per week.

The final regulations provide two measurement methods for determining whether an employee has sufficient hours of service to be a FTE.

- *Monthly Measurement Method:* Under this method, an employer determines each employee's status as a FTE by counting the employee's hours of service for each month. For employees paid on an hourly basis, an employer is required to calculate actual hours of service from records of hours worked and hours for which payment is made or due. For employees paid on a non-hourly basis (e.g., salaried employees), an employer may calculate the actual hours of service using the same method as for hourly employees, or use a days-worked equivalency crediting the employee with eight hours of service for each day for which the employee would be required to be credited with at least one hour of service, or a weeks-worked equivalency under which an employee would be credited with 40 hours of service for each week for which the employee would be required to be credited with at least one hour of service (Reg. § 54.4980H-3(c))
- *Look-back Measurement Method:* Under this method, employers may determine the status of an employee as a FTE during a future period (referred to as the stability period), based upon the hours of service of the employee in a prior period (referred to as the measurement period). The stability period is a period selected by an ALE, that immediately follows, and is associated with, a standard measurement period or an initial measurement period (and, if elected by the employer, an administrative period of no longer than 90 days). The standard measurement period is a period of at least three months but not more than 12 months, as determined by the employer. The employer determines the months in which the standard measurement period starts and ends, provided that the determination is made on a uniform and consistent basis for all employees in the same category.

- ***CAUTION*** –The look-back measurement period of some employees may change because of situations in which an employee transfers from one position to another within the same ALE, and the employer uses a different measurement period for each position. Also there are special rules when an employer changes between the monthly and the look-back measurement methods. Refer to Notice 2014-49 for guidance in both situations.

Hours of Service - Generally, an hour of service means each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer, and each hour for which an employee is paid, or entitled to payment, for a period of time during which no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence.

Under the final regulations, an hour of service does not include any hour of service performed as a bona fide volunteer, as part of a Federal Work-Study Program (or a substantially similar program of a State or political subdivision thereof) or to the extent the compensation for services performed constitutes income from sources without the United States.

In addition, until further guidance is issued, a religious order is permitted, for purposes of determining if an employee is a full-time employee for the Employer Shared Responsibility provisions, to not count as an hour of service any work performed by an individual who is subject to a vow of poverty as a member of that order when the work is in the performance of tasks usually required (and to the extent usually required) of an active member of the order.

Treasury and the IRS continue to consider additional rules for the determination of hours of service for certain categories of employees whose hours of service are particularly challenging to identify or track or for whom the general rules for determining hours of service may present special difficulties (including adjunct faculty, commissioned salespeople and airline employees) and certain categories of work hours associated with some positions of employment, including layover hours (for example for airline employees) and on-call hours. For this purpose, until further guidance is issued, employers are required to use a reasonable method of crediting hours of service that is consistent with section 4980H. The preamble to the final regulations includes examples of methods of crediting these hours that are reasonable and that are not reasonable, including a method that is considered reasonable for crediting hours of service for adjunct faculty members.

New Employer Issues – If the employer was not in existence during the preceding calendar year, the final regs include special rules for new employers establishing a group health plan in the first months of operation. (Reg. § 54.4980H-2(b)(3))

- *First Calendar Year of Operation* - The determination of whether a new employer is a large employer in its first calendar year of operation is based upon the employer's reasonable expectations at the time the business came into existence. This is true, even if the actual number of full-time employees exceeds that reasonable expectation.
- *Multiple Related Entities & The 30 Rule* - For purposes of Code Sec. 4980H(a) liability calculation, with respect to a calendar month, the number of FTE of an applicable large employer member (i.e., one of multiple related entities that, due to the application of the aggregation rules, make up an ALE) is reduced by that member's allocable share of 30. (Reg. § 54.4980H-4(e))
- *New Employee Waiting Period* - Under the look-back measurement method, if a new employee is reasonably expected to be a full-time employee and is otherwise eligible for coverage, and the employer offers coverage to the employee by the first day of the calendar month following the conclusion of the employee's initial three full calendar months of employment, the employer will not be subject to a penalty for those three months if the coverage offered provides minimum value. (Reg. § 54.4980H-3(d)(2)(iii))
- *Employee Start Date* - An employer is also not subject to a penalty with respect to an employee for the first calendar month of the employee's employment if the employee's start date is other than the first day of the calendar month. (Reg. § 54.4980H-4(c), Reg. § 54.4980H-5(c))
- *Employer Not in Existence in Prior Year* - In a case where an employer was not in existence during the preceding calendar year, the seasonal worker exception applies so that the employer will not be treated as an ALE if it reasonably expects: (1) its workforce to exceed 50 EFTE for 120 days or fewer during the current calendar year, and (2) the employees in excess of 50 employed during such 120-day period to be seasonal workers. (Reg. § 54.4980H-2(b)(2))

  An employer that was not in existence on any business day in the prior calendar year is considered an ALE in the current year if the employer is reasonably expected to employ an average of at least 50 EFTE on business days during the current calendar year and it actually employs an average of at least 50 EFTE on business days during the calendar year. In contrast, for the next year (the year after the first year the employer was in existence), the employer will determine its status as an ALE using the rules that generally apply (that is, based on the number of EFTEs that the employer employed in the preceding year).

Other Issues

- *Commonly Owned or Related Businesses* - If two or more companies have a common owner or are otherwise related, they are combined for purposes of determining whether they employ enough employees to be subject to the employer mandate. However, these rules for combining related employers do *not* apply for purposes of determining whether a particular company owes an employer shared responsibility payment or the amount of any payment. Rather, these determinations are made separately for each related company. (Q&A 6)
- *Types of Employers Subject to the Mandate* - In addition to for-profit businesses, non-profit and government entity (including federal, state, local, and Indian tribe) employers are subject to the employer mandate if they are ALEs. (Q&As 7 - 8)
- *Eligible for Health Care Coverage from Another Source* - For purposes of determining whether an employer is an ALE, all employees are counted (subject to a limited exception for certain seasonal workers), regardless of whether the employees are eligible for health coverage from another source, such as Medicare, Medicaid, or a spouse's employer. Thus, an ALE with full-time employees who are eligible for health coverage through another source, will be subject to the Employer Shared Responsibility provisions regardless of whether those employees are eligible for coverage from another source. But, employees who are eligible for Medicare or Medicaid are not eligible for a premium tax credit. If no full-time employee receives a premium tax credit (for example, because all of an employer's full-time employees are eligible for Medicare or Medicaid), the employer will not be subject to an Employer Shared Responsibility payment.

  The IRS has issued final regulations adopting an intentional or reckless disregard for the facts exception to the Code Sec. 36B eligibility safe harbors for household income below 100 percent of the Federal Poverty Level (FPL), government programs such as Medicaid, and employer-sponsored coverage. The final regulations generally apply for tax years beginning after December 31, 2016.

  However, if an ALE does not offer coverage to its FTEs (and their dependents) or offers coverage to fewer than 95% (beginning in 2016) of its FTE (and their dependents) and a FTE receives a premium tax credit, the employer will be liable for a penalty, which will be calculated based on the employer's number of FTEs. For this purpose, the number of FTEs includes FTEs who are eligible for coverage from another source.
- *Exempt Employees* - For purposes of determining whether an employer is an ALE, all employees are counted (subject to a limited exception for certain seasonal workers), regardless of whether they are exempt from the penalty. Thus, an ALE with FTEs who are exempt from the individual insurance provision will be subject to the Employer Shared Responsibility provision. Employees who are exempt from the penalty for having individual insurance may be eligible for a premium tax credit. If no FTE receives a premium tax credit, the employer will not be subject to a penalty. However, if an ALE does not offer coverage to its FTEs (and their dependents) and a FTE receives a premium tax credit, the employer will be liable for a penalty which will be calculated based on the employer's number of FTEs.
- *Waiting Period* - A group health plan or group health insurance issuer cannot impose, as a condition of eligibility for coverage under the plan, a waiting period that exceeds 90 days. In addition, a one-month orientation period can begin any day of a month (Reg. Sec. 54.9815-2708(c)(3)(iii)).

  Example - *An employee begins working full time for an employer on Oct. 16. The employer sponsors a group health plan, under which full-time employees are eligible for coverage after they have successfully completed a bona fide one-month orientation period. If the employee completes the orientation period on Nov. 15, health plan coverage for the employee must begin no later than Feb. 14, which is the 91st day after the end of the orientation period.*
- *Mandatory Electronic Filing* – All employers filing 250 or more Forms 1095-C must file Forms 1094-C (transmittal form) and 1095-C electronically. (Q&A 19)
- *1095-C Reporting Requirements* - All ALEs, regardless of whether the employer is a tax-exempt or government entity (including federal, state, local, and Indian tribal governments), are subject to the 1095-C reporting requirements. (Q&A 6) The due date for filing the 2019 1095-Cs is February 28*, 2020 (March 31* if filed electronically). (Reg Sec 301.6056-1(e)) A 1095-C for 2019 must be furnished to each full-time employee by January 31, 2020, which can be done electronically if the employee has consented to receive their copy electronically. (2019 Form 1095-C draft instructions) However, the IRS has provided an automatic 30-day extension in the past for furnishing the employee's copy, so watch for announcements for 2020. * *Regs specify 2/28 not last day of Feb so no adjustment for leap year*

  An ALE must report information with respect to all FTEs, even ones who are not offered coverage during the year. If an ALE does not offer coverage to any of its FTEs, the employer must file returns with IRS and furnish statements to each of its full-time employees to report information specifying that coverage was not offered. (Q&A 21)
- *Spouses* – Employer plans are not required to cover spouses.

- *Dependents* – Coverage must be included for an employee's child who is under the age of 26. Coverage must include the full month in which the child turned 26. The definition of a child for these purposes excludes step and foster children. Excluded from the definition are children who are not U.S. Citizens or nationals, except for those residing in Canada or Mexico or a child who is an adopted child that has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.
- *Employees Outside the U.S.* - An employer generally takes into account only work performed in the U.S. in determining whether it is an ALE – so, a foreign employer with fewer than 50 EFTE in the U.S. generally won't be subject to the employer mandate. Similarly, a company that employs U.S. citizens working abroad would only be subject to the employer mandate if the company had at least 50 EFTE, determined by taking into account only work performed in the U.S. (Q&As 13 -14)
- *Seasonal Employees* - Under an exemption, an employer will not be considered to employ more than 50 EFTE if: (a) the employer's workforce exceeds 50 FTEs for 120 days, or fewer, during the calendar year; and (b) the employees in excess of 50 employed during that 120-day (or fewer) period were seasonal workers. Seasonal workers are workers who perform labor or services on a seasonal basis as defined by the Secretary of Labor, and retail workers employed exclusively during holiday seasons. For this purpose, employers may apply a reasonable, good faith interpretation of the term "seasonal worker." (IRS Q&A #4) Special rules apply to construction industry employers.
- *Full-time Employee* - A FTE is an employee who, for a calendar month, is employed an average of at least 30 hours of service per week with the employer. For this purpose, 130 service hours in a calendar month is treated as the monthly equivalent of at least 30 hours per week. (Regulations sections 54.4980H-1(a)(21) and 54.4980H-3 and Notice 2014-49, 2014-41 I.R.B. 66)
- *Part-Time Employees* - Solely for purposes of determining whether an employer is an ALE, an employer will also have to include for that month the number of FTEs determined by dividing (a) the aggregate number of hours of service of employees who are not FTEs for the month by (b) 120.

  Example – Equivalent Full-Time Employees *- For his business, John has 45 full-time employees plus he has 20 part-time employees. His part-time employees for the month of January worked 960 hours. That is the equivalent of 8 (960/120) full-time employees. Thus, the number of John's full-time employees for the month of January is 53 (45 + 8).*

- *Prior Employee* – A rehired prior employee cannot be treated as a new hire if the employee had one hour of work in the prior 13 weeks. Note: There is a "parity" rule that shortens the period to be classified as a new hire. That applies when the no work period plus 4 weeks exceeds the duration of the previous period of work.
- *Continuing Employee* – A continuing employee, one that does not meet the 13-week rule, is considered a full-time employee upon resumption of services (no waiting period).
- *Penalty Deductibility* – This excise tax penalty is nondeductible under the general rules for excise taxes. (Code Sec. 275(a)(6))
- *Rounding of Full-Time Employee Count* – The sum of the FTEs and EFTEs is determined, and then that number rounded down to the nearest whole number before determining if the employer meets the 50-employee threshold.

  Example: *The employer has 35 FTEs and his part time employees worked 1,750 hours. Thus his EFTEs are 14.58 (1,750/120). Adding the FTEs and the EFTEs together results in a total of 39.58 (35 + 14.58). That result is then rounded down to 39 before making the determination if the employer is an ALE.*

- *Benefit Hours* **–** The hours used to determine full-time status include both hours worked and benefit hours for which the employee was paid. Benefit hours include holiday, vacation, sick time, jury duty or any period of paid leave.

Interaction with Premium Credit

Generally, if an employee is offered affordable minimum essential coverage under an employer-sponsored plan, he is ineligible for a premium tax credit and cost-sharing reductions for health insurance purchased through a state or federal insurance Marketplace.

However, if the coverage is unaffordable (see below) or the plan's share of benefits is less than 60%, then he is eligible, but only if he declines to enroll in the coverage and purchases coverage through the Marketplace instead.

IRS has clarified that the fact that an employer doesn't employ enough employees to be subject to the employer mandate does not affect its employees' eligibility for a premium tax credit. (Q&A 44)

"AFFORDABLE" DETERMINATION SAFE HARBOR

For 2019, the law defines affordable coverage as **not** costing the employee more than 9.86% (up from 9.56% in 2018) of the employee's household income. **But how is an employer able to determine an employee's household income?** Under safe harbor rules in the final regulations, an employer can use the wages they pay, their employees' hourly rates, or the federal poverty level to determine whether the coverage is affordable. (Q&As 19 - 20)

Important Concept to Understand

An employer must offer, not provide, affordable minimum essential coverage. However, for an employer's lower paid employees the employer may have to pay part of the premium to make the insurance affordable.

Rate of pay safe harbor:

- *Hourly Employee* – The safe harbor for 2019, is satisfied for a calendar month if the employee's required contribution does not exceed 9.86% of an amount equal to 130 multiplied by the employee's hourly rate of pay as of the first day of the coverage period, generally the first day of the plan year.
- *Salaried Employee* – The safe harbor for 2019 is met if the employee's required contribution for the month does not exceed 9.86% of the employee's monthly salary as of the first day of the coverage period, generally the first day of the plan year. The employer is permitted to use any reasonable method for converting payroll periods to monthly salary.

Federal poverty line safe harbor:

- *All Employees* – To meet the safe harbor under this method, the employee's contribution must not exceed 9.86% of a monthly amount determined as the "Federal poverty line" (see poverty table under Premium Assistance Credit in Chapter 12.02) for a single individual for the applicable calendar year, divided by 12.

  Example: *For 2019, the poverty level for a single individual is $12,140. Thus, the monthly poverty line safe harbor amount is $99.75 (($12,140 x .0986)/12).*

Form W-2 safe harbor (post year safe harbor)

- *All Employees* – The safe harbor is satisfied if the employee's contribution toward the coverage for the calendar year does not exceed 9.86% of the employee's Form W-2 wages (Box 1 of the Form W-2) Wage and Tax Statement from the employer for the calendar year.

W-2 SAFE HARBOR			
Plan Year	Prior Year Poverty Level	Affordability Percentage	Maximum Monthly Contribution (Self-Coverage)
2020	$12,490	9.78%	101.7879
2019	$12,140	9.86%	$99.75
2018	$12,060	9.56%	$96.08
2017	$11,880	9.69%	$95.93
2016	$11,770	9.66%	$94.75
2015	$11,670	9.56%	$92.97

COMPUTING THE EXCISE TAX (PENALTY):

For 2019 (and for employers with non-calendar-year plans, any calendar months during the 2018 plan year that fall in 2019), an employer that was an ALE in 2018 (had at least 50 EFTE in 2018), will be liable for an Employer Shared Responsibility payment only if:

- The employer does not offer health coverage or offers coverage to fewer than 95% of its FTE and the dependents of those employees, **and** at least one of the full-time employees receives a premium tax credit to help pay for coverage on a Marketplace, **OR**
- The employer offers health coverage to at least 95% of its FTE and the dependents of those employees, but at least one full-time employee receives a premium tax credit to help pay for coverage on a Marketplace, which may occur because the employer did not offer coverage to that employee or because the coverage the employer offered that employee was either unaffordable to the employee or did not provide minimum value.

PREPARER TRAP

If an employer offers an employee affordable minimum essential insurance then that employee is not eligible for a PTC, and will have to repay the APTC for any month the employer offers the affordable minimum essential insurance coverage. In these cases the employer would not be subject to the penalty.

However, if an employee does obtain coverage from the Marketplace and does not tell the Marketplace that his employer offers affordable minimum essential care, the Marketplace will allow APTC and include it on the 1095-B. At the same time the employer will issue a 1095-C showing the employee was offered qualifying care, making the employee ineligible for the PTC, and thus the employee must repay any APTC received for the months the employer offered the employee affordable minimum essential insurance.

This is where preparers that don't review the 1095-C for offers of coverage may allow the PTC on the return. In which case, they will have to deal with the IRS PTC disallowance letter down the road.

ALE Offers No Coverage – For an employer who does not offer coverage or offers it to fewer than 95% of its full-time employees and their dependents, the excise tax penalty for any month in 2019 would be $208.33 ($2,500/12) times the number of full-time employees in excess of 30.

FAILURE TO OFFER COVERAGE PENALTY (4980H(a))		
Year	Annual Penalty	Monthly Penalty
2020	$2,570 (est.)	$214.16
2019	$2,500 (est.)	$208.33
2018	$2,320	$193.33
2017	$2,260	$188.33
2016	$2,160	$180.00
2015	$2,080	$173.33
2014	$2,000	$166.67

***Example – No Health Care Plan** – In January of 2019, an ALE with 120 employees does not offer a health care plan to its employees. The penalty is 208.33 times the number of full-time employees in excess of 30. Thus, the penalty for the month of January is $18,750 ((120-30) x $208.33).*

Employer Offers Coverage and One or More Employees Qualifies for Premium Assistance Credit – An ALE would be liable for the penalty (figured monthly) if the employer offers coverage, but the cost of the coverage is not affordable for one or more employees or the insurance does not provide minimum (60%) coverage.

(1) **Offers to 95% of its full-time employees** (and their dependents) the opportunity to enroll in "minimum essential coverage" under an "eligible employer-sponsored plan" for that month; **and**

(2) **At least one full-time employee** has been certified to the employer as having enrolled for that month in a qualified health plan for which a premium tax credit or cost-sharing reduction is allowed or paid with respect to the employee.

The excise tax penalty for any month in 2019 would be $312.50 $3,750/12) times the number of full-time employees that receive premium tax credit or cost-sharing reductions through an insurance Marketplace but not to exceed the penalty imposed had the employer not offered health care insurance.

OFFERS COVERAGE BUT ONE OR MORE QUALIFY FOR PTC		
Year	**Annual Penalty**	**Monthly Penalty**
2019	$3,750 est.	312.50 est.
2018	$3,480	290.00
2017	$3,390	282.50
2016	$3,240	270.00
2015	$3,120	260.00
2014	$3,000	250.00

***Example – Health Care Plan and Employees Qualify for Premium Tax Credit or Cost Sharing Reductions** – In January of 2019, an applicable large employer with 120 employees offers a health care plan to its employees, but the cost of the plan does not meet the affordable criteria (employee contribution is more than 9.86% of the employee's household income or the plan's share of the total allowed cost of benefits is less than 60%) and 20 of the employees sign up for health insurance through an insurance Marketplace and receive a Premium Tax Credit or Cost-Sharing Reductions. The employer's excise tax penalty is 312.50 times 20. Thus, the penalty for the month of January is $6,250, which is less than the $18,750 penalty that would apply if no coverage was offered.*

Effect of Employees Purchasing Other Coverage - If an employer offers health coverage that is affordable and that provides minimum value to its full-time employees and their dependents, the fact that some of the employees (or their spouses or dependents) either purchase health insurance through a Marketplace or enroll in Medicare or Medicaid, won't cause the employer to be subject to an employer shared responsibility payment. Liability for that payment is triggered by a full-time employee's receipt of a premium tax credit, and an employee who is offered affordable coverage that provides minimum value is ineligible for the credit. (Q&As 21 - 23)

Minimum Value (Minimum Essential Coverage) - If an employer fails to provide health care coverage that offers a minimum value (minimum essential coverage), and as a result employees become eligible for a Code Sec. 36B premium tax credit or cost-sharing reduction (see Chapter (section) 12.02), the employees' eligibility will, in turn, cause the employer to be subject to the penalty. Thus, knowing what minimum value means is important for both the employer and employee. The term minimum value (MV) is described in a number of ways:

- Under Code Sec. 36B(c)(2)(C)(ii), a plan fails to provide MV if the plan's share of the total allowed costs of benefits provided under the plan (as determined under Secretary of Health and Human Services (HHS) regs) is less than 60% of the costs. In addition, to qualify as providing minimum value, employer-sponsored health plan benefits must include substantial coverage of inpatient hospital and physician services.
- Under 36B(c)(2)(C)(i)(II), an employer-sponsored plan is not affordable if the employee's required contribution for 2019 with respect to the plan exceeds 9.86% of his household income for the tax year. When determining the applicable percentage of income, that **percentage is applied to the employee's coverage only**.

> ***Example:*** *Carl is married to Jane, and Carl's employer's plan requires Carl to contribute $5,300 for coverage for Carl and Jane for 2018, which reflects 11.3% of Carl's household income. However, because the portion of the contribution ($3,750) attributable to Carl's self-only coverage does not exceed 9.86% of Carl's household income, Carl's employer's plan is considered affordable for Carl and Jane. (Reg. § 1.36B-2(c)(3)(v)(D), Example 2)*

Proposed reliance regulations clarify the term minimum value (minimum essential coverage) and provide the following safe-harbor plans (however, as noted above health plans which don't offer substantial coverage for in-patient hospitalization services or physician services or both will not be considered to provide minimum value effective as of November 4, 2014, even if they would otherwise fit into one of the safe harbors):

(1) A plan with a $3,500 integrated medical and drug deductible, 80% plan cost-sharing, and a $6,000 maximum out-of-pocket limit for employee cost-sharing;

(2) A plan with a $4,500 integrated medical and drug deductible, 70% plan cost-sharing, a $6,400 maximum out-of-pocket limit, and a $500 employer contribution to an HSA; and

(3) A plan with a $3,500 medical deductible, $0 drug deductible, 60% plan medical expense cost-sharing, 75% plan drug cost-sharing, a $6,400 maximum out-of-pocket limit, and drug co-pays of $10/$20/$50 for the first, second and third prescription drug tiers, with 75% coinsurance for specialty drugs.

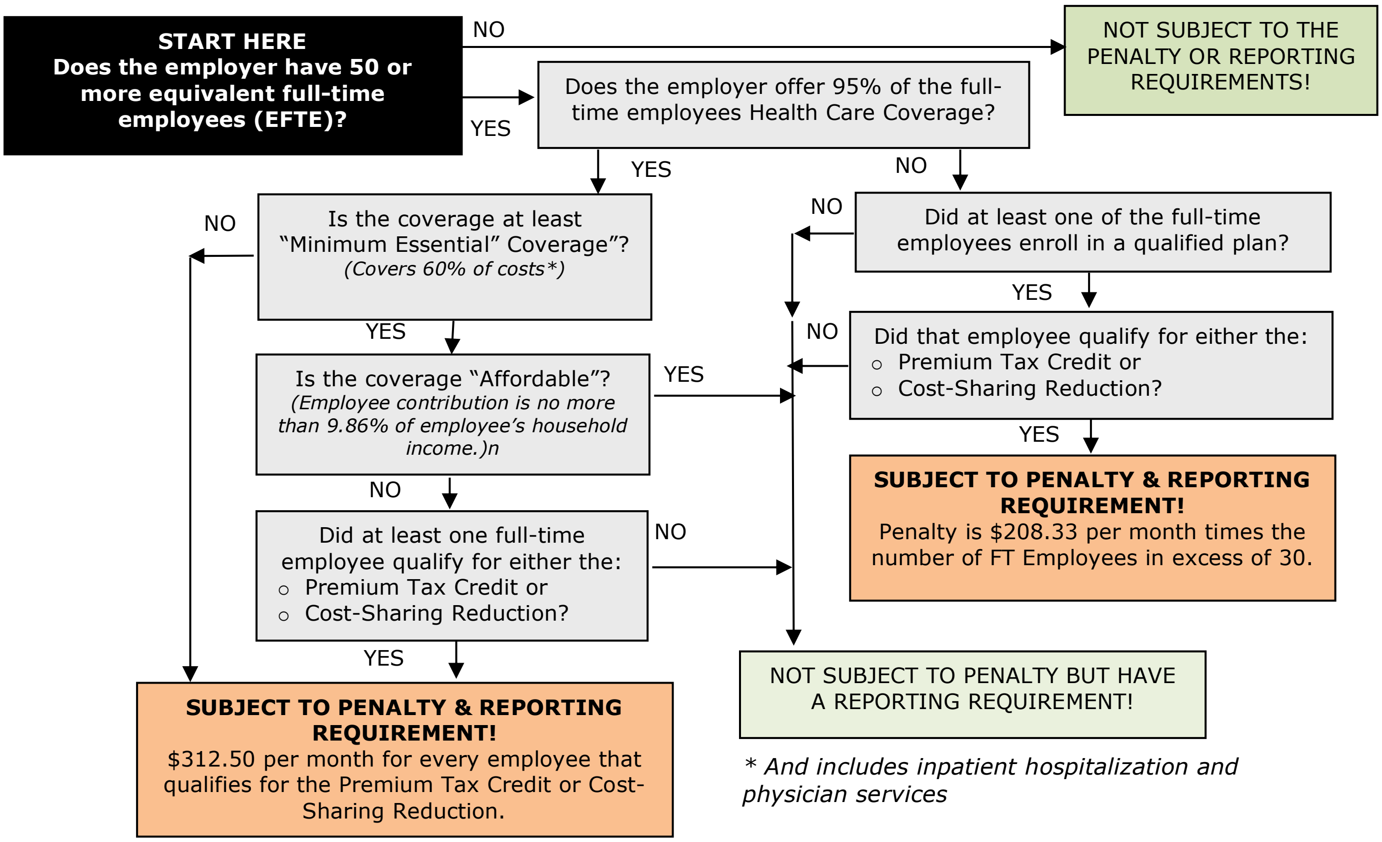
A minimum value calculator is available online at https://www.cms.gov/cciio/resources/regulations-and-guidance/index.html.

Who Computes the Employer Penalty - The employer is not required to calculate a payment with respect to Section 4980H or file returns submitting such a payment. Instead, after receiving the information returns filed by applicable large employers under § 6056 and the information about employees claiming the premium tax credit for any given calendar year, the Internal Revenue Service (IRS) will determine whether any of the employer's full-time employees received the premium tax credit and, if so, whether an assessable payment under § 4980H may be due. If the IRS concludes that an employer may owe such an assessable payment, it will contact the employer, and the employer will have an opportunity to respond to the information the IRS provides before a payment is assessed. (Notice 2013-45)

Penalty – Decision Tree – The flow chart below provides an overview of the large employer health care excise tax.

Continue to next page

2019 Large Employer Health Coverage Excise Tax Decision Tree



** And includes inpatient hospitalization and physician services*

INFORMATION REPORTING:

POINT OF CLARIFICATION Generally unless the employer is self-insured, which usually would only apply to major businesses, an employer will only complete Part I and Part II of the 1095-C. The group insurance carrier will file a 1095-B for each employee providing the insured's names and the months of coverage. Therefore, Part III of Form 1095-C need only be completed by a self-insured employer since there is no insurance carrier to report that information.

Penalties – Penalties apply for failure to file a correct information return (Code Sec. 6721) and failure to furnish correct payee statements (Code Sec. 6722). However, these penalties may be waived if the failure was due to reasonable cause and not to willful neglect. (Code Sec. 6724(a)) See page 10.01.03 for details on the penalties.

Form 1095-C – Employer-provided health insurance offer and coverage - Form 1095-C is a multipurpose form. It is used to both determine if the employer is subject to the employer penalty for not providing insurance **and** to determine if the employee is qualified for the premium tax credit.

(1) Part I: Includes employer and employee information.

(2) Part II: Use to report information needed to determine if the employer is subject to the excise tax penalty for not making affordable minimum essential coverage available to their employees.

(3) Part III: Is only used by an employer that provides health coverage through an employer-sponsored **self-insured** health plan, typically larger corporations. The employer must complete Parts I and III, for any employee who enrolls in the health coverage, whether or not the employee is a full-time employee for any month of the calendar year. **For other than self-insured plans, the insurance company or plan sponsor will provide the information included in part III using Form 1095-B.**

WHO MUST FILE 1095-Cs FOR 2019

Applicable Large Employers (ALE), generally employers with 50 or more equivalent full-time employees (EFTEs) in the previous year, must file a Form 1095-C for each full-time (for any month of the year) employee (including a Form 1094-C Transmittal). Employers with fewer than 50 EFTEs do not have a 1095-C reporting requirement.

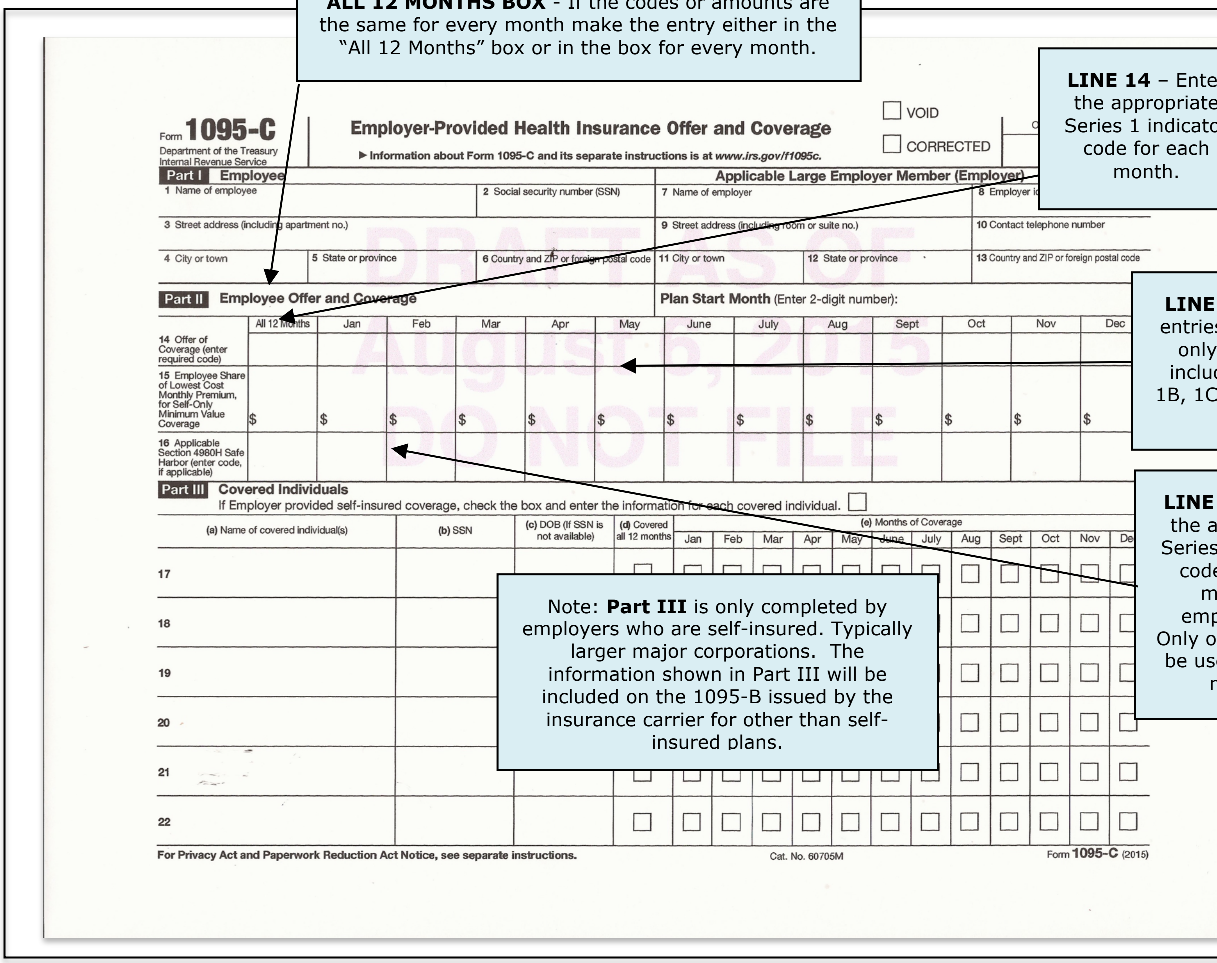
ALL 12 MONTHS BOX - If the codes or amounts are the same for every month make the entry either in the "All 12 Months" box or in the box for every month.

LINE 14 – Enter the appropriate Series 1 indicator code for each month.

LINE 15 - Make entries on line 15 only if line 14 includes codes: 1B, 1C, 1D, 1E, 1J or 1K

LINE 16 – Enter the appropriate Series 2 indicator code for each month of employment. Only one code can be used for each month.

Note: **Part III** is only completed by employers who are self-insured. Typically larger major corporations. The information shown in Part III will be included on the 1095-B issued by the insurance carrier for other than self-insured plans.


Form 1095-C
Department of the Treasury Internal Revenue Service
Employer-Provided Health Insurance Offer and Coverage
▶ Information about Form 1095-C and its separate instructions is at www.irs.gov/f1095c.
VOID
CORRECTED
Part I Employee
1 Name of employee
2 Social security number (SSN)
3 Street address (including apartment no.)
4 City or town
5 State or province
6 Country and ZIP or foreign postal code
Applicable Large Employer Member (Employer)
7 Name of employer
8 Employer identification number (EIN)
9 Street address (including room or suite no.)
10 Contact telephone number
11 City or town
12 State or province
13 Country and ZIP or foreign postal code
Part II Employee Offer and Coverage
Plan Start Month (Enter 2-digit number):

	All 12 Months	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
14 Offer of Coverage (enter required code)													
15 Employee Share of Lowest Cost Monthly Premium, for Self-Only Minimum Value Coverage	$	$	$	$	$	$	$	$	$	$	$	$	$
16 Applicable Section 4980H Safe Harbor (enter code, if applicable)													

Part III Covered Individuals
If Employer provided self-insured coverage, check the box and enter the information for each covered individual.

	(a) Name of covered individual(s)	(b) SSN	(c) DOB (If SSN is not available)	(d) Covered all 12 months	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
17																
18																
19																
20																
21																
22																

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60705M Form 1095-C (2015)

DRAFT AS OF August 6, 2015 DO NOT FILE

Line 14 Indicator Codes - Code Series 1 - If the type of coverage, if any, offered to an employee was the same for all 12 months in the calendar year, enter the Code Series 1 indicator code corresponding to the type of coverage offered in the "All 12 Months" box **or** in each of the 12 boxes for the applicable calendar months.

Code 1A - **Qualifying Offer** - Minimum essential coverage providing minimum value offered to full-time employee with employee contribution **for self-only coverage** equal to or less than 9.86% (2019) of the mainland single federal poverty line and at least minimum essential coverage offered to **spouse and dependent(s). Note:** When 1A is used then leave line 15 blank for all months for which code 1A was used.

Code 1B - **Qualifying Offer** - Minimum essential coverage providing minimum value offered to **employee only**.

Code 1C - **Qualifying Offer** - Minimum essential coverage providing minimum value offered to employee and at least minimum essential coverage offered to **dependent(s) (not spouse).**

Code 1D - **Qualifying Offer** - Minimum essential coverage providing minimum value offered to employee and at least minimum essential coverage offered to **spouse (not dependent(s))**.

Code 1E - **Qualifying Offer** - Minimum essential coverage providing minimum value offered to employee and at least minimum essential coverage offered to **dependent(s) and spouse**.

Code 1F – **Not a Qualifying Offer** - Minimum essential coverage NOT providing minimum value offered to employee; or employee and spouse or dependent(s); or employee, spouse and dependents.

Code 1G **– Not a Full Time Employee –** If an employer offers coverage through an employer self-insured plan and the employee is not full time, Code 1G is entered at Line 14 in the "All 12 Months" box or in each separate box. The employer must complete Parts I and III.

Code 1H **– No Offer Of Coverage** - Employee not offered any health coverage or employee offered coverage that is not minimum essential coverage, which may include one or more months in which the individual was not an employee.

Code 1J - Minimum essential coverage providing minimum value offered to employee; minimum essential coverage conditionally offered to employee's spouse; and minimum essential coverage NOT offered to employee's dependent(s).

Code 1K - Minimum essential coverage providing minimum value offered to employee; minimum essential coverage conditionally offered to employee's spouse; and minimum essential coverage offered to employee's dependent(s)

Line 16 Indicator Codes - Code Series 2 – For each month applicable, enter a Series 2 indicator code. These codes are used to indicate when the employer qualifies for one of the affordability safe harbors or other relief.

Code 2A – **Employee Not Employed During the Month** - Enter code 2A if the employee was **not employed on any day** of the calendar month.

Code 2B - **Employee Not a Full-time Employee** - Enter code 2B if the employee is not a full-time employee for the month and did not enroll in minimum essential coverage, if offered for the month.

Code 2B – **Full-Time Employee – Terminated Employment During Month – Coverage Would Have Continued** - Enter code 2B if the employee is a full-time employee for the month and whose offer of coverage (or coverage if the employee was enrolled) ended before the last day of the month solely because the employee terminated employment during the month (so that the offer of coverage or coverage would have continued if the employee had not terminated employment during the month).

Code 2C - **Employee Enrolled in Coverage Offered** - Enter code 2C for any month in which the employee enrolled in health coverage offered by the employer for each day of the month, regardless of whether any other code in Code Series 2 might also apply.

Code 2D - **Employee in a Limited Non-Assessment Period** - Enter code 2D for any month during which an employee is in a Limited Non-Assessment Period for section 4980H(b). If an employee is in an initial measurement period, enter code 2D (employee in a section 4980H(b) Limited Non-Assessment Period) for the month, and not code 2B (employee not a full-time employee). For an employee in a section 4980H(b) Limited Non-Assessment Period for whom the employer is also eligible for the multiemployer interim rule relief for the month, enter code 2E (multiemployer interim rule relief) and not code 2D (employee in a Limited Non-Assessment Period). See page 12.09.14 for details on limited non-assessment periods.

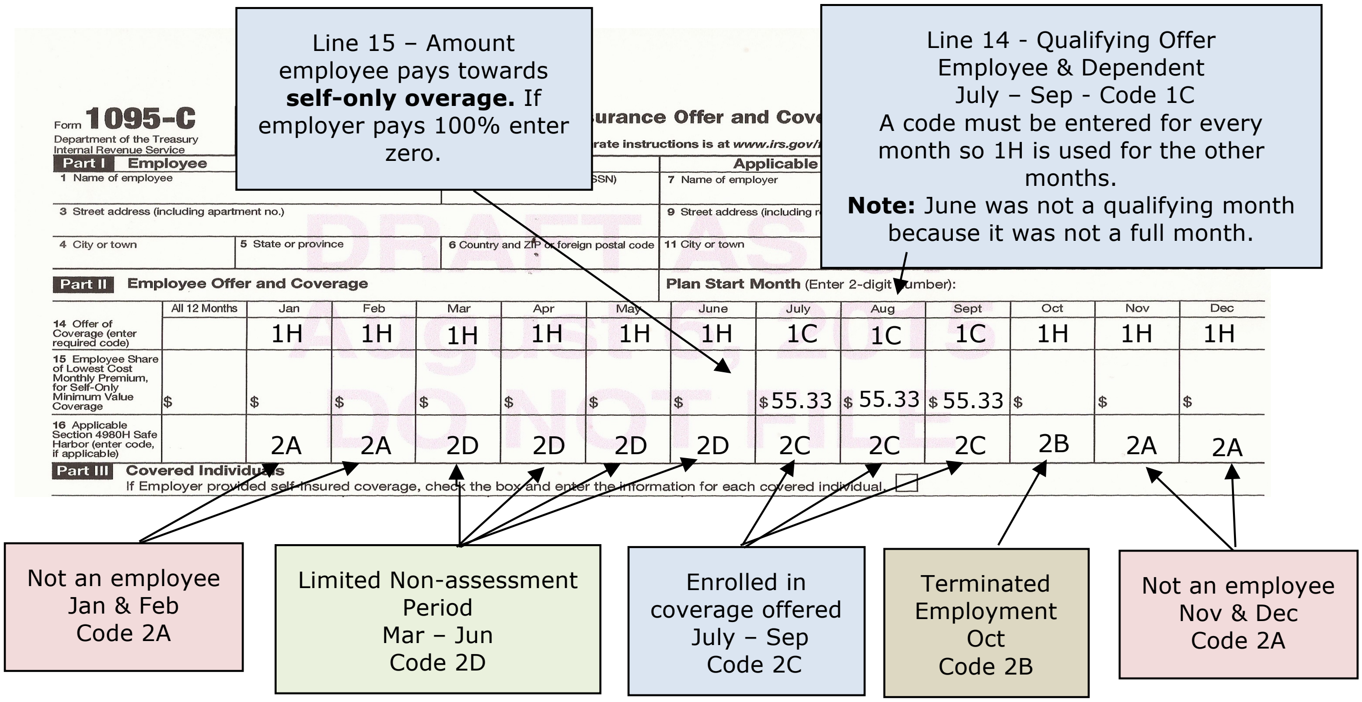
Code 2E - **Multiemployer Interim Rule Relief** - Enter code 2E for any month for which the multiemployer interim guidance applies for that employee. This relief is not covered in this material; refer to the instructions for Form 1095-C.

Code 2F - **Form W-2 Safe Harbor** - Enter code 2F if the employer used the section 4980H Form W-2 safe harbor to determine affordability for purposes of section 4980H(b) for this employee for the year. If an employer uses this safe harbor for an employee, it must be used for all months of the calendar year for which the employee is offered health coverage. See page 12.09.06 for details related to the W-2 safe harbor.

Code 2G - **Federal Poverty Line Safe Harbor** - Enter code 2G if the employer used the section 4980H federal poverty line safe harbor to determine affordability for purposes of section 4980H(b) for this employee for any month(s). See page 12.09.06 for details related to the affordability federal poverty line safe harbor.

Code 2H – **Rate of Pay Safe Harbor** - Enter code 2H if the employer used the section 4980H rate of pay safe harbor to determine affordability for purposes of section 4980H(b) for this employee for any month(s). See page 12.09.06 for details related to the rate of pay safe harbor.

Example: *ABC Inc. hired Kevin Haight on March 15, 2019. ABC has a 90-day probationary period for new employees before they offer health care insurance. On June 5, 2019 Kevin was offered insurance for himself and his dependents and enrolled in the coverage. Kevin subsequently terminated his employment October 1, 2019*



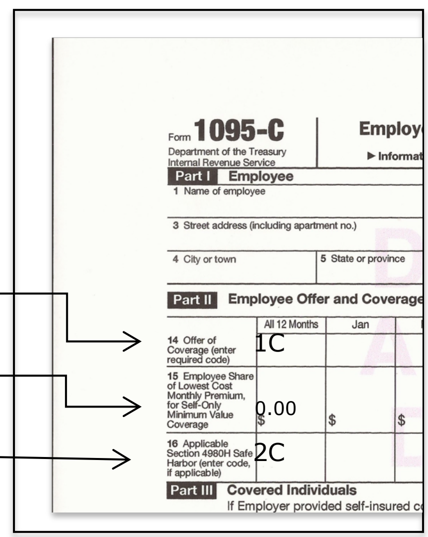
***Example:** Marty Lewis worked as a full-time employee for Carson Fabricators the entire year of 2019 and was offered insurance that provided minimum essential coverage for himself and his dependents for the entire year. The employer pays the entire premium for Marty. Marty was enrolled in coverage for the full year.*

In this situation only the "All 12 months" column need be completed.

Enrolled in coverage offered for the entire year. Code 1C

Employer paid 100% of premium so employee's cost is entered as 0.00

Enrolled in coverage offered for the entire year. Code 2C



1095-B – Health Coverage - Form 1095-B is used by providers of minimum essential health coverage, typically insurance companies, to report which months the individuals have minimum essential coverage. A simple check box is all that is needed since the insurance providers using this form only provide minimum essential coverage. Employers, including government employers, subject to the employer shared responsibility provisions that sponsor self-insured group health plans will report information about the coverage in Part III of Form 1095-C.

This information is used to determine if the individual(s) are subject to the shared responsibility payment (penalty for not being insured).

Continue to next page

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Form **1095-B** Department of the Treasury Internal Revenue Service

Health Coverage

▶ Information about Form 1095-B and its separate instructions is at *www.irs.gov/form1095b.*

☐ VOID ☐ CORRECTED

2019

Part I Responsible Individual

1 Name of responsible individual		2 Social security number (SSN)	3 Date of birth (If SSN is not available)
4 Street address (including apartment no.)	5 City or town	6 State or province	7 Country and ZIP or foreign postal code
8 Enter letter identifying Origin of the Policy (see instructions for codes): . . . . ▶ ☐		9 Small Business Health Options Program (SHOP) Marketplace identifier, if applicable	

Part II Employer Sponsored Coverage (see instructions)

10 Employer name			11 Employer identification number (EIN)
12 Street address (including room or suite no.)	13 City or town	14 State or province	15 Country and ZIP or foreign postal code

Part III Issuer or Other Coverage Provider (see instructions)

16 Name		17 Employer identification number (EIN)	18 Contact telephone number
19 Street address (including room or suite no.)	20 City or town	21 State or province	22 Country and ZIP or foreign postal code

Part IV Covered Individuals (Enter the information for each covered individual(s).)

	(a) Name of covered individual(s)	(b) SSN	(c) DOB (If SSN is not available)	(d) Covered all 12 months	(e) Months of coverage											
					Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
23				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
24				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
25				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
26				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
27				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
28				☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60704B

NOTE

Large employers: An employer subject to the shared responsibility provisions will never complete a Form 1095-B; it is for insurance companies to report insurance coverage the insurance carrier provided to the employer's employees. Thus, unless the employer is self-insured, the employee will receive a 1095-C from the employer, with Parts I and II completed, and a Form 1095-B from the insurance carrier. If the employer is self-insured the employee will only receive a 1095-C, which will include Part III completed (in lieu of a 1095-B).

Small employers: An employer not subject to the shared responsibility provisions that sponsors a self-insured group health plan will use Form 1095-B to report information about covered employees.

Forms Due dates:

Copy to employees: by January 31

Filed with government: by February 28 (March 31 if filed electronically)

Definitions:

Month of Coverage – Means the employee was covered for every day of the month

Retirees **-** A retiree (meaning an individual who was not an employee during the applicable period) is not a full-time employee. However, if the retiree was a full-time employee for any month of the calendar year (for example, before retiring mid-year), the employer must complete information in Part II of Form 1095-C for all twelve months of the calendar year, using the appropriate codes.

Minimum Value - A plan provides minimum value if the plan pays at least 60 percent of the costs of benefits for a standard population and provides substantial coverage of inpatient hospitalization services and physician services. Report on Form 1095-C as not providing minimum value if a plan fails to provide substantial coverage of inpatient hospitalization and physician services.

Offer of Health Coverage – Employee **-** An employer makes an offer of coverage to an employee if:

- It provides the employee an effective opportunity to enroll in the health coverage (or to decline that coverage) at least once for each plan year.
- It continues the employee's election of coverage from a prior year but provides the employee an effective opportunity to opt out of the health coverage. See insurance opt-out arrangements below.
- The employer provides health coverage to an employee but does not provide the employee an effective opportunity to decline the coverage, the employer is treated as having made an offer of health coverage to the employee only if that health coverage provides minimum value and does not require an employee contribution for the coverage for any calendar month of more than 9.86% (2019) percent of a monthly amount determined as the mainland federal poverty line for a single individual for the applicable calendar year, divided by 12.
- It, or another employer in the Aggregated ALE Group, or a third party such as a multiemployer or single employer Taft-Hartley plan, a multiple employer welfare arrangement (MEWA), or, in certain cases, a staffing firm, offers health coverage on behalf of the employer.

Offer of Health Coverage – Spouse **-** For purposes of reporting, an offer to a spouse includes an offer to a spouse that is subject to a reasonable, objective condition, regardless of whether the spouse meets the reasonable, objective condition. For example, an offer of coverage that is available to a spouse only if the spouse certifies that the spouse does not have access to health coverage from another employer is treated as an offer of coverage to the spouse for reporting purposes. Note that this treatment is for reporting purposes only, and generally will not affect the spouse's eligibility for the premium tax credit if the spouse did not meet the condition and therefore did not have an actual offer of coverage.

Insurance Opt-Out Arrangements - Employers occasionally provide their employees with opt-out programs. An opt-out payment is a payment that:

(1) is available only if the employee declines coverage (which includes waiving coverage in which the employee would otherwise be enrolled) under the employer-sponsored plan, and

(2) cannot be used to pay for coverage under the employer-sponsored plan.

Proposed Regulations - Prop Reg 1.36B-2(c)(3)(v)(A)(7) defines an "eligible opt-out arrangement" as an arrangement under which the employee's right to receive the opt-out payment is conditioned on:

(1) The employee declining to enroll in the employer-sponsored coverage and

(2) The employee providing reasonable evidence that the employee and all other individuals for whom the employee reasonably expects to claim a personal exemption deduction* for the tax year or years that begin or end in or with the employer's plan year to which the opt-out arrangement applies (employee's expected tax family) have or will have minimum essential coverage (other than coverage in the individual market, whether or not obtained through the Marketplace) during the period of coverage to which the opt-out arrangement applies. For example, if an employee's expected tax family consists of the employee, the employee's spouse, and two children, the employee would meet this requirement by providing reasonable evidence that the employee, the employee's spouse, and the two children, will have coverage under the group health plan of the spouse's employer for the period to which the opt-out arrangement applies.

**For years 2018 through 2025, there is no exemption deduction per the TCJA. Nonetheless, those individuals who are the employee's dependents would presumably still be covered by this proposed regulation.*

The final regulations show "reserved" for opt-out arrangements at 1.36B-2(c)(3)(v)(A)(7).

Limited Non-assessment Period **-** The term limited non-assessment period refers to a period of time at the employee's beginning of employment where an employer will not be assessed the penalty. An example would be the employee's probationary period at the beginning of employment.

An ALE will not be subject to an assessable payment under section 4980H(a), and in certain cases section 4980H(b), for a full-time employee during limited non-assessment periods. The first five periods described below are Limited Non-Assessment Periods only if the employee is offered health coverage by the *first day of the first month following the end of the period*, and are Limited Non-Assessment Periods for section 4980H(b) only if the health coverage that is offered at the end of the period provides minimum value (Regulations section 54.4980H-1(a)(26)).

1. **First Year as ALE Period:** January through March of the first calendar year in which an employer is an ALE, but only for an employee who was not offered health coverage by the employer at any point during the prior calendar year. For this purpose, 2019 is not the first year an employer is an ALE, if that employer was an ALE in 2018.

2. **Waiting Period under the Monthly Measurement Method:** If an employer is using the monthly measurement method to determine whether an employee is a full-time employee, the period beginning with the first full calendar month in which the employee is first otherwise (but for completion of the waiting period) eligible for an offer of health coverage and ending no later than *two full calendar months after the end of that first calendar month*.
3. **Waiting Period under the Look-Back Measurement Method:** If an employer is using the look-back measurement method to determine whether an employee is a full-time employee and the employee is reasonably expected to be a full-time employee at his or her start date, the period beginning on the employee's start date and ending not later than the end of the employee's *third full calendar month of employment*.
4. **Initial Measurement Period and Associated Administrative Period under the Look-Back Measurement Method:** If an employer is using the look-back measurement method to determine whether a new employee is a full-time employee, and the employee is a variable hour employee, seasonal employee or part-time employee, the initial measurement period for that employee and the administrative period immediately following the end of that initial measurement period.
5. **Period Following Change in Status that Occurs During Initial Measurement Period Under the Look-Back Measurement Method:** If an employer is using the look-back measurement method to determine whether a new employee is a full-time employee, and, as of the employee's start date, the employee is a variable hour employee, seasonal employee or part-time employee, but, during the initial measurement period, the employee has a change in employment status such that, if the employee had begun employment in the new position or status, the employee would have reasonably been expected to be a full-time employee, the period beginning on the date of the employee's change in employment status and ending not later than the end of the third full calendar month following the change in employment status. If the employee is a full-time employee based on the initial measurement period and the associated stability period starts sooner than the end of the third full calendar month following the change in employment status, this Limited Non-Assessment Period ends on the day before the first day of that associated stability period.
6. **First Calendar Month of Employment:** If the employee's first day of employment is a day other than the first day of the calendar month, then the employee's first calendar month of employment is a Limited Non-Assessment Period.

TRANSMITTAL FORM 1094-C (PAGE 1)

A 1094-C transmittal form must be used when filing 1095-Cs. Multiple 1094-Cs can be filed for an employer where all of the 1095-Cs were not filed with a single transmittal form.

Authoritative Transmittal Form – An Authoritative Transmittal is one that includes all parts of the 1094-C completed. The reason for this is that multiple 1094-Cs can be filed, but one of them must have all required parts completed while the others only require Part I to be completed.

> ***Example:*** *The employer has two divisions and each division will be submitting the 1095-C for that division separately. However, one of those 1094-Cs must be the Authoritative Transmittal with the employer information for both divisions.*

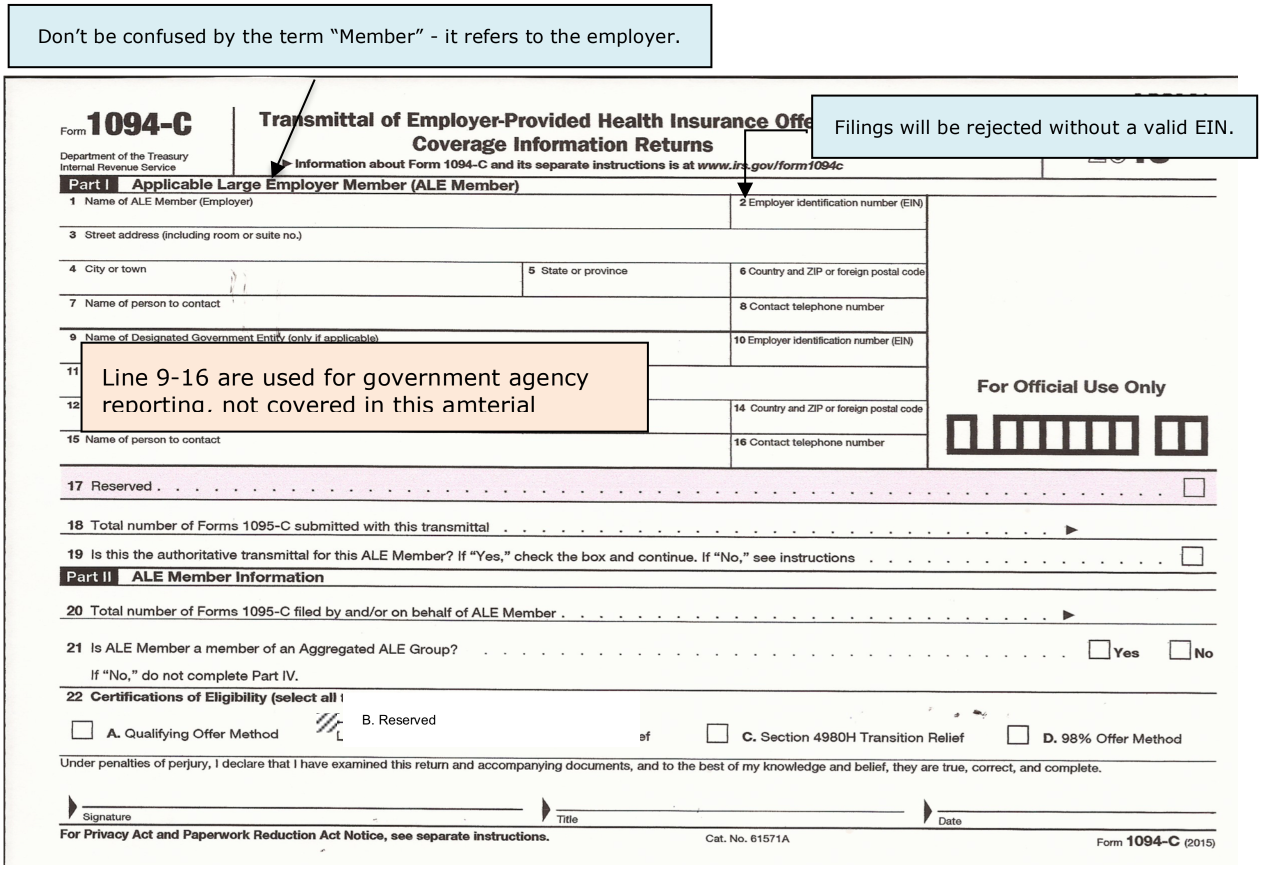
Electronic Filing Requirement – An employer must file electronically if filing 250 or more 1095-Cs. The requirement has applied separately to each type of form. However, in June 2018 the IRS proposed regulations that would change the non-aggregation rule so that all information returns, regardless of type, would need to be counted when determining whether the 250-return threshold for required electronic filing is met. The new rules generally will be effective when the Treasury Decision adopting them as final is published in the Federal Register, but they will not apply to information returns required to be filed before January 1, 2019. The proposed regulations do not change the existing regulations allowing those who are required to electronically file returns to request a waiver of the electronic-filing requirement. (NPRM REG-102951-16)

> ***Example:*** *If the employer must file 500 Forms 1095-B and 100 Forms 1095-C in 2018, the employer must file Forms 1095-B electronically, but is not required to file Forms 1095-C electronically. If in 2019 and after the proposed regulations are final, the employer is filing the same number of 1095 forms as in 2018, the 1095-B and also the 1095-C forms would need to be filed electronically.*

Extension – Form 8809 must be filed by the due date of the 1094-C to obtain an automatic 30-day extension.

Electronic Filing Waiver - Form 8508, is used to request a waiver from filing information returns electronically. It must be filed at least 45 days before the due date of the returns.

Electronic Filing Penalty – Employers may be subject to a penalty up to $250 per return for failing to file electronically when required to do so. This amount is inflation-adjusted and is $260 for years beginning in 2015, 2016 or 2017. For returns required to be filed in 2020 andr 2019 (i.e., those reporting 2019 andr 2018 information), the penalty is $270. (Rev Procs 2018-18 and 2018-57)



Form **1094-C**
Department of the Treasury Internal Revenue Service

Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns

▶ Information about Form 1094-C and its separate instructions is at *www.irs.gov/form1094c*

Part I Applicable Large Employer Member (ALE Member)

1 Name of ALE Member (Employer)
2 Employer identification number (EIN)
3 Street address (including room or suite no.)
4 City or town
5 State or province
6 Country and ZIP or foreign postal code
7 Name of person to contact
8 Contact telephone number
9 Name of Designated Government Entity (only if applicable)
10 Employer identification number (EIN)
11
12
14 Country and ZIP or foreign postal code
15 Name of person to contact
16 Contact telephone number

For Official Use Only

17 Reserved
18 Total number of Forms 1095-C submitted with this transmittal ▶
19 Is this the authoritative transmittal for this ALE Member? If "Yes," check the box and continue. If "No," see instructions

Part II ALE Member Information

20 Total number of Forms 1095-C filed by and/or on behalf of ALE Member ▶
21 Is ALE Member a member of an Aggregated ALE Group? Yes No
If "No," do not complete Part IV.
22 Certifications of Eligibility (select all
A. Qualifying Offer Method B. Reserved C. Section 4980H Transition Relief D. 98% Offer Method

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and to the best of my knowledge and belief, they are true, correct, and complete.

Signature Title Date

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 61571A Form **1094-C** (2015)

Definitions for Line 22 – Boxes A and D:

Qualifying Offer - A qualifying offer is an offer by an ALE of minimum essential coverage to one or more of its full-time employees for all months (not within a limited non-assessment period) of the year for which the employee was a full-time employee:

- Not costing more than 9.86% of the mainland single federal poverty line for the employee, and
- Minimum essential coverage to the employee's spouse and dependents.

If the employee does not have a spouse or dependent the employer is treated as if the employee did have a spouse or dependent for purposes of meeting the qualified offer.

Alternative Method of Completing Form 1095-C under the Qualifying Offer Method - If the employer reports using this method, it must not complete Form 1095-C, Part II, line 15, for any month for which a Qualifying Offer is made. Instead it must enter the Qualifying Offer code 1A on Form 1095-C, line 14, for any month for which the employee received a Qualifying Offer (or in the all 12 months box if the employee received a Qualifying Offer for all 12 months), and must leave line 15 blank for any month for which code 1A is entered on line 14.

An employer is not required to use the Qualifying Offer Method, even if it is eligible and instead may enter on line 14 the applicable offer code and then enter on line 15 the dollar amount required as an employee contribution for the lowest-cost employee-only coverage providing minimum value for that month. See the Form 1094-C instructions for additional details.

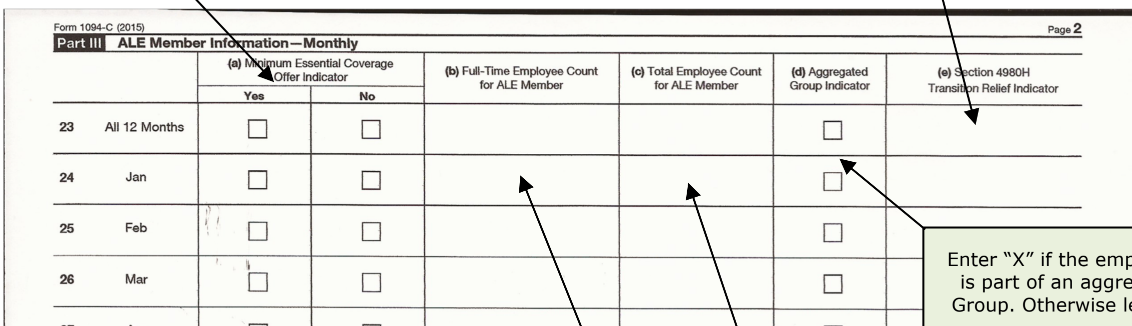
98% Offer Method - To be eligible for the 98% Offer Method, an employer must certify that the employer offered affordable (meets one of the Section 4980H safe harbors) coverage to 98% of its employees (not just full time) for all months of the year except for limited non-assessment periods (new employee waiting period) and offered dependent coverage.

To ensure compliance with the general reporting rules, an employer should confirm for any employee for whom it fails to file a Form 1095-C that the employee was not a full-time employee for any month of the calendar year.

TRANSMITTAL FORM 1094-C (PAGE 2)

An employer that offers coverage to at least 95% of its full time employees and their dependents may enter an "X" in the "Yes" checkbox either for "All 12 Months" or for the month(s) during which it met that 95% threshold. See form instructions for non-calendar year plans. Otherwise check "No".

Col E for 2018 was shaded out and titled Reserved



Form 1094-C (2015) Page 2

Part III ALE Member Information—Monthly

		(a) Minimum Essential Coverage Offer Indicator		(b) Full-Time Employee Count for ALE Member	(c) Total Employee Count for ALE Member	(d) Aggregated Group Indicator	(e) Section 4980H Transition Relief Indicator
		Yes	No				
23	All 12 Months	☐	☐			☐	
24	Jan	☐	☐			☐	
25	Feb	☐	☐			☐	
26	Mar	☐	☐			☐	

Enter "X" if the employer (ALE) is part of an aggregated ALE Group. Otherwise leave blank.

CAUTION: The full form is not displayed. Use line 23 if the information for all months is the same. Otherwise complete all the lines for Jan through Dec.

When determining the number of employees, the employer must choose one of the following days and use that day for the entire year.

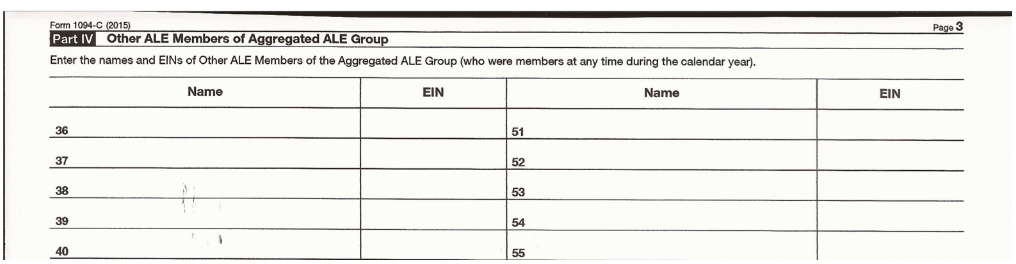
- First day of the month
- Last day of the month
- 12th day of the month
- First day of the first payroll period for each month
- Last day of the first payroll period for each month

Enter the number of EFTE. Note: The number must also include EFTE within a limited non-assessment period.

Enter the number of FTE (don't include FTEs in a limited non-assessment period). Note: If the employer (ALE) certified it was for the 98% Offer method, column b need not be completed.

TRANSMITTAL FORM 1094-C (PAGE 3)

Page 3 of the form is used to report affiliated firms that must combine employees for purposes of the penalty and reporting.



Form 1094-C (2015) Page 3

Part IV Other ALE Members of Aggregated ALE Group

Enter the names and EINs of Other ALE Members of the Aggregated ALE Group (who were members at any time during the calendar year).

	Name	EIN		Name	EIN
36			51		
37			52		
38			53		
39			54		
40			55		

Corrected Filings

- **1094-C (authoritative filing)** – File a standalone corrected 1094-C correcting the authoritative information filed on the original 1094-C and check the corrected box. Do not include any 1095-Cs with the corrected authoritative 1094-C.
- **1095-C** – Include the corrected 1095-C (with the corrected box checked) and file with 1094-C (**without** the corrected box checked) and only complete Part I of the 1094-C.

CALIFORNIA DIFFERENCES

California has no equivalent penalty.

NOTES

SMALL EMPLOYER HRA

Small Employer: **Fewer than 50 Full-Time Equivalent Employees**
Maximum Reimbursements:

- Single Individual: $5,150 (up from $5,050 in 2019)
- Family: $10,450 (up from $10,250 in 2018)

Reimbursements Excluded from income

MAXIMUM REIMBURSEMENTS			
Year	Period	Single	Family
2019	Annual	$5,150	$10,450
	Monthly	$429	$871
2018	Annual	$5,050	$10,250
	Monthly	$421	$854
2017	Annual	$4,950	$10,000
	Monthly	$413	$833

Pre-Regulations Q & As – The IRS issued Notice 2017-67 that provides guidance in question and answer format on the requirements for providing a qualified small employer health reimbursement arrangement (QSEHRA), the tax consequences of the arrangement, and the requirements for providing written notice of the arrangement to eligible employees. Topics covered include eligible employers, eligible employees, same terms requirement, the statutory dollar limit, written notice requirement, the minimum essential coverage requirement, reimbursements, reporting, and coordination with the premium tax credit and health saving account requirements. The IRS plans to issue future proposed regulations based on this guidance, which generally applies for plan years beginning on and after November 20, 2017.

Related IRC and IRS Publications and Forms

- **21ST Century Cures Act**
- **Sec 9831**

The "21st Century Cures Act" (H.R. 34), passed in late 2016, included a provision allowing small employers to reimburse their employees under a health reimbursement arrangement (HRA) for medical expenses without being liable for a $100 per day draconian penalty (IRC Sec 4980D) for violating the Affordable Care Act (ACA)'s rules.

Effective January 1, 2017, qualified small employers with an average of fewer than 50 full-time employees (including full-time equivalent employees) that maintain a qualified small employer HRA will be exempt from the penalty. Under the Act, a qualified small employer (as defied in IRC Sec 4980H(c)(2) is one that:

(1) Employs an average of fewer than 50 full-time employees (including full-time equivalent employees) and does not offer a group health plan to its employees (IRC Sec 9831(d)(3)(B)). The number of full-time equivalent employees is determined by adding up all the hours worked by part-time employees for a month and dividing by 120.

(2) Provides the HRA on the same terms to all eligible employees (IRC Sec 9831(d)(2)(A)(ii)). Eligible employees (IRC Sec 9831(d)(3)(A)) are any employees of the employer except:
   a. Those who have not completed 90 days of service.
   b. Those who have not attained the age of 25.
   c. Part-time workers (generally those working an average of less than 30 hours per week).
   d. Seasonal workers (generally those employed for 6 months or less during the year).
   e. Employees covered by a collective bargaining unit.
   f. Certain non-resident aliens.

(3) Entirely funds the HRA (no salary reduction contribution may be made under the HRA). (IRC Sec 9831(d)(2)(B)(i))

(4) Only reimburses the employees after being provided proof of their medical expenses before being reimbursed. (IRC Sec 9831(d)(2)(B)(ii))

(5) Limits reimbursements in 2018 to $5,050 ($10,050 where the plan includes family members) per year. Amounts are subject to inflation adjustments (IRC Sec 9831(d)(2)(B)(iii)). For employees who are covered for less than a full year the dollar limits are prorated (IRC Sec 9831(d)(2)(D)(i)).

Although this law is effective January 1, 2017, transitional relief is generally provided for any HRA plan beginning on or before December 31, 2016.

The medical expense reimbursements that an employee receives from a qualifying HRA are excluded from the employee's income.

CALIFORNIA DIFFERENCES

California has no similar excise penalty and does not conform to IRC section 9831, which provides for general exceptions to group health plan requirements (FTB's Summary of Federal Income Tax Changes 2016).

NOTES

GLOSSARY

Abstract fees - Expenses generally paid by a buyer to research the title of real property.

Academic Period – Schools and Universities generally conduct classes on either a semester or quarterly basis. Each quarter or semester is treated to as an academic period.

Accrual method – The accrual method of accounting requires that amounts are included in in gross income when they are earned, even though payment may be received in another year. Income is earned when: (1) all events have occurred that fix the right to receive the income, and (2) the amount to be received can be determined with reasonable accuracy. Expenses are claimed when a taxpayer becomes liable for them, whether or not they are actually paid in the same year.

Active conduct of a trade or business - Generally, for the section 179 deduction, a taxpayer is considered to conduct a trade or business actively if he or she meaningfully participates in the management or operations of the trade or business. A mere passive investor in a trade or business does not actively conduct the trade or business.

Acquisition Indebtedness - Acquisition indebtedness means indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

Active appreciation - occurs when marital funds or marital efforts cause a spouse's separate property to increase in value during the marriage.

Actual auto expense method – A method of determining automobile operating expenses based on actual expenses plus a depreciation allowance. Used in lieu of the optional aato expense (standard mileage) method.

Adjusted basis: The original cost of property, plus certain additions and improvements, minus certain deductions such as depreciation allowed or allowable and casualty losses.

Adjusted Net Minimum Tax (ANMT) - For a non-corporate taxpayer, the ANMT for a tax year equals: (a) the alternative minimum tax (AMT) paid for that year; *less* (b) the amount of AMT that would have arisen if the only applicable preferences and AMT adjustments were "exclusion preferences" *plus* (c) the amount of any qualified electric vehicles credit not allowed solely by reason of the limitation on that credit that is a function of the taxpayer's tentative minimum tax.

Aggregate - An aggregate is a collection of items that are gathered together to form a total quantity.

Alien – An individual that is not a U.S. citizen. Aliens can be non-resident or resident aliens.

Alternative Minimum Taxable Income (AMTI) — Is the taxpayer's regular taxable income increased by certain items (exclusion preferences) and adjusted by treating certain items in a manner that negates the deferral of income resulting from their regular tax treatment (deferral adjustments).

Alternative minimum tax (AMT) – A tax imposed on individuals with certain large deductions and tax preferences. It is an add-on tax and is the difference between the regular tax and the tentative alternative minimum tax.

Amortization - A ratable deduction for the cost of intangible property over its useful life.

Amount realized - The total of all money received plus the fair market value of all property or services received from a sale or exchange. The amount realized also includes any liabilities assumed by the buyer and any liabilities to which the property transferred is subject, such as real estate taxes or a mortgage.

AMT Credit - The AMT credit is the difference between the tentative AMT and adjusted net minimum Tax (ANMT) but not exceeding the AMT itself. The ANMT is generally the AMT recomputed without deferral items of preference, which for most individual means the AMT recomputed without the Incentive Stock Option (ISO) preference.

AMT Exemptions – For regular tax, taxpayers are allowed to deduct a personal exemption for the taxpayer, spouse and each person that they can claim as a dependent. For the AMT, taxpayers are allowed a single exemption based upon the taxpayer's filing status. In both cases, the exemptions are phased-out for higher income taxpayers.

Annuity - In the United States an annuity contract is created when an insured party, usually an individual, pays a life insurance company a single premium that will later be distributed back to the insured party over time. Annuity contracts traditionally provide a guaranteed distribution of income over time, until the death of the person or persons named in the contract or until a final date, whichever comes first. However, the majority of modern annuity customers use annuities only to accumulate funds free of income and capital gains taxes and to later take lump-sum withdrawals without using the guaranteed-income-for-life feature.

Asset appreciation - appreciation of an asset is an increase in its value.

At-Risk - To take a deduction for an item on a tax return, a taxpayer must have either actually paid for the item or be responsible for paying it.

Basis - The "basis" of an asset can be thought of as the amount a taxpayer has invested in the property. Without knowing the basis, deductions for depreciation, casualties, or depletion, etc. could not be determined, and gains or losses on the disposition of assets could not be established.

Basis adjustment – an adjustment made to the tax basis of an asset. Gain or loss on the disposition of an asset is generally the difference between the tax basis and the sales price less sales expenses.

Beneficiary - A beneficiary in the broadest sense is a natural person or other legal entity that receives money or other benefits from a benefactor. For example: The beneficiary of a life insurance policy is the person who receives the payment of the amount of insurance after the death of the insured.

Bonus depreciation – This is depreciation that is allowed with considering the MACRS limits. Generally allowed in the property is place in service and computed before the normal MACRS allowance.

Boot - Is unlike property or cash given or received in an exchange.

Business/investment use - Usually, a percentage showing how much an item of property, such as an automobile, is used for business and investment purposes.

Business Meal – A meal consumed in the course of a business meeting or activity including meals while on business travel status.

Capitalized - Expended or treated as an item of a capital nature. A capitalized amount is not deductible as a current expense and must be included in the basis of property.

Capital Gain - A capital gain is essentially the difference between the purchase price (or other basis) and the price at which the asset is sold (or otherwise disposed of), where the purchase price is lower than the sales price.

Capital Loss - A capital loss is essentially the difference between the purchase price (or other basis) and the price at which the asset is sold (or otherwise disposed of), where the sale price is lower than the purchase price.

Carryover – When a deduction or credit is not used up it may be allowed to be carried over to a subsequent year and is referred to as a carryover.

Case law - is the set of reported judicial decisions of selected appellate courts and other courts of first instance that make new interpretations of the law and, therefore, can be cited as precedents.

Cash method – Is the short tile for "cash receipt and disbursement method." Under this accounting method, amounts received are included in gross income in the year of actual or constructive receipt, regardless of whether the income is earned in that year. Expenses are usually deducted in the year paid.

Chronically ill person - is one who has been certified by a licensed health care practitioner within the previous 12 months as: (1) unable to perform at least two activities of daily living (eating, toileting, transferring, bathing, dressing, continence) without substantial assistance for a period of 90 days due to loss of functional capacity, (2) having a similar level of disability as determined in regulations, or (3) requiring substantial supervision to protect from threats to health and safety due to severe cognitive impairment. The requirement that a qualified long-term care insurance contract must base determination of whether an individual is chronically ill by taking into account five activities of daily living applies only to (1) above (being unable to perform at least two activities of daily living).

Circumstantial evidence - Details or facts that indirectly point to other facts.

Class life - A number of years that establishes the property class and recovery period for most types of property under the General Depreciation System (GDS) and Alternative Depreciation System (ADS).

Closely Held Corporation – Is one for which no ready market exists for the trading of shares. Many such corporations are owned and managed by a small group of businesspeople or companies, although the size of such a corporation can be as vast as the largest public corporations.

Club Dues - Amounts paid or incurred for membership in any club organized for business, pleasure, recreation or other special purpose.

COD – The acronym for cancellation of debt.

Commercial Fishermen – Seaman who works on a fishing vessel that is in the business of catching and selling fish as a livelihood.

Commission - Remuneration for services rendered or products sold is a common way to reward sales people. Payments often will be calculated on the basis of a percentage of the goods sold.

Community income - is generally income from: Community property, salaries, wages, or pay for services while registered or married, real estate that is treated as community property under the laws of the state where the property is located.

Community Property – In states that have community property laws, community property considered to belong equally to both spouses, just as with all other property that is owned or acquired by either spouse during the marriage. AZ, CA, ID, LA, NV, NM, TX, WA and WI are community property states. Alaska, although not a community property state, does permit a married couple to identify property and income to be classified as community property by agreement or trust.

Commuting - Travel between a personal home and work or job site within the area of an individual's tax home.

Compensation – Compensation includes: Wages, Tips, Bonuses, Professional Fees, Commissions, Alimony received, and Net Income from self-employment.

Constructive receipt – Refers to income that hasn't actually been received by a taxpayer but is taxed as though it had been, if the following are true: (1) The amount is readily available to the taxpayer and (2) The taxpayer's actual receipt isn't subject to substantial restrictions

Consumer Interest – Interest paid on loans to acquire non-business assets and consumer goods. Consumer interest is generally not tax deductible.

Control – The power to influence or direct people's behavior or the course of events.

CONUS – An acronym for continental United States. Does not include Alaska or Hawaii.

Convenience of the employer means a business necessity—the use of the home must be a condition of employment. The employee needs a place to work, but the employer doesn't provide it (or the office provided by the employer is inadequate or unsafe). Usage by the employee for personal convenience is not enough.

Cost - Use actual cost of merchandise, less discounts plus freight and other handling charges.

Coverdell Education Savings Account - A nondeductible education savings account. The investment earnings from these accounts accrue and are withdrawn tax-free, provided the proceeds are used to pay qualified higher education expenses of the account beneficiary.

Day Care - is care of a child during the day by a person other than the child's legal guardians, typically performed by someone outside the child's immediate family. Day care is typically an ongoing service during specific periods, such as the parents' time at work.

Declining Balance Method - An accelerated method to depreciate property. The General Depreciation System (GDS) f MACRS uses the 150% and 200% declining balance methods for certain types of property. A depreciation rate (percentage) is determined by dividing the declining balance percentage by the recovery period for the property.

Definite Temporary Assignment - Employment of short and fixed duration away from a taxpayer's regular business location, tax home does not change.

Delayed Exchange – A delayed exchange is one that is not simultaneous and must be completed through a qualified intermediary. The property to be received in the exchange must be identified within 45 days. The taxpayer is allowed to designate a maximum of either: (a) Three replacement properties regardless of FMV; or (b) Any number of properties, as long as the total FMV isn't more than 200% of the total FMV of all properties given up. Receipt of the new property must be completed before the EARLIER of: (1) 180 days after the transfer of the property given, OR (2) The due date (including extensions) of the return for the year in which the property given was transferred.

Depreciable Period – For Sec 199A the purpose the term depreciable period means the period beginning on the date the taxpayer first puts the property in service and ending on the later of:

(a) 10 years after the placed-in-service date or

(b) The last day of the last full year of the applicable MACRS recovery periodof the property (Code Sec. 199A(b)(6)(B)).

Depreciation - The allocation of the cost of assets to periods in which the assets are used.

Depreciation Convention - A method established under the Modified Accelerated Cost Recovery System (MACRS) to determine the portion of the year to depreciate property both in the year the property is placed in service and in the year of disposition.

Disabled - A taxpayer is considered disabled if the taxpayer can furnish proof that he/she cannot perform any substantial gainful activity because of the physical or mental condition. A physician must determine that the taxpayer's condition: (a) can be expected to result in death, or (b) is expected to be of a long, continued and indefinite duration.

Direct Expenses (Home Office) - are the expenses that benefit only the business part of the home. They are deductible in full (subject to the home office gross-income limit, but they are not prorated by the business-use percentage). NOTE: Don't confuse direct expenses with expenses directly related to the business. Directly related expenses aren't subject to the limitation of §280A and are fully deductible as business expenses and include such items as office supplies, postage, advertising, etc. The basic charge of the first home telephone line in the home is nondeductible. However, toll calls on that lines related to the taxpayer's business are deductible (without limitation)—i.e., they are directly related expenses without limitation. The cost of a second telephone used only for the business is a directly related expense fully deductible without limitation.

Direct sellers are those in the business of selling consumer products to buyers at other than a permanent retail establishment.

Disposition: The permanent withdrawal from use in a trade or business or from the production of income.

De minimis - is a Latin expression meaning *about minimal things*

Documentary evidence: Written records that establish certain facts.

Employee - A worker who must comply with instructions about when, where and how to work is generally considered an employee.

Estate Tax - The estate tax is a tax imposed on the transfer of the "taxable estate" of a deceased person, whether such property is transferred via a will, according to the state laws of intestacy or otherwise made as an incident of the death of the owner, such as a transfer of property from an intestate estate or trust, or the payment of certain life insurance benefits or financial account sums to beneficiaries.

Excess Debt - Interest on debt secured by the home must first be allocated to the home to the extent permitted, and any excess (excess debt) can be allocated to the use of the funds per the general tracing rules of Reg §1.163-8T. Per the tracing rules, where the use of the loan funds can be traced to another purpose, the interest on the excess debt can be allocated to that use.

Exchange - To barter, swap, part with, give, or transfer property for other property or services.

Executor - An individual appointed to administrate the estate of a deceased person. The executor's main duty is to carry out the instructions and wishes of the deceased. The executor is appointed either by the testator of the will (the individual who makes the will) or by a court, in cases where there was no prior appointment.

Expertise - knowledge or ability based on research, experience, or occupation and in a particular area of study. Also extensive study in accepted business, economic, and scientific practices.

Fair Market Value – The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

Fiduciary - The one who acts on be- half of another as a guardian, trustee, executor, administrator, receiver, or conservator.

First-Time Homebuyer - Generally, the taxpayer is a first-time homebuyer if the taxpayer had no present interest in a main home during the 2-year period ending on the date of acquisition of the home which the distribution is being used to buy, build, or rebuild. If the taxpayer is married, the taxpayer's spouse must also meet this no-ownership requirement.

FICA – Is the acronym for "Federal Insurance Contributions Act" and a term used to describe payroll tax withholding including Social Security and Medicare.

FIFO - stands for first-in, first-out, meaning that the oldest inventory items are recorded as sold first but do not necessarily mean that the exact oldest physical object has been tracked and sold; this is just an inventory technique.

Foreclosure - In a foreclosure, the lender has taken possession of the property through legal channels.

Foreign Tax Credit - A non-refundable tax credit for income taxes paid to a foreign government. The credit can only be claimed on income that is also subject to domestic taxation. For example, if some of the taxpayer's foreign income is taxable and some is exempt, then the taxpayer must be able to break down the taxes paid on the foreign income only, and only claim the credit for taxes paid on that foreign income.

Full-time – Full time refers to the status as full-time employee as opposed to being a part-time employee. The number of hours worked that constitutes full time can vary by employer and industry. The code frequently uses 2,080 hours per year to define a full time employee.

Garnishment - A garnishment is a means of collecting a monetary judgment against a defendant by ordering a third party (the garnishee) to pay money, otherwise owed to the defendant, directly to the plaintiff. In the case of collecting for taxes, the law of a jurisdiction may allow for collection without a judgment or other court order. The most common type of garnishment is the process of deducting money from an employee's monetary compensation (including salary), sometimes as a result of a court order. Wage garnishments continue until the entire debt is paid or arrangements are made to pay off the debt.

Gift Tax – Gift tax imposes a tax on transfers of property during a person's life; the gift tax prevents avoidance of the estate tax should a person want to give away his/her estate.

Goodwill - An intangible property such as the advantage or benefit received in property beyond its mere value. It is not confined to a name but can also be attached to a particular area where business is transacted, to a list of customers, or to other elements of value in business as a going concern.

Grandfathered Acquisition Debt - Debts existing before 10/14/87 are treated as acquisition debts, even if they total more than $1,000,000. But pre-10/14/87 debts decrease the amount of the $1,000,000 limitation available for acquisition debt incurred after 10/13/87. Pre-10/14/87 debt includes debt which is refinanced after 10/13/87, and which does not exceed the loan balance at the time of the refinance.

Grantor - The one who transfers property to another.

Head of Household - For a *single* individual to claim *head of household*, the taxpayer must be a U.S. citizen or resident AND must either: (a) Pay more than one-half of the cost of maintaining as his or her home a household which is the principal place of abode for more than one-half the year of for a qualified person. A qualified person generally includes a qualified child, or a relative for whom the taxpayer may claim a dependency exemption, or (b) Pay more than half the cost of maintaining a separate household that was the main home for a dependent parent for the entire year.

Health Savings Account (HAS) - Health savings accounts allows individuals under age 65 to make tax-deductible contributions to a special account tied to a high-deductible health insurance policy. Earnings inside the HSA are tax deferred. To be eligible to contribute to an HSA, an individual must have a qualified insurance policy that has specified deductible limits. The limits are inflation adjustable annually as are the contribution limits. Money from the HSA can be used tax- and penalty-free to pay the insurance policy deductible, co-payments and any other qualifying medical expenses. Money left in the account at the end of a year can be rolled over to the next year. The penalty for withdrawing HSA funds for non-qualifying purposes before age 65 is 20%. After reaching age 65, contributions to the HSA must cease, and non-qualifying withdrawals are taxed but not penalized.

HELOC – A **home equity line of credit** is a loan in which the lender agrees to lend a maximum amount within an agreed period, where the collateral is the borrower's equity in his/her house.

High-low per diem – Also referred to as the "simplified per diem method" rather than using actual per diems. Under this method there is one rate for designated high-cost areas within the continental United States (CONUS) and another per diem rate for all other areas within CONUS.

Higher Education Interest - Up to $2,500 of interest on debt to finance higher education is deductible as an adjustment to AGI. This debt can be secured by the home as long as it is not mixed-use. Therefore, a taxpayer who is using home equity to finance higher education and is subject to the AMT, can use the election to treat the mortgage as not secured by the home and convert home equity debt interest into deductible higher education interest by utilizing the election. ***Caution:*** (1) Debt must solely be for higher education purposes. (2) Before making the election, be sure the taxpayer's modified AGI doesn't exceed the top of the phase out range for deducting the student loan interest. (3) Unless Congress takes action, effective in 2013, the deduction will be limited to interest paid on a qualified loan during only the first 60 months in which the interest payments are required.

Home Acquisition Debt (Code Sec. 163(h)(3)(B)) **-** is debt incurred to purchase, construct, or substantially improve a taxpayer's principal home or second home and must be secured by the home. Combined acquisition debt on the two homes can't be more than $1,000,000 ($500,000 for married separate). Debts existing before 10/14/87 are treated as acquisition debts, even if they total more than $1,000,000. But pre-10/14/87 debts decrease the amount of the $1,000,000 limitation available for acquisition debt incurred after 10/13/87. Refinanced debt can also qualify as acquisition debt, if it doesn't exceed the amount of the acquisition debt just before the refinancing. Any excess refinanced debt would be treated as equity debt. Acquisition debt is deductible for AMT purposes.

Home Equity Debt (Code Sec. 163(h)(3)(C)) - is debt that is not acquisition debt and is secured by a taxpayer's principal or second home. For regular tax purposes, the equity debt on the two homes can't be more than $100,000 ($50,000 for married separate), or the difference between the acquisition debt on the home and the FMV of the home, if smaller. Equity debt is NOT deductible for AMT purposes.

Home Office Carryover – The home office carryover consists of two elements which must be segregated for carryover purposes: (1) Other direct and prorated indirect expenses of the home office (including excess mortgage interest for self-employed taxpayers) that were not deductible because of the gross income limitation and (2) Home depreciation that was not deductible because of the gross income limitation. In subsequent years these two elements of the carryover are combined with like expenses for the subsequent year and then the gross income limitation for that year is applied. If there is any excess the carryover to the next subsequent year is determined and that process continues year to year until the carryover is used up.

Home Office Gross Income - Gross income is defined as total income from the business less: a. The business portion of expenses deductible even if the home was not used for business (e.g., mortgage interest, taxes, casualties), plus b. The business expenses relating to the business, but not to the use of the home (e.g., supplies, advertising, etc.).

Home Mortgage Interest (Home Office) – Which is the amount of the interest that would be allowed on Schedule A taking into consideration the acquisition debt and equity debt limitations. However, do not include mortgage interest on a loan that did not benefit the home, such as an equity loan used to buy a car, pay tuition expenses, or pay off credit card debts.

Hours of service – Generally refers to the number of hours of employment. Also refers to the U.S. Department of Transportation "Hours-of-Service Regulations" that limit the number of hours long haul commercial drivers may drive**.**

Household employee – An individual that performs services in the taxpayer's home in the context of an employee.

Hybrid Method - The most common hybrid accounting method is a combination of cash and accrual. Generally, this combination is used when inventory is an income-producing factor. To simplify recordkeeping, a taxpayer accounts for inventory using accrual and uses the cash method for all other income and expense items. The hybrid method is primarily used by small businesses.

Improvement - An addition to or partial replacement of property that adds to its value, appreciably lengthens the time you can use it, or adapts it to a different use. Generally must be capitalized as opposed to being expensed like repairs.

Incentive stock option - An option that allows an employee to purchase stock of the employer below current market price. For regular income tax purposes, the bargain element (the difference between the price paid and market value of the stock) is not taxed when the option is exercised. Rather, it is taxed when the stock is sold. However, for alternative minimum tax (AMT) purposes, the spread is taxed in the year the option is exercised. This treatment creates two different tax bases, one for regular tax and one for AMT.

Incidental Expenses – Fees and tips to porters, bellhops, hotel maids and similar service providers, mailing costs of filing travel vouchers and paying employer-sponsored credit card billings and transportation between lodging or business sites and places where meals are taken, if suitable meals aren't available at the temporary work location.

Incidental materials or supplies – Refers to materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken.

Income in Respect of a Decedent (IRD) - Includes income that is includable in the estate and also taxable to the beneficiary.

Independent Contractor – Is an individual who performs services under a contractual arrangement and is not an employee.

Indirect Expenses (Home Office) - The expenses of running the entire home such as general repairs, not directly traced to the business). Indirect expenses must be pro-rated in computing the home office deduction. This is normally done on the basis of space in the home office versus total space in the home.

Inherited Basis - Under the rule of Code § 1014(a), the basis of inherited property is ordinarily stepped-up (or down) to its fair market value as of the date of decedent's death or alternate valuation date. Such inherited property is MACRS property even if the decedent placed it in service before '87. The alternate valuation date is the date six months after decedent's death, or if within that six months the property has been distributed, then the date of the distribution. *Code Sec. 1014(a); Code Sec. 2032* (Caution: these rules do not apply to property inherited from an individual who died in 2010 if the “no estate tax” provision was elected by the executor).

If no Federal estate tax return is required, an appraisal as of the date of decedent's death for state inheritance or other transmission (e.g., legacy) taxes is used for basis purposes. In this situation, no alternate valuation date is used. These appraisals govern unless there is sufficient evidence of another value. *Reg § 1.1014-3(a)*

Insolvent – Having negative net assets – in other words, liabilities exceed assets. In reference to cancellation of debt, gthe term “insolvent” means the excess of liabilities over the fair market value (FMV) of assets determined with respect to the taxpayer's assets and liabilities immediately before the discharge.

Intangible property - Property that has value but cannot be seen or touched, such as goodwill, patents, copyrights, and computer software.

Investor – An individual who puts money into financial schemes, shares, property, or a commercial venture with the expectation of achieving a profit:

Investment - Putting money into something with the expectation of gain.

Investment limit – For purposes of the IRC Sec 179 the amount of the allowable expense deduction begins to phase out as the amount invested in qualifying property exceed the annual limit.

Investment expenses - are expenses (other than interest) incurred to produce investment income and which are normally deductible as Tier 2 miscellaneous itemized deductions on Schedule A.

Investment income - is gross income from property held for investment. It includes savings account interest, dividends from stock, net gains from sales of property held for investment, annuities and certain royalties. Net income from certain passive activities is also investment income: (1) Rental of substantially nondepreciable property; (2) Equity-financed lending activities; and (3) Acquisition of certain interests in a pass-through entity licensing intangible property. (Temp. Reg. 1.469-2T(f)(10)).

Investment interest expense - is all interest on debts used to carry or purchase investment property (e.g., stocks, bonds, or land held for appreciation). However, interest on loans used to buy investments which produce tax-exempt interest income is not deductible as investment interest expense. In fact, such interest is not deductible at all. In addition, interest taken into account in determining gain or loss from a passive activity is NOT investment interest.

IRD – Is the acronym for Income In Respect to the Decedent. Which include income that is includable in the estate and also taxable to the beneficiary.

Jointly and Severally Liable - Generally when taxpayers file joint returns each spouse is jointly and severally liable for the full amount of the tax, penalties (other than civil fraud), and interest arising out of their joint return, regardless of the amount of their is separate taxable income. Only the spouse committing fraud can be subjected to fraud penalties.

Lavish or extravagant - Sumptuously rich, elaborate, or luxurious. Is not defined in the Code or Regulations, although IRS indicates an expense that is “unreasonable” (also not defined) may be considered extravagant. Facts and circumstances determine.

Lease inclusion amount – Refers to income inclusion (expense add back) amounts that represent the luxury auto limitations for leased vehicles. The add backs amount is based upon the fair market value of a vehicle at the beginning of the lease term and are determined from IRS provided tables.

LEVY - A Tax levy, under United States Federal law, is an administrative action by the Internal Revenue Service (IRS) under statutory authority, without going to court, to seize property to satisfy a tax liability. The levy "includes the power of distraint and seizure by any means". The general rule is that no court permission is required for the IRS to execute a section 6331 levy. For taxpayers in serious debt to the IRS, the most feared weapon in the IRS arsenal is the tax levy. Using the powers granted to the IRS in the Internal Revenue Code, the IRS can levy upon wages, bank accounts, social security payments, accounts receivables, insurance proceeds, real property, and, in some cases, a personal residence. Under Internal Revenue Code section 6331, the Internal Revenue Service can “levy upon all property and rights to property” of a taxpayer who owes Federal tax. The IRS can levy upon assets that are in the possession of the taxpayer, called a seizure, or it can levy upon assets in the possession of a third party, a bank, a brokerage house, etc.

Life Estate - A life estate is a concept used in common law and statutory law to designate the ownership of land for the duration of a person's life. In legal terms it is an estate in real property that ends at death when there is a "reversion" to the original owner. The owner of a life estate is called a "life tenant". Although the ownership of a life estate is of limited duration because it ends at the death of the person who is the "measuring life", the owner has the right to enjoy the benefits of ownership of the property, including income derived from rent or other uses of the property, during his or her possession. Because a life estate ceases to exist at the death of the measuring person's life, this temporary ownership agreement cannot be left to heirs (intestate) or devisees (testate), and the life estate cannot normally be inherited. At death, the property involved in a life estate typically falls into the ownership of the remainderman named in the life estate agreement.

LIFO - Stands for last-in, first-out, meaning that the most recently produced items are recorded as sold first.

Like-Kind - Like-kind means similar in nature, but not necessarily of the same quality. Real estate must be exchanged for real estate. Real estate includes: residential, commercial, storage buildings, warehouses, land, manufacturing plants (improved or unimproved qualifies). Exchanges of animals of different sexes don't qualify. Depreciable tangible personal property must be exchanged for property of "like-kind or class" as outlined in Rev Proc 87-56, 1987-2 CB 674. Property NOT considered like-kind includes inventory, partnership interests, stocks & bonds and goodwill.

Listed property - Passenger automobiles; any other property used for transportation; property of a type generally used for entertainment, recreation or amusement; and computers and their peripheral equipment unless used only at a regular business establishment and owned or leased by the person operating the establishment.

Local Transportation - Transportation between a taxpayer's home and a temporary work location in the same trade or business WITHIN the metropolitan area where the taxpayer lives and normally works.

Long Term Insurance - is an insurance contract that provides only coverage of long-term care services including necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, maintenance or personal care services prescribed by a licensed practitioner for the chronically ill. Benefits under a long-term care policy (other than dividends or premium refunds) are generally tax-free. With per diem contracts that pay a flat-rate benefit without regard to actual long-term care expenses incurred, the exclusion is limited to $175 a day indexed for medical cost inflation (amount was $300 in 2011) except when long-term care costs incurred are more than the flat rate and are not otherwise compensated by some other means. A contract isn't treated as a qualified long-term care contract unless determination of chronically ill takes into account at least five activities of daily living--eating, toileting, transferring, bathing, dressing and continence.

Lower of Cost or Market – An inventory valuation method available for most taxpayers except those who use the Last-In-First-Out Method (LIFO) method. To use this method, each item in inventory must be valued at lower of cost or market value.

Luxury auto - Any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways, and having an unloaded gross vehicle weight of 6,000 pounds or less.

M&IE - Meal & incidental expenses.

MACRS – Modified Cost Recovery System - is the current tax depreciation system in the United States. Under this system, the capitalized cost (basis) of tangible property is recovered over a specified life by annual deductions for depreciation.

Market value - Is the price at which an asset would trade in a competitive auction setting.

Material participation – To invest substantial time in the operation of an activity. For purposes of a real estate professional material participation is determined by meeting either a time or prior participation test.

Medical Expenses - Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body including dental expenses. Costs of equipment, supplies, and diagnostic devices needed for these purposes. The care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. The expenses include insurance including medical, hospital, dental, long-term care (limited), and Medicare-B and Medicare-D insurance premiums. They DO NOT include expenses that are merely beneficial to general health.

Mid-quarter convention – A reduced first-year MACRS allowance when more that 40% of assets are placed into service during the last quarter of the year.

Minimum Tax Credit - The alternative minimum tax credit is the result of incurring an alternative minimum tax in a <u>prior year,</u> which generates a credit that can be used to offset the excess of the taxpayer's regular tax over the alternative minimum tax in a <u>subsequent year</u> with unused credit carried forward to future years.

Misclassified Workers – Workers that are incorrectly classified as independent contractors when they should be classified as employees.

Mixed Use Property – In the context of this course, mixed use property refers to property where both the residential and nonresidential portions of the property are within the same dwelling unit

Necessary expense - A necessary expense that is helpful in the taxpayer's business; but it need not be indispensable.

Net investment income (NII) - NII is taxable investment income reduced by investment expenses.

Net Operating Loss (NOL) - A net operating loss **(IRC § 172)** results from a business loss or a personal casualty loss. In order to have an NOL, a taxpayer generally must have a NEGATIVE AGI, or a casualty loss as part of itemized deductions. However, a positive AGI which consists of positive nonbusiness income and a business loss may also create a net operating loss, if there are nonbusiness deductions to offset the nonbusiness income.

The net operating loss deduction is an exception to the general rule that computation of income tax for a given year is based on that year's income and deductions only. The reason for this is that when a net operating loss occurs, the loss is computed in the year of occurrence, but that loss is carried to the returns of other years and is used as a deduction in those years, resulting in a reduction of income tax (but not self-employment tax) for the other years. Carrybacks/carryovers of NOLs are explained in more detail later in this chapter.

Non-conventional Home Debt - The term non-conventional home refers to homes that are used on a transient basis, such as a motor home and boat. The interest on that debt, even if otherwise qualifying as acquisition debt for regular tax purposes, is only deductible on Schedule A and is NOT deductible against the AMT.

Nonresidential real property - Most real property other than residential rental property.

Not a Temporary Assignment - A taxpayer is deemed not on a temporary assignment if the stay away from home exceeds one year.

Off-the-Shelf Computer Software – Generally off-the-shelf software is software that is designed for general applications where customization is not provided. For example: software such as word-processing, spreadsheet, etc.

Optional auto expense method – A method of determining automobile operating expenses based on an IRS specified amount per mile as opposed to using the actual expenses. Also known as the standard mileage method.

Ordinary Expense – An expense that is customary and conventional for the taxpayer's line of business.

Parsonage Allowance - A minister's gross income doesn't include the rental value of a home (parsonage) provided, or the rental allowance paid, as part of compensation for ministerial services.

Passive Activity - Any trade or business activity in which the taxpayer "DOES NOT MATERIALLY PARTICIPATE" in actual OPERATIONS of the activity on a "REGULAR, CONTINUOUS, AND SUBSTANTIAL BASIS" is passive. This includes any limited partnership interest, which is always presumed passive. However, a taxpayer may rebut the assumption by showing he/she meets the material participation standards (see following paragraph). Generally a rental activity, whether or not the taxpayer materially participates in its operation, is a passive activity.

Personal services - Means any work performed by an individual in connection with a trade or business.

Per Diem - A daily allowance for expenses. Per diem reimbursement generally eliminates the need for employees to create expense reports documenting the amount spent while traveling on business for reimbursement.

Placed in service - Ready and avail- able for a specific use whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity.

Predominant - To meet the "predominant" test, property received in the exchange must continue in the same use (i.e., foreign or domestic) for the 24 months immediately after the exchange. Alternatively, the property given in the exchange must have been in the same use (i.e., foreign or domestic) for the 24 months just before the exchange.

Premature distribution - Withdrawals from a qualified retirement plan prior to a certain age. Such payouts are generally subject to a 10% penalty for taxpayers under the age of 59 ½. There are a number of exceptions to the penalty.

Premises – A house or building, together with its land and outbuildings, occupied by a business

Presumption - A presumption of a particular fact can be made without the aid of proof in some situations.

Principal Place of Business - A home office qualifies as a principal place of business if: a. The office is used on an exclusive and regular basis for administrative or management activities of any trade or business of the taxpayer, and b. There is no fixed location of the business where the taxpayer conducts substantial administrative or management activities of the business. If a taxpayer conducts administrative activities at a fixed location outside the home, he/she is still eligible to claim a deduction as long as the administrative activities conducted at the outside location aren't substantial (e.g., a taxpayer may do minimal paperwork at another fixed location of the business).

Private Activity Bond – Private activity bonds include those that finance mass-transit facilities, sewage and solid waste disposal facilities and certain multi-family dwellings. Interest from private activity bods is generally tax-free for regular tax but taxable alternative minimum tax.

Profitability - is the difference between the revenues earned from and the costs associated with an activity in a specified period.

Profit motive - Is the concept in economics that refers to individuals being provided incentive to relinquish something (e.g. capital, expertise, labor) for deployment to a productive purpose.

Profit or loss – A term used to describe a business's revenues recognized for a specific period, less the costs and expenses charged against these revenues, including write-offs (e.g., depreciation and amortization of various assets and taxes.

Profitability - is the difference between the revenues earned from and the costs associated with an activity in a specified period.

Property class: A category for prop- erty under MACRS. It generally deter- mines the depreciation method, recovery period, and convention.

Prorating – Means proportion. The term is used in many legal and economic contexts and is taken from the Latin phrase pro rata.

Public safety officer – Generally refers to police officers, firefighters, EMTs, probation officers, etc.

Qualified Acquisition Indebtedness - qualified acquisition indebtedness means indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

Qualified Domestic Relations Order (**QDRO)** - A Qualified domestic relations order or QDRO is a legal order subsequent to a divorce or legal separation that splits and changes ownership of a retirement plan to give the divorced spouse their share of the asset or pension plan. QDROs may grant ownership in the participant's (employee's) pension plan to an alternate payee, who must be a spouse, former spouse, child or other dependent of the participant. A QDRO may provide for marital or community property division between the participant and the alternate payee, or for the payment of alimony or child support to the alternate payee. QDROs apply only to employee benefit or pension plans subject to ERISA, the Employee Retirement Income Security Act, the American law governing private sector pensions. Comparable types of orders are available to divide military retirement pay and Federal civil service retirement plans, and for State, county and municipal retirement plans in most States. QDROs must first be entered by the State domestic relations court and then reviewed by the plan administrator for compliance with ERISA or other applicable law and the terms of the plan. The QDRO may be a separate document or it may be part of the divorce decree as long as it meets the standards for a *qualified* domestic relations order.

Qualified Farm Indebtedness - Indebtedness of a taxpayer is treated as qualified farm indebtedness (Code Sec. 108(g)(2)) if: (1) The indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and (2) 50% or more of the aggregate gross receipts of the taxpayer for the three tax years before the tax year in which the discharge of the indebtedness occurs is attributable to the trade or business of farming.

Qualified Intermediary - Is one (can't be the taxpayer or a "disqualified party") who has a written agreement with the taxpayer, which calls for the intermediary to acquire and transfer both the property given and received in the exchange. Generally, the intermediary gets legal title to the property. A qualified intermediary can't be the taxpayer or a party related to the taxpayer (as defined in §267(b) or §707(b), but regarding controlling interests, substitute the words "more than 10%" wherever the words "more than 50%" appear).

Qualified Property

Qualified property is defined as meaning tangible, depreciable property which is **held by** and **available for use** in the qualified trade or business at the close of the tax year, which is **used at any point** during the tax year **in the production of** **qualified business income**, and the depreciable period for which has not ended
before the close of the tax year (Code Sec. 199A(b)(6)(A)).

Qualified Real Estate Agent - is a licensed real estate sales person.

Qualified Business Income (QBI) - QBI is generally the net amount of income, gain, deduction, and loss relating to any qualified trade or business of the taxpayer to the extent these items are effectively connected with the conduct of a trade or business within the U.S. and included or allowed in determining taxable income for the year.

Qualified Real Property (2010 & 2011) – For purposes of the IRC Sec 179 expense deduction for 2010 and 2011, the definition of qualified real property includes: qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Qualified Real Property Business Indebtedness - Qualified Real Property Business Indebtedness is indebtedness (Code Sec 108(C)(3): (1) that was **incurred or assumed** by the taxpayer in connection with real property used in a trade or business; (2) that is **secured by the real property**, at the time the debt is incurred or assumed; (3) that is qualified acquisition indebtedness (including refinanced acquisition debt); and (4) which the taxpayer elects to treat as qualified real property business indebtedness.

Qualified Reservist – Is an individual who (because of their being members of a reserve component) are ordered or called to active duty after Sept. 11, 2001, for a period of more than 179 days or for an indefinite period.

Qualifying Child - In general, a child is a qualifying child of a taxpayer if the child satisfies each of these tests: a residency test, a relationship test, a joint return test, and an age test. In addition, with one exception, the child may not have provided over one-half of his or her own support for the year.

Qualifying Property – The definition of IRC Sec 179 expense property is generally: tangible personal property purchased for use in the active conduct of a trade or business. Except qualified real property, buildings and their structural components do not qualify.

Qualified Trade or Business – For 199A deduction, the tax code does not provide a definitive "bright line" definition of a trade or business, and simply adopted an existing subjective definition that relies on the outcomes of past court cases and interpretive rules the IRS has issued under Code Sec. 162, which is the most familiar provision using the term "trade or business."

Real Estate Professional – A real estate professional is an individual, who by meeting certain qualifications, is not subject to the passive loss rules.

Real Property Trades or Businesses – Is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.

Recapture – is when a deduction or credit is recaptured into income because a property is removed from business service before a required period of time.

Recovery Period - The number of years over which the basis of an item of property is recovered.

Refinancing – Generally refers to the replacement of an existing debt obligation with a debt obligation under different terms.

Related-Party – No deduction is allowed for losses from sales or exchanges between certain related taxpayers. (Code Sec. 267(a)) The following are related taxpayers: (1) Members of the seller's family, but only brothers and sisters (whole or half blood), spouse, ancestors, and lineal descendants. In-laws aren't members of the seller's family, (2) Controlled corporations*, (3)* A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation, and more than 50% of the capital interest, or the profits interest, in the partnership. (4) An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation. (5) An S corporation and a C corporation if the same persons own more than 50% in value of the outstanding stock of each corporation. (6) An estate and a beneficiary of that estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest. (6) Trustees, grantors, and beneficiaries, that is, the grantor and the fiduciary of a trust; the fiduciary and the beneficiary of a trust; the fiduciaries of two different trusts with the same grantor; a fiduciary of one trust and the beneficiary of another trust with the same grantor; and a trust fiduciary and a corporation more than 50% in value of the outstanding stock of which is owned directly or indirectly by or for the trust or its grantor. (7) A person and an exempt organization controlled, directly or indirectly, by that person or the members of his family.

Repossession - Generally a term associated with having a vehicle reclaimed by the lender of personal property.

Required Minimum Distribution (RMD) - IRA distributions may begin at age 59-1/2 without incurring a penalty, but <u>must</u> begin by April 1 of the calendar year following the year the IRA owner reaches age 70-1/2; otherwise, a minimum distribution penalty can apply.

Reservists - A member of a reserve component of the Armed Forces is an individual who is in the: Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; Army National Guard of the United States; Air National Guard of the United States; or Reserve Corps of the Public Health Service.

Residential rental property - Real property, generally buildings or structures, if 80% or more of its annual gross rental income is from dwelling units.

Reverse Exchange - A reverse exchange is a transaction in which a taxpayer receives replacement property and subsequently transfers relinquished property. It is distinguished from a deferred exchange, which is a transaction in which a taxpayer transfers relinquished property and subsequently receives replacement property.

Reverse Mortgage - A reverse mortgage is a form of equity release (or lifetime mortgage).. It is a loan available to seniors aged 62 or older, under a Federal program administered by HUD. It enables eligible homeowners to access a portion of their equity. The homeowners can draw the mortgage principal in a lump sum, by receiving monthly payments over a specified term or over their (joint) lifetimes, as a revolving line of credit, or some combination thereof. The homeowners' obligation to repay the loan is deferred until owner (or survivor of two) dies, the home is sold, they cease to live in the property, or they breach the provisions of the mortgage.

Revoke – To annul or cancel an act, particularly a statement, document.

Rollover - The tax-free transfer of funds from one individual retirement account to another or from a company plan to an IRA. If the taxpayer takes possession of the funds, the money must be deposited in the new IRA within 60 days. A rollover can also be used to move money from a medical savings account (MSA) to a health savings account (HSA).

Rural – Refers to areas that are not urbanized. They have a low population density, and typically much of the land is devoted to agriculture.

Safe harbor - Is a provision of a statute or a regulation that reduces or eliminates a party's liability under the law, on the condition that the party performed its actions in good faith or in compliance with defined standards

Salvage value - An estimated value of property at the end of its useful life. Not used under MACRS.

Section 1245 property - Property that is or has been subject to an allowance for depreciation or amortization. Section 1245 property includes personal property, single purpose agricultural and horticultural structures, storage facilities used in connection with the distribution of petroleum or primary products of petroleum, and railroad grading or tunnel bores.

Section 1250 property - Real property (other than section 1245 property), which is or has been subject to an allowance for depreciation.

Section 179 – A provision of the tax code that allows personal tangible and certain other specified business assets that would normally be depreciated to be expensed in the year placed in service.

Secured Debt - *A* secured debt has three characteristics for purposes of the home mortgage interest rules: (1) It makes the taxpayer's interest in the home specific security for the loan, (2) If the taxpayer defaults on the loan, the home would provide satisfaction for the debt, as with a mortgage or deed of trust, and (3) the debt must be recorded according to the applicable state law.

Separate income - is generally income from separate property.

Short Sale – In a short sale, by agreement with the lender, the property is sold for a value less than the mortgage balance. The lender ends up with all the net proceeds from the sale.

Short-Term rentals – Real estate property that is rented for periods averaging less than 7 days

Shrinkage - A term used describe a decrease in inventory due to items such as undetected theft, breakage, bookkeeping errors, etc.

Simplified Employee Pension (SEP) - Is a tax-favored retirement plan for self-employed taxpayers. Contributions to the plan can be deducted. The maximum contribution for 2012 is the smaller of 20% of net earnings from self-employment or $50,000.

Specified Service Trades or Businesses: Generally includes any trade or business described in Sec1202(e)(3)(A), but excluding engineering and architecture and trades or businesses that involve the performance of services that consist of investment-type activities.

Spousal Support – Another term for alimony.

Statute of Limitations - A statute prescribing a period of limitation for the bringing of actions of certain kinds.

Statutory – Legislative authority, such as tax law and is used to distinguish law made by legislative bodies from case law, decided by courts, and regulations issued by government agencies

Statutory employees – Individuals who are specifically classified as employees by the Internal Revenue Code.

Start-Up Costs - Start-up costs include amounts paid or incurred to create an active trade or business or to investigate the creation or acquisition of an active trade or business.

Standard mileage rate - The established amount for optional use in determining a tax deduction for automobiles instead of deducting depreciation and actual operating expenses.

Straight-line method - A way to figure depreciation for property that ratably deducts the same amount for each year in the recovery period. The rate (in percentage terms) is determined by dividing 1 by the number of years in the recovery period

Structural components - Parts that together form an entire structure, such as a building. The term includes those parts of a building such as walls, partitions, floors, and ceilings, as well as any permanent coverings such as paneling or tiling, windows and doors, and all components of a central air conditioning or heating system including motors, compressors, pipes and ducts. It also includes plumbing fixtures such as sinks, bathtubs, electrical wiring and lighting fixtures, and other parts that form the structure.

Substantially equal payments -Are one of the exceptions in the United States IRS Code that allows receiving payments without the 10% early distribution penalty from a retirement plan or deferred annuity before the usual $59^1/_2$ age restriction under certain circumstances. The rules for substantially equal payments are set out in IRS code section 72(t) (for retirement plans) and 72(q) (for annuities), and allow for three methods of calculating the allowed withdrawal amount: (1) required minimum distribution method, based on the life expectancy of the account owner (or the joint life of the owner and his/her beneficiary) using the IRS tables for required minimum distributions, (2) fixed amortization method over the life expectancy of the owner or (3) fixed annuity method using an annuity factor from a reasonable mortality table.

The interest rate that can be used in the latter two calculations has been fixed at one not more than 120% of the Applicable Federal Mid Term rate (AFR) for either of the two months prior to the calculation. SEPP payments must continue for the longer of five years or until the account owner reaches $59^1/_2$. The payments cannot be changed beyond a one time allowed change from one of the latter two calculation methods to the first or all of the payments received will be retroactively taxable and penalized.

If the retirement account owner withdraws more or less than the amount calculated under the SEPP formula, the 10% early distribution penalty that was waived would apply in all instances (where it was waived under the SEPP program), and interest on those amounts will also apply.

Surviving spouse – The official term is "qualified widow(er)" and is one where the **t**axpayer's spouse must have died in one of the prior two years and the taxpayer must have a dependent child at home. The joint rates are used, but no exemption is claimed for the deceased spouse.

SUV – an acronym form a sports utility vehicle. A luxury vehicle for tax purposes has a gross unladen weight greater than 6,000 and less than $14,001 pounds. Generally limited to a maximum Sec 179 deduction of $25,000.

Tangible property - Property you can see or touch, such as buildings, machinery, vehicles, furniture, and equipment.

Tax Attributes – include NOL carryovers, general business credit carryovers, AMT credit carryovers, capital loss carryovers, basis in assets, suspended passive losses and foreign tax credit carryover.

Tax Bracket – Federal income tax is levied at graduated rates. Each additional block of taxable income is taxed at higher tax rate. The tax rate for each block of income is referred to as one's tax bracket. A taxpayer is said to be in the 25% bracket if the taxpayer's highest dollar of taxable income falls within that bracket. Thus, for example, in 2012 if a taxpayer is in the 25% bracket, part of his income is taxed at the 10% rate, some at 15% and some at 25%.

Tax-Exempt - Not subject to tax.

Tax Home - is generally the location of a taxpayer's main place of business (not necessarily the place he/she lives). If taxpayers work regularly in more than one area, the main work location controls.

Taxable Income – Income subject to tax after all allowable adjustments and deductions.

Tentative Minimum Tax – Is the Alternative Minimum Tax (AMT) before deducting regular tax.

Term Interest - A life interest in property, an interest in property for a term of years, or an income interest in a trust. It generally refers to a present or future interest in income from property or the right to use property that terminates or fails upon the lapse of time,

Threshold – The lowest (beginning) dollar amount where certain limitations or adjustments begin to apply

Trade or Business - The tax law doesn't really give a definition of the term "trade or business," probably because no single definition will apply in all cases. But certainly to be considered a trade or business, an activity must be motivated by the taxpayer's profit motive (even if that motivation is unrealistic!) (Reg. §1.183-2(a). Along with profit motive, the taxpayer must carry on some kind of economic activity.

Transmutation – Is a legal term and occurs when a married couple demonstrates an intent, by virtue of their words and actions during marriage, to treat one spouse's separate property as marital property. (This action will require the filing of a federal gift tax return, if the annual gift tax exemption is exceeded.)

Transportation Workers – Workers covered under the U.S. Department of Transportation "Hours-of-Service Regulations"

Travel in the U.S. – includes only the fifty states and the District of Columbia. By vehicle, bus or train between points within the U.S. even if the final destination is outside the U.S. Travel by plane requires take-off and landing within the U.S.

Truck or Van – A truck or van that is a qualified non-personal use vehicle

Unadjusted basis - The basis of an item of property for purposes of figuring gain on a sale without taking into account any depreciation taken in earlier years but with adjustments for other amounts, including amortization, the section 179 deduction, any special depreciation allowance, any deduction claimed for clean-fuel vehicles or clean-fuel vehicle refueling property placed in service before January 1, 2006, and any electric vehicle credit.

Unforeseen Circumstances – Unexpected or unplanned events like drought, disease, fire, etc.

Uniform capitalization (UNICAP) - For inventory and property produced by a taxpayer, (a) the direct cost of such property, and (b) such property's share of those indirect costs (including taxes) part or all of which are allocable to such property must be capitalized.

Unit-of-production method - A way to figure depreciation for certain prop- erty. It is determined by estimating the number of units that can be produced before the property is worn out. For example, if it is estimated that a machine will produce 1000 units before its useful life ends, and it actually produces 100 units in a year, the percentage to figure depreciation for that year is 10% of the machine's cost less its salvage value.

Unrecovered Basis – The unrecovered basis in an asset is the remaining basis after reduction in basis for depreciation, casualties, and depletion. When applied to luxury vehicles where the deductions have been limited due to the luxury auto rules, then at the end of the normal recovery period, the luxury auto will have a remaining (unused) basis. This is also referred to as "unrecovered basis".

Unreimbursed Employee Business Expenses – Are employment related business expenses that are not reimbursed by the employer. These expenses are deductible as a miscellaneous itemized deduction subject to the 2% of AGI limitation.

Unrelated Expenses (Home Office) - Those incurred for purely personal purposes. Such expenses are nondeductible.

Useful life - An estimate of how long an item of property can be expected to be usable in trade or business or to produce income.

Unsecured Election - Taxpayers can elect to treat any secured debt as unsecured. *(Reg. 1.163-10T(o)(5))* The election is irrevocable without IRS consent. By making the election, the interest on the loan can be allocated to use of the proceeds by using the general tracing rules of Reg §1.163-8T.

Vacation Home Rentals – Vacation homes are home that are used party for personally and party as rental. Special rules apply: (1) If the "dwelling unit" is rented less than 15 days - exclude the rental income. Claim no deductions (except interest and taxes). (2) If the unit is rented 15 days or more AND the taxpayer's personal use is less than 15 days or less than 10% of the rental days - allocate expenses according to personal vs. rental days. No further limitation is necessary (except the usual "not-for-profit" rules must be considered). A loss can be claimed. (3) If taxpayer use is 15 days or more and over 10% of the rental days - first allocate expenses by personal vs. rental days, as in the previous paragraph. Deduct allocable taxes and interest first, then maintenance and other cash expenses, then depreciation until the net is ZERO. A loss cannot be claimed.