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Companion to PPC's

1040 Deskbook

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Interactive Self-study CPE

Companion to PPC's 1040 Deskbook

TABLE OF CONTENTS

Page

COURSE 1: BUSINESS, FARM, AND RENTAL

Overview 1

Lesson 1: Sole Proprietorships (Schedule C) 5

Lesson 2: Farm Income and Expenses (Schedule F) 29

Lesson 3: Rental Property (Schedule E) 53

Lesson 4: Tax Accounting Methods 73

Lesson 5: Travel and Entertainment 87

Lesson 6: Net Operating Losses 115

Examination for CPE Credit 133

Glossary 143

Index 145

COURSE 2: PENSION AND RETIREMENT INCOME, OTHER ITEMS OF INCOME, AND ADJUSTMENTS TO INCOME

Overview 149

Lesson 1: Pension and Retirement Income 151

Lesson 2: Other Items of Income 183

Lesson 3: Adjustments to Income 213

Examination for CPE Credit 253

Glossary 265

Index 267

COURSE 3: GAINS AND LOSSES

Overview 271

Lesson 1: Securities Transactions 273

Lesson 2: Installment Sales, Like-kind Exchanges, and Conversions of Property 311

Lesson 3: Trade or Business Property Transactions 347

Lesson 4: Bad Debt Losses, Debt Discharge Income, and Foreclosures 361

Examination for CPE Credit 391

Glossary 403

Index 405

ANSWER SHEETS AND EVALUATIONS

Course 1: Examination for CPE Credit Answer Sheet 409
Course 1: Self-study Course Evaluation 410
Course 2: Examination for CPE Credit Answer Sheet 411
Course 2: Self-study Course Evaluation 412
Course 3: Examination for CPE Credit Answer Sheet 413
Course 3: Self-study Course Evaluation 414

INTRODUCTION

Companion to PPC's 1040 Deskbook consists of three interactive self-study CPE courses. These are companion courses to *PPC's 1040 Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com/ogs** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2018**. Complete instructions for grading are included below and in the Test Instructions preceding the Examination for CPE Credit.

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Each course is divided into lessons. Each lesson addresses an aspect of the Form 1040. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions at the end of the course**. You may record your answer choices by printing the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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Checkpoint Learning is also approved for "QAS Self Study" designation.

The requirements for NASBA Registry membership include conformance with the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. Each course is designed to comply with the *Standards*. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the **Overview** page before each course.

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

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for each course. Payment (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Payment for emailed or faxed answer sheets is $89. There is an additional $10 charge for manual print grading, so please include a total of $99 with answer sheets sent by regular mail. Please take a few minutes to complete the **Self-study Course Evaluation** so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on the Overview and Exam Instructions pages.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment must accompany each answer sheet submitted ($89 when sent by email or fax; $99 when sent by regular mail). We would also appreciate a separate **Self-study Course Evaluation** from each person who completes an examination.

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Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion.* You should retain it and a copy of these materials for at least five years.

COMPANION TO PPC'S 1040 DESKBOOK

COURSE 1

BUSINESS, FARM, AND RENTAL (TDBTG171)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course takes a look at issues related to business, farm, and rental income and how they are dealt with on Form 1040. Lesson 1 discusses sole proprietorships and Schedule C. Lesson 2 discusses farm income, farm expenses, and Schedule F. Lesson 3 examines rental property and Schedule E. Lesson 4 discusses tax accounting methods. Lesson 5 covers travel and entertainment. Finally, Lesson 6 discusses net operating losses.

PUBLICATION/REVISION DATE: November 2017

RECOMMENDED FOR: Users of *PPC's 1040 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of and experience with the preparation of Form 1040.

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

IRS Enrolled Agents (EA) and Non-Credentialed Return Preparers (NCRP): This course is designed to enhance professional knowledge for IRS EAs and IRS NCRPs. Checkpoint Learning is an IRS Continuing Education Provider that is approved to deliver continuing education to IRS Enrolled Agents and IRS Non-Credentialed Return Preparers.

CTEC CREDIT: 8 CTEC Federal Tax Law Hours

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

IRS NCRP CREDIT: 8 Federal Tax Law Hours

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **November 30, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Sole Proprietorships (Schedule C)

Completion of this lesson will enable you to:

- Determine whether an activity is a trade/business or a hobby.

- Identify appropriate tax treatments for oil and gas working interests, home offices, business investigation and start-up costs, disposing of a sole proprietorship, and qualified small business health reimbursement arrangements.

Lesson 2—Farm Income and Expenses (Schedule F)

Completion of this lesson will enable you to:

- Recognize how to report cooperative patronage distributions, the appropriate tax treatment of CCC loans and prepaid farming expenses, and how to defer certain crop and livestock income.
- Determine the best way to address the depreciation of farm property, the uniform capitalization rules for plants and animals, the substantiation requirements for farm vehicles, commodity hedging transactions, crop-share rental reporting, computing tax on farm income using averaging, and the limitation on deductibility of farm losses.

Lesson 3—Rental Property (Schedule E)

Completion of this lesson will enable you to:

- Distinguish between the different types of residences and vacation homes.
- Recognize appropriate tax treatments for the temporary rental of a personal residence prior to sale, the rental of a portion of a residence, the conversion of residence to a rental property, property rented to related parties, and owning and renting timeshare units.

Lesson 4—Tax Accounting Methods

Completion of this lesson will enable you to:

- Identify appropriate methods of accounting for tax purposes, how those methods affect inventory, and how to change accounting methods.

Lesson 5—Travel and Entertainment

Completion of this lesson will enable you to:

- Identify how to substantiate travel and entertainment expenses, rules related to the 50% limitation on meal and entertainment deductions, and how to treat entertainment facilities, club dues, and accompanied travel.
- Determine the best way to treat travel out of country, travel away from home, local transportation costs, and tickets to athletic events that are considered entertainment or gifts.

Lesson 6—Net Operating Losses

Completion of this lesson will enable you to:

- Recognize the correct treatment of issues related to net operating losses (NOLs), including computing NOLs, recomputing NOLs in carryback years, applying for tentative refunds based on an NOL carryback, electing to forgo NOL carryback, and how NOL carryover and carryback rules are affected when filing status changes.

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- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
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Tax & Accounting—Checkpoint Learning
TDBTG171 Self-study CPE
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Chicago, IL 60694-6700

See the test instructions included with the course materials for additional instructions and payment information.

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Lesson 1: Sole Proprietorships (Schedule C)

Introduction

Taxpayers who are self-employed in a nonfarm business report their business transactions on Schedule C (Profit or Loss From Business) or Schedule C-EZ (Net Profit From Business). The net profit or loss from Schedule C or C-EZ is reported on page 1 of Form 1040. A separate Schedule C must be prepared for each business operated by the sole proprietor. Taxpayers operating multiple businesses as sole proprietorships cannot use Schedule C-EZ.

For simplicity, this lesson refers to Schedule C as the place to report business-related income and expenses. Where appropriate, however, Schedule C-EZ should be used when there is $5,000 or less of business expenses and the other requirements listed on Part 1, Schedule C-EZ are met.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine whether an activity is a trade/business or a hobby.
- Identify appropriate tax treatments for oil and gas working interests, home offices, business investigation and start-up costs, disposing of a sole proprietorship, and qualified small business health reimbursement arrangements.

Distinguishing a Hobby from an Active Trade or Business

Determining if an individual is engaged in carrying on a trade or business has implications beyond whether a net loss will be allowed to offset other income, although this income offset is the most obvious benefit for many taxpayers. Items affected by this determination include (but are not limited to) the following:

1. Self-employment (SE) tax and, ultimately, social security benefits.
2. IRA, Keogh, SEP, or SIMPLE retirement plan contributions.
3. Deductions for health insurance premiums and contributions to health savings accounts (HSAs).
4. Home office deductions.
5. Limited expensing (Section 179) deductions.
6. Amortization of start-up expenditures.
7. Character of gain or loss upon disposition of assets (i.e., IRC Sec. 1231).
8. Net operating loss (NOL) carryovers and carrybacks.
9. AGI-sensitive deductions including rental losses, medical expenses, casualty losses, etc.
10. AGI-sensitive credits.
11. Deferral of estate tax and the special-use valuation of assets.

Therefore, it is no surprise that this issue has historically been one of the most frequently litigated and controversial areas of individual income tax law.

Distinguishing between a Hobby and an Active Trade or Business

The Internal Revenue Code backs into the rules governing activities not engaged in for profit (commonly referred to as hobbies) by including all activities of the taxpayer other than those for which deductions are allowable under IRC Sec. 162 (expenses of carrying on a trade or business) or 212 (expenses incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income).

Determining if an activity is engaged in for profit is based on the facts and circumstances of each case. However, Reg. 1.183-2(b) provides nine factors to consider. These factors are frequently applied in relevant case law. Although certain activities are more susceptible to the hobby loss taint (e.g., weekend farmer/rancher; auto racing; certain pyramid marketing schemes; and horse or dog racing, breeding, or showing), no activities are immune. For example, in *Ranciato*, the Tax Court held that a retail pet store failed to qualify as a for-profit activity based on an

analysis of the factors outlined in Reg. 1.183-2(b). But see *Rinehart* for an example of a horse breeding activity that was held by the Tax Court to be a for-profit venture. In *Metz*, the taxpayers proved profit intent with their horse breeding business even though their farm recognized losses for many tax years. In *Roberts*, losses incurred in the first two years of horse breeding and racing activities were characterized as business start-up losses where the taxpayer intended to use assets to run a business, and conducted activity in a businesslike manner with expectation of future profits. However, see *Stuller*, where a horse breeding activity was determined not engaged in for profit because the taxpayers kept inadequate financial records, failed to adopt realistic methods to control expenses or losses, and failed to consult professional advice. In *McMillan*, a horse showing and breeding activity was determined not engaged in for profit because it had been over eight years since the taxpayer bred or showed horses and the taxpayer showed no evidence her horse activity was ever profitable. See *Morrissey* for an example where auto racing was held to be a for-profit venture and *Zenzen* when auto racing was a hobby. The presence of a profit intent in earlier years is not determinative for the tax year in question. In any case, the taxpayer must be conducting the activity with the actual and honest *intent* to make a profit in order to escape the hobby loss taint. While maintaining financial records can be an indication of a taxpayer's profit motive, the existence of financial records alone may not be enough to demonstrate that an activity is not a hobby. Obtaining professional advice about how to make the activity profitable is another indicator of a profit motive, but failure to follow the advice can demonstrate the lack of such a motive. *Mitchell*, *Keating,* and *Schlievert* have detailed discussions of the factors outlined in Reg. 1.183-2(b). IRS Fact Sheet (FS-2008-23), "Is Your Hobby a For-Profit Endeavor?" also gives general discussion and guidelines for this topic. The Audit Techniques Guide (ATG) provides a detailed look at issues the IRS considers when auditing for hobby activities. The ATG can be found on the IRS website (**www.irs.gov**) by entering the words "IRC 183 activities not engaged in for profit" in the search feature.

Reporting Hobby Income and Expenses When Activity Is Not Deemed to Be a Trade or Business

Hobby income cannot be ignored because IRC Sec. 61(a) provides that gross income includes income from whatever source derived unless there is a specific exclusion. There is no exclusion for hobby income. Hobby income is reported on page 1, line 21, of Form 1040. It is not subject to SE tax because a hobby is not considered a trade or business. Thus, practitioners should inquire as to whether a client has hobby income and, if so, also get information about related deductions. Depending on the amounts involved, practitioners should consider whether there is basis to treat the activity as a trade or business or whether, with proper planning (for example, a formal written business plan), the activity could become a trade or business in the future.

For an activity deemed to be a hobby, expenses are allowed to the extent of income produced by the activity, subject to the following ordering system:

1. Expenses incurred that are otherwise deductible without regard to the profit motive (e.g., real estate taxes).

2. Expenses incurred that would be deductible if the activity was engaged in for profit, but which do not result in a basis adjustment. These include normal trade or business expenses (such as advertising, insurance, and utilities) other than depreciation or amortization.

3. Expenses meeting the requirements in category 2, which do result in a basis adjustment (e.g., depreciation expenses).

Expenses in category 2 or 3 are allowed only to the extent of the excess, if any, of income from the activity over allowable expenses from category 1. (See Example 1A-1.) Certain types of expenses may fall in more than one category. Expenses that fall in category 2 or 3 are deductible only as miscellaneous itemized deductions and then only to the extent of any remaining hobby income. Since these deductions are subject to the 2% of AGI limitation, a taxpayer may end up with net taxable income from a hobby activity even though the allowable expenses equal the income from the activity.

Example 1A-1 Hobby loss limitations.

In the current year, Bobby Canine begins breeding and selling Labrador retrievers and derives $2,200 of income from the activity. He does not expect to report a profit for three out of five years (see safe harbor rule later in this discussion) nor can he support that the activity is for-profit based on the facts and circumstances.

Thus, the activity is deemed to be a hobby. Bobby's AGI (before the dog breeding activity) for the current year is $130,000, and he has $1,850 of other miscellaneous itemized deductions subject to the 2% of AGI floor.

His hobby expenses (food, veterinarian bills, etc.) total $2,300. These are deductible only to the extent of hobby income ($2,200) and only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed 2% of AGI. The net amount of miscellaneous itemized deductions is calculated as follows:

Miscellaneous itemized deductions from hobby (limited to hobby income)	$ 2,200
Other miscellaneous itemized deductions	1,850
Total miscellaneous itemized deductions	4,050
2% of AGI [2% × $132,200 ($130,000 plus $2,200 hobby income)]	(2,644)
Net miscellaneous itemized deductions allowed	$ 1,406

Thus, Bobby is allowed miscellaneous itemized deductions, after applying the 2% floor, of $1,406. Instead of reducing hobby income to zero, the limitation on deductible miscellaneous deductions has caused Bobby to have net taxable income from his hobby of $794 ($2,200 of income reportable on the "other income" line on page 1 of Form 1040 less $1,406 of hobby expenses deductible on Schedule A as miscellaneous itemized deductions). The 2% of AGI floor has penalized Bobby because his hobby expenses were not, in fact, deductible to the extent of hobby income. There is no provision for the carryover of disallowed hobby expenses. Bobby did not receive any deduction for depreciation on his kennel because all hobby income was offset with other types of expenses. Therefore, no reduction to the adjusted basis of his kennel is required.

Safe Harbor Rule Helps Eliminate Uncertainty between a Hobby and an Active Trade or Business

A statutory safe harbor is provided that, if met, causes a presumption that an activity is a for-profit endeavor. If the safe harbor is not met, the taxpayer must establish a profit motive using the subjective factors mentioned in the regulations. To meet the safe harbor, an activity must generate a profit in at least three of the five years (two of seven years for activities involving horse racing, breeding, training, or showing) ending with the tax year in question. If the safe harbor is met, the burden of proof for lack of profit motive is shifted to the IRS. The IRS can still rebut the profit motive presumption by proving that the activity is not engaged in for profit (e.g., by showing that the profitable years generated immaterial profits while the unprofitable years generated large losses).

Applying the Safe Harbor Rule. The safe harbor rule applies only for the third (or second) profitable year and all subsequent years within a five-year (or seven-year) safe harbor period that begins with the first profitable year.

Example 1A-2 Applying the safe harbor rule.

Tim Jones begins a new activity in Year 1 and incurs losses from that activity in Years 1 and 3. The activity is profitable in Years 2, 4, 5, and 6. Assuming the five-year test applies to the activity, the five-year safe harbor period begins with Year 2 (because it is the first profitable year) and covers Years 2–6. The safe harbor rule applies only for Years 5 and 6 (because Year 5 is the third profitable year after the start of the five-year period) but does not apply for Years 1–4.

Thus, the IRS can assert that the losses incurred in Years 1 and 3 must be reported under the hobby loss rules (unless Tim can prove otherwise under the subjective factors in the regulations. Furthermore, the IRS presumably can assert that profitable Years 2 and 4 must also be reported under the hobby loss rules as previously explained.

Because Tim cannot rely on the safe harbor rule before Year 5, he will have to rely on facts and circumstances to establish a profit motive for Years 1–4. Alternatively, Tim can make an election under IRC Sec. 183(e) to postpone the safe harbor determination.

Example 1A-3 Three profit years must precede safe harbor loss year.

At the end of Year 3 in Example 1A-2, Tim could not rely on the safe harbor (presuming that Year 3 is a profit-motive year) and report income and deductions for Year 3 on his Schedule C. Even if he knew what the

future outcome would be for Years 4–6, future years have no bearing on the ability to use the safe harbor for Year 3 under the general presumptive rule of IRC Sec. 183(d). (Also, three profitable years had not yet occurred at that time.) In fact, although two of the next three years did produce profits (thus producing an applicable safe harbor five-year period containing three profitable years), the application of the safe harbor does not apply to a loss year until Year 5.

Electing to Postpone the Safe Harbor Profit Presumption. A taxpayer may elect to delay a determination as to whether the safe harbor applies until the close of the fourth (or sixth, in the case of horse racing, breeding, training, or showing) tax year after the tax year in which the taxpayer first engages in the activity.

To make a valid election, the taxpayer must file Form 5213 (Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit). The election Form 5213 is filed, separate from any other form or return, with the IRS Service Center where the taxpayer files his or her tax return. The election automatically extends the statute of limitations for all years in the postponement period until two years after the due date (without extensions) of the return for the last tax year in the five- (or seven-) year presumption period. However, the statute of limitations is extended only for items related to the activity and other items on the return that would be directly affected by the activity's deductions.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Molly is self-employed. She owns a book shop in a small town. Which schedule will Molly need to fill out along with her Form 1040 in relation to her business transactions?

    a. Schedule A.

    b. Schedule C.

    c. Schedule E.

    d. Schedule F.

2. Which of the following factors would be most likely to indicate that an activity is an active trade or business instead of a hobby in the current tax year?

    a. Providing evidence that the activity was engaged in for a profit in previous years.

    b. Consulting with a professional about how to make the activity profitable.

    c. Maintaining financial records for the activity.

    d. Showing that there was an honest attempt to earn a profit in the current tax year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Molly is self-employed. She owns a book shop in a small town. Which schedule will Molly need to fill out along with her Form 1040 in relation to her business transactions? **(Page 5)**

    a. Schedule A. [This answer is incorrect. Schedule A of Form 1040 is used to figure itemized deductions. While Molly might need to fill out a Schedule A, it would not be used for information related to business transactions. A different schedule is used for that purpose.]

    b. Schedule C. [This answer is correct. Taxpayers, like Molly, who are self-employed in a nonfarm business report their business transactions on Schedule C (Profit or Loss From Business) or Schedule C-EZ (Net Profit From Business). The net profit or loss from Schedule C or C-EZ is reported on page 1 of Form 1040.]

    c. Schedule E. [This answer is incorrect. Generally, rental income and expenses are reported on Schedule E of an individual's tax return. Since Molly's income and loss in this scenario is based on her business and not on rental activities, this schedule does not apply.]

    d. Schedule F. [This answer is incorrect. Farmers generally report income and expenses on Schedule F (Profit or Loss From Farming). Since Molly is not a farmer in this scenario, this schedule would not apply.]

2. Which of the following factors would be most likely to indicate that an activity is an active trade or business instead of a hobby in the current tax year? **(Page 5)**

    a. Providing evidence that the activity was engaged in for a profit in previous years. [This answer is incorrect. The presence of a profit intent in earlier years is not determinative for the tax year in question.]

    b. Consulting with a professional about how to make the activity profitable. [This answer is incorrect. Obtaining professional advice about how to make the activity profitable is an indicator of a profit motive, but failure to follow the advice can demonstrate the lack of such a motive. Therefore, one would have to both have the consultation and follow the resulting advice to have a clear profit motive.]

    c. Maintaining financial records for the activity. [This answer is incorrect. As discovered in various court cases, while maintaining financial records can be an indication of a taxpayer's profit motive, the existence of financial records alone may not be enough to demonstrate that an activity is not a hobby.]

    d. Showing that there was an honest attempt to earn a profit in the current tax year. [This answer is correct. The taxpayer must be conducting the activity with the actual and honest *intent* to make a profit in order to escape the hobby loss taint. Determining if an activity is engaged in for profit is based on the facts and circumstances of each case. Reg. 1.183-2(b) provides nine factors to consider.]

Working Interests in Oil and Gas Properties

General Rules

A working interest in an oil and gas property represents a lease agreement between the landowner and the working interest owner. In consideration for the landowner's agreement to lease the land and assign the rights to the minerals underneath, the working interest owner agrees that a portion, usually one-sixth or one-eighth, of all minerals produced belongs to the landowner. The landowner receives this portion (referred to as a royalty) free of any charges or costs other than state severance (production) taxes.

The owner of the working interest (sometimes referred to as an operating interest) in an oil and gas property assumes the burden of developing and operating the property. The working interest owner bears all costs involved in finding oil or gas and, if exploration is successful, the expenses incurred in lifting the minerals from the reservoir. For the individual taxpayer, income and expenses from oil and gas working interests normally are reported on Schedule C with a supporting schedule reporting income and expenses on a property-by-property basis. If the interest is owned through a partnership or S corporation, however, the taxpayer should receive a Schedule K-1 detailing the items to be reported and where they are reported on his return. The royalty interest (RI) owner (e.g., landowner) reports the royalty income and expenses (e.g., severance taxes, depletion) on Part I of Schedule E. Finally, Form 8903 may need to be completed for the Domestic Production Activities Deduction.

In Rev. Rul. 58-166, the IRS held that income received from a working interest is included in determining the taxpayer's "net earnings from self-employment" for the self-employment tax.

Prepaid Drilling Costs

During the preproduction (drilling) stage of the well, each working interest owner receives monthly invoices from the operator for their share of expenses. Many times, however, they prepay their share of the total estimated expenses in a lump sum before the well is drilled. When the prepayment is in the nature of a deposit (and the working interest owner might receive a refund after the drilling is complete), the Tax Court held that a cash-basis taxpayer cannot deduct the payment until actual expenses have been incurred by the drilling contractor. However, when nonrefundable prepayments are made under a turnkey contract, a cash-basis working interest owner is allowed a deduction in the year of payment for intangible drilling costs (discussed below) that are otherwise deductible. (With a turnkey contract, the drilling contractor agrees to supply everything and do all the work necessary to complete the well, place it in production, and turn it over ready to turn the key and start the oil flowing into the tanks.)

Any amounts paid for equipment or leasehold costs (LHCs), whether prepaid or otherwise, must be capitalized and recovered through depreciation (for the equipment) and depletion (for the leasehold). Depreciation and depletion are discussed later in this lesson.

Intangible Drilling Costs

Frequently, the largest single cost incurred by a working interest owner is the intangible drilling costs (IDC). The regulations define *IDC* as any cost incurred that in itself has no salvage value and is incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. These costs include wages, fuel, repairs, hauling, and supplies. In the first year IDC is incurred, the taxpayer may elect to currently deduct IDC. If the election is made, the taxpayer generally must deduct IDC in all subsequent years as it is paid or incurred for all properties. However, he or she can still make an annual election under IRC Sec. 59(e) to capitalize and amortize some or all of the IDC incurred that year over 60 months. If the Section 263(c) election is not made, IDC is capitalized and recovered through cost depletion or depreciation if the cost represents physical property.

A taxpayer who does not elect to expense IDC under IRC Sec. 263(c) may still elect to expense IDC on nonproductive wells (i.e., dry holes). The deduction for the costs of the nonproductive wells is allowable only in the year the wells are completed as dry holes. Even when some costs were incurred in one year and the outcome of the well is known by the time that year's tax return is filed, the costs may not be deducted until the year the well is completed.

Intangible drilling costs may have an impact on alternative minimum tax.

Depreciation

A working interest owner's share of lease and well equipment costs is normally subject to capitalization and depreciation. However, during the drilling phase of the well, costs without any salvage value qualify as IDC and, thus, are not considered depreciable property. For many working interest owners, the majority of their depreciable costs will be incurred when a well is determined to be a producing property and pumping and storage equipment is placed in service at the well site. The operator of the well (usually *not* the working interest owner) determines the character of expenditures as either IDC or capitalizable lease and well equipment.

Assets used in drilling oil and gas wells (e.g., drilling rigs) are generally depreciated using a five-year MACRS recovery period. (See Asset Class 13.1 in Rev. Proc. 87-56, as modified by Rev. Proc. 88-22.) Assets used during the production phase and during operation, such as gathering pipelines, pumps, and related storage facilities, are depreciated using a seven-year MACRS recovery period. (See Asset Class 13.2 in Rev. Proc. 87-56.) Rather than depreciate the property, however, taxpayers can elect to expense such costs under IRC Sec. 179, provided the other Section 179 conditions are met.

Depletion

The working interest owner is entitled to a deduction for the greater of cost depletion or allowable percentage depletion (sometimes referred to as statutory depletion). Cost depletion is based on the leasehold cost (LHC) of the property and is calculated using the mineral reserves (obtained from engineering reports) and the number of units sold for the year. For cash-basis taxpayers, the number of units sold means units for which payment was actually received within the tax year. Cost depletion is similar to depreciation determined on a units-of-production method.

Percentage depletion, on the other hand, is based on a percentage of gross receipts from the property. The rate is generally 15%. (Depletion rate may be higher for marginal production properties in years that the average crude oil price falls below $20 for the preceding calendar year. This exception is not triggered for the year 2017.) Independent producers (generally working interest owners who are not retailers or refiners) with less than 1,000 barrels of daily production qualify for percentage depletion. This includes most individuals. RI owners are also eligible for percentage depletion. Percentage depletion is limited to the net income from the property before deducting any depletion or Section 199 allowance, hence the necessity of reporting income and expenses on a property-by-property basis in a supporting schedule to Schedule C. Furthermore, a taxpayer's total percentage depletion deduction for the year from all oil and gas properties cannot exceed 65% of taxable income, computed without deducting percentage depletion, the domestic production activities deduction, NOL carrybacks, and capital loss carrybacks (if a corporation). Deductions limited by this 65% limitation may be carried over to succeeding tax years. Examples 1B-1 and 1B-2 detail the calculation of percentage depletion and these limitations.

Example 1B-1 Computing percentage depletion.

Tyler Hunt invested in oil and gas properties for the first time on March 15, 2017. He owns a working interest in three producing wells that were all drilled during 2017 after Tyler acquired an interest in the properties. In addition, Tyler invested in three additional drilling projects that were determined to be dry holes and abandoned before the end of the year.

At year-end, Tyler received a separate Form 1099-MISC for each of the three producing properties. In the 1099-MISC box labeled "Nonemployee Compensation," the well operators listed the gross payments (before deducting severance tax) made to him for each well. Tyler saved all the stubs ("run tickets") from the revenue checks he received. The run tickets indicate gross revenue, severance tax expense, and barrels (oil) or MCF (thousand cubic feet—gas) produced by the well.

Tyler's other income is $94,000 in wages and $500 of interest income. His allowable itemized deductions total $24,000. He is married and has three children. The following chart details his oil and gas business interests:

	Wells					
	Deacon #1	**Deacon #2**	**Bentley #1**	**Rowe #1**	**Rowe #2**	**Rowe #3**
Dry Hole?	No	No	No	Yes	Yes	Yes
Tyler's share of:						
1. LHCs	$ 1,000	$ 1,000	$ 750	$ 850	$ 850	$ 850
2. IDC	9,000	8,500	9,200	6,700	9,100	6,200
3. Equipment	1,500	1,500	1,200	—	—	—
4. Lease operating expense (LOE)	2,200	3,000	1,800	—	—	—
5. Depreciation	179	179	143	—	—	—
6. Gross revenue	18,500	4,600	12,150	—	—	—
7. Severance tax	1,203	267	790	—	—	—

To document compliance with the various percentage depletion limitations, Reg. 1.613-6 requires the taxpayer to include in the return a schedule showing the data needed to determine taxable income from the property before the depletion deduction.

Example 1B-2 65% of taxable income limit for depletion.

Assume the same facts as in Example 1B-1. Tyler has no NOL carrybacks or Section 199 deduction. Tyler's overall limit for deducting percentage depletion is calculated as follows:

Wages	$ 94,000
Interest income	500
Schedule C	(28,853)
Itemized deductions	(24,000)
Exemptions (5 × $4,050)	(20,250)
Taxable income before the 65% limitation calculation	21,397
Add back percentage (but not cost) depletion tentatively allowed	2,992
Adjusted taxable income	24,389
Percentage limitation	× 65%
Percentage depletion limit	$ 15,853

Tyler's percentage depletion deduction of $2,992 is fully allowed on his 2017 return.

Deducting a Home Office

To deduct home office expenses, a taxpayer must use the space *exclusively* and *regularly* [IRC Sec. 280A(c)(1)]—

1. as a principal place of business,
2. as a place to meet or deal with clients and customers in the normal course of business, or
3. "in connection with" the business if the space is a separate structure from the residence (e.g., a barn or detached garage).

Home office deductions are available to both self-employed taxpayers and employees. However, if the taxpayer is an employee, the business use of the home must be for the convenience of the employer, and the space must be used exclusively and regularly for job-related activities. As a practical matter, it is difficult for employees to pass these tests. If the employee also has an office furnished by the employer, it is unlikely that working at home is for the employer's convenience. However, a home office is for the convenience of the employer when the employer does not provide office space to the employee. In addition, taxpayers cannot avoid these rules by renting the home office to their employer.

Regular and Exclusive Use

As previously stated, to qualify for a home office deduction, a taxpayer must use the space both exclusively and regularly for the business purpose. Failing to meet either of these conditions results in the disallowance of a home office deduction.

Regular Use. Regular use means the taxpayer must use the portion of the home in the business activity on a continuing basis. Although the portion of the home is used exclusively (see following discussion) for the business purpose, it will not qualify for the home office deduction if use is only occasional. Thus, a dentist who used his home office to treat emergency patients failed to meet the regular use requirement because the use was only occasional and not to meet with patients in the normal course of his business.

Exclusive Use. Exclusive use means the taxpayer must use a specific portion of the home only for business purposes; there is no other use of the space. Two exceptions to the exclusive use rule are (1) storage of inventory or product samples if the home is the sole fixed location of the trade or business, and (2) certain daycare facilities. Space used for these purposes.

The exclusive use test can be very restrictive. In *Cook*, an attorney was denied deductibility for a portion of his residence used as a home office because he failed to meet the exclusive use test. While the residence was in fact the principal place of business for the law practice, the portions used for business were also personally used by the attorney and his family after business hours and presumably on weekends and holidays. Thus, the space used for the law practice failed the exclusive use test and the entire home office deduction was denied. In *Salih*, a doctor was denied a home office deduction for failure to provide evidence that an office containing a television and a VCR had no personal use. In *Anderson*, a bed and breakfast proprietor was denied a deduction for the portion of his home used 75% for business and 25% for personal purposes. In *Miller*, the taxpayer was allowed a home office deduction for space that had *de minimis* personal use.

A home office does not need to be a separate room or permanently partitioned portion of a room. Any "separately identifiable" area can serve as an office. Thus, a corner of a room with a desk and file cabinet could qualify as a home office.

Multiple Businesses. A taxpayer can operate two or more businesses using a single home office and still meet the regular and exclusive use requirements. However, each business must separately meet the requirements to sustain the deduction. Using a home office for employment-related duties could taint the deduction for a self-employment (e.g., a sideline) business. If at least one of the activities fails the Section 280A requirements, no home office deduction is allowed for any activity.

Example 1C-1 Regular and exclusive use—employee with a sideline business.

Joe is a CPA on the staff of a local accounting firm. Joe occasionally brings work home for his own convenience during busy season and uses a room over the garage as an office. He also prepares tax returns on the side and reports the income on a Schedule C as a sole proprietor. Joe meets the Section 280A(c) requirements of regular use of the office space for his sole proprietorship. However, since the office was not used exclusively for the sole proprietorship and the work performed there as an employee was for Joe's convenience and not for the convenience of the employer, no home office deduction is allowed.

Principal Place of Business

In the landmark *Soliman* case, the Supreme Court identified two factors for determining whether a home office qualifies as the taxpayer's principal place of business: (1) the relative importance of the activities performed at each business location and (2) the time spent at each place.

The "relative importance" test is analyzed first and, if no definitive answer is reached, the "time" test is considered. In analyzing the relative importance of the activities performed at each location, the point where clients are met or goods and services are delivered must be given great weight. Whether the functions performed at home are essential to the business, while relevant, is not controlling, and the availability of alternate office space is irrelevant.

However, in *Popov*, the 9th Circuit Court of Appeals overturned a Tax Court decision regarding a musician's business use of the home. The *delivery of services analysis*, which is part of the *relative importance* test, was not an appropriate framework for determining whether a home office deduction was appropriate for the musician who practiced at home for four to five hours a day. The appeals court decision stated, "It is possible, of course, to wrench musical performance into a 'delivery of services' framework, but we see little value in such a wooden and unblinking application of the tax laws." Therefore, the court moved to the *time spent at each place* test. Since the musician spent substantially more time practicing at home than performing away from home, the home office deduction was allowed.

In Rev. Rul. 94-24, the IRS provided several examples illustrating how these tests will be applied. In addition, the IRS reiterated the Court's finding in *Soliman* that, in some cases, application of the relative importance and the time tests may result in a determination that a taxpayer has no principal place of business for home office deduction purposes.

Administrative and Management Activities. A home office deduction is allowed if (1) the office is used exclusively and regularly by the taxpayer to conduct administrative or management activities of the taxpayer's business, and (2) there is no other fixed location of the business where the taxpayer conducts substantial administrative or management activities of the business. This definition expands the *Soliman* decision, allowing many more taxpayers to meet the definition of principal place of business.

Example 1C-2 Taxpayer's principal place of business.

Taylor is a self-employed contractor who builds single family homes. She maintains an office at home where she spends a significant amount of time working on building plans, ordering materials, calling subcontractors, doing payroll, keeping books, paying bills, and conducting other administrative and managerial duties. The room is used for no other purpose. She can claim a deduction for having a home office because she uses the space exclusively and regularly to conduct administrative or management activities of her trade or business, and no significant administrative or management activities are conducted elsewhere.

The taxpayer can have another office away from the residence and still claim the home office deduction if the criteria are met. The correct test to apply is where the administrative or management work is actually done—not where it could be done. Therefore, although there is another office away from home that can be used for administrative and managerial work, the taxpayer can still claim the home office deduction if he or she chooses to do the work at home.

Example 1C-3 Principal place of business when the taxpayer has an office outside the home.

Assume the same facts as in Example 1C-2, except that Taylor also has an office in a high-rise building where she meets with clients, works on building plans, orders materials, meets subcontractors, and performs other tasks directly related to the business of building houses. She continues to work at home doing payroll, keeping books, paying bills, and conducting other administrative and managerial duties.

Taylor can claim a home office deduction because she uses the home office exclusively and regularly to conduct administrative or management activities, and there is no other fixed location where she conducts substantial administrative or management activities.

Computing the Home Office Deduction

The home office deduction rules cover different kinds of direct and indirect expenses, including utilities, insurance, property taxes, and depreciation. Direct expenses (e.g., repairs made to the specific room used for business) are deducted in full (subject to the income limitation discussed later). The computation of the home office deduction for indirect expenses (i.e., expenses that benefit the entire home) is based on the allocation of the home office usage versus total usage. Determining the portion of a dwelling used for business can be done using any reasonable method under the circumstances, including allocations based on either square footage or number of rooms used for business to total rooms in the house. However, at least one court held that square footage was the more appropriate measure where the rooms in the home were not of approximately equal size. Total area is not defined, but in *Moretti* the court allowed the taxpayer to consider only living space in determining total square footage; thus, the garage was excluded, which increased the taxpayer's business-use percentage.

Special Rules for In-home Daycare Facilities. For daycare facilities, usage also considers the amount of time used. Rev. Rul. 92-3 provides a formula for allocating expenses for a daycare facility. The computation allocates expenses based on square footage and number of hours of business usage. In determining the square footage of the home used for business, the ruling allows a room that is available during the day and regularly used for daycare (e.g., a bathroom) to be treated as used during every hour of the business day for daycare (even if it is not in use during every hour of the business day for business). To qualify for these special rules for the home office deduction, the daycare facility must be licensed or approved under the taxpayer's respective state laws (or exempt from these requirements).

Example 1C-4 Home office deduction based on ratio of time used—daycare facilities.

Nancee Kamp operates a licensed daycare facility in her home. The daycare operates from 8 a.m. to 3 p.m., five days a week, and uses 50% of the house's square footage. Nancee spends an additional hour each day preparing for and cleaning up after the children and preparing meals for when they are present during the day. Her home office percentage for deductions is computed as follows:

$$\frac{\text{8 (daily hours of daycare)}}{\text{24 (total hours in day)}} \times \frac{\text{5 (number of days daycare is operated)}}{\text{7 (total number of days in week)}} = \frac{5}{21}$$

$$\frac{\text{Business portion of home}}{\text{Total area of home}} = \frac{1}{2}$$

Home office percentage = $^5/_{21} \times {}^1/_2 = 11.9\%$

Nancee is entitled to deduct 11.9% of household expenses as home office expenses subject to the income limitation discussed later. Part I of Form 8829 (Expenses for Business Use of Your Home) is used to determine the business-use portion of the home and has three lines devoted to homes used for daycare.

Income Limitation. The deduction for business use of the home (other than from otherwise deductible expenses, such as mortgage interest and real estate taxes) is limited to net income from the business. The deductions cannot create or increase a loss from the business.

To determine the limitation, business use of home deductions are claimed in the following order:

1. Business percentage of the expenses allowable as deductions in any case (e.g., qualified mortgage interest and real estate taxes). These expenses are fully deductible even if they exceed the net income from the business.

2. Other expenses for the business use of the home (e.g., repairs and maintenance, utilities, and insurance).

3. Depreciation of the home office space.

Example 1C-5 Home office deduction limited to net income.

Jane Smith operates a sales business from her home, which qualifies as her principal place of business and as a home office. Her office takes up 20% of her home, based on square footage. Jane has the following income and expenses attributable to her sales business for the year:

Gross profit (after cost of goods sold)		$ 7,200
Business expenses:		
Supplies	(640)	
Labor	(1,740)	(2,380)
Net income before home office expense		4,820
Home office expenses:		
Qualified mortgage interest	12,500	
Property taxes	2,500	

Total interest and taxes	15,000	
Business percentage	× 20%	
Business interest and taxes		$ (3,000)
Net income before other office expenses		1,820
Other office expenses:		
Insurance	1,200	
Repairs and maintenance	800	
Utilities	1,500	
Miscellaneous expense	1,500	
Total other office expenses	5,000	
Business percentage	× 20%	
Business other office expenses		$ (1,000)
Net income before depreciation		820
Depreciation expense	1,026	
Net income limitation		(820)
Net income		$ -0-

Because of the net income limitation, $206 ($1,026 − $820) of depreciation is disallowed. This amount can be carried forward to the next year.

Sole proprietors compute their home office deduction on Form 8829 (Expenses for Business Use of Your Home). Form 8829 requires disclosure of the method used for calculating the taxpayer's business-use percentage and limits business expenses to the net income from the activity. It also requires disclosure of the business basis of the home subject to depreciation. The allowable expense attributable to the business use of the home is carried to Schedule C.

Form 8829 is used only for sole proprietors. Employees must claim the home office deduction on Form 2106 (Employee Business Expenses). The expense flows to Schedule A, subject to the 2% of AGI limitation. Qualified residential interest and taxes are fully deductible on Schedule A without limitation (i.e., not reported as miscellaneous itemized deductions), but they reduce the business income available for offset by other home office deductions. Farmers report the expense on Schedule F. Partners report the expense on Schedule E. Form 8829 can be used as a worksheet to compute the home office deduction.

Example 1C-6 Using gain from the sale of business equipment to increase home office deductions.

Assume the same facts as stated in Example 1C-5 except Jane has decided to sell her company truck exclusively used in her business. The truck had an adjusted basis of $15,500 and Jane was able to sell the truck for $17,000 resulting in a gain of $1,500. This increases the income of the business activity, thus increasing the limitation on depreciation and avoiding any carryover with the net result offsetting $206 of the gain. Form 4797 would be completed as required, then the gain would be added to the amount of Schedule C line 29 tentative profit (loss), reported on line 8 of Form 8829.

Depreciating a Home Office. When a portion of a residence is converted to business use, its basis for depreciation is the lesser of—

1. the adjusted basis, including improvements, of the portion of the home allocated to the office space on the date of conversion; or

2. the fair market value (FMV) of the portion of the home allocated to the office space at the time of conversion.

Property converted from residential to business use must be depreciated using the method and recovery period in effect in the year of conversion. The method that applied when the property was originally acquired is irrelevant. Thus, a part of a residence converted to business use in 2017 is depreciated over 39 years under MACRS.

Example 1C-7 Computing depreciation when a portion of a residence is converted to a home office.

Buddy Love is an architect doing business as a sole proprietor. He has owned a home since 1997 and until recently rented office space for his business in a downtown building. In July 2017, Buddy converted his garage into office space and moved his business to his home office.

To compute depreciation for the home office, Buddy's basis will be the lower of (1) the cost or other basis of the home allocated to the garage (net of land) plus the improvements made to convert the garage to an office, or (2) the FMV of the converted office space at the time of conversion. In addition, Buddy must use a 39-year recovery period, beginning July 2017, since the home office is considered nonresidential real property.

An income-producing activity does not always qualify as a business. For example, use of an office to keep records regarding an investment activity does not qualify as business use. In such cases, no home office deduction is allowed.

Simplified Option for Claiming a Home Office Deduction

The IRS provides a simplified option for taxpayers with home-based businesses to claim the home office deduction for business use of their homes, without having to make the complex calculations, allocations, and substantiation of expenses otherwise required (see previous discussion).

It is important to note that the simplified option is an alternative only for calculating the amount of the home office deduction. All the other requirements of IRC Sec. 280A(c) must be met, including the exclusive and regular use requirements, the deduction is limited to income from the business, and the restrictions on employees attempting to claim the home office deduction.

Safe Harbor. Under the simplified option, the allowable deduction is obtained by multiplying a prescribed rate (currently $5) by the square footage of the residence that is used for business purposes, not to exceed 300 square feet. Thus, the maximum deduction under the safe harbor is $1,500.

The safe harbor method is a yearly election; i.e., the taxpayer can elect from year to year whether to use it or calculate and substantiate actual expenses. The election must be made on a timely filed original return. Once elected, the election is irrevocable for that year. Switching from year to year is not considered a change in accounting method and therefore does not require consent from the IRS. The election is made by simply using the safe harbor method on the return.

Taxpayers who itemize their deductions and use the safe harbor method may deduct any allowable expenses on Schedule A related to the home that are deductible without regard to whether there was any qualified business use for the year (for example, mortgage interest, property taxes, and casualty losses). In other words, choosing to use the safe harbor has no impact on the taxpayer's ability to deduct qualified residence interest, property taxes, or casualty losses.

Business expenses unrelated to the qualified business use of the home (e.g., advertising, wages, and supplies) are currently deductible, even though the safe harbor is used. However, a taxpayer using the safe harbor method cannot deduct any depreciation or Section 179 expense for the part of the home used in a qualified business use for that year. Home offices are usually subject to depreciation, which when the taxpayer later sells the house is subject to recapture even if the depreciation was never claimed. Under the safe harbor rule, depreciation is deemed to be zero. This presumably eliminates depreciation recapture on a future sale of the home for those years in which the safe harbor is elected.

A taxpayer who uses the safe harbor for only part of the tax year (for example, in a newly started business) must calculate the average monthly square footage amount, based on no more than 300 square feet for any month of business use.

Example 1C-8 Using the safe harbor for part-year business use.

Tim uses 400 square feet for qualified business use beginning in August and through December. Tim's average square footage allowance for the year is 125 (5 months × 300 square feet ÷ 12 months). Tim's safe harbor deduction amount is $625 ($5 per square foot × 125).

Taxpayers that share a home (such as roommates and even spouses, regardless of filing status) may each use the safe harbor method, but not for a qualified business use of the same portion of the home. Consequently, two people sharing a home may use the safe harbor method for a qualified business use of the home they share for up to 300

square feet *each* of different portions of the home. Any actual shared space within the home must be allocated between taxpayers in a reasonable manner.

A taxpayer conducting more than one qualifying business in the home is limited to a maximum of 300 square feet for all of the businesses. In this case, the square footage used should be allocated (up to the maximum 300 square feet) among all the qualified business uses in a reasonable manner, without allocating more square feet to a qualified business use than actually used for that business.

If a taxpayer uses more than one home for business during the year (for example, the taxpayer moves during the year), the election to use the simplified method may be made for only one of the homes. The deductions for any other homes during the year must be based on actual expenses.

Lastly, a taxpayer using the safe harbor for a tax year cannot deduct any disallowed amount carried over from a previous year during which the taxpayer used actual expenses. However, the taxpayer can deduct the carried over amount in the next succeeding tax year in which he or she uses actual expenses again.

Example 1C-9 Simplified method alternating with actual method.

Irene, a self-employed wildlife biologist, began exclusively using her home office in July 2015 to conduct research, draft reports, and complete grant requests. She has no other office available. The home office takes up 400 square feet and has a cost basis of $25,000. In 2015 and 2016, she used the actual method to compute her home office expense. She claimed a total of $935 depreciation for 2015 and 2016, using the 39-year recovery period and mid-month convention available under IRC Sec. 168, leaving her with a cost basis of $24,065 ($25,000 – $935). Of the $935 depreciation claimed, $700 was disallowed due to the income limitations, and has been carried over to 2017.

In 2017, Irene decides to use the simplified method for computing her home office deduction. Therefore, her deduction for 2017 is $1,500 (300 sq. ft. maximum × $5.00 per sq. ft.). All of Irene's mortgage interest and property taxes for 2017 are deductible on Schedule A, but any other allocable expenses (such as utilities and insurance) is not separately deductible. In addition, Irene does not deduct any depreciation for 2017. Irene has sufficient income to deduct the full $1,500 deduction on her 2017 return. However, she may not deduct the $700 depreciation carryover from 2015 and 2016 on her 2017 return.

At the end of 2017, Irene still has basis in her home office of $24,065. Since she used the simplified method in 2017, she does not reduce her basis for any 2017 depreciation. She also has $700 carryover to 2018 from the disallowed depreciation from 2015 and 2016.

In 2018, Irene switches back to the actual method of computing her home office expense. She allocates her home expenses to the home office on Form 8829 and claims the reduced mortgage interest and property taxes on Schedule A. She also computes depreciation of $641 for 2018. If Irene has sufficient income in 2018, she may claim her 2018 expenses plus the $700 carried over from 2015 and 2016 on her 2018 return. Her basis in the home office at the end of 2018 will be $23,424 ($24,065 basis at beginning of 2018 – $641 depreciation claimed).

Planning Considerations. Taxpayers in a home office deduction loss situation (expenses exceed gross income from the business, even if the safe harbor is used) should consider not making the safe harbor election. If the safe harbor is elected, excess expenses cannot be carried forward and are permanently lost for that year. Under the actual expense method, excess expenses are carried forward until used in a succeeding year.

It is important to note that high income taxpayers subject to the itemized deduction phase-out (AGI of $261,500 for single filers and $313,800 for joint filers) who also make the safe harbor election will lose some benefit of their mortgage interest and property tax deductions even though they deduct 100% of them on Schedule A. These taxpayers should consider not making the safe harbor election because the portion of these deductions allocated to the business use of the home when using the actual expense method will not be lost.

Dealing with Business Investigation and Start-up Costs

Individuals starting a new business or acquiring the assets of an existing business often incur expenses, which can be considerable, in the investigation and acquisition phase before actual business operations begin. Absent any special provision in the Code, such expenses would be capital in nature since they would not be incurred in carrying on a trade or business. Therefore, Congress introduced IRC Sec. 195 so taxpayers could deduct business start-up costs that would be deductible under IRC Sec. 162 if they were incurred in a trade or business.

Distinguishing Deductible and Amortizable Section 195 Costs from Capitalized Section 263(a) Costs

Start-up costs are expenses that would be deductible if incurred by an active trade or business, but do not include interest, taxes, or research and experimental expenditures (whose treatment is governed by other statutory provisions). They generally are segregated into two broad categories—investigatory expenses and preopening costs. Investigatory expenses are those incurred before reaching a decision to acquire or create a business. They include, but are not limited to, expenses for the analysis or survey of potential markets, products, the labor supply, and transportation facilities. If incurred in the acquisition of an existing business, such expenses are subject to the Section 195 allowance only if the taxpayer has an equity interest in, and actively participates in, the management of the business. Preopening costs are incurred after a taxpayer decides to establish or acquire a business, but before the day the business actually begins. Such costs include, but are not limited to, advertising; salaries and wages paid to employees being trained and their instructors; travel and other expenses incurred in lining up prospective distributors, suppliers, or customers; and salaries or fees paid or incurred for executives, consultants, and for similar professional services. In *Woody*, the taxpayer was denied deductions for his rental real estate business for all expenses incurred before he actually purchased his first rental property because he could not be carrying on the trade or business of rental real estate if he did not actually own the property. Costs associated with for-profit activities (which may later become an active trade or business) that are not investigatory or preopening costs are deductible under IRC Sec. 212 and should not be capitalized as Section 195 start-up expenses.

Amounts that must be capitalized under the Section 263(a) regulations do not qualify as Section 195 expenses. Instead, these capitalized amounts may (or may not) be amortized or depreciated under other tax rules. In general, the Section 263(a) regulations require the following:

1. Capitalization under Reg. 1.263(a)-4 for amounts paid to do the following:

    a. Acquire certain intangible assets, including but not limited to an ownership interest in another entity such as a corporation or partnership.

    b. Create an intangible, limited to those assets described in the regulations (i.e., if the asset is not described in the regulations, it does not have to be capitalized).

    c. Create or enhance a separate and distinct intangible asset, defined as a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal, or foreign law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged separate and apart from a trade or business.

    d. Create or enhance future benefits to be identified in published guidance in the *Federal Register* or in the Internal Revenue Bulletin.

    e. Facilitate the acquisition or creation of intangible assets previously described.

2. Capitalization under Reg. 1.263(a)-5 for amounts paid other than *de minimis* costs defined under Reg. 1.263(a)-5(d)(3) to facilitate the acquisition of assets constituting a trade or business; the acquisition of an ownership interest in a business when the taxpayer and the target entity are considered related parties after the transaction; the acquisition of an ownership interest in the taxpayer; certain business entity restructuring, reorganization, capitalization and recapitalization transactions; the formation or organization of a disregarded entity; the acquisition of capital, including stock issuances or borrowing transactions; or the writing of an option.

Amounts capitalized under these provisions are generally added to the tax basis of the intangible asset being acquired or created. Capitalized amounts for acquired Section 197 intangibles are amortized over 15 years. Generally capitalized amounts for created intangibles should be amortized under the 15-year rule (25-year rule in the case of certain amounts paid for real estate) of Reg. 1.167(a)-3.

Example 1D-1 Identifying methods of treating preopening expenditures.

FastCo incurred preopening expenditures to recruit and train employees in connection with opening a new retail store that was separate and apart from its existing manufacturing operation. These expenditures and any preopening expenditures to advertise the new retail business are Section 195 expenses. Such expenditures are Section 162-type expenditures that are not required to be capitalized under the Section 263(a) regulations. These expenditures are eligible for Section 195 treatment.

Also, FastCo incurred the following preopening expenditures that *are* capitalized under the Section 263(a) regulations:

1. Amounts paid to acquire a lease agreement for the new retail store and the transaction costs to acquire or create the lease (e.g., attorneys fees to negotiate an agreement). These capitalized amounts are amortized over the life of the lease.

2. Prepaid expense items covering the next 16 months, such as prepayments for liability and casualty insurance coverage for the retail store and any prepaid rent for the retail location are deducted in the periods to which they relate.

3. For liability protection reasons, FastCo established a new single-member LLC (SMLLC) for the retail operation. The amounts paid to facilitate the formation or organization of the SMLLC are capitalized under the Section 263(a) regulations. Apparently, there is no provision that allows amortization for these amounts.

Steps for Classifying Preopening Expenditure. The following procedural steps should be used to classify preopening costs incurred in connection with business expansions and acquisitions:

1. Not considering the Section 263(a) regulations, would the expenditure be currently deductible under IRC Sec. 162 if it was incurred by an existing business? If yes, go to Step 2. If no, capitalization is required under some other rule (e.g., the Section 248 rule for costs to organize a corporation).

2. Must the expenditure generally be capitalized under the Section 263(a) regulations? If yes, go to Step 3. If no, proceed directly to Step 5.

3. Does an exception in the Section 263(a) regulations negate the capitalization requirement? If yes, proceed directly to Step 5. If no, go to Step 4.

4. The expenditure must be capitalized under the Section 263(a) regulations. Determine if there is a tax rule that permits amortization or depreciation [e.g., under the guidelines found in Reg. 1.167(a)-3].

5. The expenditure is not required to be capitalized under the Section 263(a) regulations. Either deduct the amount currently under IRC Sec. 162 or, if a separate entity or dissimilar line of business is involved, capitalize the amount and treat as Section 195 expenses.

Business Expansion Costs. Taxpayers can currently deduct start-up expenditures to expand an existing business that are ordinary and necessary business expenses (Section 162-type expenses). For example, in TAM 9645002, Section 162 deductions were allowed for a retailer's business expansion costs to establish additional stores as part of a long-term expansion program. Expansion costs are currently deductible Section 162 expenses even when the same-line-of-business expansion is accomplished through an acquisition (e.g., when a chain of retail stores expands by acquiring the assets of another retail chain). In such case, the costs of employee hiring, relocation, and training and travel costs for visiting employees of the acquiring taxpayer are Section 162-type expenses that are currently deductible when paid or incurred.

Section 162 current deductions are not allowed when the expansion is accomplished by setting up a separate taxable entity, such as a corporate subsidiary or when a separate taxable entity is used to implement a same-line-of-business expansion. For example, the stock of the target business could be purchased by an acquiring holding company, or the target's assets could be purchased by a newly formed subsidiary owned by the acquiring taxpayer. In such cases, Section 195 treatment applies to expansion costs that would otherwise be currently deductible under IRC Sec. 162.

Same-line-of-business expansion/acquisition costs and dissimilar-line-of-business acquisition costs that must be capitalized under the Section 263(a) regulations do not qualify as currently deductible Section 162 expenses, nor do they qualify as Section 195 expenses. Instead, amounts required to be capitalized under the Section 263(a) regulations may (or may not) be eligible for amortization or depreciation under other tax rules. Some amounts may qualify for the exceptions in the Section 263(a) regulations that avoid capitalization.

Deducting Start-up Costs

Start-up expenses must generally be capitalized and cannot be deducted. However, taxpayers can deduct (in the tax year an active trade or business begins) the lesser of: (1) the start-up expenditures for the active trade or business; or (2) $5,000, reduced (but not below zero) by the amount by which such expenditures exceed $50,000. Any remaining start-up expenditures are deductible ratably over 180 months beginning with the month in which the active trade or business begins. Similar rules apply to organizational costs for corporations and partnerships.

Alternately, the taxpayer may choose to forgo currently deducting start-up costs by affirmatively electing to capitalize (and not deduct) its start-up expenditures on a timely filed federal income tax return (including extensions) for the tax year in which the active trade or business begins. The election either to deduct or capitalize start-up expenditures is irrevocable and applies to all start-up expenditures of the business.

Example 1D-2 Claiming the deduction for start-up costs.

Jerry incurs $52,000 of start-up costs on October 27, 2017, for his car wash that began business in November 2017. Jerry's 2017 deduction is $3,544 [$5,000 − $2,000 (start-up costs over $50,000) + $544 ($49,000 ÷ 180 × 2 months)]. The remaining $48,456 is deductible ratably over the next 178 months at $272 per month.

Variation: Assume the same facts, except that Jerry incurs $90,000 of start-up costs. His 2017 deduction is $1,000 ($90,000 ÷ 180 × 2 months); i.e., he deducts the entire $90,000 ratably ($500 per month) over 180 months beginning in November 2017.

Treatment of Costs after Disposition or Abandonment of Business

If a business is completely disposed of before the end of the amortization period, the unamortized start-up expenditures may be deducted as an ordinary loss under IRC Secs. 62(a)(1) and 165(c)(1). If an anticipated activity never rises to the level of a trade or business, any unamortized start-up expenditures upon abandonment are deductible as an ordinary loss under IRC Sec. 67(b) and should be claimed as a miscellaneous itemized deduction (subject to the 2% limitation) on Schedule A of Form 1040.

The treatment of start-up expenditures when the taxpayer never enters into a business is not as clearly defined. Individuals may not deduct losses under IRC Sec. 165 unless they are related to business or profit-making activities or are the result of a casualty or theft. Rev. Rul. 57-418 holds that losses incurred in the search for a business or investment are deductible only when the activities are more than investigatory, the taxpayer actually entered a transaction for profit, but the project is later abandoned. In Rev. Rul. 77-254, the IRS took this analysis one step further to provide that a taxpayer will be considered to have entered a transaction for profit if, based on all the facts and circumstances, he has gone beyond a general investigatory search for a new business or investment to focus on the acquisition of a *specific* business or investment. The ruling also held that expenses related to the decision of whether to enter a trade or business (and which trade or business to enter) are personal and not deductible.

How to Dispose Disposing of a Sole Proprietorship

When a sole proprietor sells or otherwise discontinues his business, numerous tax issues must be addressed. The disposition is often reported in various places on the return for such year, and recapture provisions can lead to additional income.

Gain or Loss upon Disposition

When a sole proprietor sells the entire business, it is not treated as a single asset but, instead, as a sale of each individual asset comprising the business. Gain or loss is reported for each business asset and is determined based on the difference between the allocable sales price and adjusted tax basis. Self-employment income does not include gains or losses (whether capital, Section 1231, or ordinary) from sales of business property other than inventory or stock in trade.

The character of the gain or loss for each business asset depends on the nature of the asset. Thus, the sale may be reported in different places in the taxpayer's return. For example, gain or loss from the sale of real or depreciable property used in the business is generally reported on Form 4797. Here, gains subject to depreciation recapture are reported in Part III while other gains and losses are reported in Parts I and II. Gains and losses from the disposal of capital assets are reported on Form 8949 and Schedule D. Any gain attributable to self-created goodwill is normally reported as a capital gain and is long-term or short-term depending on how long the business was held. Acquired goodwill that is treated as a Section 197 intangible asset is a Section 1231 asset when disposed. The sale of any inventory or stock in trade is reported on Schedule C and is included in the taxpayer's self-employment (SE) tax computation.

Example 1E-1 Reporting the sale of a sole proprietorship.

Since 2002, Ann has owned a retail shop that she operates as a sole proprietorship. Ann decides to retire, so she sells the retail store on June 7, 2017, receiving $175,000 in cash. The following schedule shows how the sales proceeds were allocated, Ann's adjusted basis in each, and where the components of the sale are reported on Ann's 2017 return. (She held all of the assets sold for more than one year.) Ann also reports the income and deductions from the store's operations through June 7 on Schedule C.

Description of Asset	Allocated Sales Price	Adjusted Basis	Gain or (Loss)	Where Reported on Form 1040
Inventory	$ 50,000	$ 55,000	$ (5,000)	Schedule C
Furniture and Fixtures	15,000	12,000	3,000	Form 4797, Part III
Building	60,000	30,000	30,000	Form 4797, Part III
Land	30,000	18,000	12,000	Form 4797, Part I
Goodwill (not Section 197 asset)	20,000	—	20,000	Form 8949
Totals	$ 175,000	$ 115,000	$ 60,000	

Covenants Not to Compete

It is not unusual for a taxpayer who sells a business to enter into a covenant not to compete as part of the sales transaction. Income from a covenant not to compete is generally ordinary income not subject to SE tax unless the seller continues to provide consulting services to the buyer. If not subject to SE tax, this income should be reported on the "Other income" line on page 1 of Form 1040. Otherwise, it is reported on Schedule C.

Recapture Income

When business property is disposed of or otherwise ceases to be used in a trade or business, several recapture provisions can apply that may alter the character or amount of income recognized. The sale of depreciable property at a gain can result in ordinary income recapture, depending on the type of property.

If a Section 179 deduction was previously claimed on Section 1245 property and such property is sold, the Section 179 deduction amount is treated as depreciation for purposes of computing Section 1245 recapture. If the property

is not sold but ceases to be used in a trade or business, a portion of the Section 179 deduction originally claimed is recaptured as ordinary income.

Automobiles and other listed property are subject to recapture provisions (for Section 179 expense as well as bonus depreciation) under IRC Sec. 280F when business use of these assets originally exceeded 50% but later falls to 50% or less. This is likely to occur when a sole proprietor uses an automobile in his or her business but converts it to personal use when the business is sold or discontinued.

Short Tax Year Depreciation

In the year a sole proprietorship is sold or otherwise disposed of, the business will have a short tax year unless the disposition occurs on the last day of the tax year. Special rules apply for calculating depreciation in a short tax year, including a short tax year in which the property is disposed of. Generally, depreciation on property that was placed in service in a full tax year but disposed of in a short tax year is computed using the midpoint of the short year.

Qualified Small Employer Health Reimbursement Arrangements

For plan years beginning on or after January 1, 2017, the 21st Century Cures Act signed into legislation on December 13, 2016, removes the $100 per day per employee penalty for small employers who adopt a qualified small employer health reimbursement arrangement (QSEHRA). IRC Sec. 9831(d) contains the provisions for relief of the penalty.

This new plan allows small employers who may not be looking to offer a group health insurance plan the ability to reimburse employees for their out-of-pocket medical costs, including health insurance premiums and other eligible medical expenses outlined in IRC Sec. 213(d) on a tax-free basis to the employee.

An eligible small employer is one who employs fewer than 50 full-time employees and does not offer a group health insurance plan to any of its employees. The employee must furnish proof of health insurance coverage for the reimbursement of insurance premiums and other medical expenses. The employer must provide all reimbursements from the plan, and no salary reduction contributions by the employee are allowed. The amount of employer payments and reimbursements may not exceed $4,950 per year for single coverage and $10,000 per year for family coverage. These limits are indexed for inflation. For 2017, the maximum reimbursement amount for single coverage is $4,950 and $10,050 for family coverage. An employer may select any annual reimbursement amount within these limits.

Reimbursements made to an employee from a health reimbursement arrangement are tax deductible by the employer and tax free to the employee. However, reimbursements are taxable to employees that do not maintain health insurance coverage, measured on a monthly basis. A small employer adopting a health reimbursement arrangement must meet written notification requirements as outlined in IRC Sec. 9831(d)(4).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. Which of the following occurs in a typical oil or gas interest?

    a. The working interest owner assumes the burden of developing the property.

    b. An individual taxpayer in this type of arrangement will report income on Schedule K-1.

    c. The landowner must pay a percentage of the operating costs to the working interest owner.

    d. The landowner gets more of the minerals produced than the working interest owner.

4. Which of the following statements best describes an aspect of computing the home office deduction?

    a. Direct expenses are deducted based on an allocation of home office usage versus total usage.

    b. The home office deduction is limited to the business's net income.

    c. The first deduction claimed for the home office is the depreciation of home office space.

    d. The home office deduction requires complex calculations, so it may not be worth the time for self-employed taxpayers working out of their home.

5. Costs for which of the following should be capitalized under Reg. 1.263(a)-4?

    a. Buying an ownership interest in a corporation.

    b. Restructuring a business entity.

    c. Costs for issuing stock.

    d. Writing an option.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

3. Which of the following occurs in a typical oil or gas interest? **(Page 11)**

   a. The working interest owner assumes the burden of developing the property. [This answer is correct. The owner of the working interest in an oil and gas property assumes the burden of developing and operating the property. The working interest owner bears all costs involved in finding oil or gas and, if exploration is successful, the expenses incurred in lifting the minerals from the reservoir.]

   b. An individual taxpayer in this type of arrangement will report income on Schedule K-1. [This answer is incorrect. For the individual taxpayer, income and expenses from oil and gas working interests normally are reported on Schedule C with a supporting schedule reporting income and expenses on a property-by-property basis. If the interest is owned through a partnership or S corporation, however, the taxpayer should receive a Schedule K-1 detailing the items to be reported and where they are reported on his return.]

   c. The landowner must pay a percentage of the operating costs to the working interest owner. [This answer is incorrect. The landowner receives the agreed-upon portion (referred to as a royalty) free of any charges or costs other than state severance (production) taxes.]

   d. The landowner gets more of the minerals produced than the working interest owner. [This answer is incorrect. In consideration for the landowner's agreement to lease the land and assign the rights to the minerals underneath, the working interest owner agrees that a portion, usually one-sixth or one-eighth, of all minerals produced belongs to the landowner. Therefore, the working interest owner would get the majority.]

4. Which of the following statements best describes an aspect of computing the home office deduction? **(Page 13)**

   a. Direct expenses are deducted based on an allocation of home office usage versus total usage. [This answer is incorrect. Direct expenses are deducted in full (subject to the income limitation). The computation of the home office deduction for indirect expenses is based on the allocation of the home office usage versus total usage.]

   b. The home office deduction is limited to the business's net income. [This answer is correct. Per the Code, the deduction for business use of the home (other than from otherwise deductible expenses, such as mortgage interest and real estate taxes) is limited to net income from the business. The deductions cannot create or increase a loss from the business.]

   c. The first deduction claimed for the home office is the depreciation of home office space. [This answer is incorrect. To determine the limitation, business use of home deductions are claimed in the following order: (1) business percentage of the expenses allowable as deductions in any case, (2) other expenses for the business use of the home, and (3) depreciation of the home office space.]

   d. The home office deduction requires complex calculations, so it may not be worth the time for self-employed taxpayers working out of their home. [This answer is incorrect. The IRS provides a simplified option for taxpayers with home-based businesses to claim the home office deduction for business use of their homes, without having to make the complex calculations, allocations, and substantiation of expenses otherwise required. Therefore, self-employed taxpayers working out of their home should at least consider the deduction.]

5. Costs for which of the following should be capitalized under Reg. 1.263(a)-4? **(Page 20)**

   a. Buying an ownership interest in a corporation. [This answer is correct. Capitalization under Reg. 1.263(a)-4 is used for amounts paid to do things such as (1) acquire certain intangible assets, including but not limited to an ownership interest in another entity such as a corporation or partnership; (2) create an intangible, limited to those assets described in the regulations; and (3) create or enhance a separate and distinct intangible asset, defined as a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal, or foreign law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged separate and apart from a trade or business.]

   b. Restructuring a business entity. [This answer is incorrect. Certain business entity restructuring, reorganization, capitalization, and recapitalization transactions are capitalized under Reg. 1.263(a)-5 instead.]

   c. Costs for issuing stock. [This answer is incorrect. Costs for the acquisition of capital, including stock issuances or borrowing transactions, are capitalized under Reg. 1.263(a)-5.]

   d. Writing an option. [This answer is incorrect. The costs related to writing an option are capitalized under Reg. 1.263(a)-5, not Reg. 1.263(a)-4.]

Lesson 2: Farm Income and Expenses (Schedule F)

Introduction

An individual taxpayer is considered a farmer if he cultivates, operates, or manages a farm for gain or profit, either as an owner or a tenant. Farmers generally report income and expenses on Schedule F (Profit or Loss From Farming). Many farms are operated by part-time farmers, often at a loss that may offset income from other sources. However, such losses may be limited under the hobby loss rules or the passive activity loss rules.

Although dealers in personal property are generally prohibited from using the installment method for reporting sales, farmers disposing of any property used or produced in the trade or business of farming can use the installment method. Farmers can use the installment method for such sales for both regular tax and AMT purposes.

The following income is *not* reported on Schedule F:

1. Rent based on farm production or crop shares when the recipient does not materially participate [under the self-employment (SE) tax rules]. Such income is reported on Form 4835 (Farm Rental Income and Expenses), which feeds into Schedule E.

2. Rent from land that is based on a flat charge (reported on Schedule E).

3. Sales, exchanges, or involuntary conversions of farm property.

4. Sales of livestock (bought or raised) held for draft, breeding, sporting, or dairy purposes [reported on Form 4797 (Sales of Business Property)].

5. Casualties or theft of farm property (including livestock held for draft, breeding, sport, or dairy purposes) reported on Form 4684 (Casualties and Thefts), which feeds into Form 4797 (when used) or directly to Form 1040 (on the Form 4797 line).

Qualifying farmers, defined as those receiving at least two-thirds of their gross receipts from farming, can avoid quarterly estimated tax payments. Instead, they may make one estimated payment by January 15 following their year-end or file their return and pay all tax by March 1 following their year-end.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize how to report cooperative patronage distributions, the appropriate tax treatment of CCC loans and prepaid farming expenses, and how to defer certain crop and livestock income.
- Determine the best way to address the depreciation of farm property, the uniform capitalization rules for plants and animals, the substantiation requirements for farm vehicles, commodity hedging transactions, crop-share rental reporting, computing tax on farm income using averaging, and the limitation on deductibility of farm losses.

Cooperative Patronage Dividends

Patronage Dividends

Cooperative (co-op) patronage dividends are distributions of profits to patrons made by a cooperative. They are generally reported as income on lines 3a and 3b of Schedule F (Profit or Loss From Farming). The patronage dividend is similar to a rebate or refund on purchases and is generally allocated and reported to a member on Form 1099-PATR (Taxable Distributions Received From Cooperatives). Patrons receive the dividend in two separate components: a cash distribution of at least 20% of the total dividend, as well as a qualified written notice of allocation. Patronage dividends in excess of cash paid are allocated to the farmer's equity account on the co-op's books, and are generally distributed, tax free, to the patron in future years. A qualified written notice of allocation is a certificate treated as the equivalent of cash both for deduction by the co-op and taxation to the patron.

A patronage dividend allocable to the purchase of nondeductible personal, living, or family items is not taxable. Additionally, a patronage dividend is not taxable if it is related to the purchase of a capital asset or depreciable property used in the taxpayer's trade or business. Instead, it reduces the asset's basis as of the first day of the tax year. If the dividends exceed the asset's unrecovered basis, the excess is reported as income on Schedule F. A patronage dividend related to normal farming activities (i.e., the sale of farm commodities or the purchase of farm supplies, feed, and crop inputs) is current taxable income reported on Schedule F.

A nonqualified written notice of allocation is a certificate giving written notice of an allocation that does not meet all the requirements of a qualified written notice. The receipt of an allocation designated on a nonqualified written notice is not taxable; the taxable event occurs when the taxpayer receives money or property in redemption of the certificate.

Example 2A-1 Taxable patronage dividends.

Roger is a self-employed farmer who purchases supplies from the Farmers Co-op. During the year, he received $250 cash from the co-op that represented 20% of his patronage dividend of $1,250. (He received a qualified written notice of allocation.) Roger's records indicate he conducted $30,000 of business with the co-op. This included $27,000 of farm-related purchases and sales and $3,000 (or 10%) of personal expenses.

The full patronage dividend of $1,250 must be reported as gross income on Schedule F, line 3a, even though only 20% was distributed in cash. However, 10% of Roger's patronage dividend allocation represents a rebate on personal purchases and is subtracted to arrive at a net taxable amount on line 3b of $1,125.

Losses on Co-op Equity

Cooperatives occasionally have suffered financial problems, failed, or been subject to takeover transactions or mergers. A financially distressed cooperative may permanently reduce the member's equity account, issuing a notification to the member indicating that his equity account has been adjusted downward or eliminated. This write-off is deductible on Part II of Schedule F in the year the reduction occurs. Since the co-op equity has been previously recognized as income on Schedule F, any reduction to equity is deductible on Schedule F and self-employment income is reduced for that year even though the taxpayer may no longer be actively engaged in farming.

Per-unit Retains

A *per-unit retain allocation* is an amount paid to patrons for products marketed for them and is fixed in amount without regard to the co-op's net earnings. These allocations are paid in cash, property, or qualified or nonqualified certificates. Per-unit retains generally are treated the same as patronage dividends. Qualified certificates are taxable when received, and nonqualified certificates are taxable when redeemed for cash or property. Qualified per-unit retain allocations are reported as current income by the co-op in box 3 of Form 1099-PATR. When redeemed by the member, nonqualified retain allocations are reported in box 5 of Form 1099-PATR.

Example 2A-2 Qualified per-unit retains.

Larry is a self-employed dairy farmer. He received a Form 1099-PATR showing he received qualified per-unit retain certificates of $2,250. He did not receive any of the per-unit retains in cash. He received no other patronage dividends. His Form 1099-PATR shows $2,250 in box 3 (per-unit retain allocations). The entire $2,250 is shown as income on Schedule F, lines 3a and 3b.

Example 2A-3 Nonqualified per-unit retains.

Dan is a self-employed sugar beet farmer. He received a certificate from his sugar beet cooperative indicating he had been allocated a total of $4,550 of nonqualified per-unit retains for the year. In addition, he received a cash payment of $3,500 (reported on Form 1099-PATR, box 5) for the redemption of prior-year nonqualified per-unit retain certificates.

The $4,550 of nonqualified per-unit retains are not taxable currently and are not reflected on Schedule F or Form 1099-PATR. However, the nonqualified per-unit retains redeemed for cash are taxable (reported on Form

1099-PATR, box 5) in the year the cash is received and should be reported on Schedule F. Thus, Dan reports $3,500 on Schedule F, lines 3a and 3b.

Domestic Production Activities Deduction

Cooperatives engaged in the manufacturing, production, growth, extraction, or marketing of agricultural or horticultural products can claim the domestic production activities deduction (DPAD) attributable to certain qualified production activities income (QPAI). A series of IRS rulings concluded that even non-pooling cooperatives that lack captive marketing agreements may treat payments to producers for purchases as per-unit retains for the calculation of DPAD (e.g., Ltr. Rul. 201002009). A cooperative can choose to pass through all, some, or none of the DPAD. Any DPAD allocated by the cooperative to the patron is based upon the patron's share of patronage dividends or per-unit retains attributable to QPAI of the cooperative. A cooperative's patronage dividends, per-unit retain allocations, and nonpatronage distributions do not impact its QPAI. To claim the patron's allocable deduction shown in box 6 of Form 1099-PATR, this amount must have been identified by the cooperative in a written notice mailed to the patron during the payment period. The patron's allocable deduction is claimed by entering the amount from box 6 of Form 1099-PATR onto line 23 of Form 8903 (Domestic Production Activities Deduction).

Example 2A-4 Domestic production activities deduction for co-op patron.

Assume the same facts as in Example 2A-3. In addition, Larry's Form 1099-PATR shows that his share of the co-op's DPAD (reported in box 6) is $75, which agrees with the amount the co-op reported earlier to Larry in a letter. Larry includes the $75 on line 23 of Form 8903 to calculate his DPAD on his personal return Form 1040 for the year. There is no wage limitation for a DPAD allocated from a co-op.

The Tax Treatment for CCC Loans

Cash-method farmers generally report income from the sale of crops in the year they are sold. A farmer enrolled in U.S. Department of Agriculture (USDA) grain programs may have the option of pledging some or all of the production to secure a Commodity Credit Corporation (CCC) loan. Farmers who take out CCC loans may report the loan proceeds as income in the year received (income method) or treat the amount as a loan (loan method). A taxpayer who chooses to include CCC loans in income one year can use the automatic accounting method change procedures to switch from the income method to the loan method. The automatic change is accomplished by attaching Form 3115 (Application for Change in Accounting Method) to the tax return for the year of change. This change is made on a cut-off basis and a Section 481(a) adjustment is neither permitted nor required (i.e., there is no forward spread of the impact of the change). Under the income method, the amount of CCC loans reported as income becomes additional tax basis in the crop. Farmers using the loan method have no additional basis in the crop. Instead, they may recognize income when the loan is repaid.

A taxpayer who forfeits grain to the USDA/CCC instead of repaying a loan receives Form 1099-A (Acquisition or Abandonment of Secured Property) from the USDA. The amount of debt satisfied by forfeiting the grain (i.e., the fair market value of the property) is reported in box 4 and "CCC" is shown in box 6.

Example 2B-1 Forfeiture to satisfy CCC loan.

John is a cash-basis farmer and reports his CCC loans on the income method. In 2016, John took out a $10,000 CCC corn loan and reported this as income on line 5a of his 2016 Schedule F. In 2017, due to the difference in market prices, it was advantageous for John to forfeit the corn (basis $10,000) to the CCC rather than to repay the loan and market the crop. John received a 2017 Form 1099-A with the amount of $10,000 in box 4. John's 2017 Schedule F reports the 1099-A amount of $10,000 (on line 5b) but includes zero in taxable income (line 5c). This is because John had reported the $10,000 loan proceeds as income in 2016 and had basis in the forfeited crop equal to the forgiven loan.

Variation: Assume the same facts, except John reports CCC loans on the loan method. John's Schedule F for 2017 then includes $10,000 in income (reported on both lines 5b and 5c). When the loan method is used, a cash-basis farmer recognizes income when the crop is forfeited in satisfaction of the CCC loan.

Market Gain

The repayment amount of a CCC loan is generally the lesser of its amount or the prevailing world market price of the pledged commodity at the repayment date. Therefore, if the price of the commodity has fallen at that date, the farmer realizes a *market gain* (i.e., the excess of the loan proceeds over the repayment). The market gain is reported on Form 1099-G regardless of whether the taxpayer repays the loan in cash or with CCC certificates. Market gain is either reported as income or as a basis adjustment to the commodity, depending on the farmer's method for recognizing income on CCC loans.

Farmers who report CCC loans on the loan method report market gains as taxable income (i.e., on lines 4a and 4b of Schedule F) in the year received. The market gain has no impact on the basis of the commodity. Farmers who have elected to report CCC loans on the income method do not recognize the market gain when the loan is repaid. The market gain is reported on line 4a of Schedule F, but not included as a taxable amount on line 4b. Instead, it reduces the farmer's basis in the commodity, and will be recognized when the commodity is sold. See Notice 2007-63 for further details.

Example 2B-2 Market gain on CCC loans.

Walter, a cash-method cotton farmer, uses the loan method for CCC loans. In 2016, he pledged 1,000 pounds of cotton ($0 basis) as collateral for a $500 CCC loan. In March of 2017, when the price of cotton was $.42 a pound, he repaid the loan for $420 and in December of 2017, sold the cotton for $600. Walter has realized $80 ($500 − $420) of market gain, which is reported as taxable income on lines 4a and 4b of his 2017 Schedule F. In addition, Walter reports a $600 gain on the sale of his cotton in 2017.

Variation: Same facts as above, except that Walter has elected to report CCC loans as income. Then, in 2016, he would have recognized $500 of income when the loan was made (as if the cotton were sold for $500). In 2017, when the loan was repaid, Walter takes a basis in the cotton of $420. The $80 market gain is reported on Schedule F, line 4a, but not as a taxable amount on line 4b. When the cotton is sold in 2017, Walter recognizes $180 ($600 − $420) of gain.

The Rules for Prepaid Farming Expenses

General Rule

Cash and accrual-method taxpayers generally must capitalize prepaid expenses (although cash method taxpayers can deduct certain prepaids that provide a benefit that does not extend more than 12 months). However, these rules do not apply to expenses specifically addressed elsewhere in the Code. Therefore, prepaid farm expenses continue to be governed by IRC Sec. 464, which provides that cash-basis farmers can deduct expenses for prepaid farm supplies (e.g., feed, seed, fertilizer, other similar expenses, and certain poultry expenses) to the extent the prepaid expenses are less than 50% of the other deductible farm expenses for the tax year. Prepaid farming expenses that exceed 50% of other deductible expenses may only be deducted as the purchased items are consumed. For the 50% test, ordinary and necessary operating expenses of the farm, interest and taxes, and depreciation on farm equipment are considered. Costs that must be inventoried or capitalized are not included in the test.

Rev. Rul. 79-229 provides additional criteria for deducting prepaid farm expenses. (While the ruling deals specifically with prepaid feed, the IRS applies these criteria to all types of prepaid farm expenses.) The three additional tests are as follows:

1. *Purchase vs. Deposit.* The expenditure must be an actual purchase, rather than a mere deposit to buy in the future. A cash method farmer should obtain an invoice that clearly specifies a definite quantity, quality, and price for the items purchased. There should be no right to refund or repurchase noted on the invoice.

2. *Business Purpose.* The expenditure must have a business reason other than tax avoidance. Examples of business reasons for early purchase include securing adequate quantities, obtaining discounts, and the expectation of rising costs.

3. *No Income Distortion.* The expenditure must not result in a material distortion of income. Generally, purchases for the upcoming crop year would not distort income. Similarly, purchases of items such as feed would not normally distort income if they are reasonably expected to be consumed within the next 12 months.

Poultry Rule. Poultry expenses are subject to a special rule. If the poultry expenses meet the 50% test, the excess cost of poultry (including egg-laying hens and baby chicks) purchased for use in a trade or business must be capitalized and deducted ratably over the lesser of 12 months or their useful life. The cost of poultry purchased for resale is deducted in the tax year in which the poultry is sold.

Exceptions to the 50% Rule

Two exceptions exist to the 50% rule if the taxpayer is a farm-related taxpayer. A *farm-related taxpayer* is a person (or family member) whose principal residence is on a farm or whose principal occupation is farming. For such an individual, the 50% test is waived and prepaid expenses may be deducted in full if he or she—

1. has prepaid farm expenses that are more than 50% of other deductible expenses because of a change in business operations directly attributable to extraordinary circumstances, such as drought or changes resulting from government crop diversion programs; or

2. has aggregate prepaid farm expenses for the preceding three tax years that are less than 50% of the aggregate other deductible expenses for those three tax years.

Example 2C-1 Prepaid farm expenses deduction is not limited.

John's farm expenses, including depreciation, are $100,000. Actual use or consumption occurred on $75,000 of these expenses. The $25,000 of prepaid expenses are fully deductible since they are less than $37,500 (50% of the deductible expenses of $75,000).

Example 2C-2 Prepaid farm expenses deduction is limited.

During 2017, John bought fertilizer ($4,000), feed ($1,000), and seed ($500) for use on his farm in 2018. Thus, his total prepaid farm supplies for 2017 are $5,500. John's other deductible farm expenses (including depreciation) for 2017 totaled $10,000. None of the exceptions to the 50% rule apply to John in 2017. Therefore, his 2017 deduction for prepaid expenses cannot exceed $5,000 ($10,000 × 50%). The excess prepaid expenses of $500 ($5,500 − $5,000) are deductible in the tax year the supplies are consumed (i.e., 2018).

Special Rule for Fertilizer Expenditures

Farmers engaged in crop production activities normally incur significant fertilizer, lime, and other soil nutrient expenses. The cost of these items can be deducted currently if their benefits last for one year or less. If the benefits last substantially more than one year, the costs must be capitalized. However, farmers can elect annually to expense the costs of fertilizer and similar items, even if they would otherwise be subject to capitalization.

Capitalized Fertilizer Costs

If fertilizer expenditures provide a benefit that lasts more than a year and the farmer does not elect to expense them under IRC Sec. 180, the costs are capitalized and amortized. The IRS regulations, as well as IRS Pub. 225, give no specific direction on how the decision to capitalize is to be documented. To clarify that the option to currently expense has been declined in favor of capitalization and amortization, a statement can be attached to the tax return.

Farmers might forgo the election to currently expense fertilizer expenses when they have unexpectedly low taxable income, or find that personal exemptions and other deductions are not being utilized. The decision to capitalize fertilizer expenditures can be made as late as actual preparation of the tax return, and represents an opportunity to accomplish additional tax planning after the close of the year.

Example 2C-3 Capitalization of fertilizer in a low income year.

Ted, a cash method farmer who produces corn and soybeans, annually incurs about $32,000 of fertilizer expense. The expenditures provide a benefit that lasts beyond a year. While preparing his tax return, Ted and his practitioner discover that his taxable income is significantly below expectations so that Ted is underutilizing his itemized deductions and personal exemptions. Accordingly, fertilizer expenses are capitalized rather than expensed.

Ted's current year fertilizer expenditures included $12,000 of spring fertilizer and $20,000 of post-harvest fall fertilizer applications. The practitioner does not claim this $32,000 of expenditures on Ted's Schedule F. Ted's agronomist has informed him that about 40% of the spring fertilizer would have been consumed in the current year, and accordingly 40%, or $4,800, of amortization is claimed for that expenditure, but no amortization is claimed with respect to the fall expenditure of $20,000.

Accordingly, by electing to capitalize and amortize current year fertilizer, Ted has replaced a $32,000 fertilizer deduction with $4,800 of current amortization expense, effectively increasing his taxable income by $27,200. Ted's election to capitalize the current year fertilizer does not bind him to similar treatment with respect to fertilizer expenditures incurred in later tax years.

The Option to Defer Certain Crop and Livestock Income

Crop Insurance Proceeds

Cash-basis farmers can elect to include crop insurance proceeds in income for the tax year following the year in which the destruction or damage of crops occurred and the proceeds were received. To make this election, a farmer must check the box on Schedule F, line 6c, and attach a statement to the return stating that under normal practice, more than 50% of the income from the damaged crops would have been included in income in a year following the year in which destruction or damage occurred.

This tax deferral option also applies to drought assistance and other relief payments to farmers under USDA programs. Certain government disaster payments, such as for flood and other natural disasters, are also eligible for the crop insurance tax deferral treatment. A farmer who receives multiple crop insurance and government disaster payments attributable to a single farming business must elect to treat these receipts in a consistent manner for a particular tax year, either including all in current income or electing to defer all to the following year.

Example 2D-1 Deferring crop insurance and disaster payments to the subsequent tax year.

Larry, a cash-basis farmer, suffered drought damage in the current year that qualified him for USDA disaster assistance payments of $8,400. In the same year, a portion of his soybean crop was damaged by hail, and he received $2,000 of private crop insurance payments. Larry elected to defer these disaster and crop insurance payments by including an election statement in his return for the year stating that the damaged crops would have been marketed in later years under his normal crop sale practices.

On his return for the following year, Larry reports the $10,400 of deferred insurance and disaster payments on line 6d of his Schedule F.

The election to defer crop insurance and disaster income may also be made via an amended return. Accordingly, if a taxpayer reported such income in 2017 (the year of receipt), meets the criteria for deferral, and finds that a lower tax rate applies in 2018, the 2017 return can be amended to defer the insurance and disaster income to 2018.

Revenue-based Claims. To the extent a farmer receives insurance proceeds not attributable to the destruction or damage of crops, the proceeds would not be eligible for deferral. Another form of insurance available to farmers is known as Crop Revenue Coverage (CRC). In addition to covering losses caused by weather and casualty events, the insurance covers revenue losses caused by low price or low yield. Essentially, a farmer sets the insurance contract to guarantee a certain level of revenue from the crop, and any shortfall is reimbursed regardless of the event causing the loss. In some cases, insurance claims cover both loss of yield due to damage or destruction and

a revenue guarantee. These payments may be received simultaneously and appear on the same Form 1099. Taxpayers will need to identify the nonqualifying crop revenue coverage and revenue assurance payments from the farmer's records, perhaps with assistance from the insurance carrier, in order to determine the amount eligible for deferral.

Livestock Sold Because of Adverse Weather Conditions

A cash-basis farmer who is forced to sell livestock early due to drought, floods, or other weather-related conditions may elect to include income from the sale of the additional livestock in the tax year following the year of sale. The election is available only if the taxpayer establishes that the sale would not have occurred but for the drought, flood, or other weather-related conditions that resulted in the area being designated as eligible for federal assistance. The income that may be deferred is based on the excess of the number of livestock sold in the year over the number that would have been sold had the farmer followed usual business practices in the absence of weather-related conditions. The designation can be made by the President, the Department of Agriculture (or any of its agencies), or by other federal departments or agencies.

Example 2D-2 Sale of excess cattle due to flood.

Elmer, a cash-basis farmer, sells approximately 200 head of cattle in a normal year. As a result of severe flooding, Elmer sells 250 head during the current year at $300 per head, realizing $75,000 of income from this sale. Later that summer, the area was declared a disaster area and ruled eligible for federal disaster assistance. Elmer may defer $15,000 ($300 × 50) of income until the following year, representing the portion of the $75,000 (250 head) that exceeds the normal quantity sold (200 head per year).

If the sale qualifies under IRC Sec. 1033(e)(2) as an involuntary conversion, Elmer's election to defer proceeds from the sale of livestock for weather-related conditions can be made at any time within the four years following the close of the first tax year in which any gain is recognized. A statement must be attached to his return (original or amended) indicating that an election is made under IRC Sec. 451(e), identifying the conditions and fact of a federal disaster declaration, and providing details regarding the number of animals sold in each of the three preceding years, as well as the animals sold in the current year.

Involuntary Conversion Rules. The sale of livestock held for draft, breeding, or dairy animals due to drought, floods, or other weather-related conditions in excess of the number of livestock that normally would have been sold is treated as an involuntary conversion if the livestock is replaced within four years after the end of the first tax year in which any part of gain from the conversion is realized. The involuntary conversion provisions generally provide a greater deferral of income than the one-year election under IRC Sec. 451(e). Under the involuntary conversion rules, gain that would have been recognized reduces the basis of the replacement animals. This effectively defers gain until the replacement animals are sold rather than recognizing it all in one year, as under the Section 451(e) deferral election. Thus, it will often be advantageous to elect to defer any gain on a weather-related sale that qualifies for the four-year replacement period under the involuntary conversion rules of IRC Sec. 1033. When the deferral election is made, no gain is reported on the sale in the year it occurs. Then, the taxpayer has until the end of the replacement period to determine whether it is most advantageous to (1) report the sale in the year it occurred (i.e., on a amended return), (2) report it in the year after it occurred, or (3) defer gain under IRC Sec. 1033, provided replacement property is acquired. If the taxpayer is unable to reinvest the proceeds in property similar or related in use to the livestock, IRC Sec. 1033(f) allows the taxpayer to reinvest in other farm property (including real property in the case of soil contamination or other environmental contamination) and avoid recognition of gain.

Because of prolonged droughts in parts of the United States, the IRS has announced it will provide additional time to replace qualifying livestock that was sold as a result of drought. IRS Notice 2006-82 explains how a taxpayer can determine whether additional time is available. To assist taxpayers in determining whether the replacement period has been extended, the IRS publishes each September a list of counties that experienced exceptional, extreme, or severe drought for the 12-month period ending on the immediately preceding August 31. See IRS Notice 2016-60 for the affected counties for the 12-month period ended August 31, 2017.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. What is the term for a fixed amount paid to patrons for products marketed for them?

    a. Commodity Credit Corporation (CCC) loans.

    b. Commodity hedging transaction.

    c. Cooperative patronage dividends.

    d. Per-unit retain allocation.

7. Which of the following is a condition that must be met for a prepaid farming expense to be deductible?

    a. The expenditure is a deposit to buy farm supplies in the future.

    b. Feed purchases must be expected to be consumed in the next two years.

    c. The expenditure must be less than total deductible farm expenses for the tax year.

    d. The expenditure is made for a business purpose, not simply to avoid paying taxes.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. What is the term for a fixed amount paid to patrons for products marketed for them? **(Page 29)**

   a. Commodity Credit Corporation (CCC) loans. [This answer is incorrect. Cash-method farmers generally report income from the sales of crops in the year they are sold. A farmer enrolled in U.S. Department of Agriculture (USDA) grain programs may have the option of pledging some or all of the production to secure a CCC loan. This loan structure is different than the payments described above.]

   b. Commodity hedging transaction. [This answer is incorrect. Farmers sometimes enter into *commodity hedging transactions* to protect against unfavorable price fluctuations. These transactions can be in the form of commodity futures contracts, forward contracts, or options on futures contracts; however, they would not come in the form described above.]

   c. Cooperative patronage dividends. [This answer is incorrect. These are distributions of profits to patrons made by a cooperative (co-op), and they are a different type of payment than the one described in this question.]

   d. Per-unit retain allocation. [This answer is correct. Per the Code, a *per-unit retain allocation* is an amount paid to patrons for products marketed for them and is fixed in amount without regard to the co-op's net earnings. These allocations are paid in cash, property, or qualified or nonqualified certificates.]

7. Which of the following is a condition that must be met for a prepaid farming expense to be deductible? **(Page 32)**

   a. The expenditure is a deposit to buy farm supplies in the future. [This answer is incorrect. According to Rev. Rul. 79-229, the expenditure must be an *actual purchase*, rather than a mere deposit to buy in the future. A cash method farmer should obtain an invoice that clearly specifies a definite quantity, quality, and price for the items purchased.]

   b. Feed purchases must be expected to be consumed in the next two years. [This answer is incorrect. Per Rev. Rul. 79-229, the expenditure must *not* result in a material distortion of income. Purchases of items such as feed would not normally distort income if they are reasonably expected to be consumed within the next 12 months. It might distort income, however, if it was not used for two years.]

   c. The expenditure must be less than total deductible farm expenses for the tax year. [This answer is incorrect. Prepaid farm expenses are governed by IRC Sec. 464, which provides that cash-bases farmers can deduct expenses for prepaid farm supplies (e.g., feed, seed, fertilizer, other similar expenses, and certain poultry expenses) to the extent the prepaid expenses are *less than 50%* of the other deductible farm expenses for the tax year. Prepaid farming expenses that exceed 50% of other deductible expenses may only be deducted as the purchased items are consumed.]

   d. The expenditure is made for a business purpose, not simply to avoid paying taxes. [This answer is correct. As outlined in Rev. Rul. 79-229, one of the tests for the deduction of prepaid farm expenses is that the expenditure must have a business reason other than tax avoidance. Examples of business reasons for early purchase include securing adequate quantities, obtaining discounts, and the expectation of rising costs.]

The Depreciation of Farm Property

Property used in a farming business must be depreciated using the 150% declining balance method. This requirement applies to all assets used in the business of farming, not only agricultural equipment items. Thus, all depreciable assets associated with a Schedule F enterprise (including cars, computers, office fixtures, etc.) are subject to the slower 150% DB method, rather than the 200% DB MACRS method.

The business of farming includes (1) raising and harvesting crops; (2) raising, shearing, feeding, caring for, training, and managing animals; (3) operating a nursery or sod farm; (4) raising or harvesting trees bearing fruit, nuts, or other crops; and (5) raising ornamental trees (an evergreen tree is not considered an ornamental tree if it is more than six years old when severed from its roots).

For farm property placed in service after 1988 and before 1999, the recovery period for regular tax purposes was the regular MACRS recovery period while the recovery period for AMT purposes was the longer alternative depreciation system (ADS) recovery period based on the class life. Thus, an AMT adjustment needed to be computed even though both regular tax and AMT depreciation were computed using 150% DB. Beginning with property placed in service in 1999, however, the AMT recovery period conforms to the MACRS recovery period. Thus, there is no AMT adjustment with respect to farm property placed in service beginning in 1999; however, an AMT adjustment must still be computed for property placed in service after 1988 and before 1999.

The Uniform Capitalization Rules for Plants and Animals

General Rule

Uniform capitalization (UNICAP) rules for farmers require that direct costs and an allocable portion of indirect costs incurred to raise or grow plant or animal commodities be capitalized. However, many farming activities are exempt from the UNICAP rules. Specifically, for farming activities, the UNICAP rules only apply to the production, growing, or raising of property if it—

1. is produced by a farm entity required to use the accrual method of accounting (i.e., tax shelters, certain large farm corporations, and partnerships with a corporate partner); or

2. is a plant with a preproductive period of more than two years.

To assist taxpayers in determining which plants have a preproductive period in excess of two years, IRS Notice 2013-18 contains a list of plants with a nationwide weighted average preproductive period in excess of two years. The list, which is not all-inclusive, will be updated periodically.

Absent an election out of UNICAP (see discussion following), direct and allocable indirect costs incurred to plant, cultivate, maintain, or develop plants with a preproductive period of more than two years must be capitalized. However, costs incurred to replant and maintain plants bearing an edible crop for human consumption may be expensed if the replanting was made necessary by freezing, drought, pests, or casualty. Replanting may occur on different property but must be undertaken by the same taxpayer.

Example 2F-1 Application of UNICAP to replanting after a freeze.

Carl has a large citrus grove operation. In May, 50% of his groves were permanently damaged by a freeze. Carl replanted the damaged trees, incurring considerable cost. Under IRC Sec. 263A(d)(2), he may currently deduct the replanting costs. However, any costs relating to the planting of a new grove (not related to the freeze) must be capitalized because the preproductive period of citrus trees is more than two years.

Election Out of the UNICAP Rules

An individual farmer who grows plants with a preproductive period of more than two years may elect to not apply the UNICAP rules. This election does not apply to any costs involved in a citrus or almond grove that were incurred within the first four years that the trees were planted. An election out of the UNICAP rules must be made in the first tax year the individual is in a farming business subject to the capitalization requirements.

Two adverse consequences arise from electing out of the UNICAP rules:

1. Any plants otherwise subject to capitalization are treated as Section 1245 property upon disposition, requiring ordinary income recapture at the time of disposition to the extent that expenses would have been capitalized.

2. The alternative depreciation system (ADS) (straight-line method with longer term alternative lives) must be used to depreciate all property used predominantly in any farming business of the taxpayer or related person.

Example 2F-2 Election out of UNICAP rules.

Brian has previously grown only wheat and corn in his farming proprietorship and has not been subject to UNICAP because the preproductive period for these crops is less than two years. This year, Brian started an apple orchard and elected not to have the UNICAP rules apply. Brian makes the election by deducting preproduction costs on his Schedule F for the year. He must use ADS and will not be allowed to take bonus depreciation for all property used primarily in his farming business (including assets involved solely in his grain farming operation) and placed in service when the election out of UNICAP is in effect.

Farm Vehicle Substantiation

A taxpayer generally must be able to prove the following items to claim a deduction for vehicle expenses: (1) the amount of each separate expense, (2) the mileage for each business use of the vehicle, (3) the date of the expense or use, and (4) the business reason for the expense or use. Typically, some type of account book, diary, log, or similar record supported by adequate documentary evidence (e.g., receipt) must be kept. Recordkeeping does not need to be done contemporaneously. However, records of business use made at or near the time of the expense and supported by sufficient documentary evidence are more credible than a statement prepared after the fact.

However, Temp. Reg. 1.274-6T(b) provides an exception to the recordkeeping requirement for vehicles used directly in connection with the business of farming. If an owned or leased vehicle is used during most of a normal business day directly in the business of farming, instead of substantiating its use, the taxpayer may determine any deduction or credit for the vehicle as if the business use were 75% plus that percentage, if any, attributable to an amount included in an employee's gross income. A taxpayer who opts to satisfy the substantiation requirements of IRC Sec. 274(d) by using the 75% rule cannot use a different method in subsequent years. The converse is also true.

Example 2G-1 75% farm-use option for vehicle substantiation.

Dennis, a sole proprietor engaged in farming, owns a pickup and a car. Dennis keeps a mileage log for his car and averages 25% farm use. He claims deductions for the car on his tax return based on the 25% farm use. Dennis does not keep a mileage log for his pickup since it always remains on farm property. Dennis can rely on the safe harbor and claim 75% business use on the pickup. Because the automobile was not used primarily for farming, it is not eligible for the 75% safe harbor in any case.

Dealing with Commodity Hedging Transactions

Farmers sometimes enter into commodity hedging transactions to protect against unfavorable price fluctuations. These transactions can be in the form of commodity futures contracts, forward contracts, or options on futures contracts.

The character of gain or loss from these contracts was determined by the Supreme Court in the landmark case of *Corn Products Refining Co.* The Court held that corn futures purchased to protect a company from price increases that affected its manufacturing of syrups were *not* capital assets, and thus gains or losses from these holdings generated ordinary rather than capital gains or losses.

What Is a Hedging Transaction?

A hedging transaction is one entered into in the normal course of a taxpayer's business primarily to reduce the risk of—

1. price changes or currency fluctuations on ordinary property (i.e., property, the sale or exchange of which could not produce a capital gain or loss) that the taxpayer holds or will hold, or

2. interest rate or price changes or currency fluctuations on the taxpayer's ordinary obligations.

If not entered into to reduce risk, they are not considered hedging transactions. Instead, they are speculative transactions that give rise to capital gains or losses.

In agriculture, qualification of a futures contract, option agreement, or other contractual arrangement as a hedging transaction generally requires that three basic criteria are met:

1. The hedging contract is in commodities produced by the farmer and within the farmer's range of production.

2. The hedging contract protects the farmer from the risk of unfavorable price fluctuations (meaning that the contract secures a pricing opposite the farmer's physical position of commodities on hand or expected to be on hand or to be purchased, so as to constitute a price hedge).

3. The farmer meets identification requirements in his or her records with respect to the hedging transaction, subject to specified time limits as discussed later in this lesson.

Example 2H-1 Common hedge transaction—grain farmer.

Terry is a corn and soybean producer who operates as a cash-method proprietor. In June, he notes that the price of corn is exceptionally high, but he anticipates that it will be lower at his October harvest. Under normal crop conditions, Terry produces about 60,000 bushels of corn. Accordingly, in June, Terry sells eight contracts of corn short (representing 40,000 bushels) locking in the current June sale price. When harvest occurs, if Terry's anticipation was correct, he will sell his crops from the field at a lower price. However, he will close his short sale in October by buying contracts of the lower priced corn, thus realizing a profit. Terry's profit on the corn short sale contracts will be ordinary (reported on line 8 of Schedule F), as it is a hedging transaction (for price protection) tied directly to his corn inventory.

Example 2H-2 Farm producer—speculative transaction.

Bart is a corn producer. At harvest in October, Bart must sell a substantial portion of his crop since he lacks sufficient storage space. However, he expects corn prices to rise, so Bart immediately acquires a long futures position in corn to replace the commodity he sold at harvest. Any gain or loss on this long position will be speculative and result in capital gain or loss treatment [reported on Form 8949 (Sales and Other Dispositions of Capital Assets)] because it is not a transaction reducing risk.

Identifying Hedging Transactions

Taxpayers who enter into hedging transactions must identify them as such before the close of the day on which they are entered into. Acceptable identification methods include (1) placing hedging transactions in a separate account that has been identified as containing only hedges of a specified item or specified risk, or (2) making notations or other identifying marks within the books and records, such as designated marks on records of the transactions (i.e., trading tickets, purchase orders, or trade confirmations).

In addition to identifying hedging transactions, taxpayers must also identify the risk being hedged. This risk identification must be done within 35 days of entering into the hedging transaction. However, see Reg. 1.1221-2(g) for situations when the taxpayer's inadvertent error in properly identifying a hedge will be disregarded.

Reporting Crop-share Rental Arrangements

Farmers and other landowners often enter into crop-share arrangements for the rental of their land. The rent landlords receive in this kind of arrangement is based on a share of the crop or livestock produced on the land. The landowner is paid in kind with crops or livestock produced or with cash generated from their sale.

Regardless of whether the taxpayer uses a cash or accrual basis of accounting, amounts received in kind (including crops received under price-later and other deferred payment arrangements) are included in income when they are converted to cash or cash equivalent. If the landlord uses the crops as feed for his livestock, these crops are included in income at their FMV when they are fed to the livestock. In this case, the landowner would also deduct the same amount as feed expense.

When Are Crop-share Rents SE Income?

Rental income derived from real estate is generally not subject to self-employment (SE) tax. However, an exception to this rule causes farm landlords to be subject to SE tax on real estate rental income, including crop-share rents if the following criteria are met.

1. The rental income is derived from an arrangement under which the lessee shall produce agricultural commodities on the land.

2. The arrangement calls for the material participation of the owner in the production or management of the production of the agricultural commodity.

3. The owner does in fact materially participate in the activity.

Material Participation. In 1995, the Tax Court ruled that a farmer who leased land to his family's farm partnership in which he was a partner was subject to SE tax on the rental income. The taxpayer argued that the lease agreement did not require him to participate in farming the land, and the broad rule that real estate rentals are not subject to SE tax should be applied to his lease. However, the Tax Court agreed with the IRS's position that the lease and taxpayer's duties as a partner (where he was required to participate in the farming operation of the partnership) should be aggregated as a single arrangement, so the rental income should be treated as SE income.

In 2000, the 8th Circuit held that there must be a nexus or linkage between the rents received by a taxpayer and any arrangement that requires the landlord's material participation. An individual's role as corporate employee or self-employed partner will be segregated from the role of farm landlord unless the facts indicate the contrary. Rents that are "consistent with market rates strongly suggest that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an 'arrangement' for participation in agricultural production." Based on this decision, partners involved in self-rental agricultural arrangements should execute a written lease stating that the landlord is not participating in providing management, consulting, or other services to the tenant entity. Further, the rent received should not exceed a market value rent.

The IRS has not acquiesced to *McNamara* and intends, outside of the 8th Circuit, to continue asserting that crop-share rents are SE income if there is an agreement that the landlord will materially participate and he or she in fact does so. Practitioners should monitor this area for future developments.

Reg. 1.1402(a)-4(b) provides guidance for determining whether the landlord materially participates. Factors to consider include making management decisions about (1) when and what to plant, (2) rotation of crops, and (3) the kinds of machinery to be used. In addition, the IRS provides guidance in Pub. 225, "Farmer's Tax Guide," on what constitutes material participation. According to Pub. 225, a landlord materially participates if any of the following tests are met:

1. The landlord does any three of the following: (a) pays or stands good for at least half of the direct costs of producing the crop; (b) furnishes at least half the tools, equipment, and livestock used in producing the crop; (c) advises or consults with the tenant; or (d) inspects the production activities periodically.

2. The landlord regularly and frequently makes, or takes an important part in making, management decisions that contribute substantially to the success of the enterprise.

3. The landlord works 100 hours or more over a period of five weeks or more in activities connected with the production of the crop.

4. The landowner's activities demonstrate that he is materially and significantly involved in the production of the farm products.

Reporting Crop-share Rents

Rental income that is subject to SE tax is reported on Schedule F (Profit or Loss from Farming), which flows to the Schedule SE. If the income is not subject to SE tax, it is reported on Form 4835 (Farm Rental Income and Expenses). Any net income/loss from crop-share rental is carried from Form 4835 to Schedule E. It generally is considered income/loss from rental real estate subject to the passive activity rules. However, if the property subject to the rental arrangement is essentially bare farmland where less than 30% of the unadjusted basis is depreciable, net income is recharacterized as portfolio. Losses that retain their passive status can qualify for the $25,000 rental real estate loss privilege per the instructions to Form 4835.

Example 2I-1 Crop-share rentals.

Tom owns 10,000 acres of farmland in Kansas. During 2017, he enters into an agreement with Gene whereby Tom leases Gene 2,000 acres to grow wheat in exchange for 20% of the wheat harvest for the year. Tom does not materially participate in the production or management of the crops.

Gene harvests 40,000 bushels of wheat during 2017 and delivers Tom his share in August. Tom stores his share of the grain at the elevator until September when it is sold for $3 per bushel. In this crop-share arrangement, Tom recognizes income from the crops received in kind when the crops are converted to cash. Thus, Tom recognizes $24,000 (20% × 40,000 bushels × $3) of income from crop-share rentals in 2017. (If Tom had stored the grain until 2018 before he sold it, he would have recognized the income in 2018.) Tom reports the $24,000 of income on Form 4835 because he does not materially participate (under the SE tax rule for farming) in the farming operation and therefore, the rental income is not subject to SE tax.

Rental income based on a flat fee (often referred to as cash rent) is reported directly on Schedule E if the landowner does not materially participate in the activity.

Using Income Averaging to Compute Tax on Farm Income

Individual taxpayers engaged in a farming business can elect (by preparing Schedule J of Form 1040) to use income averaging in computing current-year federal income tax by treating an elective portion of their current-year taxable income from the trade or business of farming as if it had been taxed at the marginal tax rates applicable to the prior three years. It is not necessary for the individual to have been engaged in farming in any prior year; it is only necessary that the individual be engaged in farming in the current year. Also, it is not necessary that an individual have any specific percentage of gross receipts from farm sources to use farm income averaging. An individual engaged in a farming business includes a sole proprietor, a partner, and a shareholder in an S corporation. Estates and trusts are not individuals for this purpose and cannot use income averaging. The IRS has previously taken the position that an individual beneficiary is not engaged in the farming business of an estate or trust.

Farmers who make the election first designate all or a portion of their regular taxable income from the trade or business of farming from the current year as *elected farm income*. Then, they determine their current year tax liability by figuring the sum of (1) their current year regular tax liability as if taxable income were reduced by elected farm income, plus (2) the increases in the regular tax for each of the three prior tax years if taxable income for each year were increased by one-third of elected farm income.

Elected Farm Income

Elected farm income is the portion of the taxable income for the tax year that is (1) attributable to any farming business [as defined in IRC Sec. 263A(e)(4), including a farming business conducted via a partnership or S

corporation, and (2) specified in the taxpayer's averaging election. If the taxpayer's farm income consists of both ordinary income and capital gain, the election can be made for any combination of the ordinary and capital gain farm income. However, the maximum amount that can be elected for averaging is the net amount of farm income and loss items. Likewise, electable farm income from capital gains cannot exceed the taxpayer's net capital gain from all sources.

Farm income includes items of income, deduction, gain, and loss attributable to the individual's farming business. Rental income based on a share of production from a tenant's farming business is farm income regardless of whether the taxpayer materially participates if the income is determined under a written agreement entered into before the tenant begins significant activities on the land. Farm losses include an NOL carryover or carryback, or a net capital loss carryover, to an election year that is attributable to a farming business. Income, gain, or loss from the sale of development rights, grazing rights, and other similar rights are not treated as farm income. Compensation received by an employee generally is not farm income; however, a shareholder of an S corporation engaged in farming may treat compensation from the corporation that is attributable to the farming business as farming income.

Gain on the sale or other disposition of property (other than land) the taxpayer regularly used in a farming business for a substantial period of time (as determined by all the facts and circumstances) can be treated as elected farm income. When a farmer ceases his farming business, gain or loss realized from the sale of farm property is deemed attributable to a farming business if the sale occurs within a reasonable time after cessation of the business. Sales within one year are deemed to be within a reasonable time while sales after that will depend on the facts and circumstances.

Example 2J-1 Determining the eligible amount for elected farm income.

George, a single taxpayer, reports the following amounts on his 2017 Form 1040:

Schedule B: Interest income	$ 2,000
Schedule D: Section 1231 gains from raised breeding stock	6,000
Schedule E: Cash rent from farmland	12,000
Schedule F: Farm income	50,000
Form 4797 gains: Farm machinery sold	4,000
Gross Income	74,000
Deductions for applicable portion of SE tax, itemized deductions and personal exemption	(13,933)
Taxable Income	$ 60,067

The amount George may elect for income averaging is limited to the portion of his taxable income attributable to his farming business activity, as follows:

Schedule D: Section 1231 gains from raised breeding stock	$ 6,000
Schedule F: Farm income	50,000
Form 4797 gains: Farm machinery sold	4,000
Less self-employment tax deduction attributable to farm income	(3,533)
Taxable Income from farming	$ 56,467

Accordingly, George could choose, as his EFI on Schedule J (Income Averaging for Farmers and Fishermen), any amount up to $56,467.

Making the Election

The election is made by filing Schedule J (Income Averaging for Farmers and Fishermen) with an individual's return for the election year. The election can be made on a late or amended return if filed within the statute of limitations

for such tax year. Similarly, an election can be amended or revoked within the statute of limitations period for the election year.

Calculating the Farm Income Averaging Tax

The elected farm income is allocated evenly to the three prior base tax years. The regular tax for the prior year is then recomputed and compared to the regular tax as originally computed (or as adjusted for a previous farm income averaging election). Farm income averaging does not affect the regular tax liability for computing AMT. In other words, AMT is computed based on regular tax before considering income averaging. Thus, taxpayers do not lose the benefit of income averaging due to AMT. In addition, bunching income into one year and then taking advantage of income averaging can affect a taxpayer's income threshold for the 3.8% net investment income tax (NIIT) in the year of bunching.

Example 2J-2 Income averaging and AMT.

Angela, a farmer, has regular income tax of $22,000 and tentative AMT of $18,000 before considering income averaging. Averaging reduces her regular tax to $16,000. For purposes of comparison with AMT, Angela's regular tax is $22,000, so the AMT does not apply. Angela pays the regular tax after averaging of $16,000.

When recomputing tax for the three base tax years, the additional income resulting from the allocated farm income does not impact any amounts previously computed for those years that are impacted by the amount of AGI, taxable income, or tax liability. Similarly, a farm income averaging election does not change any amounts (e.g., allowable itemized deductions) for the election year.

Further, any NOL carryover that was partially applied in a base year is not refigured to offset the elected farm income added for averaging purposes. Also, capital gains included in elected farm income do not offset the unused capital losses of base years. Such gains are taxed at the base year's maximum capital gains rate (or, if lower, the regular tax rate).

Example 2J-3 Using three-year averaging to reduce tax liability.

Jim and Jan Thomas are married and file a joint return. Their taxable income in 2014, 2015, and 2016 was $40,000 each year. In 2017, their taxable income is $100,000 (including $60,000 of elected farm income). Jim and Jan's actual 2014, 2015, and 2017 tax is not affected, and their 2017 tax is calculated as follows:

	2014	2015	2016	2017
Taxable income	$ 40,000	$ 40,000	$ 40,000	$ 100,000
Allocate farm income	20,000	20,000	20,000	(60,000)
Taxable income, as adjusted	60,000	60,000	60,000	40,000
Tax on adjusted taxable income	8,096	8,081	8,076	5,068
Tax on original return	(5,096)	(5,081)	(5,076)	XXX
Increase in prior years' tax	$ 3,000	$ 3,000	$ 3,000	$ XXX
Increase in current year's tax				$ 9,000
Total 2017 tax				$ 14,068

Without income averaging, John and Jan's 2017 regular tax would be $16,478. Averaging saves them $2,410 ($16,478 − $14,068).

Negative Taxable Income Used in Computing Schedule J Tax. Taxable income for a base year can be a negative amount. If such amount is negative, however, any amount that may provide a tax benefit in another tax year is added back when determining base year taxable income (e.g., an NOL of a base year that was carried back and that resulted in a refund).

Example 2J-4 Negative base year taxable income.

Rick and Robin Jones elect to average $24,000 of their 2017 farm income. One-third of the elected amount, $8,000, is added to their 2015 base year income. For 2015, the Jones reported the following amounts:

Adjusted gross income	$ 9,100
Standard deduction	(12,600)
Personal exemption (three)	(12,000)
Net	$ (15,500)

After adding the elected farm income to the negative taxable income, their 2015 base year taxable income is zero[a] [$8,000 + $(15,500) = $(7,500)]. If the Jones elect to farm income average in 2018, their new base amount for 2015 is $(7,500).

Note:

[a] For purposes of computing tax, taxable income cannot be less than zero.

Self-employment Tax. A farm income averaging election does not directly affect a taxpayer's computation of SE income or tax for the election year or any prior base year. However, farming income averaging may, in some instances, produce a significant indirect benefit in the computation of SE tax.

For example, SE tax would be less for a taxpayer with taxable income for three years of $50,000, $50,000, and $200,000 than for a taxpayer with income of $100,000 for each year. Farm income averaging could be used to "level out" the taxpayer's income tax rates for the three years to minimize income taxes.

Change in Filing Status. An individual can make a farm income averaging election even though his filing status is different in the election year than it is in the base years (e.g., married filing joint in the election year but single filing status in the base years). For example, an individual who files married filing jointly in the election year but files as single in one or more base years may still elect to average farm income using the single filing status used in the base year.

Unearned Income of Minor Child (Kiddie Tax). Taxpayers who elect to include a minor child's unearned income on their return and who elect farm income averaging compute the tax on the child's unearned income for the election year using the rate determined after applying the election. If a child's income is reported on the parents' return in a base year, the tax on such income is not affected by a farm income averaging election allocating income to that year.

The Limitation on Deducting Farm Losses

Individual taxpayers that receive any direct or counter-cyclical payment, any payment elected to be received in lieu of such payment, or any CCC loan are limited in terms of the deductibility of a Schedule F farming loss. Applicable subsidy payments for this provision do not include CRP payments. The definition of a farming business for this provision is the same as that used for purposes of Schedule J farm income averaging, with a slightly expanded definition for specified processing activities.

Calculating the Excess Farm Loss

The amount of farm loss not deductible is equal to the excess of—

1. the aggregate deductions of the farmer for the year attributable to the farming business, over
2. the sum of—
    a. the aggregate gross income or gain of the farmer for the year attributable to farming, plus
    b. a threshold amount for the tax year.

The *threshold amount* for any year is the greater of $300,000 ($150,000 for married filing separately) or the total of net farm income for the previous five tax years.

Example 2K-1 Previous farm income allows deductibility of farm loss.

Kyle, a Schedule F farmer, has $1 million of net income from farming in each of the five tax years from 2012–2016, and incurs a $5 million Schedule F loss in 2017. The deductible farming loss in 2017 is limited to the greater of (1) $300,000, or (2) $5 million (total net farm income for the previous five tax years). Because the threshold amount equals the farming loss for 2017, the $5 million Schedule F loss in 2017 is fully deductible by Kyle.

Carryover of Disallowed Losses. Any farm loss disallowed in a particular year will be treated as a deduction attributable to farming in the next tax year. For purposes of calculating total net farm income for the prior five-year period, any loss that has been limited under this provision and is carried forward is taken into account only in the year in which that loss is allowed as a deduction. No limit for the carryforward period is stated.

Example 2K-2 Excess loss disallowed and carried forward.

Farmer Tom has $300,000 of net farm income and $700,000 of nonfarm income in 2012. Each year from 2013–2016, he has $1,000,000 of net farm income. In 2017, Tom incurs a $7,000,000 farm loss. His deductible farming loss in 2017 is limited to his threshold amount, which is the greater of (1) $300,000 or (2) $4,300,000 (total net farm income for the previous five tax years). Therefore, Tom's farming loss will be limited to $4,300,000 in 2017, and the remaining $2,700,000 ($7,000,000 − $4,300,000) is disallowed as an excess farm loss.

The 2017 farm loss of $4,300,000 is carried back under IRC Sec. 172(b)(1)(G) and allowed as a deduction in each of the five previous tax years. The loss will first offset the $300,000 of farm income and $700,000 of nonfarm income in 2012 to zero. Taxable income for 2013, 2014, and 2015 will also be reduced to zero. The remaining allowable farm loss of $300,000 reduces 2016 taxable income to $700,000.

Tom's excess farm loss that was disallowed in 2017 will be treated as a deduction attributable to his farming business in 2018.

Application to Partnerships and S Corporations

In the case of a partnership or S corporation, the limit is applied at the partner or shareholder level. Accordingly, each partner or shareholder takes into account his or her proportionate share of the income, gain, or deduction from the farming business of the partnership or S corporation, along with any applicable subsidies received by the partnership or S corporation during the tax year.

Coordination with Passive Activity Loss Rules

The excess loss disallowance rule in IRC Sec. 461(j) is applied before the application of the passive loss rules of IRC Sec. 469. Accordingly, even if a farm loss is not disallowed as an excess farm loss, the passive loss rules could prevent a farmer not materially participating in the farming activity from currently deducting the farm loss. The excess loss calculation worksheet should be completed before carrying the loss to Form 8582. If the taxpayer's entire investment is not at risk, and the at-risk limitations also apply, the excess loss worksheet is still prepared first, followed by the Form 6198 (At-Risk Limitations) and then Form 8582 (Passive Activity Loss Limitations).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Which of the following statements most accurately describes the uniform capitalization (UNICAP) rules for plants and animals?

   a. The UNICAP rules apply to all farming activities, including poultry and decorative trees.

   b. Electing out of the UNICAP rules could cause plants to be treated as Section 1245 property when sold.

   c. Farmers will be unable to use the alternative depreciation system (ADS) if they elect out of the UNICAP rules.

   d. Under the UNICAP rules, costs related to replanting edible crops for human consumption due to freeze are capitalized.

9. Assuming all other criteria are met, which of the following farm landlords would be subject to self-employment (SE) tax on crop-share rents?

   a. Jacob manages the crop production, but does not work the land.

   b. Rebecca does not participate in the farming activity on her land.

   c. Zach is paid for the rental in kind instead of in cash.

   d. Lisa uses the accrual basis of accounting.

10. What is the first thing a farmer does when using the income averaging method to compute current-year federal income tax?

    a. Prepare Schedule J of Form 1040.

    b. Determine their current year tax liability.

    c. Designate the amount of elected farm income.

    d. Determine whether SE tax will apply.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. Which of the following statements most accurately describes the uniform capitalization (UNICAP) rules for plants and animals? **(Page 39)**

    a. The UNICAP rules apply to all farming activities, including poultry and decorative trees. [This answer is incorrect. Many farming activities are exempt from the UNICAP rules. While poultry and decorative trees are not specifically exempted by name, per the Code, the UNICAP rules only apply to the production, growing, or raising of property if it (1) is produced by a farm entity required to use the accrual method of accounting or (2) is a plant with a preproductive period of more than two years.]

    b. Electing out of the UNICAP rules could cause plants to be treated as Section 1245 property when sold. [This answer is correct. As discussed in the Code, there are two adverse consequences to electing out of the UNICAP rules. One such consequence is that any plants otherwise subject to capitalization are treated as Section 1245 property upon disposition, requiring ordinary income recapture at the time of disposition to the extent that expenses would have been capitalized.]

    c. Farmers will be unable to use the alternative depreciation system (ADS) if they elect out of the UNICAP rules. [This answer is incorrect. One adverse effect of electing out of the UNICAP rules is that the ADS must be used to depreciate all property used predominantly in any farming business of the taxpayer or related person.]

    d. Under the UNICAP rules, costs related to replanting edible crops for human consumption due to freeze are capitalized. [This answer is incorrect. Under the Code, costs incurred to replant and maintain plants bearing an edible crop for human consumption may be expensed if the replanting was made necessary by freezing, drought, pests, or casualty. Replanting may occur on different property but must be undertaken by the same taxpayer.]

9. Assuming all other criteria are met, which of the following farm landlords would be subject to self-employment (SE) tax on crop-share rents? **(Page 42)**

    a. Jacob manages the crop production, but does not work the land. [This answer is correct. Per the regulations, one criteria that may indicate SE tax in this type of arrangement is that the rental arrangement calls for the material participation of the owner in the production or management of the production of the agricultural commodity. Though Jacob is not doing the actual farming work, because of his involvement in managing the process, he may have to pay SE taxes on the rental income.]

    b. Rebecca does not participate in the farming activity on her land. [This answer is incorrect. According to the regulations, if the owner does, in fact, materially participate in the activity, SE tax may be necessary. Since Rebecca does not participate, SE tax has not be triggered against her in this regard.]

    c. Zach is paid for the rental in kind instead of in cash. [This answer is incorrect. Farmers and other landowners often enter into crop-share arrangements for the rental of their land. The rent landlords receive in this kind of arrangement is based on a share of the crop or livestock produced on the land. The landowner is paid in kind with crops or livestock produced or with cash generated from the sale. However, per the regulations, the method used to pay the landowner is not one of the criteria that can trigger SE tax. Therefore, Zach will not have to pay SE tax on this rental income unless other criteria are also met.]

    d. Lisa uses the accrual basis of accounting. [This answer is incorrect. Regardless of whether the taxpayer uses a cash or accrual basis of accounting, amounts received in kind (including crops received under price-later and other deferred payment arrangements) are included in income when they are converted to cash or cash equivalent; however, use of the accrual method is not one of the criteria specified by the regulations to trigger SE income.]

10. What is the first thing a farmer does when using the income averaging method to compute current-year federal income tax? **(Page 43)**

    a. Prepare Schedule J of Form 1040. [This answer is incorrect. Individual taxpayers engaged in a farming business can elect (by preparing Schedule J of Form 1040) to use income averaging in computing current-year federal income tax by treating an elective portion of their current-year taxable income for the trade or business of farming as if it had been taxed at the marginal tax rates applicable to the prior three years. However, other information will be necessary to actually fill out Schedule J; therefore, this is not the first step.]

    b. Determine their current year tax liability. [This answer is incorrect. Farmers must determine their current year tax liability by figuring the sum of (1) their current year regular tax liability as if taxable income were reduced by elected farm income, plus (2) the increased in the regular tax for each of the three prior periods if taxable income for each year were increased by one-third of elected farm income. However, there are steps in this process that must be done prior to making this calculation. Therefore, there is a better answer choice.]

    c. Designate the amount of elected farm income. [This answer is correct. Farmers who make the election to use income averaging must first designate all or a portion of their regular taxable income from the trade or business of farming as *elected farm income*. Therefore, this is the first step toward initiating this process, as described in the Code.]

    d. Determine whether SE tax will apply. [This answer is incorrect. A farm income averaging election does not directly affect a taxpayer's computation of SE income or tax for the election year or any prior base year; therefore, this would not be the first step needed for this process.]

Lesson 3: Rental Property (Schedule E)

Introduction

It is not uncommon for taxpayers to own dwellings with both rental and personal use. The different combinations of rental and personal use are endless, and such variations may have different tax treatments. Generally, the rental income and expenses are reported on Schedule E of the individual's tax return. However, when a primary residence or any other residence is rented for fewer than 15 days during the calendar year, none of the rent is taxable, and the rental income and expenses are ignored.

When a taxpayer incurs a loss from a rental activity, several statutory obstacles must be overcome before the loss can be deducted, including—

1. vacation home rules,
2. hobby loss rules,
3. at-risk rules, and
4. passive activity loss rules.

Depending on the taxpayer's income level, rental income may be subject to the 3.8% net investment income tax.

Learning Objectives:

Completion of this lesson will enable you to:

- Distinguish between the different types of residences and vacation homes.
- Recognize appropriate tax treatments for the temporary rental of a personal residence prior to sale, the rental of a portion of a residence, the conversion of residence to a rental property, property rented to related parties, and owning and renting timeshare units.

Renting Residences and Vacation Homes

An interactive decision tool on *Determining If a Mixed-use Residence Is Personal or Rental Property (Sec. 280A)* is available and can guide the user through this topic.

Tax reporting of the rental of a taxpayer's residence or vacation home depends on how many days the property is used for rental purposes as opposed to personal purposes. A *residence* or *dwelling* for the purpose of IRC Sec. 280A is defined as a dwelling unit and includes a house, apartment, condominium, mobile home, boat, or similar property. Residences used personally by the taxpayer generally fall into one of three categories when determining their tax treatment:

1. *Personal Residence with Very Limited Rental Use.* A residence that is rented for fewer than 15 days during the year.
2. *Vacation Home with Both Rental and Personal Use.* Property with (a) personal use that exceeds the greater of 14 days or 10% of rental days *and* (b) rental use that exceeds 14 days.
3. *Rental Property with Very Limited Personal Use.* Property rented during the year and personal use that does not exceed the greater of 14 days or 10% of rental days.

As the following discussion indicates, the tax treatment for the three categories differs. The property's designation for tax purposes can change yearly, depending on how the property is used. It is important taxpayers keep track of both rental days and days of personal use to support the property's designation. The property's designation also impacts treatment for sale of the property.

Personal Residence with Very Limited Rental Use

A taxpayer's dwelling is treated as a residence if during the year it is used for personal purposes for more than 14 days, or more than 10% of the number of rental days if greater. Creating a trophy house used for marketing, training, and entertainment does not preclude the residence from being treated as a personal residence if the taxpayers live in it. If such residence is rented for fewer than 15 days during the calendar year, it is considered solely a personal residence. The taxpayer is not entitled to a Schedule E deduction for any expenses associated with the rental of the property, and any income received from the rental use is not taxable. Interest expense, to the extent it is qualified residential interest expense, and real estate taxes are 100% deductible as itemized expenses on Schedule A. Effectively, the taxpayer is considered to have received tax-exempt, nonreportable income.

Example 3A-1 Rental for fewer than 15 days.

John and Susan own their only home on a recreational lake. During one week in July when they take their annual vacation, they rent their home to vacationers using the lake. They receive $1,500 for the week's rental of the home. Because their home is their personal residence, and it is rented for fewer than 15 days during the year, the rental income is not taxable. In addition, any rental expenses they incur are nondeductible. They are allowed to fully deduct the qualified residential interest expense and real estate taxes on Schedule A.

Under the fewer-than-15-days-rental rule, property rented for less than fair rental value is still considered as rented. In one case, the taxpayer claimed that a $1,000 per month rental received (for a portion of the year) was less than the fair rental value of their property and consequently their property had effectively not been rented. Therefore, under the previously mentioned *de minimis* rental rule (rental of fewer than 15 days), they should be able to exclude the rental payments from their gross income. The Tax Court ruled that the property had in fact been rented for the year, even though at less than fair rental value and the exclusion did not apply.

Vacation Home with Both Rental and Personal Use

If property used as a residence is rented more than 14 days, deductions (other than interest, taxes, and casualty losses) are limited to the amount of the income from the property. A set of ordering rules applies in determining allowable deductions. If these ordering rules apply, the passive loss limitations are not applicable. Furthermore, the Section 183 hobby loss rules do not apply to such a residence for any year the ordering rules apply. However, the year will be taken into account as a tax year for purposes of the hobby loss five-year safe harbor rule.

When determining the number of days a dwelling unit is used for personal purposes, a taxpayer must consider the following rules in addition to days of actual personal use:

1. Personal use includes days the residence is used or rented to anyone at less than a fair rental.

2. Personal use by other owners (or members of their family) of the property is attributed to the taxpayer.

3. Rental to a family member (i.e., brother, sister, spouse, ancestor, or lineal descendent) is considered personal use unless the taxpayer can establish that (a) a fair market rental rate was received *and* (b) the dwelling was used as the family member's principal residence.

4. If the dwelling is used under a reciprocal arrangement that allows the taxpayer to use another dwelling, the days the taxpayer rents out his own unit are counted as personal days, even if he pays rent for the use of the other dwelling.

5. Days a taxpayer spends repairing and maintaining property on a substantially full-time basis, as well as travel days (the day arriving or leaving the property) when the primary purpose of the trip is to repair and maintain the property, are not counted as days of personal use. Substantially full-time (determined on a daily basis) means work is done on the unit for the lesser of eight hours or two-thirds of the time the individual is present on the premises. Provided all individuals on the property who are capable of working do work on the unit on a substantially full-time basis, use by other individuals or family members (e.g., children) not capable of such work is disregarded during a period of repair and maintenance. Adequate records should be maintained to substantiate time spent on repairs and maintenance each day to support engagement on a substantially full-time basis.

If a taxpayer rents or tries to rent a personal residence for 12 or more consecutive months, the use of the home as the taxpayer's principal residence in the tax year the rental period begins or ends is not counted as personal use for the vacation home rules. This 12-month period is known as a qualified rental period. A period of less than 12 months can also be a qualified rental period if it begins during the tax year and ends with the sale or exchange of the dwelling.

Example 3A-2 Use as a home before or after renting.

On February 28, 2016, after Mike accepted a job in New York, he and Jane moved out of a house in Dallas that had been their home for six years. From March 15, 2016, to June 30, 2017, they rented out their house in Dallas at fair rental value. Mike and Jane moved back into their house in Dallas on July 15, 2017.

Mike and Jane's use of the house as their principal residence from January 1, 2016, to February 28, 2016, and from July 15, 2017, to December 31, 2017, does not count as personal use for purposes of the vacation home rules (i.e., their use does not cause the property to be treated as a vacation home for 2016 and 2017). Therefore, no proration of expenses is required for the rental period, and rental expenses are not limited to gross rental income.

The property is a qualified personal residence for the periods Mike and Jane occupied the residence and a rental real estate activity (subject to the passive loss rules) during the rental period.

Example 3A-3 Rental to family member treated as personal use.

During the tax year, Dave and Kristy use their lake cabin for 7 days. They rent the cabin at fair rental value to other individuals for 60 days and to their son, Luke, for 28 days. Even though Luke paid fair rental value, his usage is considered personal use by Dave and Kristy because he is their son, and it is not his principal residence. Therefore, Dave and Kristy's personal use for the tax year is 35 days (7 days plus 28 days), which exceeds the greater of 14 days or 10% of the number of days rented (60 days $\times$ 10% $=$ 6 days). Thus, the cabin is considered a vacation home since it is rented out more than 14 days during the tax year. It is subject to ordering rules for determining allowable deductions and to the overall net income limitation. (See following discussion.)

For allocation purposes, days rented to a family member count as days rented, even though those days are considered personal use for determining whether the residence is a vacation home with rental income or a rental property with personal use. This distinction is important because the former (vacation home) is subject to limitation on overall loss, but not the passive loss limits, while the latter (rental property) is subject to the passive loss limitation but not the Section 280A overall loss limitation.

What Constitutes a Fair Rental? Neither the Code nor the regulations provide much help determining what is considered a fair rental for purposes of the vacation home rules. However, IRS Pub. 527 provides that a rent is not a fair rental if it is substantially less than rents charged for similar properties in the same geographic area. Although the term *substantially* is not defined in the publication, it does state that the following questions should be asked when comparing properties to determine if they are similar: (1) are they used for the same purpose? (2) are they approximately the same size? (3) are they in approximately the same condition? (4) do they have similar furnishings? and (5) are they in similar locations? If the answer to any one of these questions is no, then IRS Pub. 527 states that the properties probably are not similar.

Rental Income and Expenses. Rental income and expenses from vacation homes are reported on Schedule E. Rental expenses are deductible in the following order:

1. Qualified residential interest, taxes, casualty losses, and rental expenses not attributable to operating or maintaining the dwelling (e.g., expenditures to obtain tenants, such as commissions and advertising).

2. Operating expenses (including nonqualified residential interest), except depreciation.

3. Depreciation and other basis adjustments.

When applying these rules, the expenses in the second and third categories cannot produce a taxable loss. Thus, if the deductible interest and taxes completely offset the rental income, the operating expenses and depreciation are not deductible. Any expenses limited under this net income rule are eligible for carryforward to future years, but they remain subject to the net income limitation.

In addition to the net income limitation, any dwelling unit treated as a vacation home is subject to prorating of expenses. This prorating is required if the property is used personally to any degree, whether or not it meets the residence definition. The expenses attributable to the rental are determined based on the number of days the property is rented at a fair rental to the total days it is actually occupied during the year. The balance of the expenses are considered personal. (See Examples 3A-4 and 3A-5.)

Example 3A-4 Prorating expenses between rental and personal usage.

Frank and Alice live in Minnesota but spend each winter in Arizona. For January–April, or 120 days during the year, they rent out their Minnesota residence for $700 per month, or $2,800 per year. Using the proration formula, 32.88% (120 days/365 days) of the expenses are allocable to the rental portion of the residence. The remaining 67.12% of the expenses are personal.

Assume they incur the following expenses for the Minnesota property:

Home mortgage interest	$ 6,000
Real estate taxes	2,500
Insurance, utilities, and maintenance	3,500

The rental income and expenses would be reported as follows:

Rental income ($700 × 4)		$ 2,800
Interest expense ($6,000 × 32.88%)	(1,973)	
Real estate taxes ($2,500 × 32.88%)	(822)	(2,795)
Subtotal		5
Insurance, utilities, and maintenance ($3,500 × 32.88%, but limited to remaining income)	1,151	(5)
Taxable income (loss)		$ -0-

Because taxable income after deducting the interest and real estate tax expense is only $5, Frank and Alice can deduct only $5 of the $1,151 operating expenses allocated to the rental period. Also, they cannot deduct any depreciation expense. They can deduct the personal portion of the interest expense ($4,027), subject to qualified residential interest rules, and real estate taxes ($1,678) on their Schedule A. Operating expenses and depreciation allocable to the rental period that are not deducted in the year incurred because of the net income limitation may be carried forward to a succeeding year, subject to the net income limitation again in that year.

Periods of Vacancy. Many properties with mixed personal and rental usage have periods when the dwelling is vacant. In this circumstance, a controversy exists between the IRS and the courts as to how expenses are to be prorated. The IRS position [set out in Prop. Reg. 1.280A-3(c)] is that *all* expenses are to be prorated based on the period of actual usage (i.e., occupancy), whereas the courts have allowed taxpayers to prorate expenses attributable to the entire year (e.g., taxes and interest) over the full 365 days, since they accrue ratably throughout the year. The IRS position results in a greater allocation of interest and taxes to rental use, which reduces the taxpayer's deduction for operating expenses.

Example 3A-5 Prorating rental and personal expenses during periods of vacancy.

Marjo and Scott own a Montana ski villa, which they occupy personally for one month of the year and rent for three months of the year. Thus, the property is actually used for a total of four months. The remaining eight

months, the property is vacant. Rental income is $16,000; expenses and depreciation for the full year are as follows:

Real estate taxes	$ 3,500
Interest expense	14,000
Maintenance and utilities	4,800
Depreciation	12,000

The controversy between the IRS and the Tax Court is illustrated by the following rental calculation:

	IRS Position	Tax Court Position
Rental income	$ 16,000	$ 16,000
Deductions:		
Taxes and interest:		
IRS: $17,500 × 3/4	(13,125)	
Tax Court: $17,500 × 3/12		(4,375)
Other expenses:		
Maintenance and utilities: $4,800 × 3/4 (limited to net rental income)	(2,875)	(3,600)
Depreciation: $12,000 × 3/4 (limited to net rental income)	—	(8,025)
	$ -0-	$ -0-

In either case, Scott and Marjo report zero net income on their Schedule E for this rental property. However, under the IRS position, the rental activity has consumed $13,125 of their tax and interest deductions, leaving only $4,375 available as itemized deductions on Schedule A. Conversely, under the Tax Court position, only $4,375 has been consumed, leaving $13,125 deductible on Schedule A. The interest expense allocable to personal use is not deductible unless it meets the definition of qualified residence acquisition debt or home equity debt.

Rental Property with Very Limited Personal Use

If the taxpayer's dwelling is rented during the tax year and personal use does not exceed the greater of (1) 14 days, or (2) 10% of rental days, it is not considered a residence. Instead, it is considered a rental property. Accordingly, no ordering tiers exist for claiming deductions, and the rental expenses are not limited to the gross rental income of the property. However, deductions must be allocated to the period of personal use, and the property is potentially subject to the hobby loss, passive activity loss, and at-risk limitations. Furthermore, the Schedule A mortgage interest deduction is lost (for the nonrental portion) because the property does not qualify as a residence.

Example 3A-6 The 14-day personal-use test.

David and Mary own a condominium in Florida, which they personally use for two weeks in February. The remainder of the year (i.e., for 351 days) it is rented. Because they do not use the dwelling for personal purposes for more than 35 days (the greater of 14 or 10% of the rental days) during the year, it is not considered their residence and the net income limitation does not apply. However, expenses must be prorated to remove the portion attributable to the personal days. Under these facts, 14/365 of each expense is not allowable on Schedule E as rental property expense. Any property taxes attributable to the personal portion are deductible on Schedule A as an itemized deduction. The mortgage interest attributable to personal use would not be deductible since David and Mary did not use the property more than 14 days. If the property was vacant for part of the year (when neither personal nor rental use occurred), a hybrid prorated computation would apply, as discussed in Example 3A-5.

Conversely, in some situations, even a single day of personal use can result in losing tax deductions. For example, if a dwelling is vacant but held out for rent for an entire year, all expenses are deductible since the property is held for the production of income. IRC Sec. 280A does not apply, since there is no personal use of the dwelling.

However, if the owner were to spend a single personal day at that dwelling, all the expenses would become nondeductible personal expenses. IRC Sec. 280A(e) limits expenses attributable to renting a dwelling unit based on the days used for rental activity relative to total days the dwelling is used. (This applies whether or not the taxpayer used the dwelling as a residence.) If the dwelling is used a single day during the year for personal use, the fraction of the expenses attributable to the rental activity would be 0 (0 rental days divided by 1 day of use). Furthermore, as noted earlier, interest that is not allocated to the rental activity would not qualify as home mortgage interest since the dwelling was used only one day.

Conversion from Vacation Home to Rental Property

Since the Section 280A limitations are computed on an annual basis, it is possible for the same home to be treated as a vacation home one year and as a rental property with personal use the next. Any limited expenses related to the vacation home that were carried forward may be used in the year the residence is treated as a rental property. These carryforward expenses are still limited to the amount of income received from the property in the current year.

Example 3A-7 Conversion from vacation home to rental property.

Alice has a beach home. During 2016, she vacationed in it during April and September and rented it to unrelated parties at $2,000/month (FMV) for the remaining 10 months. She reported the following income and expenses on her 2016 return:

	Total	Schedule A	Rental	Carryforward	Nondeductible
Income	$ 20,000 [a]	$ —	$ 20,000	$ —	$ —
Mortgage Interest	(15,000) [b]	(2,466)	(12,534)	—	—
Property Tax	(4,000) [b]	(658)	(3,342)	—	—
Utilities	(7,000) [b]	—	(4,124) [c]	(1,725) [c]	(1,151)
Depreciation	(8,000) [b]	—	— [c]	(6,685) [c]	(1,315)
Net Loss	$ (14,000)	$ (3,124)	$ -0-	$ (8,410)	$ (2,466)

Notes:

[a] $2,000 × 10 months.

[b] Prorated based on 60 days personal use and 305 days rental use.

[c] Limited to gross income from the property. Remainder is allowed as a carryforward.

In 2017, Alice did not vacation at the property and rented it for 3 months to unrelated parties. Since Alice did not use the property more than the greater of 14 days or 10% of total property use, the property is treated as a rental property subject to the passive loss limitations. Her Modified AGI is less than $100,000 and she actively participates in its rental. In computing her 2017 net income from the property, her 2017 return reflects the following:

	2017 Amount	2016 Carryforward	2017 Schedule E
Income	$ 6,000 [a]	$ —	$ 6,000
Mortgage Interest	(14,800) [b]	—	(14,800)
Property Tax	(4,300) [b]	—	(4,300)
Utilities	(2,500) [b]	(1,725)	(4,225) [b]
Depreciation	(8,000)	(4,275) [c]	(12,275)
Net Loss	$ (23,600)	$ (6,000)	(29,600)
Passive Limitation			4,600 [d]
Allowable Loss			$ (25,000)

Notes:

[a] $2,000 × 3 months.

[b] Since Alice did not use the property in 2017, 100% is allocable to rental use.

[c] Limited to gross income from the property. Remainder ($2,410) is allowed as a carryforward.

[d] Maximum loss allowed under IRC Sec. 469(i) is $25,000.

In 2018, Alice will have two separate carryforwards from 2016 and 2017. She will have depreciation carryforward from 2016 of $2,410 ($6,685 − $4,275 allowed in 2017) subject to the Section 280A limitations, and passive loss carryforward from 2017 of $4,600, subject to the Section 469 passive loss limitations.

Example of Sale of Residence Used as Both a Vacation Home and Rental Property

As the classification of a residence as vacation or rental is determined on a year-by-year basis, historical recordkeeping becomes very important in tracing the tax consequences of a sale of a residence that has been used for both vacation property and rental property over many years, as illustrated in the following example.

Example 3A-8 Sale of residence for which IRC Sec. 280A applies.

Kristen purchased a home on the coast of Maine in 2014 for $640,000. She sold the property in 2017 for $540,000, thus incurring a loss of $100,000 before considering any adjustments to the basis for depreciation. During those years, she used the home for personal use as well as rental property, as reflected by the following schedule:

Year	Personal Use Days	Rental Days	Total Usage
2014	10	44	54
2015	31	45	76
2016	32	44	76
2017	7	7	14
Total	80	140	220

In 2014, she incurred a $37,000 rental loss on the property, including $12,000 of depreciation. The rental activity loss was reported on her Schedule E, but was suspended as a passive loss. This loss has not been used and has carried forward to 2017. For 2015 and 2016, other than the pro rata portion of mortgage interest and real estate taxes (shown on her Form 1040, Schedule A), no loss was allowed on Kristen's tax returns because her personal days exceeded 14 days in each year. Any deductions in excess of rental income are suspended and carry forward to use against future gross income from the property. Disallowed losses for 2015 and 2016 include depreciation on the property of $16,000 for each year. Before she sold the property in March 2017, Kristen collected $1,400 of rental income for one week. She paid interest and taxes of $9,000 and other expenses related to the property of $2,500 in 2017.

When the use of property has been mixed between personal use and business use, there is a well-established pattern of allocating the sale and adjusted basis between personal and business use. There is, however, no set method of allocating the transaction between personal and business use. The most common method would be to base the allocation on relative square footage, but this has no application to rental and vacation use. However, using the precedence of IRC Sec. 280A(c)(4)(C), the transaction can be allocated based on time used for personal versus rental. Kristen had used the property for rental purposes 140 days (63.6%) and personal 80 days (36.4%).

The business portion of the basis of the residence is reduced only to the extent a deduction is allowed under the vacation home rules. Because the $16,000 of annual depreciation calculated in both 2015 and 2016 were not allowed under the Section 280A ordering rules, the basis was not decreased for these amounts.

The tax consequences of Kristen's property sale in 2017 are as follows:

1. Kristen reports a loss on the sale of $51,600 (on Form 4797):

Sales price: $540,000 × 63.6%	$	343,440
Original cost: $640,000 × 63.6%	$	407,040
Less depreciation:	$	12,000
Basis of property prior to sale:	$	395,040
Loss:	$	51,600

2. Since the property has been entirely disposed of in a fully taxable transaction, the passive loss of $37,000, which has carried forward, would be allowed on her Schedule E.

3. Finally, Kristen should report the $1,400 of rental income reduced by $1,400 of interest and taxes on her Schedule E. The remainder of the interest and taxes would be reported on her Schedule A as personal itemized deductions. [During 2017, the property was not used personally for more than 14 days, and also did not achieve over 14 days of rental use (seven days of each before the sale of the property in 2017). Without any guidance relating to these rules in the year of a sale, and with the 50%-50% mix of personal and rental in 2017, the logical approach is to continue to apply the limit on deductions under IRC Sec. 280A(c)(5).]

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Martha rents her vacation home for 10 days during the state fair. The rest of the time it is used by Martha and her family. What is the most specific classification that applies?

    a. Dwelling.

    b. Personal residence with very limited rental use.

    c. Vacation home with both rental and personal use.

    d. Rental property with very limited personal use.

12. Which of the following rules apply when determining the number of days a dwelling unit is used for personal purposes?

    a. Only use by the taxpayer is considered personal use.

    b. Rental to a family member is always considered personal use.

    c. Days spent repairing the property will always be considered personal use.

    d. Days rented at below value to someone else are considered personal use.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. Martha rents her vacation home for 10 days during the state fair. The rest of the time it is used by Martha and her family. What is the most specific classification that applies? **(Page 53)**

    a. Dwelling. [This answer is incorrect. A *residence* or *dwelling* for the purpose of IRC Sec. 280A is defined as a dwelling unit and includes a house, apartment, condominium, mobile home, boat, or similar property. However, while this definition may apply in this scenario, there is a better, more specific answer choice.]

    b. Personal residence with very limited rental use. [This answer is correct. Per the Code, this is a residence that is rented for fewer than 15 days during the year. Since Martha's rental days fall below that threshold, her house falls into this category.]

    c. Vacation home with both rental and personal use. [This answer is incorrect. Under the Code, this is a property with (1) personal use that exceeds the greater of 14 days or 10% of rental days *and* (2) rental use that exceeds 14 days. Martha's home was not rented long enough to fall into this classification.]

    d. Rental property with very limited personal use. [This answer is incorrect. As described in the Code, this is property rented during the year and personal use that does not exceed the greater of 14 days or 10% of rental days. Since Martha and her family's use of the vacation home in question greatly exceed these limits, the classification would not apply.]

12. Which of the following rules apply when determining the number of days a dwelling unit is used for personal purposes? **(Page 53)**

    a. Only use by the taxpayer is considered personal use. [This answer is incorrect. Per the Code, personal use by other owners (or members of their family) of the property is attributed to the taxpayer.]

    b. Rental to a family member is always considered personal use. [This answer is incorrect. Rental to a family member (i.e., brother, sister, spouse, ancestor, or lineal descendent) is considered personal use unless the taxpayer can establish that (1) fair market rental rate was received *and* (2) the dwelling was used as the family member's principal residence.]

    c. Days spent repairing the property will always be considered personal use. [This answer is incorrect. Days a taxpayer spends repairing and maintaining property on a substantially full-time basis, as well as travel days when the primary purpose of a trip is to repair and maintain the property, are *not* counted as days of personal use.]

    d. Days rented at below value to someone else are considered personal use. [This answer is correct. As described in the Code, personal use includes days the residence is used or rented to anyone (not just the owner) at less than fair rental.]

The Temporary Rental of Personal Residence Prior to Sale

Effect of Residential Rental on the Exclusion of Gain

Under the Section 121 gain exclusion rules, the character of the residence at the time of a sale is not important, provided the taxpayer occupied it as his or her principal residence for periods adding up to at least two years within the five-year period ending on the date of the sale or exchange. Thus, taxpayers who rent their residence (whether temporarily while held out for sale or after conversion to a rental property) may still exclude gain from the sale of the property, provided the use requirement and other Section 121 requirements are met when it is sold. In all cases, however, gain exclusion cannot be claimed to the extent of depreciation adjustments (allowed or allowable) attributable to periods after May 6, 1997. In addition, for principal residence sale or exchange transactions after December 31, 2008, the Section 121 gain exclusion of up to $250,000 ($500,000 for certain married couples filing joint returns) will generally not apply for any portion of the gain allocated to periods of nonqualified use.

Also, short temporary absences from the home (even if it is rented out while the taxpayer is away) still count as personal use for the two-out-of-five-year test. In Reg. 1.121-1(c)(4), Example 4, a one-year sabbatical is not considered a short, temporary absence.

Reporting Income and Deductions of a Temporary Rental Activity

Minimal (if any) risk of losing preferential gain treatment exists when a principal residence is temporarily rented before sale (assuming the rental is short-term and the other gain exclusion requirements are met). However, an important issue is whether the property has been converted to a rental property (i.e., lost its personal residence character). This determination may impact the treatment and reporting of the rental income and deductions.

In TAM 8132017, the IRS ruled that the temporary rental of a residence prior to sale is an activity not engaged in for profit, and thus, under IRC Sec. 183(b) (hobby loss rules), rental expenses are limited to the amount of rental income so an overall loss from the activity cannot be claimed. Thus, rental income can be offset with allowable interest and property tax deductions, but rental deductions for such expenses as maintenance, insurance, and depreciation may be limited.

According to IRS Pub. 527, "Residential Rental Property," the rental income from activities not engaged in for profit should be reported on the "Other income" line on page 1 of Form 1040. The expenses allocable to this income (other than qualified residential interest and taxes, which are deductible as Schedule A itemized deductions) are deductible as miscellaneous itemized deductions subject to the 2% of AGI limitation. Consequently, this treatment may result in a portion of the income being subject to tax as a result of limitations on deductions.

Contrary to the IRS position, the 9th Circuit in *Bolaris* held that a taxpayer's rental of a residence can be a for-profit activity even though the rental is temporary, pending the home's sale. Factors supporting a profit motive were (1) a fair market rental was charged, (2) the taxpayers had abandoned the old residence and moved into a new one, and (3) the old residence offered no elements of personal recreation to the taxpayers. Because the court found the temporary rental to be for-profit, the taxpayers could deduct rental losses and still obtain favorable gain treatment when the property was sold.

The facts and circumstances of each case determine whether a residential property has lost its residential character and taken on a rental character. In the past, the courts have looked at the taxpayer's intent. Evidence that the residence continues to be listed for sale during the rental period, that the lease is short-term at its commencement, or that a depressed real estate market led to temporary rental all point to retention of personal residence status.

Renting a Portion of a Residence

When a taxpayer rents a portion of the dwelling unit used as his or her residence, the rules for deducting rental expenses generally depend on whether the property constitutes a single dwelling unit or multiple dwelling units. For example, if the taxpayer owns a duplex, with half used exclusively as a personal residence and the other half used exclusively for rental purposes (and assuming that each half has a separate entrance and no common-use areas), the Section 280A residential rental limitations on deductions do not apply to the rental unit. Conversely, a residence with mixed personal and rental use faces the restrictions of IRC Sec. 280A.

Example 3C-1 Dual personal and rental use.

Joe owns a four-bedroom house, using one bedroom himself, renting one bedroom to his sister at 75% of FMV, and renting the other two bedrooms at 100% of FMV to fellow college students, both of whom are unrelated parties. Joe and his three tenants all have access to the common areas of the house.

The two bedrooms that are rented to unrelated parties at FMV are treated as separate dwelling units under Prop. Reg. 1.280A-1(c)(2). The common areas, Joe's bedroom, and the room rented to his sister at less than FMV are a single dwelling subject to the residential rental limitations of IRC Sec. 280A. Since Joe lives in the home, he automatically fails the 14-day/10% test.

Since the two rooms rented at FMV are treated as a separate dwelling unit, an allocable share of expenses (mortgage interest, real estate taxes, utilities, maintenance, and depreciation) is fully allowable against rental income, subject to the passive loss limitations. The rent received from his sister is subject to the Section 280A limitations. An allocable share of interest and taxes is allowed against the rental income. The allocable share of other rental-related expenses (such as utilities, maintenance, and depreciation) is then allowed only to the extent of any remaining net rental income from his sister. (See Example 3A-4.) The rental use allocation percentage may be determined using any reasonable method (e.g., the ratio of the square footage of the three rented rooms to total square footage). Expenses allocable to the common areas are not deductible. The balance of Joe's taxes and interest (to the extent it is qualified residential interest) can be deducted on Schedule A.

Description	Total	Common Areas	Joe's Bedroom	Sister's Bedroom	Unrelated Parties' Bedrooms
Sq. Feet	2,500	1,600	300	200	400
Rental Income	6,600[a]			1,800[a]	4,800[a]
Expenses:[b]					
Mortgage Interest	(10,000)	(6,400)	(1,200)	(800)	(1,600)
Real Estate Taxes	(4,000)	(2,560)	(480)	(320)	(640)
Net Income after Interest and Taxes				680	
Utilities and Operating Expenses	(6,000)	(3,840)	(720)	(480)	(960)
Net Income before Depreciation				200	
Depreciation Allowance	(12,000)[c]	N/A	N/A	(200)[d]	(1,920)
Net Loss Reported on Schedule E (before passive limitations)				-0-	(320)
Mortgage Interest Reported on Schedule A		(7,600)[e]			
Real Estate Taxes Reported on Schedule A		(3,040)[e]			

Notes:

[a] Rental income based on $200/month from unrelated parties and $150/month from sister.

[b] Expenses are being allocated based on square footage of house.

[c] Depreciation that could be claimed if entire house was actually rented.

[d] Computed depreciation of $960 limited to $200 by IRC Sec. 280A.

[e] Total of common areas and Joe's bedroom.

All structures and other property appurtenant to a dwelling unit are considered part of the unit. Property is appurtenant to a dwelling unit if it is directly related to it although not an essential part of it or attached to it. For example, an individual who rents to another person space in a garage which is appurtenant to a house in which the individual occupies as a residence is subject to the Section 280A limitations on deductions attributable to the rental

because the garage is appurtenant to the dwelling unit. On the other hand, an apartment *over* a garage is, presumably, a separate dwelling structure not appurtenant to the residence, so rental of the apartment is not subject to the net income limitations.

A special exception holds that the dwelling unit limitations do not apply to that portion of a property used exclusively as a hotel, motel, or similar establishment. Property partially used as a personal residence will qualify for this exception if two tests are met:

1. The property is regularly available for occupancy by paying customers.

2. No person having an interest in the property uses the business portion as a residence during the year.

This exception applies to a motel, where one portion of the property is residential and another is used exclusively for occupancy by paying customers. This exception also applies to inns, bed-and-breakfast properties, and the portion of a home used exclusively for rental.

Example 3C-2 Hotel exception for bed-and-breakfast activity.

Ludwig and Hilda purchased a home and renovated it for use as a bed-and-breakfast. Approximately 50% of the square footage of the three-story home is occupied by Ludwig and Hilda, while the other 50% is available to the public on a year-round basis for short-term lodging and dining purposes and is advertised as such. Ludwig and Hilda do not use any of these guest rooms or dining rooms personally. Accordingly, the Section 280A restrictions on deductibility do not apply to that portion of the home used exclusively for the bed-and-breakfast activity. However, expenses for the care and maintenance of common areas and the exterior of the building do not fall under this exception (i.e., are subject to the net income limitation).

Converting a Residence into Rental Property

Taxpayers may decide to permanently convert a personal residence to rental property. Questions then arise as to the property's basis, when the property was placed in service, which depreciation methods to use, and how to determine gain or loss on a subsequent sale.

Generally, when a dwelling is used as a personal residence and rented in the same year, the owner must determine whether it is a vacation home or a rental property with personal use. Generally, personal use of the home for more than the greater of 14 days or 10% of the days the dwelling is rented results in it being classified as a vacation home subject to the Section 280A net income limit on deducting expenses.

However, if the rental period is a qualified rental period (generally a period of at least 12 months, starting or ending in the tax year and during which the property is rented or held out for fair rent), any personal use is ignored in determining the dwelling's status for that year. Absent this exception, a dwelling would almost always be subject to the Section 280A limitations in the year it is converted to or from a rental property because the owner's personal use days exceed the greater of 14 days or 10% of the days rented.

Depreciating a Converted Residence

When a personal asset is converted to business use (or for use in the production of income), its basis *for depreciation* is the lower of—

1. the adjusted basis on the date of conversion, or

2. the FMV of the property at the time of conversion.

Example 3D-1 Lower of cost or market value for depreciable basis.

John purchased a home in Boston fifteen years ago for $250,000, of which $50,000 represented the cost of the land. John lived in the home until 2017 when he moved to New York and rented out the property. The FMV

of the property, excluding the land, upon its conversion to rental property was $185,000. John's basis for depreciation is $185,000, the FMV at the time of conversion, since it was less than the adjusted basis. (Adjusted basis is generally the cost of the property plus amounts paid for capital improvements, less any depreciation and casualty losses claimed for tax purposes.)

Property converted from residential to rental use must be depreciated using the method and recovery period in effect in the year of conversion. The method that applied in the year the property was originally acquired is irrelevant. Thus, a home converted from personal to rental use during 2017 is depreciated over 27.5 years (39 if the rental is not residential) under MACRS.

Reporting Gain or Loss on the Sale of a Converted Residence

If the converted property is later sold at a gain, the basis in the converted property is the original cost or other basis plus amounts paid for capital improvements, less any depreciation taken. If the sale results in a loss, however, the starting point for basis is the lower of (1) the property's original cost or other basis or (2) FMV at the time it was converted from personal to rental property. This rule is designed to ensure that any decline in value occurring while the property was held as a personal residence (i.e., before conversion to rental property) does not later become deductible upon sale of the rental property. Thus, a loss from the sale of converted property is allowed only to the extent the property has declined in value following the conversion and taking into account any depreciation allowed or allowable.

Example 3D-2 Determining gain or loss on sale of converted property.

Jane converted her personal residence to income-producing property eight years ago. The house originally cost $50,000. Its FMV was $60,000 when it was converted to rental use. Over the eight-year rental period, assume that a total of $9,000 in depreciation was taken. In 2017, Jane sold the property for $65,000. The gain is computed as follows:

(1) Original cost	$ 50,000
(2) Conversion value	60,000
(3) Depreciation taken	9,000
(4) Adjusted basis for determining gain (1 − 3)	41,000
(5) Adjusted basis for determining loss [(lesser of 1 or 2) − 3]	41,000
(6) Sales price	65,000
(7) Realized gain (6 − 4)	$ 24,000

How would this conclusion change if the property's FMV at conversion was $45,000 rather than $60,000, the total depreciation taken was $8,000 rather than $9,000, and the sales price was $40,000 instead of $65,000? The loss would be computed as follows:

(1) Original cost	$ 50,000
(2) Conversion value	45,000
(3) Depreciation taken	8,000
(4) Adjusted basis for determining gain (1 − 3)	42,000
(5) Adjusted basis for determining loss [(lesser of 1 or 2) − 3]	37,000
(6) Sales price	40,000
(7) Realized gain, if any (6 − 4)	$ -0-
(8) Realized loss, if any (6 − 5)	$ -0-

No reportable gain or loss occurs because (1) no gain results when the original cost is used in the gain computation, and (2) no loss results when using the lower of cost or market basis for determining loss. As this example illustrates, the rules for determining gain or loss will result in neither if the sales price falls between the basis amounts used to calculate each.

Renting Property to Related Parties

Property Rented to a Family Member or Joint Owner

For determining a dwelling's status (i.e., vacation home or rental property with personal use), a taxpayer's personal use of the dwelling generally includes use by a family member (i.e., brother, sister, spouse, ancestor, or lineal descendent). This is true even if the family member pays a fair rental price. However, a family member's use is not attributed to the owner if the family member pays a fair rental price and uses the dwelling as a principal residence.

Example 3E-1 Rental at fair value to family member.

Gus owns a house that he rents to his son, Jake. Jake has no ownership interest in the property, uses it as his principal residence, and pays Gus a fair rental price for the property.

Under IRC Sec. 280A(d)(3), Jake's use of the house is not considered personal use by Gus because Jake uses it as a principal residence, he has no interest in the property, and he pays a fair rental price. The house is considered a rental property, so any rental loss incurred is deductible by Gus, subject to the hobby loss, at-risk, and passive activity loss rules. The vacation home rules do not come into play.

Example 3E-2 Rental at less than fair value to family member.

Dave rents a house to his mother at less than a fair rental price. She uses the house as her principal residence. In this situation, Dave is considered to use the house for personal purposes on the days his mother rents the property because she pays less than a fair rent. The rental house is thus considered Dave's vacation home under IRC Sec. 280A so rental deductions are subject to income limitations.

Taxpayers may argue that rental to a relative at a discount from what would be charged to an unrelated party is a FMV rent, since the relative is a better and more reliable tenant and the owner can avoid agency management fees. In *Bindseil*, the Tax Court held that such reasoning did justify a 20% discount off market rental value. While this argument may have merit, taxpayers who maintain such a position should be able to substantiate such claims with objective data (e.g., a discount equal to agency fees that would otherwise be incurred).

Shared Equity Financing Arrangement. Special rules apply when a taxpayer rents property to an individual who has an ownership interest in the property. The rental must be pursuant to a shared equity financing agreement to avoid the vacation home rules. A shared equity financing agreement involves ownership in a dwelling unit by at least two persons whereby one of the owners occupies the property as his principal residence and pays fair market rent to the other owner(s). Each owner must have an undivided interest in the entire dwelling unit, including land, for more than 50 years. Actual ownership of at least 50 years is not required; i.e., the property may be disposed of before 50 years and still qualify. A common situation in which a shared equity financing technique is used is when parents make part or all of the down payment to help a child purchase a residence. The parents have the incentive of avoiding a large, outright gift to a child, while participating in the property's appreciation, with possible positive cash flow and loss deductions for tax purposes (subject to the hobby loss, at-risk, and passive activity loss limitations).

Example 3E-3 Shared equity financing agreement.

Esther and Robert would like to help their son, Bobby, purchase his first home, which will require a down payment of $30,000 and a mortgage of $100,000. They decide to enter into a shared equity financing agreement with Bobby whereby Esther and Robert pay $15,000 of the down payment and 50% of the mortgage payments (which include property taxes and insurance) in exchange for a 50% interest in the property. Bobby pays them a fair rental for using 50% of the property, determined at the time the agreement is entered into.

Under this arrangement, Bobby treats the property as a personal residence for tax purposes, deducting his 50% share of the interest and property taxes. However, his use is not attributed to Esther and Robert, so they treat the property as a rental property (subject to the hobby loss, at-risk, and passive activity loss limitations,

but not the Section 280A vacation home limits). In addition to deducting their 50% share of interest and property taxes, Esther and Robert can claim depreciation deductions based on 50% of the property's depreciable basis.

Property Rented to a Related Business

Individuals sometimes rent real estate, equipment, and other property to business entities they own. A common type of arrangement is renting property to a closely held corporation or S corporation.

Renting property to a closely held corporation is an effective way for taxpayers to draw money out of the business in a form other than wages (which are subject to payroll tax) or corporate distributions, which are taxable to shareholders to the extent of corporate earnings and profits (E&P) and are not deductible by the corporation. However, rental amounts that are too high risk possible reclassification as dividends or compensation. On the other hand, taxpayers that receive too little or no rent for property used by their closely held corporation may be in constructive receipt of rental income.

Example 3E-4 Renting home office space to an S corporation.

Brooke and her daughter, Linda, age 31, own all the stock of BLC Inc., an S corporation. To shift some corporate income to Linda, BLC enters into a lease with her for both an office and a storage area in her home. These spaces are used by the S corporation for its business activities and by Linda to perform her duties as an employee. Based on a local property management firm's analysis, Brooke and Linda determine that a reasonable rent for this space is $12,000 per year. Thus, BLC will pay $12,000 of deductible rent to Linda, who will report $12,000 of rental income on her individual tax return. Because she is BLC's employee, she cannot claim any deductions for the rental activity. Still, as rental income, the payments are not subject to SE tax or payroll taxes.

In the case of family farm corporations, it is common for the business entity to provide lodging to shareholder-employees. This is a common practice because the business needs require the employees to reside at the premises of the farming activity. However, an arrangement may exist whereby the residence continues to be owned personally rather than by the corporation, and thus is leased by the individual to the corporation. In these situations, IRC Sec. 280A(c)(6) prohibits claiming any deductions (other than interest or taxes) in connection with the rental of the taxpayer's residence to an employer during any period in which the taxpayer uses the residence in performing services as an employee. And in *Dobbe*, the court found that the owner of a farming corporation could not convert personal expenses to deductible business expenses by leasing his residence (located on a farm) to the corporation and adopting a corporate resolution requiring the shareholder/employees to live on the premises. Also, leasing a residence to the employer's farm corporation results in losing the ability to exclude gain on the sale of the residence under IRC Sec. 121, if it causes the owner to fail the two-out-of-five-year use-as-a-personal-residence requirement. For additional information on farm self-rental, see *PPC's Specialized Industry Tax Guide*.

Timeshare Units

Like other dwelling units, the tax treatment of timeshares depends on how owners use the property. However, the rules are somewhat complicated by the fact that timeshare ownership often limits the owner to only one or two weeks a year and there is a distinct lack of guidance on the proper tax treatment of timeshare rental income and expenses. Therefore, it is necessary to analyze various Code sections and regulations in view of the owner's usage of the unit to determine how to report the income and expenses on the owner's return.

Timeshare Unit Is Not Rented

If the taxpayer uses the timeshare and does not rent it out (or hold it out for rent), the property taxes are deductible on Schedule A. Property taxes usually are included in the annual maintenance fee, but should be detailed out on the bill requesting payment of the fee. If not, the property manager may have to be contacted for the amount. The other items buried in the maintenance fee, such as utilities and association membership charges, are nondeductible personal expenses. If the timeshare is mortgaged, the interest expense can be deducted on Schedule A as qualified residence interest because of a specific exception in the mortgage interest provisions, which provides that

a dwelling unit (including a timeshare) is automatically considered a personal residence for mortgage interest deduction purposes in years that it is not rented. This removes the concern of the timeshare unit having to meet the Section 280A(d)(1) personal residence definition (owner's personal use that would exceed 14 days or 10% of rental days, whichever is greater) in order to deduct the mortgage interest. However, all of the other requirements of IRC Sec. 163(h)(3) must be satisfied in order to deduct the mortgage interest (for example, qualified residence is limited to the principal residence and one other residence). In any case, the Section 121 exclusion of gain on sale is not applicable because a timeshare used only a small portion of the year is not a principal residence.

Timeshare Unit Is Rented

A timeshare owner who rents his unit for some or all of his allotted time is virtually certain to be subject to the Section 280A vacation home rules that limit deductions and require allocations of expenses. This is because the 14-day/10% test is applied to the unit as a whole by counting the personal days of all the unit's owners during the year. As a result, the personal usage of a unit will almost always be substantial enough to cause all of its owners to be subject to the Section 280A vacation home rules.

Prop. Reg. 1.280A-3(f)(5) appears to require timeshare owners to allocate expenses between personal and rental use based on the usage of all the unit's owners during the year (i.e., the personal and rental percentages will be the same for all owners). As a practical matter, however, this information would be difficult to obtain; therefore, it is a best practice to make an allocation based on the owner's actual personal and rental use percentages.

Using whichever allocation percentages the taxpayer deems appropriate (or available), the timeshare owner then compares his rental income to his allocable rental expenses (including allocable interest and property taxes) and deducts those expenses up to the amount of rental income on his Schedule E. The personal portion of property taxes can be deducted on Schedule A. The personal portion of any mortgage interest expense can be deducted as qualified residence interest only if the individual owner's personal use exceeds the greater of 14 days or 10% of the rental days. Apparently only the individual owner's rental days are considered for this specific purpose. Alternatively, taxpayers may consider arguing that the personal portion of the interest expense qualifies as investment interest.

Example 3F-1 Allocating timeshare expenses between personal and rental use.

Rob Thomas owns weeks 27 and 28 in unit #112 at the Mountain Chalet Timeshare Resort. He rents out week 27 and uses week 28 for a family vacation. Rob's timeshare weeks cost a total of $22,000, partly financed by a $15,000 mortgage loan arranged through the developer. Rob's interest expense is $1,750 and his annual maintenance fee is $800 ($300 of which is for property taxes). In addition, Rob incurs $125 in advertising expense to rent week 27. The rental income is $1,050. Rob finds from his conversations with resort management that the unit is rented approximately half the year and used by the owners for the other half.

Based on this information, Rob should report $1,050 of rental income on Schedule E. He can then deduct up to that amount of allocable rental expenses (using 50% as the allocation percentage) on Schedule E. Allocable rental expenses before depreciation total $1,400 ($875 of mortgage interest, $150 of property taxes, $250 of maintenance fees, and $125 of advertising expense), so Rob can completely offset his rental income with allocable expenses. (The $350 of allocable expenses in excess of rental income are carried forward to the next year.) On Schedule A, Rob can deduct the remaining $150 of property taxes. The remaining $875 of mortgage interest is nondeductible (since his personal use does not exceed the greater of 14 days or 10% of his rental days).

Rent Excluded under IRC Sec. 280A(g). Under IRC Sec. 280A(g), income derived from the rental of a residence is nontaxable if the number of rental days is fewer than 15 during the calendar year. However, it is unlikely timeshare owners can take advantage of this exclusion provision because Prop. Reg. 1.280A-3(f)(4) states that the rental days during the year for *all* of the unit's owners must be fewer than 15 days for any owner to benefit from this provision. As a result, total rental days of a timeshare unit will usually turn out to be more than 14 days.

Even when total rental days are fewer than 15, an individual owner apparently must have personal use in excess of 14 days or 10% of the rental days for the timeshare to qualify as a personal residence and be eligible for the tax-free rent rule. This will rarely be the case. In other words, IRC Sec. 280A(g) is apparently available only when—

1. the total rental days for all owners are fewer than 15, and

2. the individual owner's timeshare interest meets the Section 280A(d)(1) definition of a personal residence based on the individual owner's use.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. When would the dwelling unit limitations **not** apply to a portion of a property?

    a. The portion is used exclusively as a hotel.

    b. The portion is separate from the main dwelling.

    c. The residence has mixed personal and rental use.

    d. Someone with an interest in the property uses it as a residence less than 15 days of the year.

14. Which of the following statements best describes an issue related to timeshare units?

    a. Taxpayers who do not rent out their timeshare units deduct property taxes on Schedule E.

    b. Even if a taxpayer rents his timeshare, the Section 280A vacation home rules will likely apply.

    c. Renting a timeshare often results in tax-free income.

    d. One specific section of the Code predominantly covers issues related to renting timeshares.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. When would the dwelling unit limitations **not** apply to a portion of a property? **(Page 63)**

    a. The portion is used exclusively as a hotel. [This answer is correct. A special exception holds that the dwelling unit limitations do not apply to that portion of a property used exclusively has a hotel, motel, or similar establishment. Two tests must be met under the regulations to qualify for this exception.]

    b. The portion is separate from the main dwelling. [This answer is incorrect. According to the regulations, all structures and other property appurtenant to a dwelling unit are considered part of the unit. Property is appurtenant to a dwelling unit if it is directly related to it although not an essential part of it or attached to it.]

    c. The residence has mixed personal and rental use. [This answer is incorrect. A residence with mixed personal and rental use faces the restrictions of IRC Sec. 280A.]

    d. Someone with an interest in the property uses it as a residence less than 15 days of the year. [This answer is incorrect. For the exception to apply, no person having an interest in the property can use the business portion as a residence during the year.]

14. Which of the following statements best describes an issue related to timeshare units? **(Page 68)**

    a. Taxpayers who do not rent out their timeshare units deduct property taxes on Schedule E. [This answer is incorrect. If the taxpayer uses the timeshare and does not rent it out (or hold it out for rent), the property taxes are deductible on Schedule A, not Schedule E.]

    b. Even if a taxpayer rents his timeshare, the Section 280A vacation home rules will likely apply. [This answer is correct. A timeshare owner who rents his unit for some or all of his allotted time is virtually certain to be subject to the Section 280A vacation home rules that limit deductions and require allocations of expenses. This is because the 14-day/10% test is applied to the unit as a whole by counting the personal days of all the unit's owners during the year.]

    c. Renting a timeshare often results in tax-free income. [This answer is incorrect. Under IRC Sec. 280A(g), income derived from the rental of a residence is nontaxable if the number of rental days is fewer than 15 during the calendar year. However, it is unlikely timeshare owners can take advantage of this exclusion provision because Prop. Reg. 1.280A-3(f)(4) states that rental days during the year for *all* of the unit's owners must be fewer than 15 days for any owner to benefit from this provision. As a result, total rental days of a timeshare will usually turn out to be more than 14 days.]

    d. One specific section of the Code predominantly covers issues related to renting timeshares. [This answer is incorrect. There is a distinct lack of guidance on the proper tax treatment of timeshare rental income and expenses. Therefore, it is necessary to analyze various Code sections and regulations in view of the owner's usage of the unit to determine how to report the income and expenses on the owner's return.]

Lesson 4: Tax Accounting Methods

Introduction

Choosing an accounting method for tax purposes is important because it affects how and when a taxpayer recognizes income and deductions. Individuals will normally use the cash method of accounting, although they can use different methods for business and personal items. For example, a taxpayer operating a sole proprietorship can use the cash method for personal income and deductions and the accrual method for business transactions. In many cases, taxpayers (if eligible) use the cash method for their business activities (sole proprietorships) since the accrual method often accelerates income recognition.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify appropriate methods of accounting for tax purposes, how those methods affect inventory, and how to change accounting methods.

Choosing Methods of Accounting

A taxpayer's accounting methods must be used consistently and must clearly reflect income. The IRS has broad powers to prescribe accounting methods when it determines that income has not been clearly reflected. Accounting methods include not only the taxpayer's overall method, such as cash or accrual, but also the special methods used to determine the tax treatment of specific items.

Business and personal items may be accounted for under different accounting methods. Thus, a sole proprietor may use the accrual method for his business and the cash method for nonbusiness income and deductions. Furthermore, if a taxpayer operates two or more distinct and separate businesses, he may choose a different accounting method for each, as long as it is consistently applied and clearly reflects income. A business is considered distinct and separate only if a complete and separable set of books and records is kept for that business.

Taxpayers reporting a business on Schedule C or F select an overall method of accounting by checking the appropriate box on the form for the first year the form is filed. Once selected, the method must be used unless the taxpayer gets IRS permission to change or the IRS initiates a change in the course of an examination. Most individuals use the cash receipts and disbursements method of accounting for their overall method of accounting. However, the accrual method is required by Reg. 1.446-1(c)(2) to clearly reflect income when the production, purchase, or sale of merchandise is a material income-producing factor, regardless of whether inventory is actually on hand at year-end. A hybrid method is permitted when taxpayers use the accrual method for purchases and sales and the cash method for other items of income and expense.

This discussion focuses primarily on the cash method of accounting, which is most often used by individuals and their sole proprietorships. In certain instances, a taxpayer may choose or be required to use the accrual method of accounting, particularly for certain business activities.

Cash-basis Income

Taxpayers using the cash basis of accounting report all items of income in the year actually or constructively received. If property other than cash is received, the fair market value (FMV) of the property is generally the amount recognized. When the property is a deferred payment obligation (other than an installment note eligible for installment reporting) or a right to income, the FMV of the obligation is included in income when it is received if it is freely transferable, readily marketable, and immediately convertible to cash. If these conditions are not met, income is recognized only in the year payment is actually received.

Example 4A-1 Receipt of a note receivable by a cash-basis taxpayer.

In 2017, Ted Long, an attorney who reports on the cash basis, represented a client in a bankruptcy proceeding. Because of the client's unstable financial condition, Ted accepted a $5,000 note receivable due in one

year as his fee. The note is negotiable and secured by underlying assets having an FMV of $3,000, which is therefore considered the FMV of the note. The client restructured his debts and paid the $5,000 note to Ted in 2018. Ted recognized the $3,000 FMV of the note in 2017; the remaining $2,000 is taxable in 2018. Had Ted accepted a mere promise to pay (e.g., an account receivable), he would report no income until the amount was collected.

Constructive Receipt. The doctrine of constructive receipt requires a cash-basis taxpayer to recognize income when an item is credited to the taxpayer's account or made available without restriction.

Example 4A-2 Interest coupons not redeemed until a later year.

Mary Smith, a widow who files on the cash basis, has bond interest as her primary source of income. She had interest coupons that matured and became payable in 2017, but she did not redeem them until 2018. Though she did not cash the coupons until 2018, she must include the interest in her gross income in 2017, because it was available then without restriction.

Example 4A-3 Dividend checks mailed one year and received the following year.

ABC Corp. mailed its dividend checks on December 31, 2017. Because the shareholders did not receive the checks until January, they do not realize income until 2018. This could present a problem with the IRS's matching program if ABC reported the dividends on Forms 1099 in 2017.

A business check that was lost by a cash-basis taxpayer was treated as received and taxable in the year originally received, not in the year a replacement check was issued by the taxpayer's customer.

Substantial Restrictions. Income is not treated as constructively received by a cash-basis taxpayer if substantial restrictions are placed on his or her right to its receipt. Key employees often receive from their employers stock or other property with certain restrictions to ensure their continued tenure with the company.

Example 4A-4 Receipt of restricted stock.

Fred Wilson, vice president of Aerodynamics, Inc., received company stock worth $10,000 in 2017 as part of his compensation package. It cannot be sold, however, for five years and is forfeited if Fred leaves the company within the five years. Absent a special election (as discussed in Example 4A-5), Fred will not recognize income until the restriction lapses. At that time, the FMV of the shares will be subject to tax, pursuant to IRC Sec. 83(a).

Example 4A-5 Election to include the value of restricted stock in income in the year received.

Using the facts in Example 4A-4, if Fred expected the stock to appreciate substantially by the end of the five-year period, he could elect to recognize $10,000 of income in 2017, the year he received the restricted shares. Although this election would result in additional income in 2017, Fred could defer tax on the appreciation until he actually sells the shares. Otherwise, he will be taxed on the value when the restrictions lapse, even if he sells no shares at that time. Furthermore, the holding period for the restricted stock begins when the election is made, so Fred can take advantage of any favorable tax treatment on long-term capital gains that exists when the restrictions lapse or anytime thereafter.

If Fred does not make the Section 83(b) election and the stock appreciates in value to $100,000 in five years, all $100,000 of income recognized when the restrictions lapse will be ordinary income. Furthermore, without the election, Fred's holding period starts when the restrictions lapse. However, if Fred makes the Section 83(b) election and later forfeits the stock by leaving the company before the end of the five-year period, he is *not* entitled to a deduction for the $10,000 included in income in 2017. In such a situation, the early income recognition results in Fred incurring income tax on stock for which he never receives any benefit. However, if Fred had paid anything for the stock, he would be allowed a capital loss deduction for the amount paid.

Cash-basis Expenses

Prepaid Expenses. Cash-basis taxpayers normally can deduct expenses in the year of actual payment. However, prepaid expenses (such as insurance, supplies, rent, etc.) may not be fully deductible in the year paid if the

payment creates an asset extending substantially beyond the end of the year. In such a case, the taxpayer may deduct only the portion attributable to that year. In the past, it has not been clear what substantially beyond the end of the year means. However, regulations clarify that both cash and accrual method taxpayers generally must capitalize prepaid expenses. These capitalized expenses can be amortized over the period covered by the prepayment.

However, cash-method taxpayers are not required to capitalize prepaid expenses that create a benefit that expires on or before the earlier of (1) 12 months after the first day on which the taxpayer realizes the benefit of the expense or (2) the end of the tax year after the year payment is made. Taxpayers can elect not to apply this 12-month rule by treating the amounts as capital expenditures. Cash-basis farmers may deduct prepaid farming expenses meeting certain criteria; see Lesson 2 for information.

Example 4A-6 Prepaid insurance of a cash-basis proprietor.

On December 1, 2017, Bill Parker, a cash-basis dentist, paid a $10,000 insurance premium for a one-year term property insurance policy that begins on February 1, 2018. The amount paid is a prepaid expense. Because the benefit attributable to the $10,000 payment extends beyond the end of the tax year following the tax year in which the payment is made (benefit extends into 2019), the 12-month rule does not apply and Bill must capitalize and amortize the $10,000 payment. None of the payment would be amortized in 2017. $^{11}/_{12}$ of the payment would be amortized and deducted in 2018 and $^{1}/_{12}$ in 2019.

Variation: Assuming the same facts except that the policy had a term beginning on December 15, 2017, the 12-month rule would apply. The benefit attributable to the payment would neither extend more than 12 months beyond December 15, 2017 (the first date the benefit is realized), nor beyond the tax year following the year in which the payment is made. Accordingly, Bill can deduct the $10,000 payment in 2017. Or, Bill can elect not to apply the 12-month rule. Then, he would capitalize and amortize the $10,000 over the policy's term.

An interactive decision tool on *Determining Which Expenses Can Be Prepaid by a Cash or Accrual Method Taxpayer* is available and can guide the user through this topic.

Expenses Not Paid in Cash. Issuance of a note by a cash-basis taxpayer does not constitute actual payment for current deductibility. However, expenses paid with borrowed funds are deductible when paid. Payment by check becomes deductible when it is delivered to the payee or when placed in the mail (provided the check is subsequently paid by the bank). If the taxpayer has overdraft protection and the bank honors the check even though the taxpayer has insufficient funds, the deduction is still allowable in the year the check is given. However, if the payee is instructed to hold the check or delays cashing it because he knows the taxpayer's account has insufficient funds, the expense is not deductible until the check is cashed.

Example 4A-7 Payment of expenses with a note.

On July 1, 2017, Bill Parker, a cash-basis taxpayer, purchased six months of supplies with a note for $5,000. Full payment on the note is due January 1, 2018. If Bill does not pay the note in 2017, he will receive no deduction for the supplies in 2017. If he had borrowed $5,000 from a bank and used it to pay the supplier, the $5,000 would be deductible in 2017, regardless of when he paid off the bank loan.

In Rev. Ruls. 78-38 and 78-39, the IRS ruled that charitable contributions and medical expenses charged to a credit card are deemed paid by a cash basis taxpayer when the charge is made and not when payment is made on the account. This is because the taxpayer becomes indebted to a third party (the credit card company) when the charge is made. Presumably, this same logic applies to any expenses a cash-basis taxpayer incurs by charging a credit card, including business expenses. However, if the credit card company is also the seller of the goods or service, this would not apply since the indebtedness is not with a third party.

Accrual Method of Accounting

Under the accrual method, income generally is reported in the year earned, and expenses are deducted in the year *incurred*. The underlying principle behind the accrual method is to consistently match income and expenses in the appropriate year. For this reason, the accrual method is generally required for purchases and sales of inventory;

income would not be clearly reflected if purchases were deducted in a different period from which sales of those items were recognized. (The accrual method and inventories, including the exceptions for certain small taxpayers, are discussed later in this lesson.)

All Events Test. For income to be recognized or an expense to be deducted, all events necessary to establish the right to receive that income or determine the existence and amount of a liability must have occurred, and the amounts must be able to be determined with reasonable accuracy. In Rev. Rul. 2007-3, the IRS ruled that the all-events test is met at the earlier of (1) the date when the event fixing the liability occurs (whether that event is performance or some other event), or (2) the date when payment for the liability becomes due. The mere execution of a contract is not necessarily enough to pass the all-events test. The ruling addresses the execution of an insurance contract and a services contract in one tax year, where both the insurance coverage and the services to be provided do not occur until the next tax year *and* the bills were also not due until the next tax year. The IRS ruled that the all-events test was not met in the earlier tax year (the year of executing the contracts).

In addition, for expenses, the all-events test is not satisfied until economic performance occurs. Generally, for liabilities arising from the performance of services or the receipt of goods, economic performance occurs as the goods and services are provided. However, a safe harbor exception to the general rule says that economic performance is deemed to have occurred when payment is made if property or services can reasonably be expected to be provided within $3\frac{1}{2}$ months of payment. Special rules apply to certain liabilities, including payments of recurring items (e.g., taxes, bonus payments, and rebates). A detailed discussion of the accrual method is beyond the scope of this course, but more information is available in *PPC's 1120 Deskbook*.

Prepaid Expenses. The 12-month rule for prepaid expense is also extended to accrual-based taxpayers if they meet the qualifications of the economic performance rules. This generally means that items cannot be deducted (or amortized) before the goods or services giving rise to the expense are furnished even if the benefit derived from those expenses does not extend beyond 12 months (or, if earlier, beyond the close of the following tax year).

Example 4A-8 Prepaid expenses of accrual-method taxpayers.

Asta Corporation leases office space from Winston Corporation for $2,000 per month. On August 1, 2017, Asta prepays its rent for the first six months of 2018 in the amount of $12,000. The recurring item exception provided by Reg. 1.461-5 does not apply. Asta's prepaid rent is a payment for the use of property for which economic performance occurs ratably over the period of time during which Asta is entitled to use the property. Because economic performance with respect to Asta's prepaid rent does not occur until 2018, no amount can be deducted or amortized for tax in 2017. A cash-method taxpayer would have been able to deduct this in 2017 since the benefit does not exist beyond 12 months.

As a practical matter, individuals and many sole proprietorships use the cash method of accounting. But when taxpayers choose to use the accrual method of accounting or are required to use it (e.g., because they maintain inventories and are not eligible for the small business exceptions), they must pay particular attention to the Section 461 economic performance rules and other rules unique to the accrual method.

The Implications of Maintaining Inventory

Accrual Method of Accounting Generally Required

Inventories are necessary whenever the production, purchase, or sale of merchandise is an income-producing factor. In general, when inventories are required, a taxpayer must use the accrual method of accounting for purchases and sales unless the IRS authorizes the use of another method. In addition to more obvious situations, this requirement also applies to sellers of goods who take title of the goods without taking physical possession. Thus, whether a taxpayer holds inventory at his or her place of business generally is not the controlling factor when determining if he maintains inventories. Instead, holding the title to the property, even if only momentarily, is a key consideration. However, the 2nd Circuit Court of Appeals has held that a taxpayer who is, in effect, a broker or commissioned merchant (i.e., one whose profit was based on the 5% commission or trade discount allowed by the manufacturer) is not in the business of merchandising and thus not maintaining inventory.

Example 4B-1 Accrual method requirement for sellers.

Joe Sharp is a high-tech jobber who sells disk drives and peripheral computer accessories to retail computer outlets and repair shops. Joe arranges for his vendors to ship the goods directly to his customers, but he takes title and assumes responsibility for the ultimate payment to the vendor. Joe must use the accrual method to account for the purchases and sales of the equipment even though he never takes possession of the merchandise.

IRS examiners have challenged the use of the cash method by service providers who also sell a small amount of merchandise to customers. For example, in TAM 9848001, a dentist who sold custom-ordered crowns, bridges, and dentures was in fact purchasing and selling merchandise, but that was not an income-producing factor to his dentistry practice so the accrual method was not required. The courts often look to the taxpayer's purchases of merchandise as a percentage of gross receipts when determining whether the merchandise was an income-producing factor. *Wilkinson-Beane* held that the sale of inventory that cost 14.7% of gross receipts was an income-producing factor. In another ruling, the IRS had held that merchandise costing less than 8% of gross receipts was not an income-producing factor.

In *Osteopathic Medical Oncology and Hematology, P.C.*, the Tax Court focused on the facts and circumstances of the case rather than the mechanical test (i.e., cost as a percentage of gross receipts) often used by the IRS. The Court concluded that furnishing chemotherapy drugs was an inseparable part of the taxpayer's business of rendering medical services and thus, the drugs were not sold as merchandise and inventories were not required for tax.

Special Rules for Certain Small Businesses

Small businesses with average annual gross receipts of $1 million or less may use the cash method of accounting even if, under Reg. 1.446-1(c)(2)(i), the taxpayer would otherwise be required to use the accrual method of accounting due to the presence of inventories. Although the inventory accounting rules (e.g., Section 263A uniform capitalization) do not apply to qualifying small businesses taking advantage of the relief provision, merchandise on hand at the end of the year still cannot be deducted. Instead, the cost of the merchandise is accounted for in the same manner as materials or supplies that are not incidental, that is, it must be accounted for on the cost basis under Reg. 1.162-3. (See discussion later in this section.)

Gross Receipts Test. To satisfy this test, the average annual gross receipts of the taxpayer must be no more than $1 million. This means for each prior tax year ending after December 16, 1998, average gross receipts for the three-year period ending with that year do not exceed $1 million. Thus, a separate three-year average is computed for each tax year and, once that average exceeds $1 million, the taxpayer fails the gross receipt test beginning with the following tax year.

Example 4B-2 Computing average annual gross receipts under Rev. Proc. 2001-10.

Adams Labs (AL), a calendar-year reseller of laboratory equipment that began business in 2007, had gross receipts as follows:

Tax Year	Actual Gross Receipts	3-Year Average
2007	$ 200,000	$ N/A
2008	600,000	400,000
2009	900,000	566,667
2010	1,000,000	833,333
2011	1,000,000	966,667
2012	950,000	983,333
2013	975,000	975,000
2014	925,000	950,000
2015	965,000	955,000
2016	975,000	955,000

To determine whether AL can use the cash method for 2017, it must determine if its average annual gross receipts for each prior year ending after December 16, 1998, were $1 million or less. Thus, for 2017, a three-year average must be computed for each year from 2008 to 2016. Based on the information provided, AL is eligible to use the cash method for 2017.

Unlike several other Code provisions employing an average gross receipts test, this one does *not* use a three-year rolling average. Instead, beginning with the first tax year ending after December 16, 1998 (i.e., 1998 for calendar year taxpayers), a three-year average is computed for each year based on the three-year period ending with that year. Once the three-year average for a tax year exceeds $1 million, the taxpayer will fail the gross receipts test beginning with the following tax year.

For this test, gross receipts include all sales (net of returns and allowances), all service income, interest, dividends, rents, and royalties, plus any income from incidental or outside sources. Gross receipts include all receipts from all the taxpayer's trades or businesses. Thus, all wage income, regardless of whether paid by the sole proprietorship or not, is apparently counted as gross receipts. This could preclude individuals with a large amount of wages from using the cash method for accounting for a small proprietorship. Although gross receipts are not reduced by costs of goods sold, in the case of sales of capital assets or Section 1231 assets, gross receipts *are* generally reduced by the taxpayer's adjusted basis in the property sold.

Gross receipts do not include any state or local taxes imposed on any transaction if the applicable state or local law imposes the tax on the purchaser and the seller simply collects the tax and remits it to the appropriate tax authority.

All businesses under common control must be aggregated for purposes of the test. For this rule, all taxpayers treated as a single employer under IRC Sec. 52(a) or (b) or IRC Sec. 414(m) or (o) are treated as a single taxpayer. Transactions occurring between commonly controlled entities are excluded.

If a taxpayer has not been in business for the three-year period, the test is made using the number of years the taxpayer has been in business. Any short years must be annualized to determine whether the three-year test has been met.

Example 4B-3 Annualizing gross receipts for short tax years.

Pat began operating a pet grooming salon in October 2016 and uses the cash method. The gross receipts for 2016 were $250,000 and for 2017 were $1,250,000. Since 2016 was a short tax year consisting of only three months, its gross receipts must be annualized for this test. The gross receipts of $250,000 must be multiplied by 12 and the result is divided by 3 (the number of months in the short year). Thus, the annualized gross receipts for 2016 are $1,000,000. Since the average annualized gross receipts for the number of years Pat has been in business is $1,125,000, Pat must change to the accrual method in 2018.

Treating Inventories as Materials and Supplies. Taxpayers who take advantage of Rev. Proc. 2001-10 and use the cash method must account for their inventory under the non-incidental materials and supplies rule of Reg. 1.162-3. This provision requires cash method taxpayers to expense the cost of these items only as they are consumed or used in the taxpayer's business or, if later, when the taxpayer pays for the items. Thus, the taxpayer must capitalize these costs and deduct them by adjusting the balance via perpetual inventory records or taking physical inventory at year-end to determine the amount of year-end supplies and materials. Because the costs are capitalized under the non-incidental supplies rule and not the inventory rules, the Section 263A uniform capitalization rules do not apply. Producers may use any reasonable method of estimating the amount of raw materials in their year-end work-in-process and finished goods inventory to determine the amount of raw materials used to produce finished goods sold during the year, provided the method is used consistently.

Additional Relief for Certain Taxpayers with Gross Receipts of $10 Million or Less. Rev. Proc. 2002-28 expands the ability to use the cash method to qualifying small business taxpayers whose average gross receipts are over $1 million, but not over $10 million, regardless of whether they would otherwise be required to account for inventories. A taxpayer has average annual gross receipts of $10 million or less if, for each prior tax year ending on or after December 31, 2000, the taxpayer's average annual gross receipts for the 3-tax-year period ending with the applicable prior tax year does not exceed $10 million. However, this relief for use of the cash method is not available for a farming business or if the taxpayer's principal business activity for the preceding year is described by one of

the following North American Industry Classification System (NAICS) codes: (1) mining (NAICS codes 211 and 212), (2) manufacturing (NAICS codes 31-33), (3) wholesale or retail trade (NAICS codes 42 and 44-45), and (4) information industries (NAICS codes 5111 and 5122). (See **www.census.gov/eos/www/naics** for more information on NAICS codes.) Also, the cash method is not available under Rev. Proc. 2002-28 if the taxpayer is a C corporation (other than a farming business) with gross receipts over $5,000,000, a partnership (other than a farming business) with gross receipts over $5,000,000 and a C corporation partner, or a tax shelter.

Even if their principal business activity is described in an ineligible NAICS code, taxpayers that otherwise qualify can use the cash method if their principal business activity is—

1. providing services (including providing property incident to those services), or

2. fabricating or modifying tangible personal property upon demand in accordance with customer design or specifications.

Qualifying taxpayers are also relieved from accounting for inventory under the rules of IRC Sec. 471 (and if applicable, IRC Sec. 263A). Instead, they can account for those costs under the nonincidental supplies rule of Reg. 1.162-3 (i.e., items are expensed as they are consumed). See discussion earlier in this lesson.

Changing Accounting Method. For taxpayers who satisfy the requirements of either Rev. Proc. 2001-10 or Rev. Proc. 2002-28, automatic consent is given, under Rev. Proc. 2017-30, to change to the cash method of accounting and to the non-incidental materials and supplies method of accounting for inventory. The taxpayer must follow the IRS-prescribed automatic change procedures. Generally, a Form 3115 (Application for Change in Accounting Method) must be filed with the first tax return for which the cash method is used, and a copy of the Form 3115 must be sent to the IRS in Covington, KY. As applicable, the Form 3115 should include either "Filed under Rev. Proc. 2001-10" or "Filed under Rev. Proc. 2002-28" at the top of page one. A single Form 3115 can be filed for both the change to the cash method and, if requested, the change to the nonincidental supplies method to account for inventories.

A net positive Section 481 adjustment required as a result of changing to the cash method of accounting and making any necessary change to the taxpayer's inventory method (including the discontinuance of capitalizing inventory costs under IRC Sec. 263A) is generally taken into account over four years. However, if the adjustment is less than $50,000, the taxpayer can elect to recognize the entire adjustment as income in the year of change. If the adjustment is a negative amount, the deduction is claimed in the year of change.

Benefits of Using the Cash Method. Assuming a business qualifies for (and if applicable, elects) relief under Rev. Proc. 2001-10 or Rev. Proc. 2002-28, the taxpayer may realize the following benefits:

- Trade receivables are not recognized into income until collected. Although deductible account payable items cannot be deducted until paid, this generally produces a net benefit to a business since trade receivables often exceed deductible payables.

- There is no need to comply with the inventory accounting rules and, if applicable, the Section 263A uniform capitalization rules (but the non-incidental materials and supplies rules may apply).

Valuing Inventory

Generally, tax accounting and financial accounting employ similar rules concerning inventories. IRC Sec. 471 requires that inventories be determined using the best accounting practice in the taxpayer's trade or business that most clearly reflects income. The regulations in this area give significant weight to trade customs that are incorporated into the best accounting practice in a particular industry. Thus, income tax regulations quite often defer to generally accepted accounting principles (GAAP). However, the IRS is given the ultimate authority to prescribe the best accounting practice that most clearly reflects income.

All inventory items generally are valued at cost, or the lower of cost or market value. For normal goods with an active market, *market* means current bid prices or replacement cost at the date of inventory. If no active market exists, taxpayers may use whatever evidence (i.e., purchases or sales) is available nearest the date of inventory to

establish market value. Generally, market valuations must be done for each item in inventory and not the entire stock in aggregate.

Taxpayers may estimate inventory shrinkage when an actual inventory is not taken, provided the taxpayer normally takes physical inventories on a regular and consistent basis and properly adjusts estimating methods based on actual shrinkage. (Items that cause inventory shrinkage include employee or customer theft, damaged goods, and bookkeeping errors.) Thus, a business is not required to take an actual year-end physical inventory to claim an adjustment for inventory shrinkage.

A special rule applies for valuing inventory unsalable at normal prices because of damage, imperfections, changes of style, or similar identifiable reasons (other than a mere estimate of decline in future demand, as in *Thor Power Tool Co.*). This inventory may be valued at bona fide selling prices less direct cost of disposition, provided such goods are actually offered for sale at the lower price within 30 days after the inventory date. This rule applies whether the taxpayer values normal inventory at cost or the lower of cost or market.

Example 4B-4 Write-down of out-of-style inventory despite cost method.

Maria's Jean Scene, a fashion boutique owned and operated by Maria Valdez, values its inventory using the cost method. December 31, Maria discovers she has inventory costing $2,000 that she has been unable to sell at normal prices because of fashion changes. Maria decides to mark down these items to $1,500 for a clearance sale. If Maria offers to sell the merchandise for $1,500 within 30 days after the year-end inventory date and maintains supporting records, the write-down of the ending inventory to the bona fide selling prices will be sustained. This is true even though she uses the cost method for valuing the rest of her inventory. However, if she does not offer them for sale within 30 days, the write-down is inappropriate.

Maria must disclose her inventory valuation method and her overall accounting method on Schedule C. The opening and closing inventories must be valued by the same method to meet the consistency requirement and to clearly reflect income. A change in inventory valuation methods (e.g., from cost to lower of cost or market) is considered a change in accounting method.

Accounting Method Changes

General Rules

A taxpayer elects a particular accounting method when an initial return is filed using that method (e.g., the first year an individual taxpayer uses a Schedule C to report a new business activity). A different method may be used for each distinct business of the taxpayer.

A taxpayer who wants to change an accounting method once it has been adopted must request approval from the IRS even if an improper method was adopted originally. In *Mills*, the taxpayer failed to request a change in accounting method when converting from the cash to the accrual method. Even though the taxpayer should have properly been using the accrual method and was attempting to change to that correct method from the cash method, the change to the accrual method was denied due to the failure to file Form 3115, and the taxpayer was unable to take a large deduction in the year in which he attempted to switch accounting methods.

A change in accounting method should not be confused with the correction of an error, which is handled on an amended return. For this purpose, errors include mathematical or posting errors, or errors in the computation of tax (e.g., errors in computing a foreign tax credit, net operating loss, percentage depletion, or investment credit). Rather, a change in accounting method is a change in the characterization of an item that involves the timing of when an item is included in income or when it is deducted, such as the shifting of income or deduction from one period to another. Regulations clarify that a change in a MACRS recovery period, method, or convention is a change in accounting method requiring IRS consent. If a tax year is closed under the statute of limitations, the taxpayer must determine whether the administrative burden of filing Form 3115 outweighs the loss of depreciation deductions for the closed years. Conversely, an adjustment to the useful life of non-MACRS property is not an accounting method change unless the asset's useful life is defined by the Code or other published guidance [e.g., computer software with a 36-month life under IRC Sec. 167(f)(1)].

For depreciation method changes, Rev. Proc. 2007-16 waives the rule in Rev. Rul. 90-38 that provides that a taxpayer using an erroneous accounting method on two consecutive returns establishes an accounting method. This allows taxpayers to change an erroneous depreciation method for assets for which depreciation has only been claimed for *one* tax year (i.e., assets placed in service during the year immediately preceding the year of change). Alternatively, taxpayers can correct depreciation on these assets using an amended return. The revenue procedure also permits automatic accounting method changes with regard to depreciation on certain disposed property when the taxpayer did not claim the full amount of depreciation allowed or allowable. This means that taxpayers do not permanently lose the benefit of previously understated depreciation deductions.

A change in accounting method may be initiated by the IRS or by the taxpayer. Taxpayers who file a request for change before they are contacted for IRS examination generally receive more favorable terms and conditions [e.g., a later year of change and a longer Section 481(a) adjustment period for positive adjustments—see discussion that follows]. A change initiated by the IRS during examination generally receives less favorable terms and conditions and may also be subject to penalties. IRS-initiated accounting method changes generally will be made to the earliest tax year under examination and with a one-year Section 481 adjustment period (see later discussion).

Changes in accounting method are either automatic changes or nonautomatic changes. The procedures for effecting changes differ depending on which category the change falls into. Whether a change is automatic or nonautomatic, changes typically require the taxpayer to compute a Section 481(a) adjustment to account for the change in method.

Section 481(a) Adjustment

IRC Sec. 481(a) provides that if a taxpayer changes accounting methods, adjustments must be made to ensure the change does not result in the omission or duplication of an item of income or expense. For example, in a change from the cash method to the accrual method, receivables on hand at the beginning of the accrual-method year will never be included in income unless an adjustment is made. These adjustments, referred to as *Section 481 adjustments*, quantify the cumulative effect that the change in method has on taxable income. Changes that increase taxable income are positive adjustments, while those that decrease taxable income are negative adjustments.

Section 481(a) adjustments must be considered in a taxpayer's taxable income over the period specified in the revenue procedure governing the change for positive adjustments. This is generally in the year of change for negative adjustments, or ratably over a period of four tax years beginning with the year of change. See the following discussion on automatic and nonautomatic changes for more on the Section 481(a) adjustment periods.

Automatic Changes in Accounting Methods

Certain accounting method changes receive automatic IRS consent and the procedures for making the change are typically outlined in an IRS revenue procedure or notice. In these situations, Form 3115 (Application for Change in Accounting Method) is generally filed with the return for the year of change. Filing Form 3115 separately to receive the advance consent of the IRS is not required; however, a duplicate copy of the Form 3115 must be filed with the IRS office in Covington, KY. The period for including the Section 481(a) adjustment in income is normally stated in the relevant IRS revenue procedure or notice.

Rev. Proc. 2015-13 provides the procedures for obtaining automatic and non-automatic IRS consent for accounting method changes. Under this procedure, the Section 481(a) adjustment period for a positive adjustment generally is four years, although a *de minimis* rule allows a one-year adjustment period if the adjustment is less than $50,000. A negative net adjustment is recognized in the year of change. However, some of the automatic method changes permitted by this revenue procedure have specific guidance for taking the Section 481(a) adjustment into account. See Rev. Procs. 2015-20, 2015-39, Rev. Procs. 2015-56, 2016-39, and 2017-30 for details and a list of accounting methods that can be automatically changed.

An automatic method change can be made on an amended return, but only if the original return was filed timely and the amended return is filed within six months from the due date of the return for the year of change, *excluding* extensions. The original Form 3115 must be filed with the amended return.

Example 4C-1 Automatic IRS consent for taxpayer with inventories changing from cash to accrual method of accounting.

Alfred operates a sole proprietorship that maintains inventory. Prior to 2017, Alfred's business qualified for the small business exception allowing him to use the cash method of accounting. For the 2017 tax year, however, Alfred's business failed the gross receipts test so it is now required to change from the cash to accrual method of accounting.

Alfred is eligible for the automatic change provisions of Rev. Proc. 2015-13. He initiates the change for 2017 by attaching Form 3115 [with change number "123" indicated on Part I, line 1(a) of Form 3115] and the supporting schedules to his timely filed (including extensions) 2017 tax return. A copy of the Form 3115 must also be filed with the IRS in Covington, KY. No user fee is required with either Form 3115 filing.

As of December 31, 2016, Alfred's business had accounts receivable of $60,000 and accounts payable of $10,000. Therefore, the change in accounting method results in a $50,000 ($60,000 – $10,000) positive Section 481(a) adjustment. Alfred reports a $12,500 Section 481(a) adjustment on the "Other income" line of his 2017 Schedule C (and the same amount for years 2018–2020). This reporting is beneficial to Alfred since the income is spread over four tax years with no interest charge.

Automatic Changes for Tangible Property. Regulations under IRC Secs. 162 and 263(a) address the deduction and capitalization of amounts paid to acquire, produce, or improve tangible property and provide for several additional automatic accounting method changes. An automatic accounting method change is available for changes related to repairs and maintenance and materials and supplies in Rev. Proc. 2014-16, as modified in part by Rev. Proc. 2014-54, and modified by Rev. Proc. 2015-14, which is superseded by Rev. Proc. 2016-29, which is further superseded by Rev. Proc. 2017-30.

Regulations have also been released under IRC Secs. 167 and 168 dealing with depreciation and amortization of leasehold improvements and other fixed assets. Automatic accounting method changes related to the depreciation and disposition of fixed assets for tax years beginning on or after January 1, 2014, are available in Rev. Proc. 2014-17, as modified in part by Rev. Proc. 2014-54.

As discussed earlier in this lesson, certain qualifying small business taxpayers may change to the cash method of accounting and to the non-incidental materials and supplies method by following the automatic change procedures. A qualifying small business has one or more separate and distinct trades or businesses with (1) assets totaling less than $10 million on the first day of the year the business first applies the regulations, or (2) average annual gross receipts of $10 million or less for the prior three tax years. The thresholds apply separately to each trade or business. So, if there are multiple trades or businesses that are separate and distinct from one another, some may qualify and some may not.

Accounting Methods for Intangibles. The IRS has provided additional guidance under Rev. Procs. 2006-12 and 2006-37 to help taxpayers comply with the regulations for changes in accounting methods for capitalizing costs associated with either acquiring or creating intangibles, or costs that facilitate the acquisition or creation of intangibles in acquiring a trade or business. Under the regulations, taxpayers must obtain consent from the IRS to apply these changes. For further discussion on capitalization of cost associated with intangibles, see Lesson 1.

Nonautomatic Changes in Accounting Methods

The general rules and procedures for obtaining IRS approval for taxpayer-initiated accounting method changes that do not receive automatic IRS consent are found in Rev. Proc. 2015-13.

Form 3115 Filing Deadline. Form 3115 requesting a change in accounting method can be filed any time during the requested year of change. However, the IRS warns that requests filed near the end of the year may not be acted on before the deadline for filing that year's tax return. This can necessitate an amended return if the change is approved after the original return has already been filed. Thus, taxpayers should file a change request as early in the year as possible. The user fee that must accompany Form 3115 with nonautomatic changes in accounting method is (1) $2,400 if gross income is less than $250,000; (2) $7,600 if gross income is $250,000 or more, but less than $1 million; or (3) $9,500 if gross income is $1 million or more.

Generally, taxpayer initiated accounting method changes granted under Rev. Proc. 2015-13 result in audit protection for taxpayers. That is, the IRS will not require the taxpayer to retroactively change the method in question in an earlier year because of an audit. Before the issuance of Rev. Proc. 2015-13, a taxpayer under IRS examination could not file a Form 3115 requesting an accounting method change unless it met one of four exceptions. Rev. Proc. 2015-13 allows a taxpayer under IRS examination to file a Form 3115 at anytime while under the examination. However, the taxpayer will not receive audit protection for the same item in prior tax years as the requested change unless the taxpayer meets one of the following six exceptions:

1. Taxpayers continuously under audit for at least 12 months may file Form 3115 in the three-month window, provided the accounting method change is not an item under consideration. The three-month window is the period beginning on the fifteenth day of the seventh month of the taxpayer's tax year and ending on the fifteenth day of the tenth month of the taxpayer's tax year.

2. A taxpayer can file Form 3115 within 120 days of the end of an audit even if another has commenced, provided the method of accounting change has not already been identified as an issue or placed in suspense under the second audit.

3. A taxpayer may file Form 3115 when the present method is not before the director. Present method not before the director is defined as a change from a clearly permissible method of accounting, or a change from an impermissible method of accounting that was adopted after the year(s) under examination.

4. A common parent of a consolidated group that is participating in the Compliance Assurance Process (CAP) may file Form 3115 on behalf of a new member for the tax year it joins the group. The new member must not be under examination and the requested item is not an issue under consideration for the common parent.

5. The change in accounting method for an item results a negative Section 481(a) adjustment for the year of change and would have resulted in a negative Section 481(a) adjustment for that item for each tax year under examination if the change for that item were in effect for such tax year.

6. The taxpayer files Form 3115 reflecting a positive Section 481(a) adjustment, provided the IRS has not proposed an audit adjustment with respect to the item covered by the Form 3115, by the earliest date that the exam(s) end and the change in accounting method for that item is not under consideration. Audit protection is received upon closing of an exam, and not earlier when Form 3115 is filed, and applies to subsequent tax years after the closed audit year and before the tax year of the requested change. The positive Section 481(a) adjustment is taken over two years, as opposed to four years.

See Rev. Proc. 2015-13 for details of these exceptions.

Taxpayers have no right to make retroactive method changes regardless of whether the change is from a permissible or an impermissible method. However, the Commissioner is authorized to consent to a retroactive accounting method change. On at least one occasion, a taxpayer that filed amended returns to change from an impermissible accounting method to the proper one was not forced to change back to the improper method. Although the taxpayer had retroactively changed methods without permission, there was no evidence of tax avoidance. The IRS determined that returning the taxpayer to the impermissible method, although legally possible, was poor tax policy. The IRS did note that, if tax avoidance were present, its conclusion would be different. However, in technical assistance, the IRS concluded that the lack of tax avoidance does not automatically excuse taxpayers from requesting to change from an improper to a proper accounting method.

Section 481(a) Adjustments. Positive Section 481(a) adjustments are included in taxable income ratably over a four-year period beginning with the year of change. However, if the entire Section 481(a) adjustment is less than $50,000, a *de minimis* rule permits taxpayers to take 100% of the amount into account in the year of change. A net negative Section 481(a) adjustment is recognized in the year of change.

If a taxpayer ceases to engage in a trade or business or terminates its existence, any remaining balance of a Section 481(a) adjustment related to that trade or business must be taken into taxable income in the tax year of the cessation or termination.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Which of the following rules applies to taxpayers using and choosing methods of accounting?

    a. A taxpayer must use the same method of accounting for all of his or her endeavors.

    b. The choice of an accounting method only governs the method taxpayers use to report income overall.

    c. One of the most important considerations is that the method chosen clearly reflect income.

    d. A taxpayer operating a business must get IRS approval on his or her choice of accounting method prior to filing the return.

16. The following taxpayers are all filing Form 3115 to initiate accounting method changes under Rev. Proc. 2015-13. Which taxpayer meets one of the exceptions and will receive audit protection for the same item in prior years as the requested change?

    a. Fiona has been under audit continuously for two months when she files for Form 3115.

    b. Greg files Form 3115 within 240 days of the end of one audit, though another audit has already begun.

    c. Holly files Form 3115 to request a change in accounting method while her present method is before the director.

    d. Ian's change in accounting method results in a negative Section 481(a) adjustment this year and in each year under examination.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Which of the following rules applies to taxpayers using and choosing methods of accounting? **(Page 73)**

    a. A taxpayer must use the same method of accounting for all of his or her endeavors. [This answer is incorrect. Per the regulations, business and personal items may be accounted for under different accounting methods. Thus, a sole proprietor may use the accrual method for his business and the cash method for nonbusiness income and deductions. Furthermore, if a taxpayer operates two or more distinct and separate businesses, he may choose a different accounting method for each, as long as it meets the appropriate guidelines.]

    b. The choice of an accounting method only governs the method taxpayers use to report income overall. [This answer is incorrect. Accounting methods include not only the taxpayer's overall method, such as cash or accrual, but also the special methods used to determine the tax treatment of specific items.]

    c. One of the most important considerations is that the method chosen clearly reflect income. [This answer is correct. According to the Code, a taxpayer's accounting methods must be used consistently and must clearly reflect income. The IRS has broad powers to prescribe accounting methods when it determines that income has not been clearly reflected.]

    d. A taxpayer operating a business must get IRS approval on his or her choice of accounting method prior to filing the return. [This answer is incorrect. Taxpayers reporting a business on Schedule C or F select an overall method of accounting by checking the appropriate box on the form for the first year the form is filed. Therefore, IRS approval is not required. However, once selected, the method must be used unless the taxpayer gets IRS permission to change or the IRS initiates a change in the course of an examination.]

16. The following taxpayers are all filing Form 3115 to initiate accounting method changes under Rev. Proc. 2015-13. Which taxpayer meets one of the exceptions and will receive audit protection for the same item in prior years as the requested change? **(Page 80)**

    a. Fiona has been under audit continuously for two months when she files for Form 3115. [This answer is incorrect. One of the exceptions is for taxpayers continuously under audit for at least 12 months. Such taxpayers may file Form 3115 in the three-month window, provided the accounting method change is not an item under consideration. Fiona has not been under audit long enough to qualify under this exception.]

    b. Greg files Form 3115 within 240 days of the end of one audit, though another audit has already begun. [This answer is incorrect. The exception states that a taxpayer can file Form 3115 within 120 days for the end of an audit even if another has commenced, provided the method of accounting change has not already been identified as an issue or placed in suspense under the second audit. Therefore, if Greg waits 240 days, he will have missed the filing deadline for the exception.]

    c. Holly files Form 3115 to request a change in accounting method while her present method is before the director. [This answer is incorrect. One of the applicable exceptions is that a taxpayer may file Form 3115 when the present method is *not* before the director. Therefore, Holly cannot file for a change in accounting method at this time.]

    d. Ian's change in accounting method results in a negative Section 481(a) adjustment this year and in each year under examination. [This answer is correct. One of the exceptions for filing Form 3115 is that the change in accounting method for an item results in a negative Section 481(a) adjustment for the year of change and would have resulted in a negative Section 481(a) adjustment for that item for each tax year under examination if the change for that item were in effect for such tax year. Therefore, Ian has met one of the exceptions in this scenario and can file his Form 3115.]

Lesson 5: Travel and Entertainment

Introduction

Travel and entertainment (T&E) expenses, whether generated by an employee, sole proprietor, lessor, or investor, are frequently subject to IRS scrutiny. This lesson addresses T&E documentation and the limitations and restrictions the practitioner and clients must deal with to deduct T&E expenses.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify how to substantiate travel and entertainment expenses, rules related to the 50% limitation on meal and entertainment deductions, and how to treat entertainment facilities, club dues, and accompanied travel.
- Determine the best way to treat travel out of country, travel away from home, local transportation costs, and tickets to athletic events that are considered entertainment or gifts.

Submitting Travel and Entertainment Expenses

Substantiation Requirements

The Section 274(d) substantiation rules apply to the following expenses incurred for either business or investment purposes: (1) travel, including meals and lodging while away from home overnight or long enough to require rest and sleep; (2) meals or entertainment and recreation activities, including expenses incurred for a facility used in such activities; (3) local transportation expenses; (4) gifts; and (5) those related to listed property defined in IRC Sec. 280F(d)(4). These rules disallow a deduction unless the taxpayer substantiates the following items by maintaining adequate records or by providing other sufficient corroborating evidence:

1. The amount of the expense.

2. The time and place of travel or entertainment.

3. The business purpose.

4. For gifts, a description of the item given and the business relationship to the taxpayer of the person receiving the gift.

5. For entertainment expenses, the business relationship to the taxpayer of the persons entertained.

Although the regulations use the terms "business purpose" or "business relationship" in describing the required documentation, expenses incurred for investment (i.e., IRC Sec. 212) purposes are allowed. The substantiation requirements for Section 212 expenses parallel those for Section 162 business expenses (i.e., the investment or Section 212 purpose must be substantiated). Likewise, the expenses are deductible only if ordinary and necessary to the Section 212 activity.

Adequate Records. To meet the adequate records requirement of IRC Sec. 274(d), a taxpayer shall maintain (1) an account book, diary, log, statement of expense, trip sheets, or similar record; *and* (2) documentary evidence that, in combination, are sufficient to establish each element of an expenditure or use for travel or entertainment. However, it is not necessary to record information in an account book, diary, log, statement of expense, trip sheet, or similar record which duplicates information reflected on a receipt so long as the account book, etc. and receipt complement each other in an orderly manner.

Documentary Evidence. Documentary evidence (paid bill, written receipt, or similar evidence) is required to substantiate all T&E expenses of $75 or more. A written receipt is always required for lodging while traveling away from home, regardless of the amount. However, for transportation charges, documentary evidence is not required if not readily available (e.g., cab fare).

The IRS has privately ruled that the essential element of the documentary evidence requirement of a travel expense is that it establishes the appropriate data (i.e., amount, date, place, and business purpose). The IRS believes this does not require an original document, such as an airline ticket receipt, and does not prohibit faxes or copies. In Ltr. Rul. 9805007, the IRS allowed a fax of an electronic record of an airline itinerary to satisfy the substantiation requirement. The travel agent issued the record as "ticketless travel" and it had all the essential elements to adequately substantiate the expenditure under the regulations. However, a credit card statement confirming purchase of airline tickets is not sufficient documentary evidence. The statement does not detail the purpose (business or personal), dates, or destination of the trip.

In Rev. Rul. 2003-106, the IRS approved an employer's use of an electronic system for substantiating travel and entertainment expenses and complying with the accountable reimbursement plan requirements. Under the plan, the employer issues credit cards to certain employees as a means of paying their business-related T&E expenses. Rather than each employee submitting paper receipts to the employer, the credit card company summarizes for the employer certain data from the employee charges, including date, amount, and merchant's name and location. Employees add additional information, if necessary, to the electronic report. The employer then pays the credit card company directly for these business expenses incurred by employees. For any expenses for which an itemized breakdown is not available via electronic receipt, the employer will continue to require a paper receipt from employees. In addition, the employer will continue to require paper receipts sufficient to support the respective expenditures for all out-of-pocket expenses. The IRS ruled that these paperless documents could be used to satisfy the accountable plan and T&E substantiation requirements.

Per Diem Method of Substantiating the *Amount* of Travel Costs

In 1990, the IRS issued final regulations on accountable plans. Since then, they have issued several revenue procedures clarifying how the accountable plan rules apply to per diem and mileage allowances and making substantive changes to the rules. (See Rev. Proc. 2011-47 for the most recent rules.) The annual per diem rates will be announced each year in an IRS Notice. Rates that apply for 2016–2017 are contained in Notice 2016-58. Rates that apply for 2016–2018 are contained in Notice 2017-58.

A taxpayer may use a per diem method of substantiation in lieu of accounting for and deducting the actual amount of travel costs. Rev. Proc. 2011-47 provides the rules regarding the per diem substantiation method and reimbursements. Per diems can be used to substantiate travel cost; the time, place, and business purpose must still be substantiated through adequate documentation. The per diem method is available to (1) employers for use with an employee reimbursement plan, (2) employees not covered by an accountable or other expense allowance arrangement, and (3) self-employed individuals. Self-employed individuals can use the optional per diem method only for deducting meals and incidental expenses, not for lodging.

An employer can use a per diem allowance to reimburse employees for business travel expenses incurred while away from home. The per diem amount can be at or below the applicable federal per diem rate, a flat rate or stated schedule, or in accordance with an IRS-specified rate or schedule. The amount deemed substantiated for each calendar day (or partial day) is the lesser of the per diem allowance or the amount computed at the federal per diem rate for the locality of travel.

While receipts are not required to prove the amounts of travel expenses when using the per diem method, employees may find it convenient to submit lodging receipts (these generally conclusively prove the dates and place of the travel) on which the employee has stated the business purpose for the travel. A lodging receipt can be an easy way for employees to meet the remaining documentation requirements. An airline ticket is another convenient source document that provides most of the needed information.

A travel allowance that is computed on a basis similar to that used in computing the employee's compensation (e.g., hours worked, miles traveled, or pieces produced) is not a per diem allowance unless (1) the allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the allowance, or (2) an allowance computed on that basis was commonly used in the industry in which the employee is employed.

The maximum per diem amounts that are deemed substantiated under the IRS guidelines are those that apply to federal employees. There are two separate rates for each locality: a rate for lodging and a rate for meals and

incidental expenses (M&IE). The government issues separate tables for the following travel locations: (1) continental U.S. (CONUS), (2) nonforeign locations outside the continental U.S. (Non-contiguous), which includes Alaska, Hawaii, and U.S. territories and possessions (OCONUS), and (3) foreign locations. The CONUS rates are updated October 1 of each year (although there may be occasional updates during the year) while the OCONUS and foreign location rates are normally updated each month. CONUS rates can be found at the government's General Services Administration website at **www.gsa.gov/perdiem**. The Department of Defense establishes the rates for OCONUS, which can be found at **www.defensetravel.dod.mil**. The State Department establishes foreign rates, which can be found at **https://aoprals.state.gov/web920/per_diem.asp**.

The CONUS lodging and M&IE rates vary depending on location. (See the previously mentioned website for the per diem amounts for specific locations.) Employers have the option of using a simplified per diem method known as the high/low method, which use only two sets of per diem rates—one for designated high-cost localities and another for all other localities. (This method is not available to self-employed taxpayers or unreimbursed employees. See *PPC's Payroll Tax Deskbook* and Notices 2016-58 and 2017- for information on and rates for the high/low method.) If an employer's per diem rate exceeds the federal per diem rate, the excess is treated as paid under a nonaccountable plan and therefore, is taxed to the employee and subject to payroll withholding tax.

A per diem is also allowed for incidental expenses only. This optional per diem method for incidental expenses is available for employees and self-employed individuals traveling away from home who do not pay or incur meal costs and who are not reimbursed for incidental expenses. Incidental expenses include fees and tips given to porters, baggage handlers, maids, hotel staff, and staff on ships. Incidental expenses do not include expenses for laundry, lodging taxes, the cost of transportation to get meals if suitable meals are not available at the lodging or temporary duty site, the mailing costs of filing travel vouchers or paying employer-sponsored charge cards and telephone calls. For 2017, the incidental rate for employees and self-employed taxpayers is $5 per day.

The full amount of the M&IE component of the federal rate is available only if the taxpayer incurs a full day of travel (12:01 a.m. to midnight). However, travel usually involves at least two short days—the day travel begins and the day it ends. Thus, the M&IE component of the federal per diem rate must be prorated for partial days of travel. Currently, the Federal Travel Regulations allow three-fourths of the applicable federal M&IE rate for each partial day during which the taxpayer is in travel status. Alternatively, the taxpayer may prorate the daily M&IE component of the federal rate using any method that is consistently applied and is consistent with reasonable business practice.

Transportation Industry Workers. For January–September 2017, employees and self-employed persons in the transportation industry may use $63 per day as the federal rate for M&IE incurred at all CONUS locations. For October-December, the rate remains $63 per day. The rate is $68 per day for all OCONUS locations for all of 2017. A taxpayer is in the transportation industry if his work (1) directly involves moving people or goods by airplane, barge, bus, ship, train, or truck; and (2) often requires travel, during any single trip, to localities with differing M&IE rates. If these special rates are used, they must be used for the entire calendar year—the regular M&IE rates cannot be used. However, taxpayers need not limit their deductions to these *deemed substantiated* amounts if they can document actual expenses that are greater.

50% Disallowance Rule. The 50% disallowance (20% for Transportation Industry Workers) rule for meals and entertainment applies to amounts deemed substantiated under the M&IE portion of the per diem rules. The disallowance is applied to the entire M&IE per diem even though such amount includes incidental expenses. When a per diem allowance for lodging, meals, and incidentals is paid at a rate less than the federal per diem rate, 40% of the amount paid can be considered the per diem payment for M&IE (and thus, subject to the 50% disallowance). For employees, this disallowance is calculated on Form 2106 (or Form 2106-EZ), and the net amount is carried to Schedule A as a miscellaneous deduction subject to the 2% of AGI limitation. For self-employed individuals, the 50% disallowance is calculated on Schedule C, or Schedule F for farmers.

Example 5A-1 Using per diem rates for travel expenses.

Howard owns and operates as a sole proprietor two restaurants—one in Baton Rouge and one in New Orleans. During 2017, Howard, who lives in New Orleans, spent 52 full days (and nights) in Baton Rouge. According to the rates found at **www.gsa.gov/perdiem**, the M&IE rate for Baton Rouge for all of 2017 (Howard elects to use the rates in effect from January–September 2017 for the entire year) is $59. Therefore, Howard may deduct $1,534 (52 × $59 × 50%) on his Schedule C for M&IE while traveling away from home.

In addition, Howard will deduct his *actual* lodging expenses (assuming proper substantiation), since the federal per diem rates are only available for M&IE for self-employed individuals.

This example assumes Howard can otherwise substantiate time, place, and business purpose, which presumably can be documented via hotel receipts and/or an appointment book. It also assumes Howard was away from home for a 24-hour period for his overnight trips to Baton Rouge. According to Rev. Proc. 2011-47, an example of a reasonable proration method is one that allows a per diem amount equal to two times the daily rate for travel beginning at 9 a.m. one day and ending at 5 p.m. the next day (even though only 1 1/2 times the daily rate would be allowed under the Federal Travel Regulations method).

Variation: Assume that Howard operated the two restaurants as a corporation and owned 100% of the stock. The IRS per diem that includes lodging or the high/low method cannot be used when an employee is related to the employer. *Related* is defined for this purpose by IRC Sec. 267(b) except that 10% instead of 50% is used for stock ownership. Howard may still use the M&IE or IE only per diems to receive reimbursement under an employer plan, but must provide adequate substantiation to the corporation for his lodging expenses.

Summary. The following table summarizes the availability of per diem rates depending on the type of taxpayer:

	Per Diem Rates		
Taxpayer	**M&IE and Lodging**	**M&IE Only**	**IE Only**
Self-employed taxpayer (Schedule C or F)	No	Yes	Yes
Employer reimbursement of unrelated employee	Yes	Yes	Yes
Employer reimbursement of 10% related employee	No	Yes	Yes
Unreimbursed employee (Form 2106)	No	Yes	Yes

Business Requirement for Meals or Entertainment Expenses

IRC Sec. 274(a) allows a deduction for expenses incurred for meals or entertainment only if the expenses are (1) *directly related* to the active conduct of business or (2) *associated with* the active conduct of business and directly precede or follow substantial business discussions.

It may be difficult to meet the "directly related to" or "associated with" tests for many kinds of entertainment activities. For example, in *Auto Zapper & Towing, Inc.*, the Tax Court held that the taxpayer's expenses for a weekend trip for its employees and clients did not meet the Section 274 business requirements because the primary purpose of the entertainment was to promote client goodwill and the business discussions that occurred were informal and not substantial, even though increased business resulted from the trip. To be directly related, the taxpayer must engage in business during the entertainment. The taxpayer must have more than a general expectation of deriving income or expect some other specific business benefit to occur. To be associated with the active conduct of business, a substantial and bona fide business discussion must immediately precede or follow the activity.

A business meal with a customer when business is not discussed before, during, or following the meal will fail the "directly related to" and "associated with" tests and therefore, is not deductible.

Example 5A-2 Deducting business meal expenses.

Tommy owns an accounting firm. In any given year, he incurs meal expenses for entertaining. The entertaining includes (1) bona fide business discussions with existing and potential clients, (2) practice development with contacts such as bankers and attorneys, and (3) that done on a "friendship" or goodwill basis with longtime clients and friends of the firm (not involving business discussions).

Meal expenses incurred by Tommy in the first two situations are deductible (subject to the 50% limitation) because they meet the *directly related* requirement for deductibility (assuming Tommy maintains adequate substantiation). The business goodwill meal expenses in the third situation do not meet the "directly related" test because no business is discussed or conducted during the meals. However, such expenses are not disallowed merely because they are incurred for goodwill purposes if they are *associated with* the active conduct of a trade or business and directly precede or follow a bona fide business discussion. Thus, the costs of Tommy's goodwill meals will be deductible if business is discussed immediately preceding or after the meals and Tommy maintains adequate records as provided in the Section 274 regulations.

For further discussion of planning strategies to maintain the business connection for deductible meals and entertainment expenses, see *PPC's Guide to Tax Planning for High Income Individuals*.

Employee Reimbursements

Generally, when an employer maintains a reimbursement or other expense allowance arrangement that requires employees to substantiate expenses [thus meeting the adequate records requirement of Temp. Reg. 1.274-5T(c)(2)] and return any excess funds (an accountable plan), the reimbursements or advances should not be included in the employee's Form W-2, and the employee deducts no expenses on his personal tax return. However, some employers erroneously include the entire reimbursement in income. In addition, many employees incur travel expenses that are not reimbursed or are reimbursed under a plan that is not an "accountable" plan. (A reimbursement plan that is in part an accountable plan and in part a nonaccountable plan if both parts are viewed separately is treated as two expense allowance arrangements—a fully accountable plan and a fully nonaccountable plan.) To simplify the administrative burden of substantiating travel expenses, the practitioner may consider recommending that clients (including self-employed individuals) use a per diem allowance in lieu of actual expenses to substantiate the *amount* of employee travel expenses. See Rev. Rul. 2012-25 for examples of the interrelationship between reimbursement arrangements and the accountable plan rules.

The 50% Limitation on Meal and Entertainment Deductions

Exceptions to 50% Disallowance Rule

Generally, IRC Sec. 274(n) allows a deduction for only 50% of otherwise allowable meal and entertainment expenses. However, the following exceptions apply to the 50% disallowance rules:

1. Expenses excludable from gross income as *de minimis* fringe benefits (e.g., coffee provided by the employer at the office and certain employer-provided eating facilities). The IRS has ruled that the taxpayer must incur an "unreasonable or administratively impracticable" hindrance to account for the cost of meals for the value of the provided meals to be considered *de minimis*.

2. Employers are not subject to disallowance when meal or entertainment expenses paid for or to an employee who is not an officer, director, or 10% or greater owner (under a nonaccountable plan) are treated as compensation to the employee. The 50% disallowance occurs at the employee level if the employee deducts the meals and entertainment as an employee business expense.

3. Employees or independent contractors are not subject to disallowance when their meal and entertainment expenses are reimbursed by an employer (company) under an accountable plan. In these cases, the 50% disallowance applies at the employer (company) level.

4. Expenses related to recreational, social, or similar activities incurred primarily for the benefit of employees other than certain highly compensated employees (e.g., food and beverages provided by the employer at a company picnic or a holiday party). This exception does not apply when the recipients are independent contractors.

5. Expenses for items made available to the general public (e.g., promotional popcorn or snacks at a car dealership). This exception also applies to meals provided to potential customers as part of a sales presentation. It does not, however, apply when the meals and entertainment are provided on an invitation-only basis and not otherwise available to the general public.

6. Expenses for meals and entertainment sold by the taxpayer for adequate consideration. This is a technical exception to prevent disallowance of meals sold by a restaurant or daycare provider (i.e., daycare providers are allowed to deduct 100% of meals).

7. Expenses for meals and entertainment includable in the gross income of a nonemployee recipient when a Form 1099 is issued to the recipient (e.g., as a sales promotion, a company holds a drawing and awards a dinner cruise for 10 valued at $750 to a customer, who receives a Form 1099 for the award).

8. Expenses for tickets to fund-raising charitable sporting events if—

   a. the event is organized for the benefit of a Section 501(c)(3) organization,

   b. 100% of the net proceeds are contributed to the organization, and

   c. volunteers are used for substantially all the work in staging the event.

   An example is a golf tournament to benefit a charity, when all of the net proceeds are donated to the charity.

9. Employers are not subject to disallowance for meals during a job-related move that are reimbursed and reported as income to the employee. No 50% disallowance applies at any level because meals are not deductible moving expenses.

10. Expenses for meals and entertainment to certain crew members on commercial vessels or oil and gas workers.

11. Individuals whose work is subject to the hours of service limitations of the Department of Transportation (e.g., interstate truck drivers, certain air transportation employees, certain railroad employees) can deduct 80% of their business food and beverage expenses.

Example 5B-1 Determining which taxpayer is subject to 50% disallowance rule for reimbursed expenses.

An advertising agency separately accounts and bills for meal and entertainment expenses and is reimbursed by the clients to whom the expenses relate. The agency is not subject to the 50% limitation; rather, the clients to whom the expenses are billed must apply the limitation. However, if the ad agency incurs expenses for meals and entertainment but does not separately account for them and seek reimbursement from its clients, the agency itself is subject to the 50% limitation.

The IRS allows the use of statistical sampling to establish the amount of substantiated meal and entertainment expenses that are not subject to the 50% limitation for items 1–10 previously listed. Rev. Proc. 2004-29 (as amplified by Rev. Proc. 2011-42) provides the technical specifications for the sampling methodology in its Appendices. The procedure, however, does not (1) authorize the use of sampling to substantiate expenses as required by IRC Sec. 274(d), (2) authorize the use of sampling to determine liability for employment taxes or exclusions from income, or (3) preclude the IRS from raising or pursuing any income, employment, or other tax issue identified in the review of a statistical sample.

Employee Leasing Arrangements. The IRS has addressed which taxpayer is subject to the 50% limitation when a trucking company leases truck drivers from a leasing company, and the leasing company reimburses the drivers for meal and incidental expenses they incur while performing services. In *Transport Labor*, the 8th Circuit found that an employee leasing company's clients rather than the leasing company bore the per diem expenses under the reimbursement arrangement between the parties. The IRS agreed with the 8th Circuit that the Section 274(n) limitation should apply to the party that bears the per diem expenses, but disagreed with the Court's opinion to the extent it implies that status as a common law employer is relevant to the Section 274(n) analysis.

In Rev. Rul. 2008-23, the IRS discusses three different factual situations where reimbursed expenses are substantiated by the employee to one party, who in turn passes on the cost to a third party. The ruling clarifies that the IRS will treat the company that bears the expenses and has received adequate documentation of the expenses as the

party subject to the limitations under IRC Sec. 274(n). While Rev. Rul. 2008-23 deals with leased truck drivers, the concepts can be applied to any situation in which leased employees are reimbursed for expenses subject to the Section 274(n) deduction limit.

Reimbursement Arrangements. Regulations generally provide that in a reimbursement arrangement the limitations in IRC Sec. 274(n) apply to the person or company that ultimately bears the expense, whether it is an employer, independent contractor, or other third party. However, for a reimbursement arrangement involving nonemployees, the parties may expressly identify the party subject to the Section 274 limits in their written agreement.

Disallowance Rules Are Applicable to All Meals Not Specifically Excepted

The 50% disallowance applies to expenses for all business meals (other than those specifically excepted), regardless of how the expenses are categorized on the taxpayer's books or records (e.g., advertising, business promotion). It includes those incurred while attending professional seminars and while traveling. If a hotel or other lodging establishment includes meals in its room charge or a company provides a per diem allowance to cover M&IE and lodging, a reasonable allocation must be made to determine the portion of the expenditure subject to the 50% meal disallowance. When an employer uses a per diem method for an employee's travel expenses, the federal M&IE rate is treated as an expense for food and beverages. Thus the employer is subject to the 50% limit on this amount.

Example 5B-2 Disallowance of meal expenses incurred while traveling.

Andy is a sole proprietor. During the year, he incurred $2,500 in meal expenses while traveling on business. He can deduct $1,250 (50% of $2,500) for meals on his Schedule C.

Rules for Entertainment Facilities and Club Dues

Entertainment Facilities

Generally, a taxpayer can deduct ordinary and necessary entertainment expenses (subject to the 50% disallowance rule) if the entertainment is directly related to or associated with the active conduct of a business and properly substantiated. However, a taxpayer cannot deduct any expenditure for an entertainment facility even if there is a business connection. An entertainment facility is *any property* (personal or real) owned or rented and used for entertainment. Examples of entertainment facilities include yachts, hunting lodges, hotel suites, and vacation homes. If the facility is used for entertainment, even if such use is incidental, it is considered an entertainment facility.

While it may be possible for a taxpayer to deduct expenses related to a facility such as a condo or rented apartment that is used exclusively as a place of lodging or business meetings, exceedingly detailed and precise records would need to be maintained to verify that no entertainment activities have taken place at the facility. An activity generally considered entertainment will be considered entertainment for purposes of IRC Sec. 274(a) regardless of whether the expenditure can also be described otherwise and even if it relates to the taxpayer alone. Therefore, entertainment does not necessarily need to be the entertainment of others or characterized as an expenditure for advertising or public relations.

Nondeductible entertainment facility expenses include depreciation and operating costs (including rent and utilities), maintenance costs, watchmen or caretaker salaries, and losses on disposition. Out-of-pocket expenditures incurred at the time of an entertainment activity while using a facility are not facility costs, and thus may be deductible under the general rules of IRC Sec. 274.

Example 5C-1 Operation of an entertainment facility.

Don operates a sole proprietorship in the welding supply business. During the year, Don paid $10,000 for a hunting lease that was used to entertain customers and employees. While he could produce a log showing which customers and employees used the hunting lease on certain dates, IRC Sec. 274(a)(1)(B) expressly disallows deductions for costs related to the facility itself. The $10,000 is nondeductible. Reg. 1.132-6(e)(2) provides that the value of the use of the hunting lease to an employee is not a *de minimis* fringe benefit and thus should be included in taxable wages.

Example 5C-2 Costs other than facility costs.

Gene is an accountant operating as a sole practitioner. Gene and several of his clients went skiing in Colorado at the firm's expense. Although the cost of the lodging is disallowed as an entertainment facility expense, other out-of-pocket expenses of the trip, such as meals and transportation, are not affected by the entertainment facility rules. Rather, their treatment is determined by the general rules of IRC Sec. 274 governing meals and entertainment expenses (i.e., 50% deductible if directly related to or associated with the business and properly substantiated).

Club Dues

No deduction is allowed for club dues. This rule applies to amounts paid to any club organized for business, pleasure, recreation, or other social purpose. Not even golf professionals and golf instructors are allowed to deduct golf club dues, given the statutory provisions of IRC Sec. 274(a)(3).

Clubs subject to these rules include those with a principal purpose of conducting entertainment activities for their members and guests or providing them access to entertainment facilities. (It appears to be a facility-based definition in that it includes clubs that provide a facility and excludes those without permanent facilities.) This includes, among others, country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs that provide meals in settings generally considered to be conducive to business discussions. Excluded from the definition are business leagues, trade associations, chambers of commerce, boards of trade, real estate boards, professional organizations, and civic or public service organizations. Thus, dues paid to organizations such as bar associations and medical associations, or the Kiwanis, Rotary, and Lions clubs are not subject to these disallowance rules.

An employer that reimburses an employee for club dues can (1) include the entire reimbursement in the employee's income (any disallowance for nondeductible dues occurs at the employee level), or (2) to the extent dues otherwise qualify as a trade or business expense by the employee, treat the reimbursement of such amount as a working condition fringe benefit excludable from the employee's income (the disallowance occurs at the employer level). The amount not treated as a working condition fringe benefit (i.e., employee's personal use) is included in the employee's compensation.

Example 5C-3 Reimbursement of club dues.

Jack operates a golfing school and pays the $2,000 club dues for his instructor, Nicholas. Jack chooses to include the entire $2,000 in Nicholas' Form W-2. Jack can deduct the $2,000 as wage expense. Nicholas is not allowed a deduction on Schedule A since the amount relates to golf club dues, which are nondeductible.

Variation: Jack determines that Nicholas uses the golf club 80% as a golf instructor and 20% to entertain family and friends. Jack treats $1,600 as a working condition fringe benefit under IRC Sec. 132 and includes $400 in Nicholas' Form W-2 for his personal use of the golf club. Neither Jack nor Nicholas can claim a deduction for the portion of the golf club dues characterized as a working condition fringe benefit. Jack can deduct the $400 as wage expense. Nicholas is not allowed a deduction for the amount included on his Form W-2 since the amount relates to golf club dues, which are nondeductible.

Deductions for Accompanied Travel

No deductions are allowed for travel expenses of spouses, dependents, or other individuals accompanying a taxpayer on a business trip unless (1) the accompanying person is an employee of the taxpayer paying the expenses, (2) the travel is for legitimate business purposes, and (3) the expenses of the accompanying individual would otherwise be deductible. *Other individuals* do not include bona fide business associates such as customers, clients, or professional advisers; expenses incurred for these individuals are not subject to the rules described in this lesson but are subject to the deductibility requirements that apply to self-employed individuals or employees.

An employer who reimburses an employee for (or pays directly to a third party) such expenses can (1) include the reimbursement (or the direct payment) in the employee's income, in which case the deduction is denied at the employee level; or (2) treat the reimbursement (or the direct payment) as a working condition fringe benefit excludable from the employee's income, in which case the deduction is denied at the employer level. However, the employer cannot treat the reimbursement (or the direct payment) as a working condition fringe benefit unless the accompanying person's (e.g., spouse's) travel had a bona fide business purpose and the travel expenses were substantiated.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Which of the following must be provided to substantiate each travel and entertainment expense?

    a. The total amount the taxpayer spent on travel and entertainment.

    b. The name and address of the person receiving a gift.

    c. The place and time of the travel or entertainment.

    d. A list of any personal activities that accompanied the travel.

18. Which of the following is an exception that applies to the 50% disallowance rule?

    a. Employers providing meals for officers, directors, or 10% owners.

    b. Expenses for items that are made available to the general public.

    c. Employers providing recreation activities to independent contractors.

    d. Expenses for tickets to sporting events and concerts.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Which of the following must be provided to substantiate each travel and entertainment expense? **(Page 87)**

    a. The total amount the taxpayer spent on travel and entertainment. [This answer is incorrect. While this total may be needed on the return itself, to substantiate one particular expense, the total amount of that expense is needed.]

    b. The name and address of the person receiving a gift. [This answer is incorrect. To substantiate this type of expense for a gift, the taxpayer needs to provide a description of the item given and the business relationship to the taxpayer of the person receiving the gift, not their name and address.]

    c. The place and time of the travel or entertainment. [This answer is correct. The Section 274(d) substantiation rules disallow a deduction unless the taxpayer substantiates five specific items by maintaining adequate records or by providing sufficient corroborating evidence. One of these items that must be substantiated is the time and place of the travel or entertainment.]

    d. A list of any personal activities that accompanied the travel. [This answer is incorrect. Substantiation of travel expenses require specific information, including the business purpose of the travel (or entertainment), not associated personal activities.]

18. Which of the following is an exception that applies to the 50% disallowance rule? **(Page 91)**

    a. Employers providing meals for officers, directors, or 10% owners. [This answer is incorrect. Under IRC Sec. 274(n), employers are not subject to disallowance when meal or entertainment expenses paid for or to an employee who is not an officer, director, or 10% or greater owner are treated as compensation to the employee. The 50% disallowance occurs at the employee level if the employee deducts the meals and entertainment as an employee business expense.]

    b. Expenses for items that are made available to the general public. [This answer is correct. Generally, IRC Sec. 274(n) allows a deduction for only 50% of otherwise allowable meal and entertainment expenses. However, there are certain exceptions. One such exception is for items made available to the general public, such as promotional popcorn or snacks at a car dealership.]

    c. Employers providing recreation activities to independent contractors. [This answer is incorrect. Per IRC Sec. 274(n), there is an exception for expenses related to recreational, social, or similar activities incurred primarily for the benefit of employees other than certain highly compensated employees. This exception does not apply when the recipients are independent contractors.]

    d. Expenses for tickets to sporting events and concerts. [This answer is incorrect. Many such tickets would be subject to the 50% disallowance rules under IRC Sec. 274(n). However, there is an exception for tickets to *fund-raising charitable sporting events* if specific qualifications are met.]

Traveling out of the Country

Allocating Foreign Travel between Business and Personal Purposes

Generally, a taxpayer who travels outside the U.S. for business purposes (under IRC Sec. 162) or investment purposes (under IRC Sec. 212) cannot deduct the portion of the foreign travel expense that does not relate to a business or investment activity. In other words, the taxpayer can deduct 100% of the foreign travel expense only if the entire time was spent on business activities. If the majority of time was spent on business activities, the travel expenses are allocated between deductible business expenses and nondeductible personal expenses. If the travel was primarily personal, but there was some business activity, the travel expenses are nondeductible. However, other expenses incurred during the trip that are *directly related* to business (e.g., seminar registration fees) or investment are deductible. Out-of-pocket costs incurred on personal days are never deductible. Travel expenses include transportation, meals (subject to the 50% disallowance rules covered), and lodging expenses that are not lavish or extravagant under the circumstances.

Example 5E-1 Foreign travel mainly for pleasure.

This summer, Dr. Freemont spent six days in Europe to relax. During his stay, he attended two four-hour professional seminars in Paris. Dr. Freemont wants to deduct the entire cost of his trip.

Because the primary purpose of the trip was a vacation, Dr. Freemont can deduct only the cost of the seminar registration fees and none of the travel expenses. The seminar expenses are directly related to Dr. Freemont's business and are not considered travel expenses.

No deduction is allowed for expenses for travel as a form of education. For example, a French teacher who travels to France to maintain general familiarity with the French language or culture cannot deduct his travel expenses. However, if the taxpayer travels to attend education courses, the cost of which qualify as ordinary and necessary business expenses (deductible under IRC Sec. 162), and such courses are the primary purpose of the travel, then the related travel expenses are deductible, subject to the allocation rules outlined in this discussion.

Foreign Travel Deemed Entirely for Business. Although the foreign travel rules require an allocation of expenses if business travel is combined with personal travel, several exceptions are provided by the Code and regulations. If *any* of the following exceptions are met, allocation of the *transportation* expenses (getting to and from the destination) on a day-by-day basis is not required. Instead, the taxpayer may deduct these transportation expenses as though the trip was 100% business.

1. *The Taxpayer Is Outside the U.S. Less Than One Week.* By keeping a foreign business trip to seven consecutive days or less, 100% of transportation costs and 100% of other out-of-pocket costs for business days (subject to the 50% limit on meals and entertainment expenses) are deductible. Out-of-pocket costs incurred on personal days are not deductible. For the seven-day test, the day of departure from the U.S. is ignored, but the day of return to the U.S. is included. Travel between U.S. points is not counted.

2. *The Taxpayer Spends Less Than 25% of the Total Time on Nonbusiness Activities.* For the 25% test, both the day of departure and the day of return are considered. Travel between U.S. points is not counted. The same rules for out-of-pocket costs apply as in exception 1.

3. *The Taxpayer Has No Substantial Control over Arranging the Trip.* A taxpayer who travels for an employer under a reimbursement or travel allowance arrangement is not considered to have substantial control unless he is a managing executive or related to the employer. (A self-employed individual generally is regarded as having substantial control. A related party is considered to be a 10% or more owner.)

4. *The Taxpayer Establishes That a Personal Vacation Was Not a Major Consideration.* This test applies even if the taxpayer is self-employed, related to the employer, a managing executive, or has substantial control in planning the trip. (See Example 5E-4.)

Example 5E-2 Combining minimal personal travel with a business trip.

Steve flew to London on Sunday to attend several business meetings. He spent Monday–Thursday meeting with various clients. Instead of returning home immediately after the meetings, Steve stayed in London to do some sightseeing and returned home Sunday.

Steve's trip meets the seven-day test (Monday–Sunday). Its purpose was primarily business related because four of seven days were business days. Thus, the trip meets one of the Section 274(c)(2) safe harbor exceptions. All of his airfare is deductible and all of his out-of-pocket expenses incurred on the business days are deductible (subject to the 50% rule for meals and entertainment).

Foreign Travel Primarily for Business. If the taxpayer cannot meet one of the 100% deductible safe harbor exceptions provided by the Code or regulations, the travel expenses must be allocated to deductible and nondeductible categories using a day-by-day allocation method (or other method the taxpayer establishes clearly reflects the allocation), provided the trip is *primarily* for business. To calculate deductible travel expenses using the day-by-day method, use the following equation:

$$\text{Total travel expenses} \times \frac{\text{Number of business days}}{\text{Total days outside U.S.}}$$

Include both departure and return days in the denominator. Include transportation days in the numerator if traveling to or from a business destination. The taxpayer must still establish that the primary reason for the trip was for business to allocate *any* travel expenses to the business activities. Only expenses incurred in connection with the business destination are allocable. For example, if a taxpayer 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.

Any day a taxpayer's presence is required at a particular place for a specific and bona fide business purpose is considered a business day. If the principal activity is a business pursuit, the day is considered a business day. Weekends and holidays are also business days if they fall between business days.

Example 5E-3 Wrapping business around a weekend.

In Example 5E-2, if Steve flew to London on Tuesday, spent Wednesday–Friday in business meetings, did his sightseeing on Saturday and Sunday, and had a five-hour business meeting on Monday, all of his expenses [including food (50%) and lodging on the weekend] would be considered business expenses.

Example 5E-4 Allocating travel expenses of a combined business and pleasure trip.

Karl is a self-employed owner of a clothing store in New York. He flew to Munich on a buying trip, where he spent two days meeting with clothing manufacturers. He then flew to Paris for a five-day vacation before returning to New York. Karl would not have made the trip except for the business he conducted in Munich.

His travel outside the U.S., including two days of travel, totaled nine days. He does not qualify for any of the safe harbor tests because he does not meet either the one week or less than 25% nonbusiness test. Assuming Karl cannot establish that he had no substantial control over arranging the trip or that a personal vacation was not a major consideration (which he may not be able to do in this instance), his travel expenses are subject to allocation between business and personal. Under the allocation rules, 4/9 (four business days out of a total of nine days outside the U.S.) of his expenses attributable to transportation and food (subject to 50% disallowance) from New York to Munich, and which would have been incurred had he returned from Munich to New York, are deductible business expenses.

Attending Conventions outside North America

In addition to showing that a convention, seminar, or similar meeting ("convention") directly relates to the active conduct of their trade or business, taxpayers attending such meetings either outside the North American area or

aboard a cruise ship must pass additional hurdles before claiming tax deductions for the related expenses. The North American area includes the U.S., its possessions, the Pacific Islands Trust Territory, Canada, Mexico, and certain Caribbean countries. (Rev. Rul. 2016-16 contains a list of the specific countries.)

To deduct expenses of attending a business convention outside North America, the taxpayer must establish that it is as reasonable for the meeting to be held outside the area as within the area. This reasonableness test considers such factors as (1) the purpose and activities of the meeting, (2) the sponsoring organization, (3) the residences of the organization's active members, and (4) the location of other meetings. In addition, the time spent in business meetings or activities must be substantial when compared to that spent sightseeing and engaged in other personal activities; otherwise, the travel is deemed to be a personal vacation and only the meeting registration fees and other direct business costs are deductible.

Conventions on Cruise Ships. Deductions related to conventions held aboard cruise ships are limited to $2,000 per individual per calendar year. In addition, deductions are available only if the ship is a U.S.-registered vessel, and all of its ports-of-call are in the U.S. or its possessions. A taxpayer must also attach the following written information statements to his return in the year a deduction is claimed:

1. A statement signed by the taxpayer showing the total days of the trip (excluding travel to and from the ship), the number of hours each day spent attending scheduled business activities, and the program of the convention's scheduled business activities.

2. A statement signed by an officer of the sponsoring organization that includes a schedule of each day's business activities and the number of hours the taxpayer attended those activities.

Luxury Water Travel. The deductible amount of business travel by ocean liner, cruise ship, or other form of luxury water transportation is limited to twice the highest federal per diem rate allowable at the time the business travel takes place. But, this rule does not apply to expenses allocable to a convention held on cruise ships (see previous discussion). If the cost of the travel includes a separately stated amount for meals or entertainment, those expenses are limited before application of this per diem limitation. However, if meal and entertainment expenses are not stated separately, the taxpayer is not required to allocate part of the cost.

Travel away from Home.

Determination of "Tax Home"

IRC Sec. 162(a)(2) allows a deduction for traveling expenses, including meals and lodging, while away from home *overnight* on business. To deduct travel expenses, the taxpayer must be "away from home." Thus, determining the location of an individual's *tax home* is critical to the deductibility of travel expenses. The overnight requirement is met if the trip requires sleep or rest to enable the taxpayer to continue to work. In *Bissonnette*, a ferry boat captain had workdays averaging 15–17 hours. He was not treated as away from home during peak season when his layovers were typically 1–2 (but as much as 5) hours, but was treated as away from home during off-peak season when his layovers were 6–7 hours. This case indicated that factors to consider in determining whether sleep or rest is required include age, physical condition, the length of the workday, and the importance of being alert so that the employee can carry out his or her job's responsibilities without fear of injury to others. These factors are applied against the background of the employee's employment experience and the practices and customs of similarly situated individuals. The practitioner should always consult administrative and case law to determine controlling authority based on the underlying facts and circumstances.

An individual's tax home is normally (1) his regular or principal (if more than one regular) place of business, or (2) if he has no regular or principal place of business because of the nature of his trade or business, his regular place of abode in the real and substantial sense. If a taxpayer does not come within either of these categories, he is considered an itinerant (i.e., a person who travels from place to place) with no tax home and is allowed no travel deductions.

When the taxpayer's principal place of business (i.e., tax home) is in a different geographic location than his place of abode, the cost of transportation from the residence to the principal place of business is nondeductible. Also,

any other travel expenses (e.g., lodging or meals) incurred while working at the principal place of business are nondeductible.

When a taxpayer does not have a regular or principal place of business (category 1, as described above), the deductibility of travel expenses hinges on whether he has an abode in the real and substantial sense (category 2) or is an itinerant. For these taxpayers (e.g., traveling salesmen, traveling artists, or transportation workers), the IRS has provided three factors to help determine whether the taxpayer's assertion that his claimed abode is his "regular place of abode in the real and substantial sense." These factors are as follows:

1. The taxpayer conducts business in the vicinity of the claimed tax home and uses the home for lodging while doing so.

2. Living expenses at the claimed tax home are duplicated because business requires the taxpayer to be elsewhere.

3. The taxpayer has not abandoned his historical vicinity of lodging and abode, has family members residing at the claimed abode, or uses the claimed abode frequently for lodging.

If all three factors are satisfied, the taxpayer's claimed tax home can be used to determine travel expenses. If two are satisfied, the determination depends on the facts and circumstances. If fewer than two are satisfied, the IRS will consider the taxpayer an itinerant with no tax home and allow no travel deductions.

Example 5F-1 Tax home of an itinerant outside salesman.

Rich, an outside salesman, has a sales territory covering several states. His employer has its main office in Milwaukee, but Rich does not go there for business reasons. His work assignments are temporary, and he has no way of knowing where his future assignments will be. He has a room in his sister's house in Chicago where he keeps his personal items. He stays at his sister's house (for free) for one or two weekends each year, but he performs no work near Chicago. Rich has abandoned his historical and other familial contacts, which are near St. Louis. Rich pays his own travel expenses.

Rich, not having satisfied any of the objective factors discussed earlier, is an itinerant having his "tax home" wherever he happens to work. Thus, since he is not away from home, the cost of his meals and lodging are not deductible as traveling expenses under IRC Sec. 162(a)(2).

Generally, a taxpayer engaged in two or more businesses operated in geographically separate locations may deduct traveling expenses incurred while away from the location of the principal business. Thus, expenses incurred while conducting business at the secondary location are deductible. To determine which is the principal and which is the secondary business location, the courts have considered (1) the amount of time spent at each place, (2) the proportion of the taxpayer's income earned in each location, (3) the degree of activity engaged in by the taxpayer at each location, (4) where the taxpayer maintains his permanent residence, and (5) whether employment at one location is temporary.

It is possible for a taxpayer to have two tax homes and thus not be "away from home" at either location. For example, a taxpayer may have two tax homes when he conducts business half of the year at one location and the other half of the year at another, and does not maintain a permanent residence at either location (e.g., lives in hotels at both). However, the 1st Circuit has held that when a taxpayer maintains a permanent residence in the vicinity of one of the businesses and thus incurs duplicate living expenses, he cannot be considered to have two tax homes. According to the court, considering a taxpayer to have two tax homes in this situation is inconsistent with a well-settled policy under IRC Sec. 162(a)(2) that duplicated living expenses necessitated by business are deductible.

Example 5F-2 Determining tax home when taxpayer has two geographically separate businesses.

Tony owns a ski shop in New Mexico that he personally operates during the months of November–March. The remainder of the year he runs a contracting firm that builds tennis courts in Arizona. He maintains a permanent residence in each location.

Both residences are necessary for business. Based strictly upon time spent (i.e., without considering the business activity and income earned at each location), it appears that the Arizona residence will be considered Tony's tax home, and all expenses of travel (for business purposes) between the residences and for living in New Mexico will be deductible under IRC Sec. 162. Only 50% of Tony's meals in New Mexico may be deducted and, furthermore, an allocation may be required if his family lives with him in New Mexico (since only his expenses will be deductible).

Deducting Local Lodging Expenses. Reg. 1.162-32 provides safe harbor rules for deducting local lodging expenses. The regulation stipulates that an individual's local lodging expenses can be deducted by the individual as Section 162(a) business expenses if the applicable facts and circumstances dictate that such treatment is appropriate. In turn, expenses that would qualify for Section 162(a) deductions if paid by an employee will qualify as a tax-free working condition fringe benefit if paid by the employer or if advanced or reimbursed by the employer under an accountable plan.

Under Reg. 1.162-32(b), local lodging expenses are automatically treated as Section 162(a) ordinary and necessary business expenses if all of the following conditions are met:

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 occur more frequently than once per calendar quarter.

3. In the case of an employee, the employer requires the employee 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.

Example 5F-3 Local lodging deductible for employees.

Alpha Corporation puts on periodic employee training sessions at a hotel near its main office. Alpha requires all attending employees, including employees from the local area, to remain at the hotel overnight for the bona fide business purpose of maximizing the effectiveness of the training sessions.

Alpha reimburses attending employees for the lodging costs under an accountable plan. The reimbursements are tax-free to the employees, including those who live in the local area, and Alpha can deduct the reimbursements as Section 162(a) business expenses.

Example 5F-4 Local lodging not deductible.

Alpha Corporation also pays for an employee who lives two hours away to stay in a local hotel on weeknights to maximize her availability for an important project that requires her to put in extra hours.

Under these facts, the IRS says the employer-paid hotel stay does not qualify for tax-favored treatment because it provides the employee with a personal benefit by relieving her of the daily grind of commuting to and from her home. Therefore, according to the IRS, the employer-paid cost is taxable compensation to the employee. Alpha can deduct the cost as a compensation expense.

Temporary versus Indefinite Employment away from Home

Travel expenses incurred for temporary employment away from home generally are deductible since the taxpayer is in business travel status away from the current tax home. On the other hand, travel expenses incurred for employment away from home that is of indefinite duration are not deductible. The taxpayer is considered to have relocated the tax home to the location of the extended work assignment and is no longer in business travel status. A taxpayer's employment away from home in a single location is deemed indefinite (in which case no deduction is allowed for the related travel expenses) if it lasts for more than one year. However, the one-year rule does not apply

to federal employees whose employment away from home (1) is certified by the Attorney General (or designee), and (2) is to investigate a federal crime or to provide support services for the investigation. Thus, for federal employees such as FBI agents and other investigators, travel expenses are fully deductible regardless of the length of period for which certification is given, provided all other necessary requirements for deductibility are met.

According to Rev. Rul. 93-86, the IRS will use a "realistic expectation" test to determine when the one-year rule applies. If employment away from home in a single location is realistically expected to last (and does in fact last) for one year or less, it will be treated as temporary in the absence of facts and circumstances indicating otherwise. If employment away from home in a single location is realistically expected to last for more than one year, or there is no realistic expectation that it will last for one year or less, the employment will be treated as indefinite, regardless of whether it actually exceeds one year. If employment away from home in a single location initially is realistically expected to last for one year or less, but at some later date it is realistically expected to exceed one year, at that point the employment no longer will be treated as temporary (in the absence of facts and circumstances indicating otherwise) and travel expenses are no longer deductible until the taxpayer's realistic expectation changes. Extending an 8-month working assignment an additional six months in the same city, even with a different employer, is treated as no longer temporary at the point of acceptance of the additional assignment. The emphasis is placed on employment (no matter by whom) in a specific location or city. The Tax Court determined that an open-ended, at-will employer/employee relationship, as stated in the employment agreement, was indicative of indefinite employment regardless of the duration. However, traveling expenses incurred as a result of employment that occurs on an on-again off-again basis or an as-needed basis due to unexpected happenings qualify as temporary employment expenses while away from home, even though the duration exceeds one year. Likewise, employment was considered temporary, even though it lasted for over a year, when the employee's supervisor assured her that the assignments were temporary and that she would eventually be assigned to a permanent location within her home area. Accepting a position in another city after being laid off in a former city in the hope that a position will open up in the former city does not constitute a temporary assignment, and any travel expenses related to the second city will not be deductible.

Spouses living in separate cities can each have separate tax homes for the purposes of these rules.

Example 5F-5 Tax home when spouses live in separate cities.

Steve and Ann live in Tulsa. Steve accepted a new job in Santa Barbara and plans to commute to and from California for the next two or three years until retirement. Steve's work in Santa Barbara is in a highly specialized field that does not exist in Tulsa. Ann, who runs a family business, cannot leave her position and will stay in Tulsa. Steve cannot deduct his travel to and from Tulsa nor his apartment rent in California because his job is not temporary in nature. His tax home for this purpose is considered Santa Barbara.

Example 5F-6 Tax home when spouses work in separate cities.

Scott and Brenda live in Richmond, where they both grew up, went to college, and where their extended families continue to live. Scott is a technology consultant and works Monday through Friday in Raleigh, N.C., commuting from his home in Richmond. Brenda is a civilian employee with the Department of Defense and commutes weekly to Norfolk, Va. Neither job is temporary in nature. Although they maintain their primary residence in Richmond, Scott's tax home is Raleigh and Brenda's tax home is Norfolk. Neither Scott nor Brenda can deduct their travel expenses to and from Richmond nor their apartment rent in Raleigh or Norfolk because neither job is temporary in nature.

In *Senulis*, the Tax Court held that a taxpayer could deduct business travel and meal and incidental expenses (M&IE) for the first 12 months of a temporary work assignment in Houston that ended up lasting 13 months. The court raised several points indicative of the temporary nature of the taxpayer's employment, including that he (1) maintained a personal residence in Louisiana for the prior 20 years, (2) expected on acceptance the assignment would last nine to ten months, (3) had no expectation of continued employment with the company after the completion of the project, and (4) continued to maintain his home office in Louisiana and returned there throughout his temporary employment.

Example 5F-7 Change in period of employment away from home.

John is a construction superintendent for a company in Atlanta. John and his family live in Atlanta, and he usually works in the area. However, on July 1, 2016, John started a new assignment in Washington, DC that was realistically expected to last nine months. On March 1, 2017 (after eight months on the assignment), John was asked to remain for seven more months (for a total actual stay of 15 months). John's company reimbursed him under an accountable plan for all of his travel costs while away from home. How are John's travel costs treated for this assignment?

The assignment was initially deemed temporary since the original length was expected to be one year or less. However, the change in status on March 1, 2017, converted it to an indefinite assignment of more than one year. Thus, expenses incurred from July 1, 2016–February 28, 2017, are for temporary employment, while expenses beginning March 1, 2017, are for indefinite employment. Because John is reimbursed by his employer under an accountable plan, the reimbursements for expenses incurred up to March 1, 2017, are excluded from his income. However, reimbursements for expenses on or after March 1, 2017, are additional wage income to John, and he is unable to claim any deduction for these expenses.

Deducting a Saturday Night Stay

If a taxpayer wraps up a business trip on a Friday and decides to remain at the travel location until the weekend to take advantage of lower return airfare rates, the additional lodging and meal costs incurred are deductible travel expenses if, using a common sense test, a "hardheaded" business person would have incurred the additional expenses under like circumstances.

Example 5F-8 Saturday night stay to take advantage of lower airfares.

Fred Ware frequently travels on business on Friday and customarily returns home on Saturday. To take advantage of lower "excursion" airfare rates that are available for airline travel on Sundays, Fred has decided that, when traveling on a Friday, he will stay through Saturday night and return home on Sunday. However, he will do this only if the airfare rate savings realized by utilizing the excursion rates exceeds the one day of additional lodging and meals costs incurred for the Saturday night stay. Fred will measure the cost savings realized from airfare rates using the lowest available airfare for a direct flight when the trip is originally booked.

The Saturday night stays will be undertaken only if they result in an overall cost savings for Fred. A "hardheaded" business person would do the same. Thus, Fred should be allowed to deduct the additional lodging and meal costs for the Saturday stay as ordinary business expenses. Meal and entertainment expenses would be subject to the 50% disallowance rule.

How to Deduct Local Transportation Costs

Local transportation costs are those incurred when traveling to work locations (either within or outside the taxpayer's metropolitan area) that do not require an overnight stay away from home. These are distinguished from travel costs that require the taxpayer to be away from home.

Commuting Expenses

For most taxpayers, the costs of commuting from their residences to their places of business or employment are nondeductible personal expenditures. This includes both self-employed individuals and employees who have a regular place of business away from their residence. Also, a deduction for commuting costs is disallowed regardless of the distance traveled or even if remote. See the following discussion regarding temporary work locations for possible exceptions to this rule.

Taxpayers with Home Offices

Taxpayers whose residence qualifies as a home office under the principal place of business test within the meaning of IRC Sec. 280A(c)(1)(A) can deduct all daily transportation costs incurred in going between their residences and other work locations in the same trade or business. This applies whether the other work location is regular or temporary and regardless of the distance. A taxpayer can qualify his residence for the home office deduction by meeting several tests. However, the principal place of business test must be met for local transportation costs between the residence and other work locations to be deductible, unless one of the "temporary work location" rules discussed later in this lesson applies.

In order for an *employee* to deduct daily transportation costs between his residence and other work locations in the same trade or business, his home office must be for the convenience of his employer in addition to being used exclusively and regularly as his principal place of business.

When a taxpayer has two or more regular work locations (whether in the same business or different businesses), the daily transportation costs of going between these work locations are deductible.

Example 5G-1 Deducting travel costs from a home office.

Jane Williams is an anesthesiologist. Her only office is a room in her home used regularly and exclusively to telephone patients, surgeons, and hospitals; to maintain billing records and patient logs; to prepare for treatments and presentations; and to read medical journals and books. She spends approximately 10 to 15 hours per week working at home. She spends 30 to 35 hours per week administering anesthesia and post-operative care in three hospitals within her city limits, none of which provide her with an office.

Jane's home office qualifies as her principal place of business under IRC Sec. 280A(c)(1)(A). Thus, she can deduct expenses for the business use of her home. Jane's travel costs between her residence and any of the three hospitals where she regularly works (i.e., regular places of business) are deductible. Also, under Rev. Ruls. 55-109 and 99-7, Jane may deduct any transportation costs between the hospitals on a given day.

Temporary Work Locations

In certain situations, taxpayers at temporary work locations away from their regular places of business can deduct their daily transportation costs. Taxpayers can deduct the costs of traveling between their residences and *temporary* work locations in the following circumstances:

1. When the location is a temporary work site outside the taxpayer's metropolitan area where she lives and normally works. The taxpayer must normally work in the same metropolitan area where she lives, in order to deduct transportation to temporary work sites outside that area.

2. When the location is a temporary work site in the same trade or business, regardless of distance or whether the site is inside or outside the residential metropolitan area, if the taxpayer has one or more regular work locations away from his residence.

Generally, a metropolitan area includes the area within the city limits and the suburbs that are considered part of that area.

For this purpose, "temporary" effectively means one year or less. The IRS has adopted a "reasonable expectation" criteria similar to the one-year "travel away from home" rules adopted in Rev. Rul. 93-86. If employment is expected to last (and does last) for one year or less, employment is temporary in absence of contrary indications. If it is expected to last more than one year, employment is not temporary, even if it lasts less than one year. Employment at a work location that was originally expected to last one year or less but subsequently changed so that period now exceeds one year is treated as temporary until the taxpayer's realistic expectation changes. A *regular place of business* is any location where the taxpayer works or performs services on a regular basis.

Example 5G-2 Deducting travel costs to temporary work locations.

Assume the same facts as in Example 5G-1 except Jane's home office failed to qualify as her principal residence (she used it also for personal reasons). Now, her travel costs between her residence and the three

hospitals she regularly works at would not be deductible because the hospital work sites are not temporary. However, if she worked temporarily at a different hospital (for example as a teaching resident for six months), her daily travel expenses from her residence to the hospital where she teaches would be deductible. In addition, if she traveled between hospitals within one day, the travel between hospitals would be deductible.

Infrequent Work Locations. An employee is considered to be traveling to a "temporary" work location when making recurring but infrequent or sporadic trips to a work location that is expected to extend over a year (e.g., quarterly trips to a managers' meeting). However, there must be an expectation that the employee will not work more than 35 days over the span of a year at that location, and the employee in fact meets this criteria.

Example 5G-3 Infrequent work at a nontemporary worksite.

Jane regularly works as an engineer in Plant A for her employer. However, Jane is assigned to a temporary engagement at Plant B 60 miles away for a three-week period (15 days) to assist in starting a new project. Thereafter, Jane is expected to commute to Plant B one day per month for two years, to continue to monitor progress on the new project. Even though this temporary assignment at Plant B will last over one year, because Jane will be present at that location for no more than 35 work days per year, it qualifies as a temporary assignment and Jane's mileage is deductible (or, if mileage is reimbursed by her employer, the reimbursements are tax-free).

Breaks in Temporary Engagements. The IRS has provided limited guidance as to when a break or interruption at a temporary worksite can restart the clock under the one-year temporary workplace limit. CCA 200026025 states that a break of three weeks or less is not significant and will be considered a continuation of the temporary assignment at that workplace. By contrast, a continuous break of at least seven months would be significant and would entitle the taxpayer to start a new one-year rule. The impact of breaks greater than three weeks but shorter than seven months apparently depends on the particular facts and circumstances.

Example 5G-4 Break in service at a temporary worksite.

Jack is assigned to his employer's computer center 50 miles away for a four-month engagement. Because this is a temporary workplace (expected duration of one year or less), Jack is entitled to deduct his daily transportation expenses from his residence to the computer center. Assume that after this first assignment, Jack then returns to his regular work location for approximately ten months, and is then assigned to another temporary work engagement at the computer center for six months. Because of the significant break in service between the two temporary assignments, Jack may again deduct daily transportation to the computer center during the second assignment.

Treating Tickets to Athletic Events as Entertainment or Gifts

When a taxpayer provides tickets to an athletic or other entertainment event to a business customer, proper tax treatment depends on whether the taxpayer (or his employee) attends the event with the customer. If neither attends the event with the customer, the tickets may be treated as either a business gift or entertainment expense. If the taxpayer or an employee attends, the tickets must be considered an entertainment expense. Deductions for tickets to entertainment events are generally limited to face value. However, tickets to certain fundraising sporting events are exempt from this rule.

Example 5H-1 Tickets treated as business gifts.

Each year, Rob, a sporting goods wholesaler, purchases two season tickets to the Giants baseball games. The face value of each ticket is $35 per game; Rob gives them to customers and suppliers. Neither Rob nor any of his employees attends the game.

Rob can treat the tickets as business gifts or entertainment expenses. Deductions for business gifts are limited to $25 per year per individual donee. Therefore, since two tickets cost $70, giving them both to a different customer for each game and treating them as business gifts results in a nondeductible expense of $45 per game (unless each ticket was used by a separate customer, in which case the nondeductible expense would be $20 per game).

Example 5H-2 Tickets treated as entertainment expenses.

Assume the same facts as in Example 5H-1 except Rob elects to treat the cost of the tickets as an entertainment expense. To be deductible under IRC Sec. 274(a), entertainment expenses must be directly related to the active conduct of a trade or business (i.e., engage in business during the entertainment) or be associated with the active conduct of the trade or business (i.e., the activity directly precedes or follows a substantial and bona fide business discussion).

Although there is no dollar limit on entertainment expenses, as compared to business gifts, it may be difficult to meet the directly related to or associated with test necessary to be deductible under IRC Sec. 274. Thus, treating the tickets as business gifts may be a better alternative for Rob, even though a portion of the expense may be disallowed. (See Example 5H-1.)

On the other hand, if Rob or an employee attends a game with the customer and engages in a substantial business discussion before or after the game, the cost of the tickets is deductible as an entertainment expense, subject to the 50% disallowance for meals and entertainment expenses discussed earlier in this lesson. This becomes more significant when the tickets involved cost more than $50 each. For example, a $100 ticket results in a $50 tax deduction when treated as an entertainment expense versus a $25 deduction when treated as a gift.

If a taxpayer gives athletic event tickets to a business for the eventual use or benefit of some undesignated member of the business, the transfer is not considered a business gift to the recipient unless it is reasonably practical for the taxpayer to determine the ultimate recipient of the gift. Since there is no identifiable recipient, it is not a gift for tax purposes. However, it is still treated as entertainment under IRC Sec. 274(n). Therefore, the taxpayer's deduction is not subject to the $25 gift limit but is subject to the 50% disallowance for entertainment expenses.

Example 5H-3 Tickets not treated as gifts or entertainment.

Assume the same facts as in Example 5H-1 except Rob gives the tickets to one of his customers so she can, in turn, give them to anyone within the company. Rob does not give them to anyone in particular and leaves it entirely up to the company to decide who uses them. Here, Rob is not treated as having made a business gift since the ultimate recipient is anyone from a large group of people and Rob does not know who that person will be. Thus, Rob should be able to claim a deduction for the full $70 he paid for the two tickets. However, it will be subject to the 50% disallowance for entertainment expenses.

If two spouses jointly operate a business and give a gift to a customer or business associate, only one $25 limit applies because the spouses are treated as one taxpayer. However, the reverse is not true, so a taxpayer who gives a gift jointly to a married couple should be able to claim up to $50 of the cost as a deduction, provided the taxpayer has a business relationship with both spouses. A gift to one spouse that is really intended for the other is treated as an indirect gift to the second spouse.

Tickets to Charitable Events

Deductions for entertainment tickets are normally limited to face value. However, expenses for tickets to fundraising charitable sporting events are not limited to face value (and not subject to the 50% limit for meals and entertainment) if (1) the event is organized for the primary purpose of benefiting a Section 501(c)(3) organization, (2) all the net proceeds are donated to the charitable organization, and (3) volunteers are used for substantially all of the work performed in carrying out the event.

Example 5H-4 Tickets to charitable sporting events.

Sally Stride buys tickets to a golf tournament organized by the local Big Brothers/Big Sisters organization. She pays $200 for tickets with a face value of $50. All of the net proceeds from the tournament go to the local charity. Local celebrities will host the event free of charge. The entire cost of the tickets is deductible (assuming the business connection requirement is met) without regard to the face value of the tickets. In addition, the 50% disallowance rule does not apply.

Deduction for Skybox Rental

If a business connection exists, the deduction for rental of a skybox at a sports stadium (for more than a single event) is limited to the number of seats in the skybox times the price of a nonluxury box seat ticket. The deduction is further reduced by the 50% disallowance rule. If no business connection exists, the full cost of the skybox rental is nondeductible.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Under what circumstances can a taxpayer deduct 100% of foreign travel transportation costs instead of allocating it between business and personal days?

    a. The taxpayer will be overseas a minimum of two weeks.

    b. The taxpayer spends a minimum of 50% of his or her time on personal activities.

    c. The taxpayer arranged all parts of the trip.

    d. The taxpayer establishes that a personal vacation was not a consideration.

20. Assuming all other conditions are met, when would local lodging expenses be treated as ordinary and necessary business expenses under IRC Sec. 162(a)?

    a. The lodging is necessary for participation in a business function.

    b. The lodging does not extend over more than one week.

    c. The employee chooses to remain at the business activity for his or her convenience.

    d. The lodging is high end and something the employee wants to experience.

21. Under which circumstances can a taxpayer deduct travel expenses to temporary work locations?

    a. The taxpayer does not commute there for more than six months.

    b. The location is outside of the taxpayer's normal metropolitan area.

    c. The location is in a different industry than the taxpayer normally works and outside the normal metropolitan area.

    d. The taxpayer makes recurring visits no more than weekly to a temporary location.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Under what circumstances can a taxpayer deduct 100% of foreign travel transportation costs instead of allocating it between business and personal days? **(Page 99)**

    a. The taxpayer will be overseas a minimum of two weeks. [This answer is incorrect. To qualify for the allocation exception under the Code, the taxpayer must be outside of the U.S. for less than one week. By keeping a foreign business trip to seven consecutive days or less, 100% of transportation costs and 100% of other out-of-pocket costs for business days (subject to the 50% limit on meals and entertainment expenses) are deductible.]

    b. The taxpayer spends a minimum of 50% of his or her time on personal activities. [This answer is incorrect. Under the Code, there is an exception that applies if the taxpayer spends less than 25% of the total time on nonbusiness activities. For the 25% test, both the day of departure and the day of return are considered. Travel between U.S. points is not counted.]

    c. The taxpayer arranged all parts of the trip. [This answer is incorrect. To qualify for the exception, per the Code, the taxpayer can have *no* substantial control over arranging the trip. A taxpayer who travels for an employer under a reimbursement or travel allowance arrangement is not considered to have substantial control unless he is a managing executive or related to the employer.]

    d. **The taxpayer establishes that a personal vacation was not a consideration. [This answer is correct. According to the Code, one exception to the allocation requirement is met if the taxpayer establishes that a personal vacation was not a major consideration for the trip. This test applies even if the taxpayer is self-employed, related to the employer, a managing executive, or has substantial control in planning the trip.]**

20. Assuming all other conditions are met, when would local lodging expenses be treated as ordinary and necessary business expenses under IRC Sec. 162(a)? **(Page 101)**

    a. The lodging is necessary for participation in a business function. [This answer is correct. Under Reg. 1.162-32(b), one of the conditions for this to occur is that 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.]

    b. The lodging does not extend over more than one week. [This answer is incorrect. Per Reg. 1.162-32(b), the lodging must be for a period that does not exceed *five calendar days* and does not occur more frequently than once per calendar quarter.]

    c. The employee chooses to remain at the business activity for his or her convenience. [This answer is incorrect. As described in Reg. 1.162-32(b), in the case of an employee, the employer must require the employee to remain at the activity or function overnight.]

    d. The lodging is high end and something the employee wants to experience. [This answer is incorrect. To qualify, as outlined in Reg. 1.62-32(b), the lodging cannot be lavish or extravagant under the circumstances and cannot provide any significant element of personal pleasure, recreation, or benefit.]

21. Under which circumstances can a taxpayer deduct travel expenses to temporary work locations? **(Page 105)**

    a. The taxpayer does not commute there for more than six months. [This answer is incorrect. In regard to temporary work locations, the IRS considers this to mean one year or less; therefore, the commute can last longer than six months.]

    b. The location is outside of the taxpayer's normal metropolitan area. [This answer is correct. As described in the revenue rulings, when the location is a temporary work site outside the taxpayer's metropolitan area where she lives and normally works, the costs of traveling between the location and the taxpayer's residence are deductible. The taxpayer must normally work in the same metropolitan area where she lives in order to deduct transportation to temporary work sites outside that area.]

    c. The location is in a different industry than the taxpayer normally works and outside the normal metropolitan area. [This answer is incorrect. Per the revenue rulings, the expenses can be deducted when the location is a temporary work site in the *same* trade or business, regardless of distance or whether the site is inside or outside the residential metropolitan area, if the taxpayer has one or more regular work locations away from his residence.]

    d. The taxpayer makes recurring visits no more than weekly to a temporary location. [This answer is incorrect. An employee is considered to be traveling to a "temporary" work location when making recurring but infrequent or sporadic trips to a work location that is expected to extend over a year (e.g., quarterly trips to a managers' meeting). However, there must be an expectation that the employee will not work more than 35 days over the span of a year at that location, and the employee in fact meets this criteria.]

Lesson 6: Net Operating Losses

Introduction

A net operating loss (NOL) can result when deductible business expenses and losses (including items treated as business losses such as casualty, theft, and natural disaster losses) for the tax year exceed gross income. A taxpayer who has an NOL for regular income tax purposes might also have an NOL for alternative minimum tax (AMT) purposes. However, the NOL for AMT might not be the same as that for regular income tax purposes. An additional NOL calculation is needed to calculate the loss impact on the 3.8% NIIT (net investment income tax) for tax years beginning in 2013.

Generally, an NOL must be carried back to the second tax year preceding the loss year (there are also special three-year and five-year carryback rules). If it is not completely used in that earliest year, the unused amount is carried to the next tax year subsequent to the previous carryback year. The loss is carried back on either Form 1045 (Application for Tentative Refund) or Form 1040X. Additional information on filing the carryback claim is provided later in this lesson. If the NOL exceeds the taxable income in the year to which it is carried, the taxable income for that year must be modified to determine how much NOL remains for use in the next year in the carryback or carryover period. Any remaining loss at the end of the carryback period is carried forward. The carryforward period extends for 20 years. Any portion of the NOL not used by the end of that 20-year carryforward period is lost forever. A taxpayer may elect to forgo the carryback period and only carry the NOL forward, as discussed later in this lesson. Special computations are necessary when the taxpayer's filing status is not the same in the years to which an NOL is carried as it was in the year the NOL was generated.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the correct treatment of issues related to net operating losses (NOLs), including computing NOLs, recomputing NOLs in carryback years, applying for tentative refunds based on an NOL carryback, electing to forgo NOL carryback, and how NOL carryover and carryback rules are affected when filing status changes.

NOL Computation

General Rules

Because of the way NOLs are computed, two important points must be remembered when determining whether a taxpayer has incurred an NOL: (1) negative taxable income does not always result in an NOL, and (2) an NOL may exist even if there is positive adjusted gross income (AGI). Thus, practitioners should always perform an NOL computation before advising a client about the existence of an NOL or planning with respect to one.

The following items are deductible for purposes of taxable income, but not for the NOL computation. They must be added back to negative taxable income when computing the NOL generated in a tax year:

1. Personal exemptions.
2. NOL carryover from another year.
3. Excess of nonbusiness capital losses over nonbusiness capital gains.
4. Section 1202 exclusion (i.e., the exclusion for 50% to 100% of the gain realized on the sale of qualified small business stock.
5. Excess of nonbusiness deductions over nonbusiness income.
    a. Nonbusiness income includes the following:
        (1) Investment income (e.g., dividends, interest).

(2) Nonbusiness capital gains in excess of nonbusiness capital losses.

(3) Annuities.

(4) Oil and gas royalties.

b. Nonbusiness deductions that are not attributable to, or derived from, a taxpayer's trade or business. Nonbusiness deductions include the following (not an all-inclusive list):

(1) Alimony payments.

(2) IRA contributions.

(3) Contributions to a personal retirement plan (i.e., Keogh, SEP, or SIMPLE IRA) by a self-employed person.

(4) Student loan interest deduction.

(5) Tuition and fees deduction (if extended by legislation).

(6) Archer MSA deduction.

(7) Health Savings Account deduction.

(8) Nonbusiness itemized deductions including medical expenses, taxes, interest, and charitable contributions [does not include casualty or theft losses (including Ponzi-type investment losses), state income tax on trade and business income, or employee business expenses].

(9) The standard deduction for taxpayers who do not itemize.

(10) Other nonbusiness deductions as determined by the IRS.

6. Excess of business capital losses over the total of (a) business capital gains and (b) any nonbusiness capital gains remaining after reducing for nonbusiness capital losses and other nonbusiness deductions (i.e., the taxpayer cannot take a deduction for a net capital loss when computing the NOL). A net Section 1231 loss is treated as an ordinary business loss and thus is included in the NOL. However, Section 1231 gains may not offset the excess of nonbusiness capital losses over nonbusiness capital gains. Nonbusiness capital losses are not considered when computing NOL. For example, if an individual had a net Section 1231 gain of $100,000 and a nonbusiness capital loss of $70,000, the $100,000 of Section 1231 gain would be added back to the NOL computation (thus, reducing the NOL), whereas the nonbusiness capital loss of $70,000 would be disregarded. The Section 1231 gain of $100,000 and the nonbusiness capital loss of $70,000 cannot be combined for NOL purposes. The nonbusiness capital loss is unused for NOL purposes.

7. The Section 199 domestic production activities deduction.

The business or nonbusiness character of items passed through from a partnership is determined at the partnership level. Thus, a partner's share of partnership income (or loss) is business income (or loss) if it was incurred in the partnership's trade or business, or nonbusiness income (or loss) if it was not. According to IRS Pub. 536, "Net Operating Losses (NOLs) for Individuals, Estates, and Trusts," the same rule applies to items passed through from an S corporation.

Schedule A of Form 1045 provides a worksheet for computing an NOL.

Example 6A-1 Computing the 2017 NOL.

Ira and Karen Green's 2017 income tax information is shown below.

Wages—Karen		$ 21,000
Interest and dividend income		1,600
Schedule C loss from Ira's law practice		(45,000)
Capital gain from sale of stock held for investment	$ 4,000	
Capital loss on sale of business property (not a Section 1231 loss)	(500)	
Capital loss on sale of investment jewelry	(8,000)	(3,000)[a]
Section 1231 loss from sale of business equipment		(1,000)
Rental loss		(2,000)
Domestic production activities deduction[b]		(500)
Penalty on early withdrawal of savings		(100)
Alimony paid to Ira's ex-spouse		(1,100)
Adjusted gross income		(30,100)
Mortgage interest		(11,000)
Real estate tax on home		(4,000)
Personal exemptions		(8,100)
Taxable income		$ (53,200)

Notes:

[a] Excess of capital losses over capital gains is limited to $3,000.

[b] For purposes of this example, the adjusted gross income limitation has been disregarded. Net operating losses are not allocated or apportioned to domestic production gross receipts (DPGR), nor can the DPAP add to or create an NOL.

Their taxable income is a negative $53,200. Their 2017 NOL is $27,000. Excess nonbusiness capital losses are added back to taxable income when computing the NOL, but only to the extent of $3,000 (the limitation on the amount of capital losses that can be used to reduce ordinary income on the Form 1040). The NOL is attributable to the following items:

Wages	$ 21,000
Schedule C loss	(45,000)
Section 1231 loss	(1,000)
Rental loss	(2,000)
NOL	$ (27,000)

Net Investment Income Tax (NIIT) NOL

If the taxpayer has an NOL for regular tax, some or all of the NOL may also be allowed for NIIT. The portion of an NOL deduction for a taxable year that may be deducted for NIIT purposes (referred to as the *applicable portion*) is calculated by first determining the applicable portion of the NOL that is attributable to net investment income. The applicable portion of the NOL is the *lesser* of the—

1. NOL for NIIT [NOL for the loss year if only items of gross income that are used in determining NII and only properly allocable deductions are taken into account (i.e., computed using Form 1045, with only items of income, gain, loss, and deduction on Form 8960 for that year)], or

2. actual NOL for regular tax (i.e., calculated under IRC Sec. 172, rather than the Section 1411 NIIT rules).

Next, the amount of the NOL carried from each loss year and deductible in the tax year is multiplied by the following fraction:

$$\frac{\text{applicable portion of the NOL for the loss year (as determined in the prior paragraph)}}{\text{total NOL for the loss year}}$$

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 an NIIT deduction in the tax year, referred to as the *Section 1411 NOL amount*. The sum of the Section 1411 NOL amounts for each NOL carried to and deducted in the tax year, referred to as the total Section 1411 NOL amount, is the amount of the NOL deduction for the tax year properly allocable to net investment income.

Example 6A-2 Computing the Section 1411 NOL amount to reduce future net investment income.

Assume the same facts as in Example 6A-1 except that the taxpayers also have $50,000 of income from trading in financial instruments or commodities and $53,000 in deductions from this activity. The amount of the NOL that can be used to offset future net investment income (i.e., the applicable portion) is the lesser of (1) the actual NOL ($30,000) or (2) the $3,000 NOL determined with only the net investment income and deduction items ($53,000 − $50,000).

Thus, the applicable portion of the taxpayers' $30,000 NOL that may be applied against its future net investment income is $3,000. In future years, when the taxpayer uses the NOL to reduce taxable income, it will multiply the NOL by a ratio of 10.0% (the $3,000 applicable portion of NOL $30,000 total NOL for 2017).

The $30,000 NOL for regular tax is carried over to 2018, and the taxpayers have enough income to deduct $17,800 of the NOL for that year. The taxpayers can offset their net investment income in 2018 by their Section 1411 NOL of $1,780 ($17,800 × 10.0%). An NOL of $12,200 ($30,000 − $17,800), which includes a Section 1411 NOL amount of $1,220 ($12,200 × 10.0%), may be carried over to future years.

The Section 1411 NOL deduction is entered as a negative amount on line 7 of Form 8960 (Net Investment Income Tax—Individuals, Estates, and Trusts).

Carryback Period

Generally an NOL is carried back to the second tax year preceding the loss year. If it is not completely used in that year, the unused amount is carried to the tax year immediately preceding the loss year. Filing a carryback claim is discussed later in this lesson.

There are exceptions to the standard two-year carryback period that allow a three-year carryback (eligible losses), a five-year carryback (farming losses), or a 10-year carryback (specified liability losses). Some NOLs cannot be carried back [e.g., real estate investment trust (REIT) NOLs cannot be carried back to any year in which the trust qualifies as a REIT].(See the following discussions.)

Three-year Carryback for Eligible Losses. A three-year carryback period applies to the portion of an NOL attributable to an *eligible loss*. An *eligible loss* includes (1) losses of an individual arising from fire, storm, shipwreck, other casualty, or theft (including Ponzi-type scheme losses) and (2) losses incurred in federally declared disaster areas by (a) taxpayers engaged in the trade or business of farming [as defined in IRC Sec. 263A(e)(4)] and not eligible for the five-year carryback (see following paragraph), or (b) a taxpayer engaged in any trade or business whose average annual gross receipts for the three-tax-year period ending with the loss year is $5 million or less. The IRS periodically publishes a list of federally declared disaster areas. Also, see the Federal Emergency Management Agency's website at **www.fema.gov**. Eligible losses are treated like separate NOLs taken into account and carried back after the remaining portion of the NOL.

Five-year Carryback for Farming Losses. The carryback period of a portion of an NOL attributable to a farming loss is five years. A *farming loss* is the amount of the NOL attributed to income and deductions from farming businesses, as defined in IRC Sec. 263A(e)(4). Taxpayers can irrevocably elect under IRC Sec. 172(h)(3) to forgo the five-year carryback period, in which case the two-year carryback period applies or, if the loss is attributed to an eligible loss (as previously defined), a three-year carryback period applies. The election must be made by the due date (including extensions) of the return generating the farming loss. The election is made by attaching a statement to the return stating that the taxpayer elects to forgo the five-year carryback period and be subject to the two-year (or three-year) period. An NOL attributable to a farming loss is treated like a separate NOL and is taken into account after the remaining portion of the NOL for the tax year.

10-year Carryback for Specified Liability Losses. The carryback period for specified liability loss is 10 years. In general, a *specified liability loss* is a loss arising from a product liability or from an act occurring at least three years prior to the loss year that resulted in a liability. The 10-year carryback is only applicable to the specified liability loss portion of an NOL. The 10-year carryback may be waived in the same manner as the three- and five-year carryback periods discussed later in this lesson. See *PPC's 1120 Deskbook* for further discussion of specified liability losses.

Summary of Applicable Carryback Periods. Determining the applicable NOL carrybacks is complicated by the fact that a taxpayer's NOL may actually consist of two (or more) different NOL carryback periods, depending on items causing the NOL. For 2017 NOLs, the carryback periods for the different types of NOLs consist of the following:

	Carryback Period (Years)			
NOL Attributed to:	**2**	**3**	**5**	**10**
Regular (nonfarm) loss	X			
Nonfarm casualty or theft loss (eligible loss)		X		
Small business disaster loss (eligible loss)		X		
Farm disaster loss (eligible loss)		X	X[a]	
Farming loss	X		X[a]	
Specified liability loss				X

Note:

[a] The five-year carryback period applies first. A taxpayer that elects to forgo only the five-year carryback period becomes eligible for the two-year or three-year (if small business or farm disaster loss) carryback period. To only carry the NOL forward, a taxpayer must elect to forgo all carryback periods under IRC Sec. 172(b)(3). More information on the election to forgo an NOL carryback is provided later in this lesson.

Carryforward Period

Any remaining loss at the end of the carryback period is carried forward. The carryforward period extends up to 20 years. Any portion of the NOL not used by the end of the 20-year carryforward period expires.

Recomputing the NOL in Carryback Years

As more fully discussed below, there are two instances when a taxpayer's prior year AGI-based income and deductions are recomputed when dealing with NOL carrybacks. They are as follows:

1. *Recomputing Tax for the Carryback Year.* When the NOL is deducted in the carryback year, tax for that year is refigured by claiming the NOL as a deduction in arriving at AGI. AGI-based items of income and deduction as well as credits are then recomputed based on this lower amount of AGI and tax.

2. *Determining the Amount of NOL Remaining after Carryback.* After the NOL is deducted in a carryback year, the amount left for use in other tax years is determined by computing modified taxable income for the carryback year (also called the intervening year). Modified taxable income for the intervening year is essentially the taxable income as reported for that year *before* the current NOL carryback, but increased by adding back certain items.

Thus, the adjustments to AGI-based items differ primarily because in the first instance the NOL carryback deduction reduces AGI while in the second instance the NOL carryback deduction is not considered (although there are other adjustments made to AGI).

Recomputing Tax in the Carryback Year

When recomputing the tax liability for the tax year to which the NOL is carried back (i.e., the carryback year), tax items subject to percent-of-AGI or taxable income limitations are recomputed based on AGI (or taxable income) after the NOL deduction. Consequently, items that are deductible only to the extent that they exceed a certain percentage of AGI are increased for the recomputed items. However, this increase in deductions is beneficial only

to the extent that the carryback year's taxable income is not reduced below zero. If the taxable income for the carryback year is reduced below zero, the benefit of these increased deductions is lost in the calculation of the NOL remaining to be carried forward, which is based on AGI (or taxable income) without the NOL deduction.

The items that are recomputed based on the amount of AGI after the NOL carryback deduction (i.e., a lower AGI than reported before the NOL carryback) include the following:

1. Above-the-line items: rental real estate PAL loss allowance, taxable social security benefits, IRA deductions, student loan interest deduction, tuition deduction (if extended), excludable savings bond interest, and exclusion for employer-paid adoption assistance.

2. Itemized deductions: medical expenses, personal casualty and theft losses, mortgage insurance premiums, and miscellaneous itemized deductions.

3. Phase-out amounts: overall phase-out of itemized deductions, and the phase-out of the deduction for personal exemptions, *if applicable* for the carryback year.

4. Credits: child and dependent care credit, credit for elderly and disabled, education credits, child tax credit, adoption credit, saver's credit, and first-time homebuyer credit (if applicable).

See Example 6B-2 at the end of this discussion for an illustration of how these rules apply.

Determining NOL Remaining after Carryback

When an NOL carryback exceeds the taxable income of the year to which it is carried (i.e., carryback year), taxable income for that year must be modified to determine the amount of the NOL used in the carryback year and the amount remaining for carryback to the next preceding and all subsequent years. At this point, the carryback year is often referred to as an "intervening year" since it is now a tax year that has absorbed part of the NOL carryback. These modifications do not affect the taxable income or tax liability of the intervening year. They are made solely to determine the amount of the NOL carryback absorbed in that year.

Modified taxable income for the intervening year is determined by making the following adjustments to taxable income:

1. The NOL for the loss year or any tax year thereafter is not considered.

2. Capital losses cannot exceed capital gains (i.e., no net capital loss deduction is allowed).

3. The Section 1202 exclusion for gain on the sale of qualified small business stock is not allowed.

4. No deduction is allowed for personal exemptions.

5. The Section 199 domestic production activities deduction is not allowed.

In addition, AGI must be recomputed after adjustments 1, 2, 3, and 5 are made to redetermine any deduction based on AGI or subject to an AGI-percentage limitation. This includes both above-the-line amounts and itemized deductions. Above-the-line amounts include the taxable amount of social security benefits, the special $25,000 passive loss allowed for rental real estate activities, percentage depletion, IRA deductions, excludable savings bond interest, student loan interest deduction, tuition deduction (if extended), and exclusion for employer-paid adoption assistance. The following itemized deductions may need to be recomputed: (1) medical expense deductions; (2) charitable contributions; (3) miscellaneous itemized deductions; (4) casualty losses; and (5) the overall limitation on itemized deductions (if applicable for the year).

Under a special rule, the amount of a charitable contribution carryover that arises in a tax year to which an NOL is carried back does not increase because of the NOL carryback. Instead, the charitable contribution carryover is redetermined based on the modified taxable income computation used in determining the amount of NOL used in the carryback year.

Example 6B-1 Effect of NOL on charitable contribution carryovers.

Jay has AGI (computed without regard to any NOL deduction) of $50,000 for 2017. He also made cash contributions of $30,000 to 50% charities in 2017. During 2016, he generated an NOL carryforward of $50,000. Without the consideration of the NOL, Jay would be able to deduct contributions of $25,000 ($50,000 × 50%) in 2017. However, with the NOL deduction, Jay is unable to take a contribution deduction and has tentative excess contributions of $30,000.

In order to compute the NOL remaining to be carried forward to later years, Jay calculates his modified taxable income for 2017 by deducting the $25,000 charitable contribution. Once the $50,000 NOL carryforward is applied against the remaining $25,000 ($50,000 − $25,000) of taxable income for 2017, an NOL of $25,000 remains to be carried forward. Because the NOL from 2016 reduced Jay's 2017 AGI to zero, no contributions are deductible for the year. However, Jay will have a contribution carryforward of $5,000 ($30,000 reduced by excess contributions of $25,000), and an NOL carryforward of $25,000.

Example 6B-2 Effect of NOL carryback on deductions subject to AGI limitations.

Jerry Scott, a single taxpayer, sustained a $300,000 NOL in 2017, which he carries back two years. Jerry had no taxable income in 2015. Therefore, the 2017 NOL must be carried back to 2016. Jerry's 2016 taxable income before and after the NOL carryback is as follows:

	Before Carryback		After Carryback	
Salary		$ 100,000		$ 100,000
Schedule C income[a]		200,000		200,000
Interest and dividends		33,000		33,000
Capital loss		(3,000)		(3,000)
NOL carryback from 2017		—		(300,000)
AGI		330,000		30,000
Itemized deductions:				
Medical expenses[b]	—		$ 1,000	
Mortgage interest	$ 30,000		30,000	
Investment interest	15,000		15,000	
Real estate taxes	20,000		20,000	
Charitable contributions	15,000		15,000	
Miscellaneous deductions[c]	3,400		9,400	
3% AGI floor	(2,118)		—	
Total itemized deductions		(81,282)		(90,400)
Personal exemption		(1,701)		(4,050)
Taxable income (loss)		$ 247,017		$ (64,450)

Notes:

[a] For purposes of example, ignore self-employment tax.

[b] Total medical expense for the year was $4,000.

[c] Total miscellaneous deductions subject to the 2% of AGI floor for 2016 were $10,000.

How much of Jerry's 2017 NOL is remaining after the carryback to 2016?

Since Jerry's $300,000 NOL carryback exceeds his 2016 taxable income, taxable income must be modified as follows:

Salary		$ 100,000
Schedule C income		200,000
Interest and dividends		33,000
Capital loss (none allowed)		—
NOL carryback (none allowed)		—
Modified AGI		333,000
Itemized deductions:		
Medical expenses	—	
Mortgage interest	$ 30,000	
Investment interest	15,000	
Real estate taxes	20,000	
Charitable contributions	15,000	
Miscellaneous deductions	3,340	
3% AGI floor	(2,208,)	
Modified itemized deductions		(81,132)
Personal exemption (none allowed)		—
Modified taxable income		$ 251,868

The amount of 2017 NOL available to carryforward to 2018 is:

2017 NOL	$ 300,000
Amount utilized in 2015	—
Amount utilized in 2016	(251,868)
Amount available for carryforward to 2018	$ 48,132

This example illustrates the difference between recomputing itemized deductions for purposes of recalculating the *tax liability* in the carryback year versus the recalculation for computing *modified taxable income* to determine the amount of NOL used in the carryback year. Although the carryback of Jerry's 2017 NOL increased his 2016 itemized deductions by $9,118 ($90,400 − $81,282) for purposes of recalculating his 2016 tax liability, his itemized deductions were actually reduced by $150 ($81,282 − $81,132) for purposes of determining modified taxable income and the amount of NOL used in 2016. Thus, he received no benefit from the increased itemized deductions.

Applying for a Tentative Refund Based on an NOL Carryback

Administrative Consequences of Filing Form 1045

Either Form 1045 (Application For Tentative Refund) or Form 1040X can be used to carry back an NOL. The main advantage of using Form 1045 instead of 1040X for the carryback is that the IRS must act on a Form 1045 within 90 days from the later of (1) the date it is filed, or (2) the last day of the month in which the due date falls (including any extensions granted to the taxpayer) for filing the return for the year in which the NOL was generated. In addition, Form 1040X must be filed for each carryback year separately, but Form 1045 is used to apply the NOL to all carryback years.

In the 90-day period, the IRS may only check the computations, look for omissions and disallow the application if errors cannot be corrected within the 90-day period; it cannot look for new issues to raise with the taxpayer when reviewing a Form 1045. Later, however, the IRS can audit the return for the year of the loss. If it determines that the quick refund it previously allowed was unwarranted or excessive, it has several options. It can treat the excess refund as a mathematical error and immediately assess and collect the applicable tax under the authority of IRC Sec. 6213(b)(3), it can issue a Notice of Deficiency, or it can file suit against the taxpayer to collect the erroneous refund pursuant to IRC Sec. 7405(b).

A disadvantage in using Form 1045 is that, unlike Form 1040X, it must be filed within one year after the end of the year in which the NOL arose. For example, if the NOL was generated in 2017, Form 1045 must be filed by December

31, 2018. If Form 1045 is filed after that date, it will be returned by the IRS. In that case, the practitioner should file a Form 1040X to carry back the NOL. Under a special rule, the statute of limitations for filing a refund claim for an NOL carryback is three years from the date prescribed for filing the return (including extensions) for the tax year the NOL is generated. This rule is in place of the general statute of limitations for filing refund claims.

The standard NOL carryback period is two years, except for (1) the portion of an NOL attributable to casualty, theft, and certain disaster losses, which is three years or (2) the portion of an NOL attributable to certain business farming losses, which is five years. More information was provided earlier in this lesson.

The quick refund procedure results in a *tentative refund* because Form 1045 is not considered a claim for credit or refund. This means the taxpayer cannot file a refund suit in District Court or the Court of Federal Claims if the IRS disallows the quick refund request. Instead, the taxpayer must file a *regular* claim for refund (i.e., Form 1040X) subsequent to filing Form 1045. If the IRS then fails to act on the claim for refund within six months or disallows it, the taxpayer can file suit for refund.

General Filing Requirements

Form 1045 is filed with the IRS Service Center where the taxpayer's income tax return for the year of the loss was filed. The form must be filed after the taxpayer's return is filed (and thus is filed separately from the return).

Example 6C-1 Form 1045 reporting requirements.

Jason and Cynthia filed their joint 2017 Form 1040 on August 15, 2018. The return was properly extended and the following information was reported:

Wages—Cynthia	$ 25,000
Interest income	100
Dividend income	45
Capital gain from sale of stock	6,000
Capital loss from sale of stock	(2,000)
Schedule E loss from store in which Jason is a partner	(80,000)
Alimony payments to Jason's ex-spouse	(2,000)
Adjusted gross income	(52,855)
Home mortgage interest	(8,500)
Real estate taxes on home	(4,500)
Taxable income before exemptions	$ (65,855)

Jason materially participated in the operation of the store (the partnership) in 2017. Form 1045 would be used to compute and carryback of the 2017 NOL. Copies of the following should be attached to that form:

1. Pages 1 and 2 and Schedules A, D, and E of the 2017 Form 1040.
2. 2017 Schedule K-1 from the store.
3. 2017 Form 1040 extension request.
4. 2017 Form 6251 as well as Form 6251 for all carryback years.
5. 2017 Alternative Minimum Tax Net Operating Loss (AMTNOL) or Alternative Tax Net Operating Loss Deduction (ATNOLD) calculation.

Electing to Forgo an NOL Carryback

General Rules of the Election

For NOLs arising in 2017, the general carryback period is two years, although carryback periods of three, five, or 10 years apply to losses attributable to certain eligible losses and farm losses. Depending on the causes of a

taxpayer's NOL, it is possible that more than one carryback period applies. A taxpayer can elect to forgo the NOL carryback period or periods if more than one apply.

Although eligible losses and farming losses are treated as separate NOLs for purposes of determining the carryback period, IRC Sec. 172(c) defines an NOL as including all NOL deductions for a single tax year. Given that only one NOL may exist for any tax year, an election to forgo the carryback period under IRC Sec. 172(b)(3) applies to the entire NOL no matter the event giving rise to a portion of the NOL.

A taxpayer entitled to the two-year (regular NOLs), three-year (NOLs attributable to eligible losses), five-year (farming NOLs), or 10-year (NOLs attributable to product liability losses) carryback period can elect under IRC Sec. 172(b)(3) to waive the entire carryback period and only carry the loss forward. The five-year carryback period for NOLs attributable to farming losses can be waived independently, resulting in application of the two-year or three-year carryback period (for eligible losses) periods applying. Thus, a taxpayer wanting to only carry a farm loss NOL forward must also elect to waive both the five-year and applicable two-year or three-year NOL periods.

Example 6D-1 Electing to forgo NOL carryback periods.

Edward incurred a $50,000 NOL in 2017. $40,000 of the NOL is attributable to a farm loss, and the remaining $10,000 is attributable to a pass-through loss for a nonfarm activity he materially participates in. $40,000 of the NOL is eligible for a five-year carryback and the remaining $10,000 is eligible for a two-year carryback.

If Edward wants to waive the NOL carryback periods and carry the entire $50,000 NOL forward, he must elect to waive all carryback periods under IRC Sec. 172(b)(3). Alternatively, if Edward wants to forgo only the five-year carryback period, he would make an election under IRC Sec. 172(i)(3) to waive the five-year period applicable to the $40,000 farming loss. As a result, the two-year carryback period would apply to the entire $50,000 loss. Edward can make the election in a statement attached to his timely filed tax return (including extension).

The taxpayer must attach a separate election statement to the return for the year of the NOL in order to make a valid election. The election to forgo the carryback period must be made by the due date (including extensions) for filing the return for the loss year. If the return is timely filed, an automatic six-month extension period (from the original due date of the return, excluding extensions) for making the election is allowed under Reg. 301.9100-2(b) by filing an amended return with the election attached. An NOL caused by a disaster loss that is claimed in the year prior to the year in which it occurred [under IRC Sec. 165(i)] must be carried back. The election cannot be made on an amended return filed after the extended due date of the return even if the original return did not show a loss.

Once the election is made, it is generally irrevocable. However, according to Temp. Reg. 301.9100-12T(e)(1), the permanent regulations relating to this election (which have not yet been issued) will provide for revocation with the Commissioner's consent. No applications for consent to revoke will be accepted until the permanent regulations are issued.

When Should the Election Be Made?

Taxpayers should consider making the election if—

1. carryback of the NOL will offset all of the income in the year to which it is carried and free up tax credits that may be lost in part if carried forward,

2. they will be in a higher tax bracket in the carryover years than in the carryback years (after considering the time value of money),

3. the carryback of the NOL would cause the taxpayer to lose tax benefits (e.g., IRA deductions, personal exemptions, itemized deductions) in the carryback year,

4. the carryback of the NOL generates alternative minimum tax (AMT) in the year to which it is carried, or

5. the NOL is small and it is not practical or cost-effective to carry it back.

What Happens to NOL Carryover and Carryback Rules When Filing Status Changes

NOLs incurred in years the taxpayers were not married to each other can be applied only against the separate income of the spouse who generated the loss. In other words, an NOL sustained by one spouse before marriage cannot be carried over to offset the other spouse's income on a joint return; it can be applied only against the income of the spouse who incurred the loss. Losses incurred and carried back by a spouse after a divorce or the death of a spouse can only be applied against the separate income of the spouse who incurred the loss even if the taxpayers filed joint returns in the year to which the loss is carried.

Carryback of a Postdivorce NOL to a Predivorce Tax Year

The following five-step process is used to compute a taxpayer's refund from the carryover or carryback of an NOL generated in a year when the taxpayer was not married and carried to a year when the taxpayer was married. (Example 6E-1 is an example of these procedures.) Also, see "Community Property" later in this lesson.

Step 1 Compute the income and deductions that each spouse would have reported had a separate return been filed for the year to which the loss is being carried. Reduce the recomputed separate taxable income of the spouse generating the NOL (but not below zero) by the NOL carried to that year.

Step 2 Using the MFS rates, compute each spouse's tax on the separate income determined in Step 1.

Step 3 Combine the recomputed taxable income amounts from Step 1 and compute tax using MFJ rates. Allocate tax to each spouse based on relative recomputed tax from Step 2.

Step 4 Compute each spouse's contribution to the original joint tax return liability (sum of actual payments, including withholding and estimated tax payments, plus deemed payments).

Step 5 Subtract the Step 3 amount from the Step 4 amount for each spouse to determine each spouse's share of the refund.

Example 6E-1 Single taxpayer carrying an NOL to an earlier MFJ year.

Greg and Cindy were married in 1997; their divorce became final on January 1, 2016. They filed jointly for tax years 1997–2015. Losses sustained in his landscaping business caused Greg's 2017 Form 1040 to generate an NOL of $10,000. Greg does not elect to forgo the carryback period so he must carry the loss back to the joint 2015 tax return. Greg's refund, based on 2015 income tax return information, is computed as follows:

			Greg (Separate)	Cindy (Separate)	Total (Joint)
Step 1	2015 AGI		$ 22,000	$ 37,000	$ 59,000
	Deductions for property owned jointly				
	Home mortgage	$ 9,500			
	Real estate tax	4,500			
	Total	$ 14,000	(7,000)	(7,000)	(14,000)
	Exemptions		(4,000)	(4,000)	(8,000)
	Carryback of NOL (offsets Greg's income only)		(10,000)	—	(10,000)
	Recomputed taxable income		$ 1,000	$ 26,000	$ 27,000
Step 2	Total tax on recomputed taxable income using MFS rates[a]		$ 101	$ 3,443	

		Greg (Separate)	Cindy (Separate)	Total (Joint)
Step 3	Allocated share of recomputed joint tax liability:			
	Greg: [$101 ÷ ($101 + $3,443)] × $3,131[b]	$ 89		
	Cindy: [$3,443 ÷ ($101 + $3,443)] × $3,131[b]		$ 3,042	
Step 4	Greg's and Cindy's contributions to the original joint tax return liability	$ 1,377[c]	$ 3,254[c]	
Step 5	Greg's refund ($1,377 − $89)	$ 1,288		
	Cindy's potential refund ($3,254 − $3,042)		$ 212	

Notes:

[a] *Total tax* is the term used in IRS Pub. 536, "Net Operating Losses (NOLs) for Individuals, Estates, and Trusts," which presumably includes all taxes (e.g., regular tax, AMT, self-employment tax) less applicable credits.

[b] This is not the total of the spouses' separate return tax amounts. It is the tax on the recomputed taxable income of $27,000 using the 2015 MFJ rates.

[c] Given, as part of this example.

Cindy's refund is identified as *potential* because the carryback covers only Greg. If Cindy wants her refund, she will have to file her own carryback. To claim the refund, she must file an amended return (Form 1040X) or a tentative application for refund (Form 1045).

Guidance for carrying the NOL of a single taxpayer to a MFJ year is in Rev. Ruls. 60-216, 65-140, 80-6, 80-7, 85-70, and 87-52.

Carryback of a Joint Return NOL to a Premarital Tax Year

Two spouses might have filed a joint return for a year in which an NOL was generated, but filed separate returns in the NOL carryback period (or alternatively, elected to forgo the carryback period and carry the NOL to subsequent years in which they file separate returns). In these situations, their shares of the joint NOL must be computed individually to determine how much they can each report on their separate returns in the carryback or carryover years. To do this, each spouse's deductions must be compared with his or her gross income; the excess of deductions over income is their share of the joint NOL. The same procedures are applied to determine the other spouse's portion of the NOL. If either spouse's gross income exceeds that spouse's share of deductions, no part of the loss can be allocated to that spouse.

Example 6E-2 Married taxpayer carrying an NOL to an earlier single year.

Patricia and Glen married in 2017 and filed a joint return reporting the following information:

	Patricia	Glen	Total
Wages	$ 30,000	$ —	$ 30,000
Schedule C loss	—	(25,000)	(25,000)
Partnership business loss	(12,000)	—	(12,000)
Net rentals	(5,000)	(5,000)	(10,000)
Section 1231 loss	—	(2,000)	(2,000)
Total	$ 13,000	$ (32,000)	$ (19,000)

They did not elect to forgo the carryback period; thus, any available NOL from 2017 must be carried back to 2015 and forward. In each of those years, they filed as single taxpayers. How much NOL can Patricia and Glen each carry back to offset income on their prior years' returns?

Glen's $32,000 NOL is used first to offset Patricia's $13,000 income, leaving a joint NOL of $19,000 available for carryback. Because Patricia's gross income exceeds her deductions by $13,000, the entire $19,000 is allocable to Glen for carryback to his 2015 return.

Carryover of a Joint Return NOL to a Nonmarital Tax Year

When married taxpayers generate an NOL carryover in a joint return year and subsequently file separate returns due to death or divorce, the treatment of the carryover depends on who generated the NOL. If it was generated by either one of the spouses separately, the carryover is available only to the taxpayer who generated it. If an NOL was generated by each spouse, the carryover must be allocated among the taxpayers on the basis of the NOL generated by each. The same procedure would be followed as in Example 6E-2 to determine how much of the NOL (if any) should be allocated to each taxpayer. Differing rules may apply in community property states; see "Community Property" later in this lesson.

A surviving spouse can use an NOL carryover from a joint return year only to the extent it was generated by (or allocated to) the surviving spouse. Any NOL generated by (or allocated to) the deceased spouse that cannot be used on the decedent's final tax return expires—it is not available for use by the surviving spouse or by the decedent's estate.

Guidance for taxpayers whose marital status remains the same during the NOL year and NOL carryover years is in Reg. 1.172-7. If the taxpayers file jointly for all of the years, the NOL is treated as if the taxpayers were one individual. If the taxpayers file separately for all of the years, the NOL is treated as if the taxpayers were two separate individuals, and the NOL for one spouse cannot offset any income of the other spouse. Special rules apply, however, when the taxpayers file jointly in some years and separately in others.

Community Property. In community property states, the usual rules for computing separate taxable income of married taxpayers are: (1) earned income of either spouse is divided 50/50, (2) unearned income from separate property is either separate or community income, depending on the particular state's laws, (3) deductions paid out of community property are allocated 50/50, and (4) deductions paid out of separate property are allocated to the payer-spouse. The practitioner should review the laws for the state of domicile before preparing returns or carryback claims as the courts look to state law to make determination of who is entitled to the refund. The IRS has provided guidance for allocating refunds among spouses in the various community property states in Rev. Ruls. 2004-71, 2004-72, 2004-73, and 2004-74. In *Wynne*, the taxpayer was unable to substantiate that the business losses were separate property. Therefore, any benefit from the net operating loss carryback to a predivorce year was shared with her ex-spouse.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. Which of the following rules applies to net operating losses (NOLs)?

    a. NOLs arise when there is negative taxable income.

    b. NOLs cannot exist when there is positive adjusted gross income (AGI).

    c. Personal exemptions are added back to negative taxable income for computing NOLs.

    d. NOLs are not allowable deductions for the net investment income tax (NIIT).

23. Which of the following taxpayers should consider making the election to forgo NOL carryback?

    a. Roger will have alternative minimum tax (AMT) in the carryback year.

    b. Sarah's NOL carryback is too small to offset all of the carryback year's income.

    c. Tyrone was in a higher tax bracket during the carryback year.

    d. Valerie's deductions in the carryback year will not change because of the NOL.

24. Which of the following rules applies when carrying over a joint return NOL to a nonmarital tax year in a community property state?

    a. Earned income from each spouse is divided 60/40 in favor of the earning spouse.

    b. Unearned income from separate property is community income.

    c. Deductions paid out of community property should be allocated 50/50.

    d. Deductions paid out of separate property are allocated 50/50.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. Which of the following rules applies to net operating losses (NOLs)? **(Page 115)**

    a. NOLs arise when there is negative taxable income. [This answer is incorrect. One of the general rules to remember when dealing with NOLs is that negative taxable income does *not* always result in an NOL. Therefore, it is important to accurately perform the necessary NOL computations.]

    b. NOLs cannot exist when there is positive adjusted gross income (AGI). [This answer is incorrect. Because of the way NOLs are computed, there are two rules practitioners must remember when determining whether a taxpayer has incurred a NOL. One of those rules is that a NOL *may exist* even if there is positive AGI. Thus, practitioners should always perform an NOL computation before advising a client about the existence of a NOL or planning with respect to one.]

    c. Personal exemptions are added back to negative taxable income for computing NOLs. [This answer is correct. Certain items that are deductible for purposes of taxable income are not deductible for the NOL computation. Therefore, per the Code, they must be added back to negative taxable income when computing the NOL generated in a tax year. Examples of such items are personal exemptions, NOL carryover from another year, and the excess of nonbusiness capital losses over nonbusiness capital gains.]

    d. NOLs are not allowable deductions for the net investment income tax (NIIT). [This answer is incorrect. If the taxpayer has an NOL for regular tax, some or all of the NOL may also be allowed for NIIT. The portion of the NOL deduction for a taxable year that may be deducted for NIIT purposes is calculated by first determining the applicable portion of the NOL that is attributable to net investment income.]

23. Which of the following taxpayers should consider making the election to forgo NOL carryback? **(Page 123)**

    a. Roger will have alternative minimum tax (AMT) in the carryback year. [This answer is correct. One reason that the taxpayer might consider making the election to forgo NOL carryback is if carrying back the NOL generates AMT in the year to which it is carried. Since that has happened in this scenario, it would be a best practice for Roger to at least consider making this election.]

    b. Sarah's NOL carryback is too small to offset all of the carryback year's income. [This answer is incorrect. Taxpayers should consider making this election if carryback of the NOL will offset all of the income in the year to which it is carried and free up tax credits that may be lost in part if carried forward. Since that is not the case in this scenario, Sarah should not consider making the election.]

    c. Tyrone was in a higher tax bracket during the carryback year. [This answer is incorrect. It makes more sense for a taxpayer to consider making this election if they will be in a higher tax bracket in the carryover years than in the carryback years (after considering the time value of money). Since Tyrone was in a higher tax bracket in the carryback year, the election does not make as much sense for him based on this information.]

    d. Valerie's deductions in the carryback year will not change because of the NOL. [This answer is incorrect. If the carryback of the NOL would cause the taxpayer to lose tax benefits (e.g., IRA deductions, personal exemptions, itemized deductions) in the carryback year, the taxpayer should consider making the election. However, since this is not the case for Valerie, it may not be necessary for her to forgo NOL carryback.]

24. Which of the following rules applies when carrying over a joint return NOL to a nonmarital tax year in a community property state? **(Page 125)**

    a. Earned income from each spouse is divided 60/40 in favor of the earning spouse. [This answer is incorrect. The earned income of either spouse is divided 50/50.]

b. Unearned income from separate property is community income. [This answer is incorrect. Unearned income from separate property is either separate or community income, depending on the particular state's laws.]

c. Deductions paid out of community property should be allocated 50/50. [This answer is correct. In community property states, there are specific rules for computing separate taxable income of married taxpayers. One of those rules is that deductions paid out of community property are allocated 50/50.]

d. Deductions paid out of separate property are allocated 50/50. [This answer is incorrect. Deductions paid out of separate property are allocated to the payer-spouse.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 1—Business, Farm, and Rental (TDBTG171)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($89 for email or fax; $99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     TDBTG171 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price

for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **November 30, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 1—Business, Farm, and Rental (TDBTG171)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Activities not engaged in for profit are typically called what?

    a. Businesses.

    b. Hobbies.

    c. Rental activities.

    d. Trades.

2. Assuming all of the following expenses are related to a hobby, which expenses would be deducted first?

    a. Depreciation.

    b. Advertising.

    c. Insurance.

    d. Real estate taxes.

3. To meet the safe harbor for presuming an activity is a for-profit endeavor, it must generate a profit in how many years (ending with the tax year in question)?

    a. Two out of five.

    b. Three out of five.

    c. Four out of seven.

    d. Five out of seven.

4. What is usually the largest single cost that working interest owners incur on an oil or gas lease?

    a. Intangible drilling costs.

    b. Prepaid drilling costs.

    c. Depreciation costs.

    d. Depletion costs.

5. What is based on leasehold cost and calculated using mineral reserves and the number of units sold during the year?

    a. Depreciation.

    b. Depletion.

    c. Prepaid drilling costs.

    d. Intangible drilling costs.

6. Assuming all other qualifications are met, which of the following taxpayers would most likely be able to deduct his or her home office?

    a. Allison chooses to have a home office for days that she wants to work remote from the office furnished by her employer.

    b. Bryant uses his home office space on a continuous basis—every day he works unless he is on a business trip.

    c. Caroline uses her home office space both for work and for her jewelry-making hobby.

    d. Dominick performs business activities of minor importance at his home office.

7. The cost of surveying potential markets is classified as what?

    a. Preopening costs.

    b. Investigatory expenses.

    c. Administration costs.

    d. Unamortized start-up costs.

8. What happens when sole proprietors sell their businesses?

    a. It is treated as a single asset.

    b. Gains and losses are included in self-employment income.

    c. The character of gains and losses will depend on the nature of the asset.

    d. Income from a covenant not to compete is subject to self-employment tax.

9. Small employers who do not offer a group health insurance plan can reimburse individual employees for out-of-pocket medical costs up to what amount?

    a. $100 per day.

    b. $2,573 total.

    c. $4,950 total.

    d. $10,050 total.

10. Which of the following would be reported on Schedule F of Form 1040?

    a. Farm production rent when the recipient does not participate in the farming.

    b. Losses from the theft of farm property or casualties that occur to farm property.

    c. The sale of livestock that was held for breeding, sporting, dairy purposes, or draft.

    d. Cooperative (co-op) patronage dividends made to patrons.

11. Which of the following should farmers do when they take out a Commodity Credit Corporation (CCC) loan?

    a. Report the proceeds in the year received using the income method.

    b. Increase their tax basis in the crop for the amount of the loan.

    c. Realize a market gain if the price of the commodity has fallen by the repayment date.

    d. Report market gains as taxable income in the year following their receipt.

12. The cost of prepaid expenditures for fertilizer, lime, and other soil nutrients can be deducted currently if their benefits last how long?

    a. One year or less.

    b. One year or more.

    c. At least two years.

    d. A minimum of five years.

13. Patrick owns a cattle ranch and keeps his books using the cash basis. This year, due to flooding, Patrick was forced to sell his livestock earlier than normal. The sold livestock was not planned to be kept for dairy, breeding, or draft purposes. How might this affect Patrick's income taxes?

    a. Patrick will undergo an involuntary conversion if he replaces the livestock within two years.

    b. Patrick can elect to delay including income over last year's sale to the following tax year.

    c. Patrick is required to report the gain from selling this livestock in the current tax year.

    d. Patrick is eligible to apply for crop insurance to compensate for losses on the livestock.

14. Property used in a farm business is depreciated using what method?

    a. The straight-line method.

    b. The alternative depreciation system (ADS).

    c. The 150% declining balance method.

    d. The 200% declining balance MACRS method.

15. If a taxpayer uses the substantiation requirements of IRC Sec. 274(d) for a farm vehicle, any deduction or credit related to the vehicle can be calculated as if the vehicle's business use was what percentage?

    a. 25%.

    b. 50%.

    c. 75%.

    d. 100%.

16. Which of the following is one acceptable method for identifying a hedging transaction?

    a. Placing it into the general revenue account.

    b. Making notations on the books or records.

    c. Identifying them as of the end of the fiscal year.

    d. Separating them from the risk that is being hedged.

17. Which of the following **cannot** use income averaging for farming income?

    a. A sole proprietor.

    b. A partner.

    c. An S corporation shareholder.

    d. The beneficiary of an estate or trust.

18. If a farm loss is disallowed in the current year, can it be used in other years?

    a. Yes, farm losses can be carried back up to five years.

    b. Yes, farm losses can be carried forward up to one year.

    c. Yes, farm losses can be carried forward any number of years.

    d. No, farm losses can only be taken in the year they were incurred.

19. Mengmeng owns a beachfront property that he rents out for the majority of the year. He and his wife use the property for one week each spring. What is the most specific classification that applies to his property?

    a. Dwelling.

    b. Personal residence with very limited rental use.

    c. Vacation home with both rental and personal use.

    d. Rental property with very limited personal use.

20. Which of the following occurs if a vacation home is classified as a personal residence with very limited rental use?

    a. It is rented 15 or more days during the year.

    b. The taxpayer can deduct expenses on Schedule E.

    c. The taxpayer can deduct real estate taxes on Schedule A.

    d. The rental income is taxable and should be reported.

21. Which of the following rental expenses would be deducted last?

    a. Depreciation.

    b. Operating expenses.

    c. Casualty losses.

    d. Residential interest.

22. Which of the following occurs when a taxpayer's dwelling is considered a rental property (not a residence)?

    a. A special deduction is allowed for mortgage interest.

    b. Rental expenses will be limited to gross rental income from the property.

    c. Deductions are allocated to periods of personal use.

    d. The property is exempt from the hobby loss rules.

23. To exclude gain from the sale of a residence under Section 121, a taxpayer must have occupied it as his or her principle residence for how many of the last five years (at a minimum)?

    a. One.

    b. Two.

    c. Three.

    d. Four.

24. When a residence is converted to rental property, what is the taxpayer's basis in the property for depreciation?

    a. The lower of adjusted basis at conversion or the property's FMV at conversion.

    b. The original cost of the residence, plus capital improvements, minus depreciation.

    c. The lower of the residence's original cost or its FMV at conversion.

    d. The original cost of the residence plus its FMV at conversion.

25. When would the rules to a shared equity financing arrangement apply?

    a. A taxpayer rents property to a family member at a fair price.

    b. A taxpayer rents property to a family member at less than market value.

    c. A taxpayer makes a down payment to help his or her child purchase a residence.

    d. A taxpayer converts his or her residence into rental property.

26. What is the earliest date that the all events test can be met for an accrual basis taxpayer?

    a. The date that negotiations on a contract begin.

    b. The date a contract for the event has been executed.

    c. The date that the event fixing the liability occurs.

    d. The date that all the payments for the event have been made.

27. Generally, use of the accrual method of accounting is required under what circumstances?

    a. The taxpayer holds required inventory.

    b. The taxpayer has annual gross receipts of less than $1 million.

    c. The taxpayer has prepaid expenses.

    d. The taxpayer treats inventory as non-incidental materials and supplies.

28. Which of the following rules applies to accounting method changes?

    a. If an improper method is used, approval is not required to change to an appropriate method.

    b. As with the correction of an error, a change in accounting method is made using an amended return.

    c. In regards to depreciation methods, the taxpayer has two years instead of one before the method is considered elected.

    d. Only a taxpayer can initiate a change in accounting method; the IRS does not have this power.

29. When might the per diem method be used to account for and deduct travel expenses?

    a. The 50% disallowance rule would otherwise apply to the expenses.

    b. An employer does not have an employee reimbursement plan.

    c. The expense costs $75 or more.

    d. An individual is self-employed.

30. How do the 50% disallowance rules apply to business meals?

    a. They apply to all business meals under certain classifications regardless of purpose.

    b. They apply to all business meals (with certain exceptions) regardless of classification.

    c. They do not apply when lodging establishments include food in the room charge.

    d. They apply only after expenses for meals go over a previously selected per diem amount.

31. Can costs for an entertainment facility be deducted?

    a. No, deductions are not allowed for any entertainment expenses related to a facility.

    b. No, the entertainment facility cannot be deducted, but certain out-of-pocket costs for the entertainment can be.

    c. Yes, certain costs related to entertainment facilities, like maintenance, can be deducted, but other costs cannot be.

    d. Yes, all costs related to an entertainment facility can be deducted if there is a business reason for its use.

32. The following taxpayers are accompanied on business trips by their spouses. Which one can deduct his or her spouse's travel expenses?

    a. Jonathon's spouse stays in his room and eats all her meals with him.

    b. Kristy gets a discount for her spouse's ticket with frequent flier miles.

    c. Lola's spouse is an employee of her business and has functions on the trip.

    d. Mario's spouse meets him at the destination and does not stay the whole time.

33. What is the maximum amount a taxpayer can deduct per year when attending a convention on a cruise ship?

    a. $1,000.

    b. $2,000.

    c. $3,000.

    d. $5,000.

34. Which of the following statements accurately describes an individual's *tax home*?

    a. Generally, it is his or her regular or principle place of business.

    b. If elected, it can be considered the place where he or she lives.

    c. Itinerant workers can have multiple tax homes.

    d. Tax homes must be in the same geographic location as his or her home.

35. Can taxpayers deduct expenses related to commuting from home to their regular places of business?

    a. Yes, such expenses are deductible in full.

    b. Yes, up to 50% of such expenses can be deducted.

    c. Yes, they can be deducted if specific conditions are met.

    d. No, deductions for such expenses are generally disallowed.

36. Generally, deductions for tickets to entertainment events are subject to what limitation?

    a. 25% of face value.

    b. 50% of face value.

    c. Face value.

    d. Face value plus travel expenses.

37. Which of the following adjustments must be made to determine the modified taxable income for an intervening year (carryback year)?

    a. The NOL for the loss year must be considered in that year and all other appropriate tax years.

    b. Capital gains in the intervening year cannot exceed capital losses.

    c. Section 1202 exclusion gain on the sale of qualified small business stock is only allowed under specific circumstances.

    d. Neither personal exemptions or the Section 199 domestic production activities deduction is allowed.

38. What is the main advantage of filing Form 1045 to carry back an NOL instead of filing Form 1040X?

    a. It is filed for each carryback year separately.

    b. The IRS must act on it within 90 days.

    c. It allows the IRS to look at new issues.

    d. It exempts the taxpayer from future IRS audits for the year of the loss.

39. What is the general carryback period of an NOL that arises in 2017?

    a. One year.

    b. Two years.

    c. Three years.

    d. Five years.

40. Charles sustains an NOL in 2018. In 2018, he is single; however, in the carryforward year of 2019, Charles is married to Rosa and they file a joint return. Whose income can be offset by the 2018 NOL?

    a. Just Charles.

    b. Just Rosa.

    c. Charles and Rosa equally.

    d. Charles, and then Rosa if there is any of the NOL left.

GLOSSARY

Applicable portion: The portion of a *net operating loss (NOL)* for a taxable year that may be deducted from the net investment income tax (NIIT) purposes.

Commissioned merchant: A seller of goods who takes title of goods without taking actual possession and whose profit is based on the 5% commission or trade discount allowed by the manufacturer.

Cooperative patronage dividends: Distributions of profits to patrons made by a cooperative.

Crop Revenue Coverage (CRC): Insurance available to farmers that covers losses caused by weather and casualty events, as well as revenue losses caused by low price or low yield.

Dry holes: Nonproductive wells.

Elected farm income: When using income averaging, this is the portion of the taxable income for the tax year that is (1) attributable to any farming business, including a farming business conducted via a partnership or an S corporation, and (2) specified in the taxpayer's averaging election.

Eligible loss: In relation to an *NOL*, this includes (1) losses of an individual arising from fire, storm, shipwreck, other casualty, or theft (including Ponzi-type scheme losses) and (2) losses incurred in federally declared disaster areas by (a) taxpayers engaged in the trade or business of *farming* and not eligible for the five-year carryback or (b) a taxpayer engaged in any trade or business whose average annual gross receipts for the three-tax-year period ending with the loss year is $5 million or less.

Entertainment facility: Any property (personal or real) owned or rented and used for entertainment (e.g., yachts, hunting lodges, hotel suites, vacation homes).

Farming: The business of farming includes (1) raising and harvesting crops; (2) raising, shearing, feeding, caring for, training, and managing animals; (3) operating a nursery or sod farm; (4) raising or harvesting trees bearing fruit, nuts, or other crops; and (5) raising ornamental trees.

Farming loss: The amount of an *NOL* attributed to income and deductions from farming businesses, as defined in IRC Sec. 263A(e)(4).

Farm-related taxpayer: A person (or family member) whose principle residence is on a farm or whose principal occupation is farming.

Hedging transaction: A transaction entered into in the normal course of a taxpayer's business primarily to reduce the risk of (1) price changes or currency fluctuations on *ordinary property* that the taxpayer holds or will hold or (2) interest rate or price changes or currency fluctuations on the taxpayer's ordinary obligations.

Hobby: An activity not engaged in for profit, including activities other than those for which deductions are allowable under IRC Sec. 162 or 212.

Intangible drilling costs (IDC): Any cost incurred that in itself has no salvage value and is incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas, such as wages, fuel, repairs, hauling, and supplies.

Itinerant: A person who travels from place to place with no tax home and no allowed travel deductions.

Local transportation costs: Costs incurred when traveling to work locations (either within or outside the taxpayer's *metropolitan area*) that do not require an overnight stay away from home.

Market: In relation to inventory value, this is the current bid price or replacement cost at the date of inventory.

Metropolitan area: The city limits of a particular city and its surrounding suburbs. It must be less than an entire state.

Net operating loss (NOL): This occurs when deductible business expenses and losses (including items treated as business losses such as casualty, theft, and natural disaster losses) for the tax year exceed gross income. NOLs can be carried backward or forward according to the applicable rules.

Ordinary property: Property that, when sold or exchanged, cannot produce a capital gain or loss.

Personal residence with very limited rental use: A *residence* that is rented for fewer than 15 days during the year.

Per-unit retain allocation: An amount paid to patrons for products marketed for them. It is a fixed amount without regard to the co-op's net earnings and is paid in cash, property, or qualified or nonqualified certificates.

Regular place of business: Any location where the taxpayer works or performs services on a regular basis.

Rental property with very limited personal use: Property rented during the year and personal use that does not exceed the greater of 14 days or 10% of rental days.

Residence: Under IRC Sec. 280A, this is defined as a dwelling unit and includes a house, apartment, condominium, mobile home, boat, or similar property. This can also be called a *dwelling*.

Specified liability loss: A loss arising from a product liability or from an act occurring at least three years prior to the loss year that resulted in the liability.

Tax home: An individual's regular or principal (if more than one regular) place of business, or, if the individual has no regular or principal place of business because of the nature of the trade or business, the individual's regular place of abode in the real and substantial sense. Having a tax home is important for calculating travel deductions.

Total tax: Per IRS Pub. 536, this is a term for all taxes (e.g., regular tax, AMT, self-employment tax) less applicable credits.

Turnkey contract: A contract for oil or gas property under which the drilling operator agrees to supply everything and do all the work necessary to complete the well, place it in production, and turn it over ready to turn the key and start the oil flowing into the tanks.

Vacation home with both rental and personal use: Property with (1) personal use that exceeds the greater of 14 days or 10% of rental days and (2) rental use that exceeds 14 days.

Working interest in oil or gas property: This occurs when there is lease agreement between the landowner and the working interest owner. It is also called an operating interest. The landowner agrees to lease the land and assign the rights to the minerals underneath to the working interest owner, and a portion (usually one-sixth or one-eight) of the minerals produced belong to the landowner. The owner of the working interest assumes the burden of developing and operating the property.

INDEX

A

ACCOUNTING METHODS
- Accrual method
  - •• Generally . . . 73
- Cash method
  - •• Benefits of . . . 76
  - •• Dividends . . . 73
  - •• Generally . . . 73
  - •• Interest coupons . . . 73
  - •• Inventory, small business exceptions . . . 76
  - •• Notes given . . . 73
  - •• Notes received . . . 73
  - •• Prepaid expenses . . . 73
  - •• Restricted stock . . . 73
- Changing . . . 76, 80
- Farming
  - •• Deferring crop and livestock income . . . 34
  - •• Prepaid farming expenses . . . 32
  - •• Reporting CCC loans . . . 31
  - •• Uniform capitalization . . . 39
- Installment method
- Intangibles . . . 80
- Inventories . . . 76
- Prepaid expenses
  - •• Farming . . . 32
- Tangible property . . . 80
- Uniform capitalization
  - •• Farming operations, application to . . . 39

ALTERNATIVE MINIMUM TAX
- Depletion . . . 11
- Elections
  - •• Forgo NOL carryback period . . . 123
- Intangible drilling costs (IDC) . . . 11

AMORTIZATION
- Elections to amortize
  - •• Start-up expenditures . . . 20

B

BASIS
- Residence converted to rental use . . . 65

BUSINESS ASSETS
- Sale or purchase of
  - •• Oil and gas property . . . 11
  - •• Sole proprietorship, disposition . . . 23

BUSINESS INCOME AND EXPENSES
- Hobby, distinguishing from . . . 5
- Home office . . . 13
- Start-up costs . . . 20

C

CARRYBACK AND CARRYOVER
- Charitable contributions . . . 119
- Depletion . . . 11
- Home office deduction . . . 13
- NOL
  - •• Application for tentative refund-Form 1045 . . . 122
  - •• Carryback and carryforward periods . . . 115
  - •• Carryback following a divorce or death of spouse . . . 125
  - •• Charitable contribution carryover, effect on . . . 119
  - •• Computation of . . . 115
  - •• Election to forgo carryback . . . 123
  - •• Filing status changes . . . 125
  - •• Recomputations in carryback years . . . 119
  - •• Utilization of carryback . . . 119
  - •• Utilization of carryforward . . . 119
- Rental expenses . . . 53

CASUALTY AND THEFT LOSSES
- Personal
  - •• NOL carryback period . . . 115

CHARITABLE CONTRIBUTIONS
- NOL carryback, effect on carryover of . . . 119

CLOSELY HELD CORPORATION
- Property rented to . . . 67

CLUB DUES . . . 93

CONSTRUCTIVE RECEIPT
- Cash-basis taxpayer . . . 73
- Rental income . . . 67

COVENANTS NOT TO COMPETE
- Disposition of business . . . 23

D

DAY CARE FACILITIES
- Business use of home . . . 13

DEPLETION
- Alternative minimum tax (AMT), effect of . . . 11
- Calculation of . . . 11
- Percentage depletion, limitations on . . . 11

DEPRECIATION
- Farm property . . . 39
- Oil and gas working interest . . . 11
- Recapture . . . 23
- Residence converted to rental use . . . 65
- Residence, portion converted to home office . . . 13
- Short-year depreciation . . . 23
- Vacation home . . . 53

DISASTER AREA
- Federally declared disaster area . . . 123

DIVORCE
- Net operating losses, effect on . . . 125

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION
- Farming co-op, allocable share . . . 29
- Net operating loss, effect on . . . 115

E

ELECTIONS
- Agriculture
  - •• CCC loans, to include in income . . . 31
  - •• Crop insurance proceeds, defer income from . . . 34
  - •• Disaster payments, defer income from . . . 34
  - •• Income averaging . . . 43
  - •• UNICAP, elect out of . . . 39
- Amortization
  - •• Start-up expenditures . . . 20
- Hobby activity, postpone determination . . . 5
- Natural resources
  - •• Deduct dry hole . . . 11
  - •• Deduct intangible drilling costs (IDC) . . . 11
- Net operating loss, forgo carryback period . . . 123
- Prepaid expenses, electing out of 12-month rule . . . 73
- Restricted property, receipt treated as current compensation . . . 73

EMPLOYEES
- Employer expense reimbursements
  - •• Leased employees . . . 91
  - •• Per diem arrangements . . . 87
- Foreign travel . . . 99
- Home office deduction . . . 13
- Local transportation . . . 105

ENTERTAINMENT FACILITIES . . . 93

F

FARMERS AND RANCHERS
- Expenses
  - •• Fertilizer 32

FARMING
- CCC loans 31
- Commodity hedging transactions 40
- Crop insurance 34
- Crop-share lease
  - •• Material participation in 42
  - •• Rental income from 42
- Depreciation of farm property 39
- Disaster income, weather conditions 34
- Domestic production activities deduction, share from co-op 29
- Income averaging 43
- Losses
  - •• Limitation on deductibility 46
- NOL
  - •• Special carryback period 115
- Patronage dividends 29
- Per-unit retains 29
- Prepaid farming expenses 32
- Uniform capitalization rules, plants and animals 39
- Vehicles, substantiation of farm use 40

FILING STATUS
- NOL, effect on 125

G

GIFTS
- Business, tickets given as 107

H

HOBBY LOSSES
- Active trade or business, distinguished from 5
- Election to postpone determination of whether activity is a hobby 5
- Ordering rules for claiming deductions 5
- Rental property with personal use 53
- Safe harbor rule 5
- Temporary rental of residence 63
- Vacation homes 53

HOME OFFICE DEDUCTIONS
- Benefits of use 13
- Computing depreciation when residence converted 13
- Limits on deductions 13
- Local transportation costs, effect on 105
- Qualifying as home office 13
- Reduced gain exclusion 13
- Safe harbor 13

I

INTANGIBLE ASSETS
- Covenant not to compete 23

INTANGIBLE DRILLING COSTS (IDC)
- Alternative minimum tax, effect of 11
- Election to deduct 11
- Expense or capitalize 11

INTEREST AND DIVIDEND INCOME
- Cash-method taxpayer 73
- Constructive receipt 73

INTEREST EXPENSE
- Residence
  - •• Vacation home 53
- Timeshares 68

INVENTORY
- Accrual method requirement 76
- Gross receipts de minimis exception 76
- Materials and supplies, treating as 76
- Small business accounting exceptions 76
- Storage, home office 13
- Valuation 76

ITEMIZED DEDUCTIONS
- Net operating loss, recompute for carryback of 119

K

KIDDIE TAX
- Farm income averaging, impact 43

L

LOCAL TRANSPORTATION
- Commuting expenses, nondeductibility of 105
- Home office, effect on deductibility of 105
- Temporary work locations 105

LOSSES
- Business investigation costs 20
- Hobby 5

M

MARITAL STATUS
- Change in, effect on
  - •• NOL carryovers, carrybacks 125

MEALS AND ENTERTAINMENT
- Business requirement in 87
- Employee reimbursements 87
- Limitation on 91
- Substantiation 87

MISCELLANEOUS ITEMIZED DEDUCTIONS
- Hobby activity expenses 5

N

NET INVESTMENT INCOME TAX (3.8% NIIT)
- NOL carryback and carryforward periods 115

NET OPERATING LOSSES
- Allocation between spouses 125
- Application for tentative refund—Form 1045 122
- Carryback and carryforward periods 115
- Carryback, application for tentative refund 122
- Charitable contribution carryover, effect on 119
- Computation of 115
- Divorce or death of spouse, effect on carryover 125
- Election to forgo carryback 123
- Filing status, effect on 125
- Marital status, effect of 125
- Net investment income tax (NIIT) NOL 115
- Recomputations in carryback years 119
- Utilization of 119

O

OIL AND GAS PROPERTY
- Depletion 11
- Depreciation 11
- Dry hole, election to expense 11
- Intangible drilling costs 11
- Marginal production property 11
- Prepaid drilling costs 11
- Working interest 11

P

PASSIVE ACTIVITIES
- Crop-share arrangement 42

- Rental activities
  - •• Residence 53

PER DIEM RATES 87

PREPAID EXPENSES
- General rule 73
- Twelve-month rule 73
  - •• Election out of 73

PROPRIETORSHIPS
- Business investigation and start-up costs 20
- Disposition of business 23
- Hobby versus trade or business 5
- Home office deductions 13
- Inventory 76
- Oil and gas working interests 11
- Prepaid expenses and cash method of accounting 73

RECAPTURE
- Depletion 11
- Intangible drilling costs (IDC) 11
- Section 179 deduction
- Sole proprietorship, disposition of 23

REFUNDS AND RECOVERIES
- NOL carryback—Form 1045 122

RELATED PARTIES
- Rental of residence to 67
- Rental of vacation home to 53

RENTAL PROPERTY
- Crop sharing 42
- Fair rental, definition of 53
- Personal use of 53
- Related business, rented to 67
- Relative, rented to 67
- Residence
  - •• Conversion to rental 65
  - •• Family farm corporations 67
  - •• Portion of residence rented 63
  - •• Rented and used personally 53
  - •• Temporary rental of residence held for sale 63, 65
- Shared equity financing agreement 67
- Timeshares 68
- Vacation homes 53

RESIDENCE
- Defined 53
- Home office deductions 13
- Nonqualified use 63
- Reduced gain exclusion 13
- Rental of
  - •• Conversion to 65
  - •• Personal use 53
  - •• Portion of 63
  - •• Relative 53, 67
  - •• Temporary 63
- Sale
  - •• Temporary rental before sale 63, 65
- Vacation home 53

RESTRICTED PROPERTY
- Election to treat receipt as current compensation 73

S

SECURITIES TRANSACTIONS
- Commodity hedging transactions 40
- Restricted property 73

SELF-EMPLOYMENT (SE) TAX
- Net earnings from self-employment
  - •• Crop shares 42
  - •• Farmer's 42

START-UP COSTS
- Business expansion, distinguished from 20
- Consequences of failure to elect 20
- Election to amortize 20
- Identification of start-up costs 20

TAX HOME
- Determination of 101

TIMESHARES
- Rental of 68

TRAVEL AND ENTERTAINMENT
- Athletic events, tickets to 107
- Away from home 101
- Charitable events 107
- Club dues 93
- Conventions, outside North America 99
- Corporate condo 93
- Employee expenses and reimbursements 87
- Entertainment expenses 91
- Entertainment facilities 93
- Excess allowances 87
- Foreign travel 99
- High/low method 87
- Limitation on meal and entertainment expenses 87, 91
- Local lodging expenses 101
- Local transportation costs 105
- Luxury water travel 99
- Meals–general 87, 91
- Meals–statistical sampling for substantiation 91
- Per diem rates 87
- Saturday night stay 101
- Skybox rental 107
- Spouse accompanying taxpayer 94
- Substantiation 87
- Tax home 101
- Temporary, away from home 101
- Temporary, local transportation 105
- Transportation industry workers 87

V

VACATION HOME
- Conversion to rental property 53
- Expense carryforward 53
- Ordering rules for deductions 53
- Rental 53
- Timeshares 68

VEHICLES AND LISTED PROPERTY
- Local transportation costs 105
- Substantiation of vehicle usage
  - •• Farm usage 40

W

WAGES AND SALARIES
- Restricted stock 73

WORKSHEETS
- Net operating loss
  - •• Carryback, divorce or death of spouse 125
  - •• Carryback, utilization of 119
  - •• Computation of 115

COMPANION TO PPC'S 1040 DESKBOOK

COURSE 2

PENSION AND RETIREMENT INCOME, OTHER ITEMS OF INCOME, AND ADJUSTMENTS TO INCOME (TDBTG172)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides relevant information regarding retirement income, Form 1040, and adjusted gross income (AGI). Lesson 1covers the taxation of pension and retirement income (including social security benefits and the minimum distribution rules for IRAs and qualified plans). Lesson 2 covers a variety of Form 1040 reporting issues and gross income topics. Lesson 3 focuses specifically on contributions (and their deductibility) to traditional individual retirement accounts (IRAs).

PUBLICATION/REVISION DATE: November 2017

RECOMMENDED FOR: Users of *PPC's 1040 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of and experience with preparation of Form 1040

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

IRS Enrolled Agents (EA) and Non-Credentialed Return Preparers (NCRP): This course is designed to enhance professional knowledge for IRS EAs and IRS NCRPs. Checkpoint Learning is an IRS Continuing Education Provider that is approved to deliver continuing education to IRS Enrolled Agents and IRS Non-Credentialed Return Preparers.

CTEC CREDIT: 8 CTEC Federal Tax Law Hours

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

IRS NCRP CREDIT: 8 Federal Tax Law Hours

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **November 30, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Pension and Retirement Income

Completion of this lesson will enable you to:

- Recognize how to calculate taxable social security benefits, and identify how Roth and traditional IRAs are distributed and converted.
- Determine how qualified retirement plans and IRA distributions are rolled over, and how distributions from SIMPLE IRA plans, the required minimum distribution rules (RMD) for retirement accounts, and distributions from commercial variable annuities are made.

Lesson 2—Other Items of Income

Completion of this lesson will enable you to:

- Determine when the recapture of excess alimony payments are required, how to report ministers' housing allowance, and how to exclude personal injury awards form gross income.
- Determine how to report refunds of itemized deductions under the tax benefit rule, how distributions are made from health savings accounts, and how to receive life insurance proceeds before death.
- Identify education savings accounts (ESAs), qualified tuition programs, and selected other income items.

Lesson 3—Adjustments to Income

Completion of this lesson will enable you to:

- Identify contributions to traditional and Roth IRAs, how self-employed taxpayers can adopt qualified retirement plan and simplified employee pensions (SEP) deductions for self-employed taxpayers, self-employed health insurance deduction, and how employers should establish SIMPLE IRA plans.
- Recognize the difference between alimony and nondeductible payments, how to deduct interest paid on education loans, tuition and fees, educator's expense, and contributions to health savings accounts (HSAs).

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Lesson 1: Pension and Retirement Income

Introduction

This lesson covers the taxation of pension and retirement income (including social security benefits and the required minimum distribution rules for IRAs and qualified plans).

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize how to calculate taxable social security benefits, and identify how Roth and traditional IRAs are distributed and converted.
- Determine how qualified retirement plans and IRA distributions are rolled over, and how distributions from SIMPLE IRA plans, the required minimum distribution rules (RMD) for retirement accounts, and distributions from commercial variable annuities are made.

Calculating Taxable Social Security Benefits

General Rules

Taxpayers may have to include up to 85% of social security benefits (paid because of retirement, survivorship, or disability) in taxable income. The amount of benefits includable in income depends on the taxpayer's provisional income. *Provisional income* is the taxpayer's modified adjusted gross income (MAGI) plus half of the social security benefits. MAGI is AGI before any inclusion of taxable social security benefits, plus tax exempt interest income and amounts excluded from gross income under IRC Sec. 135 (interest from Series EE and I bonds used to pay college expenses), IRC Sec. 137 (employer-provided adoption assistance, IRC Sec. 911 (foreign earned income and housing costs exclusion, IRC Sec. 931 (income from certain U.S. possessions), and IRC Sec. 933 (income from Puerto Rico). In addition, the Section 221 deduction for student loan interest, Section 222 deduction for qualified tuition and related expenses (if extended), and Section 199 deduction for domestic producers are added back in computing MAGI.

None of the taxpayer's social security benefits are included in income if provisional income does not exceed the following base amounts:

1. $25,000, if single, head of household, qualifying widow, or married but filing a separate return and the taxpayer did not live with spouse at any time during the year.

2. $32,000, if married filing a joint return.

3. Zero, if married but filing a separate return and the taxpayer lived with spouse at any time during the year.

Up to 50% of social security benefits are included in gross income when the taxpayer's provisional income exceeds the previous base amounts but is less than the adjusted base amounts. Up to 85% of social security benefits are included in income if provisional income exceeds the adjusted base amounts. The adjusted base amounts are as follows:

1. $34,000, if single, head of household, qualifying widow, or married but filing a separate return and the taxpayer did not live with spouse at any time during the year.

2. $44,000, if married filing a joint return.

3. Zero, if married but filing a separate return and the taxpayer lived with spouse at any time during the year.

Withholding on Benefits. Social security recipients can request that income tax be withheld from their benefit payments. Withholding is voluntary and can be initiated by completing IRS Form W-4V (Voluntary Withholding

Request), requesting to have 7%, 10%, 15%, or 25% withheld for federal income tax, and submitting the form to the recipient's local social security office. Voluntary withholding can be stopped by completing a new Form W-4V.

Lump-sum Social Security Payments

Generally, a lump-sum (or retroactive) payment of social security benefits (shown on either Form SSA-1099 or Form RRB-1099) is included in the taxpayer's total benefits in the year received. However, if some or all of the payment pertains to a prior year, the taxpayer can elect to determine the taxable portion of the payment for the earlier year based on the prior year's income and rates if it lowers the taxpayer's overall tax liability. Any benefits taxable under this election are added to current-year taxable benefits and included in the current year's return.

Example 1A-1 Determining the taxable portion of lump-sum payments.

In 2017, Irma received a lump-sum social security payment of $10,000, $4,000 of which was attributable to 2016. Irma's 2017 provisional AGI is such that 85% of her social security benefits are included in her taxable income. In 2016, only 50% of any social security benefits she received would have been included in income.

Without an election, $8,500 ($10,000 × 85%) of benefits will be included in Irma's 2017 gross income. However, Irma can elect to include the 2016 benefits in 2017 income only to the extent they would have been taxable based on the 2016 facts and law. If Irma makes this election, she will include only $7,100 [($6,000 × 85%) + ($4,000 × 50%)] of benefits in her 2017 income.

To make the election, Irma should report $7,100 on line 20b of her Form 1040 (the full $10,000 should be reported on line 20a). She should also enter "LSE" to the left of line 20a. The election, once made, is revocable only with IRS consent.

Repayment of Social Security Benefits

Taxpayers receiving social security benefits before they reach full benefit retirement (FBR) age are subject to limits on the amount of earned income they can have. This limit, if exceeded, can reduce the amount of their benefits.

When benefits are reduced because of excess earnings, taxpayers sometimes have to repay amounts they previously received. When this occurs, the amount of current year benefits subject to tax is reduced for the repaid amounts. However, benefits received in one year cannot be reduced by repayments in a later year when computing the taxable amount for the year they were originally received, even though the amount of the repayment cannot be determined until after year end (*Zavatto*). Thus, taxpayers might pay tax on social security benefits that they subsequently must repay because of excess earnings.

Example 1A-2 Repayment of benefits subsequent to year-end.

Tom began receiving social security benefits in 2016 at age 62 even though he continued to work part-time. He receives $8,000 of benefits in 2016. In early 2017, Tom submits to the Social Security Administration information concerning his 2016 earnings and because he exceeded the allowable amount of earned income, he is told he must repay $3,000 of his 2016 benefits. He does this in 2017.

For 2016 Tom must include the entire $8,000 of social security benefits when computing the taxable amount, even though he repays $3,000 of the benefits in 2017. The $3,000 repayment reduces the amount of Tom's 2017 benefits when computing the taxable amount for 2017.

Interaction of Taxable Social Security Benefits with IRA Deduction

The deductibility of an IRA contribution and the taxability of social security benefits both depend on the level of the taxpayer's AGI. Therefore, when a social security recipient's IRA deduction is limited because the taxpayer was a participant in a qualified retirement plan, special calculations must be made.

The procedure for calculating both the IRA deduction phase-out and the taxable amount of social security benefits can be summarized as follows:

Step 1 Ignoring any possible IRA deduction, compute a hypothetical AGI to determine tentative taxable social security benefits.

Step 2 Compute the maximum allowable IRA deduction using the hypothetical AGI from Step 1, including tentative taxable social security benefits. This amount is the actual IRA deduction for the year.

Step 3 Compute the final social security benefits subject to tax by taking into account the actual IRA deduction from Step 2.

Example 1A-3 Impact of IRA deduction on taxable social security benefits.

Clyde is single and age 65. He has investment income of $11,000 and wages of $42,875. Clyde is an active participant in a qualified retirement plan during the year. He also received $10,000 of social security benefits and makes a $6,500 traditional IRA contribution for 2017. Clyde's allowable IRA deduction and the amount of his taxable social security benefits are computed as follows:

Step 1 Determine hypothetical AGI by computing taxable social security benefits without regard to the IRA deduction, $8,500 (see computation that follows).

Step 2 Compute allowable IRA deduction based on hypothetical AGI of $62,375 ($53,875 + $8,500). Because AGI is more than $62,000 but less than $72,000, the deduction for the $6,500 IRA contribution is limited to $6,260.

Step 3 Recompute the taxable amount of social security benefits taking into account the $6,260 IRA deduction, $8,500 (see computation that follows).

	No IRA Contribution	$6,260 IRA Deduction
1. Enter social security (or Tier 1 railroad retirement) benefits received during the year.	$ 10,000	$ 10,000
2. Enter 50% of the amount on line 1.	5,000	5,000
3. Enter AGI before inclusion of taxable social security benefits.	53,875	47,615
4. Enter tax-exempt interest, etc.	—	—
5. Provisional income. Add lines 2, 3, and 4.	58,875	52,615
6. Enter $25,000 (because Clyde is single).	25,000	25,000
7. Subtract line 6 from line 5.	33,875	27,615
8. Enter 50% of the amount on line 7.	16,938	13,808
9. Enter $4,500 (because Clyde is single).	4,500	4,500
10. Enter the smaller of line 2, line 8, or line 9.	4,500	4,500
11. Enter $34,000 (because Clyde is single).	34,000	34,000
12. Subtract line 11 from line 5.	24,875	18,615
13. Enter 85% of line 12.	21,144	15,823
14. Add lines 10 and 13.	25,644	20,323
15. Enter 85% of line 1.	8,500	8,500
16. Taxable social security benefits. Enter the smaller of line 14 or line 15.	$ 8,500	$ 8,500

Clyde receives a $6,260 deduction for the $6,500 IRA contribution (the remaining $240 is a nondeductible contribution). The $6,260 deduction does not, in this case, reduce the amount of taxable social security benefits. Thus, the overall impact to Clyde's AGI because of the $6,500 IRA contribution is $6,260, which is a net tax savings of $1,565 (assuming Clyde is in the 25% tax rate bracket). Although it did not do so for Clyde, in some situations the IRA deduction will also reduce the amount of taxable social security benefits, thus further reducing AGI and generating a greater tax benefit.

Distributions from Traditional IRAs

Only Deductible Contributions Made to Traditional IRAs

If a taxpayer has made only deductible contributions to traditional IRAs, the individual has no basis in any of his or her IRAs. With no accumulated basis, all traditional IRA distributions (whether from contributions or earnings) are fully taxable as ordinary income. However, if the spouse receives IRA distributions due to forging the distribution request and the endorsement on the check, and the taxpayer did not benefit from the distribution, the taxpayer will not be considered the distributee and is not subject to tax on the distributions.

Nondeductible Contributions Made to Traditional IRAs

A taxpayer who makes nondeductible contributions to a traditional (versus Roth) IRA acquires tax basis in the IRA. Therefore, a portion of the distributions will be a nontaxable return of basis. Unfortunately, the taxpayer is not allowed to withdraw the nondeductible portion (basis) before withdrawing amounts includable as taxable income. Accordingly, each distribution will have both a nontaxable and a taxable component. Any portion of an IRA distribution that is taxable is treated as ordinary income.

The nontaxable portion of current-year traditional IRA distributions is calculated as follows:

$$\frac{\text{Total nondeductible contributions}}{\begin{array}{l}\text{FMV of all traditional IRA}\\ \text{account balances at year-end}\\ + \text{ Amount distributed during year}\\ + \text{ Outstanding rollover}^{a}\end{array}} \times \text{Traditional IRA distributions} = \text{Nontaxable portion of traditional IRA distributions}$$

Note:

[a] Outstanding rollover means any amounts distributed before year-end but rolled into another IRA in the following year under the 60-day rollover rule.

When calculating the amount of nontaxable distributions, the total fair market value (FMV) of all the individual's traditional IRAs (including SEP IRAs, SIMPLE IRAs, and IRAs containing funds rolled over from a qualified plan, but not Roth IRAs) must be included in the fraction's denominator. The taxpayer cannot use only the IRA from which the distributions were received. The FMV of all IRAs at year-end includes both realized and unrealized appreciation of IRA assets.

Example 1B-1 Calculating nontaxable portion of IRA distributions.

Tommy, age 60, has two traditional IRAs, one at National Bank and the other at State Bank. He has made $3,000 of contributions (all were deductible) to the National Bank IRA and $5,000 (none were deductible) to the State Bank IRA. During 2017, he took a $4,000 distribution from the State Bank IRA. As of December 31, 2017, the FMV of the National Bank IRA was $9,000 and the FMV of the State Bank IRA was $3,000 (after reduction by his $4,000 distribution). What is the nontaxable portion of Tommy's 2017 distribution?

Although all of Tommy's 2017 distribution was from the State Bank IRA (to which only nondeductible contributions were made), both traditional IRAs must be included in the calculation. Thus, the nontaxable portion of his distribution is calculated as follows:

$$\frac{\$5{,}000}{\$9{,}000 + \$3{,}000 + \$4{,}000} \times \$4{,}000 = \$1{,}250$$

Accordingly, $1,250 of the distribution is a tax-free return of basis; the remaining $2,750 is taxable income. Part 1 of Form 8606 (Nondeductible IRAs) is completed to show the taxable amount of Tommy's distribution.

Recognizing a Loss. A taxpayer may recognize a loss only in the year an IRA is liquidated if the account's unrecovered basis exceeds the value of the liquidating distribution (IRS Notice 89-25). Loss can be recognized only when *all* amounts in *all* of the taxpayer's traditional IRAs or *all* of the taxpayer's Roth IRAs have been distributed, and total distributions are less than the remaining basis in the accounts (IRS Notice 87-16). Per IRS Pub. 590, the deductible loss (excess of remaining tax basis over liquidating distribution) should be reported on Schedule A as an itemized deduction subject to the 2%-of-AGI floor. Also, the loss is not deductible for AMT purposes.

Distributions from Roth IRAs

A Roth IRA is simply an IRA designated as a Roth IRA when it is opened. Taxpayers make nondeductible contributions to Roth IRAs and, if certain conditions are met, receive tax-free distributions. Except as provided by IRC Sec. 408A, all the rules that apply to traditional IRAs apply to Roth IRAs.

This section focuses on the rules for distributions from Roth IRAs.

Taxation of Distributions

Taxation of a Roth IRA distribution depends on whether it is a *qualified* or *nonqualified* distribution. However, a taxpayer's basis in a Roth IRA may always be withdrawn tax-free because these contributions were not deductible. Distributions are reported in Part III of Form 8606 (Nondeductible IRAs).

Qualified Distributions from Roth IRAs Are Nontaxable. *Qualified distributions* from Roth IRAs are not taxable (and not subject to the 10% penalty tax on early withdrawals). A qualified distribution is one that is received after the five-year period beginning with the first tax year for which a contribution is made to a Roth IRA and is either:

1. made on or after the date the account owner turns age 59$^1/_2$,
2. made to the account owner's beneficiary (or estate) due to his death,
3. attributable to the account owner's being disabled, or
4. made to pay qualified first-time home purchase expenses, up to a lifetime maximum of $10,000.

Each taxpayer has only one five-year period for all of the Roth IRAs owned. The five-year period for determining a qualified distribution from a Roth IRA begins on the earlier of (1) the first day of the individual's tax year for which the first regular contribution is made to any Roth IRA or (2) the first day of the individual's tax year in which the first conversion contribution is made to any Roth IRA of the individual. Thus, it is normally advantageous for taxpayers to make their first Roth IRA contribution as soon as possible, even if it is only a small amount, to begin the running of the five-year period. A contribution for the year can be made as late as the tax return due date, without extensions [generally, April 15th (April 17th for 2017 returns)].

Example 1C-1 Determining five-year period for qualified distributions.

Steve, age 60, made an initial contribution of $2,000 to his Roth IRA in March 2013 for the 2012 tax year. A year later he made another $2,000 contribution to the same Roth IRA. On January 3, 2017, he withdraws the entire $7,400 balance (representing two contributions of $2,000 each plus $3,400 of earnings). Steve's withdrawal is entirely free from federal income tax because it was taken after the five-year period beginning with January 1 of the first tax year (2012) for which a contribution was made and Steve was at least age 59$^1/_2$ at the time of the withdrawal.

Nonqualified Distributions from a Roth IRA. Withdrawals from a Roth IRA that are not qualified distributions are includable in income to the extent attributable to earnings. However, Roth IRA distributions are treated first as a return of contributions, and all of an individual's Roth IRAs are treated as a single Roth IRA. Contributions include amounts converted (rolled over) from traditional IRAs, but these conversion contributions are considered only after regular annual Roth IRA contributions. Further, distributions of converted amounts are considered to be withdrawn on a FIFO basis.

Example 1C-2 Tax-free withdrawal of principal from a Roth IRA.

George was age 50 when he set up two Roth IRA accounts in 2015. He contributed $1,000 to each account that year and $1,000 to each in 2016 and 2017, so he made total contributions to each account of $3,000. On July 10, 2017, he has $4,500 in Account One and $4,000 in Account Two. He withdraws all $4,500 from Account One. The distribution is not a qualified distribution because George is not yet age 59½ and the five-year rule has not been met. Even though the distribution is from Account One, which has $3,000 of principal and $1,500 of earnings, the withdrawal is considered to come first from George's $6,000 of regular annual Roth IRA contributions, so the entire withdrawal is tax-free and penalty-free. George will file Form 8606 with his 2017 Form 1040 to reflect the distribution and show that it is completely offset by his basis.

Example 1C-3 Qualified and nonqualified distributions.

Ann is age 50 and has a Roth IRA with a basis of $4,000 and a total value of $9,500 (i.e., $5,500 of earnings). Assume the five-year period for qualifying distributions has been met. Ann withdraws the entire $9,500 to buy a first-time residence. How is the distribution taxed?

Because Ann has met the five-year rule and the portion of the $5,500 earnings distribution was used for a first-time home purchase (and is less than the $10,000 limit), the earnings portion of the distribution is a qualified distribution. Thus, the entire distribution is tax-free and penalty-free.

Variation: Assume Ann used the Roth IRA withdrawal to pay her daughter's college education costs. Here, $4,000 of the distribution is a return of contributions so that amount is tax-free and penalty-free. The $5,500 of earnings is a nonqualified distribution subject to income tax. However, because the funds were used for college costs, and this is an exception to the 10% early withdrawal penalty, Ann is not liable for the 10% penalty on the $5,500 taxable amount.

Application of Required Minimum Distribution Rule

Pre-death Distributions. The required minimum distribution (RMD) rules do not apply to Roth IRAs as long as the account owner is alive. Thus, a taxpayer is not required to take RMDs from a Roth IRA, so there is no requirement that distributions begin in the year following the year the taxpayer turns age 70½.

Post-death Distributions. Once the Roth IRA owner dies, the required minimum distribution rules for inherited traditional IRAs apply to the beneficiary(ies) using the rules that apply when the owner died before his or her required beginning date. Thus, nonspouse beneficiaries normally must receive the entire balance in the account within five years of the year of the owner's death, or if possible, over the beneficiary's life expectancy beginning no later than the end of the calendar year following the year of the owner's death. Spouse beneficiaries can elect to treat the Roth IRA as their own or roll it into their own Roth IRAs. Alternatively, a surviving spouse can also choose to delay distributions until the decedent would have attained age 70½.

For purposes of determining whether distributions received from an inherited Roth IRA meet the required five-year period for qualifying distributions, the five-year period is not redetermined following the owner's death. As a result, the period the Roth IRA is held in the name of a beneficiary, or in the name of a surviving spouse who treats the decedent's Roth IRA as his or her own, includes the period it was held by the decedent. The five-year period for a Roth IRA inherited by a beneficiary of a deceased Roth IRA owner is determined independently of the five-year period for the beneficiary's own Roth IRAs. The only exception is for a surviving spouse who elects to treat an inherited Roth IRA as his or her own Roth IRA. Here, the requisite five-year period for distributions from the inherited Roth IRA is deemed to end on the earlier of either the end of the five-year period for the decedent or the five-year period applicable to the surviving spouse's own Roth IRAs.

When a Roth IRA owner dies before the end of the five-year period required for qualifying distributions, the owner's contributions to the account are allocated to beneficiaries on a prorata basis.

Example 1C-4 Owner's contributions allocated among beneficiaries.

Albert died in 2017 leaving his Roth IRA account equally to his four children. At his death, the Roth IRA contained a $2,000 regular contribution, a $3,000 conversion contribution made more than five years earlier,

and earnings of $4,000. Thus, each child is allocated $500 of the regular contribution and $750 of the conversion contribution. Therefore, the first $1,250 distributed to each child will always be tax-free because it is treated as a tax-free and penalty-free return of contributions.

Example 1C-5 Beneficiary receives nonqualified distribution from inherited Roth IRA.

Assume the same basic facts as Example 1C-4, except the five-year rule has not been met. Each of Albert's beneficiaries receives a $2,250 distribution from the Roth IRA. The distribution consists of $500 of regular contribution, $750 of conversion contribution, and $1,000 of earnings. The $1,000 of earnings is taxable because it is a nonqualified distribution. However, there is no 10% penalty on either the $1,000 of earnings or the $750 conversion contribution (potentially subject to penalty since five years have not passed since the conversion—see following discussion) because the distribution was made after the account owner's death, which is one of the exceptions to the 10% penalty tax.

Distributions Following Roth IRA Conversions

Eligible taxpayers can convert traditional IRA funds to a Roth IRA. Distributions of funds that occur anytime after a taxpayer makes a conversion are subject to ordering rules that consider the taxpayer's regular annual Roth IRA contributions as well as Roth conversion contributions. These ordering rules can impact the taxability of a distribution.

Any amount distributed from an individual's Roth IRA is treated as made in the following order, determined as of the end of the tax year—

1. from regular annual contributions (including rollover contributions from other Roth IRAs and designated Roth accounts);

2. from conversion contributions (other than Roth rollover contributions), on a first-in-first-out (FIFO) basis; and

3. from earnings.

Distributions from a particular conversion contribution are treated as made first from the portion, if any, that was includable in gross income as a result of the conversion. Thus, a distribution attributable to the taxable portion of a particular conversion contribution may be subject to the 10% premature distribution penalty tax if the distribution is made during the five-year period beginning with January 1 of the year of that particular conversion contribution, unless one of the exceptions to the 10% penalty applies. If the individual's five-year holding period for Roth IRA distributions has already begun, the conversion of a regular IRA into a Roth IRA will not start a new five-year period because each Roth IRA owner has only one five-year period for all Roth IRAs for which he or she is the owner.

Roth IRA Rollovers

Distributions from a Roth IRA may be rolled over tax-free (and penalty-free) into another Roth IRA under the same rollover rules that apply to traditional IRAs.

Employees can make elective salary deferral contributions to designated Roth accounts if the employer provides such a retirement plan option [also called a Roth 401(k) feature]. Thus, eligible Roth IRA rollovers will include rollovers from these accounts into regular Roth IRAs.

Converting Traditional IRAs into Roth IRAs

If certain conditions are met, all or any part of a deductible or nondeductible traditional IRA balance can be rolled over (or converted) into a Roth IRA. Taxpayers recognize taxable income at the time of the conversion, but future benefits of the Roth IRA include nontaxable distributions, contributions that can continue past age 70$^1/_2$, and no age 70$^1/_2$ required minimum distributions rules, among others. An individual, including a taxpayer that is married filing separately, can convert a traditional IRA to a Roth IRA regardless of his or her modified adjusted gross income.

Conversion Requirements

Rollover Mechanics. An amount can be converted from a traditional IRA [or SEP IRA or SIMPLE IRA (after participating in the SIMPLE for at least two years)] to a Roth IRA by any of three methods: (1) a distribution from a traditional IRA is contributed (rolled over) to a Roth IRA within 60 days after the distribution; (2) a trustee-to-trustee transfer from a traditional IRA to the Roth IRA; or (3) a transfer of the amount in a traditional IRA to a Roth IRA maintained by the same trustee. A rollover applies to the tax year in which the rollover commences (i.e., the year the amount is withdrawn from the traditional IRA).

Tax Consequences of Conversion

A taxpayer who rolls over or converts a traditional IRA to a Roth IRA must include in gross income for the year the distribution or transfer from the traditional IRA occurs any prior deductible contributions and all the IRA earnings allocable to the converted amount. The 10% premature distribution penalty that applies to certain IRA distributions does not apply to these converted amounts. However, if distributions are made from the Roth IRA within five years of the conversion, the 10% early distribution penalty may apply to the distribution even if the distribution is not otherwise taxable. The five-year holding period for this purpose begins with the tax year in which the conversion is made.

Deductible and Nondeductible Contributions. When a taxpayer has traditional IRAs with both deductible and nondeductible contributions, taxable income from a conversion of less than all of the IRA balances is determined under the normal IRA distribution rules. Thus, under IRC Sec. 408(d)(2), all of the taxpayer's IRAs (and all the basis in those IRAs) are combined to determine the tax effect of the distribution. Although a taxpayer with both deductible and nondeductible IRAs may choose to convert only the nondeductible IRA to a Roth IRA, all his IRAs must be combined when computing income from the conversion.

Example 1D-1 Converting IRAs including nondeductible contributions.

Over an 11-year period, Tyler made $2,000 annual nondeductible contributions to IRA 1. Thus, he has a total basis in IRA 1 of $22,000 ($2,000 × 11). He also has IRA 2, which he established with a rollover of taxable dollars from his former employer's 401(k) plan. The value of each IRA is $50,000 for a combined value of $100,000. If Tyler elects to convert both IRAs into one or more Roth IRAs, only $78,000 ($100,000 value less $22,000 basis) is taxable.

Variation: If Tyler chooses to convert only IRA 1 into a Roth IRA, his basis must be spread among all IRA accounts. Thus, even though IRA 1 actually contained all of the nondeductible contributions, only $11,000 [($22,000 ÷ $100,000) × $50,000] of basis is allocated to that account. Thus, Tyler recognizes $39,000 ($50,000 − $11,000) of income from the conversion, which exceeds the $28,000 of earnings ($50,000 value less $22,000 nondeductible contributions) that actually accumulated in IRA 1.

Reversing a Rollover or Conversion

A taxpayer who converts a traditional IRA to a Roth IRA can undo all or part of the conversion by doing a trustee-to-trustee transfer of the funds from the Roth IRA to a traditional IRA no later than the due date, including the six-month extension, for the return for the year the conversion originally occurred. (The IRS refers to this as a *recharacterization* of the contribution to the Roth IRA.) Recharacterizing the contribution no later than the extended due date of the return (generally October 15) is available regardless of whether the taxpayer actually extends his tax return, as long as the return is timely filed. The transfer to the traditional IRA is treated as if it were the original recipient of the rollover, so the tax consequences of the initial conversion to the Roth IRA are avoided (i.e., the taxpayer does not recognize the income that would have been recognized with the initial Roth conversion). The transfer must include the earnings allocable to the converted amount.

Example 1D-2 Using recharacterization for post-year-end tax planning.

Jesse is a partner is Iconographic, LLP. In June 2017, Iconographic informs the partners of an large upcoming loss, of which Jesse's share will be sufficient to create a large net operating loss (NOL). Jesse was in a low income tax bracket in both 2015 and 2016, so an NOL carryback will not be beneficial to him. He decides to convert his traditional IRA into a Roth IRA. The expected partnership loss will be enough to offset any income from the conversion. The conversion is completed in August 2017.

In December 2017, Jesse receives word that the partnership loss will not actually occur until 2018. The Roth IRA conversion will now cause a large tax liability for 2017. Jesse can recharacterize the conversion at any time before October 15, 2018. Then, 30 days after the recharacterization, he can again convert the traditional IRA into a Roth IRA to offset the 2018 loss from Icongraphic.

Calculating Net Income on the Conversion Contributions. When less than the entire IRA is recharacterized, the earnings (or loss) attributable to the recharacterized amount is calculated by considering only the net income or loss that accrues during the period the Roth IRA actually holds the conversion contribution. The formula is as follows:

$$\text{Allocable Income or Loss} = \text{Contribution} \times \frac{\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance}}{\text{Adjusted Opening Balance}}$$

The *adjusted opening balance* is the FMV of the Roth IRA at the beginning of the computation period plus any contributions (including the conversion contribution) made during the computation period. The *adjusted closing balance* is the FMV of the Roth IRA at the end of the computation period plus any withdrawals taken from the IRA during the computation period. The *computation period* is the period beginning immediately before the contribution being recharacterized was made to the Roth IRA and ending immediately before that contribution is withdrawn.

Reporting a Recharacterization of a Roth Conversion. Before reversing a conversion, an individual must notify the trustees of both IRAs involved in the recharacterization that he or she has elected to treat the contribution (rollover) as having been made to the second, instead of the first, IRA for income tax purposes. Taxpayers will receive several information returns when a conversion is recharacterized. Pursuant to IRS Notice 2000-30, the trustee of the first IRA will report prior year recharacterizations on Form 1099-R, coded with Code R in Box 7, while same year recharacterizations will be coded with code, N, in Box 7. The trustee of the second IRA reports the gross amount received in a recharacterization (contributions plus earnings) on Form 5498. Taxpayers must attach a statement to their Form 1040 explaining the details of the recharacterization.

Example 1D-3 Reversing a Roth IRA conversion because of a stock market drop.

In January 2017, James takes a $50,000 distribution from a traditional IRA [that was originally funded by a rollover contribution from a 401(k) plan]. In February 2017, he rolls the $50,000 into a Roth IRA. He has until the due date (including extensions) of his 2017 income tax return to decide if he wants to undo the transaction.

James decides to extend his 2017 return in April 2018. In September 2018, the market falls dramatically and the value of James' Roth IRA conversion account (that was worth $50,000 when he originally converted) drops to $30,000. To avoid paying tax on the $20,000 of value he no longer has, James elects to undo his Roth IRA conversion. Thus, using a trustee-to-trustee transfer, he moves the $30,000 in the Roth IRA (this value already includes the earnings) to a traditional IRA account. If the transfer to a traditional IRA occurs by the due date (including extensions) of his 2017 return, the Roth IRA conversion is treated as never occurring.

Example 1D-4 Reversing an IRA conversion on an amended return.

Assume the same facts as in Example 1D-3, except that James does not extend his 2017 return and files his return on or before April 17, 2018. Under Reg. 301.9100-2, James may file an amended return on or before October 15, 2018, to reverse his IRA conversion.

Reconversions after a Recharacterization. There may be instances when a taxpayer who completes a Roth IRA conversion finds it advantageous to undo the conversion and later reconvert the amount back to Roth IRA status. For example, if the value of the taxpayer's Roth IRA falls dramatically following the conversion (e.g., due to a significant downturn in the stock market), undoing the conversion will avoid paying tax based on the higher value at the time of the conversion. The funds can then be converted back to a Roth IRA, but taxable income triggered by this reconversion will be based on the reduced value of the IRA account and taxed in the year such reconversion occurs. However, an individual who converts a traditional IRA to a Roth IRA, and then undoes the conversion, cannot then reconvert the traditional IRA to a Roth IRA until the later of—

1. the beginning of the tax year following the year of the original Roth conversion, or

2. the end of the 30-day period beginning on the day the original conversion was recharacterized (i.e., the day the Roth IRA was converted back to a traditional IRA).

Example 1D-5 Applying the Roth IRA reconversion rules.

James converts his traditional IRA to a Roth IRA in 2017. After a significant drop in the value of the account, James then recharacterizes the Roth IRA back to a traditional IRA on January 25, 2018. Under the regulations, he cannot then reconvert the traditional IRA back to a Roth IRA until February 24, 2018.

Failed Reconversions. Reconversions that are made outside of the timeframe outlined in the immediately preceding paragraph are treated as failed conversions. A failed conversion is treated as a taxable distribution from the traditional IRA [and possibly subject to the early withdrawal penalty tax unless one of the exceptions in IRC Sec. 72(t) applies] followed by a regular annual contribution to the Roth IRA. To the extent it exceeds the annual contribution limit, the amount treated as a regular contribution to the Roth IRA is treated as an excess contribution subject to the 6% excise tax of IRC Sec. 4973(a).

However, the IRS has indicated that if the failed reconversion is due to an innocent mistake or fraud victimizing the taxpayer, the assets may still be converted back into a traditional IRA. In each instance, the taxpayer either was not aware of the reconversion rules, or relied on a financial institution or other professional adviser. Each taxpayer took immediate action to correct the reconversion and ask the IRS for relief prior to the IRS contacting the taxpayer regarding the failed reconversion.

Simplified Methods for Taxing Annuity Payments from Qualified Plans

A qualified plan participant who makes nondeductible (or nonexculdible) contributions obtains a tax basis (or cost) in the plan. Technically, this basis is called the taxpayer's investment in the contract. Because the taxpayer previously paid income taxes on his investment in the contract, the law provides a series of formulas for the participant to exclude from gross income a portion of his investment (basis) in the plan.

There are two simplified methods for calculating the return of basis in an annuity: the first for annuities starting after November 18, 1996, the second for annuities beginning before November 19, 1996 (but after July 1, 1986).

Rolling Over Qualified Retirement Plan and IRA Distributions

Rolling Over Distributions from Qualified Retirement Plans

In general, a distribution from a qualified plan (less any nondeductible employee contributions) is fully taxable as ordinary income in the year received. (It may also be subject to the 10% premature distribution tax if the taxpayer is under age 59$^1/_2$). However, any distribution from a qualified plan meeting the definition of an eligible rollover distribution can be rolled over (in whole or in part) into an eligible retirement plan. Also, a nontaxable-distribution (although it is not an eligible rollover distribution) can be rolled over in a trustee-to-trustee transfer to a traditional IRA or, under certain circumstances, a qualified plan.

The rollover must occur within 60 days after the funds are received. To the extent rolled over, tax on the distribution is deferred until funds are distributed from the rollover account. If a distribution from a qualified plan includes nontaxable amounts and less than the entire distribution is rolled over, the amount rolled over is considered to come first from the taxable portion of the distribution. Therefore, the nontaxable amount will be treated as rolled over only to the extent the amount rolled over exceeds the taxable amount of the distribution. Nontaxable amounts not rolled over are considered a return of basis.

All distributions from a plan that are scheduled to be made at the same time are treated as a single distribution, regardless of whether the disbursements are made to a single destination or multiple destinations. Eligible rollover distributions made from a designated Roth account prior to January 1, 2016, were treated as separate distributions. However, employees could elect to have distributions made after September 17, 2014, and before January 1, 2016, treated as a single distribution.

What Is an Eligible Retirement Plan? An *eligible retirement plan* is any of the following:

1. An individual retirement account [traditional, Roth, or SIMPLE (once the two-year requirement is met)].
2. An individual retirement annuity.
3. A qualified pension, profit sharing, or stock bonus plan.
4. A Section 403(a) annuity.
5. A governmental Section 457 plan.
6. A Section 403(b) annuity.

Effect on LSD Treatment. Amounts rolled into a Section 457 plan, 403(b) plan, or IRA (other than a conduit IRA—see later discussion) are not eligible for the favorable tax treatment available for LSDs (i.e., the capital gain method) upon withdrawal from the plan. A rollover to another qualified plan (i.e., a qualified pension or profit-sharing plan including a 401(k) plan—not an IRA), perhaps with a new employer, preserves the taxpayer's ability to later use the capital gain method or averaging methods on an LSD of those funds. However, application of the special tax treatment available for LSDs is limited to individuals born before 1936. Although all decedents/participants born before 1936 are already over age $70^1/_2$ (and, thus, are already past their required beginning date to receive required minimum distributions), which would normally preclude lump-sum treatment, a new "triggering event" occurs upon the decedent's death. Thus, any prior distributions taken by the decedent (e.g., minimum required distributions) will not preclude an amount paid on account of the participant's death from being treated as a lump-sum distribution by the recipient. However, once distributions begin after a triggering event (in this case, death), the entire balance must be distributed within a single tax year to be considered a lump-sum distribution.

If the taxpayer cannot accomplish a direct rollover between two qualified plans, the same results (i.e., preservation of lump-sum tax benefits and a withholding-free rollover) may be accomplished by a rollover to a conduit IRA. Once the distribution is transferred (preferably through a direct rollover, so it is withholding-free) to the conduit IRA, it can be held there until eligible for rollover to a qualified plan. To qualify as a conduit IRA, the entire account must be attributable solely to the rollover contribution from the first employer's plan, plus earnings on that contribution. Thus, contributions or funds from other sources cannot be commingled with the account if conduit IRA status is to be maintained. If the account remains a conduit IRA, the funds may be transferred at any time to a qualified plan from which a later qualifying LSD may be eligible for favorable tax treatment.

What Is an Eligible Rollover Distribution? An *eligible rollover distribution* is any distribution from a qualified plan to an employee of part or all of the employee's account balance that is not one of the following:

1. *A Distribution That Is Part of a Series of Substantially Equal Periodic Payments.* The payments must be made at least once a year over (a) the life or life expectancy of the employee (or joint lives or joint life and last survivor expectancies of the employee and designated beneficiary), or (b) a specified period of 10 years or more. The test is applied at the beginning of the payout period, without regard to contingencies or modifications.
2. *A Required Minimum Distribution (RMD).* This is a distribution required because the participant has reached his or her required beginning date. Only the RMD amount for a year is disqualified from rollover treatment under this rule. Any amount exceeding the RMD qualifies (provided that it is otherwise an eligible rollover distribution).
3. *A Hardship Distribution.* Hardship distributions from any tax qualified plan, including assets attributable to employee elective deferrals and those attributable to employer matching or nonelective contributions, will be ineligible for rollover treatment.

Certain other payments are also excluded from the definition of eligible rollover distributions.

Partial Rollover. The rollover need not be for the full amount of the distribution. However, any amount not rolled over will be subject to income tax (after reduction for any basis) and the Section 72(t) penalty if under age 59 1/2 and no

exception to the penalty is met. If multiple IRA distributions occurred during the year, the partial rollover needs to meet only one of the 60-day periods, and not necessarily the first distribution or the distribution that matches exactly the dollar amount of the rollover.

In-plan Roth Direct Rollover. An elective deferral plan that includes a qualified Roth contribution program [e.g., Roth 401(k)] may allow for the rollover of a distribution from the portion of the plan that is not a designated Roth account (DRA) to the DRA maintained under the same plan for the benefit of the same taxpayer (an in-plan Roth direct rollover). The rollover is not tax-free. The amount of the transfer includable in gross income is determined under the same rules that apply to a conversion to a Roth IRA.

Non-Roth amounts in an applicable plan [i.e., 401(k), 403(b), or 457(b) plan], regardless of whether the amount is otherwise distributable, may be transferred to a DRA in the same plan.

The Section 72(t) 10% tax on early withdrawals (which generally applies to the taxable portion of a plan or IRA distribution made before the participant has reached age 59$^1/_2$, unless an exception applies) does not apply to in-plan Roth rollovers. However, the recapture rule under IRC Sec. 408A(d)(3)(F) applies to distributions within the five-tax-year holding period beginning with the first day of the participant's tax year in which the rollover was made and ending on the last day of the fifth consecutive tax year in the period.

60-day Rollover Rule. To avoid current income taxation, the distribution or an amount equal to the offset amount must be rolled over within 60 days of receipt.

Example 1F-1 Computing the 60-day limit for rollovers.

Laura terminated her employment with Kwic Co. in 2017. She is fully vested in Kwic's retirement plan, and intends to roll over her account into a new IRA she has established. She received her eligible rollover distribution on September 1, 2017.

The 60-day period starts to run the day after the distribution is received (September 2, 2017). Thus, the rollover to the new IRA must take place on or before October 31, 2017.

Withholding Rules. Eligible rollover distributions from qualified plans (except distributions of $200 or less) paid directly to the participant are subject to mandatory federal 20% withholding. However, if the distribution is rolled over via a direct rollover into an eligible retirement plan, no income tax withholding is required. (Direct rollovers are often referred to as trustee-to-trustee rollovers.) A direct rollover can be accomplished by any reasonable means, including a wire transfer or check negotiable only by the trustee (or custodian) of the eligible retirement plan designated by the taxpayer. The check can be mailed to the receiving plan, or it can be given to the employee for delivery to the eligible plan if it is made out properly.

As a result of these withholding rules, the plan participant must make the rollover decision before any funds are distributed; otherwise, the 20% withholding may make it difficult to complete a totally tax-deferred rollover.

Example 1F-2 Rolling over an eligible distribution.

During 2017, Denise, age 49, found a new job. She had $100,000 of fully vested funds in her old employer's pension plan (to which she made no contributions) that she wanted to roll over into an IRA. Denise failed to arrange for a direct transfer, so on October 1, 2017, when her old employer distributed her plan balance, $20,000 was withheld for federal income tax and she was paid the remaining $80,000. What must Denise do to accomplish a totally tax-deferred rollover?

She must roll over the entire $100,000 to an IRA before November 30, 2017 (within the 60-day period starting on October 2, 2017). Since she only received $80,000 from her employer, she must get $20,000 from some other source to accomplish a totally tax-deferred rollover. If she rolls over only the $80,000 actually received, she must include the $20,000 not rolled over in her 2017 gross income. Furthermore, since Denise is only age 49, the $20,000 taxable distribution is subject to the 10% premature distribution tax unless an exception applies.

Rolling Over Noncash Property. A participant who receives an eligible rollover distribution from a qualified plan consisting (in whole or part) of noncash property (e.g., stock) can accomplish a tax-deferred rollover by transferring to the eligible plan the cash, plus, either (1) the actual property, or (2) the sales proceeds from a bona fide sale of the property. If the property is sold prior to the rollover, the transfer of the sale proceeds is treated as a transfer of the property. If the property increases in value between the date distributed and the date sold, the increase is treated as part of the distribution.

A contribution to an eligible retirement plan of cash representing the FMV of the property received in the distribution does not qualify as a rollover if the property is not sold. Also, the Tax Court has held that a taxpayer had to include in income distributions of cash from his Keogh plan and IRA that he used to purchase stock, which was then deposited (i.e., rolled over) to a new IRA within 60 days of the distributions (*Lemishow*). The legislative history to the Keogh and IRA rollover provisions indicates that Congress intended for tax-free treatment to apply to contributions of cash from distributions of cash, not to contributions of property from distributions of cash.

No gain or loss is recognized on the sale of distributed property if the entire distribution, including the sale proceeds, are rolled over. If only part of the proceeds are rolled over, the part retained is included in the participant's income. The retained proceeds must be allocated between the part representing ordinary income (the property's value upon distribution) and the part representing the gain or loss on the sale.

Example 1F-3 Rolling over sale proceeds of property received in a distribution.

On September 1, 2017, Fred received a lump-sum distribution of $25,000 of stock. On September 30, 2017, Fred sold the stock for $30,000. On October 15, 2017, Fred contributes $30,000 to an IRA. As a result, Fred does not include either the $25,000 distribution or the $5,000 gain in gross income in 2017.

Variation 1: Fred rolls over only $26,000 of the $30,000 sale proceeds from the original example. Fred must recognize income of $4,000, the amount of sale proceeds retained. Of the $4,000 income, $667 ($5,000 ÷ $30,000 × $4,000) is short-term capital gain attributable to the sale of the property and $3,333 ($25,000 ÷ $30,000 × $4,000) is ordinary income attributable to the distribution.

Variation 2: Fred sells the property for $22,000 and contributes $22,000 to the IRA. As a result, Fred does not include the $25,000 distribution in gross income and does not deduct the $3,000 loss.

Variation 3: Fred rolls over only $20,000 of the $22,000 sale proceeds from Variation 2. Fred must recognize income totaling (a net of) $2,000, the amount of sale proceeds retained. The $2,000 of income includes part of the loss on the sale of the property. Thus, Fred will recognize a $273 ($3,000 ÷ $22,000 × $2,000) short-term capital loss. He will also report $2,273 ($25,000 ÷ $22,000 × $2,000) of ordinary income attributable to the distribution. The $2,273 ordinary income and the $273 capital loss net to $2,000, the sales proceeds Fred retained.

When the eligible rollover distribution includes both cash and noncash property, and the noncash property is sold prior to the rollover but the entire distribution is not rolled over, the participant can designate which part of the cash or property is treated as included in the rollover contribution. Additionally, if the distribution includes a nontaxable amount (i.e., nondeductible employee contribution), the participant may designate which part of the nontaxable amount is allocable to the cash and which part is allocable to the property. These designations must be made by the due date (including extensions) for filing the participant's tax return for the year in which the distribution was received. Presumably, this is done by attaching a statement to the return. Once made, the designations are irrevocable. If no designation is made, the rollover contribution or nontaxable amount must be allocated on a ratable basis.

Rolling Over Distributions from IRAs

Traditional IRAs. Distributions from traditional IRAs (other than those required to be distributed under the minimum distribution rules generally are eligible for rollover under rules similar to those applicable to qualified plans. IRA distributions that would be taxable if not rolled over can be rolled over to a qualified plan (even if the distributing IRA is not a conduit IRA), 403(b) plan, or a governmental 457 plan, as well as another IRA if the plan permits such a rollover. IRA distributions attributable to nondeductible contributions (i.e., the part of the distribution that is normally nontaxable) can only be rolled over into another IRA.

Although the law prohibits borrowing against an IRA, the IRS has ruled privately that an IRA distribution followed by a redeposit of the funds into the same (or different) IRA within 60 days qualifies as a tax-free rollover transaction. Furthermore, the transaction—

1. is not a taxable distribution subject to the 10% premature distribution tax or the 20% withholding requirement;

2. is not a prohibited loan transaction under IRC Sec. 4975; and

3. does not result in the 6% excess IRA contribution tax when the amount is redeposited.

The amount distributed is not a factor. However, the entire amount distributed must be rolled over within 60 days to avoid tax; otherwise, any amount withdrawn but not redeposited is taxable (and may be subject to penalty).

An individual can make only one rollover from an IRA (as opposed to a qualified plan) in any 365-day period. This one-year prohibition applies from the date the first IRA withdrawal is made (i.e., it does not pertain to calendar years), and applies to all IRAs held by the taxpayer, excluding conversions of a traditional IRA to a Roth IRA and trustee-to-trustee transfers. It begins with the date the withdrawal is made, not the date the rollover is completed. A direct transfer from one IRA trustee to another is not considered a rollover and thus does not affect the one-year waiting period. Also, a distribution from a qualified employer plan that is rolled over into an IRA does not affect the one-year waiting period. Thus, an individual can make an IRA-to-IRA rollover even though a qualified employer plan distribution has been rolled over to the account within the year.

Example 1F-4 One-per-year limit on IRA-to-IRA rollovers.

Ann has two separate IRAs. If Ann rolls the funds in IRA-1 into new IRA-3, she cannot also make a rollover from IRA-2 into IRA-3, or any other IRA, within one year after the rollover distribution from IRA-1. In addition, Ann cannot, within the one-year period beginning with the date she receives the funds from IRA-1, again roll over the assets she rolled into IRA-3 into any other IRA. The same one-year rule applies if she rolled over funds from IRA-2 rather than IRA-1.

Roth IRAs. A distribution from a qualified retirement plan can be rolled over to a Roth IRA through a direct rollover from the plan or an amount can be distributed from the plan and contributed (rolled over) to the Roth IRA within 60 days. In either case, the amount rolled over must be an eligible rollover distribution, and any amount that would be includable in gross income if the distribution were not a qualified rollover contribution is included in gross income for the year of distribution. If the eligible rollover distribution to the Roth IRA is made from a designated Roth account in an eligible employer plan, the amount rolled over is not includable in the individual's gross income, whether or not the distribution is a qualified distribution from the designated Roth account. All distributions from a plan that are scheduled to be made at the same time are treated as a single distribution, regardless of whether the disbursement are made to a single destination or multiple destinations. Eligible rollover distributions made from a designated Roth account prior to January 1, 2016, were treated as separate distributions. However, employees could elect to have distributions made after September 17, 2014, and before January 1, 2016, treated as a single distribution.

Roth IRA rollovers are subject to the same rules and requirements that apply to traditional IRA rollovers. Thus, the 60-day rollover period and the one-per-year rules apply.

Spousal Rollovers

A surviving spouse (including a same-sex surviving spouse) can roll over the balance from a deceased spouse's eligible retirement plan into his or her own eligible retirement plan account or to a new IRA established in his or her name. The rollover must be made within the 60-day requirement. If the sole beneficiary, he or she can also elect to treat a deceased spouse's IRA as his or her own. In such a case, the required minimum distribution (RMD) rules are applied with the surviving spouse as the owner. These options are available whether the participant died before or after RMDs had begun.

A surviving spouse/administratrix was allowed to complete a rollover of the decedent's (husband's) previously withdrawn IRA distributions to a new IRA established in the name of the decedent within 60 days of the withdrawal.

However, since the decedent had not posthumously named the surviving spouse as a beneficiary of the newly established IRA, the surviving spouse was not eligible to treat the IRA as her own. A surviving spouse who neither rolls distributions over nor elects to treat the IRA as his or her own must take distributions from the account based on the RMD rules.

Ltr. Rul. 200110033 indicates that the surviving spouse can elect the roll over option even after receiving required minimum distributions (RMDs) from the account in more than one year. The ruling also stated that even though the surviving spouse was under age 59$^1/_2$ when the RMDs were received, the later election to roll over the IRA did not subject the distributions to the early distribution penalty. The IRA was treated as a continuation of the deceased spouse's IRA until the actual rollover was made. After the rollover, it was treated as the surviving spouse's IRA.

Nonspouse Beneficiary Rollover

A qualified retirement plan account inherited by a nonspouse beneficiary can be rolled over directly to an IRA in a trustee-to-trustee transfer if the new IRA is in the name of the decedent for the benefit of the beneficiary. Once a beneficiary receives a check, all income tax deferral ends (even if deposited to an IRA within 60 days) and the distribution must be reported on the beneficiary's return and included in income to the extent taxable. The IRA is treated as an inherited IRA of the nonspouse beneficiary. Thus, for example, required minimum distributions (RMDs) from the inherited IRA are subject to the RMD rules applicable to nonspouse beneficiaries. This provision also applies to amounts payable to a beneficiary under a government Section 457 plan or a tax-sheltered annuity.

The rollover provision for inherited qualified plans by nonspouse beneficiaries applies to Roth IRAs as well as traditional IRAs . An inherited Roth IRA is subject to the usual Roth conversion rules (i.e., inclusion of the conversion amount in taxable income). Although distributions are not required during a Roth owner's life, minimum distributions will be required from the inherited Roth IRA.

Invalid Rollovers

If a taxpayer makes an invalid rollover (i.e., a rollover not complying with the rules discussed in this section), adverse tax consequences may apply. An example of this is when a taxpayer rolls over a portion of a qualified plan distribution not eligible to be rolled over (such as an RMD). If the invalid rollover is from one plan to another, part or all of the distribution (depending on whether the taxpayer has basis) will be taxable and subject to the 10% premature distribution penalty, if applicable.

If an IRA contribution that is not a valid rollover contribution, combined with other IRA contributions for the year exceeds the contribution limit [$5,500 for 2017 ($6,500 if age 50 or over by December 31, 2017)], the excess contribution is subject to a 6% excise tax until it is withdrawn. Also, special tax rules apply when such amounts are withdrawn from the IRA.

Reporting Income from Withdrawal of Excess IRA Contributions

The limits on contributions to traditional (deductible and nondeductible) IRAs and Roth IRAs are coordinated, so a taxpayer's combined contribution to all IRAs for 2017 generally cannot exceed the lesser of (1) $5,500, or (2) gross income from compensation as defined in IRC Sec. 219(f). For married couples, IRA contributions of up to $5,500 can be made for each spouse if the combined compensation of both spouses is at least equal to the contributed amount, and they file a joint return. This means that the total combined contributions can be as much as $11,000 per year. Individuals who are age 50 or over by December 31, 2017, can make up to $1,000 in catch-up contributions to their IRAs. Catch-up contributions are in addition to the normal $5,500 IRA contribution limit. Traditional IRA contributions are covered in Lesson 3.

IRA contributions that exceed the allowable amount (i.e., excess contributions) because of either the dollar limit or the compensation income limit are subject to special tax treatment upon withdrawal. The timely withdrawal of excess IRA contributions avoids the 6% excise tax on excess contributions.

An excess contribution can also result from an invalid rollover and from a traditional IRA contribution (other than a valid rollover contribution) for the year the taxpayer turns age 70$^1/_2$ and for any later year.

Taxation of Excess Contributions

Excess amounts are not deductible in the year the contribution is made. If an excess contribution and the related earnings are withdrawn by the due date (including extension) of the return for the year of the excess contribution, the excess contribution is not reported as income in the year of withdrawal. However, the earnings on the excess contribution are reported as income in the year that the contribution was made—not in the year withdrawn. Also, the additional tax for premature distributions may apply to the distribution of earnings. (See Example 1G-1.)

If an excess contribution is not withdrawn by the tax return due date (including extension), and if the total IRA contributions (excess and otherwise) to the individual's IRA were not more than $5,500 ($6,500 if age 50 or older) (excluding valid rollover contributions), there is no income to the taxpayer upon the withdrawal of the excess contribution, provided none of the excess contribution was deducted. [An amended return can be filed to add back any excess contribution previously deducted.] In this case, the earnings on excess contributions are reported as income in the year withdrawn. (See Example 1G-2.) However, the earnings do not need to be withdrawn to correct the excess contribution, as they must if the excess contribution is withdrawn on or before the due date (including extension).

If a year's total contributions exceed $5,500 ($6,500 if age 50 or older) and the excess contribution is not withdrawn by the tax return due date (including extension), the withdrawal of the entire excess amount is not subject to the Section 408(d)(5) special rules, so it is taxable in the year of withdrawal. This is true even though no tax deduction is allowed for the excess contribution. (See Example 1G-3.)

An excess contribution can be carried forward and treated as a contribution for a later year to the extent contributions for the later year are less than the maximum allowed for that year. Thus, an excess contribution can be corrected without a taxable withdrawal, but a 6% excise tax for excess contributions will apply for each year the excess contribution is held in the IRA. (See Example 1G-4.)

Reporting the Withdrawal

An IRA trustee reports the withdrawal of an excess contribution plus earnings to the taxpayer (and IRS) on Form 1099-R. The codes shown in box 7 of Form 1099-R can help determine the year the earnings are taxable. In some instances, the 1099-R will show that the earnings are taxable in the prior tax year (i.e., when the withdrawal occurs after the end of the year in which the excess contribution was made), so an amended return for that year may be required. Practitioners can help clients avoid the need to file an amended return in this situation by inquiring about excess contributions when gathering the client's information for the current year return. In some cases, practitioners can identify situations when earnings related to an excess contribution must be included on a return before the taxpayer actually receives a Form 1099-R reporting the amount.

Example 1G-1 Withdrawal of excess contribution by tax return due date.

Dwight, an investor who is single and 30 years of age, contributed $5,500 to his IRA in 2017. However, since he had no compensation income for 2017, he is unable to make an IRA contribution and the $5,500 is an excess contribution.

Dwight withdrew the $5,500 excess contribution plus earnings of $150 on February 4, 2018. What are the tax consequences of his withdrawal of the excess IRA contribution and its earnings?

Dwight cannot deduct his 2017 IRA contribution. Because he withdrew the excess contribution and related earnings on or before the due date for his 2017 return (April 17, 2018), he avoids the 6% excise tax on excess contributions, and the $5,500 is not gross income in 2018. However, the $150 of earnings related to the excess contribution is reported as income in 2017, the year of the contribution. (Dwight will receive a 2018 Form 1099-R from his IRA trustee indicating the total distribution and the earnings; the trustee should notify Dwight at the time the distribution is made that the earnings are taxable in 2017.) The Form 1099-R will have no impact on Dwight's 2018 Form 1040. The earnings should be reported as a taxable IRA distribution on his 2017 Form 1040. If Dwight is under age 59$^1/_2$, the $150 withdrawal of earnings will be subject to the 10% premature distributions tax unless an exception applies. This 10% excise tax must be paid with Dwight's 2017 return.

Example 1G-2 Withdrawal of excess contribution after the tax return due date.

Assume the same facts as in Example 1G-1 except Dwight does not withdraw the $5,500 excess contribution until April 21, 2018—after his 2017 tax return is filed. What are the tax consequences of the withdrawal of the excess contribution of $5,500?

Dwight, of course, cannot deduct the $5,500 excess contribution in 2017. Because his total IRA contributions in 2017 did not exceed $5,500, Dwight recognizes no gross income when he withdraws the excess contribution in 2018. The earnings on the excess contribution need not be withdrawn to correct the excess. The rule that related earnings must be withdrawn applies only if the excess contribution is withdrawn on or before the tax return due date for the year of the excess contribution. (See Example 1G-1.)

Dwight is subject to the 6% tax on excess IRA contributions for 2017 but not for 2018 (because the funds were withdrawn before the end of 2018). This 6% tax is computed on Form 5329. The earnings on the excess contribution are taxable in 2018.

Example 1G-3 Total IRA contributions exceed annual limit.

Jerry, a single 35-year-old taxpayer, contributed $5,500 to his traditional IRA in January 2017 for his 2017 tax year. Having forgotten about the earlier contribution, he contributed $5,500 to another IRA in December 2017. In January 2018, he contributed $5,500 for his 2018 tax year. He had compensation income of $70,000 in both 2017 and 2018. He was not a participant in an employer-maintained pension plan in either year.

Jerry filed his 2017 return on April 17, 2018 (claiming a $5,500 IRA deduction), and did not discover his 2017 excess contribution until April 21, 2018. He immediately withdrew the $5,500. What is the impact of Jerry's excess contribution?

Jerry's excess contribution for 2017 is $5,500, and he correctly did not deduct the excess contribution. However, because he did not withdraw the excess contribution by the 2017 tax return due date, and because his total 2017 contributions exceeded $5,500, Jerry is taxed on the withdrawal of the $5,500 excess contribution in 2018. He is taxed even though he received no deduction or other tax benefit in 2017 from the $5,500 excess contribution. However, see the discussion of the *Campbell* case in a Note included with the rules for taxation of excess contributions. Based on *Campbell*, Jerry can apparently take the position that his excess contribution has a basis of $5,500, which makes the excess contribution nontaxable when it is distributed back out to him. In effect, this approach treats the distribution of the excess contribution as the return of a nondeductible contribution, which makes sense because Jerry never received any tax benefit from the excess contribution.

The $5,500 excess contribution is subject to the 6% excise tax for excess IRA contributions in Jerry's 2017 tax return because the excess contribution was not withdrawn by the 2017 tax return due date.

Variation: If Jerry had withdrawn $5,600 (the excess contribution plus related earnings) before the 2017 tax return due date, the treatment of the $5,500 excess contribution would not have been an issue (it would clearly be nontaxable see Example 1G-1), and the $100 of earnings would have been reported as income in his 2017 return. The $100 is also subject to the 10% premature withdrawal penalty tax unless an exception applies.

Example 1G-4 Carryforward of excess contribution.

Assume the same facts as in Example 1G-3 except Jerry made no contribution to his traditional IRA in 2018, and he did not withdraw his 2017 excess contribution of $5,500. How does his 2017 excess contribution impact 2017 and 2018?

He cannot deduct the 2017 excess contribution in 2017. Also, the excess contribution is subject to the 6% excise tax in his 2017 return.

Because Jerry made no IRA contribution in 2018 and had sufficient earned income to support a $5,500 IRA contribution for that year, the 2017 excess contribution is treated as a 2018 contribution. Thus, it is not subject

to the 6% excise tax in 2018. Also, because Jerry is not an active participant in an employer-maintained pension plan and has sufficient earned income, the 2017 excess contribution can be deducted on his 2018 return.

Divorce-related Transfers of Retirement Plan Assets

Qualified Retirement Plan Benefits

In marital dissolutions, one spouse's qualified retirement plan benefits are often used to fund marital property settlements to a spouse, former spouse, child, or other dependents (i.e., alternate payees) of the plan participant. Qualified plan benefits paid to a nonspousal alternate payee do not receive special tax treatment and are taxable to the employee-participant; however, amounts paid to a spouse or former spouse under a qualified domestic relations order (QDRO) receive special treatment. Essentially, the spouse or former spouse "steps into the shoes" of the employee-participant with respect to the assigned interest in the plan. Furthermore, such payments are taxable to the spouse or former spouse, not to the employee-participant.

What Is a QDRO? A QDRO is a judgment, decree, or order that recognizes the rights of an individual other than the retirement plan participant (employee) to a portion of the benefits payable under the plan. A QDRO must specify all of the following:

1. The name and address of the plan participant and the alternate individual to receive benefits.
2. The percentage or amount of the benefits to be paid to the alternate individual.
3. The period over which payments are to be made.
4. Each plan to which the order applies.

QDRO Distribution Can Be Rolled Over. A distribution made to the plan participant's spouse or former spouse can be partially or wholly rolled over tax free to the spouse's eligible retirement plan [i.e., qualified plan, traditional IRA, 403(b) plan, governmental 457 plan, or IRA SIMPLE plan (if the plan has been in existence for at least two years)] if it is done within 60 days of receipt and—

1. it is distributed to the recipient under a QDRO, and
2. it would have met the definition of an eligible rollover distribution if it had been made to the employee.

Taxation of QDRO Distribution. Any amount not rolled over or not qualifying for rollover is included in the spouse's or former spouse's gross income in the year received.

A prorated portion of the participant's cost basis (if any) in the retirement plan benefits is allocated to the distributee spouse whether the benefits are received in a lump sum or otherwise.

Example 1H-1 Taxation of distribution made under a QDRO.

Richard has a vested balance in his employer's 401(k) plan of $300,000. Pursuant to a QDRO, the plan administrator makes an eligible rollover distribution of $120,000 ($150,000 gross distribution—$30,000 tax withholding) to Elaine, Richard's former spouse and the alternate payee under the QDRO. Elaine can roll the distribution over to an IRA or another eligible retirement plan. To avoid current tax, she must roll over the entire $150,000 (even though she only received $120,000 net of the 20% withholding) within 60 days of receipt (or arrange for a direct trustee-to-trustee rollover of the funds to avoid the withholding).

If Elaine chooses to keep all or part of the distribution (i.e., not roll it over), she is taxed on the amount she keeps but is not subject to the 10% early distribution tax regardless of her or Richard's age. Elaine will receive a Form 1099-R for this distribution.

Richard is not taxed on the distribution to Elaine, nor does the QDRO distribution affect his eligibility for rollovers or favorable tax treatment of LSDs.

Variation: Assume the same facts except that Richard had made nondeductible (after-tax) contributions of $30,000 to the plan. In this situation, the $30,000 basis in the plan is allocated between Richard and Elaine based on the ratio of their respective interests in the plan. As a result, $15,000 (half of the $30,000 basis) of the $150,000 distribution to Elaine is a nontaxable return of basis and the remaining $135,000 is taxable unless rolled over within 60 days.

IRAs

Unlike a qualified plan, there is no requirement that a QDRO be used with an IRA (meaning a SEP, SIMPLE IRA, traditional IRA, or Roth IRA). The transfer of all or part of an individual's interest in an IRA to a spouse or former spouse pursuant to a divorce or separation instrument is not a taxable event to either spouse if certain conditions are met.

To receive tax-free treatment, the divorce decree (or separation agreement) must specifically require the transfer and that the transfer be made directly to an IRA in the name of the spouse or former spouse. Also, it is wise for the instrument to state that the transfer is intended to be tax free under the provisions of IRC Sec. 408(d)(6). The transferred interest is treated as an IRA of the receiving spouse for all purposes. For example, if the recipient spouse is over 70$^1/_2$ years old, required minimum distributions must begin (unless the IRA is a Roth IRA). Unfortunately, the exception to the 10% premature distribution penalty that applies to QDRO distributions from qualified retirement plans does not apply to IRA distributions to a receiving spouse after such a transfer. Thus, a taxable IRA withdrawal by the receiving spouse after the transfer is subject to the 10% premature distribution penalty if he or she is under age 59$^1/_2$ unless an exception applies.

Additional guidance on the tax-related aspects of dividing retirement assets in a divorce are available in Lesson 2.

Distributions from a SIMPLE IRA Plan

Distributions from a SIMPLE IRA plan (reported to the taxpayer on Form 1099-R) generally are subject to IRA distribution rules, not qualified plan distribution rules (including the IRA required minimum distribution rules explained later in this lesson). However, some special rules apply to SIMPLE IRAs that do not apply to other IRAs. These special rules are discussed in this lesson.

Two-year Period Rules

Special rollover and early distribution tax rules apply for distributions from SIMPLE IRAs made during the two-year period beginning on the day the employee first participates in any SIMPLE IRA plan maintained by the employer. An employee begins participating in a SIMPLE IRA plan on the day the employer first deposits contributions to the employee's SIMPLE IRA.

If an employee terminates employment and two years have expired since the employee first participated in the SIMPLE plan, the employee's SIMPLE IRA is treated as a traditional IRA.

Rollovers. During this two-year period, distributions from the SIMPLE IRA can be rolled over tax-free only to another SIMPLE IRA. After the two-year period, distributions from the SIMPLE IRA can be rolled over to eligible retirement plans [i.e., traditional IRAs, qualified plans, 403(b) plans, or governmental 457 plans] or Roth IRAs or to another SIMPLE IRA. (Rollovers must be completed within 60 days of when the participant receives the distribution. Rollovers to eligible retirement plans will generally be tax-free while rollovers to Roth IRAs will be treated as taxable conversions.

Early Distribution Tax. As with any IRA, early withdrawals (i.e., distributions before age 59$^1/_2$) from a SIMPLE IRA generally are subject to the 10% early distributions tax unless a specific exemption applies. However, during the two-year period defined earlier, the early distribution tax for a SIMPLE IRA is 25% (rather than the standard 10%).

Example 1l-1 Tax treatment of distributions.

Jane, age 28, enters her employer's SIMPLE IRA plan on January 1, 2017. Her employer makes the first deposit into her SIMPLE IRA on January 15, 2017. Jane quits on March 15, 2018, when she has $8,000 in her SIMPLE IRA. If she withdraws the $8,000, how can she avoid income tax and the penalty for early withdrawal?

She must roll the $8,000 over into another SIMPLE IRA within 60 days. Since she has not participated in the SIMPLE IRA plan for two years, she cannot roll the proceeds over to another type of eligible retirement plan or Roth IRA. If she takes the distribution and does not roll it over to another SIMPLE IRA, the $8,000 will be subject to the 25% early distribution penalty as well as income tax.

Required Minimum Distribution Rules for Retirement Accounts

The required minimum distribution (RMD) rules force individuals to begin taking distributions from tax-favored retirement plans (including traditional IRAs) by a specified time to prevent indefinite tax deferral. Taxpayers who do not comply with the required minimum distribution rules are subject to a 50% penalty.

Required Beginning Date

Under the required minimum distribution rules, benefits must be distributed or commence being distributed by the required beginning date (RBD). An employee's RBD for receiving distributions from a qualified plan is normally April 1 of the year following the *later* of the calendar year the employee (1) reaches age 70½ or (2) retires (from the employer sponsoring the plan). However, 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 must begin no later than April 1 of the year following the calendar year such individual turns age 70½ (even if not retired). A participant reaches age 70½ on the date six months after his or her 70th birthday. Once begun, required minimum distributions must generally continue each year.

After the initial year, required minimum distributions (RMDs) must be made by December 31 of each year . Thus, the first and second required distributions could occur in the same year. For example, a taxpayer who turns age 70½ in 2017 must take his or her first IRA distribution no later than April 1, 2018 (for 2017), and his or her second distribution by December 31, 2018 (for 2018).

Example 1J-1 Determining when benefits must be distributed after participant reaches age 70½.

Sally works for Lake Manufacturing, where she participates in a profit-sharing plan. She reached age 70½ during 2017 and retired. Lake must commence her benefits by April 1, 2018.

If Sally had not retired during 2017, Lake would not have to commence her benefits until April 1 of the year following the year she retires (assuming the plan allowed such a deferral and Sally is not a 5% owner).

Calculating the Required Minimum Distribution (RMD)

The RMD is calculated by dividing the account balance as of the preceding December 31 by the applicable life expectancy divisor (see later discussions regarding RMDs during the owner's life and RMDs after the owner's death). The regulations do not allow an adjustment to the account balance for distributions or contributions made after this date, for example in calculating the second distribution when it is made in the same year as the initial distribution. However, the balance is adjusted for rollovers or recharacterizations outstanding at year-end.

Each year's RMD amount is calculated independently. No credit may be taken in the current year for amounts distributed in prior years that were in excess of the RMD amount.

The RMD must be calculated separately for each qualified plan and IRA. For qualified plans, the required distribution amount determined for each plan must be distributed from that plan. For IRAs, the required distributions for all IRAs can be combined, and the total can be distributed from any one or more IRAs.

RMDs during the Owner's Life

Distributions during the owner's life must begin no later than the owner's required beginning date (RBD) and be distributed over a period no longer than (1) the life of the account owner, (2) the life of the account owner and a designated beneficiary, or (3) a period not to extend beyond the life expectancy of the account owner and a designated beneficiary.

These rules are met by calculating each year's RMD using life expectancy divisors found in the Uniform Lifetime Table based on the owner's age at the end of the applicable distribution calendar year. This is true regardless of the designated beneficiary's actual age, as well as when there is no designated beneficiary. A change in the designated beneficiary generally does not affect this determination unless the owner's spouse is the sole beneficiary and more than 10 years younger than the owner. In this case, the Joint and Last Survivor Table in Reg. 1.401(a)(9)-9 can be used and the applicable factor for determining each year's RMD is based on the owner's and spouse's respective ages at the end of the particular distribution calendar year.

Example 1J-2 Determining the life expectancy factor for RMDs.

In 2017, Joe turned 81, his wife Alma turned 65, his son Bret turned 40, and his sister Betty turned 70. Joe has four IRAs, each of which has different beneficiaries. The applicable life expectancy factors Joe must use to determine his 2017 RMDs for each of the IRAs are as follows:

IRA	Beneficiary	Life Expectancy	Applicable Table
IRA 1	Joe's estate	17.9	Uniform Lifetime
IRA 2	Alma	21.9	Joint
IRA 3	Bret	17.9	Uniform Lifetime
IRA 4	Betty	17.9	Uniform Lifetime

The factor from the Uniform Lifetime table must be used for all the IRAs, except IRA 2 on which his wife Alma is the beneficiary. Because Alma is the sole beneficiary of IRA 2 and she is more than 10 years younger than Joe.

Example 1J-3 Calculating the RMDs for the year.

Assuming the same facts as in Example 1J-2 and given the following IRA balances as of December 31, 2016, the RMDs for 2017 are as follows:

IRA	(1) 12/31/2016 Balance	(2) Life Expectancy	RMD [(1)/(2)]
IRA 1	$ 500,000	17.9	$ 27,933
IRA 2	500,000	21.9	22,831
IRA 3	100,000	17.9	5,587
IRA 4	75,000	17.9	4,190
			$ 60,541

Joe's RMDs for 2017 are calculated separately for each IRA based on each account's value and the applicable life expectancy factor. However, the total of all the RMDs from all of Joe's IRAs ($60,541) can be taken from any one or any combination of his IRAs.

RMDs continue to be calculated using these rules through the year of the owner's death. Beginning in the year following the owner's death, any remaining account balance must be distributed under the post-death RMD rules.

RMDs after the Owner's Death

When the owner dies, the RMD rules depend on whether the owner died before or after the required beginning date (RBD). Roth IRA owners are always treated as dying before their RBDs.

Death after the RBD. If the owner dies after the RBD, RMDs up to and including the year of death are calculated using the lifetime rules previously discussed. Beginning with the year following the owner's death, distributions must continue to be made at least as rapidly as they were before death. How this rule is met depends on the account's designated beneficiary as of September 30 of the calendar year following the year of the owner's death.

Basically, beginning in the calendar year after the year of the owner's death, the account must be distributed over a period that is no longer than the following:

1. *No Designated Beneficiary.* The owner's single life expectancy calculated in the year of death and reduced by one each year thereafter.

2. *Nonspouse Designated Beneficiary.* The beneficiary's single life expectancy calculated in the year following the year of the owner's death and reduced by one each year thereafter. However, if longer, the owner's single life expectancy calculated in the year of death and reduced by one each year thereafter can be used. Alternatively, the distributions may be made under the five-year-rule (the entire interest must be distributed within five years of the date of death) described in IRC Sec. 401(a)(9) if the plan so requires or the beneficiary elects to do so. The determination of which distribution period applies is not based on whether distributions in fact begin timely under the applicable rule.

3. *Spouse Is Sole Designated Beneficiary.* Spouse's single life expectancy determined based on the spouse's age at the end of the applicable distribution calendar year and recalculated annually. However, if longer, the owner's single life expectancy calculated in the year of death and reduced by one each year thereafter can be used. At spouse's death, RMDs can be made over the spouse's remaining single life determined in the spouse's year of death and reduced by one each year thereafter. If the spouse is not the sole beneficiary, the rules for nonspousal beneficiaries (item 2) or no beneficiary (item 1) apply depending on who the other beneficiary is.

For the RMD rules, only individuals (including the beneficiaries of certain trusts named as plan beneficiaries) are treated as designated beneficiaries. Although a charity or the owner's estate can be named as a beneficiary, these entities are not recognized as designated beneficiaries for this purpose. Accordingly, if there is such a beneficiary as of September 30 of the year following the owner's death, RMDs must be calculated as if there were no beneficiary. Also, if at that time there is more than one designated beneficiary and the account has not been divided into separate accounts or shares for each beneficiary, the oldest beneficiary is treated as the designated beneficiary for RMD calculation purposes. However, any beneficiary eliminated by distribution of the benefit, through disclaimer, or segregation of accounts before September 30 of the year following the year of death, is disregarded.

To be a designated beneficiary for RMD calculation purposes, an individual must be a beneficiary at the date of death. With certain exceptions, the date of death beneficiaries must remain beneficiaries on September 30 of the year following the owner's death to be considered designated beneficiaries for RMD calculation purposes.

Death before the RBD. If the owner dies before the RBD (or at any age for a Roth IRA owner) one of two rules apply. The first rule (five-year rule) requires the entire benefit to be distributed on or before December 31 of the year in which the fifth anniversary of the owner's death occurs. The five-year rule always applies if there is no designated beneficiary. Under the second rule, the life expectancy rule (or exception to the five-year rule), RMDs to a designated beneficiary must begin by December 31 of the year after the year in which the owner died if the beneficiary is not the owner's spouse. Such distributions must be made over the beneficiary's single life expectancy based on his or her age at the end of the year following the year of the account owner's death. That life expectancy figure is then reduced by one to calculate the RMD for the following year, by two to calculate the RMD for the year after that, and so on for each subsequent year.

If the designated beneficiary is the owner's spouse, the surviving spouse can defer distributions until the later of (1) the end of the calendar year after the year in which the owner died or (2) the end of the calendar year in which the owner would have reached age 70$^1/_2$. If the surviving spouse dies before that date, the five-year rule and the exception to the five-year rule are applied as if the surviving spouse is the owner. However, if the surviving spouse remarries after the owner's death and designates the new spouse as the beneficiary, the special rules for surviving spouses do not apply to the new spouse.

Rollovers to Nonspouse Beneficiaries and the RMD Rules

A nonspouse beneficiary may establish a new IRA to receive a tax-free rollover of an eligible distribution from the decedent's qualified retirement plan. The rollover must be accomplished with a direct (trustee-to-trustee) transfer. Similarly, rollovers will also be allowed for amounts paid to a nonspouse beneficiary of a decedent's Section 403(a)

annuity, Section 403(b) annuity, or governmental Section 457 plan. Once in the receiving IRA, the rolled-over amount will fall under the required minimum distribution (RMD) rules that apply to inherited IRAs. This allows a nonspousal beneficiary to roll over an inherited retirement account distribution and then take out RMDs over the beneficiary's life expectancy. This will often allow the beneficiary to take advantage of the IRA's tax-deferral feature for many years.

Example 1J-4 Retirement plan rollover to a nonspouse beneficiary.

Bill participated in a retirement plan sponsored by Barnes, Inc. with Judith (not a relative) named as the sole primary beneficiary of his interest in the plan. Bill died on January 2 of the current year at age 68. Can Judith roll over Bill's retirement plan assets to her own IRA account or is she required to take a lump sum distribution?

Judith may elect to roll over any portion of Bill's eligible retirement plan when it is transferred in a direct trustee-to-trustee transfer to her individual retirement account or an individual retirement annuity (IRA). Her IRA must be established for the purpose of receiving the distribution from Bill's retirement plan and be titled in a manner that identifies it as an IRA with respect to a deceased individual, for example, "Judith as beneficiary of Bill." The transfer is treated as an eligible rollover distribution and cannot be further rolled over. This election is available whether or not Bill had begun receiving retirement plan distributions before his death. If this election is made, Judith is not required to take a lump sum distribution and may defer taxation on the distribution subject to required distributions under the required minimum distribution (RMD) rules for inherited IRAs.

IRA Distributions to Charities Qualify under the RMD Rules

An individual who has reached age 70$^1/_2$ can distribute otherwise taxable traditional and Roth IRA amounts of up to $100,000 directly to certain tax-exempt charities. Such qualified charitable distributions are federal-income-tax-free to the donor. A qualified charitable contribution equal to (or in excess of) an individual's RMD is considered to satisfy his or her minimum distribution requirement for that year, even though a charitable entity (and not the IRA owner) is the recipient of the distribution.

Distributions from Commercial Variable Annuities

Individuals often purchase commercial annuities to provide or supplement retirement savings. These annuity contracts are between the individual and the issuer (typically an insurance company but often associated with and marketed through mutual fund companies) and are not related to a qualified retirement plan. Although these commercial annuities are not qualified plans, they still receive preferential tax treatment in that the earnings accumulate tax-deferred and are not taxable until withdrawn.

Deferred annuities can be either fixed or variable, depending on the owner's investment preferences. Fixed annuities generally pay a fixed interest rate while variable annuities generally allow the owner to select from among various investment options, including equity investments. Many variable annuities invest in stock and bond mutual funds, thus making them essentially a mutual fund investment with an insurance wrapper that allows the deferral of recognizing income until funds are withdrawn.

This lesson focuses on the tax consequences of withdrawing funds from a deferred variable annuity. These are annuities that include investment options that produce variable, rather than fixed, returns during both the accumulation period and the annuitization period. Thus, the total return depends on the performance of the selected investments and cannot be predicted with any certainty.

General Tax Considerations

Income from variable annuity payments is treated as ordinary income under IRC Sec. 72. Despite the fact that an annuity may invest in stock mutual funds that generate capital gain income, all distributions from the annuity are taxed as ordinary income. Variable annuities are not subject to the mandatory minimum distribution rules beginning at age 70$^1/_2$; however, many annuity contracts require the owner to begin annuity payments by a certain age, such

as 80 or 85. Distributions before age 59½ may be subject to a 10% premature distribution penalty—see discussion later in this lesson.

Distributions from variable annuities can be either annuity payments or nonannuity payments. Annuity (periodic) payments are those that (1) are received on or after an annuity starting date, (2) are payable in regular periodic intervals (e.g., monthly, quarterly) over a period extending more than one full year, and (3) either the total is determinable at the starting date (fixed annuities) or the payments will be made over a definite or determinable time, such as single or joint life expectancy or term certain (variable annuities). Nonannuity (nonperiodic) payments are those distributions that are not part of the annuity payout. Different tax rules apply depending on the type of distribution.

Taxation of Annuity Payments

Annuity payments from variable annuities may fluctuate based on the performance of the underlying investments. However, Regs. 1.72-2(b)(3) and 1.72-4(d)(3) provide that the taxpayer's nontaxable return of investment portion of each payment is constant over the term and determined by dividing the investment in the contract (as adjusted for any refund feature) by the number of expected periodic payments. The portion of each payment that exceeds this amount is taxable ordinary income. Once basis has been completely recovered, any additional payments are fully taxable. An individual who surrenders a refund annuity in exchange for a cash payment that is less than the contract's basis recognizes an ordinary loss. If an individual has an annuity starting date after July 1, 1986, and dies without a surviving annuitant and before recovering all of the investment in the contract (basis), any unrecovered amount is deductible in the year of death.

If annuity payments for a prior year were less than the recovery of basis amount, the taxpayer can elect to recompute the exclusion amount for the current and future tax years. If the election is made, the unabsorbed exculdible amount is spread over the remainder of the term of the payments.

Example 1K-1 Computing taxable amount of variable annuity payment.

Ralph Redman purchased a variable annuity for $150,000 in 2007. On January 1, 2017, when he is 65 years old, Ralph begins taking annuity payments based on his life expectancy. The value of the contract at that time is $200,000. In 2017, Ralph receives $10,500. How much of the payment is taxable?

To determine the nontaxable amount each year, Ralph's investment in the contract is divided by the number of expected periodic payments. The single life expectancy for a 65 year old person is 20.0 years, according to Table V of Reg. 1.72-9 (IRS Pub. 939). Thus, the nontaxable amount of Ralph's 2017 payment is $7,500 ($150,000 ÷ 20 years). Ralph must include $3,000 ($10,500 − $7,500) in ordinary income in 2017.

Variation: Assume that in 2018, the value of Ralph's annuity investments dramatically decline. Because the amount he receives varies based on the value of the contract, his payment for 2018 only amounts to $6,000. This is less than his annual $7,500 basis recovery amount. Thus, none of the $6,000 received in 2018 is taxable.

Further assume that the annuity investments recover in value and in 2019 he receives $10,000. His nontaxable amount for 2019 is still $7,500. However, because his 2018 payment was less than his exculdible amount, Ralph can elect to recompute his exculdible amount for the remainder of the annuity payout period. To compute the new nontaxable recovery of basis amount, the unabsorbed amount from 2018 is allocated to the remainder of the recovery period based on Ralph's life expectancy in 2019. Ralph is 67 years old in 2019, and the life expectancy for a 67-year-old person is 18.4 years. Thus, the allocable amount of the $1,500 unabsorbed amount from 2018 to each remaining year is $82 ($1,500 ÷ 18.4). Beginning in 2019, Ralph's recomputed nontaxable amount each year is therefore $7,582 ($7,500 + $82). Of the $10,000 payment received in 2019, Ralph reports $2,418 ($10,000 − $7,582) as ordinary income.

The purpose of this provision is to prevent contract owners from purchasing multiple contracts during the same calendar year from a single issuer and making a substantial withdrawal from just one of those contracts to extract the income from that contract and then obtain nontaxable return of the investment in that particular contract. Instead, the aggregation rule will result in the income from all contracts bought that year from the same company being taxed before there is any nontaxable return of investment from any of those contracts.

Example 1K-2 Aggregating annuity contracts issued in one calendar year.

Brenda, age 50, purchased five annuity contracts from the First State Life Insurance Company in 2011. Her initial investment in each contract was $50,000. On October 1, 2017, the contracts have each earned $12,000 and are valued at $62,000. Brenda withdraws $36,000 from one of the contracts on October 1, 2017. When aggregated, the income earned in all five of Brenda's contracts on October 1, 2017, totals $60,000 ($12,000 × 5). Therefore, all of her $36,000 withdrawal is considered to be income subject to taxation and the 10% early distribution penalty (assuming none of the exceptions to the penalty are available). Aggregation of the five contracts has prevented Brenda from recognizing only $12,000 of income and the remaining $24,000 as a return of her investment from the individual annuity that was the source of her withdrawal.

Variation: Assume the same facts as in Example 1K-2 except one of the annuities has a value of $42,000 on October 1, 2017, indicating the contract has lost $8,000 since it was purchased. If Brenda makes her $36,000 withdrawal from this annuity (the contract with a loss of $8,000) the entire amount is still subject to taxation and the 10% penalty because of the aggregation rule since accumulated earnings of all five contracts is $40,000 (4 × $12,000 − 1 × $8,000), exceeding the $36,000 withdrawal. If the annuity showing the $8,000 loss was the only contract Brenda purchased in 2011, the $36,000 withdrawal would be characterized as a combination of a $30,240 nontaxable investment being returned and a $5,760 loss treated as an itemized deduction not subject to the 2% AGI limitation for 2017.

Taxation of Nonannuity Payments

Distributions from a variable annuity that are not part of an annuity payout of the contract and that are received before an annuity starting date are taxed as ordinary income to the extent such payments do not exceed the undistributed income or earnings on the contract. Basis (or investment in the contract) is not allocated to nonannuity payments until all income has been distributed. Thus, nonannuity payments are treated first as a distribution of income and then as a distribution of basis.

A special exception applies to annuities when the contract was issued before August 14, 1982. For these contracts, nonannuity payments are treated first as a return of basis (investment) before being taxed as income distributions. When an annuity contract includes investments both before August 14, 1982, and after August 13, 1982, nonannuity payments are first allocated to pre-August 14, 1982, basis, next to income related to such basis, and finally to the post-August 13, 1982, investment.

Example 1K-3 Computing the taxable amount of nonannuity payment.

In 2006, Ann purchased a variable annuity contract for $50,000. In 2017, when the value of the contract was $90,000, Ann withdrew $10,000 to help pay for a new swimming pool. She was age 55 at the time. She had not made any previous withdrawals and did not annuitize the contract. The 2017 withdrawal is a nonannuity payment. How is the withdrawal taxed?

Because the withdrawal is a nonannuity payment, no basis is allocated until all earnings on the contract have been withdrawn. Thus, Ann must report the entire $10,000 as ordinary income in 2017, because it is less than the $40,000 ($90,000 − $50,000) of total undistributed earnings on the contract. It is also subject to the 10% premature distribution penalty tax discussed later in this lesson.

Variation: Assume that Ann purchased the annuity in 1981 instead of 2006. Here, the withdrawal relates to a pre-August 14, 1982, investment so it is deemed to first be a recovery of her investment. Thus, Ann would not report any taxable income in 2017 nor would she be subject to the 10% premature distribution penalty tax.

An amount received for a full refund, surrender, redemption, or maturity of a contract is taxed as ordinary income to the extent the amount exceeds the individual's unrecovered investment in the contract.

Premature Distributions

IRC Sec. 72(q) imposes a 10% early distribution penalty on the taxable portion of payments received from annuity contracts before age 59½. The penalty does not apply to payments—

1. made on account of the owner's death or disability,

2. that are part of a series of substantially equal periodic payments,

3. that are allocable to pre-August 14, 1982, investment in the contract, and

4. that are also subject to IRC Sec. 72(t)—the 10% tax on early distributions.

Annuity and Partial Annuity Exchange

For exchanges that qualify under IRC Sec. 1035, no gain or loss is recognized on the exchange of an annuity contract for another annuity contract. In addition, IRC Sec. 1035 also allows tax-free exchange of (1) an annuity for a qualified long-term care contract; (2) a life insurance contract for another life insurance contract, an endowment contract, an annuity, or a qualified long-term care contract; (3) a qualified long-term care contract for another qualified long-term care contract; or (4) an endowment contract for another endowment contract that provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, an annuity contract, or a qualified long-term care contract. An actual exchange of policies must occur for IRC Sec. 1035 to apply. If the policyholder receives cash and then purchases another policy with the proceeds (sometimes referred to as a rollover), IRC Sec. 1035 does not apply.

Transactions not eligible for Section 1035 nonrecognition treatment that involve a surrender of an insurance policy or endowment contract result in taxable ordinary income if the proceeds exceed the premiums or other consideration paid. Long-term care insurance contracts may not be exchanged tax-free for life insurance, annuity, or endowment contracts. Although life insurance contracts can be exchanged for an annuity tax free, the holder of an annuity cannot swap the annuity for life insurance tax free. A qualifying exchange, without recognition of gain or loss, is limited to cases where the same person or persons are the obligee(s) under the contract received in the exchange as under the original contract.

The direct transfer of a portion of the cash surrender value (CSV) of one annuity contract for another annuity contract is allowed, even if the two annuity contracts are issued by different companies. A partial annuity transfer will be a tax-free exchange if no amount, other than an amount received as an annuity for a period of ten years or more (during one or more lives) is received under either the original contract or the new contract during a period of 180 days after the transfer (in the case of a new contract, the date the contract is placed in force). Accordingly, an annuity owner holding a highly appreciated annuity can, in a tax-free exchange, directly transfer a portion of the CSV of a highly appreciated annuity into another annuity followed by the surrender of either annuity contract no sooner than 180 days from the date of the transfer. A transfer is eligible for tax-free treatment regardless of whether one of the exceptions to the early distribution penalty listed in IRC Sec. 72(q) applies.

Example 1K-4 Partial annuity exchange.

Betty Lou originally invested $50,000 in an annuity which has now grown to a fair market value of $200,000. If she draws $100,000 of cash from this annuity, it is considered entirely income. But, if Betty Lou exchanges half of the annuity, such that the insurance company issues a second annuity worth $100,000, the tax cost in each annuity is also split proportionally. Accordingly, she has a $25,000 tax cost in each $100,000 annuity after the partial exchange. If Betty Lou surrenders one of the annuities in full more than 180 days after the date of the partial exchange, she receives a $100,000 distribution that is considered to be $25,000 return of basis and $75,000 of ordinary income.

Example 1K-5 Annuity exchange for long-term care insurance.

Willy, who is 72 years old, invested $50,000 in a life insurance policy many years ago with the purpose of covering his debts and other obligations. Now that he is retired, he no longer has a need for the death benefit protection, but is concerned about the possibility of incurring long-term care costs. The cash surrender value of his policy is currently $150,000. If he were to cash in the policy, this would trigger $100,000 in ordinary income. Alternatively, Willy is able to initiate a Section 1035 tax-deferred exchange of his life insurance policy for a long-term care policy and have no current income recognition.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Leslie is a social security recipient. Which of the following forms should she use to request that income be withheld from her benefit payments?

    a. Form W-4V.

    b. Form SSA-1099.

    c. Form 5498.

    d. Form 8606.

2. Which of the following statements concerning loss recognition is correct?

    a. All amounts in all of the taxpayer's traditional IRAs must have been distributed for loss to be recognized.

    b. The deductible loss should be reported on Schedule C as an itemized deduction subject to the 2%-of-AGI floor.

    c. For AMT purposes, a loss is deductible.

    d. If an account's unrecovered basis exceeds the value of the liquidating distribution, a taxpayer cannot recognize a loss in the year an IRA is liquidated.

3. Any amount distributed from an individual's Roth IRA is treated as made in the following order, determined as of the end of the tax year. Which of the following would be considered the first amount distributed from an individual's Roth IRA?

    a. Regular annual contributions.

    b. Conversion contributions.

    c. Earnings.

    d. Rollover contributions other than Roth.

4. Which of the following statements concerning rolling over distributions from qualified retirement plans is correct?

    a. Rollovers must occur within 30 days after the funds are received.

    b. If a distribution from a qualified plan meets the definition of an eligible rollover distribution it can be rolled over into an eligible retirement plan.

    c. Nontaxable amounts not rolled over are not considered a return of basis.

    d. Nontaxable distributions cannot be rolled over to a traditional IRA.

5. Which of the following statements concerning rolling over distributions from IRAs is correct?

   a. Taxpayers cannot borrow against an IRA.

   b. Taxpayers can make up to three rollover distributions in any 365-day period.

   c. IRA distributions that are part of a distribution that is normally nontaxable cannot be rolled over to other IRAs.

   d. The rollover rules that apply to Roth IRA rollovers are different from those that apply to traditional IRA rollovers.

6. Which of the following examples correctly identifies how distributions from a SIMPLE IRA plan are made?

   a. Larry rolls over distributions from his SIMPLE IRA to a traditional IRA one year after being hired by ABC Construction Co.

   b. Freestone Rock Co. begins participating in Brett's SIMPLE IRA the day he is hired.

   c. Distributions from Karen's SIMPLE IRA should be reported on Form 5329 and are subject to qualified plan distribution rules.

   d. Lisa is employed at Thompson & Thomson Law Office. During the two-year period, Lisa's early distribution tax for her SIMPLE IRA is subject to the 10% early distributions tax.

7. Which of the following statements concerning the required minimum distribution is correct?

   a. Required minimum distributions must be by December 31st after the initial year.

   b. Credit may be taken in the current year for amounts distributed in prior years.

   c. The RMD is calculated on the aggregate of all of the plans.

   d. Taxpayers who do not comply with the RMD rules are subject to a 25% penalty.

8. No gain or loss is recognized on the exchange of an annuity contract for another annuity contract for exchanges that qualify under IRC Sec. 1035. IRC Sec. 1035 allows tax-free exchange for all of the following **except:**

   a. A policy bought with the proceeds from cash received from the policyholder.

   b. A qualified long-term care contract for another qualified long-term care contract.

   c. A life insurance contract for another life insurance contract.

   d. An annuity for a qualified long-term care contract.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Leslie is a social security recipient. Which of the following forms should she use to request that income be withheld from her benefit payments? **(Page 151)**

   a. Form W-4V. [This answer is correct. Social security recipients can request that income tax be withheld from their benefit payments. Withholding is voluntary and can be initiated by completing IRS Form W-4V (Voluntary Withholding Request), requesting to have 7%, 10%, 15%, or 25% withheld for federal income tax, and submitting the form to the recipient's local social security office.]

   b. Form SSA-1099. [This answer is incorrect. Generally, a lump-sum (or retroactive) payment of social security benefits (shown on either Form SSA-1099 or Form RRB-1099) is included in the taxpayer's total benefits in the year received.]

   c. Form 5498. [This answer is incorrect. The trustee of the second IRA reports the gross amount received in a recharacterization (contributions plus earnings) on Form 5498.]

   d. Form 8606. [This answer is incorrect. Roth IRA distributions are reported on Part III of Form 8606 (Nondeductible IRAs).]

2. Which of the following statements concerning loss recognition is correct? **(Page 155)**

   a. All amounts in all of the taxpayer's traditional IRAs must have been distributed for loss to be recognized. [This answer is correct. Loss can be recognized only when *all* amounts in *all* of the taxpayer's traditional IRAs or *all* of the taxpayer's Roth IRAs have been distributed, and total distributions are less than the remaining basis in the accounts according to IRS Notice 87-16.]

   b. The deductible loss should be reported on Schedule C as an itemized deduction subject to the 2%-of-AGI floor. [This answer is incorrect. Per IRS Pub. 590, the deductible loss (excess of remaining tax basis over liquidating distribution) should be reported on Schedule A as an itemized deduction subject to the 2%-of-AGI floor.]

   c. For AMT purposes, a loss is deductible. [This answer is incorrect. According to IRS Notice 87-16, a loss is not deductible for AMT purposes.]

   d. If an account's unrecovered basis exceeds the value of the liquidating distribution, a taxpayer cannot recognize a loss in the year an IRA is liquidated. [This answer is incorrect. According to IRS Notice 89-25, a taxpayer may recognize a loss only in the year an IRA is liquidated if the account's unrecovered basis exceeds the value of the liquidating distribution.]

3. Any amount distributed from an individual's Roth IRA is treated as made in the following order, determined as of the end of the tax year. Which of the following would be considered the first amount distributed from an individual's Roth IRA? **(Page 155)**

   a. Regular annual contributions. [This answer is correct. Distributions from regular annual contributions (including rollover contributions from other Roth IRAs and designated Roth accounts) would be the first amount to be distributed.]

   b. Conversion contributions. [This answer is incorrect. Distributions from conversion contributions (other than Roth rollover contributions), on a first-in-first-out (FIFO) basis would be the second amount to be distributed.]

   c. Earnings. [This answer is incorrect. Distributions from earnings would be the third amount to be distributed.]

   d. Rollover contributions other than Roth. [This answer is incorrect. Rollover contributions other than Roth rollover contributions are considered from conversion contributions and would be the second amount to be distributed.]

4. Which of the following statements concerning rolling over distributions from qualified retirement plans is correct? **(Page 160)**

   a. Rollovers must occur within 30 days after the funds are received. [This answer is incorrect. The rollover must occur within 60 days after the funds are received.]

   b. If a distribution from a qualified plan meets the definition of an eligible rollover distribution can be rolled over into an eligible retirement plan. [This answer is correct. Any distribution from a qualified plan meeting the definition of an eligible rollover distribution can be rolled over (in whole or in part) into an eligible retirement plan.]

   c. Nontaxable amounts not rolled over are not considered a return of basis. [This answer is incorrect. According to the IRS, nontaxable amounts not rolled over are considered a return of basis.]

   d. Nontaxable distributions cannot be rolled over to a traditional IRA. [This answer is incorrect. A nontaxable distribution (although it is not an eligible rollover distribution) can be rolled over in a trustee-to-trustee transfer to a traditional IRA or, under certain circumstances, a qualified plan.]

5. Which of the following statements concerning rolling over distributions from IRAs is correct? **(Page 160)**

   a. Taxpayers cannot borrow against an IRA. [This answer is correct. Although the law prohibits borrowing against an IRA, the IRS has ruled privately that an IRA distribution followed by a redeposit of the funds into the same (or different) IRA within 60 days qualifies as a tax-free rollover transaction.]

   b. Taxpayers can make up to three rollover distributions in any 365-day period. [This answer is incorrect. An individual can make only one rollover from an IRA (as opposed to a qualified plan) in any 365-day period. This one-year prohibition applies from the date the first IRA withdrawal is made (i.e., it does not pertain to calendar years), and applies to all IRAs held by the taxpayer, excluding conversions of a traditional IRA to a Roth IRA and trustee-to-trustee transfers.]

   c. IRA distributions that are part of a distribution that is normally nontaxable cannot be rolled over to other IRAs. [This answer is incorrect. IRA distributions attributable to nondeductible contributions (i.e., the part of the distribution that is normally nontaxable) can only be rolled over into another IRA.]

   d. The rollover rules that apply to Roth IRA rollovers are different from those that apply to traditional IRA rollovers. [This answer is incorrect. Roth IRA rollovers are subject to the same rules and requirements that apply to traditional IRA rollovers.]

6. Which of the following examples correctly identifies how distributions from a SIMPLE IRA plan are made? **(Page 169)**

   a. Larry rolls over distributions from his SIMPLE IRA to a traditional IRA one year after being hired by ABC Construction Co. [This answer is incorrect. Distributions from the SIMPLE IRA can be rolled over tax-free only to another SIMPLE IRA during the first two years of employment. After the two-year period, distributions from the SIMPLE IRA can be rolled over to eligible retirement plans [i.e., traditional IRAs, qualified plans, 403(b) plans, or governmental 457 plans] or Roth IRAs or to another SIMPLE IRA.]

   b. Freestone Rock Co. begins participating in Brett's SIMPLE IRA the day he is hired. [This answer is correct. An employee begins participating in a SIMPLE IRA plan on the day the employer first deposits contributions to the employee's SIMPLE IRA.]

   c. Distributions from Karen's SIMPLE IRA should be reported on Form 5329 and are subject to qualified plan distribution rules. [This answer is incorrect. Distributions from a SIMPLE IRA plan (reported to the taxpayer on Form 1099-R) generally are subject to IRA distribution rules, not qualified plan distribution rules.]

   d. Lisa is employed at Thompson & Thomson Law Office. During the two-year period, Lisa's early distribution tax for her SIMPLE IRA is subject to the 10% early distributions tax. [This answer is incorrect. During the two-year period, the early distribution tax for a SIMPLE IRA is 25% (rather than the standard 10%).]

7. Which of the following statements concerning the required minimum distribution is correct? **(Page 169)**

   a. **Required minimum distributions must be by December 31st after the initial year. [This answer is correct. After the initial year, required minimum distributions (RMDs) must be made by December 31 of each year. Thus, the first and second required distributions could occur in the same year. For example, a taxpayer who turns age 70 1/2 in 2017 must take his or her first IRA distribution no later than April 1, 2018 (for 2017), and his or her second distribution by December 31, 2018 (for 2018).]**

   b. Credit may be taken in the current year for amounts distributed in prior years. [This answer is incorrect. Each year's RMD amount is calculated independently. No credit may be taken in the current year for amounts distributed in prior years that were in excess of the RMD amount.]

   c. The RMD is calculated on the aggregate of all of the plans. [This answer is incorrect. The RMD must be calculated separately for each qualified plan and IRA. For qualified plans, the required distribution amount determined for each plan must be distributed from that plan.]

   d. Taxpayers who do not comply with the RMD rules are subject to a 25% penalty. [This answer is incorrect. Taxpayers who do not comply with the minimum distribution rules are subject to a 50% penalty.]

8. No gain or loss is recognized on the exchange of an annuity contract for another annuity contract for exchanges that qualify under IRC Sec. 1035. IRC Sec. 1035 allows tax-free exchange for all of the following **except: (Page 173)**

   a. **A policy bought with the proceeds from cash received from the policyholder. [This answer is correct. If the policyholder receives cash and then purchases another policy with the proceeds (sometimes referred to as a rollover), IRC Sec. 1035 does not apply. However, IRC Sec. 1035 also allows tax-free exchange of an endowment contract for another endowment contract that provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, an annuity contract, or a qualified long-term care contract.]**

   b. A qualified long-term care contract for another qualified long-term care contract. [This answer is incorrect. IRC Sec. 1035 allows tax-free exchange of a qualified long-term care contract for another qualified long-term care contract.]

   c. A life insurance contract for another life insurance contract. [This answer is incorrect. IRC Sec. 1035 allows tax-free exchange of a life insurance contract for another life insurance contract, an endowment contract, an annuity, or a qualified long-term care contract.]

   d. An annuity for a qualified long-term care contract. [This answer is incorrect. IRC Sec. 1035 allows tax-free exchange of an annuity for a qualified long-term care contract.]

Lesson 2: Other Items of Income

Introduction

This lesson covers a variety of Form 1040 reporting issues and gross income topics.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine when the recapture of excess alimony payments are required, how to report ministers' housing allowance, and how to exclude personal injury awards form gross income.
- Determine how to report refunds of itemized deductions under the tax benefit rule, how distributions are made from health savings accounts, and how to receive life insurance proceeds before death.
- Identify education savings accounts (ESAs), qualified tuition programs, and selected other income items.

Recapture of Excess Alimony Payments

Alimony payments under a divorce decree or similar instrument are viewed in the Internal Revenue Code as a shift of income from the payer to the payee. Generally, the payer can deduct the alimony while the payee must recognize the payments as income. To preserve the underlying theory that alimony is a shift of income between taxpayers and not disguised property settlements, the payments must meet a three-year recapture rule. This rule provides that the payer recapture excess alimony payments as income in the third post-separation year, while the payee is entitled to the same amount from gross income. The excess alimony payments also are referred to as front-loaded payments, referring to excessive amounts paid in the early years.

When Does Recapture Occur?

Recapture can happen only in the third post-separation year. A post-separation year is any calendar year beginning with the first calendar year alimony payments are made under a divorce or separate maintenance decree or separation agreement. Payments under a temporary support order or an interlocutory decree do not start the post-separation year clock. The second and third post-separation years are the first two calendar years following the first post-separation year. For example, if in December 2017, the first alimony payment under a divorce decree is made, then 2017 is the first post-separation year, and 2018 and 2019 are the second and third post-separation years.

Amount Recaptured

The recapture amount is determined by comparing the alimony payments made in the third post separation year to alimony payments in the first and second years. If the payments in the first and second years exceed certain amounts, the sum of each year's excess is recaptured in the third year.

Excess Second-year Payments Calculated First. Excess second-year payments are calculated before excess first-year payments can be calculated. The excess second-year payments are the payments made during the second year that exceed those made during the third year by more than $15,000.

Excess First-year Payments Calculated Next. Excess first-year payments are calculated after the excess second-year payments. The amount of first-year payments that must be recaptured is the amount by which the first-year payments exceed the sum of (1) $15,000, plus (2) the average of the unrecaptured second-year payments and the third-year payments.

Example 2A-1 Computing alimony recapture.

Following their divorce in 2015, Ed and Janice resided in separate households and filed separate tax returns. In accordance with the terms of the divorce instruments, Ed made (and deducted) the following payments to Janice: 2015—$60,000; 2016—$40,000; and 2017—$20,000.

Using the following worksheet, the practitioner determines that Ed will recognize alimony recapture income of $22,500 in 2017, and Janice can deduct the same amount.

(1)	Alimony paid in 2nd year			$ 40,000
(2)	Alimony paid in 3rd year		20,000	
(3)	Floor		15,000	
(4)	Add lines 2 and 3			(35,000)
(5)	Excess alimony paid in 2nd year (line 1 − line 4)			5,000
(6)	Alimony paid in 1st year		60,000	
(7)	Adjusted alimony paid in 2nd year (line 1 − line 5)	35,000		
(8)	Alimony paid in 3rd year	20,000		
(9)	Add lines 7 and 8	55,000		
(10)	Average alimony paid in 2nd and 3rd years (line 9 × 50%)	27,500		
(11)	Floor	15,000		
(12)	Add lines 10 and 11		(42,500)	
(13)	Excess alimony paid in 1st year (line 6 − line 12)			17,500
(14)	Recaptured alimony (line 5 + line 13)			$ 22,500

Ed's 2017 recapture income is reported on Form 1040, line 11, "Alimony received." He should cross out the word "received" and write in the word "recapture" and show Janice's name and social security number on the dotted line. Similarly, Janice deducts the recapture on line 31a, "Alimony paid," with Ed's name and social security number disclosed in the space provided to the left of line 31a.

Certain situations that may otherwise result in excess alimony payments are excepted from the recapture rules. These include the following:

1. Payments made under a temporary support order (before the divorce or separation).

2. Payments that end within the three-year period because (a) either spouse dies, or (b) the payee spouse remarries.

3. Payments that vary but are fixed as a percentage or portion of income from a business, property, or employment (including self-employment) are not subject to recapture provided the agreement is effective for at least three years.

Reporting Ministers Housing Allowances

A minister of the gospel may exclude from gross income a parsonage allowance. A parsonage allowance is (1) the rental value, including utilities, of a furnished home or (2) a cash allowance paid to a minister so he can rent or purchase a home. In *Driscoll*, the Tax Court originally ruled that an ordained minister and his wife were entitled to exclude from income a parsonage allowance received for their principal residence and a second home. The 11th Circuit reversed the Tax Court and ruled that the legislative history only referred to a singular home and disallowed the parsonage allowance for the second home. In addition, the IRS has ruled that a minister's housing allowance was not excludible to the extent it exceeded reasonable compensation for the minister's services.

Although a parsonage allowance is excluded from income for income tax purposes, allowances of active (as opposed to retired) ministers must be included in calculating their self-employment (SE) income for SE tax purposes. Also, a parsonage allowance that is excluded from income is still counted as earned income for purposes of the earned income credit.

In an Information Letter, the IRS has confirmed that retired ministers are able to exclude from income a parsonage allowance that is provided as compensation for past services. The governing body of a religious organization may also set up a retirement account and designate that a portion of a retired minister's pension as a parsonage allowance for compensation for past services.

Ministers who are employees should receive a Form W-2 showing their taxable compensation. The amount shown as taxable wages should not include a parsonage or rental (housing) allowance. These amounts may be reported in box 14 (Other) of Form W-2.

Minister Receives Cash Housing Allowance

When the minister receives a cash allowance to be used for housing, the income exclusion applies only to the amount actually used to provide housing. In addition, the exclusion cannot exceed the fair rental value of the home (including furnishings and appurtenances such as a garage) plus the cost of utilities.

Example 2B-1 Computing a minister's excludible housing allowance.

Rev. Gates, an ordained minister, receives a $25,000 salary from his church in 2017 plus a designated housing allowance of $12,000. (The salary is reported in box 1 of his Form W-2 while the housing allowance is shown in box 14.) During the year, Rev. Gates spent the following amounts for housing: mortgage payments (which include taxes and insurance)—$10,000; utilities—$1,200; furnishings—$800; repairs and maintenance—$500, for a total of $12,500. Rev. Gates believes the house, as furnished, could be rented for $800 a month ($9,600 per year).

The housing allowance exclusion is limited to the lesser of:

Designated amount per ministerial agreement	$ 12,000
Fair rental value of housing plus actual utilities:	
Annual rental value of home	$ 9,600
Actual annual utilities expense	1,200
	$ 10,800
Actual annual amount expended to provide the home	$ 12,500

In Rev. Gates' case, the 2017 exclusion is limited to $10,800. The $1,200 ($12,000 − $10,800) excess of the amount received over the excludible amount is taxable income (reported on line 7 of Form 1040) in addition to the $25,000 wages. Rev. Gates' income for SE tax purposes is $37,000 ($25,000 + $1,200 + $10,800).

When a housing allowance is used to pay mortgage interest and real estate taxes and is excluded from income, the minister can still claim the interest and taxes as itemized deductions on Schedule A. In effect, he or she obtains a double tax benefit for these amounts. However, for a mortgage payment to be considered a cost of providing housing, the proceeds of the mortgage must be used to provide the minister's home. Payments on a home equity loan where the proceeds were used for other purposes do not qualify for the exclusion (*Rasmussen*).

Example 2B-2 Minister's housing exclusion limited to actual expenses.

Assume the same facts as in Example 2B-1, except that Rev. Gates had purchased his home many years ago and has since paid off the mortgage. For 2017, he does not spend $10,000 on mortgage payments; instead, he pays the insurance and taxes himself, and these total $2,500. The rest of his expenses are the same. Here, Rev. Gates' actual expenditures only total $5,000. Thus, his allowable exclusion is limited to $5,000. He must report in income the $7,000 difference between the $12,000 housing allowance he received and his allowable exclusion of $5,000. This amount is added to the wages he reports on line 7 of Form 1040. However, sometimes, if the clergy is an employee, a reconciliation must be provided to the employer before W-2s are issued and any excess housing allowance will be accounted for in the W-2. If this is the case, the tax preparer will not need to make any adjustments to the W-2.

Excluding Personal Injury Awards from Gross Income

General Rules

The amount of any damages (other than punitive damages, discussed later) received as a result of a *physical* injury or *physical* sickness is excludible from gross income. The exclusion can apply whether the damages are received

as the result of a lawsuit or a settlement agreement, and whether they are received in a lump sum or periodic payments. However, even if damages are nontaxable, the portion (if any) treated as interest must be included in taxable interest income. Similarly, delay damages added to the jury verdict in a personal injury suit have been held to be tantamount to interest (compensating the plaintiff for the lost time value of money) and are primarily a procedural tool designed to encourage settlement. Consequently, they are not damages received on account of personal injury and not excludible from gross income. A portion of a settlement for injuries can also be allocated to prejudgment interest. See, for example, *McCann* in which the 5th Circuit held that neither the settlement agreement or the general release contained a specific damages allocation to which proper regard should be paid; the Court found that the interest allocation was amply supported by the facts in that the total settlement exceeded the state's law's cap and that excess amount was coded as interest (and therefore taxable) on the settlement check.

Generally the proceeds of a personal injury settlement can be excluded from income only by the injured party. For example, in *Trent*, the court held that a mother could not exclude from income her portion of the settlement for care she provided to her son as damages received on account of personal injuries.

Determining Whether Damages or Settlements Are Taxable

Physical Injuries and Physical Sickness. Damages or settlement payments to compensate the taxpayer for a physical injury or physical sickness are excludible from income under IRC Sec. 104(a)(2) if they involve a claim based on a tort or tort-like right. In *Burke*, the Supreme Court noted that a tort generally is broadly defined to include wrongful acts, other than breach of contract, for which the courts provide a remedy in the form of an action for damages. However, the exclusion may apply to damages received for a physical injury or physical sickness under a statute regardless of whether that statute provides for a broad range of remedies and even if the injury is not defined as a tort under state or common law (this effectively reverses the decision in *Burke*). A settlement should clearly attribute payment for physical injury or physical sickness for exclusion purposes. The exclusion extends to the portion of the award that replaces lost wages, even though the wages would have been taxable if the taxpayer had earned them. However, medical expenses incurred and deducted in a year prior to settlement of a personal injury suit will be presumed recovered first out of the settlement proceeds, in the absence of an express allocation to such expenses, and are includable in gross income in the year of receipt to the extent allowed in the prior tax year. The exclusion under IRC Sec. 104(a)(1) does not extend to retirement payments occasioned by an occupational injury once disability payments were replaced by retirement benefits.

Example 2C-1 Damage award for physical injury.

In 2016, Rusty was injured in an auto wreck. He incurred unreimbursed medical expenses of $24,500 plus $15,000 in lost wages because of the accident. He also suffered substantial pain attributable to his physical injuries. On his 2016 return, Rusty claimed the $24,500 of medical expenses, of which $20,000 was actually deductible after limitations.

In 2017, Rusty agreed to a $300,000 out-of-court settlement to cover his medical expenses, lost wages, and all other compensatory damages related to the accident. The award was not allocated between the various types of damages.

Rusty can exclude $280,000 ($300,000 award less the $20,000 medical deduction claimed in 2016). $20,000 is taxable in 2017, when the lump-sum payment was received. The exclusion extends to the settlement portion that replaces Rusty's lost wages, even though, had he earned the wages, they would have been taxable.

A lump-sum settlement that is for both (1) personal injuries or sickness and (2) an agreement not to reveal the circumstances that led to the injuries must be divided into two parts. The part pertaining to the injuries can be excluded from income but the remainder has to be included in income.

Nonphysical Injuries. Amounts received for nonphysical injuries such as employment discrimination and injury to reputation are not excludible from gross income. However, if an action originates in a physical injury or sickness, all damages (other than punitive damages) paid for the injury or sickness are treated as on account of physical injury or sickness, 104th Cong., 2nd Sess. (1996)] and are excluded from income. This rule applies whether or not the recipient is the injured party. It also applies in the case of an award for emotional distress that is attributable to a physical injury or sickness.

Emotional distress itself is not considered a physical injury or illness eligible for exclusion from income under IRC Sec. 104(a)(2). However, damages received for emotional distress that are attributable to a physical injury or physical sickness or reimbursement of medical expenses incurred to treat the emotional distress (e.g., medical expenses to treat physical sickness such as insomnia, headaches, or stomach disorders that resulted from the emotional distress) are not taxable. In *Domeny*, the Tax Court found the taxpayer's exposure to a stressful work environment exacerbated her MS symptoms to the point she was unable to work, and therefore a specified portion of her settlement was excluded from gross income under IRC Sec. 104(a)(2). In a similar Tax Court ruling, one-half of an ex-employee's settlement was excluded from gross income based on his underlying claim of intentional infliction of emotional distress that led to a career-ending second heart attack.

Punitive Damages. Punitive damage awards (i.e., awards to punish the wrongdoer) are taxable whether they relate to physical or nonphysical injuries. The only exception is for damages awarded in a civil action for wrongful death when the applicable state law (as in effect on September 1, 1995, without regard to subsequent modification) provides or has been construed to provide that only punitive damages may be awarded in the action. In these rare situations, the punitive damages are excluded from income to the extent received on account of physical injury or physical sickness.

Assigning punitive damages to a third party (in this case a charitable trust) before it was certain that the damages would be received did not result in income to the assignor. However, only damages in excess of the amount paid to the attorney on a contingency basis could be assigned. The portion of the award paid to the attorney was included in the taxpayer's income, with only a miscellaneous itemized deduction available to offset it.

Reporting Refunds of Itemized Deductions under the Tax Benefit Rule

What Is the Tax Benefit Rule?

The tax benefit rule ordinarily requires taxpayers to include in gross income the amount of a prior year deduction when an event occurs that is fundamentally inconsistent with the premise of the deduction (*Hillsboro National Bank*). An event is fundamentally inconsistent with the premise of a deduction if the deduction would have been precluded had the event occurred in the same tax year as the deduction.

Under IRC Sec. 111(a), if some or all of a prior year deduction provided no tax benefit because it failed to reduce tax or increase an NOL in the year deducted, the refund or recovery of the previously deducted amount is included in gross income only to the extent of the tax benefit derived from the original deduction. For example, a refund of a deductible personal expense (itemized deduction) is not subject to tax if the taxpayer used the standard deduction in the year the amount was paid or withheld. Furthermore, even if a taxpayer itemized in the prior year, only a portion of the current refund may be taxable if the prior year's deduction did not produce a full tax benefit.

The most common recoveries are those related to itemized deductions (e.g., state income tax and property tax refunds or credits, casualty loss insurance reimbursements). However, recoveries of nonitemized deductions are also subject to the tax benefit rule. These recoveries include such items as payments received for an amount previously deducted as a bad debt or claimed as a tax credit, other than the investment credit or foreign tax credit. For tax credits, current-year tax is increased by the amount of credit attributable to any current-year downward price adjustment or similar adjustment. No increase to tax is required if the taxpayer did not receive a tax benefit for the original credit.

Although the Tax Court has held that the tax benefit rule does not apply when the original deduction was claimed in error and in a tax year that is now closed under the statute of limitations (i.e., the "erroneous deduction exception"), the circuit courts have repeatedly rejected this position, requiring instead that the recovered amounts be included in income. In *Hughes & Luce, LLP*, the 5th Circuit joined the 2nd, 6th, 7th, and 9th in holding that the tax benefit rule applies even if the original deduction was erroneous and claimed in a closed year.

This section deals specifically with the recovery or refund of an itemized deduction since this is the most common application to individuals.

Reporting Partially Taxable Refunds

Generally, the taxable portion of a refund of a previously claimed itemized deduction is reported on the appropriate line of Form 1040 (line 10 for refunds of state and local income taxes and line 21 for other refunds). Most refunds are not reported on information returns filed with the IRS, so no further disclosure is needed. However, state and local tax refunds are reported on Form 1099-G (Certain Government Payments). Therefore, the IRS will generally match the Form 1099-G amount to the return to ensure the taxpayer reported the refund as income. This gives rise to tax return presentation problems when only part (or none) of the refund is properly includable in gross income. In such cases, the IRS recommends a statement be attached to the return reconciling the amount reported on Form 1099-G with the amount reported on line 10 of the return (as shown in Example 2D-4).

Recoveries Related to Medical Expenses and Casualty Losses

Taxpayers may receive reimbursement for medical expenses and casualty losses. These are included in income as discussed in the subsequent paragraphs. (However, the rules discussed later in this section for such items as the prior-year standard deduction must be considered in computing the actual amount includable in income.)

Medical Expense Reimbursements. Medical expense reimbursements (from insurance, etc.) occurring in the same year the expenses are paid offset the expenses in calculating the deductible amount. If a taxpayer (and not his employer) pays the entire premium for medical insurance, no taxable income is generated (and no deduction is allowed) if insurance reimbursements exceed the total medical expenses incurred.

If reimbursed in a later year, some or all of it may have to be included in income. To calculate the reportable amount, if any, the practitioner must calculate the tax benefit received from the expense. This is done by computing the amount that would have been deducted in the prior year had the reimbursement been received then and comparing that recomputed deduction to the actual deduction claimed.

Example 2D-1 Reimbursement of medical expenses paid in prior year.

Biff, age 24, is single and in 2016 had AGI of $40,000 and paid $5,000 in medical expenses. His 2016 itemized deductions included $7,900 of mortgage interest and taxes and $1,000 for medical expenses [$5,000 − $4,000 (medical expenses limited to amount exceeding 10% of AGI)]. In 2017, Biff had no medical expenses but received a $4,000 insurance company reimbursement for his 2016 medical expenses.

The amount Biff must report as income in 2017 due to the reimbursement is computed as follows:

Amount actually deducted in 2016		$ 1,000
Recomputed deductible amount:		
Medical expenses	5,000	
Less reimbursement	(4,000)	
Less 10% of AGI	(4,000)	
Recomputed deductible amount (not less than zero)		—
Tax benefit received		$ 1,000

Biff must include $1,000 of the $4,000 refund in gross income in 2017.

Insurance Reimbursements of Casualty Losses. IRC Sec. 165(c)(3) allows a deduction for losses resulting from a casualty or theft of personal-use property. The amount of the loss is the lesser of the adjusted basis of the property or the decrease in FMV due to the casualty or theft. Once the amount of the loss is determined, it must be offset by expected reimbursements (e.g., insurance proceeds, etc.) and is generally deductible only to the extent the loss exceeds a $100 floor (per loss) and total net losses (aggregate losses in excess of gains) exceed 10% of AGI. (Special rules may apply for taxpayers suffering losses in federally declared disaster areas.)

If an insurance reimbursement is expected but has not been received before the return is filed, the taxpayer must consider the expected reimbursement in determining the loss. If the eventual reimbursement is less than expected, include that difference with other losses (if any) on the taxpayer's return for the year in which no more reimbursements are reasonably expected. Thus, it is subject to additional $100 and 10% of AGI reductions. (The original return is not amended.)

If the taxpayer later receives a larger reimbursement than expected, the excess is included in income in the year received to the extent of the tax benefit received in the earlier year. Separate rules apply to insurance reimbursements for living expenses following a casualty.

Example 2D-2 Insurance reimbursement of casualty loss deducted in prior year.

Jim and Mary had AGI of $55,000 in 2016 and incurred a casualty loss of $6,600 (after considering their insurance reimbursement and other limitations). However, their 2016 tax deduction for the loss was limited to $1,000 [$6,600 − $100 floor − $5,500 (10% of AGI)]. Their total 2016 itemized deductions, including the $1,000 casualty loss, were $14,500. In 2017, they received an unexpected $3,500 of additional insurance reimbursement.

The amount they must report as income in 2017 due to the reimbursement is computed as follows:

Amount actually deducted in 2016		$ 1,000
Recomputed deductible amount:		
Casualty loss	6,600	
Less additional reimbursement	(3,500)	
Less 10% of AGI plus $100 floor	(5,600)	
Recomputed deductible amount (not less than zero)		—
Tax benefit received		$ 1,000

Jim and Mary must include $1,000 of the $3,500 refund in gross income in 2017.

Note: An involuntary conversion gain occurs when total reimbursements exceed the adjusted basis of the loss property. However, taxpayers may elect to defer such gains if the property is replaced under the involuntary conversion rules.

There may be situations when a loss gives rise to a deduction so that gain attributable to a later sale that ordinarily would be excludible from income is taxable as a recovery. In IRS Technical Assistance (ITA) 1998-474, the taxpayers suffered a loss from the flooding of their personal residence and, accordingly, claimed a casualty loss deduction. Two years later, the city purchased their residences at pre-casualty fair market values to make way for the construction of a dike. The gain from the sale would normally qualify for the Section 121 home sale gain exclusion. However, the IRS viewed the city's purchase of the homes as providing compensation for their loss in the nature of the insurance. Further, the IRS ruled that inclusion of gain under the tax benefit rule overrides the Section 121 exclusion so in the year of sale, the taxpayers must recoup the casualty loss deduction they claimed in the previous year. Similarly, the tax benefit rule overrode the Section 1033 involuntary conversion gain deferral rules when a taxpayer received a condemnation award that was treated as a recovery of a previously deducted casualty loss (*Mager*). Although these situations allowed the tax benefit rule to prevail, there is no blanket application of this holding; instead, each similar situation requires an analysis of the applicable Code sections.

Effect of the Prior-year Standard Deduction

If the taxpayer did not itemize in the year an expense was originally paid, no refund of that expense is taxable. If the taxpayer did itemize, a refund or recovery of an amount previously claimed as an itemized deduction is included in income, but only to the extent itemized deductions exceeded the standard deduction (i.e., produced a tax benefit).

Example 2D-3 Standard deduction limits prior-year tax benefit.

John and Sue are married and file a joint return. They had taxable income of $50,000 and claimed $12,800 in itemized deductions in 2016. In 2017, they received a $700 refund of state and local taxes that had been paid and deducted in 2016. Itemized deductions produced only a $200 tax benefit in 2016 (since they exceeded the $12,600 standard deduction for 2016 by that amount). Therefore, the amount subject to tax from the recovery or refund of any itemized deduction cannot exceed $200, and the remaining $500 of the tax refund received in 2017 is nontaxable under the tax benefit rule.

Refunds Attributable to More Than One Year

A refund or recovery attributable to amounts paid in more than one year is allocated on a prorata basis between those years.

Example 2D-4 Refund of taxes paid in more than one year.

Mike, a cash-basis taxpayer, made these estimated state income tax payments for 2016:

First quarter	$1,000	4/15/16
Second quarter	1,000	6/15/16
Third quarter	1,000	9/15/16
Fourth quarter	1,000	1/15/17

Mike subsequently received a 2017 Form 1099-G (Certain Government Payments) reporting a $600 state tax refund. This refund was entirely attributable to his 2016 state return. Since the first three quarterly payments totaling $3,000 were deducted and provided a full tax benefit in his 2016 federal tax return, Mike must prorate the $600 refund between the 2016 and 2017 tax years. The amount of the refund allocable to 2017 will reduce his 2017 deduction for state taxes. The portion of the refund allocable to 2016 is includable in gross income (line 10 of Form 1040) because Mike received a tax benefit from the 2016 deduction.

Mike's practitioner makes the following allocation of the refund:

2017 income from refund of state taxes paid in 2016: $600 × $3,000/$4,000	450
Reduction to 1/15/17 estimated state income tax payment: $600 × $1,000/$4,000	150
Amount of state and local tax refunds reported per Form 1099-G	$ 600
Amount reported as income on 2017 Form 1040 (allocable to 2016 deduction)	$ 450
Amount used to offset 2017 state and local tax payments on 2017 Schedule A	150
Total amount reported as 2017 income or used to offset 2017 deductions	$ 600

The IRS has taken the position that a refund of state income taxes attributable to a prior year is reportable only to the extent of the excess of the actual state income tax deduction claimed over the state and local general sales tax deduction that could have been claimed for that year.

Example 2D-5 State income tax refund limited.

For 2016, Jim deducted $11,000 of state income tax in lieu of a $10,000 sales tax deduction that he could have deducted. In 2017, he received a $2,500 state income tax refund. However, Jim has to report only $1,000 of the state income tax refund in 2017.

Effect of Tax Credits in Year of Deduction

When taxable income was positive in the previous year, but no tax was paid because of tax credits, a special computation is needed to determine the tax benefit received from the refunded amount.

Example 2D-6 Effect of excess tax credits.

Dave and Sandy filed a joint 2016 return and claimed $17,000 of itemized deductions. Their taxable income was $5,000 (resulting in a tax of $500 at a 10% rate), and they were eligible to claim an $800 Lifetime Learning education tax credit.

In 2017, they received a full refund of their 2016 state tax payment. How much of their state tax refund is taxable in 2017 assuming (1) a refund of $500, or (2) a refund of $3,500?

	$500 State Tax Refund				$3,500 State Tax Refund			
	2016 Taxable Income	2016 Tax	2016 Tax Credit	Net Tax	2016 Taxable Income	2016 Tax	2016 Tax Credit	Net Tax
As filed	$ 5,000	$ 500	$ 500	$ —	$ 5,000	$ 500	$ 500	$ —
Add back deduction for state tax refunded in 2017	500				3,500			
Recomputed	$ 5,500	550 [a]	550	—	$ 8,500	850	800	$ 50

Note:

[a] $5,500 × 10%

$500 Refund. Under the tax benefit rule, the state tax refund is nontaxable in 2017 because the deduction of the state taxes in 2016 did not reduce federal income tax.

$3,500 Refund. IRS Pub. 525 indicates that if tax credits are less than the recomputed tax, the refund is included in income to the extent it reduced tax in the prior year. The taxpayer received only a $500 ($50 net tax ÷ 10% tax rate) tax benefit from the deduction in 2016. Therefore, $500 of the $3,500 refund should be included in 2017 income.

Alternative Minimum Tax in Prior Year

Recovery of a previously deducted amount does not increase gross income if the deduction did not reduce the tax imposed under Chapter 1 of the Internal Revenue Code. That chapter encompasses several types of taxes, including the alternative minimum tax (AMT). If AMT applied in the year of deduction, the practitioner must recompute both regular tax and AMT to determine if a tax benefit was received.

Taxes and miscellaneous itemized deductions subject to the 2% of AGI floor are not deductible for AMT and provide no benefit when it applies. However, when the deduction itself puts the taxpayer into AMT, a special calculation is necessary to determine the tax benefit received.

Example 2D-7 State and local tax deduction triggered prior-year AMT.

Single taxpayer Mike paid a small amount of AMT in 2016. State income taxes of $2,000 were included as an itemized deduction on his 2016 return. In 2017, Mike received a refund of the entire $2,000. To calculate the 2016 tax benefit from the refunded taxes, his 2016 regular and AMT liabilities must be recomputed. Mike's federal tax return reported the following amounts in 2016:

	Taxable Income	Tax
2016 regular tax as filed	$ 19,500	$ 2,461
2016 AMT as filed	10,000	2,600

Since AMT applied in 2016, the practitioner recomputes both the regular tax and the AMT without the $2,000 deduction.

	Taxable Income	Tax
2016 recomputed regular tax	$ 21,500	$ 2,761
2016 recomputed AMT (no change)	10,000	2,600

The 2016 recomputed regular tax exceeds the recomputed AMT by $161. Therefore, because the state tax deduction provided a tax benefit in 2016, the refund must be included in 2017 income to the extent the deduction reduced taxes in 2016. Thus, $1,073 will be included in income in 2017 ($161 difference in tax ÷ 15% tax rate).

Distributions from a Health Savings Account

Health savings accounts (HSAs) allow taxpayers to accumulate funds to pay for qualifying medical expenses. To the extent used for qualified medical expenses, any earnings on the account are tax-free. This section focuses on distributions from an HSA. Contributions to HSAs are covered in Lesson 3.

The HSA beneficiary (the individual for whom the account is set up) can take tax-free withdrawals to pay uninsured medical expenses for the account beneficiary, spouse, and dependents that would be deductible as itemized medical expenses. Medical expenses include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease. Qualified medical expenses for which a deduction is allowed are generally limited to expenses incurred for the prevention or alleviation of a physical or mental illness (e.g., hospital and surgical services, medical labs, x-rays. Additionally, items that have no other purpose than to treat a disease, illness, or physical or mental defect may qualify as medical care. Items that merely benefit overall health (e.g., a vacation or vitamins) are not considered expenditures for medical care.

HSA reimbursement for medicine or drugs is limited to (1) prescription medicine or drugs, (2) over-the-counter (OTC) drugs for which a prescription is obtained, and (3) insulin. A *prescription* is defined as a written or electronic order that satisfies the legal requirements for a prescription in the state in which the expense is incurred, and issued by someone legally authorized to issue a prescription in that state. An OTC drug is regarded as prescribed if a prescription is obtained for it, though not legally required. Proper documentation of the prescription must accompany the request for reimbursement.

Withdrawals not used for qualifying medical expenses are taxable to the account beneficiary, regardless of when they are made. In addition, a 20% penalty tax applies to such distributions unless they occur after the beneficiary reaches the Medicare eligibility age (currently, age 65). The 20% penalty tax is also waived for withdrawals after the account beneficiary becomes disabled or dies.

Generally, health insurance premiums are not qualified medical expenses, except for the following:

- Qualified long-term care insurance [subject to the same deduction limits set forth in IRC Sec. 213(d)(10)].
- COBRA health care continuation coverage.
- Health care coverage while an individual is receiving unemployment compensation.

For individuals over age 65, premiums can be paid from an HSA for Medicare Part A, Part B, and Part D, Medicare HMO, and the employee's share of premiums for employer-sponsored health insurance, including premiums for employer-sponsored retiree health insurance. However, if the account beneficiary is under age 65, but the beneficiary's spouse is age 65 or over, Medicare premiums for coverage of the spouse are not qualified medical expenses. Premiums for Medigap policies are not qualified medical expenses.

Rollovers from HSAs

HSA distributions can be rolled over into another HSA tax-free as long as another tax-free rollover has not been made within the previous 12 months. However, the rollover must occur by the 60th day after the day on which the beneficiary receives the distribution.

Divorce-related Transfers of HSAs

The transfer of an individual's interest in an HSA to a spouse or former spouse under a divorce or separation instrument is not considered a taxable distribution to either party. Subsequently, the transferee is considered the HSA beneficiary.

Transfers at the Account Beneficiary's Death

Surviving Spouse Is Named as Beneficiary. If the HSA beneficiary's surviving spouse acquires the beneficiary's interest in the HSA because he or she was the designated beneficiary of the HSA when the original account

beneficiary dies, the HSA is treated as if the surviving spouse were the original account beneficiary (i.e., the spouse is taxed only to the extent distributions from the HSA are not used for qualified medical expenses).

Nonspouse Beneficiary. If a person other than the surviving spouse acquires the account beneficiary's interest in an HSA due to the account beneficiary's death, the account ceases to be an HSA and its date-of-death value is included in the transferee's taxable income for the tax year in which the account beneficiary dies. The income amount is reduced by any qualified medical expenses of the decedent paid by the transferee within one year after the date of death. Also, the beneficiary can claim a Section 691 deduction for any federal estate tax paid and attributable to the HSA that he or she includes in taxable income.

If the HSA does not have a designated beneficiary (in the event of the original account beneficiary's death) or the estate is the designated beneficiary, the date of death value of the HSA is included in the account beneficiary's final Form 1040.

Life Insurance Proceeds Received before Death

Certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death (an accelerated death benefit) can be excluded from income. In addition, any portion of a death benefit under a life insurance contract on the life of a terminally or chronically ill individual that is sold or assigned to a viatical settlement provider is also excluded from income.

Accelerated Life Insurance Proceeds

Because seriously ill patients often do not have the funds to pay the significant expenses they incur, some insurance carriers offer benefits during the life of the insured when he is terminally ill or when he has other devastating conditions, such as Alzheimer's Disease or AIDS. Insurance carriers usually refer to such benefits as living benefits or accelerated benefits.

Amounts received under a life insurance contract on the life of a terminally ill or chronically ill individual (defined later in this section) are treated as paid by reason of death. Terminally ill individuals can generally exclude from gross income the entire amount of accelerated death benefits, while for chronically ill individuals, the exclusion is allowed only to the extent the payments are used for long-term care services and do not exceed prescribed daily and annual limits. The exclusion from gross income does not apply if the accelerated death benefits are paid to someone other than the insured individual if the recipient has a business or financial relationship with the insured.

Viatical Settlements

Viatication allows a terminally or chronically ill person to sell a life insurance policy to someone who is buying it as an investment (i.e., the buyer receives the life insurance proceeds upon the death of the insured). Amounts received from the sale or assignment of a life insurance contract on the life of a terminally ill individual to a qualified viatical settlement provider are excluded from gross income. However, the exclusion does not apply if the payments are paid to someone other than the terminally ill individual if the recipient has a business or financial relationship with the insured.

A chronically ill individual (defined later in this lesson) can also exclude amounts received for viatical settlements but only if the payments are used for long-term care services and subject to per day and annual limits. The services cannot be compensated by insurance and generally cannot be reimbursable by Medicare.

A *viatical settlement provider* is any person regularly engaged in the trade or business of purchasing or taking assignments of life insurance contracts on the lives of individuals who are terminally or chronically ill. In addition, the viatical settlement provider must generally be licensed in particular states where they do business, or must otherwise meet certain legal requirements.

An individual need not be terminally or chronically ill to enter into a viatical settlement. However, there is no income exclusion in this situation. Instead, the seller must report income to the extent the sales proceeds exceed his or her adjusted basis in the contract. The adjusted basis, which cannot be less than zero, is equal to (1) the amount of

premiums the taxpayer paid up to the time of sale less (2) the amount of any refunded premiums, rebates, dividends, or unrepaid loans that were not included in the policyholder's income. Although a life insurance policy is a capital asset in the hands of the policyholder, gain to the extent of the policy's cash surrender value over the adjusted basis is taxed as ordinary income under the assignment of income doctrine. To the extent the gain exceeds that amount, it is treated as capital gain, assuming it is a capital asset in the hands of the taxpayer.

Surrender of Life Insurance Contract

The owner of a life insurance policy must realize gain on the surrender of the policy. The gain is the amount by which the sales proceeds exceed the taxpayer's adjusted basis in the life insurance contract and is treated as ordinary income to the seller.

Example 2F-1 Surrender of life insurance policy to insurer.

In June, Cole surrendered his LifeCo. life insurance policy to LifeCo. for the policy's cash surrender value of $78,000. Cole had obtained the policy eight years earlier and had made premium payments totaling $64,000. At surrender, Cole must recognize $14,000 ($78,000 − $64,000) of ordinary income, reportable as "other income" on line 21 of his Form 1040.

Definitions

A *terminally ill* taxpayer is someone who has been certified by a physician to have an illness or physical condition that is expected to cause death within 24 months from the date of certification.

A *chronically ill* individual is generally someone who has been certified within the previous 12 months by a licensed health care practitioner as (1) needing substantial assistance to perform at least two activities of daily living (eating, toileting, transferring, bathing, dressing, and continence) for at least 90 days, due to a loss of functional capacity, (2) having a similar level of disability to item (1) as determined under regulations, or (3) requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. A *licensed health care practitioner* means any physician, registered professional nurse, licensed social worker, or other similar individual that may be prescribed by regulations.

Long-term Care Insurance Proceeds

A qualified long-term care insurance contract is generally treated as an accident and health insurance contract. Amounts received under a qualified long-term care insurance contract (other than policyholder dividends or premium refunds) may be excludible from income as amounts received for personal injury and sickness. The premiums on long-term care insurance contracts and the expenses of qualified long-term care are treated as medical expenses.

Example 2G-1 Exclusion of payments made under long-term care insurance contract.

Clem, age 60, suffers a stroke and spends 180 days in a rehabilitation facility. He is unable to perform at least two activities of daily living while there so he is treated as a chronically ill individual. His qualified LTC policy has a 30-day waiting period and then pays 80% of the amount charged by the facility. The facility charges $150 per day for a total of $27,000. The insurance company pays $18,000 [(180 days − 30-day waiting period) × $150 × 80%] and Clem pays the remaining $9,000. The $18,000 is not included in Clem's income. Furthermore, he can deduct the $9,000 as a medical expense, subject to the 10% AGI limit (for 2017).

Some long-term care insurance contracts pay a certain amount per day, regardless of the actual long-term care costs. For chronically ill individuals receiving benefits from these policies, the exclusion from income is limited. For 2017, the excludible amounts are $360 per day or $131,400 for the year. However, long-term care insurance proceeds received on a per diem basis can be excluded from income (even if they exceed the limits) if the taxpayer has long-term care expenses in excess of the cap. (For example, there would be no income to the taxpayer if the policy paid $370 per day and the cost of the long-term care facility was that amount.) Otherwise, amounts received in excess of the dollar cap are fully taxable.

The per diem limitation does not apply if the taxpayer is terminally ill when the insurance payments are received.

The taxpayer will receive Form 1099-LTC (Long-Term Care and Accelerated Death Benefits) reporting the gross long-term benefits paid for the year. Form 8853 (Archer MSAs and Long-term Care Insurance Contracts) is used in calculating whether any of the benefits received are taxable. Taxable benefits are reported on line 21 of Form 1040 with the notation "LTC" on the dotted line next to line 21. The Form 8853 may need to be filed if the taxpayer (or spouse) was a policyholder and received payments or benefits under a qualified long-term care insurance contract during 2017. See the instructions to Form 8853 for a flowchart and instructions regarding the filing requirements for the form.

An employer's plan providing coverage under a long-term care insurance contract generally is treated as an accident and health plan, and the value of coverage is excludible from the employee's income. However, employer-provided coverage under a long-term care insurance contract cannot be provided through a cafeteria plan. Also, employer-provided coverage of long-term care expenses through a flexible spending arrangement is taxable to the employee.

Understanding Education Savings Accounts

Congress created Coverdell Education Savings Accounts (ESAs) for the purpose of paying the qualified education expenses of an individual designated beneficiary. Contributions to ESAs are not deductible; instead, the tax benefit is derived from the tax-free accumulation of earnings in an account and tax-free distributions if used for qualified education expenses.

Contribution Limitations

ESA contributions are nondeductible. Up to $2,000 of aggregate contributions can be contributed annually to an ESA (or multiple ESAs) set up for a designated beneficiary. The $2,000 contribution limit is per beneficiary. Contributions must be made in cash and generally cannot be made after the beneficiary attains the age of 18, unless the beneficiary has special needs.

Phase-out for Higher Income Taxpayers. The $2,000 contribution limit is phased-out ratably for a contributor who is a joint filer with modified adjusted gross income (AGI) of $190,000 – $220,000 or a single filer with modified AGI of $95,000 – $110,000. Modified AGI is AGI increased by exclusions for foreign earned income, foreign housing costs, or income from certain U.S. possessions and Puerto Rico. The phase-out ranges are not subject to inflation adjustments.

Example 2H-1 Contribution to ESA limited.

Ian and Sally Cook have a six-year-old son, Alex. To save for his education expenses, they intend to contribute $2,000 to an ESA naming Alex the designated beneficiary. For the current year, the Cook's modified AGI is $200,000. Due to the phase-out rule, the Cooks can only contribute $1,333 [($220,000 – $200,000) ÷ $30,000 × $2,000] to an ESA for Alex in the current year.

Variation: To get the maximum $2,000 contributed for Alex, the Cooks could gift cash to Alex, which he in turn contributes to his own ESA. Alternatively, Alex's grandparents (or other relative) could contribute to his ESA if their modified AGI is less than the applicable threshold.

Deadline for Making Contributions. Contributions to ESAs are determined on a calendar year basis, but can be made anytime on or before the unextended due date of the return for that year (i.e., generally, April 15 of the following year).

Excess Contributions. The 6% excess contribution tax imposed by IRC Sec. 4973 applies to excess contributions to ESAs. The 6% penalty tax is imposed on the *designated beneficiary* and applies to contributions in excess of the $2,000 (or lesser amount if reduced due to the modified AGI phaseout that applies to the contributor) annual amount allowed for one designated beneficiary. The penalty tax can be avoided if the excess contribution (plus earnings attributable to the excess contribution) is distributed to the beneficiary on or before June 1 of the following tax year.

Gift Tax Considerations

Contributions to ESAs are treated as completed gifts of a present interest from the contributor to the beneficiary for gift tax purposes. However, an individual's contribution to a designated beneficiary's ESA is not subject to gift tax or generation-skipping transfer tax provided the contribution, when combined with other gifts made to the beneficiary during the year, does not exceed the annual gift tax exclusion amount [for 2017, $14,000, or in the case of a married couple, $28,000]. Donors can elect to take an ESA contribution into account over a five-year period for gift tax purposes if the donor's total gifts for the year to the beneficiary exceed the allowable gift tax exclusion. The election to spread transfers ratably over the five-year period is made by completing a box on Schedule A of Form 709 [United States Gift (and Generation-Skipping Transfer) Tax Return]. Contributions do not qualify as Section 2503(e) transfers, which generally allows unlimited gift transfers when paid directly for an individual's tuition.

General Rules for Distributions

Generally ESA distributions are excluded from the beneficiary's gross income to the extent the distribution does not exceed the beneficiary's qualified education expenses incurred during the year the distribution is made. When distributions during a tax year exceed the beneficiary's qualified education expenses, the earnings portion (previous tax-free build-up) of the distribution not used to pay qualified education expenses is taxed to the beneficiary. This amount can be computed by multiplying total earnings included in current year distributions by the ratio of excess (i.e., nonqualified) distributions over gross distributions. Taxpayers should receive a Form 1099-Q [Payments From Qualified Education Programs (Under Sections 529 and 530)] from the ESA trustee reporting distributions. The taxable portion of ESA distributions is reported on line 21 of Form 1040 and on Form 5329 [Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts].

When an ESA distribution is included in the beneficiary's income, an additional 10% penalty tax generally applies to the taxable portion of the distribution. However, the penalty does not apply if the distribution exceeds qualifying expenses (1) because the beneficiary dies or becomes disabled, (2) as a result of the beneficiary receiving a nontaxable scholarship or similar assistance, to the extent the distribution does not exceed the assistance, (3) because the taxpayer/beneficiary claimed an American Opportunity Tax or Lifetime Learning credit for the qualifying expenses (rather than tax-free treatment for the ESA distribution), or (4) because the beneficiary attends the U.S. Military, Naval, Air Force, Coast Guard, or Merchant Marine Academy, to the extent of the cost of advanced education [as defined by 10 USC 2005(e)(3) as in effect on November 11, 2003] attributable to such attendance. Distributions of excess ESA contributions are also excluded from the penalty if certain conditions are met for the rules on excess ESA contributions. The penalty tax (if any) is calculated on Form 5329, which should be filed even if the penalty tax is zero.

Example 2H-2 Taxable portion of ESA distribution.

Jeff has contributed a total of $6,000 to his son Bill's ESA. Bill is ready to attend college and the account has a total balance of $10,000, representing total earnings of $4,000. Bill withdraws $2,000 from the account in 2017. For the year, Bill only incurs $1,500 of qualified higher education expenses. The withdrawal consists of $1,200 of contributions [($6,000 total contributions ÷ $10,000 total balance) × $2,000] and $800 ($2,000 − $1,200) of earnings. There is a $500 excess distribution ($2,000 withdrawn less $1,500 of qualified expenses). The taxable amount is the amount of the excess attributable to earnings, which in this case is $200 [$800 earnings × ($500 excess distribution ÷ $2,000 gross distribution)]. Bill must include the $200 in income and pay a 10% penalty on that amount.

Variation: Assume the same facts as above, except that Jeff claims an American Opportunity Tax Credit with respect to the $1,500 of qualified expenses incurred in 2017. The excess distribution is now $2,000 since all $1,500 of qualified expenses were used to claim an American Opportunity Tax Credit. Of that amount, $800 is attributable to earnings and thus subject to income tax. However, only $500 ($2,000 gross distribution − $1,500 of expenses that would be qualified except that Jeff claimed an American Opportunity Tax Credit for them) of the excess distribution is subject to the 10% penalty tax. Of the $500 amount, $200 [$500 × 40% ($800 ÷ $2,000)] is attributable to earnings, so the penalty tax is only $20 ($200 × 10%).

Qualified Education Expenses. Qualified education expenses for which ESA funds can be used include tuition, fees, books, supplies, and equipment required for the beneficiary's enrollment or attendance at any college,

university, vocational school or other post-secondary educational institution qualified to participate in the Department of Education's student aid programs. If the beneficiary takes at least half the normal full-time course load as determined under the standards of the institution and is enrolled in a degree, certificate, or other program leading to a recognized educational certificate at the institution, qualifying expenses also include the school's room and board amount applicable to the student in calculating the financial aid cost of attending the institution or the actual invoice amount charged to the student, if greater. Qualified expenses also include contributions to qualified tuition programs.

Qualified education expenses also include tuition, fees, special needs services for special needs beneficiaries, tutoring, books, supplies, equipment, room and board, uniforms, transportation, and supplementary items and services (including extended day programs) incurred to enroll in or attend an elementary or secondary school (kindergarten through grade 12). Expenses for public, private, or religious schools qualify. Although regulations have not yet defined *special needs beneficiaries* it is expected that the definition will include individuals who because of a physical, mental, or emotional condition (including learning disability) require additional time to complete their education. The purchase of computer technology or equipment and Internet access and related services are also qualified education expenses if they are used by the beneficiary and the beneficiary's family during any of the years that the beneficiary is in school.

Coordination with QTP Distributions. If a beneficiary has distributions from both an ESA and a qualified tuition program (QTP, also called a Section 529 Plan) in the same year, and if together they exceed the beneficiary's qualified education expenses (after considering scholarships and expenses used to claim education credits), the beneficiary must allocate the expenses between the distributions to determine the amount includable in income.

The following example provides guidance on making the allocation.

Example 2H-3 Allocating ESA and QTP distributions.

Steve Martin withdraws $6,000 from his QTP and $1,200 from his ESA. He has $3,000 of adjusted qualified higher education expenses. Steve can allocate the $3,000 between the two distributions:

$3,000 × ($6,000 QTP distribution ÷ $7,200 total distribution) = $2,500

$3,000 × ($1,200 ESA distribution ÷ $7,200 total distribution) = $500

Steve can then compute the taxable portion of each distribution.

If the education expenses are for elementary and secondary schools, the expenses should be allocated to ESA distribution (ESA distribution can be used for elementary and secondary education, but QTP distributions cannot). IRS Pub. 970, "Tax Benefits for Education," also includes allocation examples.

Mandatory Distribution at Age 30. Funds remaining in an ESA when the beneficiary reaches age 30 must be distributed to the beneficiary within 30 days of such time unless he or she is a special needs beneficiary, in which case there is no mandatory distribution age. The distribution will be taxable (to the extent of earnings) and the 10% penalty will apply to the extent not used for qualifying expenses.

Rollovers of ESAs

Any amount withdrawn from an ESA and rolled over to another ESA for the same beneficiary or certain members of the beneficiary's family (and who are under age 30) within 60 days of the withdrawal is not taxable. Only one rollover is allowed during a 12-month period ending on the date of the distribution regardless of the number of Coverdell ESAs owned. However, unlimited transfers from one Coverdell ESA trustee directly to another Coverdell ESA trustee are allowed because such transfers are not considered to be distributions or rollovers. The once-in-any-12-month period limitation rule does not apply to the rollover of a military death gratuity or payment from Servicemembers' Group Life Insurance. Also, a change in beneficiary is not considered a distribution if the new beneficiary is a member of the prior beneficiary's family and is under age 30 at the time of the change. The age 30 limitations do not apply to new beneficiaries who are family members and have special needs. Members of the beneficiary's family for these purposes include the beneficiary's spouse, children and their descendants, stepchildren and their descendants,

brothers and sisters (including stepbrothers and stepsisters) and their children, parents and their siblings, grandparents, stepparents, certain in-laws, spouses of all the foregoing, and first cousins.

Other Transfers of ESA Funds

Divorce or Separation. The transfer of a beneficiary's interest in an ESA to his or her spouse or former spouse under a divorce or separation agreement is not a taxable transfer. After the transfer, the interest is treated as an ESA in which the spouse or former spouse is the designated beneficiary.

Death. The tax treatment of a transfer because of death depends on whether the transferee is the surviving spouse or a member of the beneficiary's family (as previously defined). A surviving spouse or family member treats an ESA as though he or she is the designated beneficiary (no income tax consequences related to the transfer). If the transferee is someone other than a surviving spouse or family member, the earnings portion of the distribution, reduced by any qualified education expenses of the decedent that are paid by the transferee within one year after the decedent's death, is taxable income to the transferee at the date of death fair market value.

When an ESA beneficiary dies, the estate tax rules applicable to qualified tuition plans under IRC Sec. 529(c) apply. The FMV of the ESA is includable in the beneficiary's estate.

Military Death Gratuity. Military death gratuities may be rolled into an ESA tax-free. This rollover must be made within one year after the contributor receives the gratuity, rather than the normal 60-day period, and there is no limit on the number of such rollovers that can be made in a year. Any such rollover will be treated as an investment in the contract.

Using Qualified Tuition Programs

Qualified tuition programs (QTPs) (also called 529 Plans) are programs for prepaying or saving for higher education costs. These programs enable a person to (1) prepay tuition benefits on behalf of a beneficiary so that the beneficiary is entitled to a waiver or a payment of qualified higher education expenses, or (2) contribute to a savings account that is established for paying the higher education expenses of the beneficiary. Normally, account owners of a QTP are allowed to change the investment strategy of an account no more than two times in any calendar year.

Contributions and Distributions

Income Tax Treatment. There are no income tax consequences to either the contributor to the QTP or the designated beneficiary when contributions are made and while funds remain in the account. (However, some states allow residents to claim a state income tax deduction for all or part of their contributions to the state's QTP.) Distributions are excluded from the distributee's gross income to the extent used to pay qualified higher education expenses (defined later in this section). If distributions exceed qualified higher education expenses, the amount otherwise includable in gross income (under the general Section 72 rules for annuities) is reduced by the ratio of qualified expenses to distributions. For determining the amount otherwise includable as income, a portion of each distribution is treated as a nontaxable return of capital, determined by multiplying the distribution by the ratio of total contributions to the account relative to the account balance on the last day of the calendar year. The earnings portion of the distribution should also be reported in box 2 of the Form 1099-Q [Payments from Qualified Education Programs reporting the distribution from the QTP.

The taxable earnings amount for each distribution is computed based on amounts as of the date of the distribution. Also, accounts are aggregated only when they are with the same state QTP and have the same account owner and the same designated beneficiary. States consider their savings and prepaid plans separately for this purpose.

Example 2I-1 Taxation of QTP nonqualified distribution.

John receives a $12,000 distribution from a QTP of which he is the beneficiary. He uses $9,000 to pay qualified higher education expenses. $5,000 of the $12,000 distribution represents earnings on the contributions to the QTP (the other $7,000 being a return of principal). Because 75% ($9,000 / $12,000) of the distribution is used for qualified expenses, $3,750 ($5,000 × 75%) of the amount that would otherwise be taxable is excluded

from income. Thus, of the $12,000 distribution, $10,750 ($3,750 of excluded earnings + $7,000 return of capital) is excluded from gross income and $1,250 is taxable.

John had two designated accounts within the same QTP. The first account, Account A contains $5,000, all contributed amounts (no earnings). Account A's distribution has a basis of $5,000. The second account, Account B contains $30,000, $20,000 of which includes contributed amounts and $10,000 attributable to earnings. John receives a total of $12,000 in distributions, a $5,000 distribution from Account A and $7,000 from Account B. Since the accounts are not aggregated for purposes of computing taxable earning, Account A has no earnings and no part of the distribution would be included in taxable income since Account A has a basis of $5,000. Account B's distribution is used entirely for qualified higher education expenses and therefore no part of Account B's distribution would be included in taxable income.

Recontributions of QTP Distributions Due to Refunds of Qualifying Expenses

In the case of a designated beneficiary who receives a refund of qualified higher education expenses, the tax on any nonqualified distributions will not apply to the part of the distributions for the year that are recontributed to the QTP within 60 days of receiving the refund, to the extent the recontribution does not exceed the refunded amount. This provision is effective for qualified higher education expenses refunded after December 31, 2014.

Example 2I-2 Recontributions of refunds of qualifying expenses.

Jan enrolls in college in July 2017 and takes a $4,000 distribution from her QTP to pay for her $3,000 tuition bill. She later decides not to attend college and receives a refund of the tuition from the college on September 1, 2017. Jan would have to recontribute the $3,000 no later than November 2, 2017 (60 days after receiving the refund) to avoid tax.

Penalties on Nonqualified Distributions. Distributions that are subject to income tax (i.e., distributions not used to pay qualifying higher education expenses, to the extent they represent plan earnings) are generally subject to a 10% penalty tax. Form 5329 is used to compute the penalty tax. It should be filed even if the penalty tax is zero (i.e., whenever taxable distributions are reported on line 21 of Form 1040).

Certain nonqualified distributions are not subject to the penalty. These include distributions that exceed qualified expenses—

1. on account of the beneficiary's death or disability,

2. due to the beneficiary's receipt of a non-taxable scholarship or similar assistance, to the extent the distribution does not exceed the assistance,

3. because the student (or his or her parent) claimed an American Opportunity Tax or Lifetime Learning credit for the qualifying expenses (rather than tax-free treatment for the QTP distribution), or

4. because the beneficiary attends the U.S. Military, Naval, Air Force, Coast Guard, or Merchant Marine Academy, to the extent of the cost of advanced education [as defined by 10 USC 2005(e)(3) as in effect on November 11, 2003] attributable to such attendance.

Qualified Higher Education Expenses. Qualified higher education expenses are generally the same as the post-secondary education costs (i.e., does not include expenses for kindergarten through 12th grade) previously described earlier in this section for Education Savings Accounts (ESAs). Room and board are included only if the student/beneficiary attends at least half time. Also included are expenses of special needs services for special needs beneficiaries. Although regulations have not yet defined special needs beneficiaries, it is expected that the definition will include individuals who, because of a physical, mental, or emotional condition (including learning disability), require additional time to complete their education.

Reasonable costs for the amount allowed for room and board are determined by the particular QTP. However, the allowable amount cannot exceed certain limits. The maximum allowable room and board is the amount applicable to the student's living arrangement in calculating the financial aid cost of attendance for the institution. However, the

amount eligible for room and board expense is increased to what the institution actually charges the student if greater than the amount used in computing cost of attendance.

Coordination with Education Credits. A student or the student's parents may claim an education credit for qualified tuition and related expenses paid by or with funds from a QTP, provided the other eligibility requirements are met. However, an individual's qualifying higher educational expenses (for determining the taxable portion of QTP distributions) must be reduced by tax-free education benefits (such as scholarships and employer-provided education assistance) plus the amount of the qualifying expenses taken into account in computing an education credit (whether allowed to the taxpayer or another taxpayer).

Example 2I-3 Education credits claimed in same year QTP distributions received.

In 2017, Sara incurs $7,000 in qualified higher education expenses. Her parents claim a $2,500 maximum American Opportunity Tax credit based on $4,000 of those expenses (100% of the first $2,000 + 25% of the next $2,000 of qualifying expenses = $2,500). Sara also receives a $6,500 QTP distribution in 2017. The distribution includes $2,000 of earnings. $1,077 of Sara's QTP distribution is taxable, calculated as follows:

Total qualified higher education expenses for year	$ 7,000
Less expenses taken into account for education credit	(4,000)
Adjusted qualified education expenses	$ 3,000

The tax-free portion of the QTP earnings distribution is $923 ($2,000 earnings × $3,000 ÷ $6,500]. Thus, $1,077 ($2,000 earnings − $923 nontaxable portion) is taxable. However, the taxable portion of the distribution is not subject to the 10% penalty since the total qualified education expenses were greater than the distribution and the QTP earnings are taxable solely due to allocating the qualified expenses to the education credit. The portion of the QTP distribution that is attributable to recovered basis (investment in the account) is always tax-free.

Coordination with Education Savings Account (ESA) Distributions. If a beneficiary has distributions from both an ESA and a QTP in the same year and together they exceed the beneficiary's qualified education expenses (after considering tax-free education benefits such as scholarships and expenses used to claim education credits), the beneficiary must allocate the expenses between the distributions to determine the amount includable in income.

Rollovers and Beneficiary Changes

Any amount withdrawn from a QTP and rolled over within 60 days to a different QTP for the benefit of the same beneficiary or for a new designated beneficiary who is a member of the family of the old beneficiary is not treated as taxable distribution. When the beneficiary does not change, a tax-free rollover from one QTP to another is allowed only once every 12 months. Similarly, the designated beneficiary can be changed without triggering taxable income provided the new beneficiary is a member of the family of the old beneficiary. Family member is defined in the same manner as for ESA rollovers.

Tax-advantaged Achieving a Better Life Experience (ABLE) Accounts for Disabled Individuals

The Achieving a Better Life Experience Act of 2014 (ABLE Act) allows states to establish an "Achieving a Better Life Experience" (ABLE) program to assist persons with disabilities in building up tax-free (or in some cases tax-deferred) accounts to pay for qualified disability expenses. The accounts established under the ABLE program must meet the requirements of IRC Sec. 529A.

ABLE accounts that are established under a qualified ABLE program are generally exempt from income tax, but are subject to the unrelated business income tax of tax-exempt organizations.

Requirements of a Qualified ABLE Program

ABLE accounts must be set up under a qualified ABLE program that is established and maintained by a state or state agency or instrumentality that—

1. prohibits noncash contributions and contributions that exceed an annual limit (except for rollover contributions from another ABLE account). The annual contribution limit to an ABLE account is limited to the annual Section 2503(b) gift tax exclusion amount ($14,000 for 2017);

2. imposes a 6% excise tax on excess contributions to an ABLE account;

3. provides separate accounting for each designated beneficiary;

4. limits changes in investments within the account to not more than twice per calendar year;

5. prohibits pledging any interest in the account as security for a loan; and

6. provides safeguards to prevent excess aggregate contributions.

Designated Beneficiaries

The designated beneficiary of an ABLE account is an eligible individual who established the account and is its owner. A designated beneficiary is limited to one ABLE account. An individual is an eligible individual for a tax year if, during that tax year, (a) 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 Supplemental Security Income (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; or (b) a disability certification for the individual has been filed with IRS for the tax year.

A disability certification must certify that (a) 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; and (b) the disability or blindness occurred before the date on which the individual reached age 26. The certification must include a copy of the individual's diagnosis, signed by a licensed physician.

Federal Income Tax Consequenes to Designated Beneficiaries

Contributions. Contributions to an ABLE account are not deductible for income tax purposes. Contributions must be made in cash. Securities cannot be contributed. Except for a rollover contribution from another ABLE account (see later discussion), total annual aggregate contributions to an ABLE account are limited to the annual gift tax exclusion amount ($14,000 for 2017) and excess contributions are subject to a 6% excise tax. However, the excise tax will not apply if a corrective distribution of the excess amount is made within the tax year].

Distributions. Distributions from ABLE accounts are tax free to the extent they do not exceed the designated beneficiary's qualified disability expenses for the year. Qualified disability expenses are any expenses related to the designated beneficiary's blindness or disability and include education; housing; transportation; employment training and support; assistive technology and personal support services; health, prevention, and wellness services; financial management and administrative services; legal fees; expenses for oversight and monitoring; funeral and burial expenses; and other expenses that are approved under IRS regulations.

Distributions that exceed qualifying disability expenses are taxable and subject to a 10% penalty tax. If distributions exceed qualified disability expenses, the amount otherwise includible in gross income (under the general Section 72 rules for annuities) is reduced by the ratio of qualified expenses to distributions. In effect, distributions are treated as a pro-rata share of the principal (contributions) and accumulated earnings in the account.

Example 2J-1 Taxation of nonqualified distribution.

During the current year, Tim receives a $12,000 distribution from an ABLE account of which he is the beneficiary. He uses $9,000 to pay qualified disability expenses; $5,000 of the $12,000 distribution represents

earnings on the contributions to the ABLE account (the other $7,000 being a return of principal). Because 75% ($9,000 ÷ $12,000) of the distribution is used for qualified expenses, $3,750 ($5,000 × 75%) of the amount that would otherwise be taxable is excluded from income. Thus, of the $12,000 distribution, $10,750 ($3,750 of excluded earnings + $7,000 return of capital) is excluded from gross income and $1,250 is taxable.

In addition, Tim must pay a $125 penalty tax (10% of the $1,250 taxable amount of the distribution).

Rollovers. Distributions can be rolled over tax-free within 60 days to another ABLE account for the benefit of the designated beneficiary or an eligible individual who 's is a family member of the designated beneficiary. For this purpose a family member means a brother, sister, stepbrother, or stepsister of the beneficiary]. Legally adopted children are considered children by blood; therefore, adopted children are considered legal siblings.

Changes in Beneficiaries. An ABLE account's designated beneficiary can be changed without being treated as a taxable distribution, as long as the new beneficiary is an eligible individual who is a family member of the designated beneficiary.

Death of a Beneficiary. Upon the death of a designated beneficiary, amounts remaining in an ABLE account are first paid for outstanding qualified disability expenses incurred but not yet paid. Then, if a claim is filed by the state, amounts are distributed as a reimbursement to the state Medicaid plan. Any remaining amounts in the ABLE account are distributed to the deceased's estate or a designated beneficiary and are subject to income tax on the investment earnings, but not the 10% penalty tax.

Selected Other Income Items

The following information presented is general in nature. For additional coverage, refer to the authoritative sources cited for each topic.

Disability Income

Disability income, both short-term and long-term, is not taxable if the individual paid the premiums on the disability policy or contributed (on an after-tax basis) to an employer-sponsored disability plan. Disability income is taxable if an employer contributes to a funded plan or pays the policy's premiums for the employee (*Kees*). When the taxpayer reimbursed his firm for disability premiums paid by the firm by deducting the premium amounts from his shareholder loan account, the Tax Court ruled that disability benefits received by this taxpayer were excludible from his gross income under IRC Sec. 104(a)(3). From the inception of the policy until the premiums were waived, the taxpayer treated the premiums as personal items and paid his share of the premiums through his loan account, and the firm never deducted them.

Payments for loss of use or function of the body (e.g., limb) are always nontaxable. Individuals receiving taxable disability income for permanent and total disability may be able to claim the credit for the elderly or disabled, discussed in IRS Pub. 524, "Credit for the Elderly or the Disabled."

For group policies purchased with both employer and employee contributions, the taxable portion of any benefits received is determined by the ratio of premiums paid by the employer to total net premiums for the three most recent years for which net premiums are known. This *three-year lookback rule* can cause a portion of benefits paid under group disability insurance to be taxable if the employer has paid some or all of the premiums in the past, even if the employee paid all the premiums in the year the benefits are received.

Plans that allow employees to annually elect whether disability insurance is paid with employer or employee funds are not subject to the lookback rule. If the employee becomes disabled in a year for which he or she has elected to have the coverage paid with his own funds (i.e., after-tax), any resulting benefits are tax-free. Likewise, any benefits attributable to a disability that occurs in a year the employee has elected to have the coverage paid by the employer (i.e., pre-tax) are fully taxable. A plan that is amended to allow employees to make this annual election is considered a new plan. Therefore, the lookback rule does not apply to the amended plan. These rules apply to both short-term and long-term disability benefits.

Workers' Compensation

Amounts received by an employee as compensation under state or federal workers' compensation acts for personal injuries or sickness incurred on the job are not taxable, unless the amounts received offset previously deducted medical expenses. However, to the extent the workers' compensation benefits reduce or offset social security benefits, they are treated and taxed as social security benefits. Amounts received under a private arrangement, such as between a corporation and shareholder-employee, are taxable since not received pursuant to a workers' compensation statute.

Bartering Income

In examinations, the IRS often asks individual taxpayers whether they engaged in any bartering transactions. Bartering is the exchange of property or services for another's property or services. The FMV of the goods or services received must be included in the taxpayer's gross income on the date received. A taxpayer can offset the bartering income with the cost (not FMV) of any property exchanged in such a transaction, as would be the case in an ordinary sale of inventory. Taxpayers who trade services, instead of property, can offset the income with any expenses that would normally be deducted against income generated by producing that service (e.g., supplies, telephone). Practitioners should attempt to obtain a written representation from clients who participate in bartering transactions(Form 1099- B or a similar statement). It should be obtained before the preparation of any applicable tax returns.

Example 2K-1 Bartering income.

Courtney is a self-employed attorney. She exchanges her services for a painting worth $5,000 that she displays in her home. She must include the value of the painting ($5,000) in income. She can deduct only the out-of-pocket expenses incurred to furnish the legal fees. This is the same result as if she had collected $5,000 in cash and used the cash to buy the painting.

Variation: Assume instead that Courtney exchanged her legal services for two months rent (worth $5,000) for the office space where she conducts her legal practice. Here, she would have $5,000 income, but also a $5,000 deduction for rental expense on her Schedule C reporting income from her legal practice. Again, the result is the same as if she had received the $5,000 in cash and used it to pay the rent on her office space.

Gambling and Lottery Winnings

Gross income includes gambling winnings. Gambling winnings, reduced only by the cost of placing the related winning bet or wager, are reported on line 21 (Other income) of Form 1040. Gambling losses are deductible to the extent of gambling income, but only as a Schedule A miscellaneous itemized deduction, not subject to the 2% floor. Form W-2G (Certain Gambling Winnings) is used by payers to report to the payee and IRS certain gambling winnings. Generally, gambling winnings that are (1) $600 or more and (2) at least 300 times the amount of the wager are reported on Form W-2G. For Keno, the reporting threshold is $1,500; for bingo and slot machines, it is $1,200; and for poker tournaments, it is $5,000. When winnings exceed $5,000, payers are generally required to withhold income tax. This includes payouts from tournament poker sponsors that exceed a player's buy-in fee by more than $5,000. Tax withholding, if any, is shown on Form W-2G. In very limited situations, an individual's gambling activity may constitute a trade or business so gambling income and expenses are reported on Schedule C.

Taxpayers cannot net gambling winning and losses and report only the net amount on line 21. Instead, the income is reported on line 21 and the losses on Schedule A. This method of reporting may not allow taxpayers to fully benefit from their losses (to the extent of winnings) if they do not itemize deductions. However, in *Shollenberger*, the Tax Court allowed a casual slot machine gambler to net winning spins against losing spins until tokens were redeemed at the end of the day.

Taxpayers who gamble frequently enough and in such high amounts that complimentary items (freebies such as tickets to sporting events and the theater, cars, vacations, etc.) are provided to them by casinos are required to include these freebies in income. See, for example, *Libutti*, in which it is determined that such freebies qualify as Section 165(d) gambling transactions.

Winnings from a no-purchase-necessary sweepstakes, although taxable, are not gambling winnings that can be offset with gambling losses. Because the taxpayer did not furnish consideration in exchange for a chance to win, the sweepstakes was not a wagering transaction, even though the taxpayer did spend money on entering by sending in a self-addressed stamped envelope (to obtain the free entry form) on many occasions. This consideration was too nominal to be considered a wager.

Lottery winnings are generally taxable to the recipient when constructive receipt occurs or all the elements of the economic benefit doctrine are satisfied (but see the special rule for qualified prizes later in this discussion). Thus, when the paying entity went through a verification process, the taxpayer was taxed when the winnings became vested and not when the winning ticket was initially drawn and claimed (*Thomas*). The doctrine of constructive receipt does not apply in the case of lottery winnings paid in annual installments because the lottery winnings are subject to substantial limitations and restrictions. Thus, a taxpayer who elects annual installments cannot claim in a later year (e.g., after the statute of limitations has expired for the year of the win) that the entire amount was constructively received in the year he won the lottery and is not taxable in the year an annual payment is received (*Jombo*).

When lottery winnings are paid in annual installments pursuant to a state's lottery system, a recipient is treated as having wagering winnings each year an installment is received. Thus, the lottery winnings are taxable as received and not all in the year the winning occurred. If a lottery winner sells his or her right to future lottery payments, the income from the sale is taxed as ordinary income (and not capital gain) under the assignment of income doctrine.

For qualified prizes, a special rule allows taxpayers to choose between lump-sum and annuity payment options without automatically being taxed on the winnings due to constructive receipt. A qualified prize is any prize (1) awarded as part of a contest, lottery, jackpot, or similar arrangement (2) which does not relate to the recipient's performance of services and (3) is payable over at least 10 years. To qualify, the option to choose between the lump-sum and annuity payments cannot extend beyond 60 days after the time the individual becomes entitled to (i.e., wins) the prize.

Military Income and Related Issues

Active members of the U.S. Armed Forces are subject to special tax rules. An active member of the U.S. Armed Forces includes commissioned officers and enlisted personnel in all regular and reserve units under the control of the Secretaries of the Defense, Army, Navy, and Air Force. The Armed Forces also include the Coast Guard, but not members of the U.S. Merchant Marine or the American Red Cross.

Income Exclusions. Active members of the U.S. Armed Forces receive many types of pay and benefits that are excludible from income, including certain pay received by members serving in designated combat zones, living and housing allowances, family, moving, and travel allowances, and in-kind military benefits (e.g., medical and dental care, legal assistance, dependent care, and travel on government aircraft).

Special Rules for Filing Returns. The due date for filing returns, paying tax, or claiming a credit or refund is extended while taxpayers are serving in a combat zone or are deployed outside of the U.S. and participating in contingency operations.

Also, if a member of the Armed Forces dies while serving in a combat zone, or from wounds, disease or injury incurred while doing so, his or her income tax liability is forgiven for the year of death. It is also forgiven for any previous tax year (still open under the statute of limitations) that ended on or after the first day the member was in active service in a combat zone. Similar tax forgiveness applies to military or civilian U.S. employees who die from wounds or injury incurred in a terrorist or military action.

Designated combat zones can be identified at the IRS website (**www.irs.gov**) by entering the words "combat zone" in the search feature.

For more information on these and other special issues that apply to members of the Armed Forces, see IRS Publication 3, "Armed Forces' Tax Guide," in general, Notice 2002-17 for specific guidance on the tax relief provided for U.S. military and support personnel involved in military operations in Afghanistan, and Notice 2003-21 for tax relief guidance for military and support personnel involved in Operation Iraqi Freedom. In addition, the IRS website at **www.irs.gov/individuals/military** has a page called "Tax Information for Members of the Military" covering various tax-related military topics.

Mortgage Assistance Payments

Federal and state payments made to or on behalf of financially distressed homeowners under programs designed by state housing finance agencies (SHFAs) and the Department of Housing and Urban Development's Emergency Homeowners' Loan Program (EHLP) are excludible from income under the general welfare exclusion. The general welfare exclusion refers to the consistent standpoint of the IRS that payments made by governmental units under legislatively provided social benefit programs for the general welfare are not includable in gross income of the recipient.

Homeowners must meet certain eligibility criteria to receive payments, the purpose of which is to provide assistance to homeowners who are at risk of foreclosure and have experienced a substantial reduction in income as a result of involuntary unemployment or underemployment due to adverse economic or medical conditions. In addition to the previously mentioned programs, the income exclusion applies to payments from any existing state program receiving funding from the EHLP, referred to as a substantially similar state program (SSSP).

Payors of payments made under the state programs, the EHLP, or an SSSP are not required to file information returns for these payments. However, a homeowner receiving payments should not report the amount as interest received on a mortgage. A safe harbor is provided for tax years 2010 through 2021 under which a homeowner may deduct the total payments actually made during the year to the mortgage servicer, HUD, or the SHFA toward the home mortgage. The total deductible may not be in excess of the dollar amount shown on the Form 1098 (Mortgage Interest Statement). The safe harbor may be used by any homeowner that meets the requirements for deducting mortgage interest and participates in one of the listed programs.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Alimony payments must meet which of the following rules to preserve the underlying theory that alimony is a shift of income between taxpayers?

    a. Three-year recapture.

    b. Tax benefit.

    c. Involuntary conversion.

    d. Three-year lookback.

10. Which of the following statements concerning how to report ministers' housing allowances is correct?

    a. Allowances of active and retired ministers must be included in calculating their self-employment (SE) income for SE purposes.

    b. A parsonage allowance that is excluded from income cannot be counted as earned income for purposes of the earned income credit.

    c. A parsonage allowance should not be included as taxable wages on a minister's Form W-2.

    d. Retired ministers cannot exclude from income a parsonage allowance that is provided as compensation for past services.

11. Amounts received for which of the following types of injuries are **not** excluded from gross income?

    a. Degradation of character.

    b. Medical expenses to treat headaches.

    c. Respiratory problems resulting from black mold.

    d. Torn meniscus from a fall.

12. Which of the following is **not** considered a qualified medical expense?

    a. COBRA health care.

    b. Premiums for Medigap policies.

    c. Health care coverage for taxpayers receiving unemployment compensation.

    d. Qualified long-term care insurance.

13. Which of the following examples correctly identifies a terminally ill individual?

    a. A physician has determined that Sarah requires substantial supervision to protect herself from threats to her health and safety due to her dementia.

    b. A physician has certified that Lupe needs substantial assistance with bathing and dressing for six months.

    c. A physician has diagnosed Wilson with an illness that is expected to cause death within 24 months of the diagnosis.

    d. A physician has certified that Larry needs substantial assistance toileting and transferring for 120 days.

14. Which of the following statements concerning education savings accounts (ESAs) is correct?

    a. The contribution limit is phased-out ratably for a contributor who is a joint filer with a modified adjusted gross income (AGI) of $95,000 – $110,000.

    b. Contributions to ESAs are determined on a calendar year-basis, and generally made April 15 of the following year.

    c. An additional 6% penalty tax generally applies to the taxable portion of the distribution when an ESA distribution is included in the beneficiary's income.

    d. Qualified education expenses generally exclude any equipment required for the beneficiary's enrollment or attendance at any college.

15. Which of the following statements concerning other transfers of ESA funds is correct?

    a. Military death gratuities cannot be rolled into an ESA tax-free.

    b. Military death gratuity rollovers must be made within the normal 60-day period.

    c. When a beneficiary transfers interest in an ESA to his or her spouse under a divorce or separation agreement the transfer is not taxable.

    d. The FMV of the ESA is not includable in the beneficiary's estate.

16. What is the general reporting threshold for gambling winnings?

    a. $600 or more.

    b. $1,200.

    c. $1,500.

    d. $5,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Alimony payments must meet which of the following rules to preserve the underlying theory that alimony is a shift of income between taxpayers? **(Page 183)**

    a. Three-year recapture. [This answer is correct. To preserve the underlying concept that alimony is a shift of income between taxpayers and not obscured property settlements, the payments must meet a three-year recapture rule.]

    b. Tax benefit. [This answer is incorrect. The tax benefit rule ordinarily requires taxpayers to include in gross income the amount of a prior year deduction when an event occurs that is fundamentally inconsistent with the premise of the deduction.]

    c. Involuntary conversion. [This answer is incorrect. Taxpayers use the involuntary conversion rules to elect to defer involuntary conversion gains if property is replaced.]

    d. Three-year lookback. [This answer is incorrect. The three-year lookback rule can cause a portion of benefits paid under group disability insurance to be taxable if the employer.]

10. Which of the following statements concerning how to report ministers' housing allowances is correct? **(Page 184)**

    a. Allowances of active and retired ministers must be included in calculating their self-employment (SE) income for SE purposes. [This answer is incorrect. Although a parsonage allowance is excluded from income for income tax purposes, allowances of active (as opposed to retired) ministers must be included in calculating their self-employment (SE) income for SE tax purposes.]

    b. A parsonage allowance that is excluded from income cannot be counted as earned income for purposes of the earned income credit. [This answer is incorrect. A parsonage allowance that is excluded from income is still counted as earned income for purposes of the earned income credit.]

    c. A parsonage allowance should not be included as taxable wages on a minister's Form W-2. [This answer is correct. Ministers who are employees should receive a Form W-2 showing their taxable compensation. The amount shown as taxable wages should not include a parsonage or rental (housing) allowance.]

    d. Retired ministers cannot exclude from income a parsonage allowance that is provided as compensation for past services. [This answer is incorrect. In an Information Letter, the IRS has confirmed that retired ministers are able to exclude from income a parsonage allowance that is provided as compensation for past services.]

11. Amounts received for which of the following types of injuries are **not** excluded from gross income? **(Page 185)**

    a. Degradation of character. [This answer is correct. Amounts received for nonphysical injuries such as employment discrimination and injury to reputation is not excludible from gross income.]

    b. Medical expenses to treat headaches. [This answer is incorrect. Damages received for emotional distress that are attributable to a physical injury or physical sickness or reimbursement of medical expenses incurred to treat the emotional distress (e.g., medical expenses to treat physical sickness such as insomnia, headaches, or stomach disorders that resulted from the emotional distress) are not taxable.]

    c. Respiratory problems resulting from black mold. [This answer is incorrect. Damages or settlement payments to compensate the taxpayer for a physical sickness are excludible from income under IRC Sec. 104(a)(2) if they involve a claim based on a tort or tort-like right.]

    d. Torn meniscus from a fall. [This answer is incorrect. Damages or settlement payments to compensate the taxpayer for a physical injury are excludible from income under IRC Sec. 104(a)(2) if they involve a claim based on a tort or tort-like right.]

12. Which of the following is **not** considered a qualified medical expense? **(Page 192)**

    a. COBRA health care. [This answer is incorrect. COBRA health care is considered a qualified medical expense according to the Code.]

    b. Premiums for Medigap policies. [This answer is correct. According to the IRS, premiums for Medigap policies are not qualified expenses.]

    c. Health care coverage for taxpayers receiving unemployment compensation. [This answer is incorrect. According to the Code, health care coverage while an individual is receiving unemployment compensation is considered a qualified medical expense.]

    d. Qualified long-term care insurance. [This answer is incorrect. According to the Code, qualified long-term care insurance [subject to the same deduction limits set forth in IRC Sec. 213(d)(10)]is considered a qualified medical expense.]

13. Which of the following examples correctly identifies a terminally ill individual? **(Page 193)**

    a. A physician has determined that Sarah requires substantial supervision to protect herself from threats to her health and safety due to her dementia. [This answer is incorrect. A chronically ill individual is generally someone who has been certified within the previous 12 months by a licensed health care practitioner as requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment.]

    b. A physician has certified that Lupe needs substantial assistance with bathing and dressing for six months. [This answer is incorrect. A chronically ill individual is generally someone who has been certified within the previous 12 months by a licensed health care practitioner as needing substantial assistance to perform at least two activities of daily living for at least 90 days, due to a loss of functional capacity.]

    c. A physician has diagnosed Wilson with an illness that is expected to cause death within 24 months of the diagnosis. [This answer is correct. A *terminally ill* taxpayer is someone who has been certified by a physician to have an illness or physical condition that is expected to cause death within 24 months from the date of certification.]

    d. A physician has certified that Larry needs substantial assistance toileting and transferring for 120 days. [This answer is incorrect. A chronically ill individual is generally someone who has been certified within the previous 12 months by a licensed health care practitioner as requiring substantial supervision with at least two activities of daily living for at least 90 days, due to a loss of functional capacity.]

14. Which of the following statements concerning education savings accounts (ESAs) is correct? **(Page 195)**

    a. The contribution limit is phased-out ratably for a contributor who is a joint filer with a modified adjusted gross income (AGI) of $95,000 – $110,000. [This answer is incorrect. The $2,000 contribution limit is phased-out ratably for a contributor who is a joint filer with modified adjusted gross income (AGI) of $190,000 – $220,000 or a single filer with modified AGI of $95,000 – $110,000.]

    b. Contributions to ESAs are determined on a calendar year-basis, and generally made April 15 of the following year. [This answer is correct. Contributions to ESAs are determined on a calendar year basis, but can be made anytime on or before the unextended due date of the return for that year (i.e., generally, April 15 of the following year.]

    c. An additional 6% penalty tax generally applies to the taxable portion of the distribution when an ESA distribution is included in the beneficiary's income. [This answer is incorrect. When an ESA distribution is included in the beneficiary's income, an additional 10% penalty tax generally applies to the taxable portion of the distribution.]

    d. Qualified education expenses generally exclude any equipment required for the beneficiary's enrollment or attendance at any college. [This answer is incorrect. Qualified education expenses for which ESA funds

can be used include tuition, fees, books, supplies, and equipment required for the beneficiary's enrollment or attendance at any college, university, vocational school or other post-secondary educational institution qualified to participate in the Department of Education's student aid programs.]

15. Which of the following statements concerning other transfers of ESA funds is correct? **(Page 195)**

    a. Military death gratuities cannot be rolled into an ESA tax-free. [This answer is incorrect. Military death gratuities may be rolled into an ESA tax-free. Such a rollover will be treated as an investment in the contract.]

    b. Military death gratuity rollovers must be made within the normal 60-day period. [This answer is incorrect. This rollover must be made within one year after the contributor receives the gratuity, rather than the normal 60-day period, and there is no limit on the number of such rollovers that can be made in a year.]

    c. When a beneficiary transfers interest in an ESA to his or her spouse under a divorce or separation agreement the transfer is not taxable. [This answer is correct. The transfer of a beneficiary's interest in an ESA to his or her spouse or former spouse under a divorce or separation agreement is not a taxable transfer. After the transfer, the interest is treated as an ESA in which the spouse or former spouse is the designated beneficiary.]

    d. The FMV of the ESA is not includable in the beneficiary's estate. [This answer is incorrect. When an ESA beneficiary dies, the estate tax rules applicable to qualified tuition plans under IRC Sec. 529(c) apply. The FMV of the ESA is includable in the beneficiary's estate.]

16. What is the general reporting threshold for gambling winnings? **(Page 202)**

    a. $600 or more. [This answer is correct. Form W-2G (Certain Gambling Winnings) is used by payers to report to the payee and IRS certain gambling winnings. Generally, gambling winnings that are (1) $600 or more and (2) at least 300 times the amount of the wager are reported on Form W-2G.]

    b. $1,200. [This answer is incorrect. This is the reporting threshold for bingo and slot machines.]

    c. $1,500. [This answer is incorrect. This is the reporting threshold for Keno.]

    d. $5,000. [This answer is incorrect. This is the reporting threshold for poker tournaments.]

Lesson 3: Adjustments to Income

Introduction

Adjusted gross income (AGI) is more than a subtotal on an individual tax return. AGI is the benchmark for claiming certain deductions or credits including rental real estate losses, IRA contributions, medical expenses, casualty losses, charitable contributions, and miscellaneous itemized deductions. AGI is defined by IRC Sec. 62 as gross income less certain specified deductions. This lesson discusses the deductions that are allowed on Form 1040 to arrive at adjusted gross income.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify contributions to traditional and Roth IRAs, how self-employed taxpayers can adopt qualified retirement plan and simplified employee pensions (SEP) deductions for self-employed taxpayers, self-employed health insurance deduction, and how employers should establish SIMPLE IRA plans.
- Recognize the difference between alimony and nondeductible payments, how to deduct interest paid on education loans, tuition and fees, educator's expense, and contributions to health savings accounts (HSAs).

Contributions to Traditional IRAs

This section focuses specifically on contributions (and their deductibility) to traditional individual retirement accounts (IRAs). Contributions to Roth IRAs taxation of traditional and Roth IRA distributions, excise and penalty taxes for excess contributions to IRAs and premature withdrawals, and retirement savings contribution credit are discussed later in this lesson.

Maximum Allowable Contributions

Contributions to traditional IRAs can be deductible, partly deductible, or nondeductible. Regardless of how the contribution is treated, the initial step is determining the maximum amount the taxpayer is allowed to contribute.

For 2017, IRA contributions generally can be made up to the lesser of (1) $5,500 ($6,500 if age 50 or older by the end of 2017) or (2) 100% of the individual's taxable compensation. For married couples, IRA contributions up to $5,500 ($6,500 if age 50 or older by the end of 2017) can be made for each spouse if the combined compensation of both spouses is at least equal to the contributed amount and they file a joint return. Contributions must be made in cash.

For purposes of calculating the maximum contribution, compensation includes wages, salaries, other amounts derived from or received for personal services actually rendered including self-employment income, and alimony. Compensation does not include retirement pension or annuity income, deferred compensation, or governmental unemployment benefits. Interest and dividend income may not be considered compensation unless the taxpayer is a securities dealer (*Kobell*).

For the year an individual attains age 70$^1/_2$, and all years thereafter, contributions to traditional IRAs (deductible or nondeductible) are no longer permitted, even if the individual continues to have earned income. However, such a taxpayer's earned income can still be used by his or her spouse (under age 70$^1/_2$) as the basis for the spouse's IRA contributions. Taxpayers over age 70$^1/_2$ can still make contributions to Roth IRAs.

Deductible Amount of IRA Contribution

Allowable contributions to traditional IRAs are always fully deductible if the taxpayer (and spouse, if married) is not an active participant in an employer-maintained retirement plan. If the taxpayer (or his or her spouse) is an active participant in an employer plan and modified adjusted gross income (AGI) exceeds certain limits, the taxpayer cannot deduct the full amount of the IRA contribution and may not be able to deduct any of the contribution.

For married couples, one spouse's participation in an employer plan not only subjects his IRA contribution deduction to phase-out, but it also causes his spouse's contribution deduction to be subject to phase-out. There are two deduction phase-out thresholds for married couples when only one spouse is covered by an employer plan: one for the participant spouse and another for the nonparticipant spouse.

Modified AGI is AGI computed after considering (1) taxable social security benefits and (2) the passive activity loss rules, but without regard to (3) any deductible IRA contributions; (4) exclusions for foreign earned income, foreign housing costs, U.S. savings bond interest income used to pay higher education expenses, and employer-provided adoption assistance; (5) the interest deduction on education loans; (6) the deduction for qualified tuition and related expenses (if extended); and (7) the deduction for domestic producers.

Example 3A-1 Determining married couple's allowable IRA deduction.

Eddie and Jane Haskel file a joint return and both are under 50 years old. For 2017, each has salary income of $60,000 and their modified AGI is $120,000. Eddie is an active participant in his employer's 401(k) plan. Jane's employer does not offer any retirement plan coverage. Each contributes the maximum allowable amount of $5,500 to a traditional IRA for 2017. How much can they deduct?

Because Eddie is covered by an employer plan, his applicable modified AGI phase-out range is $99,000–$119,000. Jane, on the other hand, is not an active participant in an employer plan, but her spouse (Eddie) is. Thus, the modified AGI phase-out range applicable to her contribution is $186,000–$196,000. Their 2017 modified AGI is $120,000; so Eddie's $5,500 contribution is not deductible, but Jane's $5,500 contribution is.

If a taxpayer (and spouse, if married) is not an active participant in an employer-sponsored plan, traditional IRA contributions are fully deductible. Modified AGI has no impact on the taxpayer's ability to deduct IRA contributions.

Example 3A-2 Contribution to traditional IRA fully deductible.

Sally and Mark Lane file a joint return and both are 45 years old. Neither is an active participant in an employer-maintained retirement plan. In 2017, Sally has $350,000 of salary; Mark has no earned income. Their modified AGI is $400,000. How much can Sally and Mark each contribute to an IRA for 2017 and how much of the contribution is deductible?

Under the spousal contribution rules, Sally and Mark can each contribute the maximum $5,500 to an IRA in 2017. Although Mark has no compensation, he is able to contribute based on Sally's. Because neither spouse is an active participant in an employer-maintained retirement plan, they can deduct the full amount of their contributions ($11,000 in total, assuming they each make a $5,500 contribution).

Nondeductible IRA Contributions

A taxpayer can always make a nondeductible contribution to an IRA when a deduction is not allowed or not allowed in full (i.e., there are no AGI limitations on making nondeductible contributions). A taxpayer can also elect to treat an otherwise deductible contribution as nondeductible. If a nondeductible contribution is made to an IRA, Form 8606 (Nondeductible IRAs) must be filed with Form 1040. If both spouses make nondeductible IRA contributions, a separate Form 8606 for each must be completed. Form 8606 is also required if any traditional IRA distributions are received in the current year and nondeductible contributions were made in prior years to *any* traditional IRA. When required, Form 8606 must be filed by itself if the taxpayer does not meet the requirements for filing an income tax return. Form 8606 is filed at the time and place the taxpayer would normally file Form 1040.

A taxpayer who makes nondeductible traditional IRA contributions acquires tax basis in his traditional IRAs. Later distributions from any of the taxpayer's traditional IRAs must be allocated between nontaxable (return of basis) and taxable.

With the availability of Roth IRAs, few taxpayers will want to make nondeductible contributions to traditional IRAs, unless that is their only permissible option. A taxpayer whose IRA choices are a nondeductible contribution to a traditional IRA or a contribution to a Roth IRA (e.g., taxpayer covered by an employer-sponsored plan but whose

modified AGI does not exceed the Roth IRA phase-out range) should choose the Roth IRA because the earnings can be withdrawn tax-free under the Roth distribution rules (versus tax-deferred under the traditional IRA rules).

Deduction Carryover. If the traditional IRA contribution is less than the deductible amount, the taxpayer may not carry over the difference and deduct it in a subsequent year.

Example 3A-3 Contribution less than the maximum deductible amount.

The maximum amount that Bob could contribute to his IRA for 2017 was $5,500. However, he elected to contribute and deduct only $4,700. What happens to the $800 that he was entitled to contribute and deduct but did not? The unused deduction limit is permanently lost. Bob cannot carry over the unused limit of $800 to 2018 and increase his contribution and deduction in that year by the $800.

Deadline for Making Contributions

IRA contributions must be made by the due date for filing the taxpayer's return *not* including extensions (i.e., by April 17, 2018, for 2017 contributions). The tax return on which the contribution is deducted may be filed prior to actually making the contribution, as long as the contribution is made before the tax return's unextended due date. No form or schedule is required to be filed with Form 1040 to support an IRA deduction but, as discussed earlier, Form 8606 is required for nondeductible contributions.

IRA Investments and Fees

IRA funds can be invested in anything the IRA trustee will allow except life insurance or collectibles (e.g., art, rugs, antiques, gems, stamps, coins, etc.). Certain U.S. and state-issued gold, silver, and platinum coins and bullion are not considered collectibles and are allowed as IRA investments.

Trustee and investment fees are treated as miscellaneous itemized deductions, subject to the 2% of AGI limit, if paid with funds outside the IRA account. Broker commissions, unlike trustee fees, are considered to be part of the purchase price of the IRA's assets and are not deductible when paid directly by the individual. However, amounts paid into the IRA to cover fees that, when combined with the contribution, exceed the $5,500 ($6,500 if age 50 or older) or 100% of compensation limitation are subject to the 6% excise tax on excess contributions. Fees paid with funds inside the IRA are not deductible.

Exposure of Assets Held in Traditional IRAs to Bankruptcy Creditors

Some account owners have worried that assets held in their IRAs might become exposed to creditors in the event of bankruptcy. This concern was reduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The law provides broad protection from bankruptcy creditors for IRAs—which include traditional and Roth IRAs, SIMPLE IRAs, and SEP IRAs. (Protection is also provided for assets held in qualified retirement plans, Section 403(b) plans, Section 457 plans, and Section 414 church and government plans.) For IRAs, the protection is generally limited to balances totaling $1 million, as indexed for inflation ($1,283,025 as of April 1, 2016; amount will be adjusted again on April 1, 2019). However, protection is provided without limit for qualified plans, SIMPLE IRAs, SEP IRAs, and amounts *rolled into* IRAs from qualified retirement plans.

Direct Deposit of Federal Income Tax Refunds

Individuals are permitted to direct their federal income tax refunds into traditional IRAs, Roth IRAs (including myRAs), or SEP IRAs, subject to the usual contribution limitation rules. Form 8888 [Allocation of Refund (Including Savings Bond Purchases)] is used for this purpose.

Roth IRA Contributions

A *Roth IRA* is simply an IRA designated as a Roth IRA when opened. Except as provided in IRC Sec. 408A, all the rules that apply to traditional IRAs apply to Roth IRAs. The tax benefits of a Roth IRA are backloaded rather than frontloaded as with deductible IRAs. Contributions to Roth IRAs are nondeductible, but earnings build up tax-free and taxpayers can withdraw funds, including earnings, tax-free if certain requirements are met.

Significant differences between traditional IRAs and Roth IRAs include the following: (1) Roth IRA contributions are never deductible; (2) Roth IRA contributions can be made beyond age 70½; (3) eligibility to contribute is based on different modified adjusted gross income (AGI) thresholds; (4) qualifying Roth IRA distributions are nontaxable; and (5) there is no requirement that distributions from Roth IRAs begin at age 70½. Traditional IRAs can be converted to Roth IRAs if certain conditions are met. This section focuses specifically on contributions to Roth IRAs.

myRA Accounts

Employers can offer a retirement savings vehicle called the myRA (for "my retirement account"). The myRA is a Roth IRA administered by the federal government, backed by government bonds, and yielding the same variable interest rate return as the Thrift Savings Plan Government Securities Investment Fund (otherwise known as the G Fund) accounts that federal employees enroll in. There are no maintenance fees charged to a myRA holder. Employers who do not offer retirement plans have the option to enroll in the myRA program and their employees may elect to set up automatic withdrawals. Even though accounts are funded only through direct deposits by the holder's employer, the account belongs to the holder/owner. The Roth distribution rules and contribution and AGI limitations apply. Once the myRA account balance reaches $15,000, the fund must be rolled over into a private sector Roth IRA. The Treasury Department's website, **myra.gov**/**about**/, provides additional details regarding myRA accounts, including how to sign up for one.

Law Change: Beginning July 26, 2017, no new enrollments will be allowed in the myRA program and taxpayers currently participating in the program are being phased out. The Treasury Department will notify the account holder when deposits and interest will cease and relevant deadlines regarding transferring or closing the holder's account. Normal Roth IRA rollover provisions will be available and can be initiated at any time. If the account is not rolled over, withdrawal will most likely result in a tax liability on any earnings, since most myRA accounts will not meet the five-year requirement for qualified distributions and may be subject to penalty tax.

Contribution Limitations

Contributions to Roth IRAs are subject to the same dollar limitations as contributions to traditional IRAs. Thus, for 2017, an individual's contribution is limited to the lesser of (1) $5,500 ($6,500 if age 50 or older at year-end) or (2) 100% of the individual's compensation. For married couples filing joint returns, one spouse's earned income can provide the basis for the other spouse's contribution.

The total contributions to Roth IRAs and traditional IRAs cannot exceed the maximum annual contribution permitted to an IRA. For example, a taxpayer allowed a $5,500 IRA contribution can contribute that amount to either a traditional or Roth IRA, or part to each, but in no circumstances may the total combined contribution(s) exceed $5,500. Roth IRA rollovers or conversions do not affect allowable current year contributions to traditional or Roth IRAs.

Participating in an employer-sponsored retirement plan does not prevent an individual from contributing to a Roth IRA. Employer contributions, including elective deferrals, made under a SEP IRA or SIMPLE IRA plan on behalf of an individual (including a self-employed individual) do not reduce the amount of the individual's maximum regular contribution to a Roth IRA. Only modified AGI in excess of the phase-out range makes an individual ineligible to make a Roth IRA contribution.

Once a taxpayer's maximum allowable Roth IRA contribution is determined, it is subject to phase-out based on the taxpayer's modified AGI. For high-income taxpayers, the phase-out can reduce or completely eliminate the amount an individual can contribute to a Roth IRA. The phase-out ranges are as follows:

Filing Status	2017 Phase-out Range (based on Modified AGI)
Married filing joint return, qualifying widow(er)	$ 186,000–196,000
Single, head of household	118,000–133,000
Married filing separate return	0–10,000

The phase-out amounts apply regardless of whether the individual (or spouse) is an active participant in an employer-sponsored retirement plan. The maximum contribution is reduced ratably when a taxpayer's modified

AGI is within the phase-out range; when modified AGI exceeds the upper limit of the phase-out range, a Roth IRA contribution cannot be made. In applying the phase-out, the maximum amount is rounded to the next higher multiple of $10 and is not reduced below $200 until completely phased out.

Modified AGI is computed in the same manner as for limits on deductions for traditional IRA contributions, except income resulting from a Roth conversion is excluded.

Example 3B-1 Determining allowable Roth IRA contribution.

Linda, a single person, age 45, has 2017 salary income of $100,000 and modified AGI of $125,500 (which puts her halfway through the Roth IRA phase-out range of $118,000 to $133,000). How much can she contribute to a Roth IRA in 2017?

Her maximum allowable IRA contribution is $5,500. However, her Roth IRA contribution is limited because her modified AGI exceeds $118,000. Her maximum allowable Roth IRA contribution is $2,750 [$5,500 × ($133,000 − $125,500) ÷ $15,000].

Assume Linda is an active participant in an employer-sponsored retirement plan. Linda can still contribute up to $5,500 to IRAs in 2017. However, her Roth IRA contribution is limited to $2,750 and contributions to traditional IRAs are not deductible (because she is covered by an employer-sponsored plan and her modified AGI exceeds $72,000).

Variation: Assume Linda is not an active participant in an employer-sponsored retirement plan. Because she is not covered by an employer plan, Linda can contribute and deduct the maximum amount ($5,500) to a traditional IRA. If Linda contributes $2,750 to a Roth IRA, the maximum amount she can contribute to a traditional IRA is $2,750 (for total IRA contributions of $5,500). Linda can contribute to her Roth and traditional IRAs in any combination she desires, provided her combined contributions do not exceed $5,500 and her Roth contribution does not exceed $2,750.

Other Roth IRA Contribution Considerations

Deductibility. Unlike traditional IRAs, contributions to Roth IRAs are never deductible.

No Age Limit. Contributions to traditional IRAs are not allowed once a taxpayer reaches the age of $70\frac{1}{2}$. However, no such rule applies to contributions to Roth IRAs. Thus, as long as a taxpayer (or the taxpayer's spouse) has earned income and does not have excessive AGI, annual contributions to a Roth IRA can continue indefinitely.

Example 3B-2 Roth IRA contributions after age $70\frac{1}{2}$.

Paul is age 74 and his wife, Alice, is 68. They are both retired and drawing pensions from their former employers. However, Paul works part-time as a ticket taker at a local minor league baseball stadium. He earns $4,000 in 2017. Their modified AGI for 2017 is $50,000. Based on this earned income and Paul's age (≥50), he is eligible to make a Roth IRA contribution of up to $4,000. He cannot make a contribution to a traditional IRA because he is over age $70\frac{1}{2}$. Alternatively, if Paul does not make a Roth IRA contribution, Alice can make a Roth or traditional IRA contribution (because she is under age $70\frac{1}{2}$) totaling up to $4,000, based on Paul's earned income.

If Paul earned $8,000, he and Alice could each make IRA contributions. His contributions could only be made to a Roth IRA while Alice could contribute to either a Roth or traditional IRA, or both. Each of their contributions can be in any amount, as long as neither contributes more than $6,500 and they do not contribute more than $8,000 in total.

Deadline for Making Contributions. Like contributions to traditional IRAs, contributions to Roth IRAs must be made no later than the due date for filing the taxpayer's return, *not* including extensions. For 2017, contributions must be made no later than April 17, 2018.

Recharacterization of Contributions. IRA contributions can be recharacterized from Roth to traditional (or vice versa) if trustee-to-trustee transfers occur before the due date, including an automatic six-month extension, for filing the return for the year of the contribution.

Choosing between Roth IRAs and Traditional IRAs

A Roth IRA contribution is the best choice for taxpayers who can choose only between a Roth IRA and a nondeductible traditional IRA. Tax on the Roth IRA earnings is permanently avoided (rather than just deferred) if the Roth distribution requirements (i.e., five-year rule and age 59½) are met. Even if these requirements are not met, the Roth IRA basis is recovered first, before any income is recognized.

When taxpayers qualify for either deductible contributions to a traditional IRA or contributions to a Roth IRA, the decision as to which is the most advantageous is less clear. Factors such as the taxpayer's current tax rate versus expected tax rate at retirement and whether the taxpayer plans to withdraw the IRA funds during retirement generally affect the decision. For many taxpayers, Roth IRAs may prove the better choice because there are no mandatory distribution rules and contributions can be withdrawn tax-free before earnings. Another consideration is that Roth IRA distributions have no impact on the taxability of social security benefits.

Exposure of Assets Held in Roth IRAs to Bankruptcy Creditors

Some account owners have worried that assets held in their IRAs might become exposed to creditors in the event of bankruptcy. This concern was reduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The law provides broad protection from bankruptcy creditors for IRAs—including Roth IRAs, traditional IRAs, SEP IRAs, and SIMPLE IRAs. [Protection is also provided for assets held in qualified retirement plans, Section 403(b) plans, Section 457 plans, and Section 414 church and government plans.] For IRAs, the protection is generally limited to balances totaling $1 million, as indexed for inflation ($1,283,025 as of April 1, 2016; amount will be adjusted again on April 1, 2019). However, the $1 million ceiling is increased without limit for SIMPLE IRAs, SEP IRAs, and amounts rolled into IRAs from qualified retirement plans.

Qualified Retirement Plan and SEP Deductions for Self-employed Taxpayers

Contribution Limits

Self-employed taxpayers can adopt qualified retirement plans and simplified employee pensions (SEPs). SEPs are actually IRAs with higher funding limits that are established by an employer for the benefit of employees. For 2017, the deductible limit for a self-employed individual's contribution to a SEP or defined contribution plan [including profit-sharing and 401(k) plans] is the lesser of (1) 25% of an employee's compensation (limited to $270,000) or (2) $54,000.

Coverage Requirements. SEP and qualified retirement plans are required to cover all employees who meet certain minimum age and service requirements. For 2017, SEPs must cover all employees who (1) are at least age 21, (2) have worked for the employer for at least three of the five years immediately preceding the tax year, and (3) have received from the employer at least $600 in compensation in the tax year. Qualified retirement plans are required to cover all employees who are at least age 21 and have at least one year of service (two years if the plan provides that after more than two years of service the employee is 100% vested). For both SEP and qualified retirement plans, an employer can adopt less restrictive coverage rules if desired. Thus, self-employed persons who employ others must consider the impact and potential cost of covering such employees when establishing a SEP or qualified retirement plan.

Adjusting Earned Income. Compensation for a self-employed individual means earned income from the business that sponsors the plan. A self-employed individual's earned income is determined *after* the deduction for the deductible portion of self-employment (SE) tax and *after* a reduction for the self-employed participant's deductible contribution to the SEP or qualified retirement plan. This latter reduction requires a simultaneous equation that effectively reduces the self-employed participant's maximum contribution percentage (based on precontribution earned income).

Depending on the type(s) of plan, a self-employed retirement plan can provide for any stated contribution rate from 1%–25% of compensation. In general, plans for self-employed individuals call for discretionary contributions of 25%, which results in a recalculated maximum contribution rate of 20% for the self-employed owner. If less than

25% is contributed for any other employees, the following formula can be used to compute the self-employed owner's maximum percentage:

$$\text{Owner \%} = \frac{\text{Employee \%}}{1 + \text{Employee \%}}$$

Using this formula, the owner's contribution percentage, based on various levels of contributions for employees, is computed as follows:

Employee's Contribution Percentage (% Contribution Based on Employee's Gross W-2 Income)	Owner's Contribution Percentage [% of Precontribution Net Self-employment Income (Net SE Tax Deduction)]
5%	4.7619 %
10	9.0909
15	13.0435
20	16.6667
25	20.0000

In contrast, if the owner's desired contribution is known, the following formula is used to determine the employee percentage:

$$\text{Employee \%} = \frac{\text{Owner \%}}{1 - \text{Owner \%}}$$

Effect of the Compensation Limit

Practitioners who encounter sole proprietors and partners with SEP and qualified retirement plans with contributions limited by the $270,000 compensation limit (for 2017) should review the specific language in the plan document to understand how contributions are determined for the self-employed participant. The compensation limit is adjusted annually for increases in the cost of living. Plans typically satisfy the requirement for the reduced owner's contribution percentage by using one of the following methods:

1. *Gross Earnings Method.* The plan provides a contribution formula for owners (the self-employed individuals) that specifies the reduced owner percentage. This reduced percentage is applied to the owner's plan-year compensation, which is defined by the plan as net profit from self-employment minus the deduction for SE tax.

2. *Net Earnings Method.* The plan provides a contribution formula of a stated rate (which is the same for all employees) of plan-year compensation. The plan defines plan-year compensation for self-employed individuals as earned income within the meaning of IRC Sec. 401(c)(2) (i.e., net profit from self-employment less the SE tax deduction and the deduction for the plan contribution on behalf of the self-employed participant).

When the plan's contribution rate is less than 25%, a self-employed person's contribution level may be greater if the plan uses the net earnings method. See Example 3C-1. SEPs established using IRS Form 5305-SEP effectively use the net earnings method.

Calculating the Maximum Contribution Deduction

The maximum deductible 2017 SEP or qualified retirement plan contribution for a self-employed individual can be calculated using a seven-step process. Example 3C-1 illustrates the seven steps.

Example 3C-1 Computing contribution limits for self-employed individual.

Pam is a self-employed attorney with 2017 Schedule C net income of $300,000. She maintains a SEP and decides to make a contribution of 20% for 2017. The language in the plan document determines how much Pam can contribute for herself since her income exceeds the $270,000 compensation limit (for 2017) and the contribution rate is less than 25%.

The *gross earnings method* applies if the plan document provides that contribution rates are 16.667% of plan-year compensation for eligible self-employed individuals and 20% of plan-year compensation for other eligible employees. Compensation for self-employed individuals is defined in the plan document as the individual's net profit from self-employment less the deduction for SE tax.

The *net earnings method* applies if the plan provides a contribution formula of 20% of plan-year compensation for all participants and defines compensation for self-employed individuals as Section 401(c)(2) earned income (i.e., net profit from self-employment less the SE tax deduction and the deduction for the plan contribution on behalf of the self-employed participant).

The maximum 2017 contribution Pam may make on her behalf depends on the language used in the plan, which in turn determines whether the gross earnings or net earnings method applies. The maximum contribution under each method is computed as follows:

		Gross Earnings Method	Net Earnings Method
(1)	Net earnings from self-employment	$ 300,000	$ 300,000
(2)	Less the deductible portion of the SE tax liability	(11,904)	(11,904)
(3)	Compensation before plan contribution	$ 288,096	$ 288,096
(4)	Reduced owner's contribution percentage	16.6667%	16.6667%
(5)	Compensation multiplied by contribution rate ($288,096 × 16.6667%)	$ 48,016	$ 48,016
(6)	$270,000 compensation limit multiplied by the separate contribution rate specified in the plan for self-employed individuals; or, if none is specified, the contribution rate applicable to all participants, including the owners (unreduced) (Gross earnings method: $270,000 × 16.6667%; net earnings method: $270,000 × 20%)	$ 45,000	$ 54,000
(7)	Maximum deductible contribution (smaller of $54,000, line 5, or line 6)	$ 45,000	$ 48,016

Excess Contributions. SEP contributions in excess of the maximum contribution limit may be subject to the 6% excise tax on excess contributions unless timely corrected. Because the IRA distribution rules also apply to SEPs, an employee may avoid the excise tax if the excess is withdrawn on or before the due date for filing the income tax return for the year, and the contribution was not excluded from income.

Adoption and Funding Deadlines

Qualified Retirement Plans. Qualified retirement plans must be adopted before the end of the year to make deductible contributions after year-end. If a qualified retirement plan is adopted by December 31, 2017, deductible contributions can be made until the tax return due date, or if the return is extended, the extended due date of the 2017 Form 1040 (i.e., as late as October 15, 2018). In some cases, however, the qualified plan minimum funding rules (i.e., funding requirements for defined benefit and money-purchase plans) may require contributions be made no later than September 15, 2018, to avoid penalties for failure to make minimum funding contributions (*Wenger*).

In addition, Form 5500 (or 5500-SF, 5500-EZ) must be filed by July 31 of each year for calendar-year plans. However, certain one-participant plans with assets of $250,000 or less need not file returns.

SEP Plans. A SEP (unlike a qualified plan) need not be established or funded until the tax return due date, including extensions. Therefore, the SEP offers a significant post-year-end tax planning opportunity for self-employed persons. Contributions made by the due date, including extensions, are treated as made on the last day of the tax return year. For example, an individual taxpayer may establish and fund a SEP plan on October 15, 2018, and claim the deduction on the 2017 tax return if the tax return was extended to that date.

Example 3C-2 Post-year-end contributions for a SEP.

Lisa starts a home-based business in 2017 and ends the year with Schedule C net income of $75,000. In March 2018, Lisa consults with her newly-hired CPA regarding preparation of her 2017 tax return.

Lisa should consider establishing a SEP. A self-employed individual can establish a SEP on or before the due date of their tax return (including extensions). Thus, Lisa has until October 15, 2018, to establish a SEP, make the appropriate contributions, and deduct the amounts on her 2017 tax return if her tax return is extended to that date.

A SEP generally is easy to adopt, and the rules governing participation are straightforward. For most employers, adopting a SEP means completing and signing Form 5305-SEP (Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement). The form is not filed with the IRS but is maintained as part of the employer's permanent records. In addition, a copy of the form (including the accompanying instructions) and a disclosure statement must be given to each employee covered by the SEP. Sponsoring employers must also give each participating employee an annual statement showing any contribution made to the employee's SEP IRA. If the contribution is made before year-end, this last requirement is satisfied by reporting it on the employee's Form W-2. If the contribution is made after year-end (but before the employer's income tax return for the year is filed), notification should be given to each participating employee on a separate statement within 30 days of the contribution. In addition, employers generally need not file the Form 5500 series for the SEP.

A SEP is not considered adopted until each eligible employee sets up an IRA with a qualified IRA sponsor (e.g., a bank, an insurance company, or a mutual fund). Normally, employees establish their own SEP IRAs. However, the employer can establish a SEP IRA for eligible employees who are unable or unwilling to establish their own. The employer then funds the SEP by making contributions directly to the employee's IRA. SEP contributions can be made to an employee's or self-employed individual's existing traditional IRA in lieu of establishing a separate IRA for the SEP contributions. If a separate SEP IRA is established, only the employer may make contributions to it.

Earned Income from Directors' Fees

An often overlooked source of earned income (i.e., compensation) that a client can use as the basis for establishing and contributing to a qualified retirement or SEP plan is directors' fees. These plans often are not considered for corporate executives since their primary source of income is salaries rather than Schedule C or F income. However, individuals who receive directors' fees can establish qualified retirement or SEP plans even though they are covered by their employer's retirement plan. SEPs often may be the preferable plan for directors' fees since they are easy to administer and can be established and funded after year-end. Directors' fees can also be the basis for contributing to a SIMPLE IRA, subject to certain limitations. Allowable contributions to a qualified plan or SEP (unless a salary-reduction SEP is established before 1997) generally are not impacted by an individual's elective contributions to an employer-provided 401(k) plan; however, allowable contributions to a SIMPLE IRA may be reduced due to such contributions since there is an annual limitation ($18,000 for 2017, or $24,000 if the individual is age 50 or older) on employee-elective deferrals.

Employer-sponsored SIMPLE IRAS

A savings incentive match plan for employees (SIMPLE IRA plan) is a written salary reduction arrangement under which an eligible employee can elect to have the employer make contributions to a SIMPLE IRA rather than receiving that amount in cash. An employer that establishes a SIMPLE IRA plan must make either matching contributions or nonelective contributions.

SIMPLE IRAs are available to employers with 100 or fewer employees receiving at least $5,000 of compensation in the prior calendar year. Self-employed individuals are also eligible to participate in a SIMPLE IRA plan. The employer may not currently maintain any other qualified retirement plans while contributing to a SIMPLE IRA plan.

If an employer establishes a SIMPLE IRA plan, all employees who received at least $5,000 in compensation from the employer during *any* two prior tax years (whether or not consecutive) and who are reasonably expected to receive at least $5,000 in compensation during the current year must be eligible to participate in the plan for the year. The employer can provide more liberal participation requirements than these, but not more restrictive ones. For example, an employer could allow employees to begin participating as soon as they are employed. This enables employers, including self-employed individuals, to establish SIMPLE IRA plans in their first year of existence without regard to any compensation requirement for prior years.

An advantage of SIMPLE IRA plans is that they are easier to operate than qualified retirement plans. SIMPLE IRA plans do not have to meet the nondiscrimination requirements, minimum participation and minimum coverage rules, vesting rules, or the top-heavy rules applicable to qualified plans.

Contribution and Eligibility Rules

SIMPLE IRA plans allow employee elective contributions and require either employer matching contributions or nonelective contributions. For 2017, employee elective contributions are limited to the lesser of (1) the employee's compensation or (2) $12,500 ($15,500 if age 50 or older). Employer contributions must be made under one of two formulas:

1. *Matching Contribution Formula.* Employers must generally match employee contributions on a dollar-for-dollar basis, up to 3% of the employee's compensation for the calendar year. However, in two out of every five years, the employer has the option of electing a matching percentage as low as 1% of each eligible employee's compensation. For purposes of the matching contribution, compensation is not limited.

2. *Nonelective Contribution Formula.* In lieu of making matching contributions, the employer may make a nonelective contribution of 2% of compensation for each eligible employee having at least $5,000 of compensation during the calendar year. For purposes of this formula, compensation of each eligible participant is limited to the Section 401(a)(17) limit ($270,000 for 2017), thus limiting the contribution to no more than $5,400 per employee. The employer must make the nonelective contribution to each eligible employee's account regardless of whether the employee contributes any of their own money to the plan.

Rollovers from traditional IRAs, qualified trusts, qualified annuities, 403(b) tax-sheltered annuities, and governmental section 457 plans may occur if the participant has been in the plan for two years.

There is a limit as to total amount of compensation an individual can elect to defer each year. This aggregate limit applies to all elective deferrals the individual makes to 401(k) plans, 403(b) plans, SARSEPs, as well as SIMPLE IRA plans for the year regardless of whether the plans are provided by related or unrelated employers. For 2017, an employee's aggregate elective deferral limit is $18,000 ($24,000 if age 50 or older).

Example 3D-1 Computing the elective deferral limit for a SIMPLE IRA.

Jane, age 40, is a participant in LMN Corp.'s 401(k) plan under which she elected to defer $9,000 during 2017. She has no ownership in LMN Corp. During 2017, Jane earned $15,000 in directors' fees from Snakes, Inc., which is not related to LMN Corp. This $15,000 will be reported as self-employment (SE) income (sole proprietorship) on Jane's 2017 return and she would like to establish a SIMPLE IRA plan on behalf of this business. If she does so, how much can she elect to defer under the plan for 2017?

Jane's aggregate elective deferral limit for 2017 is $18,000. Therefore, her elective deferral limit for the SIMPLE IRA is $9,000 [$18,000 aggregate elective deferral limit − $9,000 elective deferral made to the 401(k) plan].

Variation: What if Jane had deferred $2,000 (rather than $9,000) to the 401(k) plan? Jane's remaining aggregate elective deferral limit would be $16,000 [$18,000 aggregate elective deferral limit − $2,000 elective deferral made to the 401(k) plan]. However, the elective deferral to the SIMPLE IRA plan would be further limited to $12,500 [the lesser of 100% of her compensation from the sole proprietorship ($15,000) or the SIMPLE IRA elective deferral limit ($12,500)].

Deferrals in excess of the aggregate elective deferral limit (excess deferrals) are included in the employee's income in the year the deferral was made.

The 60-day Election Period. Each eligible employee must be allowed to elect to participate in the SIMPLE IRA plan or modify previous elections as to the amount deferred in the 60-day period before the beginning of any year (or the 60-day period before first becoming eligible to participate). For the year an employee first becomes eligible to participate in the plan, the 60-day election period must include either the day the employee becomes eligible or the day before. Employees must be allowed to stop participating (i.e., no longer make contributions) in the SIMPLE IRA plan at any time during the year. Once an employee stops participating, the plan may provide that the employee cannot begin participating again until the following year. The plan may (but is not required to) allow participants to change their elective deferral percentage during the year.

Payroll Tax Issues. Employer matching or nonelective contributions are not treated as wages for income or employment tax purposes and thus are not subject to federal income tax (FIT) withholding or payroll taxes. Employee elective deferrals are not treated as wages for FIT withholding purposes. They are, however, treated as wages for social security, Medicare, and federal unemployment (FUTA) tax purposes. Accordingly, the employer must withhold social security and Medicare taxes and pay its share of those taxes (plus FUTA) on the elective deferrals. Furthermore, the elective deferrals are included in the Form W-2 wages for social security and Medicare tax purposes, but not for FIT purposes.

Distributions. Distributions from SIMPLE IRA plans generally are taxed under the rules applicable to traditional IRAs. Tax-free rollovers can be made from one SIMPLE IRA to another at any time. A SIMPLE IRA can be rolled over to another eligible retirement plan [i.e., qualified plan, traditional IRA, 403(b) plan, or governmental 457 plan] on a tax-free basis only after the participant has been in the plan for two years. If an employee terminates employment and two years have expired since the employee first participated in the SIMPLE IRA plan, the employee's SIMPLE IRA is treated as a traditional IRA.

Early withdrawals from a SIMPLE IRA generally are subject to the 10% early distribution penalty tax applicable to IRAs. However, if the participant receives a distribution before being in the plan for two years, a 25% early withdrawal tax applies (rather than 10%).

Compensation

For the rules relating to SIMPLE IRA plans, *compensation* means taxable wages required to be reported by the employer on Form W-2, plus any elective deferrals made by the employee under a 401(k), 403(b), SARSEP, or SIMPLE IRA plan sponsored by the employer. For a self-employed individual, compensation means net earnings from self-employment as defined by IRC Sec. 1402(a) without regard to the self-employed person's SIMPLE IRA plan contribution.

Under IRC Sec. 1402(a)(12), SE income is reduced by the product of the SE income multiplied by half of the self-employed social security tax rate. This reduction occurs regardless of whether the income is above or below the $127,200 social security wage base for 2017. Thus, for 2017, the adjustment is equal to 7.65% [$1/2 \times (12.4\% + 2.9\%)$]. Mathematically, Schedule C net income can be multiplied by 92.35% (100% − 7.65%), which is the approach taken on Form 1040, Schedule SE. Although not authoritative, IRS Pub. 560, "Retirement Plans for Small Business" follows this approach, stating that a self-employed person's earnings are the amount reported on line 4 of short Schedule SE, or line 6 of long Schedule SE, which is self-employed earnings *after* taking the "in lieu of deduction."

Special Rules for Self-employed Persons

Self-employed persons must be eligible to participate in the SIMPLE IRA plan the same as any other employee. However, the following special rules apply to such persons:

1. Special rules apply for determining compensation.

2. Income is deemed to be earned as of the last day of the year. This means that the self-employed person's deferral election need not be made until the last day of the year. Also, elective deferrals on behalf of the self-employed person need not be deposited until after the last day of the year (but no later than 30 days after the year-end). It also means that a self-employed person's total net earnings for the year are used in

determining the maximum contribution allowed, even if the deferral election is made after the first day of the year (but no later than the last day of the year).

3. Matching contributions can be made for self-employed persons in the same manner and under the same rules applicable to any other employee.

When and Where Contributions Are Deductible

SIMPLE IRA contributions made on behalf of employees are deducted on Schedule C (or F) on the line for "Pension and profit-sharing plans." Payments made on behalf of the self-employed business owner are deducted on line 28 of Form 1040 as an adjustment to gross income.

Employee elective deferrals must be deposited to the employee's SIMPLE IRA as soon as reasonably possible, but in no case later than 30 days after the end of the month to which the contributions relate. Under the timing rules for making contributions, the self-employed owner's elective deferral must be deposited no later than 30 days after the end of the tax year since the self-employed owner's income is deemed earned as of the last day of the year. The company match, however, need not be made until the due date, including extensions, of the return for the year to which they relate.

Example 3D-2 Computing and reporting SIMPLE IRA contributions.

Eric, age 40, is self-employed and operates his business as a sole proprietorship. He has one employee, Jane. He establishes a SIMPLE IRA in which both he and Jane participate. Neither has any elective deferrals from other sources.

In 2017, Jane earned $36,000 and chooses to contribute 10% of her salary to her SIMPLE IRA. For 2017, Eric's net earnings from self-employment are $60,000 and he also chooses to contribute 10% to his SIMPLE IRA. The company (Eric's sole proprietorship) makes a 2% nonelective contribution. For 2017, the SIMPLE IRA contributions made for Jane and Eric are as follows:

	Jane	Eric
Salary reduction contribution:		
Jane: $36,000 × 10%	$ 3,600	
Eric: $60,000 × 10%		$ 6,000
Company 2% nonelective contribution:		
Jane: $36,000 × 2%	720	
Eric: $60,000 × 2%		1,200
Total contributions	$ 4,320	$ 7,200

Jane's salary reduction contributions must be made as soon as reasonably possible but no later than 30 days after the end of the month in which the salary would have otherwise been payable to her. Therefore, if her salary is paid throughout the year, her contributions must be made throughout the year. Eric's salary reduction contribution, on the other hand, can be made as his income is earned or as late as January 30, 2018, since a self-employed individual's income is deemed to be earned as of the last day of the year. The $1,920 ($720 + $1,200) company match contribution must be made no later than the due date, including extensions, of Eric's 2017 Form 1040. The $720 nonelective contribution made on behalf of Jane is reported on line 19 (Pension and profit-sharing plans) of Eric's Schedule C for the business. All $7,200 of contributions made on Eric's behalf is reported on line 28 of his 2017 Form 1040.

Assume the same facts except Eric has net earnings from self-employment of $150,000. Although he elected a 10% salary reduction, the maximum reduction is limited to $12,500 for 2017. The employer's 2% nonelective contribution is $3,000 ($150,000 × 2%). Thus, the total contribution made on Eric's behalf for 2017 is $15,500 ($12,500 + $3,000). There is no change to the contributions made on Jane's behalf.

Establishing SIMPLE IRA Plans

An eligible employer can generally establish a SIMPLE IRA plan effective on any date between January 1 and October 1 of the year. However, if an employer (or predecessor employer) previously maintained a SIMPLE IRA plan, a new SIMPLE IRA plan can be established effective only on January 1. Also, a new employer that comes into existence after October 1 can establish a SIMPLE IRA plan effective between October 1 and December 31 if the plan is established as soon as administratively feasible after the employer comes into existence.

SIMPLE IRA plans must be maintained on a calendar year basis. Accordingly, the contribution amount is determined on a calendar year basis.

Adopting a SIMPLE IRA Plan. An employer can establish a SIMPLE IRA plan by adopting any of the following:

1. An IRS model agreement (i.e., Form 5304-SIMPLE or 5305-SIMPLE). Such plans are referred to as model plans.

2. A prototype SIMPLE IRA plan sponsored by a qualified financial institution (e.g., a bank or an insurance company) or an individually designed plan. Such plans are referred to as nonmodel plans.

Reporting and Disclosure Requirements. Simplified reporting and disclosure requirements apply to SIMPLE IRA plans. The employer maintaining the plan is not required to file any annual reports, such as Form 5500. However, the employer is required to notify employees immediately before the 60-day election period of their right to make contributions under the plan. The notice must include a copy of the summary description received from the SIMPLE IRA trustee.

Deducting Moving Expenses

Certain expenses incurred in moving to a new principal residence are deductible if the move is job related. These expenses are deductible above the line in computing adjusted gross income. Moving expenses (for both foreign and domestic moves) are first reported on Form 3903 (Moving Expenses). The total deductible expense is then carried to line 26 of Form 1040 as an adjustment to gross income.

Deductible Moving Expenses

The following expenses are deductible if the move is job related (see discussion later in this section).

1. The cost of transporting household goods and personal effects from the former residence to the new residence. This includes the cost to pack and crate, store, and insure household goods and personal effects within any period of 30 days in a row after they were moved from the taxpayer's old home and before they were delivered to the new home.

2. The cost of traveling from the former residence to the new residence. (Traveling expenses include lodging but not meals.)

Automobile expenses can be calculated per mile in lieu of actual expenses. For 2017, the standard mileage rate for moving is $.17 per mile.

Nondeductible Moving Expenses

Moving expenses other than those specifically allowed as deductions (see preceding discussion) are not deductible. Common nondeductible moving expenses include:

1. Meals while moving from an old residence to a new residence.

2. Travel expenses, meals, and lodging for a pre-move house-hunting trip.

3. Meals and lodging while occupying temporary quarters in the area of the new job.

4. Expenses of buying or selling a home or of entering or breaking a lease.

Move Must Be Job-related

For moving expenses to be deductible, the move must be job related. A move is job related if the taxpayer meets two tests—(1) the time test and (2) the distance test. The *time test* requires the taxpayer to be employed full-time in the general location of the move for at least 39 weeks during the 12-month period following arrival at the new location. Employment need not be with same employer for all 39 weeks. A self-employed taxpayer must work full-time (at his own business or as an employee) for at least 39 weeks during the first 12 months and for at least 78 weeks during the 24-month period following the move. The *distance test* generally requires the new principal place of work to be at least 50 miles farther from a taxpayer's former home than his former principal place of work. (In other words, had the taxpayer not moved, commuting to the new work location would have increased his commute by 50 miles or more when compared to the commute to the prior workplace.)

For a taxpayer that goes to work full-time for the first time (e.g., college graduate), the taxpayer's place of work must be at least 50 miles from the taxpayer's former home to meet the distance test. This distance test also applies to a taxpayer returning to full-time work after a substantial period of part-time work or unemployment. The regulations do not define what constitutes a substantial period.

If a taxpayer claims a moving expense deduction with the expectation that the two tests will be satisfied and later fails to meet one or both tests, the amount deducted should be included in gross income for the first year that one or both of the tests are not satisfied. Alternatively, the taxpayer can amend his return for the year the moving expense was deducted.

Example 3E-1 Employee changing jobs.

Jeff moved from Dallas to Denver in November 2017 for a new job. He deducted $5,000 in moving expenses on his 2017 return. In April 2018, Jeff accepted an employment offer from another company in the Denver area; he remained employed there for the rest of 2018. Jeff's moving expenses are deductible because he met the time and distance tests. The 39 weeks need not be with the same employer as long as the taxpayer works full-time in the same general commuting area, and they do not have to run consecutively. Also, the 39-week test need not be met if the first employer had transferred Jeff to another location.

Example 3E-2 Obtaining employment after a move.

Steve moved from Montana to Ohio in March 2017 to find a job. He did not have a job when he moved, but found employment soon afterwards and remained employed for a 39-week period. Steve's moving expenses are deductible in 2017. A taxpayer need not secure employment before a move as long as the time and distance tests are met after the move. Generally, moving expenses should be incurred within one year from the start of work, unless circumstances cause the taxpayer to incur expenses beyond that time.

A situation commonly encountered by two-earner families is for one spouse to be transferred, thus requiring the other spouse to find employment in the new location. The move often is accomplished in two stages, with one spouse moving immediately to take the new position and the other following later. However, moving expenses incurred more than a year after the start of a new job may not be deductible, depending on the particular facts and circumstances causing the delay.

Example 3E-3 Expenses incurred within one year of move.

Clark was transferred by his company in February 2016 and moved from New York to Dallas. His wife, Lois, remained at her job in New York until June 2017 to allow their children to finish school. She then relocated to Dallas and resumed her job at her employer's Dallas office.

Although Lois moved more than a year after Clark started working at his new location, the 2017 expenses of moving the family and household goods are deductible because circumstances prevented completing the move within the one-year period. Assuming no employer reimbursement for the move, Clark's moving expenses are deductible in 2016, the year they were paid, and Lois's moving expenses will be deducted on the 2017 return.

Employer Reimbursements of Moving Expenses

Employer-paid moving expenses paid to the employee are reported on the employee's Form W-2. Employers handle employee moving expenses as follows: (1) deductible moving expenses paid by the employer to a third party or provided by the employer in-kind are not reported on Form W-2, (2) deductible moving expense reimbursements the employer pays directly to the employee are reported in box 12 of Form W-2 and identified with Code P, and (3) employer reimbursements for nondeductible moving expenses are included in the employee's taxable wages reported in box 1 of Form W-2.

When an employee is reimbursed for deductible moving expenses (i.e., shown with Code P in box 12 of Form W-2), the reimbursement is reported on Form 3903 along with all deductible moving expenses the employee incurred if the deductible moving expenses exceed the employer reimbursement. The excess expense is then carried to and deducted on line 26 of Form 1040. If reimbursed moving expenses exceed actual deductible expenses incurred, the excess is carried from Form W-2 to line 7 of Form 1040 and reported as additional taxable wages. The taxpayer need not file Form 3903 if deductible moving expenses equal the amount of reimbursed moving expenses included in box 12 of Form W-2.

If an employee's entire reimbursement is included in box 1 of Form W-2, Form 3903 should be filed with any allowable expenses included. Reimbursements received are not included on the Form 3903 when reported to the taxpayer as wages (i.e., box 1 of Form W-2).

Example 3E-4 Form W-2 reporting reimbursements of moving expenses.

Henry was transferred by his company from New York to Denver in July 2017. The company reimbursed him $4,000 for the cost of moving his personal property, $1,500 for temporary housing expenses, and $2,000 for closing costs on the purchase of a new home.

Henry's 2017 Form W-2 should include in box 1 $3,500 of taxable wages for the reimbursements for temporary housing ($1,500) and closing costs ($2,000) because these expenses are not deductible moving expenses. The reimbursement for the cost of moving his personal property ($4,000) should not be included in Henry's taxable wages (box 1), but should be included in box 12 with Code P. If Henry has other deductible moving expenses, Henry reports the $4,000 reimbursement on his Form 3903, thereby offsetting part of his deductible moving expenses. If Henry has no other deductible moving expenses, he does not need to file Form 3903.

Reimbursement Received and Expenses Paid in Different Tax Years

Generally, cash-basis taxpayers deduct moving expenses in the year paid, but often the reimbursement is received in the preceding or following year. If this occurs, the taxpayer can choose to deduct the expenses in the year of reimbursement if (1) the expenses were paid in a year before the year of reimbursement, or (2) the expenses were paid in the year immediately after the year of reimbursement but on or before the due date (including extensions) for filing the tax return for the year of the reimbursement. By reporting deductions in the year of reimbursement, taxpayers can avoid prepaying tax on the reimbursement income by matching revenues and expenses in the year incurred.

A taxpayer who wants to deduct moving expenses in the year of reimbursement simply deducts them in that year. No special attachments or statements are required to document the election.

Example 3E-5 Expenses incurred in year after reimbursement.

Dean, a single taxpayer, is transferred by his company from Iowa to California. He receives a $10,000 lump-sum moving expense allowance in December 2017 and need not account to his employer how the allowance was spent. He pays all his deductible moving expenses in January 2018. However, the $10,000 reimbursement is correctly reported as taxable wages on his 2017 Form W-2.

Because Dean paid his deductible moving expenses by the due date of his 2017 return, he can deduct them on his 2017 return (even though he actually paid them in 2018).

Example 3E-6 Expenses incurred in year before reimbursement.

Susan, a single taxpayer, was transferred by her company. She moved and paid all her moving expenses in December 2017. Her company fully reimbursed her deductible moving expenses in February 2018.

Susan can deduct her moving expenses on Form 3903 in 2017, the year they were paid. If she does so, the reimbursement her employer reports in box 12 of her 2018 Form W-2 must be reported on Form 3903 in 2018 and will carry to Form 1040 as taxable income.

If Susan does not deduct the expenses in 2017, the 2018 reimbursement is an excludable fringe benefit that is not includable in her 2018 taxable wages. As a result, Susan reports neither income nor deduction related to her move in either 2017 or 2018.

Self-employed Health Insurance Deduction

Self-employed taxpayers are allowed an above-the-line deduction for 100% of the cost of providing medical, dental, and qualifying long-term care insurance for themselves and their families. The amount is deducted on line 29 of Form 1040, not as a trade or business expense. Although the deduction reduces AGI, it is not allowed as an expense when calculating net earnings subject to SE tax.

The following special rules apply to the deduction:

1. *Employer-subsidized Health Plan.* The deduction applies only for calendar months when the self-employed taxpayer is not eligible to participate in a subsidized health plan maintained by any employer of either the taxpayer or the taxpayer's spouse. A subsidized plan is one in which the individual's premiums are reduced (i.e., the employer is paying a portion).

2. *Earned Income Limit.* The deduction applies to a medical insurance plan established under the taxpayer's business and only to the extent of the taxpayer's earned income from that business.

3. *Long-term Care Premiums.* The deduction applies for long-term care insurance premiums only if the policy is a qualified contract and subject to the following limits:

Age before the End of the Tax Year	2017 Limit on Deduction for Premiums Paid
Age 40 or under	$ 410
Age 41–50	770
Age 51–60	1,530
Age 61–70	4,090
Over age 70	5,110

Example 3F-1 Calculating the deduction for long-term care premiums.

Brad, age 56, owns and operates a small service business as a sole proprietorship. Brad reported a $75,000 profit from the business in 2017. He paid $6,000 for medical insurance coverage in 2017 and $1,600 of long-term care insurance premiums for the year. Brad's self-employed health insurance deduction for 2017 is calculated as follows:

Medical insurance premiums	$ 6,000
Long-term care insurance premiums ($1,530 maximum)	1,530
Total deduction	$ 7,530

The remaining $70 ($1,600 − $1,530) of long-term care insurance premiums are not deductible because they exceed the $1,530 maximum for Brad's age.

Medicare Insurance Premiums

Medicare premiums (including Parts A, B, C, and D) paid voluntarily to obtain insurance that is similar to qualifying private insurance are deductible for purposes of the self-employed health insurance deduction. The IRS has also clarified that premiums paid by a taxpayer for Medicare A, Medicare B, or Medicare D coverage are all deductible on Schedule A as itemized medical expenses to the taxpayer.

Who Is Self-employed?

The individuals eligible for the health insurance deduction generally include those with net income reportable on Schedule C (sole proprietorship), E [partnership, limited liability company (LLC), or S corporation] or F (farming) of Form 1040. However, the underlying business must be one in which the personal services of the self-employed person are a material income-producing factor. The requirement that the personal services of the self-employed person be a material income-producing factor focuses on whether the owner provides services or capital to the business. If the owner's services are income producing, it appears the deduction is allowed.

Partners and LLC Members. Partners or LLC members may claim a deduction for premiums paid on a medical insurance policy in either the partner's name or the name of the partnership. The partnership must either establish the medical plan that covers the partner or have been deemed to establish the plan under one of the following circumstances:

1. The partnership directly pays the premiums, and the partnership-paid premium amounts are reported on the partner's Schedule K-1 (Form 1065) as guaranteed payments includable in the partner's income.

2. The partner pays the premiums, furnishes proof of the premium payments to the partnership, and then the partnership reimburses the partner and reports the premium amounts on the partner's Schedule K-1 (Form 1065) as guaranteed payments includable in the partner's income.

More-than-2% S Corporation Shareholder-employees. A more-than-2% S corporation shareholder may claim a deduction for premiums paid on a medical insurance policy in either the shareholder's name or the name of the S corporation. The S corporation must either establish the medical plan that covers the shareholder or have been deemed to establish the plan under one of the following circumstances:

1. The S corporation directly pays the premiums, and the company-paid premium amounts are reported as compensation on the more-than-2% shareholder-employee's Form W-2 and included in gross income on his or her Form 1040. The reimbursement will not be subject to FICA tax in this scenario. However, see *Interrelationship with the American Healthcare Act* later in this lesson for issues related to potential penalties involved when the premium payment is not subject to FICA. The corporation can claim a wage deduction for the premiums on its Form 1120S.

2. The more-than-2% shareholder pays the premiums, furnishes proof of the premium payments to the S corporation, and then the S corporation reimburses the shareholder in the current year for the premium payments. The premium amounts must be included as compensation on the more-than-2% shareholder-employee's Form W-2 and included in gross income on his or her Form 1040. The reimbursement will not be subject to FICA tax in this scenario. However, see *Interrelationship with the American Healthcare Act* later in this lesson for issues related to potential penalties involved when the premium payment is not subject to FICA. The corporation can claim a wage deduction for the premiums on its Form 1120S.

A pass-through loss has no effect on the deductibility of the health insurance premiums because earned income for S shareholders is defined as wages. (See Example 3F-2.)

S shareholder-employees who own 2% or less of the corporation are treated as nonowners. Thus, they can receive tax-free health insurance coverage, the cost of which is deductible by the corporation.

Interaction with the Affordable Care Act for S Corporations

Due to the Affordable Care Act (ACA) market reform requirements it is unclear how reimbursements for individual health insurance premiums for more-than-2% S corporation shareholder/employees will be affected. While

guidance issued so far by the IRS, DOL, and HHS has not directly addressed coverage for S corporation shareholders, it has addressed the issue of an employer paying for an employee's individual health insurance policy.

Generally, in IRS Notice 2013-54 2013-40 IRB 287, the IRS states that plans that reimburse an employee for individual health insurance policy premiums (or directly pay those premiums) fail to meet certain market reform requirements and subject the employer to a $100 per-day/per-employee penalty under IRC Sec. 4980D. So a company that reimburses an employee (or S Corporation owner) for premiums for an individual policy (or pays those premiums directly to the insurance company) could be subject to a $36,500 annual penalty for each employee (or owner) for whom it reimburses (or pays) the premiums.

The IRS has acknowledged that additional guidance is needed to clarify the treatment of premium reimbursements for individual health insurance policies for more-than-2% S corporation shareholder/employees. Until further guidance is released, the excise tax under IRC sec. 4980D will not apply, and the guidance in IRS Notice 2008-1 continues to apply.

What Counts as Earned Income?

A self-employed person's (or a partner or more-than-2% S corporation shareholder-employee's) health insurance premiums are only eligible for the above-the-line deduction to the extent they are less than the individual's earned income from the business that established the health insurance plan. For an S shareholder, earned income equals the shareholder-employee's FICA taxable cash wages from the corporation (as shown on Form W-2). For other taxpayers eligible for the deduction, earned income equals net SE earnings less two deductions to the extent they relate to the business that established the health insurance plan-the deduction for the employer equivalent portion of the SE tax (line 27, Form 1040) and the deduction for a qualified retirement plan, SEP, or SIMPLE IRA contribution (line 28, Form 1040).

Example 3F-2 Deduction for S corporation shareholder-employee.

Jerry is president and sole shareholder of Jerrico, Inc., an S corporation. Jerry's Form W-2 from Jerrico reflects FICA wages of $60,000 and taxable wages of $64,000, which includes $4,000 of medical insurance premiums paid by the company for him and his family. His Schedule K-1 from Jerrico reflects a $75,000 net loss passed through for the current year. Neither Jerry nor his wife, Doris, is eligible to participate in an employer-subsidized health plan.

Jerry and Doris can claim the $4,000 of premiums above the line on line 29 of their Form 1040. The $75,000 pass-through loss has no effect on the deductibility of the health insurance premiums; instead, Jerry's FICA wages of $60,000 are his earned income from Jerrico.

Example 3F-3 Earned income limitation.

Earl owns and operates a feed store as a sole proprietorship. He reported a $12,000 loss on his Schedule C. In addition, Earl raises cattle and reported a $20,000 profit on Schedule F. He paid $5,000 of medical insurance premiums. If the premiums are paid in connection with Earl's operation of the feed store, he is not entitled to an above-the-line deduction. However, if the premiums are attributable to the ranching activity, Earl can deduct $5,000 above the line on line 29 of Form 1040.

Example 3F-4 Earned income limitation for non-paid family member.

Assume the same facts as in Example 3F-2. In addition, Jerry's dad, Tom, is a retired past-president of Jerrico, Inc. Jerrico continues to pay Tom's health insurance premiums for his past employment services to Jerrico and Tom receives no other compensation from Jerrico. Tom is considered a more than 2% shareholder of Jerrico because of the family ownership attribution rules mentioned previously. As a result, Jerrico reports the health insurance premiums as wages in box 1 of a W-2 for Tom as taxable wages for income tax purposes, but not in box 2 as FICA wages.

Tom will not be able to claim the 100% self-employed health insurance deduction to offset these taxable wages. Only cash wages reported by Jerrico subject to FICA can be considered earned income for purposes of the deduction.

Example 3F-5 Shareholder not entitled to self-employed health insurance deduction.

Lily, sole shareholder of her S corporation, obtains a health insurance policy in her own name and makes the premium payments on the policy. The S corporation makes no payments or reimbursements with respect to the premiums. Because the S corporation did not establish a plan providing medical care for Lily, she is not entitled to the self-employed health insurance deduction under IRC Sec. 162(l). Lily may deduct the health insurance premiums as a Schedule A itemized deduction.

Coordination with the Premium Tax Credit

An individual eligible for both the self-employed health insurance deduction under IRC Sec. 162(l) and the premium assistance credit under IRC Sec. 36B may have a difficult time calculating these amounts because of the circular nature of their relationship. Rev. Proc. 2014-41 provides optional method for taxpayers to calculate both amounts and circumvent the circular calculation.

Distinguishing Alimony from Nondeductible Payments

Payments properly classified as alimony are deducted above the line on the payer's return. For a payment to be classified as alimony and thus deductible by the payer and includable as income by the recipient, it must be made under a written divorce or separation instrument and meet all of the following requirements:

1. The payment must be in cash or cash equivalents.

2. The payment is made to (or on behalf of) a spouse or former spouse.

3. The payer's obligation to make payments must be relieved upon the recipient's death. (See Example 3G-6 and the caution following it.)

4. The payer and the payee do not file a joint return with each other.

5. For payments made after the divorce or legal separation is final (the couple is no longer married for tax purposes), the payer and payee cannot be members of the same household at the time payments are made.

6. The divorce or separation instrument does not state that the payment is *not* alimony for tax purposes.

7. The payment cannot be explicit or disguised child support.

Alimony is taxable to the receiving spouse under IRC Sec. 71. The payor deducts the payment to compute adjusted gross income. Alimony payments meeting these requirements are deductible by the payor spouse even when the payee spouse is a foreigner who, because of a treaty, does not have to report them as income. There is no withholding on alimony payments, other than 30% withholding on alimony payments to nonresident aliens under IRC Sec. 1441(a) (unless a tax treaty exempts the alimony from withholding). Alimony payments are treated as earned income to the recipient, potentially qualifying the recipient for an IRA contribution.

Written Instrument Required

To qualify as alimony for income tax, a payment must be made under a written agreement or decree; voluntary payments do not qualify. Temporary support payments made prior to divorce and based on negotiations that were never finalized are not deductible as alimony since they were not made pursuant to a written separation agreement as required by IRC Sec. 71. Additionally, the agreement cannot expressly provide that the payment be treated as nonalimony.

The timing of payments is critical. Payments made before a written instrument is executed or a decree or order of support becomes effective are not alimony for tax purposes—even if the divorce or separation instrument is made retroactive to the date the earlier payments were made.

Example 3G-1 Treatment of payments made before and after a written agreement.

After Joe and Marti decided to divorce, Joe moved into an apartment. He paid Marti $1,500 support per month for four months before executing a separation agreement that continued the same amount of support payments. The $6,000 Joe paid before executing the separation agreement is not alimony for income tax purposes. Joe cannot deduct the payments, and Marti is not required to report them as income. After Joe and Marti have executed their written separation agreement, providing all of the requirements are met, any future payments are deductible for Joe and counted as income for Marti.

Payments Must Be Cash

Alimony payments must be cash or cash equivalents. Checks, money orders, and payroll deduction payments qualify as cash. Bonds, annuity contracts, promissory notes, and other similar assets do not. Transferring services or property other than cash, or using the payor's property (e.g., rent-free use of the paying spouse's home), is not alimony.

Example 3G-2 Noncash payments or services.

Lyle and Jean have been divorced for several years. Under the divorce decree, Lyle must pay Jean $1,500 per month as alimony. When Lyle lost his job, he and Jean agreed that he would shingle Jean's house in lieu of making the June payment. (Jean would buy the shingles.) Can Lyle deduct as alimony the value of shingling Jean's house?

No. Alimony payments must be made in cash (checks and money orders qualify as cash) to be deductible. Transfers of services or property other than cash do not qualify as alimony for income tax purposes.

Payment Must Be to (or on Behalf of) a Spouse or Former Spouse

An alimony payment must be made in cash (or a cash equivalent), but it is not required that the payment be made directly to the receiving spouse. Payments may be made to a third party on behalf of the payee spouse under the terms of the divorce or separation instrument or at the receiving spouse's written request or consent.

Common payments made to third parties and treated as alimony include medical expenses, housing costs, taxes, and tuition. However, any payments to maintain property owned by the paying spouse and used by the receiving spouse are not considered alimony. If spouses jointly own property for which the payer spouse is responsible for making payments, then half of the payment may be deductible alimony.

Example 3G-3 Mortgage payments as alimony.

Under the terms of Neil and Patty's divorce decree, Neil must make monthly alimony payments to Patty, who received the house as part of the settlement. Neil has always made the monthly mortgage payments out of his checking account. Can he continue to pay the monthly mortgage and deduct it as alimony?

Neil can make the monthly mortgage payment and deduct this amount as alimony if he is required to make the payments to a third party under the divorce decree or maintenance agreement. However, if Neil and Patty were jointly liable on the mortgage and remained so after the divorce, Neil would only be entitled to an alimony deduction for one-half of the mortgage payments he is paying because one-half of the payment is considered a discharge of his own obligation.

Example 3G-4 Payments that benefit the payer.

Before they divorced, Wayne and Lisa jointly owned a house. After the divorce, Wayne moved to another town, but Lisa and their children continued to live in the house even though the divorce decree awarded it to

Wayne. Under the decree, he pays the mortgage, property taxes, and insurance premiums on the house in addition to any regular and necessary upkeep. Can Wayne deduct these payments as alimony?

Even if the divorce or separation instrument states Wayne must make these payments, they cannot be classified as alimony because he owns the property. The interest expense, however, might be deductible as qualified residence interest expense on Wayne's second home, provided the criteria of IRC Sec. 163(h) are met. If the interest is not qualified mortgage interest, it will be personal interest (or possibly investment interest). The property taxes are deductible on Schedule A.

Payments Must Not Be Child Support

Child support payments are not alimony for tax purposes and are not deductible by the paying spouse or taxable to the receiving spouse or the child. Both payments called child support in the divorce instrument and payments that are deemed child support fail as an alimony deduction for tax purposes. Certain payments deemed child support are not identified in a divorce or settlement agreement as child support, but are treated as such for income tax purposes when the written instrument reduces the payment due to a child-related contingency. Designating such a payment as alimony in a divorce instrument does not change this result.

Example 3G-5 Alimony versus child support payments.

Frank and Linda were divorced in the current year. Stephanie, their only child, has lived with Linda since the divorce. Under the divorce decree, Frank must pay Linda $2,000 per month; $1,000 of that amount is designated as child support. When Stephanie reaches age 12, the child support payment increases to $1,250, but the amount of the total payment remains $2,000 per month.

Until Stephanie reaches age 12, $1,000 of each monthly payment will qualify as deductible alimony. Linda must report the same amount as alimony income. After Stephanie is 12, Frank and Linda will treat $750 of the monthly payment as alimony. The remainder will be child support, which Frank will not be able to deduct and Linda will not have to report as income.

The IRS concluded that when under a divorce decree the recipient spouse's alimony would be cut in half if she stopped homeschooling their son and returned to work as tied to a child-related contingency and denied the alimony deduction. Under the terms of the decree, it was completely up to the former wife's discretion as to whether she would go back to work or continue homeschooling the child. Although she wanted more support, the former husband would not pay more, so she decided to return to work for financial reasons. The Tax Court overruled the IRS and stated that the contingency related to the ex-spouse's return to work, and was not based on the child.

Payments Must End at Recipient's Death

Payments that continue after the receiving spouse's death are not alimony for tax purposes. The parties' intent or language in the agreement describing payments as being for the ex-spouse's "support and maintenance" will not cause a payment to be deductible as alimony if the payments do not clearly and objectively end on the recipient's death. When the instrument is silent, the taxpayer must prove that, under state law, that type of payment would not survive the death of the payee. Some courts have disallowed alimony deductions based on the relevant state law. Others have allowed the deduction.

Example 3G-6 Support payments that do not terminate at recipient's death.

Under Jack and Carla's divorce decree, Jack must pay Carla $2,000 a month in alimony for 10 years. The decree does not state that the payments terminate upon Carla's death. Jack pays $12,000 of alimony in the year of divorce. Can he deduct the alimony payments on his return?

Because the decree does not state that the payments terminate upon Carla's death, Jack cannot deduct them as alimony payments. However, if the applicable state law provides that the payments terminate at death regardless of whether such language is in the decree, the payments will qualify as deductible alimony to Jack.

Substitute Payments

A lump-sum payment made in lieu of future alimony payments qualifies as deductible alimony if it meets the statutory requirements for alimony.

Example 3G-7 Lump-sum payment of alimony.

Under John and Sandra's divorce decree, Sandra was to pay $1,500 spousal support until John's death. The decree defines these payments as alimony that is deductible by Sandra and includible in John's income. Under the decree, Sandra has the option, at her sole discretion, to make a one-time $100,000 lump-sum payment in complete satisfaction of her obligation to pay future alimony. If she makes the lump-sum payment can she deduct the payment as alimony in the year of payment?

Yes, the lump-sum payment should qualify as alimony as it was made in satisfaction of Sandra's alimony obligation and, thus, stands in the place of the periodic alimony payments required by the divorce decree. The $100,000 payment should be deductible by Sandra and includible in John's income.

Deducting Interest Paid on Education Loans

Individuals who have taken out loans to pay the cost of attending an eligible higher educational institution for themselves, their spouses, or their dependents may be able to deduct the interest they pay, subject to certain limitations and restrictions. The deduction is claimed in computing adjusted gross income (AGI) (i.e., above-the-line); so a taxpayer need not itemize deductions to benefit. For 2017, the deduction is reported on line 33 of Form 1040.

Maximum Allowable Deduction

The maximum amount a taxpayer is permitted to deduct is $2,500. The limitation is the same regardless of how many students are in the taxpayer's family. Only the taxpayer (or taxpayers, if there is a cosigner) legally obligated to make interest payments under the terms of the qualified education loan can claim the interest deduction. However, if someone other than an individual legally obligated to make a payment of interest on a qualified education loan (i.e., a third party) makes a payment of interest on behalf of a taxpayer who is legally obligated to make the payment, then the taxpayer is generally treated as receiving the payment from the third party and, in turn, paying the interest.

The maximum allowable deduction phases out ratably when a taxpayer's modified AGI exceeds certain amounts. Modified AGI is AGI before the deductions for education loan interest, qualified tuition and expenses (if extended), and domestic production activities, and before the exclusions for (1) foreign earned income and housing costs, and (2) income from certain U.S. possessions and Puerto Rico. For 2017, the deduction phases out ratably as modified AGI moves from $135,000–$165,000 for married joint filers and $65,000–$80,000 for single and head of household filers. Married taxpayers must file a joint return to claim a deduction and no deduction is allowed to an individual that is claimed as a dependant on another taxpayer's return for the tax year.

Other Considerations

Qualified Education Loan. A *qualified education loan* is any indebtedness incurred solely to pay qualified higher education expenses at an eligible educational institution for a student (taxpayer, spouse, or dependent at the time the indebtedness is incurred) enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. Eligible educational institutions include colleges, universities, vocational schools and other post-secondary educational institutions eligible to participate in the federal student aid program plus institutions conducting internships or residency programs leading to a degree or certificate awarded by an institution, hospital, or health care facility offering postgraduate training. For a list of institutions eligible for the federal financial aid program, see the school code search section on the U.S. Department of Education's Federal Student Aid website at **www.fafsa.ed.gov**.

Qualified education expenses are the total cost of attending an eligible education institution and include (1) tuition and fees normally assessed someone carrying the same academic workload as the student, (2) an allowance for

room and board, and (3) an allowance for books, supplies, transportation, and miscellaneous expenses of the student. The qualified higher education expenses must be reduced by the following:

1. The exclusion from gross income for employer-provided educational assistance under IRC Sec. 127.

2. The exclusion of income from U.S. savings bonds used to pay higher education expenses under IRC Sec. 135.

3. The exclusion from income for distributions from an education savings account under IRC Sec. 530 and qualified tuition programs under IRC Sec. 529.

4. The amount of any scholarship, veteran's educational assistance, or any other nontaxable payment received for educational expenses.

The higher education costs must be paid or incurred within a reasonable period of time before or after the indebtedness is incurred. The reasonable period requirement is deemed met if the education loan proceeds are disbursed within a period beginning 90 days before the beginning and ending 90 days after the end of the academic period to which the higher education costs relate. It is also deemed met if the expenses are paid with the proceeds of an educational loan that is part of a Federal post-secondary education loan program. Actual tracing of the loan proceeds to the payment of the qualified higher education expenses is not required.

If a qualified education loan is refinanced, the new loan is also a qualified education loan. A loan does not qualify as a qualified education loan, however, if the lender is related to the taxpayer within the meaning of IRC Sec. 267(b) or 707(b)(1), or if the loan is from a qualified employer retirement plan. If the qualified education loan is refinanced for more than the original loan amount, the interest expense will not be deductible unless the additional amounts are also used only for qualified education expenses.

Example 3H-1 Mixed-use loans fail to qualify as education loan.

To pay for his son's college expenses, Jim signs a home equity loan secured by his personal residence. In addition to the college expenses, Jim plans to use part of the loan proceeds to pay for improvements to his residence. Because the loan is not incurred by Jim solely to pay qualified higher education expenses, the loan fails to qualify as a higher education loan.

Loan Origination Fees and Capitalized Interest. Capitalized interest and certain fees are deductible as qualified education loan interest. Capitalized interest means any accrued and unpaid interest on a qualified education loan that, in accordance with the terms of the loan, is added by the lender to the outstanding balance of the loan.

Example 3H-2 Deducting capitalized interest when loan is paid.

Interest on Tara's loan accrues while she is in school, but she is not required to make any payments on the loan until six months after she graduates or otherwise leaves school. At that time, the lender rolls the accrued but unpaid interest into the outstanding principal amount of the loan. From that point forward, Tara is required to make monthly payments of interest and principal on the loan. The interest payable on the loan, including the capitalized interest, is original issue discount.

Although original issue discount (OID) normally is deductible as it accrues, OID on a qualified education loan is not deductible until paid. A payment on an education loan is treated first as a payment of interest to the extent of any accrued interest as of the date the payment, and second as payment of principal. This characterization of the payment as interest or principal applies regardless of how the parties label the payment (as interest or principal). Thus, taxpayers may be able to deduct a portion of a payment labeled as principal by the lender if the payment is allocable to capitalized interest. (See Example 3H-3.)

If a loan origination fee is paid to the lender in connection with an education loan and the fee is not for property or services provided by the lender, the fee reduces the issue price of the loan. This in turn creates or increases OID on the loan in an amount equal to the fee. Thus, the fee (such as points paid to secure the loan) is treated as capitalized interest.

Example 3H-3 Deducting loan origination fee when loan is paid.

Assume the same facts as in Example 3H-2 and that the lender charges Tara a 1% loan origination fee which isn't for any property or services provided by the lender. The loan's OID (which includes the capitalized interest and the loan origination fee) that accrues each year is determined under IRC Sec. 1272 and Reg. 1.1272-1. In effect, the loan origination fee accrues over the life of the loan.

Payments of stated interest on a loan are treated as interest payments. Beyond this, any additional payments on the loan (regardless of the payment's designation by the parties) are treated first as payment of deductible OID, to the extent of the OID that has accrued as of the date the payment is due and that has not been allocated to prior payments, and second as a principal payment.

Lenders are required to include loan origination fees and/or capitalized interest computed under the OID rules on Form 1098-E (in box 1).

Dependent Not Eligible for Deduction. An individual who is a dependent of another taxpayer for the year cannot claim an interest deduction.

Example 3H-4 Interest deduction for child when dependency exemption is not allowed.

Tyler is legally obligated on certain education loans and pays $750 of interest on those loans during the current year. Because their AGI is too high, his parents are not allowed a dependency exemption for Tyler in the current year. Thus, assuming Tyler meets all of the relevant requirements for deducting education loan interest, he can deduct the $750 of interest on his own return.

Tuition and Fees Deduction

Caution: The deduction for tuition and fees expired on December 31, 2016. This discussion has been retained because of the likelihood that Congress will extend it. Practitioners should be alert for future developments.

Taxpayers whose modified AGI does not exceed certain thresholds can claim an above-the-line deduction of up to $4,000 for qualified tuition and related expenses. No deduction may be claimed by taxpayers with a filing status of married filing separately or if another person can claim a dependency exemption on his or her tax return for the individual. The deduction is claimed on Form 8917 (Tuition and Fees Deduction).

Qualified Tuition and Related Expenses

Qualified tuition and related expenses are defined the same as for the education credits and include out-of-pocket costs for tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent (if the taxpayer claims a dependency exemption for that person) at an eligible educational institution. Prepaid expenses qualify if the academic term they relate to begins no later than three months into the following tax year. The education need not be work-related.

Eligible Educational Institution. The qualified tuition and expenses do not have to be incurred in connection with a postsecondary degree program but must be paid to an eligible educational institution, defined by reference to Section 481 of the Higher Education Act of 1965. These institutions generally are accredited post-secondary educational institutions (including certain proprietary and vocational schools) offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. The institution must be eligible to participate in Department of Education student aid programs. For a list of institutions eligible for the federal financial aid program, see the school code search section on the U.S. Department of Education's Federal Student Aid website at **www.fafsa.ed.gov**.

Books, Supplies, and Equipment. Student activity fees and charges for course-related books, supplies, and equipment are qualified tuition and related expenses if the fee must be paid to the eligible educational institution as a condition of the enrollment or attendance of the student at the institution.

Room and Board and Other Expenses. Costs associated with room and board; medical expenses (including student health fees); athletics; insurance; transportation; and similar personal, living, or family expenses are not

qualified tuition and related expenses even when required for enrollment. The same is true for expenses involving sports, games, or hobbies or any noncredit course, unless this education is part of the student's degree program.

Limitations on AGI and Maximum Deduction

Taxpayers with modified AGI that does not exceed $65,000 ($130,000 in the case of married taxpayers filing joint returns) can claim a maximum deduction of $4,000. Furthermore, taxpayers with adjusted gross income that does not exceed $80,000 ($160,000 in the case of married taxpayers filing joint returns) can claim a reduced deduction of up to $2,000.

Modified AGI. *Modified AGI* is AGI computed without regard to the qualified tuition deduction and is increased by the income exclusions for income earned in a foreign country, Puerto Rico, and certain U.S. possessions and by the deduction for domestic production activities.

Adjustment for Refunds and Tax-free Education Benefits

The amount of qualified tuition and related expenses for purposes of the education benefits must be out-of-pocket costs. Therefore, the otherwise qualified tuition and related expenses for the tax year are reduced by refunds or other tax-free educational assistance allocable to the tax year and paid for the benefit of the student. These benefit reductions include the following:

1. A qualified scholarship excludable from gross income under IRC Sec. 117.

2. A payment (other than a gift, bequest, devise, or inheritance) for the student's educational expenses, or attributable to the student's enrollment at an eligible educational institution that is excludable from gross income (such as employer-provided educational assistance under IRC Sec. 127).

3. A veteran's educational assistance allowance under Chapters 30, 31, 32, 34, or 35 of Title 38 of the United States Code.

4. An educational assistance allowance for members of the Selected Reserve under Chapter 1606 of Title 10 of the United States Code.

No Double Benefit

An expense cannot be claimed as an above-the-line qualified tuition deduction if it is deducted under some other provision, such as a deduction for business continuing education.

No Deduction If the American Opportunity, Hope, or Lifetime Learning Credit Is Claimed

Taxpayers are not eligible to claim a tuition deduction and the American Opportunity, Hope, or Lifetime Learning Credit in the same year for the same student.

No Deduction for Amounts Excludable Due to ESA and Other Distributions

A taxpayer may not claim a tuition deduction for amounts taken into account in determining the tax-free portion of: (1) a distribution from a Coverdell Education Savings Account (ESA), (2) the interest from U.S. savings bonds under IRC Sec. 135, or (3) the income portion of a distribution from a qualified tuition plan.

A taxpayer can, however, claim a deduction for the amount of a distribution from a qualified tuition plan that is not attributable to earnings. Amounts a student receives as loans, gifts, inheritance, or as payment for services do not reduce qualified education expense.

Example 3I-1 ESA distributions eliminate deductions.

Norman incurs $1,000 of qualified tuition and related expenses during the year. He also receives a $1,000 distribution from an ESA. The initial investment portion of the $1,000 distribution is $600, and the income

portion is $400. Norman cannot deduct any of the tuition and related expenses as an above-the-line deduction because the $1,000 of expenses must be reduced by an amount equal to the entire distribution from the ESA when determining the amount of education expenses taken into account for purposes of the above-the-line deduction.

Example 3I-2 ESA distribution reduces deduction.

Assume the same facts as in Example 3I-1, except Norman incurs $1,500 of qualified tuition and related expenses during the year, and receives a $1,000 distribution from an ESA. Norman can deduct $500 ($1,500 − $1,000) of the qualified tuition and related expenses as an above-the-line deduction.

Example 3I-3 Income portion of qualified tuition plan reduced deduction.

Assume that Norman incurs $1,000 of qualified tuition and related expenses during the year and receives a distribution of $1,000 from a Section 529 qualified tuition plan. Norman's practitioner calculates that the distribution is made up of $600 return of contributions to the plan and $400 of income. Norman can deduct $600 ($1,000 − $400) of the qualified tuition and related expenses as an above-the-line deduction. Qualified expenses have to be reduced by only the income portion of qualified tuition plan distributions to determine the amount of education expenses taken into account for purposes of the above-the-line deduction.

Educator's Expense Deduction

An eligible educator is allowed an above-the-line deduction for up to $250 (for 2017) for classroom expenses paid during the tax year. Eligible expenses include 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 and supplementary materials used by the educator in the classroom, and certain professional development expenses. These expenses must meet the definition of Section 162 ordinary and necessary employee business expenses. Qualified expenses do not include expenses for home schooling. The deduction is claimed on line 23 of Form 1040.

An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a K–12 school for at least 900 hours during a school year.

Taxpayers filing joint returns who are both eligible educators are each eligible for the $250(for 2017) deduction, for a total of $500 on the return. However, neither spouse can deduct more than $250 of his or her own expenses.

Example 3J-1 Teacher's deduction for classroom expenses.

Seth, age 25 and single, is a seventh grade history teacher. He incurs $300 for supplemental classroom materials and supplies that are not reimbursed by his employer. Seth can deduct $250. If Seth's marginal federal rate is 15%, this saves $38; if his marginal federal rate is 25%, the savings are $63.

Deducting Contributions to Health Savings Accounts

A health savings account (HSA) is a tax-exempt trust or custodial account established exclusively for the purpose of paying unreimbursed qualified medical expenses of the participant who, for the months for which contributions are made to an HSA, is covered under a high-deductible health plan (HDHP).

A taxpayer is not required to use distributions from an HSA for medical expenses; however, distributions are taxable and a 20% penalty may apply if they are used for expenses other than qualified medical expenses and received before the taxpayer reaches age 65.

What Is an HDHP?

An HDHP is generally a health plan that satisfies certain requirements with respect to deductibles and out-of-pocket expenses. Specifically, for 2017 self-only coverage, the qualifying HDHP must have (1) an annual deductible of at

least $1,300 and (2) an annual limit on total out-of-pocket costs (including the deductible, copayments, and other amounts, but not HDHP premiums) for covered benefits of no more than $6,550. For 2017 family coverage, the qualifying insurance must have (1) an annual deductible of at least $2,600 and (2) an annual cap on total out-of-pocket costs of no more than $13,100.

Deducting Contributions to HSAs

Contributions to an HSA can be made by, or on behalf of (for example, by a family member) any eligible individual and are deductible by the eligible individual above the line in arriving at AGI. Thus, eligible individuals can benefit whether they itemize deductions or not. However, the individual cannot also deduct the contributions as a medical expense under IRC Sec. 213 and the deduction will not reduce a self-employed person's SE tax. HSA contributions can be made by or on behalf of an eligible individual even if the individual has no compensation (or earned income) or if the contributions exceed their compensation.

Contribution Limits. 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.

For 2017, the maximum monthly contribution for eligible individuals is $^1/_{12}$ of $3,400 for single coverage or $6,750 for family coverage. HSA *contribution* eligibility is based on the individual's eligibility status as of the last month of the year. Therefore, if the taxpayer establishes the HSA in the middle of the year (and is still eligible on December 1), he or she will be treated as eligible during each of the months in the tax year and as having been enrolled in the same HDHP that currently qualifies him for an HSA. However, if the taxpayer ceases to be eligible (except for reason of death or disability) for an HSA during a 13-month testing period that begins with the last month of the year the taxpayer becomes eligible and ends on the last day of the 12th month following that month (i.e., December 1 of current year through December 31 of following year), he or she must recapture as income the amount contributed for the period he or she was ineligible, plus pay a 10% penalty tax. It is not necessary to distribute this amount from the HSA, and earnings on this amount are not included in gross income or subject to the additional 20% penalty tax on nonqualified distributions as long as the earnings remain in the HSA or are used for qualified medical expenses. This amount is also not considered an excess contribution to the HSA and is therefore not subject to the Section 4973 6% excise tax for excess contributions to HSAs. However, if an individual who fails the testing period leaves the recaptured funds in the HSA and later makes a nonqualified HSA distribution (one that is not used for qualified medical expenses), the distribution is taxable and subject to penalty without regard to the previous inclusion in income and penalty.

Example 3K-1 Annual contribution to an HSA.

William is a 45-year-old self-employed sole proprietor. He begins self-only coverage under an HDHP on August 1, 2017, and continues to be covered throughout the remainder of the year. He continues this coverage beyond December 31, 2018. For 2017, William can contribute (and deduct) a maximum amount of $3,400 to an HSA.

Variation: William accepts a new position with Whizzigig, Inc. in June 2018. Whizzigig provides comprehensive medical coverage as part of its compensation package. Since William ceased being an eligible individual prior to December 31, 2018, he must report $1,983 ($3,400 × $^7/_{12}$ related to January–July 2017) recapture income on his 2018 return, plus pay $198 ($1,983 × 10%) in penalty tax.

All HSA contributions made by or on behalf of an eligible individual are aggregated for purposes of applying the limit. The same annual contribution limit applies whether an employee, an employer, a self-employed person, or a family member makes the contributions. (Family members may make contributions to an HSA on behalf of another family member as long as that other family member is an eligible individual.) The annual limit is also decreased by an individual's aggregate contributions to an MSA.

Contribution Limits for Eligible Individuals. For a participant (and his or her spouse covered under an HDHP) who is 55 or older as of the end of the tax year, the annual contribution limit that would otherwise apply for 2017 is increased by $1,000. If both spouses are eligible for catch-up contributions, each spouse must make any catch-up contribution to his or her own HSA. No contributions can be made for participants after reaching the Medicare eligibility age, which is age 65 under current law.

Example 3K-2 Catch-up contributions to HSAs for eligible individuals.

Amanda has family health insurance coverage with a $3,000 deductible. If she will be 55 or older on December 31, 2017, she can contribute up to $7,750 to her HSA for 2017 (the normal $6,650 limitation + $1,000 extra due to her age). If Amanda's family policy covers her spouse and he is also 55 or older as of December 31, 2017, Amanda can still contribute $7,750 to her HSA (the normal $6,750 limitation + $1,000 extra due to her age) and her spouse can contribute $1,000 (catch-up contribution) to his HSA.

Example 3K-3 Annual contribution prorated for Medicare eligibility.

Jason is single and maintains self-only coverage under an HDHP. During July 2017, he attains age 65 and becomes eligible for Medicare benefits. He can no longer make HSA contributions (including catch-up contributions) after June 2017. Jason can make total contributions for 2017 (January through June) equal to $2,200 [($3,400 × 6 ÷ 12) + ($1,000 × 6 ÷ 12)]. This example conforms to the principles stated in the IRS Office of Associate Chief Counsel Info Letter 2016- 0003.

Spouses with Family Coverage. If either an individual or spouse has family HDHP coverage (i.e., any coverage other than self-only coverage), they are both considered to have only family HDHP coverage. Likewise, if one spouse has self-only coverage and the other has family coverage, the maximum contribution limit is the maximum for family coverage. If the spouses have different family HDHP coverage plans, only the one with the lowest deductible is counted for HSA eligibility purposes. The family contribution amount can be allocated between eligible spouses in any way they want, but must be divided equally among the spouses if they do not agree on a different division. However, no HSA contribution is allowed for an ineligible spouse. The IRS has ruled that an eligible individual does not fail to be an eligible individual merely because the individual's spouse has non-HDHP family coverage, if the spouses' non-HDHP does not cover the individual. Consequently, that individual may contribute to an HSA. The following examples illustrate how the HSA contribution limitation rules work in this scenario.

Example 3K-4 Spouse not under other spouse's non-HDHP coverage.

Hud and Worthy are married. Both are under age 55. For all of 2017, Hud has self-only coverage under an HDHP with a $2,000 annual deductible. He has no other health coverage. Worthy has non-HDHP family coverage for herself and the couple's two dependent children. Hud is not covered by Worthy's non-HDHP. Because he has no health coverage beyond his own HDHP, Hud is eligible to contribute up to $3,400 to an HSA for the 2017 tax year (the maximum contribution amount for self-only coverage for 2017). Since Worthy is under non-HDHP coverage, she is ineligible to make any HSA contribution for 2017.

Example 3K-5 Spouse and child not under other spouse's non-HDHP coverage.

Assume the same facts as in Example 3K-4, except that Hud has HDHP family coverage for all of 2017 for himself and one of the dependent children. The HDHP has an annual deductible of $5,000. Worthy has non-HDHP family coverage for herself and the other dependent child. Once again, Hud has no other health coverage and is not covered by Worthy's non-HDHP. Because he has no health coverage beyond his own HDHP, Hud can contribute up to $6,750 to an HSA for the 2017 tax year (the maximum for family coverage for 2017). Worthy has non-HDHP coverage and is therefore ineligible to make any HSA contribution for 2017.

Example 3K-6 Calculating contribution and catch-up amounts with two separate family coverage HDHPs.

David, age 58, and Mary Jane, age 53, are married. Both have family coverage under separate HDHPs. David's HDHP has a $3,000 deductible and Mary Jane's has a $2,600 deductible. David and Mary Jane are treated as covered under the plan with the $2,600 deductible and therefore meet the minimum $2,600 requirement for a family coverage HDHP. For 2017, David can contribute $4,375 to his HSA (half of the family coverage limit of $6,650 + the full $1,000 catch-up contribution) and Mary Jane can contribute $3,375 to her HSA (unless they agree on a different division).

Form and Timing of Contributions. Contributions to an HSA must be made in the form of cash; stock or other property is not allowable. Contributions for the tax year can be made in one or more payments, at the convenience

of the individual or the employer, at any time before the due date (without extensions) for filing the eligible individual's federal income tax return for that year (generally April 15th following the year for which the contribution is made), but not before the beginning of that year). Although the annual contribution is determined monthly, the maximum contribution can be made on the first day of the year.

HSA Contribution by Partnership for a Partner. An HSA contribution made by a partnership (or multi-member LLC treated as a partnership for federal tax purposes) on behalf of a partner (LLC member) who is eligible to make the HSA contribution can be treated as either (1) a generally tax-free cash distribution to the partner under IRC Sec. 731, or (2) an IRC Sec. 707(c) guaranteed payment to the partner in exchange for services rendered to the partnership (assuming the partner in fact renders services). If guaranteed payment treatment applies, the HSA contribution amount is subject to both income and SE tax at the recipient partner level, but the amount is deductible by the partnership. The treatment that is selected by the partnership will be reflected on the partner's Schedule K-1. Under either treatment, the partner then claims an above-the-line deduction for the HSA contribution amount in the usual fashion on line 25 of Form 1040.

HSA Contribution by S Corporation for a Shareholder-employee. When an S corporation makes an HSA contribution on behalf of an eligible employee who is also a more-than-2% shareholder, it can be treated as either (1) a generally tax-free corporate cash distribution to that shareholder-employee or (2) a wage payment to that individual. If wage treatment applies, the HSA contribution amount is generally subject to FIT withholding and FICA tax, but the amount is deductible by the corporation. The treatment that is selected by the S corporation will be reflected on the shareholder-employee's Schedule K-1. Under either treatment, the shareholder-employee then claims an above-the-line deduction for the HSA contribution amount in the usual fashion on line 25 of Form 1040.

Rollovers. Rollover contributions from MSAs and other HSAs into an HSA are permitted. They must be completed within 60 days after the day on which the participant receives the payment or distribution and only one rollover from an HSA to another HSA is allowed within a one-year period ending on the day of such receipt.

In addition, a taxpayer may make one tax-free rollover from a traditional or Roth IRA (that would be otherwise taxable when distributed) to an HSA. The rollover contribution from an IRA may not exceed the taxpayer's maximum HSA contribution for the year. The rollover must be made directly to the HSA by the IRA trustee or the taxpayer's employer. The taxpayer must remain eligible for an HSA until the last day of the 12th month following the rollover or the distribution will be includable in income and subject to a 10% penalty tax unless the failure is due to death or disability. Rollover contributions are nondeductible. However, IRA rollover contributions do reduce an individual's deductible HSA contribution maximum for the year of the rollover.

Domestic Production Activities Deduction

IRC Sec. 199 allows a deduction for income attributable to certain manufacturing and domestic production activities conducted in the U.S. (the *domestic production activities deduction*, or DPAD). It is not limited to any specific entity and is available to sole proprietorships, C and S corporations, and partnerships, among other entities(the deduction is not actually claimed by an S corporation or partnership at the entity level; those pass-through entities provide the necessary information to the owner and it is claimed by the owner). The DPAD is not allowed in computing self-employment income and the taxpayer can claim the deduction for both regular tax and AMT.

General Rules

The DPAD equals 9% (6% for certain oil-related qualified production) of the lesser of—

1. *qualified production activities income* (QPAI) for the year, or
2. adjusted gross income (for an individual taxpayer) determined—
    a. after application of IRC Sec. 86 (Social Security and tier 1 railroad retirement benefits), IRC Sec. 135 (income from U.S. savings bonds used to pay higher education tuition and fees), IRC Sec. 137 (adoption assistance programs), IRC Sec. 219 (retirement savings), IRC Sec. 221 (interest on education loans),

IRC Sec. 222 (qualified tuition and related expenses, if extended), and IRC Sec. 469 (passive activity losses), and

b. without regard to the DPAD.

QPAI is defined as the taxpayer's *domestic production gross receipts* for the year, reduced by the sum of (1) the cost of goods sold allocable to such receipts and (2) other deductions, expenses, or losses directly allocable to such receipts.

The taxpayer's domestic production gross receipts drive the deduction, but the deduction is limited to 50% of the qualified Form W-2 wages reported for the year that are allocable to domestic production gross receipts. Thus, for those taxpayers with large production activities but little W-2 wages (because the work is subcontracted out), the benefits of the deduction may be minimal. See further discussion of W-2 wages later in this section.

Domestic Production Gross Receipts (DPGR)

Taxpayers must have income from qualified production activities to be eligible for the DPAD. In order to compute income from qualified production activities, taxpayers must determine the amount of DPGR that they have for the tax year. The definition of DPGR from qualified production activities is very broad. DPGR includes the taxpayer's gross receipts from the lease, rental, license, sale, exchange, or other disposition of any of the following:

1. Tangible personal property, computer software, and sound recordings (qualifying production property or QPP) if the property is manufactured, produced, grown, or extracted (see discussion later in this section) by the taxpayer in whole or significant part in the U.S.

2. Motion picture, film, videotape, and sound recording production, renting, and licensing (with exclusions provided in the statute), provided at least 50% of the total compensation relating to the production of the film is compensation for specified production services (such as actors, directors, or producers) performed in the U.S.

3. Production of (but not transmission or distribution of) electricity, natural gas, or water in the U.S.

4. Construction or substantial renovation of real property in the U.S., including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities.

5. Civil engineering and architectural services performed in the U.S. for construction projects in the U.S.

6. Farming (i.e., growing and selling agricultural products and food).

7. Processing of agricultural products and food (but not the sale of food and beverages prepared by the taxpayer at a retail establishment).

With certain exceptions, only one owner of property may claim the DPAD. The general rule is that the business entitled to claim the deduction is the one bearing the benefits and burdens of ownership of the property while the qualifying production activity occurs. Therefore, a subcontractor who manufactures qualifying production property for another taxpayer may not necessarily have the benefits and burdens of ownership of the property it is manufacturing. Determining the benefits and burdens of ownership entails examining the contract terms, production activities, and the economic risks of the involved taxpayers. The subcontractor could not claim the DPAD in this case; but the taxpayer who contracted with the subcontractor could. The recent *ADVO, Inc.* case provides a discussion of 9 factors to be examined when determining if a taxpayer meets the benefits and burdens of ownership requirement to deduct the DPAD.

Qualifying Production Property (QPP). IRC Sec. 199(c)(5) provides that the term QPP include tangible personal property, computer software, and sound recordings. The definition of tangible personal property comes primarily from Reg. 1.199-3(j)(2). The fact that property is personal property or tangible property under local law is not controlling. Conversely, property may be tangible personal property for Section 199 purposes even if local law considers it a fixture and, thus, real property. Tangible personal property does not include land, buildings, inherently permanent structures, or land improvements, oil and gas wells, or infrastructure.

Machinery, printing presses, transportation equipment, office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and signs that are contained in or attached to a building are tangible property for purposes of the deduction. Furthermore, machinery, other than structural components of a building, is tangible personal property even though located outside a building. For example, a gasoline pump, hydraulic car lift, or automatic vending machine, although attached to the ground, is tangible personal property.

Manufactured, Produced, Grown, or Extracted (MPGE). MPGE qualifying activities include manufacturing, producing, growing, extracting, installing, building, developing, improving, and creating QPP. MPGE activities also include creating QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an item, or by combining or assembling two or more items. Qualifying agricultural activities include cultivating soil, raising livestock, fishing, and mining minerals.

Installation activities qualify as an MPGE activity only if the taxpayer installs QPP that it manufactured, produced, grew, or extracted. In addition, the taxpayer must have the benefits and burdens of ownership of the QPP while the installation activity is taking place. For example, where the taxpayer manufactures a part that it later installs for its customer, the taxpayer retains ownership of that part while it conducts the MPGE activity. If the taxpayer installs an item of QPP, but engages in no other MPGE activity for the item of QPP, the installation activity does not qualify as MPGE because it is considered a service activity.

MPGE activity also includes storage, handling, or other processing activities, but not transportation activities, in the U.S. However, the storage, handling, and processing activities must be related to the sale or other disposition of agricultural products. In addition, the agricultural products must be used in connection with or become part of other QPP, whether or not the taxpayer is involved in the process.

Computing W-2 Wages Paid by the Taxpayer

The DPAD is limited to 50% of W-2 wages that are allocable to DPGR paid by the taxpayer to employees or former employees, which include common law employees, but not wages paid as an agent of another entity to persons who are not employees. The wages must be reported no later than 60 days after the extended due date for filing the Form W-2s with the Social Security Administration. The taxpayer can include wages paid to workers who receive their W-2 forms from a professional employer organization (PEO) or employee leasing firm, but only for the amount that represents employment by the taxpayer.

Wages include the total amount of taxable wages subject to income tax withholding under IRC Sec. 3401(a) and reported on the W-2 under IRC Sec. 6051(a)(3), and amounts reported on the W-2 (but not taxable) under IRC Sec. 6051(a)(8), which include (1) employee elective deferrals to a cash or deferred arrangement under IRC Sec. 402(g)(3); (2) compensation deferred under IRC Sec. 457 (deferred compensation plans of state and local governments and tax-exempt organizations); and (3) the amount of employee's designated Roth contributions.

Taxpayers have a choice of three methods for computing the appropriate W-2 wages:

1. *Unmodified Box Method.* W-2 wages are the wages computed by taking the lesser of Box 1 (wages, tips, and other compensation) or Box 5 (Medicare wages).

2. *Modified Box 1 Method.* Taxpayers start with the total of Box 1 wages. Any amounts in Box 1 that are not wages for income tax withholding purposes (i.e., wages paid to statutory employees) and amounts included in Box 1 of Forms W-2 that are treated as wages under IRC Sec. 3402(o) (such as supplemental unemployment compensation benefits) are subtracted. The taxpayer then adds amounts reported in Box 12 of Form W-2 that are properly coded D, E, F, G, or S (elective deferrals and SIMPLE contributions).

3. *Tracking Wages Method.* This is the most complex method, since it requires the company to track total wages subject to federal income tax withholding and then make appropriate modifications. The taxpayer makes the same modifications as made under the Modified Box 1 Method.

As stated previously, the Section 199 deduction is limited to 50% of W-2 wages properly allocable to DPGR. After using one of the three options under Rev. Proc. 2006-47 to compute W-2 wages, the rules contained in Reg. 1.199-2

are used to allocate these wages to DPGR. Taxpayers can use any reasonable method to allocate wages between DPGR and non-DPGR. Alternatively, they can use one of the following safe harbors to allocate wages.

1. *Wage Expense Safe Harbor.* This safe harbor is available to taxpayers using either the Section 861 method or the simplified deduction method to allocate other deductions, expenses, or losses between DPGR and non-DPGR. The taxpayer multiplies W-2 wages determined under Rev. Proc. 2006-47 by the ratio of the taxpayer's wage expense included in calculating QPAI to the total wage expense used in calculating taxable income.

   When determining the amount of wage expense included in COGS, the taxpayer may use any reasonable method to allocate wages between DPGR and non-DPGR. Taxpayers are cautioned that the current-year COGS could include W-2 wages from the prior tax year, and the taxpayer may have to make adjustments.

2. *Small Business Simplified Overall Method.* This safe harbor is available to taxpayers using the small business simplified overall method to allocate COGS, other deductions, expenses, and losses between DPGR and non-DPGR. Under this safe harbor, the taxpayer multiplies W-2 wages determined under Rev. Proc. 2006-47 by the ratio of DPGR to total gross receipts.

Calculating the DPAD

The taxpayer calculates the domestic production activities deduction after determining QPAI, as defined previously in this section. The following steps compute the DPAD:

Step 1 Compare QPAI to taxable income and select the lower amount.

Step 2 Compute the tentative deduction by multiplying the result from Step 1 by 9% (6% if oil-related).

Step 3 Compute the limitation based on W-2 wages. (Compare the amount from Step 2 with 50% of W-2 wages allocable to DPGR.)

Example 3L-1 Calculating the domestic production activities deduction.

Mel Myers owns Myers Manufacturing, a sole proprietorship that makes sweaters in the U.S. The company conducts no other activities; therefore, all of its income is qualified production activity income. Mel's adjusted gross income is $250,000. During the year, Myers Manufacturing showed the following income and expense:

Gross receipts	$ 900,000
Cost of goods sold (including $350,000 of W-2 wages allocable to DPGR)	(600,000)
Other allocable expenses, losses and deductions	(100,000)
Net income	$ 200,000

Mel's QPAI is $200,000 and his tentative deduction is $18,000 [9% × $200,000; the lesser of QPAI ($200,000) or modified adjusted gross income ($250,000)]. His DPAD is limited to 50% of W-2 wages, which is $175,000 (50% of $350,000). Mel's deduction under IRC Sec. 199 is $18,000.

Treatment of Losses

Taxpayers with losses under IRC Sec. 165 must deduct those losses from DPGR if the proceeds from the sale of the property are, or would have been, included in DPGR. The proceeds from the sale of property are included in DPGR if the underlying property is QPP.

Taxpayers do not allocate the net operating loss deduction under IRC Sec. 172 to DPGR to arrive at QPAI, even if the taxpayer's manufacturing activities generated the losses. Because taxpayers must base the DPAD on the lesser of QPAI or taxable income, NOL carryovers (carrybacks and carryforwards) to a tax year with the DPAD may reduce or eliminate the deduction. If the NOL deduction reduces modified adjusted gross income to zero, the DPAD for that

year is zero. Furthermore, the taxpayer cannot use the DPAD to create (or increase) an NOL carryover to another tax year.

Reporting the DPAD

The DPAD is computed by completing Form 8903 (Domestic Production Activities Deduction) and attaching the form to the income tax return. For an individual, the DPAD is reported on line 35 of Form 1040 (U.S. Individual Income Tax Return).

Alternative Minimum Tax Considerations

The taxpayer may deduct the DPAD when computing alternative minimum taxable income (AMTI). When computing AMTI, the taxpayer determines the DPAD by using the lesser of the QPAI (as determined for the regular tax) or AMTI, regardless of the DPAD. When computing AMTI, QPAI is determined without any adjustments under IRC Secs. 56 through 59. The deduction cannot be used to determine the alternative tax net operating loss deduction.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Modified AGI is AGI calculated after considering which of the following?

    a. Taxable social security benefits.

    b. Any deductible IRA contributions.

    c. Foreign earned income exclusions.

    d. Domestic producer deductions.

18. Which of the following examples is correct regarding simplified employee pensions (SEPs)?

    a. Company A files Form 5305-SEP Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement) with the IRS.

    b. Company B gives each employee covered by SEP a copy of the form and a disclosure statement.

    c. The IRS requires Company C to file Form 5500 series for the SEP.

    d. The IRS prohibits Company D from establishing a SEP IRA for eligible employees who are unwilling to establish their own.

19. Which of the following statements concerning the distribution from SIMPLE IRAs is correct?

    a. Distributions from SIMPLE IRAs generally are taxed under the rules applicable to Roth IRAs.

    b. Tax-free rollovers from one SIMPLE IRA to another can be made at any time.

    c. An employee's SIMPLE IRA is treated as a traditional IRA if employees terminate employment and 1year has expired since the employee first participated in the SIMPLE IRA plan.

    d. Early withdrawals from a SIMPLE IRA generally are subject to the 25% early distribution tax applicable to IRAs.

20. Which of the following is considered a deductible moving expense?

    a. Lodging for a pre-move house-hunting trip.

    b. Food while moving from an old residence to a new residence.

    c. Expenses of traveling from a former residence to a new residence.

    d. Expenses from breaking a lease.

21. Under which of the self employed health insurance deduction rules are the individual's premiums reduced?

    a. Employer-subsidized health plan.

    b. Long-term care premiums.

    c. Earned income limit.

    d. MAGI limitation.

22. Which of the following is considered qualified tuition and related expenses?

    a. Costs paid to the eligible educational institution for supplies as an enrollment condition.

    b. Costs associated with transportation.

    c. Costs associated with athletics if required for enrollment.

    d. Costs associated with medical expenses.

23. Domestic production gross receipts (DPGR) includes the taxpayer's gross receipts from the license, sale, rental, lease, of all of the following **except:**

    a. Architectural services performed in New York for construction of a bridge in Long Island.

    b. Transmission of water in the U.S.

    c. Selling rice.

    d. New computer protection software.

24. Taxpayers have a choice of three methods for computing appropriate W-2 wages. Which of the following methods is the most complex to use?

    a. Unmodified Box.

    b. Tracking wages.

    c. Modified Box 1.

    d. Simplified general.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. Modified AGI is AGI calculated after considering which of the following? **(Page 213)**

    a. Taxable social security benefits. [This answer is correct. Modified AGI is AGI computed after considering taxable social security benefits and the passive activity loss.]

    b. Any deductible IRA contributions. [This answer is incorrect. Any deductible IRA contributions are not considered when computing modified AGI.]

    c. Foreign earned income exclusions. [This answer is incorrect. Exclusions for foreign earned income and foreign housing costs are not considered when computing modified AGI.]

    d. Domestic producer deductions. [This answer is incorrect. The deduction for domestic producers is not considered when computing modified AGI.]

18. Which of the following examples is correct regarding simplified employee pensions (SEPs)? **(Page 218)**

    a. Company A files Form 5305-SEP Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement) with the IRS. [This answer is incorrect. The form is not filed with the IRS but is maintained as part of the Company A's permanent records.]

    b. Company B gives each employee covered by SEP a copy of the form and a disclosure statement. [This answer is correct. A copy of the form (including the accompanying instructions) and a disclosure statement must be given to each employee covered by the SEP.]

    c. The IRS requires Company C to file Form 5500 series for the SEP. [This answer is incorrect. According to the IRS, employers generally need not file the Form 5500 series for the SEP.]

    d. The IRS prohibits Company D from establishing a SEP IRA for eligible employees who are unwilling to establish their own. [This answer is incorrect. Normally, employees establish their own SEP IRAs. However, the employer can establish a SEP IRA for eligible employees who are unable or unwilling to establish their own.]

19. Which of the following statements concerning the distribution from SIMPLE IRAs is correct? **(Page 221)**

    a. Distributions from SIMPLE IRAs generally are taxed under the rules applicable to Roth IRAs. [This answer is incorrect. Distributions from SIMPLE IRA plans generally are taxed under the rules applicable to traditional IRAs.]

    b. Tax-free rollovers from one SIMPLE IRA to another can be made at any time. [This answer is correct. Tax-free rollovers can be made from one SIMPLE IRA to another at any time. However, a SIMPLE IRA can be rolled over to another eligible retirement plan type (such as a qualified plan) tax-free only after the participant has been in the plan for two years.]

    c. An employee's SIMPLE IRA is treated as a traditional IRA if employees terminate employment and 1year has expired since the employee first participated in the SIMPLE IRA plan. [This answer is incorrect. If an employee terminates employment and two years have expired since the employee first participated in the SIMPLE IRA plan, the employee's SIMPLE IRA is treated as a traditional IRA.]

    d. Early withdrawals from a SIMPLE IRA generally are subject to the 25% early distribution tax applicable to IRAs. [This answer is incorrect. Early withdrawals from a SIMPLE IRA generally are subject to the 10% early distribution penalty tax applicable to IRAs.]

20. Which of the following is considered a deductible moving expense? **(Page 225)**

    a. Lodging for a pre-move house-hunting trip. [This answer is incorrect. Travel expenses, meals, and lodging for a pre-move house-hunting trip are considered nondeductible moving expenses.]

    b. Food while moving from an old residence to a new residence. [This answer is incorrect. Meals while moving from an old residence to a new residence are considered nondeductible moving expenses.]

    c. Expenses of traveling from a former residence to a new residence. [This answer is correct. The cost of traveling from the former residence to the new residence is deductible if the move is job related.]

    d. Expenses from breaking a lease. [This answer is incorrect. Expenses of buying or selling a home or of entering or breaking a lease are considered nondeductible moving expenses.]

21. Under which of the self employed health insurance deduction rules rules are the individual's premiums reduced? **(Page 228)**

    a. Employer-subsidized health plan. [This answer is correct. Under the employer-subsidized health plan, the deduction applies only for calendar months when the self-employed taxpayer is not eligible to participate in a subsidized health plan maintained by any employer of either the taxpayer or the taxpayer's spouse. A subsidized plan is one in which the individual's premiums are reduced (i.e., the employer is paying a portion).]

    b. Long-term care premiums. [This answer is incorrect. Under long-term care premiums, the deduction applies for long-term care insurance premiums only if the policy is a qualified contract.]

    c. Earned income limit. [This answer is incorrect. Under the earned income limit, the deduction applies to a medical insurance plan established under the taxpayer's business and only to the extent of the taxpayer's earned income from that business.]

    d. MAGI limitation. [This answer is incorrect. MAGI is AGI before any inclusion of taxable social security benefits, plus tax exempt interest income and amounts excluded from gross income under IRC Sec. 135 (interest from Series EE and I bonds used to pay college expenses), IRC Sec. 137 (employer- provided adoption assistance), IRC Sec. 911 (foreign earned income and housing costs exclusion. It does not reduce an individual's premiums.]

22. Which of the following is considered qualified tuition and related expenses? **(Page 236)**

    a. Costs paid to the eligible educational institution for supplies as an enrollment condition. [This answer is correct. Student activity fees and charges for course-related books, supplies, and equipment are qualified tuition and related expenses if the fee must be paid to the eligible educational institution as a condition of the enrollment or attendance of the student at the institution.]

    b. Costs associated with transportation. [This answer is incorrect. Costs associated with transportation are not considered qualified tuition and related expenses even when required for enrollment.]

    c. Costs associated with athletics if required for enrollment. [This answer is incorrect. Even if required for enrollment, costs associated with athletics are not considered qualified tuition and related expenses.]

    d. Costs associated with medical expenses. [This answer is incorrect. Costs associated with medical expenses (including student health fees) are not considered qualified tuition and related expenses.]

23. Domestic production gross receipts (DPGR) includes the taxpayer's gross receipts from the license, sale, rental, lease, of all of the following **except: (Page 241)**

    a. Architectural services performed in New York for construction of a bridge in Long Island. [This answer is incorrect. DPGR includes the taxpayer's gross receipts from the lease, rental, license, sale, exchange, or other disposition of civil engineering and architectural services performed in the U.S. for construction projects in the U.S.]

    b. Transmission of water in the U.S. [This answer is correct. DPGR includes the taxpayer's gross receipts from the lease, rental, license, sale, exchange, or other disposition of production of (but not transmission or distribution of) electricity, natural gas, or water in the U.S.]

    c. Selling rice. [This answer is incorrect. DPGR includes the taxpayer's gross receipts from the lease, rental, license, sale, exchange, or other disposition of farming (i.e., growing and selling agricultural products and food).]

    d. New computer protection software. [This answer is incorrect. DPGR includes the taxpayer's gross receipts from the lease, rental, license, sale, exchange, or other disposition of tangible personal property, computer software, and sound recordings (qualifying production property or QPP) if the property is manufactured, produced, grown, or extracted by the taxpayer in whole or significant part in the U.S.]

24. Taxpayers have a choice of three methods for computing appropriate W-2 wages. Which of the following methods is the most complex to use? **(Page 241)**

    a. Unmodified Box. [This answer is incorrect. When using the unmodified box method, W-2 wages are computed by taking the lesser of Box 1 (wages, tips, and other compensation) or Box 5 (Medicare wages); however, this method is not considered the most complex.]

    b. Tracking wages. [This answer is correct. This is the most complex method, since it requires the company to track total wages subject to federal income tax withholding and then make appropriate modifications.]

    c. Modified Box 1. [This answer is incorrect. When using this method, taxpayers start with the total of Box 1 wages. Any amounts in Box 1 that are not wages for income tax withholding purposes (i.e., wages paid to statutory employees) and amounts included in Box 1 of Forms W-2 that are treated as wages under IRC Sec. 3402(o) (such as supplemental unemployment compensation benefits) are subtracted. The taxpayer then adds amounts reported in Box 12 of Form W-2 that is properly coded D, E, F, G, or S (elective deferrals and SIMPLE contributions). This method is not considered the most complex.]

    d. Simplified General. [This answer is incorrect. This is not one of the three methods used for computing appropriate W-2 wages.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 2—Pension and Retirement Income, Other Items of Income, and Adjustments to Income (TDBTG172)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

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   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

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EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 2—Pension and Retirement Income, Other Items of Income, and Adjustments to Income (TDBTG172)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. Taxpayers may have to include up to what percentage of social security benefits in taxable income?

   a. 85%.

   b. 75%.

   c. 65%.

   d. 50%.

2. Lily is married filing a joint return. None of Lily's social security benefits are included in income if her provisional income does not exceed which of the following?

   a. $25,000.

   b. $32,000.

   c. $34,000.

   d. $44,000.

3. When computing the amount of nontaxable distributions, the total fair market value (FMV) of all the individual's traditional IRAs must be included in the fraction's denominator **except**:

   a. Roth IRAs.

   b. SEP IRAs.

   c. SIMPLE IRAs.

   d. IRAs.

4. A qualified distribution is one that is received after the five-year period beginning with the first tax year for which a contribution is made to a Roth IRA and is which of the following?

   a. Made on or after the date the account owner turns 59.

   b. Made to pay qualified, first-time home purchase expenses, up to a lifetime maximum of $20,000.

   c. Made to the account owner's estate due to his death.

   d. Attributable to the account owner's employment being terminated.

5. Which of the following is correct regarding required minimum distribution rules for Roth IRAs?

   a. As long as the Roth IRA account owner is alive, the RMD rules do not apply.

   b. Nonspouse beneficiaries must receive the entire balance within twelve months of the owner's death.

   c. Spouse beneficiaries cannot roll the Roth IRA into their own Roth IRA.

   d. Roth distributions cannot be delayed by the surviving spouse.

6. There are three methods taxpayers can use to convert an amount from a traditional IRA to a Roth IRA. Which of the following is **not** one of those methods?

   a. A distribution from a traditional IRA is contributed to a Roth IRA within 60 days after the distribution.

   b. A trustee-to-trustee transfer from a traditional IRA to the Roth IRA.

   c. A transfer of the amount in a traditional IRA to a Roth IRA maintained by the same trustee.

   d. A transfer of the amount in a SIMPLE IRA to a Roth IRA after participating for at least one year.

7. Joy made $1,000 annual nondeductible contributions to IRA 1 over an 11-year period. Thus, she has a total basis in IRA of $11,000 ($1,000 × 11). Joy also has IRA 2, which she established with a rollover of taxable dollars from her former employer's 401(k) plan. The value of each IRA is $25,000 for a combined value of $50,000. If Joy elects to convert both IRAs into one or more Roth IRAs, how much is taxable?

   a. $11,000.

   b. $25,000.

   c. $39,000.

   d. $50,000.

8. Lucy terminated her employment with King Co. in 2017. She is fully vested in King's retirement plan, and intends to roll over her account into a new IRA she has established. Lucy received her eligible rollover on July 4. When must Lucy's rollover to the new IRA take place?

   a. September 2.

   b. September 10.

   c. September 30.

   d. October 18.

9. What is the mandatory federal withholding percentage for eligible rollover distributions from qualified plans paid directly to the participant?

   a. 10% for distributions over $100.

   b. 20% for distributions over $200.

   c. 5% for distributions less than $101.

   d. 35% for distributions less than $501.

10. What is the annual IRA contribution limit for 2017 if under the age of 50?

    a. $4,500.

    b. $5,500.

    c. $6,500.

    d. $8,500.

11. How is the required minimum distribution (RMD) calculated?

    a. Dividing the account balance as of the preceding January 1st by the applicable life expectancy divisor.

    b. Dividing the account balance as of the preceding December 31st by the applicable life expectancy divisor.

    c. Dividing the account balance as of the preceding April 15th by the applicable life expectancy divisor.

    d. Dividing the account balance as of the preceding September 30th by the applicable life expectancy divisor.

12. Under which of the following rules are RMDs made to a designated beneficiary required to begin by December 31 of the year after the year in which the owner died if the beneficiary is not the owner's spouse?

    a. Withholding.

    b. Life expectancy.

    c. Lifetime.

    d. Five-year rule.

13. Which of the following statements concerning commercial variable annuities is correct?

    a. Nonannuity payments must be treated as a distribution of income before being treated as a distribution of basis.

    b. Variable annuities are subject to the mandatory minimum distribution rules starting at age 70½.

    c. Fixed commercial annuities generally allow the owner to choose from various investment options.

    d. Commercial annuities are considered qualified plans.

14. When does recapture of excess alimony payments occur?

    a. First post-separation year.

    b. Second post-separation year.

    c. Third post-separation year.

    d. Fourth post-separation.

15. How is the recapture amount determined for excess alimony payments?

    a. By comparing the alimony payments made in the first post-separation year to alimony payments in the second and third years. If the payments in the second and third years exceed certain amounts, the sum of each year's excess is recaptured in the first year.

    b. By comparing the alimony payments made in the second post-separation year to alimony payments in the first and third years. If the payments in the first and third years exceed certain amounts, the sum of each year's excess is recaptured in the third year.

    c. By comparing the alimony payments made in the third post-separation year to alimony payments in the first and second years. If the payments in the first and second years exceed certain amounts, the sum of each year's excess is recaptured in the third year.

    d. By comparing the alimony payments made in the third post-separation year to alimony payment in the first year. If the payments in the second and third years exceed certain amounts, the sum of each year's excess is recaptured in the second year.

16. Which of the following statements concerning a minister's cash housing allowance is correct?

    a. A minister can still claim the interest and taxes as itemized deductions on Schedule A when a housing allowance is used to pay mortgage interest and real estate taxes and is excluded from income.

    b. When a minister receives a cash allowance to be used for housing, the cost of utilities is not included.

    c. Payments on a home equity loan where proceeds were used for *other* purposes qualify for the housing exclusion.

    d. Proceeds of the mortgage do not necessarily have to be used to provide the minister's home for a mortgage payment to be considered a cost of providing housing.

17. In 2016, Rufus was injured in a boating accident. He incurred unreimbursed medical expenses of $20,000 plus $10,000 in lost wages because of the accident. Rufus also suffered substantial pain and trauma attributable to his physical injuries. On his 2016 return, Rufus claimed the $20,000 of medical expenses, of which $16,000 was actually deductible after limitations.

    In 2017, Rufus agreed to a $200,000 out-of court settlement to cover his medical expenses, lost wages, and all other compensatory damages related to the accident. The award was not allocated between the various types of damages.

    How much can Rufus exclude in 2017?

    a. $160,000.

    b. $180,000.

    c. $184,000.

    d. $190,000.

18. Which of the following statements concerning recoveries related to medical expenses and casualty losses is correct?

    a. If there is a reportable amount, the practitioner must calculate the tax benefit received from the expense.

    b. The taxpayers must include reimbursement for medical expenses, but not casualty losses in income.

    c. None of a taxpayer's medical expense reimbursements may be included in income if reimbursed in a later year.

    d. No taxable income is generated if an employer pays the entire premium for medical insurance.

19. Which of the following is **not** considered expenditures for medical care?

    a. Insulin.

    b. Over-the-counter drugs for which a prescription is obtained.

    c. Prescription medicine.

    d. Vitamins.

20. Nick and Robin Thompson have a 5-year-old daughter, Alexa. To start saving for her education, up to what is the maximum the Thompson's may contribute to an ESA naming Alexa the designated beneficiary per year?

    a. $500.

    b. $1,000.

    c. $1,500.

    d. $2,000.

21. How old is a beneficiary before remaining funds in an ESA must be distributed, and how soon should those funds be distributed?

    a. 21;30 days.

    b. 21;60 days.

    c. 30;30 days.

    d. 30;60 days.

22. Which of the following statements regarding ESA rollovers is correct?

    a. If a beneficiary is a member of the prior beneficiary's family and is under age 40 at the time of the change, a change in beneficiary is considered a distribution.

    b. Any amount withdrawn from an ESA and rolled over to another ESA for the same beneficiary is not taxable if made within 60 days of the withdrawal.

    c. The age limitations apply to new beneficiaries who are family members even if they have special needs.

    d. Members of the beneficiary's family do not include first cousins.

23. Which of the following statements concerning using qualified tuition programs is **incorrect**?

    a. The penalty tax is computed using Form 5329, but the form should not be filed if the penalty tax is zero.

    b. Distributions that exceed qualified expenses on account of the beneficiary's death or disability are not subject to the 10% penalty tax.

    c. Distributions that exceed qualified expenses because the student claimed an American Opportunity Tax credit for the qualifying expenses are not subject to the 10% penalty tax.

    d. If contributions are made and funds remain in an account, there are no income tax consequences to the contributor to the QTP, nor the designated beneficiaries.

24. For purposes of calculating the maximum contribution to a traditional IRA, compensation includes which of the following?

    a. Governmental unemployment benefits.

    b. Alimony.

    c. Deferred compensation.

    d. Annuity income.

25. Which of the following forms is required if any traditional IRA distributions were received in the current year and nondeductible contributions were made in prior years to any traditional IRA?

    a. Form 1040.

    b. From 5500.

    c. Form 8606.

    d. Form 8888.

26. IRA funds can be invested in anything the IRA trustee will allow with limited exceptions. In which of the following may the trustee allow the IRA to invest?

    a. Stamps.

    b. Platinum coins.

    c. Art.

    d. Gems.

27. Which of the following statements concerning Roth IRA contributions is correct?

    a. Individuals can make Roth IRA contributions beyond age 70½.

    b. Traditional IRAs cannot be converted to Roth IRAs.

    c. Distributions from qualifying Roth IRAs are taxable.

    d. Roth IRA contributions are deductible under certain circumstances.

28. Which of the following companies is eligible to offer SIMPLE IRAs?

    a. Company A has 200 employees receiving $3,000 of compensation in the prior calendar year.

    b. Company B has 150 employees receiving $5,000 of compensation in the prior calendar year.

    c. Company C has 95 employees receiving $8,000 of compensation in the prior calendar year.

    d. Company D has 150 employees receiving $2,000 of compensation in the prior calendar year.

29. When must eligible employees be permitted to elect to participate in the SIMPLE IRA plan?

    a. In the 30-day period before the beginning of the year.

    b. In the 60-day period before the beginning of the year.

    c. In the 90-day period before the beginning of the year.

    d. In the 120-day period before the beginning of the year.

30. Company X came into existence after October 1. Company X can establish a SIMPLE IRA plan effective between which of the following dates, if the plan is established as soon as administratively feasible after Company X comes into existence?

    a. October 1 and December 31.

    b. October 1 and January 1.

    c. October 1 and April 15.

    d. October 1 and September 30.

31. A move is job related if the taxpayer meets the time test and the distance test. The distance test generally requires the new principal place of work to be at least how many miles farther from a taxpayer's former home than his former principal place of employment?

    a. 100 miles.

    b. 75 miles.

    c. 50 miles.

    d. 25 miles.

32. Which of the following statements regarding employer reimbursements of moving expense is correct?

    a. Taxpayers do not need to file Form 3903 if deductible moving expenses equal the amount of reimbursed moving expenses included on Form W-2, box 12.

    b. Employees must use Form 1040 to report employer-paid moving expenses.

    c. Deductible moving expenses paid by the employer to a third party or provided by the employer in-kind are not reported on Form 1040.

    d. Reimbursements received are reported on Form 3903 when reported to the taxpayer as wages.

33. Which of the following is an example of a cash alimony payment?

    a. Bond.

    b. Payroll deduction payment.

    c. Promissory note.

    d. Annuity contract.

34. What is the maximum amount of interest paid on education loans a taxpayer is permitted to deduct?

    a. $1,000.

    b. $1,500.

    c. $2,000.

    d. $2,500.

35. If a taxpayer has a modified AGI that does not exceed certain thresholds, how much can he or she claim as an above-the-line deduction for qualified tuition and related expenses in 2016?

    a. $1,000.

    b. $2,000.

    c. $2,500.

    d. $4,000.

36. In 2017, an educator is allowed an above-the-line deduction for up to what amount for classroom expenses paid during the tax year?

    a. $250.

    b. $500.

    c. $1,000.

    d. $1,500.

37. An eligible educator is a kindergarten through 12-grade teacher, principal, counselor, or aide in a K-12 school for at least how many hours during a school year?

    a. 500.

    b. 600.

    c. 800.

    d. 900.

38. For self-only coverage, a qualifying HDHP must have which of the following?

    a. An annual deductible of at least $1,300.

    b. An annual limit on total out-of-pocket costs for maximum covered benefits of $6,650.

    c. An annual deductible of at least $2,000.

    d. An annual limit on total out-of-pocket costs for maximum covered benefits of $13,500.

39. Which of the following is considered qualifying production property (QPP)?

    a. Gas pump.

    b. Oil well.

    c. Infrastructure.

    d. Land improvements.

40. Which of the following activities does **not** qualify as a manufactured, produced, grown, or extracted (MPGE) activity, assuming these activities are related to the sale or other disposition of agricultural products?

    a. Processing.

    b. Transportation.

    c. Handling.

    d. Storage.

GLOSSARY

Accelerated benefits: Benefits offered by insurance companies to individuals who are terminally ill of has other devastating conditions, such as Alzheimer's disease or AIDS.

Adjusted closing balance: The FMV of the Roth IRA at the end of the computation period plus any withdrawals taken from the IRA during the computation period.

Adjusted opening balance: The FMV of the Roth IRA at the beginning of the computation period plus any contributions (including the conversion contribution) made during the computation period.

Chronically ill: Someone who has been certified within the previous 12 months by a licensed health care practitioner as (1) needing substantial assistance to perform at least two activities of daily living (eating, toileting, transferring, bathing, dressing, and continence) for at least 90 days, due to a loss of functional capacity, (2) having a similar level of disability to item (1) as determined under regulations, or (3) requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment.

Computation period: The period beginning immediately before the contribution being recharacterized was made to the Roth IRA and ending immediately before that contribution is withdrawn.

Eligible retirement plan: An individual retirement account (traditional or Roth); individual retirement annuity; qualified pension, profit sharing, or stock bonus plan; Section 403(a) annuity; governmental Section 457 plan; and a Section 403(b) annuity.

Eligible rollover distribution: Any distribution from a qualified plan to an employee of part or all of the employee's account balance that is not a distribution that is part of a series of substantially equal periodic payments, a required minimum distribution (RMD), or a hardship distribution.

Five-year rule: Requires the entire benefit to be distributed on or before December 31 of the year in which the fifth anniversary of the owner's death occurs.

Front-loaded payments: Excess alimony payments.

Gross earnings method: The plan provides a contribution formula for owners (the self-employed individuals) that specifies the reduced owner percentage.

Licensed health care practitioner: Any physician, registered professional nurse, licensed social worker, or other similar individual who may be prescribed by regulations.

Health savings account (HSA): A tax-exempt trust or custodial account established exclusively for the purpose of paying unreimbursed qualified medical expenses of the participant who, for the months for which contributions are made to an HSA, is covered under a high-deductible health plan (HDHP).

High-deductible health plan (HDHP): A health plan that satisfies certain requirements with respect to deductibles and out-of-pocket expenses.

Life expectancy rule: RMDs to a designated beneficiary must begin by December 31 of the year after the year in which the owner died if the beneficiary is not the owner's spouse.

Living benefits: Benefits offered by insurance companies to individuals who are terminally ill of has other devastating conditions, such as Alzheimer's disease or AIDS.

Modified adjusted gross income (MAGI): AGI before any inclusion of taxable social security benefits, plus tax exempt interest income and amounts excluded from gross income under IRC Sec. 135 (interest from Series EE and I bonds used to pay college expenses), IRC Sec. 137 (employer-provided adoption assistance IRC Sec. 911 (foreign earned income and housing costs exclusion IRC Sec. 931 (income from certain U.S. possessions), and IRC Sec. 933 (income from Puerto Rico).

Net earnings method: The plan provides a contribution formula of a stated rate (which is the same for all employees) of plan-year compensation.

Prescription: A written or electronic order that satisfies the legal requirements for a prescription in the state in which the expense is incurred, and issued by someone legally authorized to issue a prescription in that state.

Provisional income: The taxpayer's modified adjusted gross income (MAGI) plus half of the social security benefits.

Qualified domestic relations order (QDRO): A judgment, decree, or order that recognizes the rights of an individual other than the retirement plan participant (employee) to a portion of the benefits payable under the plan.

Qualified education loan: Any indebtedness incurred solely to pay qualified higher education expenses at an eligible educational institution for a student (taxpayer, spouse, or dependent at the time the indebtedness is incurred) enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

Qualified education expenses: The total cost of attending an eligible education institution and include (1) tuition and fees normally assessed someone carrying the same academic workload as the student, (2) an allowance for room and board, and (3) an allowance for books, supplies, transportation, and miscellaneous expenses of the student.

Qualified tuition programs (QTPs): Programs for prepaying or saving for higher education costs (also called 529 Plans).

Roth IRA: IRA designated as a Roth IRA when opened.

SIMPLE IRA plan: A written salary reduction arrangement under which an eligible employee can elect to have the employer make contributions to a SIMPLE IRA rather than receiving that amount in cash.

Tax benefit rule: Ordinarily requires taxpayers to include in gross income the amount of a prior year deduction when an event occurs that is fundamentally inconsistent with the premise of the deduction.

Three-year recapture rule: Provides that the payer recapture excess alimony payments as income in the third post-separation year, while the payee is entitled to deduct the same amount from gross income.

Terminally ill: Someone who has been certified by a physician to have an illness or physical condition that is expected to cause death within 24 months from the date of certification.

Viatical settlement provider: Any person regularly engaged in the trade or business of purchasing or taking assignments of life insurance contracts on the lives of individuals who are terminally or chronically ill.

Viatication: Allows a terminally or chronically ill person to sell a life insurance policy to someone who is buying it as an investment (i.e., the buyer receives the life insurance proceeds upon the death of the insured).

INDEX

A

ADJUSTMENTS TO INCOME
- Educator's expense deduction . . . 238
- Interest expense, student loans . . . 234
- Self-employed health insurance deduction . . . 228
- Tuition deduction . . . 236

ALIMONY AND SEPARATE MAINTENANCE
- Child support, distinguished from . . . 231
- Deduction for payment of . . . 231
- Foreign spouse . . . 231
- Lump-sum payment . . . 231
- Mortgage payments . . . 231
- Nondeductible payments . . . 231
- Property settlements, distinguished from . . . 231
- Recapture of excess alimony . . . 183

ALTERNATIVE MINIMUM TAX
- Refund of itemized deductions . . . 187
- Tax benefit rule, effect on . . . 187

ANNUITY PAYMENTS
- Simplified method for calculating return of basis . . . 160

B

BARTER TRANSACTIONS
- Taxability to recipient . . . 202

C

CASUALTY AND THEFT LOSSES
- Insurance reimbursement, tax benefit rule . . . 187

COLLEGE EXPENSES
- Interest paid on student loans . . . 234

CREDITS
- Tax benefit rule, effect on . . . 187

D

DECEASED TAXPAYERS
- IRA distributions attributable to . . . 160, 170
- Roth IRAs . . . 155, 157

DISABILITY INCOME
- Taxability of . . . 202

DISASTER RELIEF PAYMENTS
- Taxability of . . . 202

DIVORCE
- Retirement plan distributions under a QDRO . . . 168

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION
- AMT considerations . . . 241
- Determining which guidance to follow . . . 241
- Domestic production gross receipts . . . 241
- Eligible activities . . . 241
- Filing and reporting requirements . . . 241
- MPGE qualifying activities . . . 241
- Qualified production activities income . . . 241
- Qualifying production property . . . 241
- Reporting on Form 8903 . . . 241
- W-2 wages . . . 241

E

EDUCATIONAL EXPENSES
- Interest paid on student loans, deduction for . . . 234
- Tuition deduction . . . 236

EDUCATION LOANS
- Defined . . . 234
- Interest paid, deduction for . . . 234

EDUCATION SAVINGS ACCOUNTS
- Contributions . . . 195
- Distributions . . . 195
- Rollovers . . . 195

EDUCATOR
- Expense deduction . . . 238

ELECTIONS
- IRA
  - •• Rollovers . . . 160
  - •• Surviving spouse, owner of decedent's IRA . . . 160
- Retirement plans
  - •• Rollover distributions from . . . 160
  - •• Surviving spouse as owner of decedent's IRA . . . 160
  - •• Surviving spouse, owner decedent's Roth IRA . . . 155, 157
- Social security lump-sum payment . . . 151

EMPLOYEES
- Employer expense reimbursements
  - •• Moving expenses . . . 225
- Moving expenses . . . 225

F

FARMING
- Health insurance deduction . . . 228

G

GAMBLING
- Winnings . . . 202

H

HEALTH SAVINGS ACCOUNTS
- Contribution limit . . . 238
- Contributions for pass-through owners . . . 238
- Distributions from . . . 192
- High deductible health plan . . . 238
- Rollovers . . . 238
- Spouses with family coverage . . . 238

I

INDIVIDUAL RETIREMENT ACCOUNTS
- Active participant in a qualified plan
  - •• Defined . . . 213
- Bankruptcy exposure . . . 213
- Comparing IRAs, SEPs, and SIMPLE IRAs . . . 221
- Contributions and deductions . . . 213
- Converting to Roth IRA . . . 157
- Decedent's interest . . . 160
- Distributions
  - •• Excess contributions . . . 165
  - •• Inherited IRAs . . . 160
  - •• Nondeductible contributions . . . 213
  - •• Qualified charitable . . . 170
  - •• Rollovers . . . 160
  - •• Trustee-to-trustee, allowed from retirement plans . . . 160
- Early distributions
  - •• Withdrawals of excess contributions . . . 165
- Employer-sponsored IRAs . . . 221
- Excess contribution
  - •• Carryover of . . . 165
  - •• Withdrawals of . . . 165
- Inherited . . . 160
- Investment fees . . . 213
- Investments allowed . . . 213
- Minimum distribution requirement
  - •• Generally . . . 170

- Nondeductible IRA contributions
  - •• Reporting requirements . . . 213
- Nontaxable combat pay contributed to . . . 213
- Rollover
  - •• Limitation, one-per-year . . . 160
  - •• Lump-sum distributions, interaction with . . . 160
  - •• Nonspouse beneficiary . . . 170
- Roth IRAs
- SEPs
  - •• Calculating deduction for owners . . . 218
  - •• Compared to employer-sponsored IRAs . . . 221
  - •• Contribution and participation requirements . . . 218
  - •• Contribution deadline . . . 218
  - •• Deduction limits for owners . . . 218
  - •• Establishing . . . 218
  - •• Notifying employees . . . 218
- SIMPLE plans
  - •• Contribution to . . . 221
  - •• Distributions from . . . 169
  - •• Generally . . . 221
  - •• Penalty taxes . . . 169
- Social security benefits, interaction with . . . 151
- Surviving spouses, distribution requirements . . . 160
- Traditional IRAs
  - •• Directing federal income tax refunds into . . . 213
  - •• Inflation adjustments allowing deductible contributions to . . . 213
  - •• Versus Roth IRAs . . . 215

INTEREST AND DIVIDEND INCOME
- Personal injury award . . . 185

INTEREST EXPENSE
- Education loans . . . 234
- Student loans . . . 234

ITEMIZED DEDUCTIONS
- Recoveries and refunds of . . . 187

L

LIFE INSURANCE
- Proceeds received before death . . . 193
- Viatical settlements . . . 193

LONG-TERM CARE
- Insurance
  - •• Deduction for . . . 228
  - •• Employer-provided . . . 194
  - •• Proceeds from . . . 194

LOTTERY WINNING
- Taxation . . . 202

LUMP-SUM DISTRIBUTIONS
- Rollover of . . . 160
- Withholding on distributions . . . 160

M

MEDICAL EXPENSES
- Health savings accounts, distributions . . . 192
- Insurance reimbursement, tax benefit rule . . . 187
- Long-term care insurance proceeds . . . 194
- Medical insurance
  - •• Reimbursements from . . . 187
  - •• Self-employed taxpayers . . . 228

MINISTERS
- Housing allowances
  - •• Exclusion of . . . 184

MORTGAGE ASSISTANCE PAYMENTS
- Taxation . . . 202

MOVING EXPENSES
- Deductible expenses . . . 225
- Employer reimbursements . . . 225
- Reimbursement in different tax year than expenses . . . 225
- Time and distance tests . . . 225

P

PARTNERSHIPS AND PARTNERS
- Health insurance, partner deduction . . . 228

PERSONAL INJURY AWARDS
- Attorney fees . . . 185
- Interest on . . . 185
- Nonphysical injuries . . . 185
- Physical injuries and sickness . . . 185
- Punitive damages . . . 185
- Wrongful incarceration . . . 202

PROPRIETORSHIPS
- Health insurance
  - •• Deduction . . . 228

Q

QDRO
- Defined . . . 168
- Distributions, subject to . . . 168

QUALIFIED TUITION PROGRAMS
- Beneficiary changes . . . 198
- Contributions . . . 198
- Distributions . . . 198

R

RECAPTURE
- Alimony payments . . . 183

REFUNDS AND RECOVERIES
- Tax benefit rule . . . 187

REIMBURSEMENTS
- Medical expenses . . . 187
- Moving expenses reimbursed by employer . . . 225
- Tax benefit rule . . . 187

RESIDENCE
- Mortgage payments as alimony . . . 231
- Moving expenses . . . 225

RETIREMENT PLANS
- Distributions from
  - •• Annuity, taxable amount . . . 160
  - •• Qualified domestic relations order . . . 168
  - •• Rollover, eligibility . . . 160
  - •• Roth IRAs . . . 155
  - •• Trustee-to-trustee rollovers . . . 160
  - •• Withholding on . . . 160
- Elections
  - •• Recalculate life expectancies . . . 170
  - •• Surviving spouse as owner of decedent's IRA . . . 170
- Minimum required distributions
  - •• Calculating the amount of . . . 170
  - •• Required beginning date . . . 170
- Qualified retirement plans
  - •• Contributions to . . . 218
  - •• Multiple plans . . . 218
  - •• Self-employed owner's deduction . . . 218
- SEPs
  - •• Contributions to . . . 218
  - •• Self-employed owner's deduction . . . 218

ROLLOVER
- Inherited IRA . . . 160
- Invalid rollovers . . . 160

- IRA distributions 160
- IRA to IRA 160
- Nonspouse beneficiary 160
- Property distributions 160
- Qualified plan distributions 160, 170
- Roth IRA 155
- Roth IRA conversion 157
- Surviving spouse, IRA 160
- Traditional IRA to Roth IRA 157

ROTH IRAs
- Bankruptcy exposure 215
- Contributions
  - Deadline 215
  - Inflation adjustments allowing 215
  - Limitations 215
- Converting traditional IRAs to Roth IRAs
  - Death of accountholder 157
  - Distributions of converted amounts 155, 157
  - Law changes under TIPRA 157
  - Requirements 157
  - Reversing a conversion 157
  - Tax consequences 157
- Distributions
  - Converted from traditional IRA 157
  - Minimum distribution rules 155
  - Nonqualified distributions 155
  - Qualified distributions 155
- Rollovers 155
- Versus traditional IRAs 215

S

SAMPLE STATEMENTS, CORRESPONDENCE, AND SCHEDULES
- SEP employee notification form 218

S CORPORATIONS AND SHAREHOLDERS
- Health insurance, shareholder deduction 228

SOCIAL SECURITY
- Repayment of benefits 151
- Taxable social security benefits
  - Calculating amount 151
  - IRA deduction, interaction with 151
  - Lump-sum payments 151
  - Repayment of benefits 151

STANDARD DEDUCTION
- Tax benefit rule, effect on 187

T

TAX BENEFIT RULE
- Alternative minimum tax, effect on 187
- Casualty loss, insurance reimbursement 187
- Medical expense, reimbursement of 187
- Refund of itemized deductions 187
- Standard deduction, effect on 187
- Taxable income, effect on 187
- Tax credits, effect on 187

TAX PAYMENTS
- State taxes, refunds of 187

W

WAGES AND SALARIES
- Moving expense reimbursement 225

WITHHOLDING
- Distributions from retirement plans 160
- Social security benefits 151

WORKERS' COMPENSATION
- Exclusion from gross income 202

WORK-LEARNING-SERVICE PROGRAMS
- Income Exclusion 202

WORKSHEETS
- IRAs
  - Deduction computation 213
- Qualified retirement plan contribution deduction 218
- SEP contribution deduction 218

WRONGFUL INCARCERATION—DAMAGES
- Income Exclusion 202

COMPANION TO PPC'S 1040 DESKBOOK

COURSE 3

GAINS AND LOSSES (TDBTG173)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course takes a look at a selection of topics related to the gains and losses that are reported on Form 1040. Lesson 1 discusses securities transactions. Lesson 2 covers installment sales, like-kind exchanges, and conversions of property. Lesson 3 examines transactions related to trade or business property. Finally, Lesson 4 discusses bad debt losses, debt discharge income, and foreclosures.

PUBLICATION/REVISION DATE: November 2017

RECOMMENDED FOR: Users of *PPC's 1040 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of and experience with the preparation of Form 1040

CPE CREDIT: 8 NASBA Registry "QAS Self-Study" Hours

This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.

IRS Enrolled Agents (EA) and Non-Credentialed Return Preparers (NCRP): This course is designed to enhance professional knowledge for IRS EAs and IRS NCRPs. Checkpoint Learning is an IRS Continuing Education Provider that is approved to deliver continuing education to IRS Enrolled Agents and IRS Non-Credentialed Return Preparers.

CTEC CREDIT: 8 CTEC Federal Tax Law Hours

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

IRS NCRP CREDIT: 8 Federal Tax Law Hours

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **November 30, 2018**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Securities Transactions

Completion of this lesson will enable you to:

- Identify the best way to address stock holding periods, capital gain rates, mutual fund income and sales, and losses on Section 1244 stock and worthless securities.

- Determine the appropriate treatment for publicly traded options, futures contracts, short sales, employee stock options, the anticonversion rules, qualified small business stock, wash sale losses, and virtual currency, and recognize the difference between a stock trader and an investor.

Lesson 2—Installment Sales, Like-kind Exchanges, and Conversions of Property

Completion of this lesson will enable you to:

- Determine when the installment method is available; how to treat installment sales between related parties; how to elect out of the installment method; and how to deal with installment sale purchase price adjustments, repossessing real estate sold on the installment basis, and installment sales using wraparound mortgages.
- Assess issues related to the disposal of installment obligations, like-kind exchanges, and involuntary conversions.

Lesson 3—Trade or Business Property Transactions

Completion of this lesson will enable you to:

- Recognize the best way to address the abandonment of business property, nonrecaptured Section 1231 loss carryovers, purchase price allocations, depreciation recapture, losses on related-party sales, business casualty losses, and gains from the sale of depreciable real property.

Lesson 4—Bad Debt Losses, Debt Discharge Income, and Foreclosures

Completion of this lesson will enable you to:

- Identify the appropriate treatment for business and nonbusiness bad debts.
- Assess issues related to debt discharge income for solvent taxpayers and insolvent or bankrupt taxpayers, as well as recourse and nonrecourse debt from foreclosures by lenders, the reduction of seller-financed debt, and the consumer credit card debt modification.

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Lesson 1: Securities Transactions

Introduction

This lesson covers commonly encountered security transactions. Unless held by a dealer, securities are generally capital assets subject to the capital gain provisions. However, the gains and losses of a securities trader who makes the mark-to-market election under IRC Sec. 475(f) are ordinary rather than capital.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the best way to address stock holding periods, capital gain rates, mutual fund income and sales, and losses on Section 1244 stock and worthless securities.
- Determine the appropriate treatment for publicly traded options, futures contracts, short sales, employee stock options, the anticonversion rules, qualified small business stock, wash sale losses, and virtual currency, and recognize the difference between a stock trader and an investor.

Considerations for Stock Holding Periods and Capital Gain Rates

Stock Holding Periods

A nondealer's sale of stock results in long-term or short-term capital gain or loss depending on the stock's holding period. Stock sales receive long-term treatment whenever the holding period exceeds one year.

A stock's holding period generally begins on the day following the day of acquisition and ends on (and includes) the day of disposition. For securities traded on an established securities market, the holding period begins on the day after the *trade date* and ends on the date of disposition (i.e., the trade date). The *settlement date* is ignored. Thus, the taxpayer's overall method of accounting does not affect when the transaction is reported, and gain or loss must be reported in the tax year the disposition (i.e., trade date) falls.

Stock can be acquired other than by purchase, which can impact how the holding period is determined. These include the following:

1. *Stock Dividends.* If the stock dividend is nontaxable, the taxpayer's holding period for the new stock is the same as for the old shares upon which the dividend was based. If the stock dividend is taxable, the holding period of the new shares begins on the date of distribution.

2. *Dividend Reinvestment Plans.* Where a shareholder buys stock under a dividend reinvestment plan, either with the company or through a company-arranged open market transaction, the participating shareholder's holding period begins on the date following the day on which the shares are credited to the participant's account.

3. *Stock Splits.* The holding period for stock received in a stock split is the same as for the old shares upon which the stock split was based.

4. *Stock Received as a Gift.* When a taxpayer receives a gift of stock and his or her basis is determined with reference to the donor's, his or her holding period includes that of the donor. However, if the donee's basis in the gifted stock is its fair market value (FMV) at the date of gift (i.e., when gifted property is sold at a loss and the donor's basis in the stock exceeded its FMV at the time of the gift), the donee's holding period begins on the day after the date of the gift.

5. *Inherited Stock.* The general rule is that stock inherited from a decedent is automatically deemed to be held more than one year. Therefore, the sale or exchange of inherited stock will generally result in long-term treatment regardless of how long the heir actually holds it. However, for decedents dying in 2010, an executor or executrix could elect out of the estate tax and have the basis of stock acquired from a decedent

determined under the modified carryover basis rules of IRC Sec. 1022. If this election was made, the basis is generally the lesser of the property's adjusted basis or FMV on the date of death. The holding period of the stock includes the decedent's holding period (i.e., is "tacked" or added to the holding period).

6. *Stock Acquired by Exercising a Stock Option.* The holding period of stock acquired by the exercise of a stock option begins on the date after the option is exercised.

7. *Tax-free Stock Exchange.* If stock is received in a tax-free exchange, the holding period of the old stock tacks on to that of the new stock.

8. *Employer Stock Received from an Employer's Retirement Plan.* If a taxpayer receives employer stock in a distribution from its retirement plan, his or her holding period in the stock usually begins on the day after the day the plan trustee delivers the stock to the transfer agent with instructions to reissue it in the taxpayer's name. To the extent the distributed stock includes net unrealized appreciation (NUA), gain from a subsequent sale may automatically receive long-term treatment to the extent of such NUA.

Identifying Shares Sold. Taxpayers often acquire stock in a company at different dates and at different prices. When less than the entire holding of stock is sold, identifying which shares were sold not only affects the amount of gain or loss but also whether the sale is long- or short-term. The two methods for identifying shares of stock sold when taxpayers sell less than their entire holdings in a particular stock are (1) the first-in, first-out (FIFO) method and (2) the specific identification method.

FIFO is used when a taxpayer does not or cannot specifically identify which shares of stock are sold. This method assumes the shares acquired first are sold first. In a case when the taxpayer had no documentation or other objective evidence that he had attempted to inform the broker to use a method of identification other than FIFO, the Court found that the taxpayer must use the regulatory default method of FIFO.

If the taxpayer specifically identifies the shares sold, the basis and holding period of those shares are used in computing the character and amount of gain or loss. Adequate identification is made when the taxpayer delivers the specific shares to be sold to the broker selling the stock. If the stock is held by the taxpayer's broker in street name (1) the taxpayer must, at the time of sale, specify to the broker which shares are to be sold; and (2) the broker must, within a reasonable time after the sale, confirm this specification to the taxpayer in a written document. The identified stock is then deemed to be sold even if the broker actually delivers to the buyer shares from another lot of stock.

Capital Gain Tax Rates

A *capital asset* is any property except—

1. inventory;

2. depreciable or real property used in the taxpayer's trade or business, but IRC Sec. 1231 allows capital gain treatment on such items (subject to limitations);

3. specified literary or artistic property;

4. business accounts or notes receivable; or

5. certain U.S. publications.

Thus, securities generally are capital assets unless held by a dealer. Gains and losses from the sale of securities by a dealer produce ordinary income and losses rather than capital gains. (Reg. 1.471-5 defines a dealer as a merchant of securities with an established place of business who is regularly engaged in the purchase of securities and their resale to customers. As a practical matter, few individuals meet this definition.)

Securities sold by a trader receive capital gain or loss treatment [unless the trader has made the mark-to-market election under IRC Sec. 475(f)], and the trader's expenses, including subscriptions to financial periodicals, telecommunication and clerical expenses, and depreciation on data processing equipment and related software, etc., are deducted in arriving at adjusted gross income rather than as itemized deductions.

The applicable capital gain tax rate depends on the taxpayer's marginal tax rate, how long the property is held, and the type of property sold. The long-term capital gain rate for taxpayers in the 10% or 15% ordinary tax bracket is generally 0%. However, to the extent long-term capital gain causes the taxpayer's taxable income to exceed the upper threshold of the 15% ordinary income tax bracket, the capital gain is taxed at 15% or 20%. Thus, taxpayers can have long-term capital gain taxed at two different rates. A long-term rate of 15% or 20% generally applies if the property is held more than 12 months, while a short-term rate (i.e., generally ordinary income rate) applies when the property is held one year or less. Capital gains also may be subject to the 3.8% NIIT. Also, special rules and rates apply to the sale of collectibles, qualified small business stock, and unrecaptured Section 1250 gain.

Example 1A-1 Capital gain rate reduced for taxpayers in the lower tax brackets.

Nancy is single and has taxable income of $60,000 for 2017. Included in this amount is $42,000 of gain from the November 5, 2017, sale of stock she purchased in 2010.

The 2017 25% rate for a taxpayer using the single filing status begins at $37,950. Thus $19,950 ($37,950 − $18,000 of ordinary income) of Nancy's long-term capital gain would otherwise be taxed at 15%. As a result, this amount is taxed at 0%; the remaining $22,050 ($42,000 − $19,950) of capital gain is taxed at 15%. Nancy's 2017 tax is computed as follows:

Ordinary income	
$9,325 × 10%	$ 933
$8,675 × 15%	1,301
Long-term capital gain:	
$19,950 taxed at 0%	—
$22,050 taxed at 15%	3,308
Total tax	$ 5,542

Adjusted Net Capital Gain. The 20%, 15%, and 0% capital gain tax rates apply to adjusted net capital gain. Qualifying dividends are taxed at the same rate as long-term capital gains. This is accomplished by adding qualified dividend income to the net capital gain to arrive at adjusted net capital gain. However, to prevent dividends from being offset by capital losses, adjusted net capital gain is computed by first reducing (but not below zero) net capital gain (i.e., net long-term gain) by (1) capital gain attributable to Section 1250 property and (2) 28% rate capital gains. Add qualified dividends to this amount to arrive at adjusted net capital gain.

Capital gain attributable to Section 1250 property is the gain on a sale of Section 1250 property to the extent depreciation adjustments on the property exceed those subject to ordinary income recapture. Total 28% rate capital gains are the sum of collectible gains (gains from assets such as art, rugs, antiques etc. that are capital assets in the taxpayer's hands and held for over a year) and Section 1202 gain from the sale of certain small business stock reduced (but not below zero) by losses from collectibles, net short-term capital losses, and long-term capital loss carryovers.

Gains and Losses from Pass-through Entities. Pass-through entities must determine and disclose to owners the proper category of capital gains and losses. Pass-through entities include regulated investment companies (i.e., mutual funds), real estate investment trusts (REITs), S corporations, partnerships, estates, trusts, common trust funds, certain foreign investment companies, and Section 1295 qualified electing funds.

Alternative Minimum Tax (AMT). The maximum capital gain rates also apply to AMT.

Capital Losses

Taxpayers offset capital gains with capital losses, and excess capital losses up to $3,000 ($1,500 for married filing separate returns) can be deducted against ordinary income. Remaining capital losses can be carried forward indefinitely, retaining their character as either short- or long-term. However, losses not used in a decedent's final return expire unused.

A taxpayer's capital loss carryover is the amount that his or her total net capital loss for the year exceeds the lesser of (1) the allowable capital loss deduction for the year or (2) his or her adjusted taxable income for the year.

Adjusted taxable income is taxable income increased by the allowable capital loss deduction for the year and the deduction for personal exemptions. For many taxpayers, this method of determining the carryover effectively allows them to convert all or part of a net capital loss deduction to a carryover when they receive no tax benefit from the deduction (e.g., they have negative taxable income for the year); however, this will not always be the case if the taxpayer would have positive taxable income without the deductions for personal exemptions and allowable capital losses.

Example 1A-2 Computing a capital loss carryover.

Al and Ann file a joint return for 2017. For 2017, they incur a $5,000 net capital loss. What is their capital loss carryover to 2018 based on the following three income scenarios?

	Scenario 1	Scenario 2	Scenario 3
Wages	$ 47,500	$ 47,500	$ 47,500
Business loss	—	(34,000)	(50,000)
Capital loss deduction	(3,000)	(3,000)	(3,000)
Standard deduction	(12,700)	(12,700)	(12,700)
Personal exemption deduction	(8,100)	(8,100)	(8,100)
Taxable income	$ 23,700	$ (10,300)	$ (26,300)
Adjusted taxable income	$ 34,800	$ 800	$ (15,200)
Capital loss used in 2017	3,000	800	—
Capital loss carryover to 2018	2,000	4,200	5,000

In Scenario 1, the capital loss carryover is computed using the $3,000 capital loss deduction allowed in 2017, since that amount is less than adjusted taxable income. In Scenarios 2 and 3, however, adjusted taxable income is less than the $3,000 allowable capital loss deduction, so the capital loss carryover is computed using the adjusted taxable income amount (but not less than zero).

When a taxpayer has capital gains and losses that are subject to different capital gain rates, the capital gains and losses are first divided into short-term and long-term groups, with the long-term group further divided by capital gain tax rates [15% (or 0%), 20%, 25%, and 28%]. A net loss in a long-term group first offsets gains in the highest long-term rate group before being applied to gains in the next highest long-term rate group. For example, a net long-term loss in the 15% group offsets a net gain in the 28% group before offsetting net gain in the 25% group. If there is an overall net long-term loss, it offsets net short-term gain. If there is a net short-term capital loss, it first offsets net gain from the 28% long-term group before applying to net gains from the 25%, 20%, and 15% groups.

A long-term capital loss carryover offsets long-term capital gains first, beginning with the highest (28%) long-term capital gain tax rate group. A short-term capital loss carryover offsets net short-term gain first; any remaining carryover offsets long-term gains, beginning with the highest long-term capital gain tax rate group.

Example 1A-3 Offsetting capital gains and losses.

John has the following capital gains and losses (grouped by the applicable capital gains tax rate):

Category	Amount	Applicable Tax Rate Group
Unrecaptured Section 1250 gain	$ 4,000	25%
Net short-term loss	(3,000)	39.6%
Net collectibles gain	6,000	28%
Net long-term loss	(2,000)	20%

Using the ordering rules, the $2,000 long-term loss (20% group) first offsets the $6,000 collectibles gain (28% group, leaving a $4,000 collectibles gain, which is then offset by the $3,000 short-term capital loss. Thus, John has a $1,000 collectibles gain (subject to 28% tax) and a $4,000 unrecaptured Section 1250 gain (subject to 25% tax).

Mutual Fund Income and Sales

Reporting Shareholder Income

Capital gain or loss is recognized when an individual sells, exchanges, or redeems mutual fund shares. This includes an exchange of shares in one fund for shares in a different fund, even if the funds are in the same mutual fund family. The amount of gain or loss is the difference between the adjusted basis in the shares and the selling price (less any costs associated with the sale, exchange, or redemption) and is reported on Form 8949.

The SEC requires certain money market funds to price shares in a manner that more accurately reflects the market value of their underlying portfolios rather than a stable $1 per share. A taxpayer who makes frequent purchases and redemptions of these "floating NAV" (net asset values) money market funds could experience a high volume of small gains and losses, making tax compliance burdensome. In response, the IRS issued guidance providing a simplified, aggregate annual method of tax accounting for gains and losses in these floating NAV funds. Specifically, the regulations permit shareholders to measure net gain or net loss without transaction-by-transaction calculations. In addition, the final regulations expand the availability of the simplified method to all money market funds. See Section 15.17 of Rev. Proc. 2017-30 for guidance on how to make the automatic change (doesn't require consent) to or from this simplified NAV method of accounting.

Distributed and Reinvested Income. Mutual fund income reported on Form 1099-DIV is taxable to shareholders whether the income and gains are distributed, reinvested in additional fund shares, or retained by the fund itself. In addition, distributions declared and payable to mutual fund shareholders of record as of calendar year-end and paid by January 31 of the following year are taxable in the year declared. Thus, the Form 1099-DIV amount and actual distributions a shareholder receives during the year may differ.

Retained Capital Gains. In some cases, a mutual fund will retain (rather than distribute to shareholders) realized long-term gains. The fund must pay a fund-level income tax on retained gains and send a Form 2439 (Notice to Shareholder of Undistributed Long-Term Capital Gains) to each shareholder. Form 2439 reports each shareholder's portion of the retained gains and fund-level income tax paid on those gains. Each shareholder reports his or her share of the retained gain on Part II of Schedule D and claims a credit (on line 73 of Form 1040) for his or her share of income tax paid by the fund. In addition, box a of line 73 should be checked, and Copy B of Form 2439 must be attached to the shareholder's return. The shareholder's basis in fund shares is increased by the gain and reduced by the share of fund-level income tax reported on Form 2439.

Tax-exempt Income. Mutual fund income from tax-exempt interest is reported to shareholders in box 8 of Form 1099-INT. Tax-exempt dividends from mutual funds are reported in box 10 of Form 1099-DIV. The shareholder should include these exempt interest amounts on the tax-exempt interest line on page 1 of Form 1040, along with other exempt interest income. Some or all of the tax-exempt interest may be an AMT preference item. The tax-exempt income is also used in computing the taxability of social security benefits and may result in some of the taxpayer's expenses associated with carrying the mutual fund shares being disallowed.

Return of Capital (Nontaxable) Distributions. A distribution that is not out of earnings and profits is a return of the shareholder's investment, or capital, in the mutual fund and is shown in box 3 of Form 1099-DIV (Nondividend distributions). These return of capital distributions are generally not taxed; however, they do reduce the shareholder's basis in the shares. If a distribution exceeds the shareholder's basis in the funds, the excess is either a short- or long-term taxable capital gain reportable on Form 8949.

Determining Basis in Mutual Fund Shares

Investors in mutual funds may reinvest dividends and capital gains so they have current income without actually receiving any distributions or, in some cases, a fund may retain realized capital gains. In these situations, special calculations are necessary to determine the tax basis of the mutual fund shares.

When mutual fund shares are sold, exchanged, or redeemed, their basis must be determined. The shares' original cost is the starting point. It is increased for the following items:

1. Reinvested dividends (included in income reported on Form 1099-DIV).
2. Reinvested capital gains (included in income reported on Form 1099-DIV).
3. Undistributed long-term capital gains (reported as income on Form 2439).
4. Reinvested tax-exempt dividends (reported on information statements issued by the fund).

The following reduce basis:

1. Distributions consisting of return of capital (reported as nontaxable distributions on Form 1099-DIV).
2. Fund-level income tax paid on retained long-term capital gains (reported on Form 2439).

A special rule applies to mutual fund load charges if (1) the load charges are incurred in a transaction in which the taxpayer acquires fund shares and a reinvestment right, (2) such shares are disposed of within 90 days, and (3) the taxpayer subsequently buys other mutual fund shares with a reduced load charge due to the reinvestment right. To the extent the load charge is reduced in the second transaction, the taxpayer cannot consider the original load charge in determining gain or loss in the disposition of the original mutual fund shares (it is considered in the second transaction instead). A reinvestment right is the right to acquire stock in a mutual fund without paying a load charge or with the payment of a reduced charge. This rule prevents taxpayers from taking a quick loss equal to the load charge on the original shares simply by switching to another fund in the same family.

Example 1B-1 Calculating basis when income is reinvested.

John purchased 100 shares of Blue Sky Growth Fund, a mutual fund, for $2,000 in February 2015. He incurred a load charge of $100. His beginning cost basis in the mutual fund is $2,100, or $21 per share. In January 2016, he received a 2015 Form 1099-DIV reflecting a $150 dividend, which John reinvested in Blue Sky. In January 2017, John received a 2016 Form 1099-DIV reflecting a $300 long-term capital gain and a $100 dividend, both of which were reinvested in the fund. John sold all of his shares on August 3, 2017, for $3,100. John's basis in Blue Sky is determined as follows:

Original cost (including commissions)	$ 2,100
2015 dividend (reinvested in Blue Sky)	150
2016 capital gain (reinvested in Blue Sky)	300
2016 dividend (reinvested in Blue Sky)	100
Total tax basis	$ 2,650

Therefore, John reports a capital gain of $450 ($3,100 − $2,650) on his 2017 return. The gain associated with the shares acquired (from the reinvested income) on or after August 3, 2016, is short-term; the remainder of the gain is long-term.

Three methods exist for determining the basis of mutual fund shares when taxpayers sell less than their entire holdings in a particular fund: (1) the first-in, first-out (FIFO) method, (2) the specific identification method, and (3) the average basis method. Selecting a particular method may enable taxpayers to save taxes because it can result in the highest basis for the shares sold or, alternatively, may allow the taxpayer to control whether gains or losses are long- or short-term. Practitioners must examine each client's particular tax situation to determine the most beneficial method. Sometimes this determination will be influenced by the amount the client has invested in the fund because the use of some methods may require more time and cost in computing than the taxpayer will save in taxes.

The use of the *FIFO* and *specific identification* methods are applied in the same manner as for regular stock sales (discussed earlier in this lesson).

The *average basis method* of calculating mutual fund share basis can be used if the shares are in an account handled by a custodian or agent who acquires or redeems shares. In general, average basis is determined by averaging the basis of all shares of identical stock in an account regardless of the holding period. The basis of each share of identical stock in the account is the aggregate basis of all shares of that stock in the account divided by the aggregate number of shares.

Basis and Character Reporting Rules for Mutual Fund Sales

For mutual fund shares acquired or transferred after December 31, 2011 (covered securities), every broker that is required to file an information return reporting the gross proceeds of a mutual fund share sale must include in the return the customer's adjusted basis in the fund shares and whether any gain or loss with respect to the fund share's sale is short term or long term. The broker can choose its default method (FIFO, average basis, or specific identification) for identifying shares sold. This default method is used unless the taxpayer notifies the broker and properly chooses another permissible method. Taxpayers must report gain or loss using the broker's default method unless they properly choose another method.

Average Basis Method. For sales of mutual fund shares acquired before 2012 (noncovered securities), taxpayers can choose the average basis method by indicating on their return for the year the decision is first effective. Presumably, this election is made by making a notation on Form 8949.There is no clear authority on how to make this election; IRS Pub. 550 indicates "showing on your return" that the election is made.

For sales of mutual fund shares acquired after 2011 (covered securities), taxpayers choose the average basis method for certain accounts by notifying the custodian or agent in writing by any reasonable means, including electronic format. Taxpayers can choose the average basis method at any time. The decision takes effect for sales that occur after the choice is made.

Taxpayers who choose to average the basis of mutual fund shares will compute separate averages for fund shares held in different accounts. They may also choose to average the basis of mutual fund shares in one account but not average them in another account. Mutual fund shares acquired before 2012 (noncovered securities) are treated as being held in a separate account from shares that are covered securities (acquired after 2011).

Taxpayers can revoke their decision to use the average basis method for covered securities by the date of the first sale or other disposition of the shares after the decision (or by one year from the date of making the decision, if earlier). According to the regulations, a revocation is effective when the taxpayer notifies in writing the custodian holding the securities. After the decision is revoked, the taxpayer's share basis is the basis before averaging.

Taxpayers may change from the average basis method to another permissible method on a prospective basis. There is no limit on the number of times or frequency taxpayers can change their basis determination method. After a change, however, the taxpayer's share basis remains the same as the basis immediately before the change.

Wash Sales. The wash sale rules (discussed later in this lesson) apply to losses on sales of mutual fund shares. A loss from a disposition of shares is disallowed to the extent any shares in the fund were acquired (including through the reinvestment of dividend income) during the period beginning 30 days before and ending 30 days after the date of sale. The unrecognized wash sale loss is added to the shares acquired during the 61-day period. This can result in some complex computations in the context of mutual funds, especially when a dividend reinvestment program is in place, or a consistent monthly investment program is utilized by the investor.

Special Rules for Certain Short-term Losses. If a taxpayer receives, or was considered to have received, a capital gain distribution (i.e., long-term capital gain) on mutual fund shares he or she held for six months or less and sold at a loss, only the loss in excess of the capital gain distribution is treated as a short-term loss. Any part of the loss that is not more than the capital gain distribution is reported as a long-term capital loss.

If a taxpayer receives tax-exempt interest on mutual fund shares he or she held for six months or less and sold at a loss, only the part of the loss in excess of the tax-exempt interest can be claimed as a short-term loss. Any loss to the extent of the tax-exempt interest received is disallowed.

Losses on a Taxpayer's Section 1244 Stock

A taxpayer who incurs a loss on an original investment in Section 1244 stock can treat it as an ordinary loss (rather than a capital loss) up to $50,000 for a single taxpayer or $100,000 on a joint return. The loss is triggered (1) by either a sale or exchange, or (2) at the time the stock becomes worthless. Section 1244 stock is issued to an individual (or partnership) for money or other property by a domestic small business corporation.

Section 1244 Stock Requirements

Section 1244 stock generally can be either common or preferred stock. However, stock issued before July 19, 1984, must be common stock to qualify for Section 1244 treatment. Common stock does not include securities that are convertible into common stock or common stock that can be converted to other securities. The determination of whether stock qualifies as Section 1244 stock is made when the stock is issued.

A corporation (either C or S) is treated as a small business corporation if, when stock is issued, the aggregate amount of money and other property it received in exchange for stock or as a contribution to capital or paid-in-surplus does not exceed $1 million. Thus, stock associated with the first $1 million of capital (i.e., capital stock and paid-in-capital) can qualify as Section 1244 stock. When total capital exceeds $1 million, the corporation (not the shareholders) may designate the Section 1244 shares issued in that year instead of a proportional allocation. For the stock to receive Section 1244 treatment when it becomes worthless or is sold by the taxpayer, the corporation must have derived more than 50% of its aggregate gross receipts from sources other than investments (such as interest, dividends, royalties) during the five most recent tax years ending before the date the taxpayer's loss is sustained (or since inception if the corporation is in existence for less than five years).

Claiming a Section 1244 Loss

An ordinary loss on Section 1244 stock can be claimed only by an individual to whom the stock was originally issued (or an individual who was a partner in a partnership when it acquired the stock from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership). Shareholders who acquire their stock by gift or inheritance or by purchase from the original holder are not eligible for Section 1244 treatment.

The maximum amount that can be claimed as an ordinary loss in a tax year is $50,000 for a single taxpayer or $100,000 on a joint return. The $100,000 maximum applies whether the losses are sustained by one or both spouses. The $50,000 and $100,000 limitations are annual limitations on the amount treated as an ordinary loss under IRC Sec. 1244. Any losses in excess of the $50,000 and $100,000 limitations are treated as capital losses subject to the usual capital loss limitation rules.

For losses sustained by a partnership, the $50,000 and $100,000 limits apply separately to each partner. The partner's share of the partnership's Section 1244 loss is limited to the lesser of his distributive share percentage when the stock is issued or the partner's distributive share percentage when the loss is sustained. (The partnership is considered the original owner.) If the partnership distributes the stock to the partners, they will not be entitled to Section 1244 loss treatment because they are not the original owners.

Losses from Worthless Securities

Taxpayers are allowed a capital loss for worthless securities held as capital assets. The loss can be taken only when the security becomes wholly worthless; losses for partial worthlessness cannot be claimed. This rule requires taxpayers to correctly identify the year that a security becomes wholly worthless. In addition, taxpayers must maintain sufficient records to substantiate the loss.

Generally, a security is considered worthless at the time it first has no liquidation value and no reasonable hope or expectation exists that the security will become valuable at some future date. A taxpayer may be able to establish worthlessness by showing a fixed and identifiable event demonstrating the worthlessness of the security.

The question of when a security becomes worthless has been the subject of many court cases and IRS rulings. For example, a corporation declaring bankruptcy is not sufficient to permit a loss claim when it is possible that the

shareholders will obtain stock in a reorganization. The IRS has indicated that the sale of assets and distribution to creditors in bankruptcy can serve as documentation to establish nothing was received by the taxpayer for the stock. In *Thun*, a loss claimed three years before the corporation ceased business was not allowed, but in *Steadman*, a taxpayer's loss two years prior to the corporation filing bankruptcy was allowed. Stock is also worthless at the date a corporation elects to be treated as a disregarded entity if its liabilities exceed the value of its assets, including intangibles, at that date. Worthlessness depends on the particular facts.

To give taxpayers relief from the obvious difficulties of determining when a security becomes worthless, IRC Sec. 6511(d)(1) allows a seven-year statute of limitations (instead of the normal three-year period) to file an amended return for refund claims due to losses from worthless securities (or bad debts).

Example 1D-1 Timing of worthless stock loss.

Teddy bought 200 shares of HAU Corp. for $15 per share in 2005. HAU is a publicly traded company. As of the end of 2017, the stock price had declined to $1.50 per share, and the company was in Chapter 11 bankruptcy.

Teddy cannot take a worthless stock deduction in 2017 for his anticipated loss on HAU stock. The stock is not wholly worthless—as evidenced by its trading value. To establish a deductible capital loss, Teddy must sell his shares or wait for an event that renders his stock worthless. Even if his ownership interest is significantly diluted in the Chapter 11 reorganization, he will be unable to claim a loss as long as he holds securities that have some value—however nominal. If, however, HAU is liquidated in bankruptcy, Teddy should be able to claim a worthless security loss when it is established that his equity holder class will receive nothing in liquidation.

Abandoned Securities

A loss established by abandonment of a security, other than a security in a corporation affiliated with the taxpayer, that is a capital asset is treated as a loss from the sale or exchange of a capital asset on the last day of the year. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Generally, how is a stock's holding period determined?

    a. It is automatically considered to have been held over one year at the date it is received.

    b. Time with the previous owner is included.

    c. From the trade date to the settlement date.

    d. From the day after it is acquired until the day on which it is disposed.

2. Which of the following will reduce the basis of mutual fund shares?

    a. Reinvested dividends.

    b. Distributions of returned capital.

    c. Undistributed long-term capital gains.

    d. Reinvested capital gains.

3. Which of the following statements best describes Section 1244 stock?

    a. Losses associated with this type of stock are treated as capital losses.

    b. Only preferred stock can be considered Section 1244 stock.

    c. This type of stock is issued by a small business corporation in exchange for money or property.

    d. To qualify as this type of stock, the amount received for the stock must exceed $1 million.

4. Julia invested in SmallCo. In the current tax year, value of the SmallCo stock has plummeted and it seems likely that the company will declare bankruptcy and dissolve its holdings. Julia decides to permanently surrender all her rights in the SmallCo stock, and she receives no consideration for doing so. Julia's stock would be considered what?

    a. Abandoned.

    b. Partially worthless.

    c. Worthless.

    d. Section 1244 stock.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Generally, how is a stock's holding period determined? **(Page 273)**

   a. It is automatically considered to have been held over one year at the date it is received. [This answer is incorrect. According to IRC Sec. 1223(9), the general rule for stock inherited from a decedent is automatically deemed to be held more than one year. However, this applies specifically to the holding period of inherited stock, not stock acquired using other means.]

   b. Time with the previous owner is included. [This answer is incorrect. When a taxpayer receives a gift of stock and his or her basis is determined with reference to the donor's, according to Reg. 1.1223-1(b), the taxpayer's holding period includes that of the donor. However, this rule does not apply to stock acquired other than a gift.]

   c. From the trade date to the settlement date. [This answer is incorrect. For securities traded on an established market, the holding period begins on the day after the trade date and ends on the date of disposition (i.e., the trade date). The settlement date is ignored.]

   d. From the day after it is acquired until the day on which it is disposed. [This answer is correct. According to Rev. Rul. 66-7, a stock's holding period generally begins on the day following the day of acquisition and ends on (and includes) the day of disposition.]

2. Which of the following will reduce the basis of mutual fund shares? **(Page 277)**

   a. Reinvested dividends. [This answer is incorrect. Reinvested dividends, which are included in income reported on Form 1099-DIV, *increase* the basis of mutual fund shares.]

   b. Distributions of returned capital. [This answer is correct. When mutual fund shares are sold, exchanged, or redeemed, their basis must be determined. The shares' original cost is the starting point. It is increased and decreased for specific items. The two items that reduce basis are distributions consisting of return of capital (reported as nontaxable distributions on Form 1099-DIV) and fund-level income tax paid on retained long-term capital gains (reported on Form 2439).]

   c. Undistributed long-term capital gains. [This answer is incorrect. The basis of mutual fund shares is *increased* by undistributed long-term capital gains, which are reported as income on Form 2439.]

   d. Reinvested capital gains. [This answer is incorrect. Reinvested capital gains are included in income reported on Form 1099-DIV. Their effect on the basis of mutual funds is to *increase* the basis in shares.]

3. Which of the following statements best describes Section 1244 stock? **(Page 280)**

   a. Losses associated with this type of stock are treated as capital losses. [This answer is incorrect. A taxpayer who incurs a loss on an original investment in Section 1244 stock can treat it as an ordinary loss (rather than a capital loss) up to $50,000 for a single taxpayer or $100,000 on a joint return.]

   b. Only preferred stock can be considered Section 1244 stock. [This answer is incorrect. Section 1244 stock generally can be either common or preferred stock. However, stock issued before July 19, 1984, must be common stock to qualify for Section 1244 treatment.]

   c. This type of stock is issued by a small business corporation in exchange for money or property. [This answer is correct. Section 1244 stock is issued to an individual (or partnership) for money or other property by a domestic small business corporation.]

d. To qualify as this type of stock, the amount received for the stock must exceed $1 million. [This answer is incorrect. A corporation (either C or S) is treated as a small business corporation if, when the stock is issued, the aggregate amount of money and other property it received in exchange for stock or as a contribution to capital or paid-in-surplus does not exceed $1 million, according to IRC Sec. 1244(c)(3).]

4. Julia invested in SmallCo. In the current tax year, value of the SmallCo stock has plummeted and it seems likely that the company will declare bankruptcy and dissolve its holdings. Julia decides to permanently surrender all her rights in the SmallCo stock, and she receives no consideration for doing so. Julia's stock would be considered what? **(Page 280)**

a. Abandoned. [This answer is correct. According to IRC Sec. 165(g)(3), a loss established by abandonment of a security, other than a security in a corporation affiliated with the taxpayer, that is a capital asset is treated as a loss from the sale or exchange of a capital asset on the last day of the year. To abandon a security, per Reg. 1.165-5(i), a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. Based on Julia's actions in this scenario, she has abandoned her stock in SmallCo.]

b. Partially worthless. [This answer is incorrect. Stock is not considered partially worthless, per IRC Sec. 165(g)(1).]

c. Worthless. [This answer is incorrect. As determined in the *Morton* court case, there are specifications for when a stock is considered worthless. However, while it seems possible that SmallCo's stock might ultimately be considered worthless, that designation does not take into account Julia's actions in the scenario above. Therefore, there is a better answer to this question.]

d. Section 1244 stock. [This answer is incorrect. Section 1244 stock is a type of stock issued by a specific type of corporation for a specific purpose. The Section 1244 description is not associated with whether stock has lost value.]

Dealing with Publicly Traded Options and Futures Contracts

A publicly traded option giving the holder the right to sell a specified stock at a set price (the strike price) on or before a specified date is called a put option. An option giving the holder the right to buy at a set price on or before a specified date is referred to as a call option.

A taxpayer who grants put or call options is called a *writer*. A taxpayer who owns a put or call option is called a *holder*. Writers of options receive a premium or fee for agreeing to take the risk to buy or sell securities under the terms of the option. Holders of options pay the premium to either the option writer or a previous holder to acquire the opportunity to buy or sell securities under the terms of the option.

The following discussions expand on and illustrate the taxation of publicly traded options.

Tax Rules for Option Writers

Option writers (sometimes called *grantors*) have tax consequences when an option (1) lapses without exercise (i.e., expires), (2) is exercised, or (3) is offset by a closing transaction. The receipt of the premium for writing an option has no tax consequences to the writer until one of these events occurs.

Option Lapses (Expires). When a put or call option lapses (expires), the premium payment received by the option writer is a short-term capital gain at that time.

Example 1E-1 Effect of lapse of option on writer.

On November 7, 2017, Ernie wrote a January 2018 put option at $20 per share for 100 shares of QwikBux, Ltd. He received a premium of $250 for writing the option. The stock soared to $28 per share by the January 2018 expiration date, and the option was not exercised.

Ernie treats the $250 as short-term capital gain occurring in 2018. No gain or loss is reported in 2017 since the option was still open at December 31, 2017.

Option Exercised. If a put is exercised (i.e., the writer must purchase the stock), the writer reduces his or her tax basis in the shares acquired by the amount of premium received. If a call is exercised (i.e., the writer must sell the stock), the writer adds the premium to the proceeds from the sale of the securities to the option holder.

Example 1E-2 Effect of exercise of option on writer.

On October 1, 2017, Buford wrote a December 2017 put option for 100 shares of MightyFine, Inc., at a price of $10 per share. He also wrote a December 2017 call option for 100 shares of Shiftee Stores Corp. at a price of $8 per share. Buford received premiums of $300 for writing the MightyFine put option and $400 for writing the Shiftee Stores call option. Both options were exercised by their holders in December 2017. Buford paid $1,000 to acquire the MightyFine shares and received $800 for delivering 100 shares of Shiftee Stores.

Buford's tax basis in the 100 shares of MightyFine that he now holds is $700 ($1,000 paid to acquire the shares − $300 premium received for writing the put option).

Buford's sales proceeds from the 100 shares of Shiftee Stores delivered to the call option holder (i.e., $800) are increased by the $400 received for writing the call option on the shares. He then calculates capital gain or loss using his basis and his holding period in the shares delivered.

Closing Transaction. A closing transaction occurs when the writer's economic obligation under the option's terms is offset and, in effect, canceled by purchase of an equivalent option. If an option writer enters into a closing transaction, any gain or loss is short-term and is measured by the difference between the amount received from premiums for writing the option and the amount paid to acquire options in the closing transaction.

Example 1E-3 Effect of closing transaction on writer.

Assume the same facts as in Example 1E-2, except Buford decides he wants to avoid the consequences of having the options he wrote exercised. Therefore, he acquires offsetting positions on December 5, 2017, by

purchasing a December 2017 put option for 100 shares of MightyFine (at $10 per share) for $400 and a December 2017 call option for 100 shares of Shiftee Stores (at $8 per share) for $600.

Buford has a $100 short-term capital loss from his MightyFine option writing ($300 premium received − $400 paid in closing transaction) and a $200 short-term capital loss from his Shiftee Stores option writing ($400 premium received − $600 paid in closing transaction). These losses are recognized on December 5, 2017, the date the closing transactions occurred.

The open transaction doctrine and treatment of the extension of variable prepaid forward contracts (VPFCs) as still an open transaction was likened to extending or modifying the expiration date of an option in McKelvey. In that case, the Court concluded that the execution of various VPFC extensions did not constitute a sale or exchange (or a closing transaction), thus treating them as still open until they were closed by a future delivery of stock by the extended settlement date. The Court then analogized this situation to option taxation. Thus, the conclusion is that the extension of the expiration date of an option by the option writer would not constitute a closing transaction.

Tax Rules for Option Holders

The tax consequences to option holders depend on whether the options expire, are exercised, or are sold before expiration. To summarize:

1. The loss on an expired option will be either short-term or long-term depending on how long the option was held, unless the option is part of a straddle (see discussion below).

2. If a put option is exercised (i.e., the holder sells the stock to the option writer), the cost of the option is deducted from the sales proceeds received from the sale of the securities under the terms of the put.

3. If a call option is exercised (i.e., the holder buys the stock from the option writer), the cost of the option is added to the cost of the securities acquired under the terms of the call.

4. If an option is sold prior to expiration, gain or loss will be either short- or long-term depending on how long the option was held.

Example 1E-4 Effects of option transactions on holder.

On March 7, 2017, Selena made the following option transactions: (1) bought an April 2017 call option to purchase 100 shares of McD, Ltd., at $15 per share for $150, (2) bought a June 2017 put option to sell 100 shares of Fort, Inc., at $10 per share for $250, and (3) bought a December 2017 call option to purchase 100 shares of Luckee, Inc., at $7 per share for $100.

On March 7, 2017, Selena did not own any shares in McD, Ltd., Fort, Inc., or Luckee, Inc. On March 14, 2017, Selena sells her McD option for $600, recognizing a $450 short-term capital gain.

On June 13, 2017, Fort was selling for $14 per share; thus, Selena let the option expire. She has a short-term capital loss of $250 when it expires because she held it for one year or less.

On December 12, 2017, Luckee is selling for $15 per share, and Selena exercises her option. Her option cost of $100 is added to the $700 paid to exercise the call; so her basis in the shares is $800. Her stock's holding period starts on December 13, 2017, the day after she acquired the shares by exercising her option.

Put Options Treated as Straddles. Purchasing a put option on stock owned by the taxpayer can result in the application of the straddle rules under IRC Sec. 1092. Holding a position [including an option to buy (other than a qualified covered call as described in IRC Sec. 1092) or sell] that substantially diminishes a taxpayer's risk of loss of holding property is a straddle. Although stock is generally excluded from the definition of personal property when applying the straddle rules, it is included when it is part of a straddle in which at least one of the offsetting positions is an option to buy or sell the stock or substantially identical stock or securities. However, a straddle consisting entirely of regulated futures contracts, nonequity options (e.g., an option on the S&P 500 index), or dealer equity options is not subject to this rule. Instead, the mark to market rules apply.

If the straddle rules apply, losses on positions making up the straddle may be deferred until the year any gains are recognized on the remaining position(s). Loss is deferred to the extent of unrecognized gain in the offsetting positions, determined as of the close of the year. For a protective put (i.e., a put option acquired with respect to stock owned by the option holder), any loss incurred because the option expires unexercised is deferred to the extent the stock would generate a gain if sold on the last day of the tax year. If the straddle rules apply, the option's holding period is also subject to special rules. If the taxpayer held the stock subject to the option for more than 12 months before purchasing the put option, any loss on the option's expiration is long-term. If the taxpayer held the stock subject to the option for 12 months or less before acquiring the put, the option's holding period does not begin until the offsetting position (i.e., the stock) is sold. Thus, if the option expires before the stock is sold, the loss is short-term. Also, any interest and carrying charges associated with the straddle must be capitalized.

Example 1E-5 Applying the straddle rules to expired put options.

Assume the same facts as in Example 1E-4. Also assume that Selena owns 100 shares of Fort, Inc., that she purchased three years ago for $5 per share. Selena does not sell the Fort stock during 2017. At December 31, 2017, it is worth $14 a share. Thus, Selena has an unrecognized gain with respect to the Fort stock of $900 [($14 FMV less $5 basis) × 100 shares]. None of the loss on the expired put can be recognized during 2017 since the $900 unrecognized gain in the Fort stock exceeds the $250 loss on the expired put.

Variation: Assume instead that Selena's basis in the 100 shares of Fort is $20 per share. Thus, at December 31, 2017, she has an unrecognized loss of $600 [($14 FMV − $20 basis) × 100 shares]. Selena recognizes the $250 long-term loss when the put option expires (June 13, 2017). This is because the stock she owns would not generate a gain (if sold on December 31, 2017) that exceeds the loss she realized on the expiration of the option. In fact, in this situation, a sale of the stock would result in a loss.

Straddles and Qualified Covered Call Options. Under a special rule in IRC Sec. 1092(c)(4), a straddle consisting of a stock and a qualified covered call option on the stock do not constitute a straddle for purposes of the loss deferral rules unless such positions are part of a larger straddle. This exception to the straddle rules normally applies when an individual writes a publicly traded call option on stock he or she owns as an investment strategy to enhance the investment return on the stock.

A qualified covered call option is any option a taxpayer grants to purchase stock he holds (or stock he acquires in connection with granting the option), but only if all of the following are true: (1) the option is traded on a national securities exchange or other market approved by the Secretary of the Treasury, (2) the option is granted more than 30 days before its expiration date, (3) the option is not a deep-in-the-money option [i.e., an option with a strike price lower than the lowest qualified benchmark (LQB); generally, the LQB is the highest available strike price that is less than the applicable stock price], (4) the taxpayer is not an options dealer who granted the option in connection with his activity of dealing in options, and (5) gain or loss on the option is capital gain or loss.

In Rev. Rul. 2002-66, the IRS ruled that if a taxpayer owns stock on which he or she has written a qualified covered call option and acquires a put option on the same stock, the presence of the put option causes the stock and qualified covered call option to constitute a larger straddle and, thus, it no longer qualifies for the exception to the straddle rules. The taxpayer is then subject to the loss deferral and other restrictions applicable to straddle positions, as discussed earlier.

Example 1E-6 Acquiring a put option disqualifies covered call option from straddle exception.

On October 3, 2017, Tom purchases 100 shares of ABC Corp. for $102 per share. On October 7, 2017, when the FMV of ABC stock is $100, Tom writes a 12-month qualified covered call option on the 100 shares with a strike price of $110. On December 5, 2017, when the FMV of the stock remains at $100, Tom purchases a 12-month put option on 100 shares of ABC stock with a strike price of $95.

Before December 5, 2017, the combination of the qualified covered call option and the underlying ABC stock are not treated as a straddle for purposes of IRC Secs. 1092 and 263(g). However, beginning on December 5, 2017, all of Tom's positions in ABC stock are part of a larger straddle, so the exception for covered call options no longer applies to any of them beginning on that date. Thus, a loss realized on any part of the straddle (i.e., the ABC stock, the call option, or the put option) after December 5, 2017, could be recognized only to the

extent it exceeded any unrecognized gain in the offsetting positions (determined at the close of the tax year). (See Example 1E-5.)

Example 1E-6 follows the facts of an example found in Rev. Rul. 2002-66. One of the assumptions the IRS makes in its example is that each option position substantially diminishes the risk arising from holding the equity position. Unfortunately, however, the IRS does not state in the ruling when an option is deemed to substantially diminish the risk of holding the equity position, nor is it readily apparent how the IRS defines this term. Nevertheless, practitioners should be aware of this requirement when applying the straddle rules.

Section 1256 Contracts

IRC Sec. 1256 was enacted to curb abuse in the futures contract markets whereby taxpayers could accelerate the recognition of loss on a contract even though they held another contract with an offsetting but unrealized gain that would be recognized in the future. The abuse has been curtailed by requiring each Section 1256 contract held by the taxpayer at the end of the year to be treated as having been sold at FMV on the last day of the business year (i.e., marked to market). When the contract is subsequently closed in a future tax year, gain or loss realized is adjusted to account for gain or loss resulting from the prior year's marking to market. Any gain or loss from a Section 1256 contract is automatically treated as 60% long-term and 40% short-term capital gain or loss. Any loss on a Section 1256 contract recognized due to the mark to market rules is exempt from the wash sale rules described later in this lesson.

A *Section 1256 contract* is defined as any—

1. regulated futures contract (i.e., a contract that is traded on or subject to the rules of a qualified board or exchange, and for which the amount that must be deposited or withdrawn depends on a system of marking to market);

2. foreign currency contract (i.e., forward purchases or sales of foreign currency);

3. nonequity option (e.g., listed options on commodities, futures, foreign currencies, etc.);

4. dealer equity option (i.e., an equity option granted or purchased by an options dealer in the course of the dealer's business as a market maker in listed options); or

5. any dealer securities futures contract.

The term *Section 1256 contract* shall not include—

1. any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract; or

2. any 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.

The taxpayer (other than a corporation) can elect to carry a net Section 1256 loss back to the three previous tax years. A net Section 1256 loss for the year is the lesser of (1) the net loss on Section 1256 contracts for the year, or (2) the amount allowable as a capital loss carryover for the year. The amount that can be carried back cannot exceed the net Section 1256 gains for the year to which the loss is carried. A net Section 1256 gain for the year is the lesser of (1) the capital gains for the year considering only gains and losses from Section 1256 contracts, or (2) capital gain net income for the year. The election is made by checking box D on Form 6781 (Gains and Losses From Section 1256 Contracts and Straddles).

Example 1E-7 Marked-to-market treatment of Section 1256 contracts.

John, a speculator, had an open position on a corn contract on December 31, 2016, with an unrealized profit of $3,500, which he recognized in 2016 per IRC Sec. 1256. When he closed the contract in June 2017, he realized a profit on the contract of only $2,000 (reflecting a price decline since December 31, 2016).

John also entered into a futures contract in 2016 calling for delivery of 10,000 bushels of soybeans in May 2018 at $6 per bushel. On December 31, 2017, John still holds the contract, and the May soybean futures price has declined to $5.50 per bushel. How does John treat the decline in the price of the soybean futures on December 31, 2017?

In 2017, John recognizes a $1,500 loss on the corn contract and a $5,000 (10,000 × $.50) loss on the soybean futures contract. The aggregate loss of $6,500 is treated as $3,900 (60% × $6,500) long-term and $2,600 (40% × $6,500) short-term. John reports the transaction on Form 6781, Part 1. Additionally, he can elect (on Form 6781) to carry a net Section 1256 loss back to the three previous tax years as discussed previously.

Example 1E-8 Section 1256 treatment when contract is closed.

Assume the same facts as in Example 1E-7. In March 2018, John closes out the soybean contract by offset when the May price is $6.75. How much gain does he recognize from this transaction in 2018?

The contract is again marked to market in 2018 for a total gain of $7,500 [($6.75 − $6.00) × 10,000)]. However, this gain is adjusted to reflect the $5,000 loss recognized in 2017. As a result, John recognizes a total gain of $12,500 in 2018. The gain is treated as a $7,500 (60% × $12,500) long-term and a $5,000 (40% × $12,500) short-term capital gain.

(Contract prices used in Examples 1E-7 and 1E-8 may not reflect current market conditions.)

Short Sales of Borrowed Securities

What Is a Short Sale?

A *short sale* occurs when a taxpayer sells borrowed securities. A short seller is betting that the price of the securities will decline. If it does, he or she can buy the securities (at the lower price) to replace those borrowed and sold short, and profit from the price difference. The short sale itself is not a taxable transaction. However, when the seller covers by delivering securities to the lender to replace those borrowed for the original short sale, a taxable sale is completed. While the short position is open, the taxpayer is charged interest to the extent the market value of the securities rises above the sales price plus commissions.

General Tax Consequences

Taxable gain or loss is computed based on the difference between the proceeds from the short sale and the tax basis of the securities delivered to cover. The holding period of the securities used to cover generally determines whether the gain or loss is short- or long-term. However, special holding period rules apply to prevent taxpayers from using short sales to convert short-term gains into long-term gains and long-term losses into short-term losses. These special rules under IRC Sec. 1233 are as follows:

1. If, on the date of the short sale, substantially identical property has been held by the taxpayer (or spouse) for a period less than one year (or if substantially identical property is acquired after the short sale, but before the closing of the short sale by replacement of the borrowed securities), the holding period is deemed short-term regardless of how long the securities actually used to cover have been held. This rule applies only to gains.

2. If, on the date of the short sale, substantially identical property has been held by the taxpayer (or spouse) for more than one year, any loss from the short sale will be deemed to be long-term regardless of the holding period of the securities actually used to cover. This rule applies only to losses.

3. These deemed holding period rules apply only to the quantity of shares sold short.

The term *substantially identical property* is to be applied according to the facts and circumstances in each case. See Reg. 1.1233-1(d)(1) for some examples.

Example 1F-1 Recognizing gain or loss on a short sale.

On March 14, 2017, Jenny borrows 100 shares of MXL stock from her broker and sells it short for $5,000 ($50 a share). She did not own any MXL stock at the time. On April 28, 2018, Jenny purchases 100 MXL shares for $6,000 and delivers them to her broker to close the short sale. Jenny does not report any gain or loss from the short sale until April 28, 2018, the date she closes it. She reports a $1,000 short-term capital loss in 2018 because the holding period for the delivered stock was less than one year.

Variation: Assume that when Jenny sold the stock short, she held 100 shares of MXL stock she had acquired in January 2017 for $3,500. Here, Jenny's MXL stock is considered an appreciated financial position subject to the constructive sale rules. Thus, she must recognize a $1,500 short-term capital gain on March 14, 2017, the date she enters into a constructive sale of her MXL stock (the date of the short sale of other MXL stock).

Transferring borrowed stock to cover a short sale obligation does not close that sale. The sale remains open until it is finally discharged (generally, by delivering stock that the taxpayer owns or purchases to the second lender). However, if property sold short becomes substantially worthless before being delivered to close the transaction, the short sale is treated as closing and gain is recognized as of the date the property became substantially worthless. This prevents a taxpayer from deferring gain recognition.

Example 1F-2 Reconciling short sale proceeds.

Sally sold several stocks in her investment portfolio during 2017. The proceeds from these sales totaled $189,500. She also sold short 100 shares of Bubble.com stock for $62,200 on December 9, 2017, and the short position was still open on December 31, 2017. However, Blue Sky Securities, Inc., Sally's brokerage firm, reported sales proceeds of $251,700 ($189,500 + $62,200) on the Form 1099-B issued to her.

The IRS will expect Sally's 2017 Form 8949 to reflect securities sales of $251,700 (i.e., match the Form 1099-B amount). To help avoid an IRS matching notice for the short sale, when Sally reports the transaction on line 1, Part 1 of Form 8949, she should enter code "O" in column (f) and <62,200> in column (g).

Applying the Constructive Sale Rules

The Section 1259 constructive sale rules that apply to taxpayers holding appreciated financial positions also apply to certain short sale transactions. With regard to short sales, the constructive sale rules cause a taxpayer owning an appreciated security who enters into a short sale with respect to that security to recognize gain at the time of the short sale (rather than when the short sale is closed). This rule, which effectively eliminates short-against-the-box as a year-end gain deferral technique, applies unless an exception to the constructive sale rules applies.

Rev. Rul. 2002-44 clarifies how the constructive sale rules apply when a taxpayer acquires stock to close an appreciated short position. Under the ruling, if a taxpayer is holding a short position that has increased in value (because the underlying asset has decreased in value), merely acquiring the property to close the sale will trigger the gain (under the constructive sale rules), regardless of Reg. 1.1233-1(a)(1), which says gain or loss is recognized on the date the property is delivered to close the sale.

Example 1F-3 Recognizing loss on a short sale.

Courtney sells 100 shares of Acme Inc. (a publicly traded stock) short on October 24, 2017, when Acme is trading at $40 per share. Courtney does not own any Acme, Inc. stock. On December 26, 2017, Acme is trading at $43 per share, so Courtney's short position has declined in value. She instructs her broker to acquire 100 shares of Acme to close her short sale. The trade date of the purchase is December 26, 2017, but the shares are not delivered to the lender to close the short sale until January 2018. Courtney does not realize her loss on the short sale until January 2, 2018.

Example 1F-4 Recognizing gain on a short sale.

Assume the same facts as Example 1F-3, except that on December 26, 2017, the Acme Inc. stock is worth $35 per share. Now, Courtney's short position is an appreciated financial position. So, when her broker purchases

(on her behalf) the stock to close the transaction on December 26, 2017, the constructive sale rule applies. Courtney recognizes her gain on the short sale on December 26, 2017 (the trade date), even though the shares are not delivered to the lender to close the sale until January 2, 2018.

Applying the Wash Sale Rules

Under IRC Sec. 1091(e), wash sale principles also apply to short sale loss transactions when another short sale of substantially identical securities is entered into within 30 days before or after the closing of the short sale giving rise to a loss. (Wash sales are discussed more fully later in this lesson.)

Example 1F-5 Short sale that is also a wash sale.

Will is convinced that DiveTech's stock value will decline, so on October 14, 2017, he sells 1,000 shares short at $30. The stock rises, and on December 6, 2017, DiveTech is selling for $35 a share. Will could use a 2017 short-term loss for tax purposes, so on December 6, 2017, he buys 1,000 shares at $35 and covers his short position. With his $5,000 short-term loss presumably recognized in 2017, Will sells another 1,000 shares of DiveTech short at $35 on December 9, 2017, because he is still convinced that DiveTech inevitably will decline.

In this case, Will entered into a short sale of identical stock three days after the December 6, 2017, closing of his original short position that gave rise to the $5,000 loss. Will's $5,000 loss will be deferred and added to the tax basis of the securities eventually delivered to close out his December 9, 2017, short position.

Payments in Lieu of Dividends

Dividends paid on stock that has been sold short are payable to the shareholder of record (i.e., the party that purchased the stock from the short seller) because neither the short seller nor the lender retains any legal ownership in the stock. To compensate the lender for the loss of the dividend, the short seller must make a payment in lieu of dividends to the lender.

Example 1F-6 Treatment of "in lieu of" dividends by the short seller.

On November 7, 2017, Tom sells 1,000 shares of Nukes, Inc. short at $45 a share. On December 9, 2017, Nukes declares a $1.50 per share dividend payable to shareholders of record on December 16, 2017. Tom makes a $1,500 in lieu of dividend payment to the lender on December 24, 2017. As of December 31, 2017, Tom has not closed the short sale transaction (and he is not subject to the constructive sale rules).

Generally, payments in lieu are deductible by the seller as investment expenses under IRC Sec. 212. However, since they resemble amounts paid for the use of money, they are subject to the investment interest limitations and are deductible only to the extent of net investment income. The $1,500 payment is reported by Tom on Form 4952 (Investment Interest Expense Deduction). To the extent the payment is not limited by the investment interest rules, it is deducted as investment interest expense on Schedule A.

Incentive Stock Options, Nonqualified Stock Options, and Other Information about Employee Stock Options

Two basic kinds of stock options are received as compensation by employees—incentive stock options (ISOs, also referred to as qualified or statutory stock options) and nonqualified stock options (NQSOs).

Incentive Stock Options

An ISO can have both regular tax and alternative minimum tax (AMT) implications. Generally, the recipient of an ISO recognizes no income for regular tax purposes and the 3.8% NIIT does not apply upon the grant (when the option is received) or the exercise (when converting the option to stock) of the ISO. The price at which the option is exercised becomes the taxpayer's basis in the stock; the taxpayer then recognizes income on the difference between his basis and the sales price when the stock is sold. When stock received from the exercise of an ISO is sold, the transaction receives capital gain treatment if the participant has held the stock for at least one year, and the ISO was granted at least two years before.

If this holding period requirement is not met, the taxpayer will have a disqualifying disposition when the stock is sold. Generally, if the employee sells the stock within two years of the grant date or one year of the exercise date, the difference between the option (exercise) price and the fair market value (FMV) on the date it is exercised (i.e., the bargain element) is ordinary income to the employee. If the amount realized upon the sale of the stock exceeds the FMV at the exercise date, the excess of sales price over the FMV at the exercise date is capital gain. However, if the amount realized is less than the FMV at the date of exercise and greater than the exercise price, only the excess of the amount realized (not the FMV) over the exercise price is taxed as ordinary income. This limitation on compensation income recognized only applies if the disposition is a sale or exchange on which a loss, if sustained, would be recognized. For example, if the stock is sold to a related party (under IRC Sec. 267) at a price less than the FMV at the date of exercise, the compensation amount is the excess of the exercise price over the option price. If the amount realized is less than the exercise price, the excess of the exercise price over the amount realized is a capital loss.

Example 1G-1 Disqualifying disposition of ISO stock.

Brian is an executive with Gem Corp. In January 2015, he was granted ISOs to purchase 2,000 shares of Gem's stock at $50 per share (which was the market price of its stock on that date). Brian exercises the options in February 2017 when the stock is trading at $61 per share; no regular tax consequences occur. His regular tax basis in the 2,000 shares is $100,000 (the exercise price). (However, AMT tax consequences exist at the time of exercise. See the discussion following this example.)

Brian sells the 2,000 shares in December 2017 for $134,000 (2,000 shares × $67 per share), realizing a $34,000 ($134,000 − $100,000) gain for regular tax purposes. Brian's sale of the stock within one year of the date the option was exercised is a disqualifying disposition. Therefore, Brian must recognize $22,000 (of the total $34,000) as ordinary income for regular tax purposes in 2017, computed as follows:

	Value of stock on exercise date (2,000 shares × $61)	$ 122,000
	Exercise price paid (2,000 shares × $50)	(100,000)
(1)	Excess of value over exercise price	$ 22,000
	Amount realized from the stock disposition (2,000 shares × $67)	$ 134,000
	Exercise price paid (2,000 shares × $50)	(100,000)
(2)	Excess of amount realized over exercise price	$ 34,000
	Ordinary income [lesser of (1) or (2)]	$ 22,000

The $22,000 is compensation income and is reported to Brian on either Form W-2, box 1 (for employees), or Form 1099-MISC (for former employees). The remaining $12,000 of gain realized on the sale ($34,000 − $22,000) is short-term capital gain (reported on Form 8949 and Schedule D) because Brian held the stock for one year or less.

An employee has three months after termination of employment to exercise an ISO. The option generally must be exercised within three months of the employee's last day of employment by the corporation, its parent, or its subsidiary. Thereafter, the option becomes nonqualifying, resulting in less favorable tax treatment. If an employee terminates employment because of permanent and total disability, the period is extended to one year.

When an ISO is exercised, the employer must furnish a statement to the participant. It should include such data as the FMV of the stock received, the exercise price per share, and the tax consequences of the exercise of the option and the eventual sale of the stock. Practitioners should review this information during the return preparation process.

Mergers. The IRS issued guidance on whether stock purchased through an employee's ISO is considered disposed of when the employer is merged into another corporation. In the first scenario, the stock is exchanged through a merger qualifying as a Section 368(a) reorganization. The exchange of stock, in this instance, is not a disposition, and the employee's stock satisfies the holding period requirements under IRC Sec. 422(a)(1).

However, gain is recognized for cash (boot) received in the exchange. When the stock is ultimately sold, capital gain is recognized on the qualifying disposition. In the second scenario, the merger does not qualify as a reorganization under IRC Sec. 368(a); thus, the stock is deemed to be disposed of on the date of the exchange. Since the employee has not satisfied the holding period requirements at the time of the exchange, the excess of FMV over the exercise price of the stock is taxable as compensation (ordinary income) from the disqualifying disposition and the boot received is capital gain.

AMT Considerations. The difference between the option price and the FMV on the date the option is exercised (unless the stock is subject both to restrictions on transferability and a substantial risk of forfeiture) is a positive AMT adjustment, increasing alternative minimum taxable income (AMTI), which may trigger AMT in the year an ISO is exercised. The taxpayer's stock basis for AMT is FMV at the date of exercise (cost plus amount included in AMTI as an adjustment). A taxpayer disposing of the stock will have a negative AMT adjustment for the excess of the basis for AMT over the basis for regular tax. If the stock is disposed of in the same year as exercise, the two adjustments will offset, and the tax effect will be the same for both regular tax and AMT. A taxpayer may avoid the application of AMT resulting from an ISO exercise by staggering it so that the adjustment does not trigger AMT.

Payroll Tax Issues. The compensation from a disqualifying disposition of an ISO is reported on the employee's (or former employee's) Form W-2 in box 1 in the year of the stock disposition. However, it is not subject to FITW or to FICA or FUTA taxes. If a disqualifying disposition occurs after an employee's death, the employer must report the ordinary income to the deceased employee's estate or beneficiary on Form 1099-MISC.

Nonvested Stock. The stock received upon exercising an ISO may be subject to forfeiture (i.e., nonvested). For regular tax, receiving nonvested stock is no different from receiving vested stock if the holding period requirements are met. However, if the nonvested stock is sold in a disqualifying distribution (i.e., after it vests but before the holding period requirements are met), the ISO rules no longer apply. Therefore, compensation income is recognized at the sale date, equal to the excess of the stock's FMV on the date it vests (or, if less, the sales price, assuming the sale is not subject to loss deferral) over the exercise price. The stock's holding period begins on the vesting date.

Example 1G-2 Nonvested stock received by exercising an ISO.

In June 2015 , Courtney, an executive with Round Top Enterprises, is granted an ISO to purchase 100 shares of stock at $100 per share. When the option is exercised, the stock cannot be transferred for six months. Courtney exercises the option in February 2016 when the stock price is $120 a share. On August 10, 2016, the stock vests when trading for $130 a share. In February 2017, Courtney sells the stock for $150 a share. This is a disqualifying disposition because the ISO was granted less than two years before the stock was sold. Courtney recognizes compensation income of $3,000 [($130 − $100) × 100]. She also recognizes capital gain of $2,000 [($150 − $130) × 100]. This is a short-term capital gain because Courtney's holding period began on August 11, 2016 (the day the stock vested).

Corporations must furnish a written statement to the IRS containing specific information on employees who exercise ISOs or who receive stock under an employee stock purchase plan (ESPP) after November 16, 2009. The information required for ISO stock transfers is reported on Form 3921 [Exercise of an Incentive Stock Option Under Section 422(b)]. For ESPP stock transfers, the required information is reported on Form 3922 [Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c)].

Nonqualified Stock Options (NQSOs)

An NQSO is any option that is not a qualified stock option, as defined in IRC Sec. 422. Unlike ISO holders who meet the required holding period, the recipient of an NQSO is not allowed either to defer income recognition on the bargain element until the stock is sold or to have all the income associated with the option treated as capital gain.

Generally, the excess of the stock's FMV when the option is exercised over the option price (i.e., the bargain element) is taxable as compensation in the year of exercise. However, if the FMV of the option is readily ascertainable when the option is granted, income will be recognized then rather than when the option is exercised. From an employee's perspective, this may be the most advantageous time for income recognition if the stock value increases significantly after the option is granted. Unfortunately, if the option is not traded, it can be difficult to

determine whether the option has a readily ascertainable FMV. An option does not have a readily ascertainable FMV unless the following conditions are met:

1. The option may be transferred freely.

2. The option is exercisable immediately in full.

3. There are no restrictions on the option or stock that have a significant effect on the FMV of either.

4. The FMV of the option privilege can be determined by the value of the property subject to the option, the probability of an increase or decrease in value, and the length of the option period.

The burden is on the taxpayer to prove that an option has a readily ascertainable value. Most NQSOs do not have a readily ascertainable value, and are therefore not taxed at the grant date.

Example 1G-3 Taxation of NQSOs.

Tom is an executive with Smith Corp., a closely held company. On March 1, 2013, he was granted NQSOs to purchase 3,000 shares of Smith Corp. stock at $30 per share (which was the market price of the stock on that date). The options have some restriction on transferability and therefore do not have a readily ascertainable FMV. Tom exercises the options on March 3, 2017, when the stock is trading at $45 per share.

Since the options had no readily ascertainable FMV at the grant date, there was no taxable event on that date. However, Tom must recognize $45,000 ($15 per share bargain element × 3,000 shares) of ordinary compensation income in 2017 when the options are exercised. Tom's basis in the stock is $135,000, or $45 per share ($30 per share option price + $15 per share compensation income × 3,000 shares). If he holds the stock as a capital asset for more than one year before he sells it, he will receive long-term capital gain (or loss) treatment.

Variation: If the options themselves had a readily ascertainable FMV of $5 per option at the date of grant (March 1, 2013), the value of the options ($5 × 3,000 = $15,000) is taxable to Tom in 2013 as ordinary compensation income. There would be no tax consequences to Tom in 2017 when he exercised the options. Tom's basis in the stock would be $105,000, or $35 per share (option price of $30 per share + $5 per option of compensation income recognized). If Tom holds the stock as a capital asset for more than one year after exercise before he sells it, he will receive long-term capital gain (or loss) treatment.

Example 1G-4 Cashless exercise of NQSOs.

Assume the same facts as in Example 1G-3 except that Tom exercises the NQSOs in a cashless transaction. Tom works with a brokerage firm that pays Smith Corp. $90,000 ($30 × 3,000 shares) on March 3, 2017, to purchase the NQSO shares on Tom's behalf. The brokerage firm immediately sells 2,000 shares for $90,000 ($45 per share) and uses the funds to repay Tom's margin loan.

Tom must recognize $45,000 ($15 per share bargain element × 3,000 shares) of ordinary compensation income in 2017 when the options are exercised. His basis in the remaining 1,000 shares of stock is $45,000 or $45 per share ($30 per share option price + $15 per share compensation income × 1,000 shares). If Tom holds the remaining 1,000 shares of stock as a capital asset for more than one year, he will receive long-term capital gain (or loss) treatment when he sells those shares.

The option may pertain to stock that is nontransferable or subject to a substantial risk of forfeiture (i.e., restricted stock). Here, compensation income generally is not recognized until the restrictions lapse, and it is based on the difference between the FMV of the stock when the restrictions lapse less the exercise price. This can be detrimental to the employee if the stock appreciates after the option is exercised and before the restrictions are lifted. Accordingly, if the stock is expected to appreciate, the employee might want to elect under IRC Sec. 83(b) to recognize the income when the option is exercised rather than when the restrictions lapse based on the appreciated value.

In *Hilen*, the taxpayer borrowed funds from a commercial bank, used the borrowed funds to exercise stock options, and pledged the stock as collateral for the bank loan. The taxpayer recognized income equal to the difference

between the exercise price and the FMV and paid taxes on that gain. The stock subsequently declined in value, the taxpayer defaulted on his bank loan, and he filed an amended return reversing the recognition of income on the option gain. The taxpayer claimed the option exercise was nonrecourse financing, that he should not have to bear the risk of market value decline, and the recognition of gain should be delayed until he made a substantial payment on the debt. The court ruled the debt was recourse financing and the taxpayer must recognize income from the exercise of his NQSOs as stated in the original tax return.

If the sale of property (e.g., stock) at a profit could subject a person to suit under Section 16(b) of the Securities Exchange Act of 1934, that person's rights to such property are subject to a substantial risk of forfeiture. For stock acquired as a result of exercising an NQSO granted prior to an IPO, the six-month holding period for Section 16(b) generally begins when the NQSO was granted, not when it was exercised.

In *Sheedy*, the Tax Court held that stock received on exercise of an NQSO was not worthless on the exercise date (September 2006) even though the company declared bankruptcy in March 2007. As a result, the taxpayer had to include in 2006 gross income the difference between the FMV of the stock on the exercise date ($750,000) less the amount paid to acquire the stock ($5,533.75). However, the Tax Court agreed with the IRS that the taxpayer was entitled to a worthless stock deduction for 2007 (limited to $3,000) and a capital loss carryover of $747,000.

Employee Stock Purchase Plans (ESPPs)

Employee stock purchase plans (ESPPs) are plans under which employees are given the right to purchase shares of the employer's stock, usually at a discount. If the ESPP meets the requirements of IRC Sec. 423, employees do not have to pay federal income tax on the discount at the time the option to purchase is provided or exercised. An ESPP must meet the following requirements:

1. Options must be granted only to employees of the employer corporation, its parent, or subsidiary corporation to purchase stock in any such corporation.

2. Stockholders of the granting corporation must approve the plan within 12 months before or after the date it is adopted by the corporation's board of directors.

The terms of an offering made under the plan must meet the following requirements:

1. No employee can be eligible to participate if immediately after the option is granted, the employee owns 5% or more of the employer corporation, its parent, or subsidiary corporation.

2. Options must be granted to all employees of any corporation whose employees are granted any options by reason of their employment by the corporation, except the plan can elect to exclude—

    a. employees who have been employed less than two years;

    b. employees whose customary employment is 20 hours or less per week;

    c. employees whose customary employment is for not more than five months in any calendar year;

    d. highly compensated employees (HCEs) [within the meaning of IRC Sec. 414(q)]; and

    e. employees who are citizens or residents of a foreign jurisdiction, if granting an ESPP option is prohibited under the laws of the foreign jurisdiction, or compliance with the laws of the foreign jurisdiction would violate the Section 423 requirements.

3. All employees must have the same rights and privileges, except that the amount of stock that may be purchased may bear a uniform relationship to compensation and the plan may provide for a maximum amount of stock that may be purchased under the plan.

4. The option price cannot be less than the lesser of—

    a. 85% of the FMV of the stock at the time the option is granted, or

    b. 85% of the FMV of the stock at the time the option is exercised.

5. The option cannot be exercised after the expiration of—

   a. five years from the date the option is granted if, under the terms of the plan, the option price cannot be less than 85% of the FMV of the stock at the time of the exercise, or

   b. 27 months from the date the option is granted, if the option price is not determinable in the manner described in a.

6. No employee may be granted an option that permits his or her rights to purchase stock under all such plans of the employer corporation, its parent, and subsidiary corporations to exceed $25,000 of the FMV of such stock (determined at the time the option is granted) for each calendar year the option is outstanding at any time.

7. The option cannot be transferable by the employee other than by will, or the laws of descent and distribution, and is exercisable, during life, only by the employee.

Payroll Tax Issues. Options received from an ESPP are taxed like ISOs (i.e., no compensation income to the employee on grant or exercise of the option). The income arising from the exercise of an ESPP option is not subject to FICA or FUTA taxes. Furthermore, such exercises are not subject to federal income tax withholding (FITW).

Income Tax Consequences upon Qualifying Dispositions. An employee who disposes of ESPP shares in a qualifying disposition (i.e., a sale more than two years from the date the options were granted and one year after the options were exercised) recognizes compensation income of the lesser of (a) the FMV of the stock at the time the option is granted over the option price or (b) the excess of the FMV of the stock at the time of sale over the price paid for the stock. However, the compensation income is not subject to FITW, FICA, or FUTA. The excess, if any, of the sales price of the stock over the employee's basis in the stock is capital gain income to the employee. The employee's basis in the stock equals the sum of the amount paid for the option plus the amount included in income as compensation. For these rules to apply, the employee must have remained an employee of the company at all times from the grant date until three months prior to the exercise date.

Income Tax Consequences upon Disqualifying Dispositions. An employee who disposes of ESPP shares in a disqualifying disposition (i.e., a sale within two years from the date the options were granted or one year from the date the options were exercised), recognizes ordinary (compensation) income for the difference between the FMV of the stock at the exercise date minus the amount the employee paid to exercise the option.

Ordinary income from a disqualifying disposition is reported on the employee's (or former employee's) Form W-2 in the year of the stock disposition, and the employer takes a compensation deduction in its tax year that includes the date of the disqualifying disposition. The Form W-2 or W-2c must be furnished to the employee (or former employee) and filed by the date the employer files the return or amended return claiming the deduction related to the disqualifying disposition. Therefore, to be able to claim a compensation deduction following a disqualifying disposition of an ESPP under the Section 83 regulations, the employer should prepare and furnish Form W-2 or W-2c within the applicable time limits. If a disqualifying disposition occurs after an employee's death, the employer must report the ordinary income to the deceased employee's estate or beneficiary on Form 1099-MISC [assuming the $600 reporting threshold under IRC Sec. 6041(a) is met]. According to the Form 1099-MISC instructions, such payments are entered in box 3 and are subject to the general backup withholding rules. See *PPC's Payroll Tax Deskbook* for information on backup withholding.

Neither FICA nor FUTA taxes apply to the income received upon the disqualifying disposition of stock acquired by an employee pursuant to the exercise of an ESPP option. Also, the disposition is not subject to FITW. However, although FICA, FUTA, and FITW do not apply, individuals must include in income all compensation resulting from a disqualifying disposition of stock acquired by exercising an ESPP stock option.

The difference between the employee's basis in the stock and the stock's sales price is capital gain or loss to the employee. The employee's basis in the stock equals the sum of the amount paid for the option plus the amount included in income as compensation.

Identifying Ordinary Income and Capital Gain under the Anticonversion Rules

With the significant tax rate advantage for long-term capital gains, Congress enacted provisions to restrict taxpayers from artificially converting ordinary income into capital gains (a conversion transaction). These rules provide that gains are treated as ordinary income if they are primarily related to the time value of money (i.e., economically similar to interest income received from a loan) rather than economic reward for putting one's capital at risk in an investment.

A conversion transaction is any one of the following transactions if substantially all of the taxpayer's expected return is attributable to the time value of the taxpayer's net investment in the transaction:

1. The holding of any property (whether or not actively traded), and the making of a contract to sell that property (or substantially identical property) at a price determined in accordance with the contract, but only if it was acquired and the contract was made on a substantially contemporaneous basis.

2. Any applicable straddle [i.e., any straddle within the meaning of IRC Sec. 1092(c) except that stock is also treated as personal property in defining a straddle for this provision].

3. Any other transaction that is marketed or sold as producing capital gains from a transaction if substantially all of the taxpayer's expected gain from it is attributable to the time value of the taxpayer's net investment in the transaction. This category is limited to transactions marketed or sold on the basis of having the economic characteristics of a loan and an interest-like return that will be taxed as capital gain.

4. Any other transaction specified in regulations issued by the IRS.

Under the anticonversion rules, any gain normally treated as capital gain realized from the disposition (or other termination) of a position held as a part of a conversion transaction is treated as ordinary income (but not as interest). The amount of gain recharacterized will not exceed the amount of interest that would have accrued on the taxpayer's net investment for the term of the conversion transaction at a yield equal to 120% of the applicable rate. This limit is subject to appropriate reduction to reflect prior inclusion of ordinary income items from the conversion transaction or the capitalization of interest on acquisition indebtedness under IRC Sec. 263(g), which relates to straddle transactions. If the conversion transaction has a definite term, the applicable rate is the semiannual applicable federal rate (AFR) (appropriate for the term of the transaction) when the taxpayer enters into the transaction. If the conversion transaction has an indefinite term, the applicable rate is the federal short-term rate determined under IRC Sec. 6621(b) compounded daily.

Example 1H-1 Recharacterizing gain on a conversion transaction.

Adam purchased investment property for $100,000 on January 4, 2016, and on that same day agreed to sell it to Andy for $115,000 on December 31, 2017. On December 31, 2017, Adam delivered the property to Andy for $115,000 in satisfaction of their agreement. Without the anticonversion rules, the entire $15,000 gain would be long-term capital gain. However, because this is a conversion transaction, some or all of the gain must be recharacterized as ordinary income. The amount that must be recharacterized is limited to Adam's investment of $100,000 times 120% of the short-term semiannual AFR on January 4, 2016, or 0.90% (0.75% × 120%), for the term of the transaction. Thus, $900 ($100,000 × 0.90%, compounded semiannually for two years) of the $15,000 is recharacterized as ordinary income. The remaining $14,100 is long-term capital gain.

A special rule applies when the taxpayer has a built-in loss on a position that becomes part of a conversion transaction. Upon disposition or other termination of such position, the built-in loss is recognized, and the character of the loss is not affected by the anticonversion rules.

Because these rules convert the character of gains (not losses) from capital to ordinary, an inequity can occur if the positions of a single conversion transaction are closed out in separate transactions, one or more of which result in a loss. To alleviate this potential mismatch, Reg. 1.1258-1 allows taxpayers to net gains and losses (other than built-in losses) related to each conversion transaction provided (1) all positions are closed out within a 14-day period in a single tax year, and (2) each position is identified on the taxpayer's books and records before the close of the day it becomes part of a conversion transaction.

Considerations for Qualified Small Business Stock

Qualified small business stock (QSBS) (also known as Section 1202 stock) is stock originally issued after August 10, 1993, by a C corporation with aggregate gross assets not exceeding $50 million at any time from August 10, 1993, to immediately after the issuance of the stock. The taxpayer must have acquired the stock at its original issue, or in a tax-free transaction such as a gift, inheritance, or partnership distribution.

In addition, the corporation must meet an active business requirement whereby 80% or more of its assets are used in one or more businesses other than those specifically excluded. Ineligible businesses include certain personal service activities (health, law, engineering, accounting, etc.), banking and other financial services, farming, mineral extraction businesses, and hotels and restaurants. Thus, businesses such as manufacturing, wholesale or retail trade, and transportation activities generally qualify. QSBS can be acquired either in exchange for money or other property (but not stock) or as compensation for services.

When QSBS is sold, the normal capital gain and loss rules apply unless the stock is sold for a gain and either (1) held for more than five years under the gain exclusion rule, or (2) held for more than six months and the sales proceeds are rolled over into other QSBS within 60 days under the Section 1045 rollover rules.

Gain Exclusion

Depending on when acquired, a percentage of gain realized on the sale of QSBS stock held for more than 5 years may be excluded from taxation. The applicable percentages are as follows:

- For QSBS acquired before February 18, 2009, 50% of gain may be excluded with the remaining gain taxed at a 28% rate [IRC Sec. 1202(a)(1); IRC Sec. 1(h)(4)(A)(ii)]. 7% of the excluded gain is an AMT preference item [IRC Sec. 57(a)(7)].
- For QSBS acquired after February 17, 2009 and before September 28, 2010, 75% of gain may be excluded with the remaining gain taxed at a 28% rate [IRC Sec. 1202(a)(3); IRC Sec. 1(h)(4)(A)(ii)]. 7% of the excluded gain is an AMT preference item [IRC Sec. 57(a)(7)].
- For QSBS acquired after September 27, 2010, 100% of gain may be excluded [IRC Sec. 1202(a)(4)]. No part of the sale is an AMT preference item [IRC Sec. 1202(a)(4)(C)].

The gain eligible for exclusion for each taxpayer is limited on a per issuer basis and cannot exceed the greater of (1) $10 million reduced by the taxpayer's aggregate prior-year gains from stock of the same issuer, or (2) 10 times the taxpayer's basis in his or her QSBS from such corporation disposed of during the year.

Rollover of QSBS Gain

Under IRC Sec. 1045, noncorporate taxpayers who realize a gain from the disposition of QSBS held more than six months can elect to roll over (defer) the gain to the extent they acquire QSBS during the 60-day period beginning on the date of the sale. Gain is recognized to the extent the sales proceeds exceed the cost of replacement stock(s) reduced by any part of the cost of the replacement QSBS that was previously taken into account to defer recognition of gain on the sale of other QSBS. Gain treated as ordinary income is not eligible for rollover. When determining whether the replacement QSBS meets the Section 1202(c)(2) active business requirement, only the first six months the taxpayer holds the stock is considered.

The basis in the QSBS acquired is reduced for any gain deferred. In addition, the holding period of the replacement stock generally will include the holding period of the stock sold, except the replacement stock must be held for more than six months to accomplish another tax-free rollover.

Example 1I-1 Rollover of gain on QSBS.

Charlie invests $400,000 in Eagle Corp., a manufacturing concern, on August 26, 2016. Eagle stock qualifies as QSBS under IRC Sec. 1202(c). On October 6, 2017, Charlie sells the Eagle stock for $625,000, resulting in a $225,000 gain. On October 20, 2017, he purchases stock in newly formed Hawk Corp. for $600,000. His Hawk stock also qualifies as QSBS.

Charlie elects to roll over the gain from the sale of the Eagle stock. Accordingly, he recognizes only $25,000 of the gain because this is the amount the sales proceeds ($625,000) exceed his investment in Hawk ($600,000). His basis in his Hawk stock is $400,000 ($600,000 cost less deferred gain of $200,000). His holding period in Eagle stock is added to the holding period of the Hawk stock for all purposes except for determining whether Hawk meets the active business requirement for the six-month period following purchase.

A taxpayer (other than a C corporation) that sells QSBS and elects to defer gain can satisfy the replacement QSBS requirement with QSBS that is purchased within the statutory period by a partnership in which the taxpayer is a partner on the date the QSBS is purchased (purchasing partnership). In addition, an eligible partner of a partnership that sells QSBS (selling partnership) and elects to defer gain can satisfy the replacement QSBS requirement with QSBS purchased by a purchasing partnership during the statutory period.

Options Do Not Qualify

Affirming the Tax Court, the 9th Circuit held that the word "stock" for purposes of the gain exclusion for the sale of QSBS does not include options to acquire the stock. As part of a merger agreement, the taxpayer's options were converted into options to purchase Intel stock. The taxpayer exercised his options and sold the Intel stock on the same day for a $295,285 gain. The taxpayer failed to prove that the target corporation was a qualified small business as required by IRC Sec. 1202(d)(1) or that he held the options for a combined duration of more than five years. Instead, the court ruled that the five-year holding period is determined by counting the time the shares were owned, not the time the stock options were held.

Considerations for Wash Sale Losses

A loss from the sale or disposition of stock or securities is not deductible if, within a period beginning 30 days before the date of the sale and ending 30 days after the date of the sale, the taxpayer acquires substantially identical stock or securities. Stock or securities include stock options, but do not include commodity futures contracts and foreign currencies. In addition, dealers in stocks or securities are not subject to these rules if the loss is from a transaction made in the ordinary course of business. The wash sale rules apply only for losses; gains resulting from wash sales are taxable in the year of sale.

When a wash sale deferred loss transaction occurs, the basis of the substantially identical securities is increased by the realized but unrecognized loss. The holding period of the acquired securities includes that of the original stock sold.

Some taxpayers have tried to circumvent the wash sale rules by having a related party purchase the replacement stock or securities. Although the Section 1091 wash sale rules do not specifically apply to related parties, the courts generally have not allowed the loss in these situations. In *McWilliams*, the court found that the sale by one taxpayer and the purchase by a related taxpayer should be collapsed into a single related party transaction, resulting in loss disallowance under IRC Sec. 267. The Section 267 related party loss disallowance rules are even more onerous than the wash sale rules since they cannot be avoided by timing the sale and repurchase to avoid the 61-day window. Also, the disallowed loss does not automatically increase the basis in the acquired securities. Instead, it can only be used to offset any subsequent gain on a sale by the related party. Taxpayers and their IRAs are related parties. Thus, the sale of a security at a loss would be disallowed if, as part of a plan, the taxpayer's IRA purchased an identical security.

For the wash sale rules to apply, the stocks or securities must be substantially identical. All facts and circumstances must be considered in each case. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. Also, IRC Sec. 1091 is not intended to apply to bona fide sales made to reduce a taxpayer's holdings of a security. Thus, a taxpayer who simply buys 200 shares of a stock and within the next 30 days sells 100 shares at a loss will not have the loss disallowed under the wash sale rules. However, the rules will apply if additional shares are acquired within the 30 days following the sale at a loss.

When a Form 1099-B is received for a loss transaction that is a wash sale, the transaction must be reported on Form 8949 to avoid IRS matching problems.

Example 1J-1 Accounting and reporting for a wash sale.

Robert purchased 100 shares of XYZ Corp. stock on July 7, 2017, for $700. On September 8, 2017, he sold the shares for $500. On September 15, 2017, he purchased another 100 shares of XYZ for $600. Robert received a 2017 Form 1099-B reflecting the $500 sale on September 8, 2017.

Because the sale and subsequent repurchase of the XYZ stock is a wash sale, the $200 loss from the September 8 sale is not deductible. Instead, Robert's basis in the 100 shares acquired on September 15, 2017, is adjusted to $800 [cost of the reacquired shares ($600) plus the disallowed wash sale loss ($200)]. In addition, the holding period for the shares acquired on September 15 includes the July 8–September 8 holding period for the original 100 shares.

The wash sale is reported on Form 8949. Enter code "W" in column (f) and the amount of the nondeductible loss as a positive number in column (g).

Further discussion of the wash sale rules as they apply to sales of mutual fund shares and short sales appeared earlier in this lesson.

The Use of Virtual Currency

Virtual currency, such as the Bitcoin, has been increasing in popularity. 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, but it does not have legal tender status in any jurisdiction. For federal tax purposes, virtual currency is treated as property. As such, it can be classified as business property, investment property, or personal property. General tax principals applicable to property transactions apply to transactions using virtual currency.

Basis in virtual currency is the FMV of the currency on the date the currency is received. If received as payment for services, it is considered taxable income and will be subject to both income and social security taxes. Using the virtual currency to obtain cash or purchase goods is a recognizable transaction. If the FMV of property received for the virtual currency exceeds the taxpayer's adjusted basis in the currency, the taxpayer has a taxable gain. A loss will occur if the FMV is less than the taxpayer's basis. The character of the gain or loss depends on whether the virtual currency is a capital asset for that particular taxpayer.

Example 1K-1 Use of virtual currency for investments.

Arnold believes the Bitcoin will increase in value. He purchases 15 Bitcoins on March 15, 2016, for $1,000 each and 20 Bitcoins on May 19, 2016, for $1,100 each. On April 3, 2017, he sells 10 Bitcoins for $1,050 each. Since Arnold held the Bitcoins for investment purposes, any gain or loss will be capital in nature. If he sells 10 Bitcoins from his March 15 batch, he will recognize a $500 [($1,050 - $1,000) × 10] long-term capital gain. If he sells 10 Bitcoins from the May 19 batch, he will recognize a $500 [($1,050 - $1,100) × 10] short-term capital loss. Since the Bitcoins were held for investment purposes, the short-term capital loss may be included on Arnold's Form 8949 for 2017.

Practitioners should be aware of various unresolved issues related to virtual currency, including the following:

- Since virtual currency is considered property, is it eligible for a Section 1031 like-kind exchange?
- Since virtual currency is considered property, is it eligible for a valuation discount or premium in estate or gift tax situations?
- Should the costs to mine and acquire virtual currency be capitalized?
- Are retirement accounts permitted to hold virtual currency?
- The IRS has not provided guidance on whether virtual currency is a security and thus subject to the dealer rules of IRC Sec. 475 and the wash sale rules.

- Uncertain exchange rates make it difficult to determine fair market value (FMV).
- It is difficult to get appraisals for charitable contribution deductions.
- While it is essential to track basis in virtual currency transactions, the IRS has provided no guidance on which accounting method to use (e.g., LIFO, FIFO, or some other method).

Stock Traders versus Investors

Taxpayers buying and selling securities for their own account generally will qualify as either investors or traders for tax purposes. The distinction between trader and investor is important because the tax rules are generally more favorable for traders. As a general rule, most taxpayers are categorized as investors. However, with the proliferation of online trading and discount brokers, some taxpayers are spending considerable time trading stocks on a regular basis, which may qualify them for trader status.

Taxation of Investors

Investors treat their stock holdings as capital assets and, when shares are sold, report either long-term or short-term capital gains or losses, depending on whether the shares were held for more than one year. The expenses they incur in connection with their stock investing activity are treated as Section 212 expenses incurred for the production of income. These expenses are deductible only as miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) limitation. In addition, these expenses are not deductible in computing the taxpayer's alternative minimum tax (AMT). Any commissions paid in purchasing the securities are capitalized as part of its cost basis while commissions paid at the time of sale reduce the sales proceeds. Any interest expense incurred in the activity is deductible only to the extent of the taxpayer's net investment income.

The Tax Court has held that an investor cannot deduct the cost of a seminar in securities day trading. The taxpayer had taken a Section 212(l) deduction for the course expenses. However, IRC Sec. 274(h)(7) denies a Section 212 deduction for (non-business related) "expenses allocable to a convention, seminar, or similar meeting." The court in *Jones* concluded that the day trading course was a "seminar or similar meeting" within the meaning of IRC Sec. 274(h)(7). The court observed that had Jones been a trader rather than an investor, the course expenses would have been deductible under IRC Sec. 162.

Taxation of Traders

Unlike investors, securities traders are deemed to be conducting a trade or business, so their trading expenses are deductible as ordinary and necessary business expenses under IRC Sec. 162. A trader's business expenses include interest paid on margin accounts used in connection with the trading activity. However, if the taxpayer does not materially participate in the trading activity (e.g., a limited partner in a trader partnership), interest incurred in the activity is subject to the investment interest expense limitation. In addition, a trader's business status makes him or her eligible for claiming a home office deduction, provided the requirements of IRC Sec. 280A(c) are met. Individuals report their trading expenses (including interest on margin accounts) on Schedule C.

When a trader disposes of a stock, the general rule is that the sale is treated as a short-term or long-term capital gain or loss, depending on how long the stock was held. This capital asset treatment occurs because traders do not have customers to whom they sell stock; therefore, their stock does not meet any of the exceptions to capital asset treatment under IRC Sec. 1221. Thus, traders generally report their stock gains and losses as capital gains and losses on Form 8949 and Schedule D and, accordingly, are subject to the $3,000 annual limitation that applies to net capital losses under IRC Sec. 1211(b) and the wash sale rules. The Section 1091 wash sale rules can be particularly detrimental to traders because they defer the recognition of a stock loss when the taxpayer acquires the same stock within a period beginning 30 days before and ending 30 days after the date of sale.

Mark-to-market Election. As an alternative to capital asset treatment, IRC Sec. 475(f) allows traders to elect to mark their stock holdings to market at the end of the tax year. If the election is made, all security gains and losses are treated as ordinary income and all securities on hand at year-end are deemed to be sold at the year-end market value, thus recognizing unrealized gains and losses. For traders, the primary benefit of making the election is that

the $3,000 limitation on net capital losses and the wash sale rules no longer apply. Conversely, the trader is no longer allowed to treat trading activity gains and losses as capital asset transactions, but this should have minimal negative impact since traders by definition should have few, if any, long-term capital gains. The IRS does permit automatic revocation of the Section 475(f) election.

Because capital gains and losses are specifically excluded from the definition of net earnings from self-employment (SE), earnings from a trading activity are not subject to the SE tax. A Section 475 mark-to-market election converting the gains and losses to ordinary income does not change their status for SE tax purposes [IRC Sec. 475(f)(1)(D); see also the Joint Committee on Taxation's General Explanation (Blue Book) to the TRA '97, Act Section 1001(b)]. However, since a trader's net earnings are not SE income, he or she cannot contribute to a retirement plan (e.g., SEP or IRA) based on such income.

Tax Reporting Issues for Stock Traders. Because of the unique tax rules that apply to securities traders, properly reporting trading information on Form 1040 can be a challenge. Practitioners should consider the following reporting issues and recommended solutions:

1. *Schedule C Loss.* Traders who do not make a Section 475 election report no income and only expenses on Schedule C, resulting in a loss on that form. This reporting may get the IRS's attention since Schedule C losses sometimes stem from disallowable hobby losses. To help avoid IRS questions regarding this reporting, a footnote or statement explaining the taxpayer's trader status and the filing implications should be attached to the return.

2. *Reconciling to Forms 1099-B.* Because traders report their security sales on Form 8949, the amounts reported to them on brokers' Forms 1099-B will normally agree with the reported gross proceeds. However, traders who make the Section 475 election treat their trading gains and losses as ordinary income reported on Form 4797 (Part II). The Form 4797 instructions state that these traders should enter the total gross proceeds from Forms 1099-B on line 1 of Form 4797. To help avoid IRS matching notices for gross proceeds shown on Form 1099-B and ultimately reported on Form 4797, taxpayers should also report the gross proceeds for these transactions on Form 8949 and enter the appropriate code (see the Form 8949 instructions) in column (f) and the appropriate dollar amount in column (g) to reconcile any Forms 1099-B and 8949 differences.

3. *Detailing Trading Activity.* In many cases, the taxpayer will have detailed records reporting each trade that can be attached to the return to support the amounts shown on Form 8949. The Form 8949 instructions indicate that, instead of reporting each stock transaction on a separate line, taxpayers can report them on an attached statement containing all the same information as Form 8949 and in a similar format. They can use as many attached statements as they need. The combined totals from all the attached statements are entered on a Form 8949 with the appropriate box checked. The Form 4797 instructions state that traders who make the Section 475 mark-to-market election should attach a statement to the return detailing each trading transaction and carry the totals to line 10 of Form 4797.

Summary of Taxation Rules for Traders and Investors

Following is a summary of the tax treatment of investors and traders, including traders who make the Section 475 mark-to-market election. See *PPC's Guide to Tax Planning for High Income Individuals* for more discussion on the advantages and disadvantages of each status.

Summary of Tax Attributes—Investors and Traders

	Investor	Trader	Mark-to-market Trader
Gains and losses	Capital (Sch. D)	Capital (Sch. D)	Ordinary (Form 4797)
Interest expense	Investment interest expense	Trade or business expense[a]	Trade or business expense[a]
Trading expenses	Miscellaneous itemized deductions subject to 2% AGI limitation (Sch. A). Expenses reduce net investment income.	Trade or business expenses (Sch. C). No effect on net investment income.[b]	Trade or business expense (Sch. C). No effect on net investment income.[b]
SE tax	Not applicable	Not applicable	Not applicable

Notes:

[a] Assuming individual materially participates in the trading activity. If not, interest expense is investment interest expense subject to Section 163(d) limitation.

[b] Assuming individual materially participates in the trading activity. If not, trading expenses reduce net investment income.

Distinguishing Traders from Investors

There are no IRS guidelines on the distinction between a securities investor and a stock trader for tax purposes. The general presumption is that individuals hold stocks and securities as investors unless their actions demonstrate that they are carrying on a business of securities trading. The courts, however, have been more helpful by pointing out several factors to consider when evaluating whether an individual is an investor or a trader.

The Federal Circuit Court of Appeals and the Tax Court have used the following factors to determine whether an individual is a trader: (1) the taxpayer's investment intent; (2) the nature of the income to be derived from the activity; and (3) the frequency, extent, and regularity of the taxpayer's securities transactions. A taxpayer is a securities trader only when both of the following are true: (1) the taxpayer's trading activity is substantial; and (2) the taxpayer seeks to profit from short-term swings in the daily market movement, rather than to profit from the long-term holding of investments. Thus, it is important to look at such factors as the number of trades, the average holding period, the sources of income, the taxpayer's ongoing involvement in the activity, and the percentage of available trading days on which trading activity occurred.

The Tax Court considers the number of executed trades in a year and the amount of money involved in those trades when evaluating whether a taxpayer's activities are substantial. However, *Jamie* implies that the amount involved may be more important than the number of trades. In this case, the IRS agreed that the taxpayer was a trader even though he averaged only 84 trades each year over a three-year period, presumably because each sale averaged $67,190.

Ideally, trading should be regular and continuous rather than sporadic. Factors unrelated to securities trading may also bear on a court's decision. For example, in *Cameron* the taxpayer was collecting unemployment compensation while trading stocks. The Court observed that this helped undermine his argument that he was engaged in a trade or business.

Given that a trader has a short-term perspective, it would be reasonable to expect few, if any, long-term gains (i.e., stocks held more than one year). For example, in *Levin*, the taxpayer spent most of his working days engaged in making stock transactions and in performing his own research on companies to identify potentially attractive trades. The Court of Claims ruled he was a trader rather than an investor.

In contrast, in *Steffler*, the Tax Court assigned investor status to a taxpayer who claimed to have spent 40–60 hours per week on commodity trading activities over a three-year period. He conducted his activities under a firm name, had business cards, used a separate bank account, and did his own research using a computerized investment analysis system. Nonetheless, he lost his case because he actually traded only 5 to 12 days during each of the three years in question, bought only 16 to 44 contracts per year, and dealt in only five different commodities. Likewise, in *Chen*, the taxpayer had a great number of trades and appeared to be attempting to profit from daily market movements. However, this trading activity lasted only a few months. Because his activity was not continuous, the court found that the taxpayer was not a trader entitled to ordinary loss treatment and mark-to-market accounting. In *Yaeger*, the Second Circuit Court of Appeals focused mainly on the holding period. Although the taxpayer's trading activity was admittedly vigorous (more than 2,000 transactions in a two-year period), he often held securities longer than a year and the shortest holding period was three months. The taxpayer was found to be an investor, not a trader. Finally, in *Endicott*, the Tax Court ruled that the number of days the taxpayer engaged in trading activity during the year was not substantial for a trade or business and he was not seeking to profit from the daily swings in the market since most of his positions were held for an average of 35 days. A taxpayer's interest in a partnership that is a securities dealer does not make the taxpayer a securities dealer. In CCA 201423019, the IRS indicated that because the partnership was not a disregarded entity, the partnership's activities did not flow through to the partner.

Following is a summary of the factors from these and other cases that have been used to determine whether an individual is a trader or investor.

Characteristics of Traders and Investors

Characteristic	Trader	Investor
Criteria for buying and selling stocks	Expects short-term swings in the market and stock price; stock selection based on technical factors.	A more long-term perspective; considers stock's income (dividends) and potential for long-term capital appreciation; stock selection based on fundamental factors.
Involvement	Substantial personal involvement; frequent, regular, and continuous; devotes considerable time to activity; a primary source of individual's income for meeting personal living expenses.	Active primarily on weekends or after-work hours; may rely on a broker or agent; has other primary sources of income for meeting personal living expenses. Relatively short periods of high-volume trading may occur.
Stock holding periods	Generally 30 days or fewer; few, if any, stocks held longer than a year.	A mixture of long-term and short-term holding periods.
Frequency of trades	Daily or almost daily trading; average one or more trades each day; few periods without any activity.	Sporadic trading; no particular pattern to activity; may go for long periods without any activity.
Source of Income	Short-term gains.	Interest, dividends, long-term gains.

Can an Individual Be Both a Trader and an Investor? There is nothing to prevent an individual who qualifies as a trader to also hold stocks and securities for investment. However, it is important for the individual to clearly designate which securities are held for trading and which are held for investment. This can be accomplished by using separate accounts for investment and trading activity. Alternatively, meeting the identification requirements for traders who elect to mark securities to market (see below) should suffice for traders who do not make the mark-to-market election. However, these requirements may be onerous, and non-electing traders are not explicitly required to meet them.

A trader who makes the Section 475 mark-to-market election must clearly identify a security as not held for trading before the close of the day on which it was acquired, originated, or entered into. When substantially similar securities are held for trading and investing, the trader must hold the investment securities in a separate, nontrading account maintained with a third party.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. What happens when a put or call option expires?

    a. The writer adds the premium to the proceeds from the securities that go to the holder.

    b. The writer reduces his or her tax basis in the shares by the premium amount.

    c. The premium payment received by the writer is short-term capital gain at the time it expires.

    d. Gain or loss is measured as the difference between the premiums received to write options and the amounts paid to acquire them.

6. All of the following can be considered a Section 1256 contract **except**:

    a. A nonequity option.

    b. A foreign currency contract.

    c. A dealer equity option.

    d. An interest rate swap.

7. Assuming all other conditions are met, a nonqualified stock option (NQSO) will have a fair market value (FMV) that can be readily ascertained under which of the following circumstances?

    a. There is a limit on when or how the option can be transferred.

    b. Only a portion of the option can be exercised until it has been held a certain length of time.

    c. Restrictions exist on the stock that may have an effect on its FMV.

    d. The option's FMV can be determined by the value of the property to which it is subject.

8. Assuming all other qualifications are met, which of the following individuals is holding qualified small business stock (QSBS)?

    a. Alan holds stock that was issued in August 1989.

    b. Betty holds stock issued by a C corporation worth $70 million.

    c. Carlos holds stock he acquired at its original issue.

    d. Darby holds stock issued by a corporation that specializes in mineral extraction.

9. Which of the following statements best describes an aspect of virtual currency?

    a. Because it carries value, it is considered a real currency.

    b. It can be considered business property.

    c. Its basis is its FMV at the end of the year.

    d. It is exempt from income tax.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. What happens when a put or call option expires? **(Page 286)**

    a. The writer adds the premium to the proceeds from the securities that go to the holder. [This answer is incorrect. When a call option is exercised (i.e., the writer must sell the stock), the writer adds the premium to the proceeds from the sale of the securities to the option holder. Exercising an option calls for different treatment than when an option expires.]

    b. The writer reduces his or her tax basis in the shares by the premium amount. [This answer is incorrect. If a put is exercised (i.e., the writer must purchase the stock), the writer reduces his or her tax basis in the shares acquired by the amount of the premium received. When an option lapses, as described above, it is treated differently than when an option is exercised, as described here.]

    c. The premium payment received by the writer is short-term capital gain at the time it expires. [This answer is correct. When a put or call option lapses (expires), per IRC Sec. 1234(b)(1), the premium payment received by the option writer is a short-term capital gain at that time.]

    d. Gain or loss is measured as the difference between the premiums received to write options and the amounts paid to acquire them. [This answer is incorrect. A closing transaction occurs when the writer's economic obligation under the option's terms is offset and, in effect, canceled by purchase of an equivalent option. If an option writer enters into a closing transaction, any gain or loss is short-term and is measured by the difference between the amount received from premiums for writing the option and the amount paid to acquire options in the closing transaction. A closing transaction has a different type of treatment than the lapse of an option.]

6. All of the following can be considered a Section 1256 contract **except: (Page 286)**

    a. A nonequity option. [This answer is incorrect. According to IRC Sec. 1256(b)(1), the definition of a *Section 1256 contract* includes nonequity options (e.g., listed options on commodities, futures, foreign currencies).]

    b. A foreign currency contract. [This answer is incorrect. Based on the guidance in IRC Sec. 1256(b)(1), foreign currency contracts are included in *Section 1256 contracts*. Examples of these are forward purchases or sales of foreign currency.]

    c. A dealer equity option. [This answer is incorrect. Dealer equity options (i.e., equity options granted or purchased by an options dealer in the course of the dealer's business as a market maker in listed options) are considered part of *Section 1256 contracts*, per IRC Sec. 1256(b)(1).]

    d. An interest rate swap. [This answer is correct. According to IRC Sec. 1256(b)(2), the term *Section 1256 contract* does not include (1) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract or (2) any 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.]

7. Assuming all other conditions are met, a nonqualified stock option (NQSO) will have a fair market value (FMV) that can be readily ascertained under which of the following circumstances? **(Page 292)**

    a. There is a limit on when or how the option can be transferred. [This answer is incorrect. According to Reg. 1.83-7(b)(2), one condition that indicates an option has a readily ascertainable FMV is that the option may be transferred freely.]

    b. Only a portion of the option can be exercised until it has been held a certain length of time. [This answer is incorrect. As described in to Reg. 1.83-7(b)(2), one of the conditions that must be met for an option to have a readily ascertainable FMV is that the option is exercisable immediately in full.]

c. Restrictions exist on the stock that may have an effect on its FMV. [This answer is incorrect. For an option to have a readily ascertainable FMV, one of the conditions that must be met under to Reg. 1.83-7(b)(2) is that there are no restrictions on the option or stock that have a significant effect on the FMV of either.]

d. The option's FMV can be determined by the value of the property to which it is subject. [This answer is correct. Per to Reg. 1.83-7(b)(2), one condition that indicates an option has a readily ascertainable FMV is that the FMV of the option privilege can be determined by the value of the property subject to the option, the probability of an increase or decrease in value, and the length of the option period.]

8. Assuming all other qualifications are met, which of the following individuals is holding qualified small business stock (QSBS)? **(Page 299)**

a. Alan holds stock that was issued in August 1989. [This answer is incorrect. To be considered QSBS, the stock must have been originally issued after August 10, 1993. Therefore, Alan's stock was issued too early to be considered QSBS.]

b. Betty holds stock issued by a C corporation worth $70 million. [This answer is incorrect. To qualify as QSBS, the stock must have been issued by a C corporation with aggregate gross assets not exceeding $50 million at any time from August 10, 1993, to immediately after the issuance of the stock. Therefore, Betty's stock was issued by a C corporation with too many assets to qualify.]

c. Carlos holds stock he acquired at its original issue. [This answer is correct. According to IRC Sec. 1202(c) and (d), to qualify as QSBS, the taxpayer must have acquired the stock at its original issue or in a tax-free transaction such as a gift, inheritance, or partnership distribution. Because Carlos did acquire his stock at original issue, assuming he meets all other qualifications, his stock will be considered QSBS.]

d. Darby holds stock issued by a corporation that specializes in mineral extraction. [This answer is incorrect. One of the qualifications that must be met for stock to be considered QSBS is that the corporation must meet an active business requirement whereby 80% or more of its assets are used in one or more businesses other than those specifically excluded. Ineligible businesses include certain personal service activities (health, law, engineering, accounting, etc.), banking and other financial services, faming, mineral extraction businesses, and hotels and restaurants. Therefore, because of the industry in which the corporation operates, Darby's stock is ineligible for being considered QSBS.]

9. Which of the following statements best describes an aspect of virtual currency? **(Page 301)**

a. Because it carries value, it is considered a real currency. [This answer is incorrect. In some environments, virtual currency operates like "real" currency, but it does not have legal tender status in any jurisdiction.]

b. It can be considered business property. [This answer is correct. According to Notice 2014-21, for federal tax purposes, virtual currency is treated as property. As such, it can be classified as business property, investment property, or personal property. General tax principals applicable to property transactions apply to transactions using virtual currency.]

c. Its basis is its FMV at the end of the year. [This answer is incorrect. Basis in virtual currency is the FMV of the currency on the date the currency is received.]

d. It is exempt from income tax. [This answer is incorrect. If received as payment for services, virtual currency is considered taxable and will be subject to both income and social security taxes.]

Lesson 2: Installment Sales, Like-kind Exchanges, and Conversions of Property

Introduction

This lesson discusses issues that may arise for taxpayers with significant real estate and investment property activities. In addition to installment sale issues, practitioners must recognize and deal with like-kind exchanges, wraparound mortgages, and involuntary conversions.

Generally, if property is sold at a gain and at least one payment is received after the close of the tax year of sale, installment reporting is required (under IRC Sec. 453) unless the taxpayer elects out.

Installment reporting does not apply to losses. Also, a number of restrictions and limitations exist on the use of the installment method of reporting gain from the sale of real property. In general, dealers cannot use the installment method except for sales of farm property, timeshares, and residential lots. Nondealers with installment sales in excess of $150,000 are subject to special interest payment and pledge rules.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine when the installment method is available; how to treat installment sales between related parties; how to elect out of the installment method; and how to deal with installment sale purchase price adjustments, repossessing real estate sold on the installment basis, and installment sales using wraparound mortgages.
- Assess issues related to the disposal of installment obligations, like-kind exchanges, and involuntary conversions.

When Can the Installment Method Be Used?

Property Eligible for Installment Reporting

Most tangible property is eligible for the installment method of accounting and real estate is commonly sold using this method. However, the installment method of accounting is *not* available for dispositions of—

1. real or personal property by dealers,
2. personal property considered inventory,
3. personal property under a revolving credit plan, or
4. stock or securities traded on an established securities market.

An installment gain for regular tax and AMT may differ because of a different adjusted basis in the asset sold (due to use of different depreciation methods).

Dealer property can be personal property sold by a person who regularly sells property of the same type on the installment plan or real property held for sale to customers in the ordinary course of a taxpayer's trade or business. While not commonly addressed, taxpayers may be able to sell assets such as accounts receivable using the installment sale method.

Certain exceptions apply to dealer sales of timeshares, residential lots, and property used or produced in the trade or business of farming. The farm property exception to the general dealer disposition rule applies only if the seller used the property in farming. It does not apply to dealer property that was merely going to be used in farming by the buyer. Sales of timeshares and residential lots are eligible for installment reporting (for both regular tax and AMT) only if the taxpayer agrees to pay interest on the tax deferred from using the installment method.

Example 2A-1 Installment sale of residential lots or timeshares.

Arthur, a dealer in residential lots, purchased a six-acre tract of land for $30,000 and intends to sell 12 half-acre lots. In December 2017, he receives an offer to purchase one of the lots for $5,000, with $1,000 down in 2017, and $4,000 payable the following year. No interest is stated in the offer. If Arthur accepts the offer, he has two choices:

1. Recognize the entire $2,500 profit ($5,000 proceeds less $2,500 basis) in 2017.

2. Elect under IRC Sec. 453(l)(2)(B) to use the installment method. (This election and interest calculation only applies to sales of residential lots or timeshares.) To make this election, Arthur must agree to pay interest on the tax attributable to the deferred gain. The interest is calculated at the applicable federal rate (AFR) in effect at the time of the sale (compounded semiannually) and is payable with the tax due for each year gain is recognized on the installment note after the initial year of the sale. (Short-term rates are used if the term of the installment obligation does not exceed three years. Midterm rates are used for obligations with terms exceeding three years but not more than than nine years. Long-term rates are used for obligations with terms exceeding nine years.) The interest period runs from the date of sale to the date of collection. Therefore, assuming the semiannual AFR in December 2017 was 1% and a 28% marginal federal tax rate in 2018, Arthur would owe interest of $6 in 2018, determined as follows:

Amount collected in 2018	$ 4,000
Gross profit percentage	% 50 %
Gain recognized in 2018	$ 2,000
Marginal tax rate	% 28 %
Tax attributable to gain	$ 560
Interest on deferred tax for one year at 1% compounded semiannually	$ 6

Taxpayers cannot elect to use the installment method for residential lots if they or any related person make any improvements to the lots. Also, installment obligations subject to this election cannot be guaranteed by any person other than an individual. The election is made by properly reporting the interest in the return for the year it is due. The interest is reported on the "Taxes from:" line of Form 1040. Check box c with code "453(l)(3)" written in the blank provided. This interest charge is not included in regular tax, so it is due even if Arthur is subject to AMT.

The interest due for any year is calculated on the amount of tax attributable to payments received during the year. Interest paid is taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid during the year. If the taxpayer has no tax liability for the year, there is no interest charge.

Installment Sales Made between Related Parties

Sale of Depreciable Property between Related Parties

Installment reporting is not allowed for sales of depreciable property between certain related persons. *Depreciable property* is any property that can be depreciated by the purchaser. When the disallowance rule applies, all payments are deemed to be received in the year the sale occurs. Furthermore, the purchaser cannot increase the basis of the property until the income has been reported by the seller. Under another rule, gain recognized from the sale or exchange of depreciable property between related persons (as defined) is treated as ordinary gain (i.e., IRC Sec. 1231 does not apply).

In this context, a related person includes an individual and all entities controlled by that individual. A controlled entity includes more than 50% owned corporations (based on stock value) and partnerships (based on capital or profits ownership). Other related persons include an individual and a trust in which such person is a beneficiary (other than a remote contingent beneficiary), an estate and a beneficiary of the estate, and two or more partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests. Constructive ownership rules apply in determining an individual's ownership in a related entity.

An exception to the prohibition of installment reporting for related persons allows installment reporting if the taxpayer can demonstrate that the principal purpose of the transaction was not the avoidance of federal income taxes. Lack of a significant tax deferral can be used to establish that avoidance of federal taxes was not the principal purpose of the transaction. Conversely, if a significant tax benefit is achieved, the IRS may successfully argue that tax avoidance was a principal purpose of the transaction. In *Guenther*, the Tax Court held that a taxpayer who sold depreciable real estate to an S corporation owned by him and his daughters failed to prove tax avoidance was not one of the principal purposes of the sale. The court looked at, among other items, the depreciation available to the related buyer.

When the sale or exchange involves both depreciable and nondepreciable property, the gain must be allocated between the two. The installment method may be used on the nondepreciable property.

Example 2B-1 Installment sale of depreciable property between related parties.

Mark sold the land and office building that house his medical practice to his professional corporation in 2017 for $190,000. He received $40,000 in cash in 2017 and a 10-year interest-bearing note. The land and building were appraised at $30,000 and $160,000, respectively. The adjusted basis at the time of the sale was $15,000 (land) and $75,000 (building). Mark cannot demonstrate that tax avoidance was not a principal purpose for the transaction. How much gain does Mark recognize in 2017?

The total gain realized from the sale was $100,000 [$190,000 − ($15,000 + $75,000)]. Since the sale was to a related person and involved depreciable property, the installment method cannot be used to report the gain attributable to the sale of the building. Therefore, the entire $85,000 gain ($160,000 − $75,000) attributable to the sale of the building is recognized as ordinary income in 2017. Mark reports this gain on Part II of Form 4797 (Sales of Business Property).

In 2017, Mark must also recognize a portion of the gain attributable to the sale of the land. Since it is nondepreciable property, the installment method is used. The gain realized on the sale of the land is $15,000 ($30,000 − $15,000). Therefore, 50% of the proceeds attributable to the land will be included in Mark's income each year as proceeds are received.

Proceeds received each year will be allocated between the sale of the land and the building, based on their relative fair market value (FMV). Thus, $6,316 [$40,000 × ($30,000 ÷ $190,000)] of the proceeds received during 2017 are allocated to the land sale. Of this amount, $3,158 (50% gross profit percentage) is recognized by Mark and reported on Form 6252 (Installment Sale Income). Because the gain is attributable to land held more than one year, it is carried to Part I of Form 4797. Mark must file Form 6252 for 2017 and any other year payments are received. In addition, he must file Form 6252 for the following two years (i.e., 2018 and 2019) even if no payments are received per the instructions to Form 6252. (See Example 2B-2 regarding second dispositions by related parties.)

Two-year Disposition Rule

Gain recognition on the installment sale of property to a related party is accelerated if the related party disposes of the property within two years of the installment sale (i.e., the first disposition) and the second disposition is before all payments on the first disposition were received. Under the two-year disposition rule, a related party generally includes a spouse; child; grandchild; parent; sibling; or a related C or S corporation, partnership, estate, or trust. A second disposition includes a sale, exchange, or gift of the property. The initial seller is treated as having received proceeds equal to the excess of the amount realized on the second disposition (or, if less, the contract price on the first disposition) over the actual payments received on the initial sale.

However, gain is not accelerated under any of the following circumstances:

1. The second disposition is the result of an involuntary conversion under IRC Sec. 1033, and the first disposition occurred before the threat of conversion.

2. The second disposition occurs after the earlier of the death of (a) the person making the first disposition or (b) the person who acquired the property in the first disposition.

3. Neither the first nor the second disposition had tax avoidance as one of its principal purposes. Generally, second dispositions that are involuntary (e.g., the result of bankruptcy or foreclosure) are not considered to be tax motivated. In addition, if the terms of payment on the second disposition are substantially equal to or longer than those of the first disposition, the second generally will not be viewed as tax-motivated.

Example 2B-2 Second disposition by related party.

Art owns rare coins (FMV of $50,000, basis $10,000). On June 1, 2016, he sells them to his son Bart for $50,000. Bart makes a $5,000 payment on June 1, 2016, and signs a note to pay $5,000 (plus interest) each June 1 for the next nine years. Bart has cash flow problems and sells the coins to a third party on December 15, 2017, for $60,000. How much income does Art recognize in 2017 as a result of Bart's sale of the coins?

Art's realized gain on the initial sale of the coins was $40,000. Since it qualified as an installment sale, Art recognizes gain on 80% ($40,000/$50,000) of the proceeds received. However, since Bart, a related person, disposed of the coins in 2017 (i.e., within two years of the original sale), Art is treated as having received additional proceeds of $40,000 in 2017 computed as follows:

Initial sales price	$ 50,000 [a]
Less payments received:	
June 1, 2016	(5,000)
June 1, 2017	(5,000)
Deemed payment on December 15, 2017	$ 40,000

Note:

[a] The initial contract price is used instead of Bart's sales price on the second disposition because the second disposition's sales price was in excess of the initial contract price.

As a result of the second disposition, Art realizes total gain of $36,000 in 2017 [($40,000 + 5,000) × 80%]. (In the year of sale, another $4,000 of gain was recognized from the down payment received in that year.)

Art must file Form 6252 with his tax return for the year of sale and any other year payments are received. In addition, since the property was sold to a related party, Art must file Form 6252 for the two years following the sale even if no payments are received. (The form must be filed each year until the entire contract price has been received if the sale involved marketable securities.) Any gain recognized would be reported on Form 8949 (or Form 4797 if the property was business property).

Collections from Bart in future years will be nontaxable as Art has reported the entire gain in 2017. If Art had reported less than the entire gain in 2017 (because Bart's sales price was less than the initial contract price), future collections are nontaxable until cumulative collections exceed Bart's sales price.

Electing Not to Use the Installment Method

An *installment sale* is any disposition of property where at least one payment is received after the close of the tax year in which the sale occurs. Under the installment sale rules, a taxpayer recognizes a portion of each payment as gain when received. These rules are mandatory for eligible sales unless the taxpayer elects out of installment reporting. (Certain sales to related parties and most sales made by dealers are not eligible for installment reporting, as discussed earlier in this lesson.) Taxpayers using the installment method normally are taxed on collections based on the tax rules in effect for each collection year. Thus, 2017 collections related to installment sales of capital assets held more than one year are generally taxed at the applicable 2017 tax rate on long-term capital gains regardless of the year the sale took place.

Maximizing the Benefits of the Election Out

It may be beneficial for a taxpayer to elect out of the installment method and report the entire gain in the year of sale. For example, if a taxpayer has expiring carryovers (e.g., net operating loss, charitable contribution, or business

credit), the gain from an installment sale could allow use of these carryovers. A taxpayer who has no carryovers, but has little taxable income or a tax loss, should consider electing out of the installment method and including the total gain in current income to either avoid wasting the tax benefit of exemptions and itemized deductions or to offset a tax loss. A taxpayer who sells a passive activity that contains suspended losses might also find the election to be advantageous. This election may also benefit taxpayers whose social security benefits, without the installment sale income, are not subject to tax. If reported on the installment method, the gain could raise AGI to the point where the social security benefits are taxed every year that payments are received. On the other hand, if the taxpayer elects out of installment reporting, AGI would only be boosted in the year the asset is sold and all the gain recognized. Then the social security benefits are subject to tax in only one year, as opposed to every year that gain is recognized. If a taxpayer knows or believes applicable tax rates will increase in future years, it may be advantageous to elect out of installment sale treatment.

Example 2C-1 Electing out of installment method to use expiring NOL.

The Morgans are retired and living off their pension and investment income. In 2017, they sold a vacant lot for $72,000, receiving $12,000 at closing and a $60,000 note (bearing adequate interest) for the balance. The note will be paid in five annual installments of $12,000, plus interest, in years 2018–2022. The Morgans' basis in the lot was $12,000, so a total gain of $60,000 was realized. Their gross profit percentage is 83.33% ($60,000 gain ÷ $72,000 sales price); thus, $10,000 ($12,000 × 83.33%) of each annual installment will be taxable if installment method reporting is used. They have an NOL carryforward of $60,000 that will expire in 2017.

The following table compares the Morgans' adjusted gross income (AGI) with and without the use of the installment method for 2017 and projected for 2018–2022:

	2017		Each Year 2018–2022	
	Using Installment Method	Electing out of Installment Method	Using Installment Method	Electing out of Installment Method
Interest and dividends	$ 7,000	$ 7,000	$ 7,000	$ 7,000
Pension income	18,000	18,000	18,000	18,000
Gain from land sale	10,000	60,000	10,000	—
NOL carryforward	(35,000)	(60,000)	—	—
AGI	$ -0-	$ 25,000	$ 35,000	$ 25,000

As this example illustrates, electing out of the installment method results in additional income in 2017. However, by electing out, they use all of the NOL expiring in 2017, rather than only being able to use $35,000 of it.

Mechanics of Making the Election Out

An election out of the installment method must be made by the due date, including extensions, for filing the tax return for the year the sale occurred. The election is made transaction by transaction (i.e., a taxpayer can elect out for one sale and use installment reporting for other sales in the same year). Generally, the election is irrevocable unless the IRS consents to a revocation. See Ltr. Ruls. 9511027, 9519014, 200226039, 200230016, 200317014, 200813019, and 201332009 for situations where taxpayers were allowed to revoke an election out of the installment method when their agent failed to carry out their instructions or elected out based on the erroneous belief that the installment method was unavailable.

An after-the-fact planning idea exists for a taxpayer who has already filed a tax return but decides later that an election out of an installment sale may be beneficial. By amending the return, Reg. 301.9100-2(c) allows an election out of an installment sale as late as the final due date of return with extensions.

Taxpayers generally may not make retroactive elections to opt out of the installment method. Rev. Rul. 90-46 makes it clear that retroactive elections will be allowed only in very limited circumstances. In one example cited in the

ruling, the IRS stated that a retroactive election may be allowed when a taxpayer actually instructed his return preparer to elect out in the year of sale but the return preparer failed to do so. In addition, the IRS has allowed a late election on an amended return where the taxpayer's accountant failed to consider the state tax ramifications of not electing out of the installment sale rules.

Taxpayers using the installment method assume the risk of changes to the tax law that may occur during the course of the installment obligation. The IRS will not allow a taxpayer to retroactively elect out of the installment method because subsequent tax law changes increase the tax on the gain. However, when a tax increase was known at the time the taxpayer's return was filed, but the taxpayer's accountant failed to inform the taxpayer of the option to elect out of the installment method, the IRS allowed a retroactive election.

Purchase Price Adjustments for Installment Sales

When property is sold on the installment method and the buyer and seller later agree to a reduction in the purchase price, both parties must reflect the adjustment for tax purposes. For the seller, this requires a recomputation of the gross profit percentage for the remaining payments.

Example 2D-1 Seller's treatment of purchase price adjustment.

Five years ago, Don sold a parcel of land to Lyle for a $200,000 interest-bearing installment note. His basis in the land was $75,000. Selling expenses were $5,000. Don computed the gain and gross profit percentage as follows:

Selling price	$ 200,000
Basis	(75,000)
Selling expenses	(5,000)
Gain on sale (60% gross profit)	$ 120,000

The sale terms called for Don to receive annual principal payments of $20,000 plus interest over 10 years. During the first five years, Don received $20,000 per year and reported gain of $12,000 each year ($20,000 × 60%) on Form 6252. In the sixth year, Don and the buyer renegotiated the selling price down from the original $200,000 to $175,000. Under the renegotiated deal, Don will receive $15,000 per year for the remaining five years for a total of $175,000 ($100,000 collected before the renegotiation and $75,000 to be collected after). Don incurred legal fees of $2,250 to renegotiate the sale. He must recompute his gross profit percentage as follows:

Reduced selling price	$ 175,000
Basis	(75,000)
Original selling expenses	(5,000)
Renegotiation expenses	(2,250)
Recomputed gain on sale	92,750
Less gain previously reported ($100,000 × 60%)	(60,000)
Gain to be reported over next five years	$ 32,750
Recomputed gross profit percentage ($32,750 remaining gain ÷ $75,000 remaining principal payments)	43.67%

For each of the remaining five years, Don will report gain of $6,550 ($15,000 × 43.67%).

Example 2D-2 Buyer's treatment of purchase price adjustment.

Assume the same facts as in Example 2D-1 except that, instead of purchasing raw land, Lyle purchased land and an office building. Originally, Lyle had allocated $30,000 to the land and $170,000 to the building. In the sixth year, when the purchase price is renegotiated from $200,000 to $175,000, Lyle must reduce his basis in the land and building and reallocate the new purchase price between them. Lyle determines it is appropriate to use the same ratio as in the original transaction (i.e., 15% of the value is allocated to land and 85% to the

building). Therefore, $26,250 ($175,000 × .15) of the renegotiated purchase price is allocated to land and $148,750 ($175,000 × .85) is allocated to building. The depreciable basis of the building is therefore reduced by $21,250 ($170,000 − $148,750).

There is no definitive guidance on how to compute depreciation after basis has been adjusted for the reduction in purchase price. Presumably, the rules as provided in the regulations for the former ACRS depreciation apply. Accordingly, the applicable depreciation percentage for the remainder of the recovery period is recomputed and applied to the adjusted basis in the property after the purchase price adjustment. Lyle's depreciation after the purchase price adjustment is computed as follows:

Adjusted basis in building after purchase price adjustment	$ 128,949[a]
Recomputed depreciation percentage (for years 6–39)	% 2.902 %[b]
Depreciation in years 6–39	$ 3,742
Proof:	
Depreciation in years 6–39 ($3,742 × 34 years)	$ 127,228
Depreciation in year 40 (final year) [1.177% ÷ (100% − 11.647%)] × $128,949	1,721[c]
Total depreciation claimed	$ 128,949

Notes:

[a] $170,000 original cost − $19,801 total depreciation claimed for first five years − $21,250 purchase price adjustment = $128,949.

[b] Current year recovery percentage divided by (100% − cumulative recovery percentages for years prior to basis redetermination) = 2.564% ÷ (100% − 11.647%) = 2.902%.

[c] Adjusted for rounding.

The Repossession of Real Estate Sold on Installment Basis

If a taxpayer sells real property on the installment basis and later repossesses the property, a mandatory rule for reporting gain due to the repossession may apply under IRC Sec. 1038(b). If so, the FMV of the repossessed property is irrelevant. Generally, the result is that the seller reports all interim installment payments (i.e., principal payments received before repossession) as gain to the extent they exceed the amount of gain reported as income before the repossession. However, the gain that must be reported upon repossession is limited to the seller's gross profit calculated for the original sale less (1) the amount of gain reported as income before the repossession and (2) repossession costs. The gain reported as income before the repossession (in both cases) appears to include both gain from receipt of installment payments and ordinary income recapture in the year of sale. Typically, the limitation on gain does not come into play, and as a result of these rules, the seller's tax basis in the repossessed real estate is the same as when the property was sold (increased by any expenses incurred in repossessing the property). See Example 2E-1.

The Section 1038 rules for calculating repossession gain (no loss is allowed) and tax basis for real property are mandatory. They apply whether the seller realizes a gain or sustains a loss on the original sale of the real property. However, they apply only if all the following conditions are met:

1. The repossession must be by the original seller and be undertaken to protect the seller's security rights in the real estate.

2. The installment obligation that is fully or partially satisfied by the repossession must have been received by the seller in the original sale.

3. The seller cannot pay any additional consideration to the buyer to get the property back, unless (a) the reacquisition and payment of the additional consideration was provided for in the original contract of sale or (b) the buyer has defaulted or default is imminent.

If these conditions are not met, the seller (or other party repossessing the property) cannot calculate the gain on repossession and the new basis in the repossessed property using the Section 1038 rules. Instead, the gain (or loss) on repossession equals the FMV of the repossessed property (at repossession date) less the sum of the adjusted basis of the note and any repossession costs, and the repossessed property's basis equals its FMV at the time of repossession.

The worksheet in the following example can be used to compute the taxable gain on repossession of real property sold on the installment method under the special rules of IRC Sec. 1038.

Example 2E-1 Repossession of land and building.

Rob sold a commercial building on December 31, 2015, for $300,000. He received $25,000 cash and a note (bearing adequate interest) for $275,000. Semiannual principal payments of $5,000 are to be paid for five years. At that point, a balloon payment for the remaining $225,000 becomes due. Rob received two $5,000 principal payments in 2016 but none in 2017.

Rob's adjusted basis in the building at the time of sale was $200,000, resulting in a 33.333% installment sale gross profit percentage. On December 1, 2017, he repossessed the building after incurring legal fees and other costs of $5,000.

The gain on the repossession and the new basis in the building after repossession are computed as follows:

Taxable gain on repossession:

Cumulative down payment and principal payments received		$ 35,000
Minus: Gain already reported ($35,000 × 33.333%)		(11,667)
Gain on repossession (tentative) (A)		$ 23,333
Gross profit on original sale		$ 100,000
Gain already reported	11,667	
Plus: Repossession costs	5,000	(16,667)
Unreported gross profit less repossession costs (B)		$ 83,333
Taxable gain on repossession [lesser of (A) or (B)]		$ 23,333

Basis of repossessed real property:

Face value of seller's installment receivable at time of repossession ($275,000 − $10,000 payments received)		$ 265,000
Less: Unreported gross profit ($265,000 × 33.333%)		(88,333)
Adjusted basis of receivable on date of repossession		176,667
Plus:		
Taxable gain on repossession	23,333	
Repossession costs	5,000	28,333
Basis of repossessed real property		$ 205,000

After the repossession, Rob is basically back in the same position he was before the sale; his basis in the property is $205,000 ($200,000 original basis + $5,000 repossession costs). Thus, the full amount of payments Rob received from the buyer ($35,000) on the original sale must be recognized as income. Since $11,667 was previously reported as prior-year installment gain, the remaining $23,333 (for a total of $35,000) must be reported in 2017 as repossession gain. [The repossession gain is reported on the same form (e.g., Form 4797) as the previously reported installment gains.] The FMV of the property at the time of repossession does not affect the amount of gain Rob reports.

The repossessed property's holding period (for purposes of any subsequent sale) includes the period when the taxpayer owned the property before the original sale plus the period after the repossession. It does not include the period that the buyer from whom the property was repossessed owned the property. Repossessed property is depreciated as if it had never been sold. The IRS has not issued regulations stating how reacquired MACRS property is to be depreciated. Presumably, the rules will be similar to those for ACRS property, whereby depreciation resumes using the remaining recovery period and applicable rate at the time of disposition. Any basis in excess of the original basis is treated as a new asset.

Wraparound Mortgages

What Is a Wraparound Mortgage?

A *wraparound mortgage* is a special agreement in connection with an installment sale. Normally, when the seller has an existing mortgage on the property, the buyer either assumes the mortgage, or the seller uses sales proceeds to pay off the existing mortgage with the buyer obtaining a new mortgage (or sometimes both). In some cases, however, it may be beneficial to one or both parties (or required by the original lender) to leave the seller liable on the original mortgage and have him or her pay it off over time, as though he or she still owns the property. Meanwhile, the buyer gives a new mortgage to the seller in an amount equal to the entire purchase price less any down payment. In other words, the buyer's mortgage wraps around the seller's mortgage. The seller receives payments from the buyer, which are used to make payments on his or her own mortgage.

Effect of a Wraparound Mortgage on an Installment Sale

In general, if a buyer assumes a mortgage or takes property subject to a mortgage, the excess of that debt over the seller's basis is treated as a gain-recognized payment received in the year of sale. In addition, this mortgage is not included in the contract price, and the resulting gross profit percentage is increased.

If a wraparound mortgage is used, the contract price is the entire sales price, resulting in a lower gross profit percentage (and thus less gain recognized with each year's collections). Also, since the property is not taken subject to the seller's mortgage, the seller is not taxed on a phantom payment received in the year of sale, even when the mortgage exceeds the seller's basis.

In Reg. 15a.453-1(b)(3)(ii), the IRS defined a *wraparound mortgage* as "an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage encumbering the property (wrapped indebtedness) and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness." Thus, according to the regulation, a wraparound mortgage is deemed to have been taken subject to the seller's mortgage, even though title has not passed and the seller remains liable for payments on the underlying debt.

The conclusion of the regulation is that the gross profit ratio for a wraparound mortgage is a fraction. The numerator is the face value of the obligation minus the taxpayer's basis in the obligation, and the denominator is the face value of the obligation. This treatment, which effectively removes all of the tax benefits of wraparounds, was held invalid by the Tax Court in *Professional Equities, Inc.* (acquiesced to by the IRS). The IRS now states to subtract mortgages or other debts the buyer assumed from the seller or took the property subject to, but not new mortgages the buyer gets from a bank, the seller, or other sources.

A wraparound mortgage is valid unless the purchaser must discharge the underlying mortgage or the seller has so little control over the proceeds that he or she is essentially acting as a conduit for the mortgagee (e.g., a bank). In such situations, the wraparound is ignored, and the transaction is treated as if the buyer took the property subject to the first-lien note. Therefore, to preserve wraparound treatment, the seller should avoid—

1. payment terms substantially identical to those of the underlying mortgage, and

2. payments directly from the buyer to the underlying mortgagee.

Example 2F-1 Wraparound mortgage.

Murphy owns a parcel of real estate with an adjusted basis of $40,000 and a mortgage against it of $60,000. He enters into a contract to sell the property to John in 2017 for $150,000. The contract consists of a note for the entire amount, payable over several years. In 2017, Murphy receives principal payments of $12,000. In 2018, he receives an additional $24,000.

Assuming a valid wraparound mortgage, Murphy's gain is calculated as follows:

Contract price	$ 150,000
Basis	(40,000)
Gain on sale	$ 110,000
Gross profit percentage ($110,000 ÷ $150,000)	73.33%
Collections in 2017	$ 12,000
Gain in 2017 ($12,000 × 73.33%)	8,800
Collections in 2018	24,000
Gain in 2018 ($24,000 × 73.33%)	17,600

Example 2F-2 Wraparound mortgage requirements not met.

Assume the same facts as in Example 2F-1 except the wraparound mortgage was not valid (e.g., John made principal payments on Murphy's $60,000 mortgage directly to the bank). While Murphy's gain on the sale is still $110,000 ($150,000 sales price − $40,000 basis), his gross profit percentage is calculated as follows:

Sales price	$ 150,000
Mortgage assumed by buyer	(60,000)
Contract price	$ 90,000
Gross profit %	100%

Thus, Murphy will recognize 100% of the installment payments received each year as gain. However, note that although Murphy holds a $150,000 note receivable, $60,000 of that amount (the $60,000 paid directly to the bank by John) was considered to be debt assumed by the buyer and taken into consideration in the year of sale, resulting in a $20,000 gain in that year. Thus, the 100% gross profit percentage is only applied to $90,000 ($150,000 − $60,000) of note collections in later years. Murphy's total recognized gain will be $110,000 ($20,000 in the year of sale plus a $90,000 note from payments received in later years).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. Under what circumstances would accelerated gain recognition occur under the two-year disposition rule?

    a. An installment sale is made between related parties, and the buyer disposes of the property within two years, prior to finishing the installment payments on the first sale.

    b. Two years after purchasing a property from a related party, a buyer goes through an involuntary conversion on property that was not foreseen.

    c. An installment sale is made between related parties, and the property is sold again within two years after the original seller's death.

    d. One year after purchasing property from a related party, the buyer disposes of the property in order to avoid taxes.

11. Which of the following occurs if taxpayers elect out of using the installment method to account for the disposition of property?

    a. Payments for the property will be spread out longer than the year that the property is sold.

    b. Their AGI will be boosted for several years, which could cause social security benefits to be taxed.

    c. They will recognize all of the gain on the sale in the year of the sale.

    d. They will receive business credit for the extra gain recognized during the tax year.

12. Assuming all other conditions are met, the Section 1038 rules for calculating repossession gain will apply under which of the following circumstances?

    a. A third party repossesses the property.

    b. The seller realizes a gain on the property's original sale.

    c. The obligation satisfied by the repossession was received by the seller in the original sale.

    d. At the buyer's request during repossession, the seller pays a token fee for the property's return.

13. Mary has a mortgage on a piece of real estate. She sells the property to Joe before she has paid off the mortgage, but Mary remains liable for the original mortgage. Mary receives Joe's payments for the property, which she uses to make her own mortgage payments. This is an example of what?

    a. The sale of depreciable property.

    b. A like-kind exchange.

    c. A short sale.

    d. A wraparound mortgage.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. Under what circumstances would accelerated gain recognition occur under the two-year disposition rule? **(Page 312)**

    a. An installment sale is made between related parties, and the buyer disposes of the property within two years, prior to finishing the installment payments on the first sale. [This answer is correct. According to IRC Sec. 453(e), gain recognition on the installment sale of property to a related party is accelerated if the related party disposes of the property within two years of the installment sale (i.e., the first disposition) and the second disposition is before all payments on the first disposition were received. The second disposition includes a sale, exchange, or gift of the property. The initial seller is treated as having received proceeds equal to the excess of the amount realized on the second disposition over the actual payments received on the initial sale.]

    b. Two years after purchasing a property from a related party, a buyer goes through an involuntary conversion on property that was not foreseen. [This answer is incorrect. According to the guidance found in IRC Secs. 453(e)(6) and (7), gain will *not* be accelerated if the second disposition is the result of an involuntary conversion under IRC Sec. 1033 and the first disposition occurred before the threat of conversion.]

    c. An installment sale is made between related parties, and the property is sold again within two years after the original seller's death. [This answer is incorrect. If the second disposition occurs after the earlier of the death of (1) the person making the first disposition or (2) the person who acquired the property in the first disposition, gain would *not* be accelerated, per IRC Secs. 453(e)(6) and (7).]

    d. One year after purchasing property from a related party, the buyer disposes of the property in order to avoid taxes. [This answer is incorrect. When following the guidance of IRC Secs. 453(e)(6) and (7), gain will not be accelerated if either the first or the second disposition had tax avoidance as one of its principle purposes.]

11. Which of the following occurs if taxpayers elect out of using the installment method to account for the disposition of property? **(Page 314)**

    a. Payments for the property will be spread out longer than the year that the property is sold. [This answer is incorrect. According to IRC Sec. 453(b)(1), an *installment sale* is any disposition of property where at least one payment is received after the close of the tax year in which the sale occurs. Typically, this type of sale is accounted for under the installment sale rules. Electing out of using the installment method does not change when the payments will be received by the seller.]

    b. Their AGI will be boosted for several years, which could cause social security benefits to be taxed. [This answer is incorrect. Electing out of the installment method can benefit taxpayers whose social security benefits, without the installment sale income, are not subject to tax. If reported on the installment method, the gain could raise AGI to the point where social security benefits are taxed every year that payments are received. On the other hand, if the taxpayer elects out of installment reporting, AGI would only be boosted in the year the asset is sold. Therefore, electing out of the installment method will minimize the AGI boost, whereas using the installment method could boost AGI for multiple years.]

    c. They will recognize all of the gain on the sale in the year of the sale. [This answer is correct. Under the installment sale rules, a taxpayer recognizes a portion of each payment as gain when received. These rules are mandatory fo eligible sales unless the taxpayer elects out of installment reporting. If the taxpayer does elect out, he or she will report the entire gain in the year of the sale.]

d. They will receive business credit for the extra gain recognized during the tax year. [This answer is incorrect. If taxpayers have expiring carryovers (e.g., net operating loss, charitable contribution, or business credit), the gain from an installment sale could allow use of these carryovers. Therefore, it may be beneficial for them to elect out of using the installment method to account for the disposition of property. However, the act of electing out does not, in and of itself, provide business credit to taxpayers.]

12. Assuming all other conditions are met, the Section 1038 rules for calculating repossession gain will apply under which of the following circumstances? **(Page 317)**

a. A third party repossesses the property. [This answer is incorrect. According to Reg. 1.1038-1(a)(3), the repossession must be by the original seller (not a third party) and be undertaken to protect the seller's security rights in the real estate.]

b. The seller realizes a gain on the property's original sale. [This answer is incorrect. Per Reg. 1.1038-1(a)(1), the Section 1038 rules apply whether the seller realizes a gain or sustains a loss on the original sale of the real property. Therefore, the application of these rules is not reliant on the realization of a gain.]

c. The obligation satisfied by the repossession was received by the seller in the original sale. [This answer is correct. The Section 1038 rules for calculating repossession gain and tax basis for real property are mandatory. However, they apply only if the three conditions outlined in Reg. 1.1038-1(a)(3) are met. One of those conditions is that the installment obligation that is fully or partially satisfied by the repossession must have been received by the seller in the original sale.]

d. At the buyer's request during repossession, the seller pays a token fee for the property's return. [This answer is incorrect. Based on the guidance in to Reg. 1.1038-1(a)(3), for the Section 1038 rules to apply, the seller *cannot* pay any additional consideration to the buyer to get the property back, unless (1) the reacquisition and payment of the additional consideration was provided for in the original contract of sale or (2) the buyer has defaulted or default is imminent.]

13. Mary has a mortgage on a piece of real estate. She sells the property to Joe before she has paid off the mortgage, but Mary remains liable for the original mortgage. Mary receives Joe's payments for the property, which she uses to make her own mortgage payments. This is an example of what? **(Page 319)**

a. The sale of depreciable property. [This answer is incorrect. *Depreciable property* is any property that can be depreciated by the purchaser. While it is possible that the buyer of real estate could depreciate the property, whether or not that is the case is not depending on how the buyer and seller of the real estate structure their mortgages and payments. Therefore, there is a better answer to this question.]

b. A like-kind exchange. [This answer is incorrect. The term *like-kind* refers to the nature or character of the property and not to its grade or quality. Because Joe is paying for the real estate with money, the sale in this scenario would not be considered a like-kind exchange.]

c. A short sale. [This answer is incorrect. A *short sale* occurs when a taxpayer sells borrowed securities. Buying and selling securities is different from the real estate sale described in this scenario; therefore, another answer choice would be preferred.]

d. A wraparound mortgage. [This answer is correct. A *wraparound mortgage* is a special agreement in connection with an installment sale. Normally, when the seller has an existing mortgage on the property, the buyer either assumes the mortgage or the seller uses sales proceeds to pay off the existing mortgage with the buyer obtaining a new mortgage. In a wraparound mortgage, however, the seller remains liable on the original mortgage and will pay it off over time, as if he or she still owns the property. Meanwhile, the buyer gives a new mortgage to the seller in an amount equal to the entire purchase price less any down payment. The seller receives payments from the buyer, which are used to make payments on his or her own mortgage, which is what occurred between Mary and Joe in this scenario.]

The Disposition of Installment Obligations

An installment obligation may be sold, satisfied at other than face value, or otherwise disposed of before all the gain from the installment sale has been recognized. In such cases, the remaining gain generally must be recognized upon disposition. However, certain transfers do not trigger the unrecognized gain.

Gain or loss on disposition is determined in one of two ways, depending on whether the obligation was (1) satisfied at other than face value, sold, or exchanged; or (2) distributed, transmitted, or disposed of other than by sale or exchange (e.g., by gift, dividend, cancellation, or in any way other than by sale or exchange). Any gain or loss is considered as resulting from the sale or exchange of the property for which the installment obligation was received, so the character of the gain or loss is the same as that of the original sale.

Under proposed regulations, no gain or loss is recognized on the disposition of an installment obligation for—

- certain transfers to corporations under IRC Secs. 351 and 361;
- contributions to a partnership under IRC Sec. 721; and
- distributions by a partnership to a partner under IRC Sec. 731 [except as provided by IRC Secs. 704(c)(1)(B), 736, 737, and 751(b)].

However, gain or loss must be recognized by the transferor when the transferor disposes of an installment obligation in a transaction that results in the satisfaction of the installment obligation. Dispositions include, but are not limited to, the receipt of stock of a corporation and the receipt of an interest in a partnership in satisfaction of the installment obligation.

Sale, Exchange, or Satisfaction at Other Than Face Value

The gain or loss on a sale or exchange of an installment obligation (including satisfying the obligation for less than face value) is the difference between the obligation's basis and the amount realized. Basis is the excess of the obligation's face value over the income that would be reported if it had been paid in full.

Example 2G-1 Selling an installment obligation.

Jeff sold a painting for $10,000 that he had bought for $6,000 several years earlier, resulting in a gross profit percentage of 40%. He received a $2,800 down payment and a $7,200 note calling for 36 monthly payments of $200 plus interest. After receiving 10 payments, Jeff sold the note for $4,000.

Jeff's basis in the obligation at the time of sale is calculated as follows:

Initial face value of the note	$ 7,200
Less payments received ($200 × 10)	(2,000)
Face value at time of sale	5,200
Less gain not yet reported ($5,200 × 40%)	(2,080)
Basis of the installment note at time of sale	$ 3,120

The gain on sale of the note is $880 ($4,000 received − $3,120 basis). Assuming the original sale resulted in a capital gain, the gain is reported on Form 8949.

Example 2G-2 Settling an installment obligation at less than face value.

In 2012, Don sold a parcel of land (acquired 12 years prior) to Jack by taking an installment note for $200,000. Don's basis in the land and his selling expenses totaled $80,000, so his gain was $120,000 (60% gross profit). The note (which had an adequate stated interest rate) called for Don to receive annual principal payments of $20,000 over 10 years. For years 2012–2016, Don received $20,000 per year and reported long-term capital gain of $12,000 each year ($20,000 × 60%) on Forms 6252 and 8949.

In 2017, Jack approached Don with an offer to settle the balance of the note ($100,000) for $30,000. Because the value of the land had declined, Don accepted Jack's offer. Don reports a 2017 long-term capital gain or loss equal to the difference between the amount accepted in settlement ($30,000) and his remaining basis in the note. Thus, he has a long-term capital loss of $10,000 computed as follows:

Settlement amount		$ 30,000
Basis in installment note:		
Face value at time of settlement	100,000	
Less gain not yet reported ($100,000 × 60%)	(60,000)	(40,000)
Loss from settlement		$ (10,000)

Gain or loss from the settlement retains the same character as that resulting from the original sale of the property. The loss is reported on Form 8949 as a long-term capital loss.

Disposition Other Than by Sale

The gain or loss on a disposition other than by sale is the difference between the obligation's basis and its FMV at the time of disposition. If an obligation is canceled or becomes unenforceable, it is considered a disposition other than by sale. In addition, if the canceled or unenforceable obligation is between related parties, the FMV of the obligation cannot be less than its face value.

Example 2G-3 Disposition of installment obligation by gift.

Assume the same facts as Example 2G-1 but, instead of selling the note, Jeff gives it to his sister, Marge. At the date of the gift, the FMV of the note is $4,500.

The gain is the difference between the FMV ($4,500) and Jeff's basis ($3,120) or $1,380.

Example 2G-4 Disposition of installment obligation due to bankruptcy.

Assume the same facts as in Example 2G-1 but, instead of selling the note, the buyer filed for bankruptcy, which caused the note to become worthless.

Jeff reports a loss of $3,120 (his basis in the note at the time of default) as a result of the bankruptcy. Since the original sale resulted in capital gain, the resulting loss is capital.

Transfer at Death. When an installment obligation is transferred at death, no gain or loss is recognized due to the transfer. The estate or heir generally is taxed on installment payments received in the same manner as the decedent would have been, with a possible income in respect of decedent deduction under IRC Sec. 691(c) for estate taxes paid. However, if the obligation transfers to the buyer (i.e., maker of the note) at death or is canceled at death per the terms of either the original note agreement or the will (i.e., a self-cancelling installment note, or SCIN), the transfer or cancellation is treated as a disposition, and the unreported installment gain is included in gross income of the decedent's estate.

Example 2G-5 Note canceled by decedent's will.

Mark Falwell sold a residence to his daughter several years ago, accepting a cash down payment and a 20-year installment note. Mark died in the current year when the outstanding balance on the note was $95,000. In his will, Mark forgave the balance of the note.

Since the note was forgiven by will instead of by a provision in the initial sales contract and note agreement, the note is included in Mark's gross estate at its date-of-death value.

Transfers Incident to Divorce. In a transfer of an installment obligation between spouses during marriage or incident to divorce, no gain or loss is triggered by the transfer. Instead, the same tax treatment will apply to the transferee as would have applied to the transferor.

Transactions Not Considered Dispositions

Certain transactions will not be considered dispositions for purposes of IRC Sec. 453B. In Field Service Advice (FSA) 200125073, the IRS stated that its ruling position in regard to this issue could be summarized as follows:

1. Modification of an installment obligation by changing payment terms (e.g., increasing the rate of interest or deferring or increasing the payment dates) will not be considered a disposition under IRC Sec. 453B. See Rev. Rul. 68-419 in which the IRS ruled that the modification of the terms of a note to defer the payment of principal due under a note for five years and increase the interest from 6% to 7% was not a disposition within the meaning of former IRC Sec. 453(d) (the predecessor to IRC Sec. 453B). Likewise, reducing the purchase price and interest rate, and modifying the payment date was not a disposition. Nor was deferring the maturity date, substituting a new obligor, and altering the interest rate.

2. When an original installment note is replaced, the substitution of a new note without any other changes will not be treated as a disposition. See Rev. Rul. 75-457 in which the IRS ruled that a substitution of obligors, deeds of trust, and promissory notes, without any other changes, was not considered a satisfaction or disposition of an installment obligation. In that ruling, a taxpayer sold real property for cash, a deed of trust, and a promissory note. Under the terms of the deed and note, the buyer was allowed to resell the property, provided that the subsequent buyer executed a new note under the same conditions and terms as the original deed of trust. Per the IRS, this is not a satisfaction or disposition of an installment obligation.

Dealing with Like-kind Exchanges

Mandatory nontaxable exchange treatment applies if all of the following requirements are satisfied:

1. The form of the transaction is a sale or exchange.

2. Both the property transferred and the property received are held either for productive use in a trade or business or for investment.

3. The properties transferred and received are like-kind property.

Because the nonrecognition treatment for like-kind exchanges is mandatory, a taxpayer who wants to recognize a realized gain or loss must structure the transaction so that it will fail to qualify as a like-kind exchange (e.g., by actually or constructively receiving cash or other boot or by failing the exchange requirement). However, when parties to the exchange are related, a two-year holding period exists for IRC Sec. 1031 to apply, as discussed later in this lesson.

What Is Like-kind Property?

The term *like-kind* refers to the nature or character of the property and not to its grade or quality. Although the term was intended to be interpreted broadly, limitations exist. One kind or class of property cannot be exchanged for property of a different kind or class. Real estate can be exchanged only for other real estate, and personal property can be exchanged only for other personal property. Therefore, the exchange of a machine for an office building is not a like-kind exchange. In addition, a multiple-use (part business and part personal) asset cannot be bifurcated into two separate assets based on usage, but must be considered one asset. The predominant use of the asset will determine if it is eligible for Section 1031 treatment.

The exchange of one business for another (each including assets such as cash, accounts receivable, real property, and personal property) cannot be treated as an exchange of a single property for another. Rather, the determination of whether IRC Sec. 1031 applies (or the extent to which it applies) to an exchange of the assets of one business for those of another requires an analysis of the underlying assets exchanged. Lesson 3 covers purchase price allocations when a business is bought or sold.

Real Estate. Real estate includes buildings and land as well as various real estate interests, such as co-op units or producing oil leases. The IRS has held that a condominium and a share in a cooperative are like-kind properties, as

are permanent conservation easements in two different pieces of real estate. It does not matter if the real estate is improved or unimproved. Thus, unimproved land can be exchanged for an apartment house. However, an exchange of improved for unimproved real estate may generate recapture income to the owner of the improved realty if accelerated depreciation has been used. See the "Computing Gain or Loss" discussion later in this lesson for more on recapture. In *Wiechens*, water rights and a fee-simple ownership interest in land were not like-kind assets because the water rights were limited in quantity, priority, and duration. In Ltr. Rul. 200404044, however, water rights of unlimited duration and farmland were like-kind assets and thus eligible for a tax-deferred Section 1031 exchange. In Ltr. Rul. 200842019, the IRS allowed like-kind exchange treatment for the swap of leasehold interests in office property. In Ltr. Rul. 200901020, IRS ruled that development rights for residential property was like-kind to fee-simple interest in real estate, long-term leasehold interest in real estate, and land development rights for a hotel. Also, the IRS will issue rulings on whether an exchange of fractional interests in rental real property qualifies for gain deferral under IRC Sec. 1031.

Personal Property. Whether property is like-kind is generally construed more narrowly for personal property than for realty. Under Reg. 1.1031(a)-2, depreciable tangible personal property used in a business or held for investment is exchanged for property of a like kind if it is exchanged for property that is either of a like kind or a like class. Personal property is of a *like class* if the exchanged properties are either within the same General Asset Class or within the same Product Class. However, livestock of different gender do not qualify as like-kind property. Rev. Proc. 87-56 (as modified by Rev. Proc. 88-22) and Reg. 1.1031(a)-2(b)(2) describe 13 General Asset Classes. Six-digit product classes, based on the North American Industry Classification System (NAICS), generally apply for determining whether tangible personal property is within the same product class.

Property may be of a like-kind even if it is not of the same class. The IRS has ruled that cars, passenger vans, and sports utility vehicles (SUVs) are of a like-kind, even though they are not in the same general asset or product class. The IRS determined that the differences between those vehicles are merely differences in grade or quality. However, the IRS earlier ruled that a light-duty truck and an automobile are different enough in nature to be considered not of a like-kind. After Ltr. Rul. 200450005, this earlier ruling appears problematic.

Foreign Property. Real property located in the U.S. and real property located outside the U.S. are not like-kind. A similar rule for personal property provides that personal property used predominately within the U.S. and personal property used predominately outside the U.S. are not like-kind.

Purpose of Holding Property

To qualify for nonrecognition treatment, both the property exchanged and the property received must be held either for the productive use in a trade or business or for investment. Like-kind exchanges can include business for business, business for investment, investment for business, or investment for investment property. Property held for personal use, inventory, and partnership interests do not qualify under the like-kind exchange provisions. Securities (e.g., stocks and bonds), even though held for investment, do not qualify for like-kind exchange treatment.

An exchange qualifies only if the taxpayer meets the requisite holding purpose for both the property exchanged and the property received. Whether the other party to the exchange qualifies for nonrecognition treatment is irrelevant.

Example 2H-1 Requirement that property be held for investment or business purposes.

Andy owns a building he uses in his sole proprietorship. He exchanges his building for one owned by JAD Corp., an unrelated corporation. Immediately after the exchange, Andy transfers (in a prearranged transaction) the building he received to a new corporation (Ancorp) he formed. The transfer was a qualified Section 351 exchange for the corporation's stock. Ancorp will use the building in its trade or business. JAD Corp. uses both the building it exchanged and the one received in its trade or business.

For JAD Corp., the exchange is tax-free because it holds both the building exchanged and the one received for use in its trade or business. For Andy, however, the exchange is not tax-free. By immediately transferring the building received in the exchange to Ancorp in a prearranged transaction, Andy fails to meet the requirement that the he hold the property received in the exchange for use in a trade or business or for investment. (Although the building is used in a trade or business by his wholly-owned corporation, Andy was the party to the exchange so he must use the property received in the exchange in a trade or business or for investment.)

Andy must recognize gain or loss on the exchange based on the difference between the fair market value of the building received and basis of the one he exchanged.

Variation: Could Andy have received tax-free exchange treatment if he transferred his building to Ancorp just before the exchange and let Ancorp be the party to the exchange? No. Ancorp must hold the property exchanged for use in its trade or business for the exchange to be tax-free. This requirement would not be met if it received the building in anticipation of making the exchange. If, on the other hand, Ancorp uses the building in its business so it meets the held for requirement and then makes the exchange, the exchange should qualify as tax-free.

Note that in Ltr. Rul. 200131014, the IRS stated that an individual transferring replacement properties to a limited liability company (LLC) treated as a disregarded entity (i.e., sole proprietorship) does not violate the Section 1031(a)(1) requirement that the property be used in a trade or business or held for investment.

Exchange Requirement Must Be Met

The transaction must involve a direct exchange of property to qualify as a like-kind exchange. Thus, the sale of old property and the purchase of new property, even though of a like kind, is generally not an exchange. On the other hand, if the transactions are mutually dependent, the IRS could argue that the two interdependent transactions are a like-kind exchange. For example, according to Rev. Rul. 61-119, if the taxpayer sells an old business machine to a dealer and purchases a new one from the same dealer, a like-kind exchange could result. However, in a similar situation, an Arkansas district court held that transactions involving a sale of property (such as the one in Rev. Rul. 61-119) must be reciprocal and mutually dependent. In *C. Bean Lumber Transport, Inc.*, the Court ruled that was not the case. The taxpayer received proceeds from the trade-in of trucks used in a business. However, these proceeds were not used to purchase the replacement trucks from the dealer. The taxpayer received the cash from trading in its trucks, spent it on whatever it desired and financed 100% of the purchase price of the replacement trucks (from the same dealer). The Court distinguished the case from Rev. Rul. 61-119 because the taxpayer simply converted property to cash, with no mutual dependency to use that cash to acquire the replacement trucks. Finally, in *Crandall*, an escrow deposit was determined to be current versus deferred sale proceeds because the escrow agreement did not reference like-kind exchange treatment.

Computing Gain or Loss

Gain realized is the excess of the fair market value (FMV) of property received over the tax basis of the property given up. *Gain recognized* is the gain reported as taxable income because of the transaction. All, part, or none of the gain realized in a like-kind exchange may be recognized at that time for tax purposes. However, in no case can the gain recognized exceed the gain realized.

Effect of Boot on Exchange. If the taxpayer in a like-kind exchange gives or receives property that is not like-kind property, gain recognition may occur. Property that is not like-kind property (including cash) is called *boot*.

Receiving boot triggers gain recognition if there is realized gain. Gain is realized if the FMV of the property received exceeds the tax basis of the property given. The recognized gain is the lesser of the boot received or the realized gain (i.e., realized gain serves as the ceiling on the amount of gain that can be recognized).

Example 2H-2 Effect of boot received.

Jim and Bill exchange land in a transfer qualifying as a like-kind exchange under IRC Sec. 1031. Since Jim's land (adjusted basis of $20,000) is worth $24,000 and Bill's land is worth only $19,000, Bill also gives Jim $5,000 cash. Jim's recognized gain is $4,000, the lesser of the realized gain ($24,000 − $20,000) or the FMV of the boot received ($5,000).

Example 2H-3 Gain recognized limited to boot received.

Assume the same facts as in Example 2H-2 except Bill's land is worth $21,000 (not $19,000), and he gives Jim $3,000 cash to make up the difference. Jim's recognized gain is $3,000, the lesser of the realized gain ($24,000 − $20,000) or the FMV of the boot received ($3,000).

The receipt of boot does not result in loss recognition if there is a realized loss.

Example 2H-4 Realized loss with boot received.

Assume the same facts as Example 2H-2 except the adjusted basis of Jim's land is $30,000. His realized loss is $6,000 ($24,000 − $30,000). Jim does not recognize a loss on the transaction, whether or not he receives boot.

If the only boot given is cash, any realized gain or loss will not be recognized by the party who gives the cash. If, however, the boot given is appreciated or depreciated property, gain or loss is recognized to the extent of the difference between the adjusted basis and the FMV of the boot. For this purpose, appreciated or depreciated property is defined as property for which the adjusted basis is not equal to the FMV. The effect of this rule is that gain or loss is recognized on the boot given, but no gain or loss is recognized on the like-kind property transfer by the party who gives the boot.

Example 2H-5 Realized gain with cash boot given.

Joan and Beth exchange real property, which qualifies as a like-kind exchange under IRC Sec. 1031. Joan receives property with a FMV of $25,000 and transfers property worth $21,000 (adjusted basis of $15,000) and cash of $4,000. Joan's realized gain is $6,000 ($25,000 − $15,000 basis of property − $4,000 cash given in the exchange). However, none of the realized gain is recognized because Joan gave cash boot.

Variation: Assume that instead of $4,000 in cash, Joan transferred securities worth $4,000 (basis $3,000) to Beth to equalize the value of the property exchanged. Joan realizes and recognizes gain of $1,000 ($4,000 − $3,000) with respect to the boot (securities) transferred. Her gain relative to the like-kind property exchanged is not recognized because she did not receive boot.

Section 1245 and 1250 Recapture. If property subject to Section 1245 depreciation recapture is transferred, recapture income is triggered to the extent of (1) gain recognized on the exchange determined without regard to Section 1245 recapture plus (2) the FMV of like-kind property received that is non-Section 1245 property and that is not taken into account under item (1). When Section 1250 property is transferred, Section 1250 recapture is recognized to the extent of (1) gain recognized on the exchange or (2) the amount by which potential Section 1250 recapture income exceeds the FMV of the Section 1250 property received in the transaction. However, any Section 1250 recapture that is not recognized carries over to the property received in the like-kind exchange.

Example 2H-6 Section 1245 recapture on like-kind exchange.

Taylor bought an office building (located on land subject to a 50-year lease) for $300,000 in 1984. The building was depreciated under accelerated ACRS. In 2017, when the building was fully depreciated, Taylor traded it for another building (Section 1250 property) in a transaction qualifying as a like-kind exchange. No boot was involved. The building she received was worth $500,000. Taylor realized a $500,000 ($500,000 FMV received

less $0 basis given up) gain on the exchange. Because the property given up was Section 1245 property, her previous depreciation deductions are subject to recapture, as follows:

(1) (1) Depreciation subject to recapture	$ 300,000
(2) (2) Section 1245(b) limitation:	
Gain recognized before Section 1245 recapture, plus	$ —
FMV of non-Section 1245 property received (to the extent not included in gain recognized before Section 1245 recapture)	500,000
	$ 500,000
(3) Depreciation recapture [lesser of (1) or (2)]	$ 300,000

Therefore, Taylor recognizes $300,000 of ordinary income (depreciation recapture) and takes a basis of $300,000 in the building received in the exchange. (See the discussion of "Basis and Holding Period of Property Received" later in this lesson.)

Section 179 Recapture. Generally, in the year property for which a Section 179 deduction was claimed is no longer predominantly used in the taxpayer's trade or business, the Section 179 expense must be recaptured as income. Although not entirely clear, this course suggests that exchanging an asset in a like-kind exchange does not cause the asset to cease to be used predominantly in the taxpayer's trade or business. Disposing of an asset in a transaction covered by IRC Sec. 1245(a) is specifically excepted from the types of transactions that result in the asset no longer being used predominantly in the taxpayer's business. Like-kind exchanges can result in ordinary income recapture, but the amount of recapture income is determined under IRC Sec. 1245(b). Because it is subject to IRC Sec. 1245(a) [even though recapture income may be limited by IRC Sec. 1245(b)], a like-kind exchange should generate recapture income only to the extent of the Section 1245 recapture described above, but not of the entire Section 179 expense.

Example 2H-7 Recapture income at like-kind exchange.

Two years ago, Walter purchased a phone system for his business for $15,000 and expensed the entire cost under IRC Sec. 179. In the current year, he traded the system (then worth $10,000) for a new system in a like-kind exchange. The system Walter received in the exchange was only worth $8,000, so Walter also received $2,000 cash (boot) in the exchange. Walter's realized gain on the exchange is $10,000 ($10,000 FMV of property received less $0 adjusted basis in property given up). However, his recognized gain is limited to the boot received, $2,000. The entire $2,000 gain is ordinary income because the previously claimed Section 179 expense must be recaptured (to the extent of recognized gain).

Basis and Holding Period of Property Received

Basis. If an exchange does not qualify as nontaxable under IRC Sec. 1031, gain or loss is recognized, and the property's basis received in the exchange is its FMV. If the exchange qualifies for nonrecognition, the basis of property received is adjusted to reflect any deferred gain or loss. The basis of like-kind property received in a Section 1031 exchange is computed as follows:

	Adjusted basis of like-kind property given
+	FMV of boot given (if any)
+	Gain recognized on like-kind property given (if any)
−	FMV of boot received (if any)
=	Basis of like-kind property received

Holding Period. The holding period of the property surrendered in a Section 1031 exchange carries over and tacks on to the holding period of the like-kind property received. The boot received has a new holding period (i.e., beginning on the date of exchange) rather than a carryover holding period.

Example 2H-8 Like-kind transactions—comprehensive example.

Glenn, a small-scale vintner, exchanged the following land parcels used for growing grapes for new parcels in five independent like-kind exchanges in 2017:

Exchange	Adjusted Basis of Old Parcel	FMV of New Parcel	Cash Boot Given	Cash Boot Received
1	$ 8,000	$ 18,000	$ —	$ —
2	8,000	18,000	6,000	—
3	8,000	18,000	12,000	—
4	8,000	18,000	—	6,000
5	8,000	7,000	—	600

Glenn's realized and recognized gains and losses and the basis of each of the like-kind properties received are computed as follows:

Exchange	Realized Gain (Loss)	Recognized Gain (Loss)	Old Adj. Basis	Boot Given	Gain Recognized	Boot Received	New Basis
1	$ 10,000	$ —	$ 8,000	$ —	$ —	$ —	$ 8,000
2	4,000	—	8,000	6,000	—	—	14,000
3	(2,000)	—	8,000	12,000	—	—	20,000
4	16,000	6,000	8,000	—	6,000	6,000	8,000
5	(400)	—	8,000	—	—	600	7,400

Depreciating Property Acquired in Like-kind Exchanges

Regulations provide rules for depreciating property acquired in a like-kind exchange.

Tax Reporting

Taxpayers who engage in like-kind exchanges of investment or business property must file Form 8824 (Like-Kind Exchanges) for each exchange. As shown in Example 2H-8, Section 1031 exchanges should be reported even when no gain is recognized. If gain or loss is recognized on the exchange, it is reported on Form 4797 (for business property) or Form 8949 (for investment property). If a single exchange involves multiple properties, the details of the exchange should be reported on a statement attached to Form 8824. Both real and personal property exchanges are reported on Form 8824.

In most real property transactions, the seller will receive Form 1099-S (Proceeds From Real Estate Transactions). It is a best practice to report the Form 1099-S sales price on Form 4797 (or Form 8949, if applicable), and plugging basis to result in the gain actually recognized (if any).

Like-kind Property with Liabilities Attached

Like-kind exchanges may involve properties burdened by debt. The assumption of debt by a transferee is treated by the transferor as boot. Whether a liability has been assumed for this purpose is determined under IRC Sec. 357(d), and is generally based upon the facts and circumstances. The taxpayer who assumes the debt gives boot, and the taxpayer whose debt is assumed receives boot. To determine the boot given or received, the boot resulting from liabilities is netted for both parties. However, net boot given in the form of liabilities cannot reduce boot received in the form of cash or other property.

Example 2H-9 Exchange of like-kind properties burdened by liabilities.

Joe exchanged Blue Acres for Chase Downs, a property owned by Stan. Both Joe and Stan assumed the debt on the existing mortgages. The transaction qualified for Section 1031 treatment. Information on the properties includes:

	Blue Acres	Chase Downs
FMV	$ 2,000,000	$ 1,800,000
Mortgage	1,700,000	1,750,000
Basis	1,500,000	1,600,000

Since the equity in Blue Acres is $300,000 (versus $50,000 for Chase Downs), Stan had to pay Joe $250,000 cash to close the deal.

Joe's realized gain is computed as follows:

Blue Acres debt shifted to Stan	$ 1,700,000
+Cash boot received	250,000
+FMV of Chase Downs	1,800,000
−Basis of Blue Acres	(1,500,000)
−Chase Downs debt assumed	(1,750,000)
Gain realized	$ 500,000

Joe's recognized gain is limited to $250,000, the amount of cash received. Because Joe gave more boot (by assuming debt of $1,750,000) than he received (by surrendering debt of $1,700,000), he is deemed to have paid boot of $50,000 in debt. However, net boot given in the form of debt may not be offset against boot received in the form of cash or other property. Therefore, Joe must recognize gain to the extent of the $250,000 of cash received.

Joe's basis in Chase Downs is $1,550,000, calculated as follows:

Adjusted basis of Blue Acres	$ 1,500,000
FMV of boot given (debt assumed)	1,750,000
Gain recognized	250,000
FMV of boot received ($1,700,000 debt transferred + $250,000)	(1,950,000)
Adjusted basis—Chase Downs	$ 1,550,000

Joe has deferred $250,000 of his realized gain on the exchange ($500,000 gain realized less $250,000 gain recognized). However, the FMV of Chase Downs exceeds Joe's adjusted basis in the property by $250,000 ($1,800,000 − $1,550,000). Thus, Joe has a $250,000 built-in gain in Chase Downs.

Line 15 of Joe's Form 8824 is calculated as follows:

Cash and other property (*not* like-kind):	
Cash received	$ 250,000
−Cash given	—
+FMV of other property received	—
−FMV of other property given	—
Net cash and other property received (given)	250,000
Liabilities:	
Liabilities transferred	1,700,000
−Liabilities assumed	(1,750,000)
Net liabilities transferred (not below zero)	—

Excess liabilities assumed	$ 50,000	
Exchange costs		—
Net boot received (not below zero)		$ 250,000
Excess cash and other property given	$ -0-	

Line 18 of Joe's Form 8824 is calculated as follows:

Adjusted basis of property transferred	$ 1,500,000
+Excess liabilities assumed	50,000
+Excess cash and other property given	—
Adjusted basis of like-kind property received	$ 1,550,000

Stan's realized gain is $200,000 (computed the same way as for Joe). Stan will not have to recognize any gain because the boot he is deemed to have received in the form of debt is less than the boot he gave. Stan gave boot of $1,950,000 (assumed $1,700,000 in debt and paid $250,000 in cash), and received (surrendered) boot of $1,750,000. The net boot received in the form of liabilities is offset by the amount of boot paid in the form of cash.

Related Person Exchanges

IRC Sec. 1031(f) provides a special rule for exchanges between related persons. A related person generally includes family members (spouse, sibling, parent, child, etc.), more than 50% controlled corporations and partnerships, and certain fiduciary relationships.

If related taxpayers exchange properties and either of them disposes of their property within two years, gain or loss originally not recognized under the Section 1031 rules will be recognized (i.e., IRC Sec. 1031 will not apply). Any gain or loss so recognized is considered in the year the disqualifying disposition occurs. However, losses are subject to the disallowance rules of IRC Sec. 267 for sales or exchanges between related parties.

A disposition during the two-year period will *not* trigger the unrecognized gain or loss if—

1. the disposition is after the death of the taxpayer or the related person;

2. the disposition is in a compulsory or involuntary conversion, as long as the exchange occurred before the threat or imminence of the conversion; or

3. it is established to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes.

Example 2H-10 Related person exchange.

Max owns a parcel of real estate with a basis of $20,000 and FMV of $50,000. His brother, Loki, owns a similar parcel with a basis of $40,000 and FMV of $50,000. They exchange properties, and afterward their bases in their new property is the same as their bases in their old property—$20,000 for Max and $40,000 for Loki.

If Loki sells his property one year after the exchange and cannot prove that neither the exchange nor disposition had tax avoidance as a principal purpose, IRC Sec. 1031 no longer applies. As of the date of the sale, both Loki and Max must recognize gain on the exchange, to the extent of the excess of FMV of the asset received ($50,000 for both Max and Loki) over the adjusted basis of the asset surrendered in the exchange ($20,000 for Max and $40,000 for Loki). Thus, Max would recognize gain of $30,000 and Loki would recognize a gain of $10,000.

Like-kind Exchanges Involving Personal Residences or Rental Vacation Homes

Taxpayers cannot claim the Section 121 exclusion for a personal residence acquired in a like-kind exchange subject to the rules of IRC Sec. 1031 if the residence is sold during the five-year period after the date the residence was acquired [IRC Sec. 121(d)(10)]. Consequently, if a taxpayer acquires a personal residence in a like-kind exchange, he or she must wait at least five years after the date of acquisition to take advantage of the $250,000/$500,000 gain exclusion on a sale of the residence. This five-year required holding period also applies to personal residences acquired in a like-kind exchange to any person whose basis in the principal residence is determined in whole or in part by reference to the basis in the taxpayer's hands (i.e., as the result of a gift, divorce, etc.).

Gain deferral on like-kind exchanges under IRC Sec. 1031 is normally not available to homes unless held for the production of income or as investment property. A vacation home does not qualify for like-kind exchange, even if one of the motives in acquiring the home was the prospect of appreciation. However, Rev. Proc. 2008-16 provides a safe harbor for when a second home will qualify as held either for productive use in a trade or business or for investment purposes.

Under Rev. Proc. 2008-16, the IRS will not challenge that a property qualifies for Section 1031 gain deferral if—

1. the relinquished property has been held for at least 24 months immediately preceding the exchange and in each of the two 12-month periods immediately preceding the exchange,

    a. the taxpayer rents the residence to another person at fair market value for at least 14 days, and

    b. the taxpayer does not use the property more than the greater of 14 days or 10% of the total number of days the property was used; and

2. the replacement property is held for at least 24 months immediately after the exchange and in each of the two 12-month periods immediately following the exchange,

    a. the taxpayer rents the residence to another person at fair market value for at least 14 days, and

    b. the taxpayer does not use the property more than the greater of 14 days or 10% of the total number of days the property was used.

For this safe harbor, personal use and fair rental are determined under the same rules as for a vacation home.

Example 2H-11 Like-kind exchange of second residence.

Albert owns a second residence that he has used as a vacation home. He purchased the property in 2013. From September 1, 2015, through August 31, 2016, he personally used the property eight days and rented it at fair value for 26 days. From September 1, 2016, through August 31, 2017, he personally used the property 24 days and rented it at fair value for 260 days. On September 1, 2017, he exchanged the property for a new vacation home (no boot given or received).

Since for each 12-month period in the 24 months preceding the sale Albert rented the property for at least 14 days (26 for September 1, 2015, through August 31, 2016, and 260 for September 1, 2016, through August 31, 2017) and his personal use did not exceed the greater of 14 days or 10% of total usage [fewer than 14 days for September 1, 2015, through August 31, 2016, and less than 10% (24/284 = 8.45%) for September 1, 2016, through August 31, 2017], the relinquished property qualifies for the safe harbor. As long as Albert continues the same pattern of renting the replacement property for the period from September 1, 2017, through August 31, 2019, this exchange will meet the safe harbor and qualify as a Section 1031 exchange.

Deferred Exchanges

A *deferred exchange* is one in which property received in the exchange (replacement property) is not received immediately upon the transfer of property given up (relinquished property). The deferred exchange rules are the result of the *Starker* case, which first allowed exchanges that were not simultaneous.

Reg. 1.1031(k)-1 provides rules governing deferred exchanges. The two primary requirements to qualify a deferred exchange as a like-kind exchange are that (1) the replacement property must be identified before the end of the 45-day identification period and (2) the identified property must be transferred before the earlier of the 180-day or return due date exchange period.

Identification Period. The identification period begins when the taxpayer transfers the relinquished property and ends 45 days thereafter. During this period, the replacement property must be identified or unambiguously described. The courts require strict adherence to this rule. Replacement property is identified if it is received before the end of the period or if it is so designated by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building) in the exchange agreement or in a written document signed by the taxpayer and hand delivered, mailed, faxed, or otherwise sent to either (1) the person obligated to transfer the replacement property to the taxpayer, or (2) any other person involved in the exchange other than the taxpayer or a disqualified party (e.g., an intermediary, an escrow agent, or a title company). A disqualified party includes both related parties and someone who acts as the taxpayer's agent (including individuals performing services as the taxpayer's employee, attorney, or broker).

The replacement property received must be substantially the same property identified in the notice, but an original designation can be revoked and a new one made within the 45-day period. Furthermore, the taxpayer may identify (1) up to three properties as replacement properties without regard to FMV; (2) more than three properties provided the aggregate FMV of these properties at the end of the identification period does not exceed 200% of the aggregate FMV of all properties relinquished; or (3) any number of properties of any value provided that 95% of the FMV of all properties identified are received by the end of the exchange period (see below).

Exchange Period. The exchange period also begins on the date of transfer of the relinquished property, and ends on the earlier of (1) 180 days thereafter or (2) the due date, including extensions, of the tax return for the year the relinquished property is transferred. Taxpayers should consider extending their return if the 180-day period straddles year-end and is cut short by the original due date of the return. If more than one property is relinquished, the earliest transfer date controls (also for purposes of the identification period).

The exchange period must be met to qualify as a deferred (like-kind) exchange. An exchange did not qualify when the taxpayer relied on the automatic four-month extension for filing his tax return to complete the exchange, even though he never requested the extension. However, in *Christensen*, the Court allowed the transaction to be treated as an installment sale because the property received in the exchange was received in a tax year subsequent to the tax year in which property was relinquished. Also, if the 45-day or 180-day period ends on a Saturday, Sunday, or holiday, IRC Sec. 7503 does not apply to extend the deadline to the next business day.

Both the 45-day identification period and the 180-day exchange period begin when the taxpayer transfers the relinquished property. Thus, the time prior to the closing (i.e., transfer) date is, in effect, additional time the taxpayer can use to meet these deadlines. The IRS can extend both deadlines in situations involving federally declared disasters, terrorist attacks, military actions, and cases where taxpayers are serving in combat zones or contingency operations.

Multiple-party Exchanges. Often, when replacement property is located, its owner wants cash (or other property) rather than the property that the taxpayer wants to exchange. A multiple-party exchange can be arranged to result in each party getting the property (including cash) that they want, while preserving Section 1031 treatment for the party who gives up and receives like-kind property in the exchange. Multiple-party exchanges with three or four parties are permitted. Often, a qualified intermediary (QI) is used to facilitate the exchange by locating the parties to the exchange and holding and eventually disbursing the property and cash transferred between the parties. However, a QI cannot be a related party even if in the trade or business of being a QI. Where a QI accidentally returned funds to a depositor for one day, the disbursement did not invalidate the deferred like-kind exchange.

Example 2H-12 Exchanges involving three-way swaps.

Ed owns property A, which he wants to exchange for property B, held by Sam. Sam wants cash and is unwilling to exchange B for A. However, Paul wants Ed's property and is willing to pay cash for it. A and B are considered to be like-kind property. Paul buys B from Sam and then exchanges B for A with Ed. Sam receives cash and Paul and Ed wind up with their desired properties.

This transaction can qualify under IRC Sec. 1031 as a like-kind exchange for Ed even though Paul never has title to the property transferred to Ed. This approach alleviates the task and the cost of having to transfer title to the property twice.

Bankrupt or Insolvent Qualified Intermediaries. Because IRC Sec. 1031 does not provide for an extension of the statutorily mandated period to complete a like-kind exchange, a problem can occur when a qualified intermediary files for bankruptcy, jeopardizing the like-kind exchanges it was handling for clients. For a taxpayer whose like-kind exchange fails due to a qualified intermediary (QI) default, Rev. Proc. 2010-14 provides a safe harbor method of reporting gain or loss for certain taxpayers who initiate deferred like-kind exchanges but fail to complete the exchange because a QI defaults on its obligation to acquire and transfer replacement property to the taxpayer.

Avoiding Constructive Receipt of Cash or Unlike Property. In a typical deferred exchange, the taxpayer transfers property to the transferee (or a qualified intermediate) who promises to acquire replacement property and transfer it to the taxpayer. Normally, the transferor wants some sort of guarantee that the transferee will follow through on this obligation. However, if the guarantee is structured so that the transferor is considered in constructive receipt of cash or unlike property before receiving the like-kind property, the transaction will be treated as a sale rather than a deferred exchange.

Several safe harbors exist so that the transferor will not be considered in constructive receipt of cash or unlike property if the transferee's obligation to transfer replacement property to the transferor is secured by a mortgage, standby letter of credit, third-party guarantee, qualified escrow account, or qualified trust or if the transferor retains a qualified intermediary to facilitate the exchange. Furthermore, a taxpayer's use of these safe harbors will not result in receipts for the installment sale rules. This exception applies only if the taxpayer, at the beginning of the exchange period, had a bona fide intent (based on facts and circumstances) to enter into a deferred exchange. Thus, the installment method remains available to a taxpayer if gain is ultimately recognized on the deferred exchange.

Example 2H-13 Deferred exchange using a qualified escrow account.

Bob owns a parcel of real estate with a basis of $40,000 and an FMV of $100,000 that he wants to exchange for another parcel of real estate. Bill wants to acquire Bob's property, but he does not own any property that Bob is interested in acquiring. Bill is, however, willing to enter into a deferred exchange with Bob.

On October 1, 2017, Bob transfers the property to Bill, and Bill agrees to acquire suitable replacement property and transfer it to Bob. Bill's obligation is secured by $100,000 deposited in a qualified escrow account. Bob has no right to this cash until the earlier of the date the replacement property is delivered or the exchange period ends.

On November 10, 2017, Bob identifies suitable replacement property with an FMV of $80,000. Bill acquires the property and delivers it along with the remaining $20,000 to Bob on January 31, 2018.

All of the requirements of a deferred exchange have been met. Therefore, Bob's receipt of Bill's obligation on October 1, 2017, does not constitute payment. Instead, Bob is treated as receiving payment on January 31, 2018, of $80,000 of like-kind property and $20,000 cash. Therefore, he will recognize a $20,000 gain (the lesser of his $60,000 realized gain on the exchange or the $20,000 boot received) in 2018.

Specific guidance does not currently exist on the reporting requirements for 2017 in this situation. It is a best practice to complete the applicable lines of Part I of Form 8824 and attach a supplement schedule to that form explaining the details of the transaction and stating that it was not completed until 2018. Then in 2018, the Form 8824 should be completed in accordance with the instructions to that form reporting the gain recognized.

Taxation of Earnings Inside Escrow Accounts. In a deferred exchange, funds often are placed in a qualified escrow or trust account by the purchaser until suitable replacement property can be purchased and exchanged with the transferor. Funds held in these types of accounts can generate taxable earnings (i.e., interest, capital gains). In these situations, the exchange facilitator (i.e., the qualified intermediary) is generally treated as owning the qualified escrow or trust account and usually is taxed on the income generated by the account. However, if the taxpayer is paid all the income generated by the escrow account, the taxable income is allocated to that party. Reg.

1.7872-16(f) provides an exemption from imputed interest rules for transactions of less than $2,000,000 lasting six months or less in which funds are treated as being loaned by the taxpayer to the exchange facilitator.

Example 2H-14 Taxing the earnings of a qualified escrow account.

Assume the same facts as in Example 2H-13. The earnings of the account from October 1, 2017–December 31, 2017, are taxable to Bob in 2017 and the earnings from January 1, 2018–January 31, 2018, are taxable to Bob in 2018.

LKE Programs. Rev. Proc. 2003-39 provides safe harbors with respect to ongoing programs involving multiple exchanges of 100 or more tangible personal properties using a single intermediary. These exchanges are referred to as LKE programs. The revenue procedure outlines the characteristics that must be present in a qualifying program.

Rev. Proc. 2003-39 provides safe harbors for certain aspects of qualification under IRC Sec. 1031 of LKE program property exchanges. However, a transaction must also satisfy the Section 1031 requirements for which safe harbors are not provided in the procedure (e.g., whether property involved in an exchange meets the Section 1031 definition of like-kind property). These safe harbors pertain to (1) treatment of each property exchange as a separate and distinct exchange; (2) treatment of money or other property as actually or constructively received; and (3) determining whether an intermediary is a qualified intermediary or disqualified person. In addition, LKE programs do not override the related party restrictions of IRC Sec. 1031(f).

Reverse Exchanges. The regulations do not address reverse Starker exchanges (a taxpayer first receiving replacement property, then transferring relinquished property). However, Rev. Proc. 2000-37 (as modified by Rev. Proc. 2004-51) provides a safe harbor for reverse like-kind exchanges under a qualified exchange accommodation arrangement (QEAA). If the safe harbor requirements are met, the IRS will not challenge the qualification of the property involved as replacement property or relinquished property. Also, the intermediary's status as the property's beneficial owner will be respected. The IRS has also approved a direct reverse Starker exchange that did not involve a third party.

Considerations for Involuntary Conversions

A taxpayer can elect, pursuant to IRC Sec. 1033, to defer gains realized from involuntary conversions of property resulting from destruction (including hurricanes, wildfires, and other natural disasters), theft, seizure, condemnation, or threat thereof (see Rev. Rul. 81-180 and Ltr. Rul. 200145001 for guidance on when a sale is deemed to be "under the threat of condemnation"). To completely defer the gain, the taxpayer must purchase property (or stock in a corporation holding similar assets) that is similar or related in service or use to the original property that costs at least as much as the amount realized upon conversion (e.g., insurance proceeds).

To qualify for Section 1033 gain deferral, the property must be so damaged that it cannot be repaired. However, in *Willamette Industries*, the Tax Court allowed the taxpayer to defer gain realized on property (trees) that were damaged by various natural calamities and thus harvested early and processed into paper in the taxpayer's ordinary course of business. Although it was possible to process the trees in the same manner as if they had been harvested at maturity, the Court focused on the fact that the casualty forced the taxpayer to harvest the trees earlier than scheduled to prevent further loss.

It is not necessary that the entire amount of the conversion proceeds received be used to acquire the replacement property rather than the use of a mortgage. IRC Sec. 1033(a)(2) and Reg. 1.1033(a)-2 say only that gain must be recognized if the amount realized exceeds the cost of the replacement property. It does not say that the amount realized has to actually be invested in the replacement property.

Example 2I-1 Using a mortgage to acquire replacement property.

Ted Smith received $50,000 from his insurance company for the destruction of a piece of real estate with an adjusted basis of $20,000. He purchased a replacement piece of property by using $10,000 cash and assuming a $40,000 mortgage on the replacement property. The replacement property's cost is at least equal

to the proceeds; therefore, Ted does not have to recognize any gain on the transaction even though he did not use all of the insurance proceeds to purchase the replacement property.

Replacing the converted property with similar use property also includes restoring the converted property to its original condition so it can be used in the same manner as it was used prior to the conversion. Whether expenditures made by the taxpayer are necessary to restore the property to its original usefulness is a question of fact, and any enhancements or improvements to the original property should be *de minimis*.

Similar or Related in Service or Use

IRC Sec. 1033(a)(2) requires that replacement property be similar or related in service or use (hereafter referred to as similar-use property) to qualify for gain deferral. This is a functional rule, meaning the taxpayer-owner's end use of the replacement property must be substantially the same as the replaced property. It is a much more stringent rule than the like-kind requirement for like-kind exchanges. For example, the following would probably not qualify as similar-use replacement property:

1. Unimproved real estate replaced with improved real estate.
2. Mobile home park replaced by a motel.
3. Bowling alley replaced by a billiard center.
4. Rental building replaced with stock in a real estate investment trust.

The following are examples of what probably would qualify:

1. Farmland used to grow crops replaced with farmland used to grow fruit or raise livestock.
2. Residential property in one city replaced with residential property in another city.
3. Two buildings used for a particular purpose replaced with one used for the same purpose.

IRC Sec. 1033(f) provides that property used for farming purposes will qualify as similar or related to the use of livestock if it is not feasible for the taxpayer to reinvest the proceeds from involuntarily converted livestock due to drought, flood, other weather-related conditions, etc.

Special Like-kind Rule for Condemned Real Property. IRC Sec. 1033(g) contains a special rule for condemned real estate. Real estate used in a business or held for investment that is condemned (or threat or imminence thereof) is deemed to be converted into similar-use property if it is replaced with like-kind property. Consequently, such property may qualify for gain deferral even though the replacement property does not meet the stringent similar-use requirements discussed earlier. For example, unimproved real estate replaced by improved real estate is not similar-use replacement property. It would, however, qualify for gain deferral under IRC Sec. 1033(g) because it is like-kind property. Conversely, replacement of real property not qualifying as like-kind may qualify under the similar-use test. For example, the use of condemnation proceeds (from land or land and building) to construct a building on land already owned by the taxpayer may not qualify as like-kind property (Rev. Rul. 67-255), but could qualify under the similar-use test. A discussion of what constitutes like-kind property appeared earlier in this lesson.

Acquiring Corporate Stock. IRC Sec. 1033(a)(2) provides that a taxpayer can replace converted property with either qualifying property or stock in a corporation that owns qualifying property, provided the taxpayer acquires control of the corporation. When corporate stock is purchased as the replacement property, the taxpayer's basis in the stock is its cost, decreased by the amount of gain not recognized. In addition, the basis of the replacement property owned by the corporation must also be reduced by the taxpayer's deferred gain. Thus, basis at both the shareholder and corporate levels is reduced for the same gain deferral.

Replacement Period

The replacement period begins on the earlier of (1) the date the property is disposed of, or (2) the date of the threat or imminence of requisition or condemnation of the property. It generally ends two years (three years for

condemned real estate used in a business or held for investment and converted to like-kind property) after the close of the tax year any gain is realized. The replacement period to defer involuntary conversion gains from certain forced early sales of livestock due to drought, flood, or other weather-related conditions is four years, and property other than livestock can qualify as replacement property in certain circumstances. The IRS is authorized to extend the replacement period even longer if regional weather-related conditions persist for more than three years. A four-year replacement period is available for a principal residence or any of its contents located in a federally declared disaster area. The term *federally declared disaster* means any disaster subsequently determined by the president of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The taxpayer may apply to the IRS for an extension based on reasonable cause. The extension must be requested within the replacement period, unless reasonable cause is shown for a later request.

Replacement Property Acquired from Related Person

Individuals cannot avoid gain recognition if the replacement property is acquired from a related person. However, this related-party rule does not apply if (1) the gain realized from the involuntary conversion is $100,000 or less, or (2) the related party acquired the replacement property from an unrelated party during the taxpayer's replacement period. The Sections 267(b) and 707(b)(1) definitions of related persons apply.

Recognition of Gain

If property is converted only into similar-use property, nonrecognition is mandatory. If a taxpayer receives cash or property that is not similar-use, gain is recognized only to the extent the total of the cash and other nonsimilar property (proceeds) exceeds the cost of the replacement property, provided the taxpayer has timely replaced the property and elected the benefits of nonrecognition. The election is made by including the appropriate portion of gain, if any, in gross income and excluding the deferred portion.

Example 2l-2 Gain on condemnation of real property.

Carol, a calendar-year taxpayer, owns an office building with an adjusted basis of $175,000 on land that cost $30,000. The property was condemned and taken in return for a condemnation award of $250,000. She received the condemnation proceeds on March 18, 2017.

Because her real property was condemned, Carol can replace it with either similar-use or like-kind property. If Carol buys like-kind property costing at least $250,000 by December 31, 2020 (the end of the three-year replacement period), none of the $45,000 realized gain will be recognized. The basis of the replacement property will be its cost less the deferred gain of $45,000. If she does not reinvest by that date, the entire gain must be recognized.

If Carol acquires like-kind property for $180,000, the excess of the conversion amount ($250,000) over the cost of the replacement property is $70,000, and the entire $45,000 realized gain is recognized. The basis of the replacement property is $180,000 because there was no gain deferred. If she acquires like-kind property for $230,000, the excess of the condemnation award over the cost of the new property is $20,000. In this situation, she recognizes only the $20,000, and the basis of the replacement property will be $205,000 ($230,000 cost − $25,000 deferred gain).

Alternately, if the award had been only $180,000, the loss of $25,000 (basis of $205,000 less award of $180,000) is recognized regardless of any replacement. Section 1033 deferral applies only to gains.

If the taxpayer fails to replace the converted property within the allowable period or does so at a lower cost than anticipated at the time of the election, an amended return reporting the recognized gain must be filed for the tax year the gain was originally realized. Interest is owed on any additional tax resulting from the gain recognition.

Interplay of Involuntary Conversion Rules and Section 121 Gain Exclusion Rules for a Principal Residence Under IRC Sec. 121(d)(5), the involuntary conversion (from destruction or condemnation) of a taxpayer's principal residence is treated as a sale of the residence eligible for the Section 121 gain exclusion, if the taxpayer otherwise meets the requirements of those gain exclusion rules. This rule applies whether or not the involuntary conversion

results from a federally declared disaster (see additional special rules for property damaged by federally declared disasters later in this lesson). Any portion of the gain that cannot be excluded (for example, because it exceeds the $250,000 or $500,000 limitations) may be deferred under the involuntary conversion rules. In applying the Section 1033 involuntary conversion rules for any remaining gain, the amount realized from the conversion (insurance proceeds) is reduced by the gain excluded under IRC Sec. 121 [IRC Sec. 121(d)(5)(B)].

Example 2I-3 Personal Residence Destroyed; Involuntary Conversion and Gain Exclusion

In March 2017, fire destroys Dan's personal residence that had a basis of $70,000. Dan is single and owned and used this property as his principal residence for 10 years before its destruction. Dan received $400,000 in insurance proceeds for the house. Therefore, Dan has a realized gain of $330,000 ($400,000 − $70,000). In November 2017, Dan buys a new house at a cost of $130,000.

The destruction of the residence is treated as a sale for purposes of the Section 121 gain exclusion rules, so Dan can exclude $250,000 of the realized gain. In applying the Section 1033 involuntary conversion rules to the remaining gain, the amount realized is treated as $150,000 ($400,000 − $250,000), the realized gain is now $80,000 (amount realized of $150,000-basis of $70,000), but the recognized gain is only $20,000 ($150,000 amount realized − $130,000 cost of the new house). The remaining $60,000 of gain is deferred and Dan's basis in the new house is $70,000 ($130,000 cost minus $60,000 gain not recognized).

Special Rules for Property Damaged by Federally Declared Disasters

Taxpayers with property destroyed in federally declared disaster areas are subject to special relief provisions that broaden the scope of the normal involuntary conversion rules. In addition, for taxpayers affected by disasters in federally declared disaster areas or by certain terrorist or military actions, the IRS can extend the normal deadline for many actions, including replacing damaged or destroyed property under IRC Sec. 1033. Note, however, that postponements under IRC Sec. 7508A are not automatic when a disaster occurs. Generally, the IRS will publish a Notice or issue other guidance (including an IRS News Release) authorizing the postponement. Such guidance will describe the acts postponed, the duration of the postponement, and the location of the covered disaster area.

Trade or Business or Investment Property. No gain is recognized if property held for use in a trade or business or for investment is involuntarily converted as a result of being in a location that the president declares a disaster area (i.e., a federally declared disaster) and is replaced with tangible property used in a trade or business. This rule applies even if the replacement property is not similar-use to the converted property.

Example 2I-4 Gain deferral for dissimilar and unrelated-use property.

Sue's Diner was destroyed by a flood. The location becomes a federally declared disaster area. Sue decides not to reopen the diner and uses the insurance proceeds to purchase a bowling alley before December 31st at the end of the two-year period following the disaster. She recognizes no gain on the transaction because the new property is trade or business property (treated as being similar-use to the property destroyed in the federally declared disaster).

Property lost in the involuntary conversion can be either business or investment property, but the replacement property must be "of a type held for productive use in a trade or business."

Example 2I-5 Gain deferral denied for investment replacement property.

Assume the same facts as in Example 2I-4 except Sue uses the insurance proceeds to purchase valuable works of art for investment. She cannot defer the gain on the conversion of the diner.

Variation: If Sue had lost the artwork in a federally declared disaster and purchased the diner with the insurance proceeds, the gain deferral provisions should apply because she replaced investment property with business property.

Principal Residences. The involuntary conversion rules for a disaster in a federally designated disaster area also apply to a taxpayer's principal residence. The following occurs when a taxpayer's principal residence (or any of its contents) is located in a disaster area and is involuntarily converted as a result of a federally declared disaster:

1. No gain is recognized on the receipt of insurance proceeds for unscheduled personal property that was part of the contents of such residence. This rule applies regardless of the taxpayer's basis in the unscheduled personal property or how the insurance proceeds are used.

2. Any insurance proceeds for the residence or its separately scheduled contents can be treated as a common pool of funds. The taxpayer can elect to recognize gain only to the extent that the funds exceed the cost of replacing the residence and its contents. Any type of replacement contents (whether separately scheduled or unscheduled) qualify for this purpose. Insurance proceeds for separately scheduled property (e.g., jewelry, art) do not have to be used to purchase the same type of property.

3. The taxpayer must make the replacement within four years (as opposed to the normal two-year period for involuntary conversion replacements) after the close of the year gain is first realized. (A discussion of the interaction of the Section 121 residence gain exclusion rules and the Section 1033 involuntary conversion rules appeared earlier in this lesson.)

Example 2I-6 Personal residence and contents destroyed in disaster.

Tom's personal residence and contents are totally destroyed by a hurricane in September 2017. His residence was subsequently included in a location that was designated as a federally declared disaster area. Tom received the following insurance proceeds: $300,000 as compensation for destruction of the residence, $35,000 for the unscheduled household contents, $7,000 for scheduled jewelry and $3,000 for scheduled firearms. In March 2020, Tom spends $300,000 to replace the previously destroyed residence and $50,000 to furnish the new home ($40,000 for general furnishings and $10,000 for a painting).

Tom recognizes no gain upon the receipt of the $35,000 for the destruction of the unscheduled personal property, regardless of how he uses or spends this money.

Because Tom spent $350,000 within the 4 four-year statutorily prescribed replacement period under IRC Sec. 1033(h)(1)(B) to purchase a replacement dwelling and contents, which is in excess of the $310,000 common pool of funds he received from insurance [$300,000 for the residence + $10,000 for scheduled personal property ($7,000 + $3,000)], Tom will not be required to recognize any gain upon the destruction of the residence and its contents.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. When might unrecognized gain be triggered when disposing of an installment obligation?

    a. The obligation was transferred to a corporation, per IRC Secs. 351 and 361.

    b. The obligation was gifted to another taxpayer, per the guidance in IRC Sec. 453B.

    c. The obligation was contributed to a partnership, as discussed in IRC Sec. 721.

    d. The obligation was distributed by a partnership to one of the partners, per IRC Sec. 731.

15. Assuming all other requirements are satisfied, when would mandatory nontaxable exchange treatment apply?

    a. The transaction is structured using the installment method.

    b. The properties transferred are held for investment or productive use.

    c. The transferred properties have different character or nature.

    d. Cash or other boot is received as part of the exchange.

16. If a taxpayer's principal residence (including contents of the residence) is involuntarily converted as part of a federally designated disaster area, which of the following will occur?

    a. Gain will be recognized on insurance proceeds.

    b. The taxpayer has two years to make necessary replacements.

    c. Funds from insurance proceeds can be mingled in a common fund.

    d. No gain is recognized if the property is held for use in a trade or business.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. When might unrecognized gain be triggered when disposing of an installment obligation? **(Page 324)**

    a. The obligation was transferred to a corporation, per IRC Secs. 351 and 361. [This answer is incorrect. Under Prop. Reg. 1.453(c)(1)(i), when certain transfers of obligations to corporations under IRC Secs. 351 and 361 are made, no gain or loss is recognized.]

    b. The obligation was gifted to another taxpayer, per the guidance in IRC Sec. 453B. [This answer is correct. An installment obligation may be sold, satisfied at other than face value, or otherwise disposed of before all the gain from the installment sale has been recognized. In such cases, according to IRC Sec. 453B, the remaining gain generally must be recognized upon disposition. Gain or loss on disposition is determined in one of two ways, depending on whether the obligation was (1) satisfied at other than face value, sold, or exchanged or (2) distributed, transmitted, or disposed of other than by sale or exchange (e.g., by gift, dividend, cancellation, or in any way other than by sale or exchange). Therefore, based on this information, disposing of an obligation as a gift is not one of the instances when no gain or loss would be recognized; therefore, unrecognized gain would most likely be triggered with such a gift.]

    c. The obligation was contributed to a partnership, as discussed in IRC Sec. 721. [This answer is incorrect. No gain or loss is recognized on the disposition of an installment obligation, per Prop. Reg. 1.453(c)(1)(i), when it is contributed to a partnership under IRC Sec. 721.]

    d. The obligation was distributed by a partnership to one of the partners, per IRC Sec. 731. [This answer is incorrect. Distributions of installment obligations by a partnership to a partner under IRC Sec. 731 are one instance, according to Prop. Reg. 1.453(c)(1)(i), when no gain or loss would be recognized on the disposition of an installment obligation.]

15. Assuming all other requirements are satisfied, when would mandatory nontaxable exchange treatment apply? **(Page 326)**

    a. The transaction is structured using the installment method. [This answer is incorrect. According to IRC Sec. 1031, mandatory nontaxable exchange treatment applies when, among other things, the form of the transaction is a sale or exchange. Use of the installment method is not required by the Code.]

    b. The properties transferred are held for investment or productive use. [This answer is correct. One requirement for mandatory nontaxable exchange treatment under IRC Sec. 1031 is that both the property transferred and the property received are held either for productive use in a trade or business or for investment.]

    c. The transferred properties have different character or nature. [This answer is incorrect. The properties transferred and received must be like-kind property, per IRC Sec. 1031, for mandatory nontaxable exchange treatment to apply. If the properties differ in their character or nature, they do not meet the definition of like-kind discussed in Reg. 1.1031(a)-1(b).]

    d. Cash or other boot is received as part of the exchange. [This answer is incorrect. Receiving cash or other boot would make an exchange fail one of the tests that must be passed for nontaxable exchange treatment to be mandatory.]

16. If a taxpayer's principal residence (including contents of the residence) is involuntarily converted as part of a federally designated disaster area, which of the following will occur? **(Page 337)**

    a. Gain will be recognized on insurance proceeds. [This answer is incorrect. According to Rev. Rul. 95-22, no gain is recognized on the receipt of insurance proceeds for unscheduled personal property that was part of the contents of such a residence. This rule applies regardless of the taxpayer's basis in the unscheduled personal property or how the insurance proceeds are used.]

    b. The taxpayer has two years to make necessary replacements. [This answer is incorrect. As discussed in IRC Sec. 1033(h)(1)(B), the taxpayer must make the replacement within four years (as opposed to the normal two-year period for involuntary conversion replacements) after the close of the year gain is first realized.]

    c. Funds from insurance proceeds can be mingled in a common fund. [This answer is correct. Per Rev. Rul. 95-22, any insurance proceeds for the residence or its separately scheduled contents can be treated as a common pool of funds. The taxpayer can elect to recognize gain only to the extent the funds exceed the cost of replacing the residence and its contents. Any type of replacement contents qualify for this purpose. Insurance proceeds for separately scheduled property do not have to be used to purchase the same type of property.]

    d. No gain is recognized if the property is held for use in a trade or business. [This answer is incorrect. No gain is recognized if property held for use in a trade or business or for investment is involuntarily converted as a result of being in a location that the president declares a disaster area and is replaced with tangible property used in a trade or business. However, trade or business or investment property is a different classification than principal residences; therefore, there is a better answer to this question.]

Lesson 3: Trade or Business Property Transactions

Introduction

This lesson discusses some of the special issues and problems regarding sales, exchanges, and losses of business property. Section 1231 gain or loss treatment, purchase price allocations, various recapture rules, and related-party loss issues are included in the discussion.

Under IRC Sec. 1231, net gains from the disposal of real (whether or not depreciable) or depreciable personal property used in a trade or business and held more than one year generally are treated as long-term capital gains (unless the depreciation recapture or Section 1231 loss recapture rules apply). Such gains may qualify for installment sale reporting and may be taxed at favorable rates. On the other hand, net Section 1231 losses are treated as ordinary losses (unless the related-party sale rules apply) and are deductible against ordinary income.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the best way to address the abandonment of business property, nonrecaptured Section 1231 loss carryovers, purchase price allocations, depreciation recapture, losses on related-party sales, business casualty losses, and gains from the sale of depreciable real property.

The Abandonment of Business Property

When a taxpayer owns and abandons property used in a business or in a transaction entered into for profit, a loss deduction generally may be claimed. Abandonment losses attributable to business property generally are deductible in the year sustained without regard to any capital loss limitations.

Distinguishing Various Types of Abandonment Losses

The following summarizes various kinds of abandonment losses allowed and where they are covered in the Code and regulations.

1. *Depreciable Property.* Final regulations related to dispositions of MACRS property were issued in August 2014 and apply to tax years beginning on or after January 1, 2014. Among the various items included in the final regulations was the clarification of when to recognize dispositions including losses as a result of abandonment of property.

   Abandonment results in a loss deduction allowable (treated as a disposition) under the depreciation and cost recovery regulations. The loss equals the adjusted basis of the property when it is irrevocably discarded by the taxpayer, so that it will never be used again or retrieved for sale, exchange, or other disposition. A disposition also occurs when the property is placed in a supplies or scrap account. The manner of disposition (for example, normal retirement, abnormal retirement, ordinary retirement, or extraordinary retirement) does not matter in determining whether a disposition occurs or gain or loss is recognized. Even though they may ultimately become the lessor's property under the terms of the lease, depreciable leasehold improvements may give rise to an abandonment loss by the lessee.

   Formerly, the term *disposition* included the retirement of a structural component of depreciable real estate, which created many pitfalls for taxpayers that had not separately classified the structural components; however, the final regulations remedy this situation by treating a building and its structural components as one asset for disposition purposes. The final regulations include an election in which a taxpayer can elect to recognize a disposition of a partial asset. For example, a taxpayer who replaces the roof on a building is allowed an abandonment loss deduction for the retirement of the old roof equal to the adjusted basis attributable to the old roof at the time of the abandonment. To determine the adjusted basis of a roof (or any component of a larger asset) disposed of that is not separately identified, the depreciation allowed or allowable for the roof (or other component asset) is computed by using the depreciation method, recovery

period, and applicable convention for the asset of which the disposed portion was included and by including the portion of the additional first-year depreciation deduction claimed for the asset that is attributable to the disposed portion. The taxpayer may use any reasonable method for determining the unadjusted depreciable basis for the disposed portion of the asset if it is impractical to determine the basis from the taxpayer's records. If a taxpayer disposes of more than one portion of the same asset, the taxpayer may use any reasonable method that is consistently applied to all portions of the same asset for purposes of determining the unadjusted depreciable basis of each disposed portion of the asset. Reasonable methods include, but are not limited to, discounting the cost of the replacement portion of the asset to its placed-in-service year cost using the Consumer Price Index, a pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the asset, and a study allocating the cost of the asset to its individual components.

2. *Nondepreciable Property (e.g., land).* A loss deduction will be allowed under IRC Sec. 165(a) for the abandonment of nondepreciable property if (a) the loss is incurred in a business (or transaction entered into for profit), (b) the loss arises from the sudden termination of the property's usefulness in the business, and (c) the business is discontinued or the property is permanently discarded. A loss for abandonment requires both an intent to abandon and an affirmative act of abandonment. The loss is deductible in the year sustained, which may not be the same year in which the overt act of abandonment or passage of title occurs.

3. *Mineral Property (e.g., oil or gas lease or a well).* A taxpayer is allowed a deduction under IRC Secs. 165 and 612 for mineral property that becomes worthless. To deduct the loss, the taxpayer must permanently cease using the property. Whether an oil or gas (or other mineral) property is worthless in a particular year is a question of fact.

   Special rules apply to intangible drilling and development costs (IDC); a taxpayer may either expense or capitalize them. If the taxpayer elected to capitalize IDC, and a well becomes nonproductive, such costs may be deducted as an ordinary loss at the election of the taxpayer. This election is made by including a statement in the first return in which a nonproductive well (dry hole) is completed.

4. *Leased Property.* The cost of improvements made to leased property by a lessee is recovered under the MACRS depreciation rules without regard to the term of the lease. If, upon termination of the lease, there is unrecovered cost and the property is lost to the lessee, an abandonment loss is computed with reference to the remaining adjusted basis of the improvements and as though the property had been sold for a zero sales price in the year it was abandoned.

5. *Partnership Interest.* A partner can take a deduction upon abandoning an interest in a partnership or if the partnership interest becomes worthless. The *Echols* and *Citron* cases establish the criteria for determining the date of an abandonment or worthlessness loss and the nature (capital or ordinary) of the loss.

Identifying an Abandonment Loss

A loss is deductible in the year sustained, which generally is the year the identifiable event occurs. The taxpayer bears the burden of proof in establishing that the loss was sustained in the same year the loss was claimed on the return.

A loss deductible under IRC Sec. 165 must be evidenced by a completed transaction that is established by an identifiable event. For an abandonment loss, the taxpayer must also show (1) the owner's intent to abandon the asset and (2) an affirmative act of abandonment. Intent to abandon normally is determined by the related facts and circumstances, and the subjective judgment of the taxpayer is given great weight. Thus, identifiable events such as plugging an oil well, scrapping machinery, and discontinuing a line of business generally would be considered affirmative acts that constitute property abandonments. Another common abandonment situation arises upon termination of a lease when leasehold improvements are abandoned.

Example 3A-1 Abandonment of leasehold improvements.

Sam, a self-employed attorney, signed a five-year lease for office space beginning March 1, 2012, in a building that was first placed in service November 1, 2011. Shortly thereafter, he placed in service $15,000 of leasehold

improvements. Sam did not renew his lease when it expired in February 2017. All improvements will remain with the leased property. Therefore, Sam effectively abandoned all the leasehold improvements when the lease terminated.

Because leasehold improvements placed in service before three years after the date the building was first placed in service are depreciated using real property recovery periods, Sam's adjusted basis in the improvements at the time of abandonment was $13,076 ($15,000 − $1,924 accumulated depreciation). Thus, he may claim a $13,076 abandonment loss on Part II of his 2017 Form 4797.

Lessors are subject to the same abandonment loss rules as lessees for leasehold improvements. Thus, if leasehold improvements made by the landlord are abandoned or disposed of at the end of a lease, the landlord can deduct the unamortized or undepreciated basis of the improvements in the year of abandonment or disposition. If the lessor purchased the building after the leasehold improvements were already in place, an allocation of the purchase price must have been made to the leasehold improvements before the lessor could deduct an abandonment loss on the improvements. However, if the new tenant continues to use the improvements, no loss is available to the landlord. In *Standard Commodities Import and Export Corp.,* the Tax Court determined a transfer of leasehold improvements to a majority shareholder did not constitute a factual abandonment because both parties received consideration in exchange of the leasehold property for the release of liability; thus, any abandonment loss was disallowed under IRC Sec. 267. In addition, see the discussion of related party transactions later in this lesson.

Reporting the Loss. Losses on abandonment of business property are reported on Form 4797 Part II as an ordinary loss. However, if the property was abandoned due to a casualty, the loss is reported on Form 4684. Reg. 1.1402(a)-6 states that gain or loss from the disposition of business property (other than inventory) is excluded in determining net earnings from self-employment. According to Reg. 1.168(i)-8(b)(2), the term *disposition* includes abandonment.

Considerations for Nonrecaptured Section 1231 Loss Carryovers

General Rules

Real or depreciable property used in a trade or business or for the production of rental income and held more than one year is Section 1231 property. Net gains from Section 1231 property are treated as long-term capital gains while net losses are treated as ordinary losses. When reporting the disposition of depreciable property, the practitioner first calculates ordinary gain (if any) resulting from depreciation recapture. Any remaining gain is Section 1231 gain. Both are reported on Form 4797.

If Section 1231 losses exceed gains, the net Section 1231 loss for the year is ordinary. If Section 1231 gains exceed losses, the net Section 1231 gain is treated as a long-term capital gain if no nonrecaptured Section 1231 losses exist from prior years. If there are nonrecaptured prior-year Section 1231 losses, Section 1231 net gains in subsequent years are taxed as ordinary income to the extent of those unexpired prior-year nonrecaptured Section 1231 losses.

Applying the Rules

Nonrecaptured Section 1231 losses are the aggregate net Section 1231 losses deducted in the five preceding tax years that have not offset Section 1231 gains. These losses are considered recaptured in chronological order (i.e., FIFO) and expire if they have not been recaptured after five years. Nonrecaptured Section 1231 losses cannot be carried back to affect the character of prior-year Section 1231 gains; they can only be carried forward.

A nonrecaptured Section 1231 loss carryover schedule is helpful for keeping the information necessary to apply these rules.

Example 3B-1 Tracking nonrecaptured Section 1231 loss carryovers.

Leona, a calendar-year taxpayer who owns several partnership interests, has the following net Section 1231 gains and losses:

Year	Gain	Loss
2010	$ 15,000	$ —
2011	—	20,000
2012	8,000	—
2013	5,000	—
2014	—	—
2015	6,000	—
2016	—	—
2017	5,000	—

Leona had no Section 1231 gains or losses before 2010. The 2010 gain is not affected by the 2011 loss since nonrecaptured losses cannot be carried back. In 2012 and 2013, the $8,000 and $5,000 gains are taxed as ordinary income due to the $20,000 nonrecaptured Section 1231 loss carryover from 2011. In 2015, the $6,000 gain is taxed as ordinary income due to the remaining $7,000 ($20,000 − $8,000 − $5,000) nonrecaptured Section 1231 loss carryover. Since no Section 1231 transactions occurred in 2016, the $1,000 remaining nonrecaptured Section 1231 loss carryover originating in 2011 expires at the end of the 2016 tax year. In 2017, the $5,000 gain is treated as a long-term capital gain because no nonrecaptured Section 1231 losses remain.

It is worth noting the importance of separately reporting Section 1231 gain property and capital gain property in a business sale to avoid potential ordinary income on nonrecaptured Section 1231 loss carryover. Section 1231 gain on real property in a business sale would be subject to nonrecaptured Section 1231 loss carryover, while capital gain on goodwill in a business would go to Schedule D and avoid the carryover.

Purchase Price Allocations and Form 8594

When a taxpayer transfers (either directly or indirectly) assets that constitute a trade or business, and the transferee's basis in the assets is determined wholly by reference to the consideration paid for the assets, specific allocation rules under IRC Sec. 1060 must be applied to determine the transferee's basis in the assets acquired and the transferor's gain or loss on the transfer. In addition, buyers and sellers are mutually bound by any purchase price allocations and FMV determinations specified in any written buy/sell agreement, unless the parties can refute the allocation or valuation under the standards set forth in *Danielson*. A party wishing to challenge the tax consequences of an agreement must show proof that "in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc." These agreements under the rules of IRC Sec. 1060 cannot be subsequently changed by a cost segregation study.

Identifying Assets That Constitute a Trade or Business

A group of assets constitutes a trade or business if the use of such assets constitutes an active trade or business under IRC Sec. 355 or if goodwill or going-concern value could, under any circumstances, attach to such assets. In making this determination, all facts and circumstances surrounding the transaction should be considered, including the following:

1. The presence of any intangible assets (whether or not Section 197 intangibles). (However, the transfer of an isolated Section 197 asset will not constitute a trade or business for Section 1060 purposes.)

2. The total consideration given is in excess of the aggregate book value of the tangible and intangible assets purchased (other than goodwill or going concern value).

3. Related transactions, such as lease agreements, management contracts, noncompete agreements, or other similar agreements between the buyer and seller made in the transfer.

Reporting Requirements

The IRS requires both the buyer and seller to attach a completed Form 8594 (Asset Acquisition Statement Under Section 1060) to their tax returns in the year the transaction occurs. Form 8594 requires the parties to disclose how the purchase price is allocated to seven asset categories. A revised Form 8594 must be filed if the purchase price allocated to any asset is increased or decreased after the tax year that includes the purchase date. Form 8594 expands the tax return disclosures required for sales and purchases of businesses and increases the IRS's ability to monitor allocations of purchase price to ensure the buyer and seller use the same allocation.

Effect of Like-kind Exchanges. Under the like-kind exchange rules of IRC Sec. 1031, the exchange of one business for another (each including assets such as cash, accounts receivable, real property, and personal property) cannot be treated as an exchange of a single property for another single property. Instead, the determination of whether IRC Sec. 1031 applies (or the extent to which it applies) to that exchange requires an analysis of all the underlying assets exchanged. (See Lesson 2 for additional coverage of like-kind exchanges.)

To the extent the like-kind exchange rules apply, IRC Sec. 1060 does not apply, and disclosure on Form 8594 is not required. However, the application of IRC Sec. 1031 to some of the assets transferred does not exclude the transfer of other nonlike-kind assets from Section 1060 requirements. Form 8594 disclosure is required for such assets. [In addition, Form 8824 (Like-Kind Exchanges) will be required to the extent IRC Sec. 1031 applies to the assets.] Also, all assets transferred (including any like-kind assets not subject to the Section 1060 rules) are considered for determining whether a trade or business was acquired.

Procedures for Allocating Purchase Price

Mandatory rules apply for allocating purchase price to the basis of the business assets acquired. The assets constituting a trade or business are separated into seven classes:

I. Cash and cash equivalents (other than CDs).

II. Actively traded personal property as defined in IRC Sec. 1092(d) (e.g., readily marketable stock or securities) and certificates of deposit and foreign currency, even if not actively traded.

III. Accounts receivable, mortgages, and credit card receivables arising in the ordinary course of business and any assets that the taxpayer marks to market at least annually for federal income tax purposes.

IV. Stock in trade or other property of a kind that would ordinarily be included in inventory if on hand at the close of the tax year, or property held for sale in the ordinary course of business.

V. All assets not in Classes I, II, III, IV, VI, or VII. (This category includes land and buildings.)

VI. All Section 197 intangibles except goodwill or going concern value.

VII. Goodwill and going concern value (whether or not qualified as a Section 197 intangible).

When making this allocation, the purchase price is first reduced dollar for dollar by Class I assets (if any). The price is then reduced by the FMV of assets in Classes II–VI, in ascending order. The remaining purchase price, if any, is allocated to Class VII assets. Once the purchase price is allocated to these classes, the allocation within a particular class to individual assets is based on the relative FMV of the assets in that class.

This method of purchase price allocation is known as the residual method because the amount allocated to each class of assets is determined by the residual left after allocation to the preceding class. The use of the residual method means that an allocation of purchase price to an asset cannot exceed FMV—except for Class VII assets.

Example 3C-1 Form 8594 for asset acquisition including goodwill.

Tom sold the assets in his proprietorship business to John on July 1. The purchase price was $325,000 ($100,000 cash plus assumption of a $225,000 mortgage). The assets Tom sold have the following FMV:

Cash (Class I asset)	$ 1,000
Accounts receivable (Class III asset)	25,000
Inventory (Class IV asset)	25,000
Land (Class V asset)	30,000
Building (Class V asset)	195,000
Equipment (Class V asset)	25,000
Covenant not to compete—three years (Class VI asset)	15,000
	$ 316,000

John and Tom agreed on this allocation prior to sale, and it was written into the agreement. After allocating $1,000 to Class I assets, $25,000 to a Class III asset, $25,000 to a Class IV asset, $250,000 to Class V assets and $15,000 to a Class VI asset, John allocates the remaining purchase price (the residual) of $9,000 to Class VII. This becomes the value of the goodwill for the business.

Example 3C-2 Form 8594 for asset sale—bargain purchase.

Assume the same facts as in Example 3C-1 except the purchase price is $275,000 ($50,000 cash plus assumption of the $225,000 mortgage) and there is no covenant not to compete.

The FMV of the tangible business assets is $301,000. The $275,000 purchase price is first reduced by $1,000 cash (Class I) then by $25,000 (Class III), and again by $25,000 (Class IV). The remaining $224,000 is allocated to Class V; there is no value allocated to Class VI or VII. The $224,000 is allocated between Class V assets based on their relative FMV. The allocation to Class V assets will be (a) $26,880 ($30,000/$250,000 × $224,000) for the land, (b) $174,720 ($195,000/$250,000 × $224,000) for the building, and (c) $22,400 ($25,000/$250,000 × $224,000) for the equipment.

Effect of Debt on Asset Allocation. FMV, for allocating the purchase price to individual assets, is determined without regard to mortgages, liens, or other debt to which the asset is subject. However, in determining a seller's gain or loss, the FMV of property subject to nonrecourse debt is deemed to be at least the amount of the nonrecourse debt.

Postsale Adjustments to Purchase Price

If an increase in purchase price occurs after the sale date, it is allocated to the assets purchased based on the original purchase price allocation. The FMV of assets as of the purchase date must still be used to allocate any postsale increase in purchase price. Generally, the purchasing taxpayer will be unable to show that an increase in the FMV of assets in Classes II–VI caused the increase in the purchase price. Accordingly, the postsale increase in purchase price, (to the extent the original purchase price equaled or exceeded the purchase date FMV), usually results in an increased allocation to Class VII intangibles only.

Postsale reductions in purchase price are allocated in reverse order, starting with Class VII intangibles. Decreases in the allocation to an individual asset cannot exceed the original purchase price allocated to it (i.e., the allocated amount cannot be reduced below zero). The FMV as of the purchase date must be used to allocate any postsale price decrease. This means that negative postsale price adjustments usually affect only the allocations to Class VII intangibles.

Calculating Depreciation Recapture

A gain on the disposition of Section 1231 business property qualifies for preferential capital gain treatment. This is important because gains of this character may be eligible for the installment method of reporting. They are also taxed at rates that are typically lower than the taxpayer's rate on ordinary income.

However, for personal property, Section 1245 depreciation recapture converts Section 1231 gains into ordinary income to the extent of depreciation claimed on the property. Similarly, Section 1250 recapture potentially converts

capital gain from sale of depreciable real property into ordinary income. To the extent Section 1231 gain is converted into ordinary income, it is taxed at the taxpayer's ordinary income rate and is not eligible for installment reporting. Only gain in excess of ordinary income recapture can be reported on the installment method.

In addition to depreciation recapture, Section 1231 gains can be taxed as ordinary income if the taxpayer has nonrecaptured Section 1231 loss carryovers from the five previous tax years. Also, gain from the sale or exchange of depreciable real property between certain related persons is treated as ordinary income under Section 1239 rather than as Section 1231 gain.

When a single transaction involves the disposal of a combination of Section 1245, Section 1250, and nondepreciable property (e.g., land), the sales price must be allocated to each class to determine the gain or loss with respect to each class. This should be based on the FMV of each property and the agreement of the buyer and seller. For example, the sale of land and building requires an allocation of sales price between the building (which may be subject to recapture) and land (which is not subject to recapture).

Losses Incurred on Related-party Sales

General Rules

Losses on sales or exchanges of property, directly or indirectly, between certain related parties are disallowed. The loss-disallowance rules prevent taxpayers from manipulating recognition of losses for tax purposes when an economic loss has not been realized. Exceptions to the rules apply to complete corporate liquidations and transfers of property between spouses or incident to divorce. The rules apply to any sale or exchange, even if it is bona fide and the terms are determined on a fair market basis. These rules have also been applied to involuntary sales.

An interactive decision tool on *Determining Related Parties for Ownership Attribution Rules* is available and can be used to guide the user through this topic.

What Is a Related Party?

Related parties include the following:

1. Individuals and their spouse; siblings (including half-brothers and half-sisters); parents and grandparents (or any other ancestor); and children, grandchildren, or any other lineal descendants.

2. An individual and a corporation (C or S corporation) in which the individual owns, directly or indirectly, more than 50% in value of the outstanding stock.

3. A partnership and a person who either directly or indirectly owns more than 50% of either a capital or profits interest.

4. A tax-exempt organization and an individual that directly or indirectly controls the organization.

5. A fiduciary of a trust and (a) a grantor, (b) a beneficiary of that trust, (c) a fiduciary or beneficiary of another trust if both have the same grantor, and (d) a corporation in which more than 50% of the stock is owned by either the trust or an individual who is a grantor of the trust.

6. An executor of an estate and an estate beneficiary, except for sales or exchanges in satisfaction of a pecuniary bequest.

Constructive Ownership. Indirect ownership of corporate stock is also considered in determining whether parties are related. Stock owned by one person is considered owned by another in the following situations:

1. Stock owned by a corporation, partnership, estate, or trust is considered owned proportionately by the shareholders, partners, or beneficiaries.

2. Individuals are considered to own the stock owned directly or indirectly by other family members (as described in item 1 under "What Is a Related Party?").

3. An individual who is a partner in a partnership and who owns stock in a corporation (other than stock attributed from a family member) is considered to own all the stock owned by his partners.

Stock attributed to an individual from a family member or a partner cannot be reattributed to someone else. Stock owned directly by related family members can be owned indirectly by multiple family members. Stock owned indirectly through a corporation, partnership, or trust can be attributed to another individual.

Example 3E-1 Indirect ownership of corporate stock.

Jan owns 25% of the outstanding stock of Essco, Inc. Her son, Bob, and her daughter, Jane, each own 12.5% of the stock. The remaining 50% is owned by an unrelated person. Jan sold a parcel of land to Essco for its FMV of $62,000; her basis in the land was $70,000. Jan realized a loss of $8,000.

Jan must include the stock owned by her children to determine whether the Section 267 loss limitations apply. Thus, Jan is considered to own 50% of the Essco stock. However, under IRC Sec. 267(b)(2), an individual must own more than 50% of the stock for the limitation to apply. Therefore, Jan can deduct the loss, since her direct and indirect ownership of Essco stock was not more than 50%. Essco's basis in the land is its cost of $62,000.

Applying the Related-party Rules

If several properties are sold in one transaction to a related party, gain or loss must be computed separately for each item. Gains on some items cannot offset losses on others. As a result, gains are recognized and losses are disallowed even if the items are sold at one time. Because of this, the allocation of the sale proceeds to the various assets sold is critically important. If possible, the taxpayer should attempt to allocate the proceeds in a way that will not generate losses which cannot currently be deducted. However, the guidelines for purchase price allocations must be considered.

Example 3E-2 Nonaggregation of related party gains and losses.

Jack owns a 60% interest in Woodlands II, a partnership. As of January 1, 2017, Jack owed $72,000 to Woodlands from loans in prior years. To pay off the loans, Jack transferred $72,000 of marketable securities to Woodlands in 2017, resulting in realized gains to Jack on some of the securities and losses on others.

Jack must compute gains and losses separately (without offset) on the transfer of securities in satisfaction of the debt. He must recognize the gains for tax purposes. However, Jack may not deduct the losses under IRC Sec. 267.

A disallowed loss may reduce the related buyer's gain on a subsequent sale. However, if the related buyer subsequently sells the property for a loss, the loss disallowed on the original sale to the related party is never recognized.

Example 3E-3 Gain on subsequent sale.

Several years ago, Stan sold an asset to his grandson, Dan, resulting in a realized yet unrecognized loss of $10,000. In 2017, Dan sold the asset for a $15,000 profit. (His basis was his purchase price when he bought the asset from Stan.) In 2017, Dan must recognize a gain of $5,000 from the sale, which is the $15,000 realized gain offset by Stan's previously disallowed $10,000 loss. Presumably, Dan would increase his original basis on Form 4797 or Form 8949 by the $10,000 previously disallowed loss. If, instead, Dan had sold the asset for a $5,000 profit, he could eliminate his realized profit by offsetting it with $5,000 of Stan's disallowed loss. The remaining $5,000 disallowed loss is never recognized.

Dealing with Business Casualty Losses

A deduction for business casualty losses is allowed under IRC Sec. 165(c)(1). A *casualty loss* is defined as the damage, destruction, or loss of property resulting from a sudden, unexpected, or unusual identifiable event (e.g., car accidents, storms, floods). The amount of the loss is generally the lesser of the adjusted basis in the property or the decrease in the FMV due to the casualty.

Three important differences exist between business and personal casualty losses:

1. No percentage of AGI or $100 per casualty threshold applies to limit the amount deductible for business casualty losses.

2. For real property, a business casualty loss or involuntary conversion gain is calculated separately for each identifiable piece of property. For example, if a casualty damages or destroys an office building and its landscaping, the properties are taken into account separately to determine the casualty loss or conversion gain attributable to each.

3. If business property is totally destroyed in a casualty and the fair market value of the property is less than its adjusted basis immediately before the casualty, the loss is calculated solely by considering the adjusted basis and the insurance proceeds. The decrease in FMV is not considered.

The deductible amount of a casualty loss is determined after reduction for any insurance proceeds or other reimbursement a taxpayer receives or expects to receive on the casualty. If insurance proceeds exceed the casualty loss, taxable gain results unless those proceeds are used to acquire qualifying property under the involuntary conversion rules.

If property is used partly for business and partly for personal purposes, basis must be allocated between the two components. A loss is then computed for each component based on either the business or personal casualty loss rules. The $100 per casualty and 10% of AGI limitations are only applied to the personal portion of the loss.

Example 3F-1 Computing a business casualty loss.

Jack, a self-employed contractor, drives a pickup truck that he uses 60% for business purposes and 40% for personal purposes. His adjusted basis in the pickup truck is $5,250 for the business use portion ($12,000 cost less $6,750 of accumulated depreciation) and $8,000 for personal use. Jack's adjusted gross income for 2017 is $25,000.

In July 2017, Jack was involved in an auto accident. His insurance company reimbursed him for the cost to repair the truck, subject to his $1,000 deductible. It cost Jack $6,000 to have his pickup repaired. [This is assumed to be the decrease in FMV.] Because the pickup was used partly for business and partly for personal purposes, a separate casualty loss is calculated for each.

	Business Loss	Personal Loss	Total
(1) Adjusted basis in truck before accident	$ 5,250	$ 8,000	$ 13,250
(2) Decrease in FMV	3,600	2,400	6,000
(3) Amount of loss (lesser of line 1 or 2)	3,600	2,400	6,000
(4) Less insurance reimbursement	(3,000)	(2,000)	(5,000)
(5) Loss after reimbursement (line 3 minus line 4)	$ 600	$ 400	$ 1,000

The $600 business loss is reported in Part 1, Section B, of Form 4684 (Casualties and Thefts). This loss is deductible without limitation in arriving at AGI (i.e., not an itemized deduction). The $400 loss related to the personal-use portion of the pickup is reported in Section A of Form 4684 and is deductible subject to the limitations placed on personal-use property casualty losses. Also, Jack's basis in the pickup is reduced by the amount of insurance reimbursement and by the casualty losses deducted and is increased by the cost of the repairs.

The final tangible property regulations under Section 1.263(a)-3(k)(1)(iii) require capitalization of the amounts paid for the restoration of damage to property for which a taxpayer has taken a depreciation adjustment as a result of a casualty loss or relating to a casualty event. The amount capitalized as restoration costs is limited to the property's adjusted basis immediately before the casualty. Remaining costs, if any, in excess of the restoration costs are categorized under rules other than the restoration rules. For example, excess costs may be capitalized as improvements or deductible as repairs depending on the nature of the work performed.

Gains from Sales of Depreciable Real Property

Reporting Unrecaptured Section 1250 Gain

Under IRC Sec. 1(h)(6)(A), unrecaptured Section 1250 gain is the excess of (1) gain to the extent of depreciation claimed on the property, other than gain treated as ordinary income because of Section 1250 recapture or nonrecaptured Section 1231 loss carryovers, over (2) the excess of 28% rate loss [the sum of (a) loss from the sale of collectibles, (b) net short-term capital loss, and (c) the amount of any long-term capital loss carryover coming into the tax year] over 28% rate gain [the sum of (a) gain from the sale of collectibles and (b) the gain exclusion from the sale of qualified small business stock under IRC Sec. 1202].

A maximum 25% rate applies to the unrecaptured Section 1250 gain if the real property has been held more than 12 months. Any remaining gain in excess of the amount subject to Section 1250 recapture and the unrecaptured Section 1250 provisions is classified as Section 1231 gain, subject to the regular capital gains rate. Furthermore, the 3.8% NIIT may apply to gains from the sale of depreciable real property. A full discussion of the 3.8% NIIT is beyond the scope of this course, but more information is available in *PPC's 1040 Deskbook*.

The following table summarizes the maximum tax rates that apply to sales of Section 1250 real property:

Holding Period	Character of Gain	Maximum Tax Rate[a]
12 months or less	Ordinary gain	39.6%
More than 12 months	Section 1250 recapture	39.6%
	Unrecaptured Section 1250 gain	25%
	Section 1231 gain	20%

Note:

[a] In addition to these maximum tax rates, the 3.8% NIIT may apply.

When real property is sold or exchanged, the total amount realized must be allocated among the Section 1250 property and the non-Section 1250 property (i.e., Section 1245 personal property or nondepreciable land). Thus, a sale of depreciable real property typically requires an allocation of the sales price between the land and building. The allocation should be based on the relative fair market values of each component. Due to the different tax effects to the buyer and seller (it is more beneficial for the seller to allocate a greater portion to land due to the tax rate differential and more beneficial for the buyer to allocate a greater portion to the depreciable building), both parties should execute a written agreement allocating the total proceeds to each component of the sale. The seller will report each component as a separate asset on Form 4797. In other words, the portion allocable to Section 1250 property will be reported on Part III separate from any allocable portion to Section 1245 property.

Example 3G-1 Analyzing gain from the sale of depreciable real property.

On December 1, 2017, Allen sold a rental building that he has owned since 2004. His original cost basis in the building was $500,000 and he has taken straight-line depreciation deductions of $200,000, leaving an adjusted basis of $300,000. His basis in the land is $100,000. The sales price of the property was $850,000, of which $650,000 was allocable to the building and $200,000 to the land. He has no unrecaptured Section 1231 loss carryovers.

Allen's gain from the sale of the building is computed as follows:

		Building	Land	Total
Selling price		$ 650,000	$ 200,000	$ 850,000
Adjusted basis:				
Cost	$ 500,000			
Accum. depr.	(200,000)	(300,000)	(100,000)	(400,000)
Gain from sale		$ 350,000	$ 100,000	$ 450,000

There is no Section 1250 ordinary income recapture because the building was always depreciated using the straight-line method. Thus, the $350,000 gain attributable to the building is taxed as follows: (1) $200,000 (the amount of depreciation claimed) of the gain is unrecaptured Section 1250 gain taxed at a maximum rate of 25%, and (2) the remaining $150,000 of gain is a Section 1231 gain eligible for the 20% maximum capital gain rate. The $100,000 gain attributable to the land is a Section 1231 gain eligible for the 20% maximum capital gain rate.

Section 1250 Ordinary Income Recapture

Gain on the disposition of Section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. IRC Sec. 1250(b) defines additional depreciation as the amount of depreciation allowed for the property, except in the case of property held for more than one year, and then the amount of depreciation is allowed only to the extent it exceeds the amount of depreciation that would have resulted if the property were depreciated for each tax year under the straight-line method. For Section 1250 property, MACRS requires depreciation adjustments according to the straight-line method of recovery, seemingly eliminating potential Section 1250 ordinary income recapture. However, any special depreciation allowance claimed, including bonus depreciation, can give rise to additional depreciation, creating Section 1250 ordinary income recapture if gain is recognized upon the disposition of the property. Reg. 1.168(k)-1(f)(3) provides for purposes of Section 1250(b), bonus depreciation is not treated as straight-line depreciation.

For 2017, Section 168(k) allows taxpayers that own qualified property a 50% depreciation deduction, also known as bonus deprecation, in the year the property is placed in service. Qualified property includes most types of machinery, equipment, other tangible personal property, and computer software. Prior to 2016, qualified property also included qualified leasehold improvement property. Beginning in 2016, the Protecting Americans from Tax Hikes Act of 2015 (2015 PATH Act) created a new class of nonresidential real property eligible for bonus depreciation called "qualified improvement property" that expanded the definition of property for which bonus depreciation may be claimed.

Example 3G-2 Section 1250 recapture when bonus depreciation claimed.

Lora owns an office building and spends $100,000 in July 2016 on various improvements, including new walls, office dividers, and ceiling lighting. The improvements meet the definition of qualified improvement property for bonus depreciation purposes as defined in Section 168(k)(3). In 2016, Lora deducted bonus deprecation of $50,000 plus MACRS depreciation of $589 (using a factor of 1.177% times the remaining depreciable basis of $50,000) for total depreciation of $50,589. Upon sale of the property, Lora must recapture as ordinary income the lesser of the gain on sale or the amount of bonus depreciation allowed on the property. When Lora sells the building in October 2017, the sales price attributable to the improvements is $105,000. She claims an additional $1,015 of depreciation in 2017 [$50,000 x 2.564% (year 2 depreciation) x 9.5 / 12]. Therefore, her basis in the improvements at the time of sale is $48,396 ($100,000 − $50,000 − $589 − $1,015). Her gain on the sale attributable to the improvements is $56,604 ($105,000 − $48,396). If she had used straight-line depreciation rather than bonus depreciation, the total depreciation claimed would have been $3,206 [($100,000 x 1.177%) + ($100,000 x 2.564% x 9.5 / 12)]. Therefore $48,398 ($51,604 depreciation claimed less $3,206 straight-line depreciation) of Lora's gain would be Section 1250 recapture taxed at ordinary rates, $3,206 would be unrecaptured Section 1250 gain taxed at a maximum 25% rate, and $5,000 would be Section 1231 gain.

Installment Sales of Depreciable Real Property

As Example 3G-1 illustrates, the sale of depreciable real property can result in gain being taxed at more than one capital gain rate. Thus, installment gains of depreciable real property may be taxed partly at 25% and partly at the applicable capital gain rate if the total gain exceeds the unrecaptured Section 1250 gain.

Reg. 1.453-12 takes a front-loaded approach to the installment recognition of unrecaptured Section 1250 gain. According to the regulation, if gain from an installment sale includes both unrecaptured Section 1250 gain (25% gain) and adjusted net capital gain (20% gain), the unrecaptured Section 1250 gain is reported before the adjusted net capital gain.

Example 3G-3 Reporting unrecaptured Section 1250 gain.

Colleen owns a building that she purchased several years ago for $500,000. In 2017, she sold the building for $1 million, to be paid in five annual installments beginning June 1, 2017. Assume Colleen has no other gains or losses. Through the date of the sale, Colleen has claimed $300,000 of straight-line depreciation on the building. The deferred installment gain is $800,000 [($1,000,000 - $500,000) + $300,000].

The unrecaptured Section 1250 gain ($300,000) is recognized as income before the net capital gain ($500,000). The $200,000 installment payment received in 2017 will result in unrecaptured Section 1250 gain of $160,000 [$200,000 × ($800,000 ÷ $1,000,000)]. The installment payment received in 2018 will recognize the remaining $140,000 of unrecaptured Section 1250 gain with the other $20,000 ($160,000 - $140,000) being recognized as long-term capital gain subject to the applicable tax rate. For each of the remaining three installments, Colleen will recognize $160,000 of net capital gain subject to the applicable tax rate.

Variation: Assume that Colleen had a $70,000 unrecaptured Section 1231 loss in 2017. Her recognized gain would then be as follows:

	2017	2018	2019	2020	2021	Total
Sec. 1231 Ordinary	$ 70,000	$ —	$ —	$ —	$ —	$ 70,000
25% LTCG	90,000	140,000	—	—	—	230,000
Applicable LTCG rate		20,000	160,000	160,000	160,000	500,000
Total	$ 160,000	$ 160,000	$ 160,000	$ 160,000	$ 160,000	$ 800,000

The front-loading rule creates a tax friendly position for installment sales that occurred before the date that the 25% tax rate became effective (May 7, 1997). Therefore, even though the 25% rate was not applicable to gain recognized from payments received before May 7, 1997, that gain is treated as unrecaptured Section 1250 gain to the extent it does not exceed the total amount of unrecaptured Section 1250 gain recognized on the sale.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. When allocating purchase price to the basis of business assets, the purchase price will be reduced first by which class of assets?

    a. Goodwill and going concern value.

    b. Actively traded personal property.

    c. Accounts receivable from the ordinary course of business.

    d. Cash and cash equivalents.

18. What is one difference between business and personal casualty losses?

    a. Business casualty losses are limited by either the $100 per casualty threshold or a percentage of AGI.

    b. Business casualty loss is calculated on an aggregated total of all properties.

    c. If business property is destroyed and FMV is lower than its basis, FMV is not considered when calculating the loss.

    d. The deductible amount of a business loss is determined after insurance proceeds are taken into account.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. When allocating purchase price to the basis of business assets, the purchase price will be reduced first by which class of assets? **(Page 350)**

    a. Goodwill and going concern value. [This answer is incorrect. Goodwill and going concern value are considered Class VII assets under Reg. 1.338-6. The purchase price remaining, after it has been reduced by all the other classes, is allocated to Class VII assets.]

    b. Actively traded personal property. [This answer is incorrect. Per Reg. 1.338-6, actively traded personal property as defined in IRC Sec. 1092(d) (e.g., readily marketable stock or securities) and certificates of deposit and foreign currency, even if not actively traded, make up Class II assets. The purchase price is reduced by the FMV of Class II assets second.]

    c. Accounts receivable from the ordinary course of business. [This answer is incorrect. Classes of assets constituting a trade or business are discussed in Reg. 1.338-6. Accounts receivable, mortgages, and credit card receivables arising in the ordinary course of business and any assets that the taxpayer marks to market at least annually for federal income tax purposes are considered to be Class III assets. They are the third class of assets used to reduce the purchase price.]

    d. Cash and cash equivalents. [This answer is correct. When making this allocation, the purchase price is first reduced dollar for dollar by Class I assets (if any). According to Reg. 1.338-6, Class I assets are cash and cash equivalents (other than CDs).]

18. What is one difference between business and personal casualty losses? **(Page 355)**

    a. Business casualty losses are limited by either the $100 per casualty threshold or a percentage of AGI. [This answer is incorrect. No percentage of AGI or $100 casualty threshold applies to limit the amount deductible for business casualty losses. This is different from how personal casualty losses are treated.]

    b. Business casualty loss is calculated on an aggregated total of all properties. [This answer is incorrect. According to Reg. 1.165-7(b)(2), for real property, a business casualty loss or involuntary conversion gain is calculated separately for each identifiable piece of property. For example, if a casualty damages or destroys an office building and its landscaping, the properties are taken into account separately to determine the casualty loss or conversion gain attributable to each. Personal casualty losses are treated differently from business casualty losses in this way.]

    c. If business property is destroyed and FMV is lower than its basis, FMV is not considered when calculating the loss. [This answer is correct. Per Reg. 1.165-7(b)(1)(ii), if business property is totally destroyed in a casualty and the FMV of the property is less than its adjusted basis immediately before the casualty, the loss is calculated solely by considering the adjusted basis and the insurance proceeds. The decrease in FMV is not considered. This way of calculating the loss is different for business casualty losses and does not apply to personal casualty losses.]

    d. The deductible amount of a business loss is determined after insurance proceeds are taken into account. [This answer is incorrect. The deductible amount of a casualty loss is determined after reduction for any insurance proceeds or other reimbursement a taxpayer receives or expects to receive on the casualty. However, this consideration applies to all casualty losses, so it is not a difference between business and personal casualty losses.]

Lesson 4: Bad Debt Losses, Debt Discharge Income, and Foreclosures

Introduction

Transactions involving bad debt losses, debt discharges, and foreclosures are relatively common for individual taxpayers. This lesson covers the rules for deducting bad debt losses and explains the tax treatments of debt discharge income and foreclosures.

Banks, other financial institutions, and certain government agencies generally must report debt discharges (partial or complete) on Form 1099-C (Cancellation of Debt) if the discharge is $600 or more. The discharged amount includes any amount owed to the lender that is forgiven, including loan principal, interest, penalties, administrative costs, and fines. To determine the year in which a debt is discharged, the lender must identify an event (e.g., bankruptcy of debtor, running of statute of limitations for debt collection, nonpayment for a 36-month period, cessation of collection activities, etc.) indicating the debtor will never have to pay the amount that is discharged (considering all the facts and circumstances). Sometimes the lender will issue Form 1099-C for the wrong year. For example, in *De Shon*, the taxpayer received a 1099-C for 2001. However, the Tax Court determined that the debt discharge event actually occurred in 1999, when the credit card lender ceased collection activities. Since 1999 was a closed year, the taxpayer did not have to recognize taxable debt discharge income with respect to that particular credit card debt.

This information reporting requirement helps eliminate questions concerning the date and amount of a discharge, although the debtor should make sure the information reported is accurate. A discharge based on a debt settlement agreement that is contingent on some future event (e.g., the debtor's payment of specified amounts) generally is deemed to occur on the date the contingencies are satisfied rather than the date the agreement is entered into.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the appropriate treatment for business and nonbusiness bad debts.
- Assess issues related to debt discharge income for solvent taxpayers and insolvent or bankrupt taxpayers, as well as recourse and nonrecourse debt from foreclosures by lenders, the reduction of seller-financed debt, and the consumer credit card debt modification.

Deducting Business and Nonbusiness Bad Debts

Individual taxpayers can deduct two types of bad debt losses: business and nonbusiness. Business bad debts result in ordinary losses; nonbusiness bad debts result in short-term capital losses. This distribution has been the subject of much litigation due to the $3,000 annual limit on deducting net capital losses ($1,500 for married taxpayers who file separately).

This discussion focuses on the rules of IRC Sec. 166(a), which provide a deduction for debts that become wholly or partially worthless within the tax year. However, IRC Sec. 166(a) does not apply to any debt securities. Rather, IRC Sec. 165 applies to debt securities. Loss on a debt security can be potentially deducted under the provisions of IRC Sec. 165(g). Worthless securities were discussed in Lesson 1.

Because of the difficulties in pinpointing the year a loan becomes wholly worthless, the normal three-year statute of limitations for filing amended returns does not apply to bad debt losses. Instead, a seven-year statute of limitations generally applies for refunds due to such losses.

Business Bad Debts

A business bad debt arises from—

1. a debt created or acquired in the ordinary course of the taxpayer's business (e.g., an account receivable) or

2. a worthless debt, the loss from which is incurred in the taxpayer's trade or business.

Item 2 is the most frequently contested. It often occurs when a shareholder or employee loans funds to a corporation and claims a business bad debt deduction when the loan becomes either wholly or partially worthless.

Trade or Business Requirement. In determining whether a bad debt loss was incurred in the taxpayer's trade or business, the focus is on the relation the loss bears to the taxpayer's business. If at the time of total or partial worthlessness, the relation is "proximate" in the conduct of the trade or business, the debt qualifies as a business bad debt. The Supreme Court, in *Generes*, stated that in determining whether the relation is proximate, the *dominant motivation* for making the loan must be business oriented. A significant motivation does not satisfy this requirement.

A business debt usually is made in the course of the lender's own trade or business, as opposed to a loan to another business. However, the taxpayer may establish that a loan to another business is a business loan if it was made (1) as part of the taxpayer's business of making loans or of promoting businesses, or (2) to protect the taxpayer's status as an employee, source of income, business relationship, or business reputation. For example, in *Newman*, the Tax Court concluded the taxpayer's substantial and recurring activities of promoting, organizing, financing, and selling various businesses constituted a trade or business. Therefore, the taxpayer's losses from loans advanced to the businesses and from guarantees of the businesses' loans qualified as business bad debt losses. In *Dagres*, a venture capitalist loaned money to a businessman who had provided him several leads to companies that the capitalist would invest in and operate. When the debtor defaulted, the Tax Court allowed a business bad debt deduction because the dominant motivation for making the loan was to protect and enhance his business of managing venture capital funds and not merely to protect his investments. A president of a family-owned moneylending business made personal loans to a commercial laundry business which went bankrupt. The taxpayer was able to show that his private lending activities constituted a trade or business and he was entitled to a business bad debt deduction.

In *Haury*, when a taxpayer transferred $435,000 from his personal IRA to two companies (documented properly as a loan) wherein he held a 49% ownership in each, and was an officer of each company, the Tax Court ruled that the dominant motivation for making the loans was not his trade or business as an employee of the companies. When the companies defaulted on the notes because of the loss of a major government contract, the Court held that the taxpayer was only entitled to a nonbusiness bad debt deduction. The Court indicated that although the taxpayer designed the software used by the companies and invested a significant amount of time and money to ensure their success, protection of his investment interests in the companies rather than protection of his salary was the dominant motivation for the loans.

A taxpayer who owned and operated a real estate maintenance service loaned money to a real estate developer whose debts were later discharged in a federal bankruptcy hearing. In *Chapman*, the Tax Court ruled that the taxpayer could not claim a bad debt deduction because the discharged loans were more indicative of a capital contribution to a joint venture. The Court cited the high level of risk of the unsecured loans, the high interest rate, and the irregular payments. In addition, the debtor performed personal services for the taxpayer, which indicated that the notes served as both an investment and as compensation to the taxpayer.

In Field Service Advice (FSA) 199911003, the IRS examined the factors for determining whether a taxpayer's loan qualifies as a trade or business. The IRS concluded the taxpayer could deduct the uncollectible amount of a note he had purchased as a business bad debt. The IRS found that the taxpayer was in the trade or business of lending money since he had loaned money and purchased notes for many years, had a reputation in the community as a lender and purchaser of notes, had been approached by unrelated borrowers and sellers of notes, and had taken action to enforce his rights under the note. Thus, the taxpayer's actions were consistent with an individual engaged in the money lending business.

The taxpayer's overall accounting method may affect whether a bad debt is deductible, even if it arises in the course of a trade or business. Thus, if the bad debt arose from an unpaid item of taxable income (e.g., account receivable for services rendered), a bad debt deduction is not allowed unless the related income was included in taxable income in either the current or prior tax year. For cash-basis taxpayers, a bad debt deduction is generally not allowed for uncollectible accounts receivable since these items are normally not included in income until received.

Partial versus Total Worthless Debt. A deduction can be claimed when a business bad debt becomes either partially or totally worthless. If the taxpayer can collect some, but not all, of the debt, the debt is partially worthless. If the taxpayer cannot collect any of the outstanding debt (even if part was collected in the past), the debt is totally worthless.

Before a taxpayer can deduct a partially worthless business debt, he must show that (1) partial worthlessness has occurred and (2) the amount was charged off on the books of the business. For tax purposes, the taxpayer has the following options:

1. Claim a deduction for any portion of the debt, up to the amount actually written off the books during the year. (For example, if EasyCredit, an accrual-basis sole proprietorship, wrote off $10,000 of a $30,000 receivable due from Thrift Co. for book purposes, the taxpayer can claim a current-year bad debt deduction for any amount up to and including $10,000.) Recording a book charge-off requires that the portion charged off must no longer appear as an asset in the business's financial records or on its financial statements. However, it does not mean the business must cancel the debt or notify the debtor of the charge-off. Thus, the taxpayer may still continue its collection efforts while claiming a tax deduction for a partially worthless debt.

2. Forgo a current-year tax deduction in favor of waiting until the balance of the debt is either collected or deemed worthless to claim a bad debt deduction.

The taxpayer can treat each partially worthless debt differently. However, in no case can a deduction be claimed any later than the year a debt becomes completely worthless.

A totally worthless debt is deductible only in the tax year it becomes totally worthless. Naturally, the deduction for that year does not include any amount deducted in an earlier year when the debt was only partially worthless.

Employee versus Shareholder Loans. In *Litwin*, the 10th Circuit allowed an employee-shareholder's business bad debt deduction for amounts loaned to the corporation. The deduction was allowed because the taxpayer's predominant motives for making the loans were that he (1) wanted to remain employed, earn a salary, and remain useful to society; (2) spent a large portion of his time working for the corporation; (3) intended to draw a salary in the future; and (4) took a sizable risk when he guaranteed loans far in excess of the value of his investment (indicating there was another motive besides investment). Although the taxpayer's loans were much larger than the salary anticipated in the near future, the Court ruled his business motives outweighed his investment motives.

In contrast, the 7th Circuit ruled in *Hough* that a taxpayer's advances to a controlled corporation did not result in business bad debts. The taxpayer received no compensation from the corporation and was not considered to be in the business of loaning money, nor was he in the business of selling corporations he owned. Thus, when a taxpayer's predominant motivation for making loans is to protect his investment as a shareholder, nonbusiness bad debt status generally applies. *Mills* and *Scallen* illustrate situations in which the courts have ruled shareholders should be denied business bad debt deductions.

In *Dickinson*, the Tax Court found that a taxpayer who advanced funds to a new employee was not entitled to deduct as a business bad debt either the funds that he knowingly advanced or the funds that the employee misappropriated from the business. The Court noted that the taxpayer failed to prove that the arrangement constituted a bona fide loan because of the absence of any objective characteristics of a loan such as interest or a debt instrument. In addition, the Court found that the taxpayer had no reasonable expectation that he would be able to recover any portion of the funds at the time they were advanced because of the employee's known financial problems.

Loans versus Capital Contributions. The first step in analyzing a shareholder loan (for bad debt deduction purposes) is determining whether the advance is a valid debt as opposed to a capital contribution. In TC Memo 2013-170, the 9th Circuit agreed with the Tax Court that a series of advances by a shareholder to a family corporation did not constitute a bona fide loan and thus disallowed the loss deduction. Factors used in deciding whether payments by a shareholder to a corporation are debt or equity include (1) the name given to the certificate evidencing the indebtedness, (2) whether a fixed maturity date exists, (3) whether the party providing the funds can enforce payment, (4) the source of the payments, (5) whether the party providing the funds is given an increased participation in management, (6) the intent of the parties, (7) whether the corporation is adequately capitalized, (8) whether interest is paid, (9) whether the corporation can obtain loans from outside lenders, (10) the extent to which the corporation uses the advance to acquire capital assets, (11) whether shareholders provide funds in proportion to their stock interests, (12) whether the business repaid the amount advanced when due, and (13) whether the business's obligation to repay the advance is subordinated to other creditors.

In *Nachman*, a 50% shareholder-employee was allowed a business bad debt deduction for funds advanced to the corporation. The advance was treated as a loan because it (1) provided for payment of interest and the shareholder reported interest income on his return, (2) did not increase the shareholder's participation in management, and (3) was treated as a loan on the corporate books and tax returns. In addition, the corporation was adequately capitalized and used the funds for working capital. The loan met the trade or business requirement because the motivation for making the loan was to protect the corporation's line of credit. The bank required the shareholder to provide working capital to the corporation in return for continued financing.

Conversely, an 80% shareholder was denied a bad debt deduction for funds advanced to the corporation in *Kadlec*; the funds were deemed to be a capital contribution. Although the shareholder received a note from the corporation, the factors indicating that the advance was actually a capital contribution were (1) the corporation could not obtain other financing, (2) the loan repayments were to be made from corporate profits, (3) the corporation was thinly capitalized, and (4) no interest payments were made on the note.

In *Bell*, the 8th Circuit upheld the Tax Court's denial of a business bad debt deduction for purported loans, which the Court characterized as capital contributions. The taxpayer made the purported loans to two corporations that he purchased to rehabilitate and resell. Moreover, he provided no personal services to the corporations. The purported loans were made to provide capital and thus were related to the taxpayer's role as shareholder of the corporations.

In TC Memo 2017-12017, the taxpayer owned an S corporation that provided tax return preparation services. Over several years, the S corporation advanced funds to various small businesses in exchange for minority equity interests. After determining that the ventures would never be profitable, the S corporation reported a bad debt deduction of approximately $10.6 million. According to the taxpayer, it was the intent of both parties to treat the arrangements as loans. The Tax Court disagreed, however, concluding that the advances were equity contributions. The parties never executed a formal loan agreement, interest was not charged, and there was no fixed maturity date. The Tax Court also noted that the S corporation continued to finance the businesses after the tax year in which the bad debt deduction was claimed.

In TC Memo 2017-362017, unpaid loans made by the taxpayer were not deductible as bad debts due to a lack of substantiation. The taxpayer loaned money to Continental Financial Services, a sole proprietorship owned by a close friend. The taxpayer was unable to provide evidence that he actually advanced money to Continental, that he reasonably expected that he would be repaid or that he was in the business of lending money.

In *Indmar Products*, the Sixth Circuit ruled that the shareholders' cash advances to their closely held C corporation were debt rather than equity based on the following 11 factors.

1. *Descriptions on Documents.* If shareholder advances are not described as loans payable on the corporation's books and as loans receivable in the shareholder's financial records, the case is weakened for treating shareholder advances as debt.

2. *Maturity Date and Repayment Schedule.* The presence of a fixed maturity date and defined schedule of payments indicates debt. Actual repayments of purported debt principal amounts are very persuasive in making the case that shareholder advances are legitimate debt. However, fixed maturity dates and

repayment schedules are not required for demand loans (payable at any time upon the demand of the shareholder-lender).

3. *Interest Rate and Payments.* The presence of a fixed rate of interest and the presence of actual interest payments indicate debt. Actual timely payments of fixed-rate interest persuasively make the case that shareholder advances are legitimate debt.

4. *Source of Repayment Funds.* The Sixth Circuit opined that relying on company profits to generate cash to repay loans is more characteristic of equity. However, in the real world, operating profits are often expected to be the main (if not the only) source of funds to repay even unquestionably legitimate third-party loans.

5. *Debt-to-Equity Ratio.* An excessively high debt-to-equity ratio indicates that shareholder advances may be equity. However, this factor is basically moot when the corporation demonstrates a pattern of repaying purported debt amounts along with appropriate interest.

6. *Overlap Between Shareholders and Lenders.* Purported loans made by shareholders strictly in proportion to their stock ownership interests indicate equity unless there is only one shareholder.

7. *Security.* A lack of adequate security indicates equity.

8. *Availability of Debt Financing from Outside Sources.* When a corporation is demonstrably able to obtain third-party debt financing if it wishes, purported shareholder loans are more likely to be legitimate debt.

9. *Subordination.* Subordination of purported shareholder loans to all debt owed to third-party creditors is indicative of equity.

10. *Use of Proceeds.* Using the proceeds from shareholder advances to acquire long-term capital assets indicates equity, while using the proceeds for working capital indicates debt. In the real world, however, corporations commonly take out unquestionably legitimate third-party loans to acquire capital assets.

11. *Sinking Fund.* The Sixth Circuit opined that the existence of a sinking fund indicates debt. However, the existence of a sinking fund is actually just another form of security, and the security factor was already taken into account in item 7 above. Also, in the real world, many closely held corporations will be unwilling to establish sinking funds even for unquestionably legitimate third-party debt.

Tax Return Presentation. A business bad debt gives rise to an ordinary loss deduction. Report a bad debt that arises in the ordinary course of an individual's unincorporated business (i.e., accounts receivable) on Schedule C or F, whichever is applicable. Report a bad debt that is the result of an employee-shareholder loan to a corporation as an unreimbursed employee business expense (subject to the 2% of AGI limit) on Schedule A of Form 1040. It is important to remember that miscellaneous itemized deductions are added back to income when making the AMT calculation.

Example 4A-1 Business bad debt.

Ted runs his business as a sole proprietorship. He guaranteed payment of a $10,000 note of his best supplier in an effort to ensure the supplier continued in business. The supplier later filed bankruptcy and defaulted on the note. Ted was forced to make full payment under his guarantee. His efforts to recover from the supplier proved unsuccessful. What is the nature of Ted's $10,000 bad debt loss?

Ted's loss is a business bad debt loss since his guarantee was spurred by his business motive to retain his best supplier. The bad debt loss is claimed on Ted's Schedule C.

Variation: Assume that Ted is an employee of his solely owned C or S corporation. In this case, the business bad debt deduction should be reported as unreimbursed employee business expense on Schedule A.

Nonbusiness Bad Debts

Bad debts that are not business bad debts are nonbusiness bad debts (assuming they are not actually gifts). A nonbusiness bad debt is deductible as a short-term capital loss only in the year it becomes totally worthless. A deduction for partial worthlessness of a nonbusiness debt is not allowed.

Timing of Nonbusiness Bad Debt Loss. The lender is not required to wait until the debt is due to determine it is worthless. The debt becomes worthless in the year when it becomes clear there is no chance of repayment. Bankruptcy of the debtor is generally good evidence that an unsecured or nonpreferred debt is worthless. However, in most cases, worthlessness exists only after the debt is due and collection efforts have begun. The lender must show that reasonable steps were taken to collect the debt.

Tax Return Presentation. A nonbusiness bad debt is deducted as a short-term capital loss on Form 8949 (Sales and Other Dispositions of Capital Assets) and Schedule D (subject to the normal limitations on short-term capital losses). If there is more than one nonbusiness bad debt deduction in the tax year, list each bad debt separately on Form 8949. A statement should also be attached to the tax return to document each nonbusiness bad debt. The following information should be included: (1) a description of the debt, including the amount and due date; (2) the debtor's name and relationship to the taxpayer; (3) the collection efforts made; and (4) why the debt is considered wholly worthless.

Example 4A-2 Nonbusiness bad debt.

In January 2017, John, an attorney, made a personal unsecured loan of $5,000, due October 1, 2017, to Peter, a client. On September 1, 2017, Peter declared bankruptcy; the debt became totally worthless. Although Peter was a valued client, his business was not critical to the success of John's practice. John can deduct the loss on Peter's bad debt as a nonbusiness bad debt. Since John is not in the business of lending money and no overriding business reason existed for him to make the loan, the debt is nonbusiness. The loss is reported as a short-term capital loss on Form 8949 and Schedule D.

Variation: If the loan only became partially worthless in 2017, no portion of the loss would be deductible that year because it is a nonbusiness bad debt.

Intrafamily Loans

Bad debts resulting from loans between family members are subject to close scrutiny, and are generally presumed to be gifts unless it can be established that a bona fide loan exists. If a bona fide loan exists, a bad debt deduction is possible if the borrower defaults. To qualify as a bona fide loan, an advance must be made with a reasonable intention of noncontingent repayment. While no one factor is controlling, the courts review the intent of the parties and the existence of the following as evidence of a bona fide loan: (1) a note or other evidence of indebtedness; (2) interest being charged; (3) a fixed repayment schedule; (4) security or collateral; (5) a demand for repayment; (6) the parties' records, if any, reflecting the transaction as a loan; (7) any repayments made; and (8) the solvency of the borrower. Advances made after a family member becomes insolvent are deemed to be gifts since a reasonable expectation of repayment cannot exist when the advance is made.

Although these loan formalities help establish a debtor-creditor relationship, a bona fide debt can exist without them. In *Bowman*, the Tax Court allowed a taxpayer's nonbusiness bad debt deduction for money transferred to his daughter even though the only documentation was the notation "loan" on several of the checks. The Court found the taxpayer had a history of making similar loans to other family members and friends (which were repaid) and that his and his daughter's actions showed the requisite intent to establish a debtor-creditor relationship. However, the better the documentation, the better the chance of establishing the existence of a bona fide debt (and thus a bad debt deduction).

Example 4A-3 Bad debt loss from loan to relative.

Bowen loaned his son, Rocky, $3,000 to buy a car. Rocky was to pay Bowen $50 a month until the $3,000 was repaid. Rocky paid back $500 but was unable to repay the remaining $2,500, which was then forgiven by Bowen. There was no documentation of Bowen's loan to Rocky. Can Bowen deduct $2,500 as a nonbusiness bad debt?

Because the transaction was between relatives; had no business, profit, or investment motivation; and lacked evidence of being a bona fide debt, the forgiveness of the debt is considered a gift and not a bad debt loss. No deduction is allowed.

Loan Guarantees

To claim a bad debt loss deduction, a taxpayer making a payment on a loan guarantee that becomes unrecoverable (i.e., worthless) must be able to show that the guarantee was made in the course of his trade or business or in a transaction entered into with a profit motive. In addition, the taxpayer must receive reasonable consideration for entering into the guarantee agreement. For the guarantee of a nonfamily member's debt, consideration can be either direct (i.e., cash or other property) or indirect. Indirect consideration is determined in accordance with normal business practice and may, for example, be in the form of improved business relationships. For the guarantee of a family member's debt, however, the consideration must be direct (i.e., cash or other property). Here, the term *family member* is defined very broadly (e.g., the term includes in-laws and step-relationships) and includes all individuals listed in IRC Sec. 152(a) relating to the dependency exemption.

When payment is made under a loan guarantee, the taxpayer usually assumes the role of the original lender. Thus, payment under the guarantee generally gives the guarantor the right to, in turn, demand payment from the borrower. The guarantor, therefore, cannot claim a bad debt loss until reasonable collection efforts against the borrower have failed. This often means a bad debt loss will not be allowable in the same year payment under the guarantee occurs. Once collection efforts have failed, the guarantor has either a business or nonbusiness bad debt loss (or a gift) depending on the facts and circumstances of the original guarantee.

Example 4A-4 Paying on guarantee of family member's loan.

Alfred retired from farming and began leasing his farmland to his son, Michael, who continued working the farm. Alfred had dealt with First National Bank (FNB) for many years. When Michael secured a farm loan from FNB, Alfred agreed to guarantee it to assist Michael and to ensure a continued good relationship with FNB. In the current year, Michael quit farming because of ongoing losses and, therefore, was unable to repay the balance of the FNB loan. Under the terms of the guarantee, Alfred paid FNB $110,000. Based on Michael's financial situation, Alfred will not be able to recover any of the funds from Michael.

Alfred cannot claim a $110,000 nonbusiness bad debt. Since Michael is a family member, Alfred can claim a nonbusiness bad debt for paying on the loan guarantee only if he had received from Michael cash or other property as consideration for his guarantee. Alfred received neither, so the $110,000 payment is not deductible.

Recoveries of Bad Debts

A taxpayer who deducts a bad debt and subsequently recovers (collects) all or part of the debt must include the amount recovered in income. However, the amount includable in income is subject to the tax benefit rule. The recovery is included in income only to the extent the original deduction provided a tax benefit. If a deduction gave rise to a net operating loss carryover or capital loss carryover that has not expired before the beginning of the tax year in which the recovery occurs, the deduction will be treated as having provided a tax benefit.

Presumably, the character of the income recognized because of a recovery is the same as that of the originally claimed bad debt deduction. Thus, the recovery of a business bad debt normally generates ordinary income while a nonbusiness bad debt recovery is treated as short-term capital gain.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. A business bad debt can arise from which of the following?

    a. Nonbusiness debts.

    b. The taxpayer's accounting method.

    c. A taxpayer's worthless personal debt.

    d. A debt acquired during the ordinary course of business.

20. Aaron, Theresa, Wade, and Jennifer all make cash advances to their closely held C corporation, Rockin' C Construction. Which advance is most likely to be considered debt rather than equity?

    a. Aaron's payment is described as an advance in both his personal records and Rockin' C's books.

    b. Theresa allows Rockin' C to repay her when it has enough revenue and payments have not yet begun.

    c. Wade makes his advance after ensuring the funds are secure and Rockin' C would qualify for an outside loan.

    d. Jennifer allows Rockin' C to pay her back the amount of the advance without interest.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. A business bad debt can arise from which of the following? **(Page 361)**

    a. Nonbusiness debts. [This answer is incorrect. Bad debts that are not business bad debts are nonbusiness bad debts (assuming they are not actual gifts), as outlined in IRC Sec. 166(d)(2). Therefore, a nonbusiness bad debt is a separate consideration from a business bad debt, and one cannot arise from the other.]

    b. The taxpayer's accounting method. [This answer is incorrect. The taxpayer's overall accounting method may affect whether a bad debt is deductible, but it is not the source of the bad debt, as described in IRC Sec. 166(d)(2).]

    c. A taxpayer's worthless personal debt. [This answer is incorrect. Under IRC Sec. 166(d)(2), a bad business debt can arise from a worthless debt, the loss from which is incurred in the taxpayer's trade or business. This type is the most frequently contested by the IRS. However, since a taxpayer's personal debts are not associated with the business, a business bad debt would not arise from a personal debt, even if the personal debt becomes worthless.]

    d. A debt acquired during the ordinary course of business. [This answer is correct. According to IRC Sec. 166(d)(2), a business bad debt can arise from two places. One way business bad debts occur is from a debt created or acquired in the ordinary course of the taxpayer's business (e.g., an account receivable).]

20. Aaron, Theresa, Wade, and Jennifer all make cash advances to their closely held C corporation, Rockin' C Construction. Which advance is most likely to be considered debt rather than equity? **(Page 361)**

    a. Aaron's payment is described as an advance in both his personal records and Rockin' C's books. [This answer is incorrect. If shareholder advances are not described as loans payable on the corporation's books and as loans receivable in the shareholder's financial records, per the Sixth Circuit's ruling in *Indmar Products*, the case is weakened for treating shareholder advances as debt. Therefore, Aaron is less likely that some of his cohorts to have his advance considered debt.]

    b. Theresa allows Rockin' C to repay her when it has enough revenue and payments have not yet begun. [This answer is incorrect. Based on the findings in *Indmar Products*, the presence of a fixed maturity date and defined schedule of payments indicates debt. Actual repayments of purported debt principal amounts are very persuasive in making the case that shareholder advances are legitimate debt. Therefore, due to the lack of maturity and repayment dates, Theresa's debt is less likely to be considered true debt.]

    c. Wade makes his advance after ensuring the funds are secure and Rockin' C would qualify for an outside loan. [This answer is correct. The Sixth Circuit looked at 11 factors in *Indmar Products* to determine whether shareholders' cash advances to their closely held C corporation were debt rather than equity. Based on those factors, a lack of adequate security indicates equity rather than debt; however, that is not the case for Wade's advance. Also, when a corporation is demonstrably able to obtain third-party debt financing if it wishes, purported shareholder loans are more likely to be legitimate debt. Therefore, based on these two factors, Wade's advance is the most likely to be treated as debt in this scenario.]

    d. Jennifer allows Rockin' C to pay her back the amount of the advance without interest. [This answer is incorrect. The presence of a fixed rate of interest and the presence of actual interest payments indicate debt, per *Indmar Products.* Actual timely payments of fixed-rate interest persuasively make the case that shareholder advances are legitimate debt. However, since Jennifer did not charge the corporation interest, her advance is less likely to qualify as debt.]

Debt Discharge Income in Relation to Solvent Taxpayers

Cancellation or forgiveness of a debt (other than as the result of a gift) results in gross income for the debtor unless an exception applies because he is in bankruptcy or insolvent, or the debt is qualified farm debt, qualified real property business debt, a certain type of student loan, or qualified principal residence indebtedness. See discussions for these exceptions later in this lesson. A special rule applies to a reduction of a seller-financed (i.e., purchase money) debt owed to the seller of the property.

Similar to determining when a debt can be deducted, debt cancellation income is recognized when the lender has absolved the borrower from any future repayment of that portion of the debt. However, unlike a debt deduction, a portion of the loan may be forgiven and recognized as income in the current year, as opposed to the full loan. In addition, there must be documentation that the loan has been forgiven. The Tax Court ruled that a taxpayer did not need to recognize cancellation of indebtedness income after selling a mortgaged property for less than the balance due. The mortgage holder did not issue the taxpayer a Form 1099-C. Instead, the mortgage holder sent the taxpayer a letter indicating that, while the loan had been "charged off," the taxpayer was still "obligated for the repayment of the debt."

Taxpayers may have elected to defer the recognition of income arising from the cancellation of indebtedness from the reacquisition of certain debt in calendar year 2009 or 2010. To have been eligible for deferral, the debt must have been issued by the taxpayer "in connection with" a trade or business. Generally the deferred cancellation of indebtedness income must be recognized ratably over five years beginning in 2014. Such deferral is terminated under certain circumstances. A full discussion of those circumstances is beyond the scope of this course, but more information is available in *PPC's 1120 Deskbook*.

Debt discharge income resulting from debt allocated to passive activity expenditures (e.g., when a rental property's mortgage balance is reduced by a lender) is passive income and can be offset by passive losses. Debt discharge income resulting from the cancellation of investment-related debt is treated as investment income for purposes of the investment interest expense limitation.

Example 4B-1 Loan renegotiation.

Helen borrowed $250,000 for her sole proprietor dress shop in 2014, financing it with a balloon payment loan from Qwik Savings. Helen reports her business on a cash basis. In 2017, she was forced to sell the business. Unfortunately, its value had dropped to $200,000. Helen found a buyer and then renegotiated the principal balance of her loan from $250,000 to $200,000; $10,000 of accrued but unpaid interest was also forgiven. She used the $200,000 sale proceeds to pay off the loan. Helen was not insolvent when the loan was renegotiated.

Because Helen was not insolvent when the loan was renegotiated, the full amount of the loan reduction ($50,000) is taxable income from debt discharge in 2017. No income is recognized for the $10,000 of forgiven interest since she is on a cash basis and no deduction had been taken for the interest expense.

An exception to the usual treatment of debt discharge income may apply to contested liabilities. If a party demands payment for a liability over which there is a dispute, the eventual agreement to pay a reduced amount may not give rise to debt discharge income. The 3rd Circuit, in *Zarin*, found that the disputed debt doctrine applied when the debt's existence was in doubt. The taxpayer incurred gambling debts of more than $3 million according to a casino. Eventually, he settled with the casino for $500,000. Because the gambling debt was illegal, and thus, unenforceable, the court found the excess of the original debt over the settlement amount was not taxable income. In *Earnshaw*, the taxpayer disputed the amount of interest and late fees added to his credit card balance. When he settled the debt for less than the balance on the credit card company's books, only the amount of the liquidated debt (i.e., the amount fixed by agreement or by the operation of law) over the amount paid was taxable debt discharge income. The cancellation of the disputed charges did not generate debt discharge income.

In *Preslar*, the Circuit refused to apply the disputed debt doctrine when the amount but not the existence of the debt was contested.

A loan guarantor who pays off another taxpayer's loan at a discount generally does not recognize debt discharge income because the guarantor is not the primary obligor. In *Whitmer*, the Tax Court has ruled that a shareholder-guarantor of corporate debt did not recognize debt discharge income upon payment of the debt at a reduced amount. The shareholder was merely the guarantor of the corporate debt; the debt discharge income was attributable to the corporation. Likewise, a taxpayer who transfers property to a lender to release another taxpayer from debt does not realize a gain or loss since the transferor was not obligated under the debt. Thus, its cancellation is not consideration to the transferor. Without consideration, the Court found in *Friedland* there could be no gain.

Effect of Debt Modifications

A debtor that issues a new debt instrument in satisfaction of existing debt is treated as having paid off that debt with an amount of money equal to the *issue price* (determined under the OID rules of IRC Secs. 1273–1274) of the new debt. To avoid default, a lender will often modify the terms of a debt in favor of the debtor. Significant modification of the terms of a debt instrument is considered an exchange of old debt for new and may give rise to debt discharge income.

A modification is significant if, based on all facts and circumstances, the legal rights or obligations being changed and the degree to which they are changed are economically significant. To determine this, generally all modifications to the debt instrument are considered collectively (when a series of modifications, if considered separately, would not be significant). However, certain modifications listed in Reg. 1.1001-3(e)(2) through (6) are considered independently. The regulations also provide guidelines for determining whether these independently-considered modifications are significant. The modifications listed in the regulations are as follows:

1. Changes in the obligation's yield.

2. Changes in the timing of payments.

3. Changes in the obligor or security.

4. Changes in the nature of the debt instrument.

5. Changes in customary accounting or financial covenants.

The new (i.e., significantly modified) debt will generate debt discharge income if its issue price is less than the balance of the old debt. Under the OID rules applicable to nonpublicly traded debt, if the new debt has an interest rate at least equal to the applicable federal rate (AFR), and interest is unconditionally payable at least annually, the debt's issue price is deemed to be its stated principal amount. Thus, the issuance of new debt (or significant modification of an existing debt) with a principal balance equal to the old debt will *not* result in debt discharge income, provided the new (or modified) debt's interest rate equals or exceeds the AFR and interest is paid at least annually. However, if the interest rate is less than the AFR or payments occur less frequently than annually, the issue price is generally the present value of all payments required under the terms of the debt discounted at the AFR, and debt discharge income will result.

Example 4B-2 New debt issued for existing debt; interest rate exceeds AFR.

John purchased machinery for his sole proprietorship business on January 1, 2013, financed with a $350,000, 8% note due in 10 years, payable monthly. The balance at January 1, 2017, was $257,000. On January 2, 2017, John and the lender agreed to refinance the note at a 5% annual rate. No other terms were modified.

Because the changed loan terms resulted in a significant modification under Reg. 1.1001-3, the old loan is considered exchanged for a new loan (with a term of six years). However, there are no tax consequences to the refinancing since the stated rate of 5% exceeded the January 2017 midterm AFR. Thus, the issue price of the new debt is deemed to be its stated principal amount ($257,000), which equals the face value of the old debt.

Acquisition of Debt by Related Party

The direct or indirect acquisition of indebtedness by a person related to the debtor from a person who is not related results in debt discharge income equal to the difference between the outstanding balance of the debt acquired and its FMV. A related person includes family members, more-than-50%-owned corporations, and more-than-50%-owned partnerships, as well as certain trust and beneficiary relationships. For this rule, family members include the debtor's parents, spouse, children, grandchildren, and their spouses.

A direct acquisition occurs if a person related to the debtor acquires the indebtedness from a person who is not. An indirect acquisition is generally a transaction in which the holder of outstanding debt becomes related to the debtor, if the holder is treated as having acquired the debt "in anticipation of" becoming related to the debtor.

Example 4B-3 Acquisition of debt by party related to debtor.

In 2014, Dawn borrowed $500,000 by executing a note with Last Bank. The terms provide for interest payments of 5% due each December 31 and a balloon at maturity of $500,000. The note matures on December 31, 2019. On June 1, 2017, Bloom Corp. (owned 100% by Dawn) purchased the note from Last Bank for $450,000 (its FMV at that time).

Since Bloom is a related party, Dawn recognizes $50,000 of debt discharge income in 2017. The income would be excludable under IRC Sec. 108(a) if Dawn is bankrupt or to the extent she is insolvent.

Special Rules for Farmers

In addition to bankrupt and insolvent taxpayers, farmers do not have to recognize debt discharge income if the forgiven debt is *qualified farm indebtedness*. For this exception, all of the following conditions must be met:

1. The debt was incurred directly in the business of farming.

2. At least 50% of the taxpayer's gross receipts from all sources, including farming, for the preceding three years were attributable to the business of farming.

3. The lender is unrelated to the taxpayer and is actively and regularly engaged in the business of lending money or is a government agency or instrumentality.

The amount of debt discharge income excludable by farmers is limited to the total of certain tax attributes plus the aggregate bases of business property and property held for the production of income. To the extent the debt discharge exceeds these attributes, income must be recognized.

Example 4B-4 Discharge of farm indebtedness.

Bill has been in the farming business for 10 years. More than 50% of his annual gross receipts are attributable to farming. In 2014, he borrowed $75,000 from a state agricultural agency for farm operating expenses. For several years, he could not meet certain financial obligations, although he was not insolvent or in bankruptcy. In 2017, the state agency discharged the $70,000 remaining balance of its loan to Bill.

The discharge will not result in income to Bill because he meets the Section 108(g) rules for discharge of qualified farm indebtedness. However, assuming Bill has no other tax attributes that can be reduced (as discussed later in this lesson), he must reduce his tax basis in depreciable business or income-producing property, then reduce his basis in farmland, and finally reduce his basis in other business or income-producing property to the extent of the $70,000 discharged indebtedness. This basis reduction is reported on Form 982 [Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)]. Any debt discharge income in excess of these basis reductions is includable in gross income on the "Other income" line of Schedule F of Bill's Form 1040.

Special Rules for Real Property Business Debt

A taxpayer who is *not* insolvent or bankrupt can elect to exclude from gross income any income from the discharge of qualified real property business debt. Qualified real property business debt includes debt—

1. that was incurred or assumed in connection with real property used in a trade or business and that is secured by such real property;

2. that was incurred or assumed (a) before January 1, 1993, or (b) on or after January 1, 1993, and is qualified acquisition debt (i.e., debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business); and

3. with respect to which an election to invoke the special rules of IRC Sec. 108(a)(1)(D) has been made. If the taxpayer wishes to treat a partnership interest as depreciable property, it must obtain the consent of the partnership.

In Rev. Rul. 2016-15, the IRS gave two examples of individual taxpayers who had debt forgiven on property used in their real property trades or businesses.

The first example involved a taxpayer who borrowed $10 million from a bank and used it to build an apartment building for use in his rental trade or business. The taxpayer made payments on the loan and reduced the loan principal to $8 million, but was unable to pay it off on the maturity date. At that time, the FMV of the building was $5 million, and the taxpayer's adjusted basis was $9.4 million. Upon negotiation, the bank agreed to accept $5.25 million to forgive the loan. The taxpayer was not insolvent or bankrupt when the loan was forgiven. The taxpayer elected to exclude the amount forgiven ($2.75 million) under IRC Sec. 108(a)(1)(D). The debt is considered qualified real property indebtedness because the taxpayer held the property for use in a trade or business and was allowed to depreciate the property. As a result, the taxpayer can exclude the gain from gross income and reduce his basis in the building.

The taxpayer in the second example borrowed $10 million to construct a residential community. The taxpayer then subdivided the property and attempted to sell the individual lots. The rest of the facts are the same. The taxpayer wanted to exclude the amount forgiven ($2.75 million) from gross income. However, he may not because the qualified real property indebtedness rules cannot be applied to property that is not depreciable in the taxpayer's hands. This is the case for property primarily held for sale to customers. Therefore, this taxpayer does not qualify to exclude the income under IRC Sec. 108(a)(1)(D).

Qualified real property business debt does *not* include qualified farm indebtedness but does include debt incurred to refinance qualified real property business debt (to the extent refinancing proceeds do not exceed the principal amount of the qualified real property business debt being refinanced).

Example 4B-5 Determining qualified real property business debt.

George operates an auto repair shop as a sole proprietor. He purchased a tract of land in 2015 and built his own shop. The cost of the land and building was $200,000, financed by a $25,000 down payment and a $175,000 nonrecourse note obtained from a third-party lender. On July 31, 2017, when the FMV of the land and building is $100,000 and the balance of the note is $150,000, the lender agrees to reduce the principal of the note by $50,000. Since the note is qualified acquisition debt, the debt discharge income is excluded from George's gross income if he makes the Section 108(a)(1)(D) election.

As previously stated, the debt must be incurred or assumed in connection with a trade or business. This trade or business requirement can be particularly difficult for rental properties to meet and is usually based on the extent of the taxpayer's involvement in the rental activity. In Ltr. Rul. 9426006, the IRS concluded that a taxpayer's involvement was sufficient to constitute a trade or business even though a management company was engaged as the leasing agent and handled day-to-day operations. Rentals conducted as "net leases" (the lessee is responsible for all lease expenses, including taxes, insurance, rent, operating expenses, any mortgage interest/principal payments, etc.), however, generally do not qualify as a trade or business.

The taxpayer must make a valid election to exclude income from the discharge of qualified real property business debt. It is made on Form 982 and attached to the taxpayer's return for the tax year the discharge occurs.

Limitation on Exclusion. The amount of qualified real property business debt discharge income that can be excluded cannot exceed the lesser of the following:

1. *FMV Limitation.* The excess of the outstanding principal amount (immediately before the discharge) over the FMV of the real property securing the debt (reduced by the principal amount of any other qualified real property business debt secured by the property). The outstanding principal amount is the principal amount of indebtedness together with all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future.

2. *Overall Limitation.* The aggregate adjusted basis of all depreciable real property held by the taxpayer immediately before the discharge reduced by depreciation claimed for the year of the excluded debt discharge income.

When applying the overall limitation, the adjusted basis of the taxpayer's depreciable real property must first be reduced by (1) any reduction in basis made under IRC Sec. 108(b) for reductions in tax attributes of a bankrupt or insolvent taxpayer, or (2) any reduction made under IRC Sec. 108(g) for the discharge of qualified farm debt. If depreciable real property is acquired in contemplation of a discharge of qualified real property business debt, the property's basis is not included in applying the overall limitation.

Example 4B-6 Application of real property business debt limitations.

Joan owns a building used in her business. Its FMV is $150,000 (adjusted basis $175,000). The building secures a first mortgage of $110,000 and a second mortgage of $90,000. None of the debt is qualified farm indebtedness. Joan is not insolvent or bankrupt and owns no other depreciable real property.

On July 1, 2017, the second mortgagee agrees to reduce its debt from $90,000 to $30,000, resulting in debt discharge income of $60,000. The FMV rule limits the total amount of debt discharge income that can be excluded to $50,000, the amount by which the principal of the debt ($90,000) exceeds the FMV of the collateral property, reduced by other qualified real property business debt securing the property ($150,000 − $110,000 = $40,000). Therefore, Joan can exclude $50,000 of debt discharge income if she files an election to do so with her 2017 return. The remaining $10,000 of debt discharge income is included in her 2017 income.

Basis Adjustment Requirement. Income excluded for the discharge of qualified real property business debt reduces the basis of the taxpayer's depreciable real property. [The reduction is made under IRC Sec. 1017, except the election to treat real property inventory as depreciable property is not available.] The basis reduction is made first to the adjusted depreciable basis of the real property securing the discharged debt. Any excess reduces the depreciable bases of the taxpayer's other depreciable real property proportionately, based on each property's relative adjusted basis. The basis reduction is deemed to occur at the beginning of the tax year following the tax year during which the discharge occurs. However, if the property is disposed of before the beginning of the tax year following the discharge, the basis reduction occurs immediately before the disposition.

Example 4B-7 Reducing the basis of depreciable real property.

Bill owns Garden Apartments. On July 1, 2017, the property has an adjusted basis of $2.2 million and outstanding nonrecourse debt of $2.5 million. The property's FMV is $2 million.

On that day, the mortgage holder reduces the principal amount of the outstanding mortgage to $2 million, resulting in debt discharge income of $500,000. Bill elects to exclude this $500,000 of income under the qualified real property business debt rules. Therefore, his depreciable basis in the apartments is reduced by $500,000 as of January 1, 2018, and depreciation calculated for periods subsequent to that date will take the $500,000 basis reduction into account.

Partnership Debt Reduced. For a discharge of partnership debt, the determination of whether debt is qualified real property business debt and the application of the FMV limitation is made at the partnership level. The election to

apply the exclusion is made at the partner level on a partner-by-partner basis. When an election causes a basis reduction to the partner's allocable share of the partnership's depreciable real property, the partner's basis of his interest in the partnership and the partnership's basis of the depreciable realty allocated to the partner are reduced by such amount.

S Corporations Apply Rules at the Entity Level. The income exclusion under IRC Sec. 108 and any resulting reduction in tax attributes are applied at the S corporation level. IRC Sec. 108(d)(7)(A) clarifies that income excluded under IRC Sec. 108 does not increase a shareholder's basis in S corporation stock.

Special Rules for Certain Student Loans

Cancellations of all or part of certain student loans obtained to attend qualified educational institutions do not result in gross income to the borrower. This special rule applies only to student loans that contain a provision stating that all or part of the loan will be cancelled if the borrower works for a certain period of time in certain professions for any of a broad class of employers (i.e., a public service requirement), and the borrower satisfies such requirement. To qualify, the loan must be made by either—

1. a federal, state, or local government unit, or instrumentality, agency, or subdivision thereof;

2. a tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law; or

3. an educational institution that makes the loan under (a) an agreement with an entity described in item 1 or 2, or (b) a program of the institution to encourage students to serve in occupations or in areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or other tax-exempt organization.

Loans made by educational institutions and tax-exempt organizations to refinance loans that assist individuals in attending such educational institution also qualify, provided the refinancing is pursuant to a program as described in item 3 above. Loans from educational institutions and tax-exempt organizations do not qualify if the discharge is on account of services the individual performs for the lender organization.

In addition to federal loan programs, some families seek funds from other sources. Most states have college loan programs for their residents. Many colleges have their own loan programs that they fund out of their endowments. Banks and other private lenders offer loans that can be used for educational expenses. And individuals can borrow from insurance policies and various retirement plans, or tap into their home equity, as a source for college funding.

Special Rules for Principal Residence Debt

The ability to exclude discharge of principal residence debt from taxable income expired on December 31, 2016 (with exception for certain discharges that occur in 2017). Taxpayers can exclude up to $2 million from gross income for a discharge (in whole or in part) of qualified principal residence indebtedness before January 1, 2017. Congress has extended this provision in the past. Practitioners should monitor this situation to determine if this provision was extended after the date of this course's publication. This exclusion applies where a taxpayer restructures his or her acquisition debt on a principal residence, loses his or her principal residence in a foreclosure, or sells a principal residence in a *short sale* (where the sales proceeds are insufficient to pay off the mortgage and the lender cancels the balance). The exclusion does not apply if the discharge is on account of services performed for the lender (for example, an employee of the lender and the discharge relates to employment services performed) 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 also does not apply to a taxpayer in a Title 11 bankruptcy case; the regular Title 11 bankruptcy exclusion applies. Insolvent taxpayers other than those in a Title 11 bankruptcy case can elect to not have this special exclusion apply and instead rely on the Section 108(a)(1)(B) rules for insolvent taxpayers.

For 2017, the exclusion will apply to certain discharges in 2017 if the indebtedness is discharged subject to an arrangement that was entered into and evidenced in writing prior to January 1, 2017. The exclusion applies if (a) before that date, the mortgage servicer sends the borrower-homeowner a notice outlining terms and conditions of modifications, (b) the borrower-homeowner satisfies the conditions, and (c) the borrower-homeowner and servicer enter into permanent modification of the mortgage loan on or after January 1, 2017.

Qualified Principal Residence Indebtedness. *Qualified principal residence indebtedness* is debt that meets the Section 163(h)(3)(B) definition of acquisition indebtedness for the residential interest expense rules, but only with respect to the taxpayer's principal residence (i.e., does not include second homes or vacation homes), and with a $2 million limit ($1 million for married filing separate taxpayers) on the aggregate amount of debt that can be treated as qualified principal residence indebtedness.

For purposes of these rules, a principal residence has the same meaning as under the Section 121 home sale gain exclusion rules.

Operative Rules. Most residential mortgages are classified as recourse debt. As such, a foreclosure involving recourse debt is treated as a deemed sale with proceeds equal to the lesser of FMV at the time of foreclosure or the amount of secured debt. If the amount of debt exceeds FMV, the difference is treated as debt discharge income if it is forgiven. Therefore, it is possible for a residential foreclosure transaction (involving recourse debt) to result in either a gain or loss from the sale of property and debt discharge income. However, only the portion of the transaction (if any) treated as debt discharge income is available for the special exclusion rule for qualified principal residence indebtedness; any income from the foreclosure treated as gain is not eligible.

Example 4B-8 Exclusion for home mortgage debt discharge.

Tim, who is not in bankruptcy and is not insolvent, owns a principal residence that is subject to a $300,000 mortgage secured by the residence. The adjusted basis of the home was $270,000 and the lender foreclosed on the loan in 2017 when the property's FMV was $280,000. The discharge met all requirements to be an eligible discharge before January 1, 2017.

The foreclosure results in a taxable gain of $10,000 ($280,000 less $270,000) and debt discharge income of $20,000 ($300,000 less $280,000). The $10,000 gain must be recognized (or excluded under IRC Sec. 121, if applicable), but the $20,000 of debt discharge income is excluded.

Tim and his lender had not entered into any agreement regarding the discharge of the loan prior to January 1, 2017. In this case, the $20,000 of debt discharge must be included in taxable income.

In a rare case that a residential mortgage is nonrecourse, a foreclosure transfer is treated as a sale or exchange with the full amount of the debt as the amount realized, even if it is greater than the FMV of the property at time of foreclosure. Therefore, there is no debt discharge income and the exclusion rule does not apply.

The basis of the taxpayer's principal residence must be reduced (but not below zero) by the amount of any income excluded under the special principal residence debt exclusion rules.

Debt Discharge Income in Relation to Bankrupt or Insolvent Taxpayers

Special mandatory relief provisions apply to debt discharge income of bankrupt or insolvent taxpayers. These relief provisions allow such taxpayers to exclude debt discharge income from gross income. However, certain tax attributes are reduced by the amount of excluded debt discharge income. To the extent the excluded income exceeds the tax attributes available for reduction, the "excess" income, in effect, disappears (with no further tax consequences to the debtor).

An interactive decision tool on *Determining if Cancellation of Debt Income is Excludable* is available and can guide the user through this topic.

Final regulations state that, for purposes of these rules, the term "taxpayer" in the case of a grantor trust or a disregarded entity means the *owner* of the trust or the disregarded entity, not the entity itself. This means that the tests for insolvency are applied to the owner and not the entities themselves.

Amount Excludable from Gross Income

Bankrupt Taxpayers. *Bankrupt* taxpayers exclude all debt discharge income from taxable gross income under these rules. *Bankrupt* means that the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11

(of the U.S. Bankruptcy Code) case. Title 11 encompasses the federal bankruptcy statutes and includes Chapter 7 (liquidation), Chapter 11 (business reorganization), Chapter 12 (family farmer or fisherman), and Chapter 13 (adjustment of an individual's debts) bankruptcies.

Example 4C-1 Excludable debt discharge income for taxpayer in bankruptcy.

Horton's sole proprietorship business failed in 2017. He also owns land (free and clear) worth $300,000 that he holds for investment. In November 2017, the bankruptcy judge granted Horton a discharge from $400,000 of personal indebtedness related to his failed business (in a Chapter 7 case). He had no assets other than the land and no other liabilities at the time of this debt discharge.

Horton can exclude the entire $400,000 from taxable gross income under IRC Sec. 108 because the debt discharge occurred in a Title 11 bankruptcy proceeding. (See Examples 4C-5, 4C-6, and 4C-7 for discussions of the tax attribute reduction rules.)

Insolvent Taxpayers. *Insolvent* taxpayers exclude debt discharge income from taxable gross income to the extent of insolvency before the debt discharge transaction. Any debt discharge income in excess of insolvency is taxable income. The extent of insolvency is the excess of the taxpayer's liabilities over the FMV of his assets immediately before the debt discharge. The assessed value by the local county tax office is generally not equivalent to the FMV of a residence, absent other objective, supporting, corroborating evidence. At a minimum, comparable sales should also be considered in determining FMV.

An insolvent taxpayer overdrew funds from his checking account and failed to reimburse the bank. After his account was closed, the taxpayer was issued a Form 1099-C, reporting COD income of $7,875. He did not report the amount on his Form 1040, and the IRS issued a notice of deficiency for the unreported COD income. Although the Tax Court agreed that the taxpayer had COD income, the Court held that it was excludable under IRC Sec. 108(a)(1)(B) because the taxpayer's debts exceeded the value of his assets by $14,500, which exceeded the amount of the COD income. Therefore, the taxpayer was allowed to exclude the full amount.

When determining whether a taxpayer is insolvent or the extent of insolvency, the following rules apply:

- *Exempt Assets.* All assets, including assets that, by operation of state law, are exempt from creditors must be included in determining insolvency.

  In light of the tax return preparer penalties, tax practitioners have an added incentive to consider using Form 8275 in the foregoing situation. Specifically, a tax return preparer who prepares any tax return or claim for refund that understates tax liability because of an unreasonable position is subject to a tax equal to the greater of $1,000 or 50% of the fees for preparing the return or claim. Filing Form 8275 should diminish the likelihood of a penalty assessment.

- *Spouse's Separate Property.* A spouse's separately owned assets can be excluded from the determination of the insolvent spouse's net worth, even if the couple files a joint return.

- *Nonrecourse Debt.* When computing insolvency, nonrecourse debt is treated as a liability to the extent of the FMV of the property securing the debt. Nonrecourse debt in excess of the property's FMV is treated as a liability to the extent it is discharged; otherwise, it is ignored. (See Example 4C-3.)

- *Contingent Liabilities.* Before a contingent liability can be included in the insolvency computation, taxpayers must be able to prove "it is more probable than not" that they will be called on to pay the liability. Thus, loan guarantees and disputed debts may or may not be considered, depending on the facts and circumstances.

- *Measurement Date.* A taxpayer's insolvency is determined immediately before a debt discharge. According to the Tax Court, this means the day before the debt forgiveness income is realized.

Example 4C-2 Excludable debt discharge income for insolvent taxpayer.

All of Max's personal assets and liabilities are from his sole proprietorship business. As of August 1, 2017, business operating debts owed to Last Bank were $500,000, and the FMV of business assets was $350,000.

The bank discharges $200,000 of Max's debts in exchange for his promise to take no money out of the business until it becomes healthy. This debt discharge occurs outside of bankruptcy in a voluntary "workout" between the borrower and lender.

Just before the debt discharge, Max was insolvent to the extent of $150,000 ($500,000 of liabilities less $350,000 FMV of assets). Thus, he can exclude $150,000 of the $200,000 discharge from income. However, he must reduce tax attributes by up to $150,000. (See Examples 4C-6 and 4C-7.)

The remaining $50,000 of debt discharge income must be included in Max's income. After the debt discharge, his assets are still worth $350,000, and his liabilities are only $300,000. Thus, $50,000 is taxable because he has been made solvent by that amount as a result of the debt discharge transaction.

Example 4C-3 Effect of nonrecourse debt on insolvency calculations.

In 2015, Sally borrowed $200,000 from Bob to purchase land valued at $200,000. The note bore interest at a fixed market rate payable annually; no principal payments were due until 2017. The note was secured by the land and was nonrecourse to Sally.

In 2017 (when the outstanding note balance was still $200,000 and the FMV of the property had declined to $100,000), Bob agreed to reduce the note's principal balance to $150,000. At that time, Sally had other assets valued at $100,000 and other liabilities (for which she was personally liable) of $90,000. She had not declared bankruptcy.

Sally was discharged from $50,000 of debt in 2017. However, she will not recognize debt discharge income to the extent she was insolvent immediately before the discharge. The FMV of Sally's assets before the debt discharge was $200,000 ($100,000 land plus $100,000 other assets). In calculating Sally's insolvency, her liabilities were $240,000 ($100,000 nonrecourse financing, included to the extent of the FMV of the secured property, plus $50,000 nonrecourse financing in excess of the secured property's FMV, included to the extent discharged, plus $90,000 other recourse debt). Thus, Sally is insolvent to the extent of $40,000 ($200,000 assets − $240,000 liabilities) immediately before the discharge. She will recognize $10,000 ($50,000 debt discharged − $40,000 excluded under the insolvency rule) of debt discharge income in 2017. (See Examples 4C-6 and 4C-7 for tax attribute reduction rules that apply.)

When an insolvent taxpayer's debt is partly discharged and partly satisfied by the transfer of property, the transaction must be bifurcated between the debt discharge and the property disposition. The amount of debt satisfied by the transfer of the property is treated as sales proceeds for the property, from which gain or loss is computed. The separate debt discharge amount is eligible for exclusion under IRC Sec. 108, to the extent the taxpayer is insolvent.

Example 4C-4 Property transferred by insolvent debtor.

Tad transfers a vacant lot with an FMV of $30,000 and $5,000 cash in complete settlement of a $50,000 unsecured loan from the bank. The bank forgives the remaining $15,000 of the loan. Assume Tad is insolvent both before and after the debt discharge. His basis in the lot was $25,000. The transfer of the property and the debt discharge are treated as two separate transactions. The transfer of the lot is considered a sale of the property, so Tad has a $5,000 taxable gain based on the difference between the FMV and basis ($30,000 − $25,000). The $15,000 debt discharge amount is excluded from Tad's income under the insolvency rule.

Reduction of Tax Attributes

While bankrupt and insolvent taxpayers can exclude debt discharge income from taxable gross income, they must reduce (to the extent possible) certain tax attributes. This reduction of attributes means that some or all of the excluded debt discharge income will eventually be recognized because of reduced tax attributes or basis in property.

The following tax attributes are reduced by debt discharge income (dollar for dollar, except for credits, which are reduced by 33 1/3 cents for each dollar) in the following order:

1. *NOLs.* Any NOL from the tax year of debt discharge, and any NOL carried into that year.

2. *General Business Credits.* Any credit carryover to or from the year of discharge.

3. *Minimum Tax Credit.* Any credit under IRC Sec. 53(b) as of the beginning of the year following the year of discharge.

4. *Capital Loss Carryovers.* Any net capital loss from the year of discharge, and any capital loss carryover into that year.

5. *Basis.* The tax basis of the depreciable and nondepreciable property of the taxpayer—under the rules prescribed in IRC Sec. 1017. (See the "Ordering Rules for Basis Reduction" discussion later in this lesson.)

6. *Passive Activity Loss and Credit Carryovers.* Any passive activity loss or credit carryover under IRC Sec. 469(b) from the year of discharge.

7. *Foreign Tax Credit Carryovers.* Any credit carryover to or from the year of discharge.

When determining the amount of debt discharged under bankruptcy law, taxpayers need to consider that as a debtor, "all debts that arose before the date of the bankruptcy order are discharged" even if the creditor did not file proof of claim on the debts. If the debt existed, such as mortgage liens, prior to the bankruptcy, and they are part of the bankruptcy estate, they can reduce the taxpayers subsequent tax attributes such as the net operating loss deduction.

Basis Reduction Elections

Two basis reduction elections are available to bankrupt and insolvent taxpayers. Instead of reducing tax attributes in the order just described, the taxpayer can elect under IRC Sec. 108(b)(5) to first reduce the basis of *depreciable* assets. Excluded debt discharge income in excess of the basis of depreciable assets is then used to reduce other attributes according to the normal ordering procedure. This "basis reduction" election can be beneficial to taxpayers with NOL or credit carryovers (that will be used in the near future) and long-lived depreciable property. Bankrupt or insolvent taxpayers who make the Section 108(b)(5) election can also elect under IRC Sec. 1017 to treat real property inventory as depreciable property.

Ordering Rules for Basis Reduction

For debt discharges that result in a reduction in the taxpayer's basis in assets due to the exclusion of debt discharge income, basis in assets is reduced in the following order:

1. Real property used in a trade or business (other than inventory) or held for investment that secured the debt.

2. Personal property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable) that secured the debt.

3. Any excess of the amount excluded from gross income over the adjustments in items 1 and 2 reduces the basis of the remaining trade or business property (other than inventory, accounts receivable, or notes receivable) and property held for investment.

4. Any excess of the amount excluded from gross income over the adjustments in items 1–3 reduces the adjusted basis of inventory (including real property held as inventory), accounts receivable, and notes receivable.

5. Any excess of the amount excluded from gross income over the adjustments in items 1–4 reduces the adjusted basis of any remaining property.

Generally, reduction resulting from adjustments in items 3–5 is allocated within each category of assets as follows:

$$\frac{\text{Adjusted basis of the property}}{\text{Adjusted basis of all property in that category}} \times \text{Excess debt discharge income}$$

Example 4C-5 Impact of basis reduction on Section 1250 property.

Rigby purchased an office-warehouse on June 5, 2013, for use as a rental property. All $500,000 of his purchase price was allocated to building. During 2017, Rigby declared Chapter 13 bankruptcy and was relieved of significant liabilities. Pursuant to IRC Sec. 1017, he reduced the basis in the office-warehouse by $80,000. At the end of 2017 (before considering the Section 1017 basis adjustment), Rigby's adjusted basis in the building was $441,772 ($500,000 cost less $58,228 straight-line depreciation). Rigby sells the building for $450,000 on January 1, 2018. The Section 1017 basis reduction occurs on the first day of 2018 (see "Timing of Attribute Reduction" later in this lesson) resulting in an adjusted basis of $361,772 ($441,772 − $80,000).

Rigby realizes a gain of $88,228 ($450,000 − $361,772). Straight line depreciation that would have been allowed (for computing recapture) is $58,228. Depreciation taken (including the Section 1017 basis adjustment) is $138,228. The difference between those amounts, $80,000, is recaptured as ordinary income. The remaining gain of $8,228 ($88,228 − $80,000) is Section 1231 gain.

Variation: Assume instead that Rigby sells the building nine years later for $450,000 (on January 1, 2027), realizing a $185,149 gain. His adjusted basis at that time would be $264,851 ($361,772 adjusted basis on January 1, 2018, less $96,921 additional straight line depreciation taken over nine years on $420,000 depreciable basis). Thus, total depreciation taken at the time of the sale (including the Section 1017 basis reduction) is $235,149 ($138,228 + $96,921). Total straight line depreciation that would have been allowed is $173,617 (based on the original $500,000 basis). Thus, $61,532 ($235,149 − $173,617) of the gain is recaptured as ordinary income, and the remaining gain of $123,617 ($185,149 − $61,532) is Section 1231 gain, which is taxed as unrecaptured Section 1250 gain (25%), unless the taxpayer has any nonrecaptured Section 1231 losses.

Basis Reduction Limitation. If the basis of a taxpayer's property is reduced under the general attribute reduction ordering rules (i.e., after NOL, general business credit, minimum tax credit, and capital loss carryovers, if any, have been reduced), a special limitation on the amount of basis reduction applies. The aggregate basis of the taxpayer's assets cannot be reduced below the aggregate of the taxpayer's liabilities immediately after the discharge. This limitation does not apply to depreciable property if the election is made to first reduce its basis before other tax attributes. However, the basis of depreciable property cannot be reduced below zero.

Timing of Attribute Reduction

When tax attributes of bankrupt or insolvent taxpayers are reduced because of excluded debt discharge income, the required attribute reductions are deemed to occur *after* taxable income for the year of discharge has been determined. This rule allows the taxpayer to use any NOL, capital loss, or credit carryovers into the year of discharge to offset other taxable income for that year before the carryovers are reduced for debt discharge income. Furthermore, the taxpayer can depreciate or amortize the full tax basis of property in computing taxable income for the year of discharge before reducing tax basis because of excludable debt discharge income. In effect, the attribute reductions occur on the first day of the tax year after the debt discharge occurs.

Example 4C-6 Attribute reduction for insolvent taxpayer.

Roxanne runs a toy distribution business as a sole proprietorship. National Bank continued to lend money to her even though she had financial problems. Roxanne stopped paying interest to the bank for most of 2017. As a result, she made a profit. At the end of 2017, the bank agreed (outside of bankruptcy proceedings) to forgive $150,000 of Roxanne's debts. Before the debt forgiveness, her liabilities were $500,000, and the FMV of her assets was $490,000. After the discharge, she had $350,000 of liabilities.

Roxanne had the following 2017 tax information:

NOL carryover into 2017	$ 60,000
Capital loss carryover into 2017	5,000
Credit carryover into 2017	1,000
Tax basis of depreciable assets at December 31, 2017	120,000
Tax basis of inventory at December 31, 2017	124,000
Tax basis of other property at December 31, 2017	100,000
2017 taxable income before any debt discharge income	25,000

The $150,000 debt discharge is treated as follows. Roxanne can exclude only $10,000 from gross income—the amount by which her predischarge liabilities ($500,000) exceeded the FMV of her assets ($490,000). The $10,000 of excludable debt discharge income means tax attributes must be reduced by that amount, to the extent possible. The remaining $140,000 of debt discharge income is included in Roxanne's 2017 income.

Roxanne's tax attributes are reduced only after her 2017 taxable income has been computed. Thus, her NOL carryover of $60,000 into 2017 is used to offset 2017 taxable income of $165,000 ($25,000 + $140,000 of nonexcludable debt discharge income). Of her $5,000 capital loss carryover into 2017, $3,000 (the annual maximum) is used, leaving only $2,000. Finally, Roxanne can use all of her $1,000 credit carryover to reduce her 2017 tax liability. Thus, the only carryover remaining for attribute reduction after the determination of Roxanne's 2017 taxable income is the $2,000 capital loss carryover. That carryover is eliminated under the attribute reduction rules. Because her aggregate liabilities after the discharge ($350,000) exceed the aggregate tax basis of her property ($344,000), no basis reduction is required. Therefore, no further attribute reduction occurs.

In summary, Roxanne can exclude $10,000 of debt discharge from taxable gross income, and her tax attributes are reduced by only $2,000. The remaining $8,000 of excluded debt discharge income vanishes without impacting Roxanne's tax situation.

Example 4C-7 Election to reduce basis of depreciable assets.

Assume the same facts as in Example 4C-6 except Roxanne elects to first reduce the tax basis of depreciable property before reducing other tax attributes. Generally, the overall basis reduction cannot exceed the excess of the aggregate of the bases of property over liabilities immediately after the discharge. However, this limitation does not apply to depreciable property if the election to first reduce basis before other tax attributes is made. Roxanne's tax basis in her depreciable property on January 1, 2018, would be reduced from $120,000 to $110,000. This would not affect her 2017 depreciation calculation; however, only $110,000 of depreciable basis would be available going into 2018.

The difference in the tax impact on Roxanne as compared to the result in Example 4C-6 is that all $10,000 of excluded debt discharge income causes a reduction in tax attributes. In this set of facts, Roxanne should *not* make the election to first reduce the basis of depreciable property before reducing other tax attributes.

Recourse Debt When a Lender Forecloses

Recourse debt is debt that is not backed by collateral from the borrower. This type of debt allows the lender to collect from the borrower and the borrower's assets in the case of default as opposed to looking to a particular property; thus, the borrower is personally liable and bears the economic risk of loss.

A foreclosure (or deed in lieu of foreclosure) transaction may result in debt discharge income to the borrower when recourse debt is involved. The taking of the property by the lender in satisfaction of the recourse debt is treated as a deemed sale with proceeds equal to the lesser of FMV at the time of foreclosure or the amount of secured debt. If the amount of debt exceeds FMV, the difference is treated as debt discharge income if it is forgiven.

As a result of these rules, it is possible for a foreclosure transaction involving recourse debt to result in both (1) a gain or loss from the sale of the property (because FMV is more or less than basis) and (2) debt discharge

income (because the secured debt is in excess of FMV). The amount credited or received in the foreclosure sale determines sales proceeds for computing gain or loss. The character of the gain or loss depends on the character of the property subject to foreclosure. (See Examples 4D-1 and 4D-2.)

Debt discharge income occurs in a foreclosure transaction only if the lender discharges part or all of any deficiency (excess of indebtedness over the property's FMV) upon taking the property securing it. If the lender continues to pursue the debtor for the deficiency, debt discharge income does not result until that deficiency is discharged for less than full value. (See Example 4D-3.) If the lender fails to pursue the debtor or to discharge all the indebtedness, debt discharge income results when the statute (under state law) for enforcing the debt expires.)

Example 4D-1 Deed in lieu of foreclosure on land and building.

Rob bought a commercial building on January 1, 2014, for $500,000. He financed the purchase with a $450,000 recourse bank loan and a $50,000 cash down payment. Each year, $5,000 in principal is due. The purchase price was allocated $50,000 to land and $450,000 to the building.

During 2014–2016, Rob paid $5,000 of principal each year. During the first half of 2017, he paid $2,500 of principal and then ceased making payments because of financial difficulties. As of December 31, 2017, the outstanding debt principal was $432,500, and his adjusted basis in the building and land (after depreciation) was $405,250 ($355,250 in building and $50,000 in land). Rob transferred the property deed to the bank in lieu of foreclosure on December 31, 2017, and the bank discharged him from any further liability on the loan. The FMV of the property on that day was $425,000 ($60,000 allocated to land and $365,000 allocated to building). Rob was not bankrupt or insolvent at the time of the transfer and did not make the qualified real property business debt election.

In a deed in lieu transaction, the transfer of the property to the recourse debt lender is treated as a sale with proceeds equal to the lesser of the FMV of the property ($425,000) or the amount of debt ($432,500). Thus, Rob reports gain of $19,750 ($425,000 FMV − adjusted basis of $405,250) on Form 4797. The $10,000 gain on the land ($60,000 sales price − $50,000 basis) is reported in Part I of Form 4797, and the $9,750 gain on the building ($365,000 sales price − $355,250 adjusted basis) is reported in Part III.

The excess of the debt principal discharged in the deed in lieu transaction ($432,500) over the FMV of the property ($425,000) results in debt discharge income. Thus, Rob has debt discharge income of $7,500 in 2017. Because he was not bankrupt or insolvent at the time of the debt discharge, all $7,500 is taxable gross income. The tax treatment of debt discharge income was discussed earlier in this lesson. Rob should report the debt discharge income on the "Other income" line on page 1 of Form 1040.

Example 4D-2 Deed in lieu of foreclosure when FMV is less than basis.

Assume the same facts as in Example 4D-1 except on December 31, 2017, the FMV of the property was only $400,000 ($50,000 allocated to land and $350,000 allocated to building). Here, Rob recognizes a $5,250 Section 1231 loss on the sale (FMV of $400,000 − adjusted basis of land and building of $405,250). A second step is again necessary to compute debt discharge income, if any. In this case, there is debt discharge income of $32,500 (debt principal discharged of $432,500 − FMV of property of $400,000). Rob should report the debt discharge income on the "Other income" line on page 1 of Form 1040.

Example 4D-3 Lender pursues borrower for deficiency after foreclosure.

Assume the same facts as in Example 4D-2 except the bank seizes the property on December 31, 2017, and sues Rob for the $32,500 deficiency (debt of $432,500 − FMV of the seized property of $400,000). Rob still has a 2017 Section 1231 loss of $5,250 on the deemed sale of the property to the bank for its FMV of $400,000. However, he has no debt discharge income until his $32,500 deficiency is settled for less than full value—if that occurs. Thus, until resolution, the $32,500 deficiency is an open transaction.

Nonrecourse Debt When a Lender Forecloses

Nonrecourse debt is debt that is secured by a pledge of collateral and for which the borrower is not personally liable. In the case of a default, the lender can seize the collateral and the recovery is limited to that collateral.

A foreclosure (or deed in lieu of foreclosure) transaction involving nonrecourse debt is treated as a deemed sale by the borrower to the lender with proceeds equal to the amount of nonrecourse debt. An abandonment of real property encumbered by nonrecourse financing is also treated as a deemed sale.

The amount realized on the deemed sale includes the full amount of the nonrecourse debt plus any additions to principal for items (such as accrued interest) that previously generated ordinary deductions for the borrower. For a cash-basis borrower, however, the amount realized on the deemed sale equals only the principal balance of the nonrecourse debt.

Treating the full amount of nonrecourse debt principal as the amount realized from a deemed sale means there can be no debt discharge income due to a foreclosure or deed in lieu transaction involving only nonrecourse debt. Unlike the treatment of foreclosures involving recourse debt (as previously discussed), the FMV of the property is irrelevant. Also, insolvent or bankrupt status of the taxpayer does not affect the results.

Example 4E-1 Deeding back land in satisfaction of nonrecourse debt.

Frank purchased a parcel of land on July 1, 2014, for $320,000. He paid $32,000 down, with the balance due to the seller under a nonrecourse "contract for deed" arrangement. Annual payments of $10,000 of principal, plus interest, are due each July 1.

Frank made the payments on July 1, 2015, and July 1, 2016. However, he determined in July 2017 that it was not beneficial for him to continue to make payments on the land; his outstanding debt on the land was $268,000, and its value was only $200,000. Frank agreed to transfer the land back to the seller in full satisfaction of the debt on December 1, 2017. Because this is a satisfaction of *nonrecourse* indebtedness, the outstanding debt amount ($268,000) becomes the deemed sales price of the land. Since the adjusted basis is $320,000, this transaction results in a capital loss of $52,000 for Frank. There is no debt discharge income because the debt was all nonrecourse.

Example 4E-2 Deeding back depreciable real estate in satisfaction of nonrecourse debt.

Lotta purchased an apartment building in 2008. She financed the entire purchase with a $500,000 nonrecourse loan from Bucks Savings. By the end of 2017, the land and building had an adjusted tax basis of $350,000, and the building was experiencing negative cash flow.

Lotta could not continue to fund the negative cash flow, and on December 31, 2017, she deeded the building back to Bucks. At the time of the transfer, the nonrecourse loan principal balance was $497,000. Lotta was insolvent as of December 31, 2017.

The transfer to the lender is a deemed sale for $497,000—the amount of nonrecourse debt satisfied by the transfer. Thus, Lotta has a 2017 gain of $147,000 ($497,000 sales proceeds − $350,000 adjusted basis). None of the gain can be characterized as excludable debt discharge income, even though Lotta was insolvent when the property was deeded back.

The Reduction of Seller-financed Debt

A special rule may apply when seller-financed (i.e., purchase money) debt of the property purchaser is reduced. This rule applies only if (1) the creditor is the original seller of the property, (2) the debt arose from the debtor's purchase of the property, and (3) the purchaser (debtor) would recognize debt discharge income except for this provision (i.e., the purchaser is not bankrupt or insolvent and did not make a qualified real property debt election).

If these conditions are satisfied, the purchaser reduces the basis in the property acquired with the seller-financed debt and does not recognize debt discharge income. This treatment is not elective; it is mandatory if the requirements of IRC Sec. 108(e)(5) are met.

Example 4F-1 Reduction of seller-financed residential mortgage.

Stella bought her residence from Fran in 2014 for $135,000. Fran financed the transaction by taking back a recourse $125,000 mortgage from Stella in addition to receiving a $10,000 cash down payment. Stella made

her payments to Fran until the middle of 2017. She threatened to abandon the property unless Fran reduced the remaining mortgage debt. (The property had substantially decreased in value.)

Fran agreed to reduce the remaining balance of Stella's mortgage from $121,000 to $100,000, and Stella agreed to make payments to Fran under a revised loan amortization schedule. Stella was solvent at the time of the debt reduction.

Stella must reduce her basis in the home by $21,000 to reflect the reduction in the purchase money debt owed to Fran. Stella does not recognize any debt discharge income because (a) the debt arose from the purchase of the property, (b) the original seller of the property held the obligation that was reduced, and (c) Stella was solvent at the time.

See Lesson 2 for a discussion of the effect of this transaction on Fran, the seller.

Variation: The result would be the same even if the purchase money debt involved was nonrecourse instead of recourse. If the requirements of IRC Sec. 108(e)(5) are met, basis reduction is mandatory; whether the debt is recourse or nonrecourse is irrelevant.

The seller-financed debt basis reduction rule applies to a partially insolvent taxpayer to the extent he is solvent. Therefore, a taxpayer can exclude debt discharge income (1) to the extent he is insolvent under the general rules of IRC Sec. 108(a) (discussed earlier in this lesson), and (2) in excess of his insolvency under the seller-financed debt rule discussed in this lesson—assuming the rule otherwise applies.

The reduction of undersecured nonrecourse debt by a third-party lender (i.e., a lender other than the seller) is treated as a Section 108(e)(5) purchase price reduction (i.e., resulting in a reduction of basis rather than debt discharge income) to the extent the reduction is based on an infirmity that clearly relates to the original sale (e.g., the seller's inducement of a higher purchase price by misrepresentation of a material fact or fraud). This is a limited exception to the rule that a basis adjustment (rather than income) is available only for seller-financed debt. Alternatively, if IRC Sec. 108(e)(5) does not apply but the debt is qualified real property business debt, the taxpayer may be able to elect to exclude the debt discharge income under IRC Sec. 108(a)(1)(D).

Modification of Consumer Credit Card Debt

Credit card debt default and delinquencies have risen in recent years. Late payments generally result in significant penalties and higher interest rates on the unpaid balances. As a result, the fees, penalties, and interest portion of a taxpayer's credit card balance may exceed the amount originally borrowed.

Applicable Exceptions to Income Recognition

As discussed earlier in this lesson, no income is realized from the discharge of indebtedness to the extent that payment of the discharged liability would have resulted in a deduction. Since consumer credit card debt is generally nonbusiness, this rule is not likely to prevent the recognition of income when this debt is modified.

A purchase-money debt reduction for a solvent debtor is treated as a reduction of the purchase price rather than a cancellation of indebtedness. However, the Tax Court has rejected the application of this rule to the modification of consumer credit card debt for accumulated interest charges that were cancelled. Thus, unless a taxpayer is in bankruptcy or insolvent, a reduction in his credit card liability will result in income.

The Measure of Income Recognition

In *Payne, Jr.*, Tax Court held that a credit card company's forgiveness of defaulted interest is cancellation of debt (COD) income to the cardholder. Another Tax Court decision involving a loan transaction is equally applicable to credit card debt. The Court in *Hahn, Jr.* ruled that COD income includes not only a cancellation of principal, but also a cancellation of an obligation to pay interest, late charges, and attorneys' fees. Consequently, solvent credit card holders generally must include in income the full amount of any credit card debt reduction.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. The following individuals have each had debts discharged. Which one will have to recognize income on the transaction?

    a. David's lender forgives a portion of his debt, but not the whole loan.

    b. Julie, who is solvent, has income from the discharge of a qualified real property business debt.

    c. Mark has declared bankruptcy under Chapter 13 of the U.S. Bankruptcy Code.

    d. Sue's debt was incurred from a bank for her long-term farming business.

22. Which of the following occurs when determining whether a taxpayer is insolvent?

    a. Assets exempt from creditors under state law are excluded from the determination.

    b. Assets owned by the taxpayer's spouse are included in the determination.

    c. All of the taxpayer's nonrecourse debt is treated the same way when making the determination.

    d. The determination is finalized before any of the taxpayer's debt is discharged.

23. When an insolvent taxpayer's debt is discharged, the income is used to reduce specific attributes that could affect the individual's taxes. Which attribute is considered last in the reduction cycle?

    a. General business credits.

    b. Foreign tax credit carryovers.

    c. Capital loss carryovers.

    d. Net operating losses (NOLs).

24. Which of the following allows a lender to collect a borrower's assets in case of default instead of being limited to a particular property?

    a. Recourse debt.

    b. Nonrecourse debt.

    c. Foreclosure.

    d. Consumer credit card debt.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. The following individuals have each had debts discharged. Which one will have to recognize income on the transaction? **(Page 371)**

    a. David's lender forgives a portion of his debt, but not the whole loan. [This answer is correct. Debt cancellation income is recognized when the lender has absolved the borrower from any future repayment of that portion of the debt. A portion of the loan may be forgiven and recognized as income in the current year, as opposed to the full loan. Therefore, merely breaking the loan apart is not enough to exclude David from the normal tax treatment for the cancellation or forgiveness of debt, which is to consider the amount gross income unless specific exclusions apply.]

    b. Julie, who is solvent, has income from the discharge of a qualified real property business debt. [This answer is incorrect. A taxpayer who is *not* insolvent, like Julie, can elect to exclude from gross income any income from the discharge of a qualified real property business debt, per IRC Sec. 108(a)(1)(D). Therefore, while Julie does have to elect the exclusion, it is not mandatory for her to include the income from discharging the debt.]

    c. Mark has declared bankruptcy under Chapter 13 of the U.S. Bankruptcy Code. [This answer is incorrect. According to IRC Sec. 108(a), special mandatory relief provisions apply to debt discharge income of bankrupt or insolvent taxpayers. These relief provisions allow such taxpayers (like Mark) to exclude debt discharge income from gross income.]

    d. Sue's debt was incurred from a bank for her long-term farming business. [This answer is incorrect. Per IRC Sec. 108(a)(1)(C), farmers do not have to recognize debt discharge income if the forgiven debt is *qualified farm indebtedness*. To meet this exception, (1) the debt must be incurred directly in the business of farming; (2) at least 50% of the taxpayer's gross receipts from all sources, including farming, for the preceding three years were attributable to the business of farming; and (3) the lender is unrelated to the taxpayer and is actively and regularly engaged in the business of lending money or is a government agency or instrumentality. As Sue meets these qualifications, she will not have to recognize income on the discharging of her debt.]

22. Which of the following occurs when determining whether a taxpayer is insolvent? **(Page 377)**

    a. Assets exempt from creditors under state law are excluded from the determination. [This answer is incorrect. According to *Carlson* and Ltr. Ruls. 199932013 and 199935002, among other sources, all assets, including assets that, by operation of state law, are exempt from creditors must be included in determining insolvency.]

    b. Assets owned by the taxpayer's spouse are included in the determination. [This answer is incorrect. Based on the guidance in Ltr. Rul. 8920019, a spouse's separately owned assets can be excluded from the determination of the insolvent spouse's net worth, even if the couple files a joint return.]

    c. All of the taxpayer's nonrecourse debt is treated the same way when making the determination. [This answer is incorrect. According to Rev. Rul. 92-53, when computing insolvency, nonrecourse debt is treated as a liability to the extent of the FMV of the property securing the debt. Nonrecourse debt in excess of the property's FMV is treated as a liability to the extent it is discharged; otherwise, it is ignored.]

    d. The determination is finalized before any of the taxpayer's debt is discharged. [This answer is correct. A taxpayer's insolvency is determined immediately before a debt discharge, per IRC Sec. 108(d)(3). According to the Tax Court, this means the day before the debt forgiveness income is realized.]

23. When an insolvent taxpayer's debt is discharged, the income is used to reduce specific attributes that could affect the individual's taxes. Which attribute is considered last in the reduction cycle? **(Page 377)**

    a. General business credits. [This answer is incorrect. General business credits, including any credit carryover to or from the year of discharge, are the second item reduced by debt discharge income, per IRC Secs. 108(b)(2) and 108(b)(3).]

    b. Foreign tax credit carryovers. [This answer is correct. According to IRC Sec. 108(b)(2) and 108(b)(3), there are seven tax attributes that are reduced by debt discharge income (dollar for dollar, except for credits, which are reduced 331/3 cents for each dollar). Those attributes are considered in a specific order, and the final item on the list is foreign tax credit carryovers. This includes any credit carryover to or from the year that the debt was discharged.]

    c. Capital loss carryovers. [This answer is incorrect. Capital loss carryovers, including any net capital loss from the year of discharge, and any capital loss carryover into that year, are the fourth item on the list of attributes provided by IRC Secs. 108(b)(2) and 108(b)(3) that are reduced by debt discharge income. This puts capital loss carryovers in the middle of the list, as it includes seven different attributes.]

    d. Net operating losses (NOLs). [This answer is incorrect. Based on the list provided in IRC Secs. 108(b)(2) and 108(b)(3), the first attributes reduced by debt discharge income are NOLs. This includes any NOL from the tax year of debt discharge, and any NOL carried into that year.]

24. Which of the following allows a lender to collect a borrower's assets in case of default instead of being limited to a particular property? **(Page 382)**

    a. Recourse debt. [This answer is correct. Recourse debt is debt that is not backed by collateral from the borrower. This type of debt allows the lender to collect from the borrower and the borrower's assets in the case of default as opposed to looking to a particular property. Thus, the borrower is personally liable and bears the economic risk of loss.]

    b. Nonrecourse debt. [This answer is incorrect. Nonrecourse debt is debt that is secured by a pledge of collateral and for which the borrower is not personally liable. In case of default, the lender can seize the collateral and the recovery is limited to that collateral.]

    c. Foreclosure. [This answer is incorrect. Merely foreclosing on defaulted debt does not give the lender the right to go after the borrower's assets. Other items must be considered before the form of the foreclosure is chosen.]

    d. Consumer credit card debt. [This answer is incorrect. There are specific methods in place for dealing with consumer credit card debt and the modification of this type of debt; however, this is a different consideration than the property-related one described above. Therefore, there is a better answer to this question.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 3—Gains and Losses (TDBTG173)

Testing Instructions

1. Following these instructions is an **EXAMINATION FOR CPE CREDIT** consisting of multiple choice questions. You may print and use the **EXAMINATION FOR CPE CREDIT ANSWER SHEET** to complete the examination. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to the examination questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of all course materials.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $89 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may email, mail, or fax your completed answer sheet, as described below ($89 for email or fax; $99 for regular mail). The answer sheets are found at the end of the course PDFs. Answer sheets may be printed from the PDFs; they can also be scanned for email grading, if desired. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

   - Email to: *CPLGrading@thomsonreuters.com*
   - Fax to: **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     TDBTG173 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($89 for answer sheets sent by email or fax; $99 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $254 (a 5% discount on all three courses). If you complete four courses, the price for

grading all four is $320 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $378 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

4. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **November 30, 2018**. CPE credit will be given for examination scores of 70% or higher.

5. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 3—Gains and Losses (TDBTG173)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet can be printed out from the back of this PDF or accessed by logging onto the Online Grading System.

1. The sale of stock will be given long-term treatment if the holding period exceeds what time limit?

    a. Six months.

    b. One year.

    c. Two years.

    d. Five years.

2. Which of the following is most likely to be considered a capital asset?

    a. Artistic property.

    b. Inventory.

    c. Real estate.

    d. Securities.

3. How should taxpayers deal with capital losses?

    a. Capital losses can only be deducted to the extent the taxpayer has capital gains.

    b. After capital gains are offset, up to $3,000 in capital losses can be deducted against ordinary income.

    c. If capital losses are not used in the tax year in which they are incurred, they will expire unused.

    d. If capital losses are carried forward, they will be characterized as long-term capital losses.

4. A group of mutual fund shares are held in an account by Edwardian Investments. As the agent for the account, the investment company acquires and redeems the shares. What method would most likely be used to calculate the basis of these mutual fund shares when only a portion of them are sold?

    a. The average basis method.

    b. The first-in, first-out (FIFO) method.

    c. The last-in, first-out (LIFO) method.

    d. The specific identification method.

5. What is one of the basis and character reporting rules for mutual fund sales?

   a. The default method for determining a taxpayer's adjusted basis in mutual fund shares is specified in the Internal Revenue Code.

   b. If the average basis method is used, fund shares held in different accounts should be aggregated before the average is taken.

   c. To change the default method for identifying mutual fund shares sold, the taxpayer must notify the broker and choose another permissible method.

   d. If a taxpayer holds shares for six months or less and sells them at a loss, the entire loss is considered short-term regardless of any associated gains.

6. What is the maximum amount of Section 1244 loss a single taxpayer can claim in one tax year?

   a. $10,000.

   b. $50,000.

   c. $100,000.

   d. $150,000.

7. When can a taxpayer take a capital loss for worthless securities?

   a. When it has no liquidation value or hope for future value.

   b. When it has become at least partially worthless.

   c. When the corporation has declared bankruptcy.

   d. Within three years of the date the stock becomes worthless.

8. Match the following terms related to publicly traded options and futures contracts with the correct definitions.

1. Holder	i. Taxpayer who grants a put or call option.
2. Writer	ii. Taxpayer who owns a put or call option.
3. Put option	iii. The set price at which a put or call option will be exercised.
4. Call option	iv. A publicly traded option giving a holder the right to sell a specific stock at a set price on or before a specific date.
5. Strike price	v. A publicly traded option giving the holder the right to buy a specific stock at a set price on or before a specific date.

   a. 1., i.; 2., ii.; 3., v.; 4., iv.; 5., iii.

   b. 1., ii.; 2., i.; 3., iv.; 4., v.; 5., iii.

   c. 1., iii; 2., i.; 3., ii.; 4., v.; 5., iv.

   d. 1., v.; 2., iv.; 3., i.; 4., iii.; 5., ii.

9. What happens when a holder buys stock from an option writer?

    a. The option will be considered part of a straddle.

    b. The cost of the option is deducted from the sales proceeds received.

    c. The gain will be considered long-term.

    d. The cost of the option is added to the cost of the securities that were acquired.

10. What is different about the way Section 1256 contracts are treated that allows them to help curb abuse related to futures contract markets?

    a. They are accounted for using the straddle rules under IRC Sec. 1092.

    b. This type of contract is not treated as a taxable transaction.

    c. Net loss from such contracts must be used in the current tax year or it will be lost.

    d. They are treated as sold at fair market value (FMV) on the last day of the business year.

11. Marcus borrows securities and then sells them for a profit. He buys them back later, when the price of the securities declines. This is an example of which of the following?

    a. A call option.

    b. An incentive stock option (ISO).

    c. A put option.

    d. A short sale.

12. Jeff is fired from Whammy Inc. in July 2018. How long does he have to exercise his ISOs before they become nonqualifying?

    a. Until August 2018.

    b. Until October 2018.

    c. Until December 2018.

    d. Until July 2019.

13. Which of the following statements most accurately describes conversion transactions?

    a. They are typically used to help a taxpayer convert long-term capital gains to ordinary gain.

    b. If gains are primarily related to the time value of money, they will be treated as ordinary gain.

    c. Under the anticonversion rules, the gain will be treated as interest instead of capital gains.

    d. The character of any built-in loss will be changed under the anticonversion rules.

14. Angelica sells qualified small business stock (QSBS) that she purchased in January 2008. How will her gain on the sale be taxed?

    a. She can exclude a maximum of 25% of any gain if she sells the QSBS.

    b. She can exclude gain on selling options to acquire QSBS stock.

    c. She can roll over the gain to the extent she acquires more QSBS within 60 days.

    d. Alternative minimum tax (AMT) will not apply.

15. Is it better to be considered a stock trader or an investor?

    a. Stock trader status is preferred because the tax rules are more favorable.

    b. Stock trader status is preferred because they report ordinary gain or loss.

    c. Investor status is preferred because it allows use of the mark-to-market election.

    d. Investor status is preferred because it is the default classification under IRS guidelines.

16. What type of property, when sold, is most likely to use the installment method of accounting?

    a. Inventory.

    b. Real estate.

    c. Property using a revolving credit plan.

    d. Stocks and securities.

17. If a sale of depreciable property between related parties is ineligible for installment reporting, which of the following will occur?

    a. Payments will be recognized in the year they are received.

    b. The buyer will increase his or her basis in the property immediately.

    c. The gain recognized by the seller will be considered ordinary gain.

    d. The principle purpose of the transaction will be considered to be tax avoidance.

18. Which of the following statements best describes the election to use the installment method?

    a. The election is made once and applies to all transactions in that class.

    b. The election cannot be revoked without IRS approval.

    c. The election must be made by the sale date.

    d. The election can be made retroactively.

19. Mike sells a piece of property to Joan on the installment basis. Halfway through the scheduled payments, Mike and Joan agree on a reduction in the purchase price. How will this be reported for tax purposes?

    a. As the seller, only Mike needs to account for the change.

    b. As the buyer, only Joan needs to account for the change.

    c. Both Mike and Joan will need to make necessary recomputations.

    d. Both Mike and Joan need to amend their prior year returns.

20. Which of the following occurs when real estate sold on an installment basis is repossessed?

    a. The FMV of the property is the most important consideration when applying IRC Sec. 1038(b).

    b. The seller reports interim payments before repossession as gain, but gain after repossession could be limited.

    c. The seller's holding period on the repossessed property starts as of the date the property is returned to the seller's custody.

    d. The seller's basis in the repossessed property will typically become the basis that the buyer had in the property prior to the repossession.

21. When would a wraparound mortgage be ignored?

    a. The mortgage exceeds the seller's basis in the property.

    b. The mortgage is not included in the contract price.

    c. The seller must discharge the underlying mortgage.

    d. The seller is a conduit for the mortgagee.

22. When would a taxpayer recognize gain on the disposal of an installment obligation?

    a. The obligation is transferred due to death.

    b. The obligation is transferred due to a divorce.

    c. The obligation is satisfied for less than face value.

    d. A new note is substituted for the old note.

23. For personal property to be considered like-kind property, it needs to be which of the following?

    a. Of the same grade.

    b. Of the same class.

    c. Of the same value.

    d. Of the same quality.

24. Which of the following statements best describes an aspect of a like-kind exchange?

    a. Property held for personal use qualifies for nonrecognition treatment.

    b. Gain recognized may exceed gain realized on the exchange.

    c. Form 8824 should be filed for each exchange of investment or business property.

    d. If a transferee assumes debt on the property, he or she receives boot.

25. Which of the following occurs in a deferred exchange of like-kind property?

    a. The replacement property must be identified within 30 days.

    b. The replacement property must be transferred before the due date of the tax return or 180 days.

    c. At least three or four parties are involved in the exchange.

    d. The replacement property is received by the taxpayer before the other property is relinquished.

26. Which of the following replacement properties meets the "similar or related in service or use" requirement of IRC Sec. 1033(a)(2)?

    a. Replacing unimproved real estate with improved real estate.

    b. Replacing a mobile home park with a motel.

    c. Replacing farmland with ranchland.

    d. Replacing a bowling alley with a billiard center.

27. Which of the following is needed to identify an abandonment loss on business property?

    a. The time period over which the property lost value.

    b. The purchase date of the property.

    c. Concerns by the owner about abandoning the property.

    d. An act performed by the owner that indicates abandonment.

28. To be considered Section 1231 property, real or depreciable property that is used in a trade or business must be held for more than what length of time?

    a. One month.

    b. One year.

    c. Five years.

    d. Ten years.

29. How does Section 1250 depreciation recapture affect gains from the sale of depreciable real property?

    a. Qualifies the property for capital gains treatment.

    b. Converts the capital gain into ordinary income.

    c. Make it eligible for installment reporting.

    d. Ensure that the sales price is attributable to a single property class.

30. Losses associated with which of the following are disallowed?

    a. Related party sales.

    b. Postsale adjustments to the purchase price.

    c. Business casualties.

    d. Section 1231 losses.

31. Jamie has owned a piece of real estate for two years. Her nonrecaptured Section 1250 gain will be taxed at a maximum of what percentage?

    a. 3.8%.

    b. 20%.

    c. 25%.

    d. 39.6%.

32. What is the most important consideration when determining if a bad debt is related to a taxpayer's trade or business?

    a. If the loan was made from one business to another.

    b. If the debt is partially or totally worthless.

    c. If the loan is related to the purchase or maintenance of real estate.

    d. If the dominant reason for making the loan was business oriented.

33. A business bad debt produces which of the following?

    a. An ordinary loss deduction.

    b. A short-term capital loss.

    c. Alternative minimum tax (AMT).

    d. A carryover of debt to a future year.

34. When is a nonbusiness bad debt determined to be worthless?

    a. On the payment due date.

    b. The year it is clear it will not be repaid.

    c. The date the debtor files for bankruptcy.

    d. After a minimum of six months of collections.

35. When would a new, modified debt generate discharge income?

    a. The issue price is enough to completely discharge the old debt.

    b. There are changes in the nature of the debt instrument.

    c. The legal obligations changed are economically significant.

    d. Its price is less than the old debt balance.

36. What is the limit on qualified principal residence indebtedness for a single taxpayer or married taxpayers filing jointly?

    a. $100,000.

    b. $500,000.

    c. $1 million.

    d. $2 million.

37. When an insolvent taxpayer receives debt discharge income that reduces his or her basis in assets, what is the first type of asset for which the taxpayer's basis is reduced?

    a. Personal property that is used in a trade or business or held for investment that was used to secure the debt.

    b. Real property that is used in a trade or business or held for investment that was used to secure the debt.

    c. Inventory (including real property), accounts receivable, and notes receivable.

    d. Remaining trade or business property and property held for investment, except for inventory, accounts receivable, or notes receivable.

38. What happens when a debtor defaults on nonrecourse debt?

    a. The foreclosure is treated as a deemed sale of the collateral.

    b. Property used as collateral cannot be abandoned.

    c. Only the original nonrecourse debt can be recognized in relation to the transaction.

    d. The debtor will recognize debt discharge income in the value of the property.

39. Assuming all other conditions are met, for the special rules related to seller-financed debt reduction to apply, which of the following must occur?

    a. The creditor must be one of the previous owners of the property.

    b. The debt must be from the debtor's purchase of the property.

    c. The debtor has filed bankruptcy.

    d. The debtor made a qualified real property debt election.

40. Jason's credit card liability spiraled out of control. He is still solvent, but he sought relief from the credit card debt. The credit card company was willing to forgive some of his accumulated interest charges in return for payments on the balance. Which of the following occurs?

    a. Jason's debt is considered business debt, so income is not recognized.

    b. Jason treats the reduction as a reduction of purchase price, and income is not recognized.

    c. Jason treats the reduction as cancellation of debt, so he will recognize income.

    d. Jason will not recognize income until he actually pays off the balance on the credit card.

GLOSSARY

Bankrupt: A taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 (of the U.S. Bankruptcy Code) case.

Call option: An option giving the holder the right to buy at a set price on or before a specified date.

Capital asset: Any property except (1) inventory, (2) depreciable or real property used in the taxpayer's trade or business (except for items allowed capital treatment by IRC Sec. 1231), (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) Certain U.S. publications.

Casualty loss: The damage, destruction, or loss of property resulting from a sudden, unexpected, or unusual identifiable event (e.g., car accidents, storms, floods).

Dealer: A merchant of securities with an established place of business who is regularly engaged in the purchase of securities and their resale to customers.

Deep-in-the-money option: An option with a *strike price* lower than the *lowest qualified benchmark*.

Deferred exchange: One in which property received in the exchange (replacement property) is not received immediately upon the transfer of property given up (relinquished property).

Depreciable property: Any property that can be depreciated by the purchaser.

Federally declared disaster: Any disaster subsequently determined by the president of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Floating NAV money market funds: Certain money market funds required by the SEC to price shares in a manner that more accurately reflects the market value of their underlying portfolios rather than a stable $1 per share.

Gain realized: The excess of fair market value of property received over the tax basis of the property given up.

Gain recognized: The gain reported as taxable income because of the transaction.

Holder: A taxpayer who owns a *put option* or a *call option*. They pay a premium to the option *writer* or a previous holder to acquire the opportunity to buy or sell securities under the terms of the option.

Installment sale: Any disposition of property where at least one payment is received after the close of the tax year in which the sale occurs.

Like-kind property: This refers to the nature or character of property, and not its grade or quality. One class of property (i.e., real estate or personal property) cannot be exchanged for another class of property.

Lowest qualified benchmark (LQB): Generally, this is the highest available *strike price* that is less than the applicable stock price.

Nonrecourse debt: Debt that is secured by a pledge of collateral and for which the borrower is not personally liable. In the case of default, the lender can seize the collateral and the recovery is limited to that collateral.

Put option: A publicly traded option giving the holder the right to sell a specified stock at a set price on or before a specified date.

Qualified covered call option: Any option a taxpayer grants to purchase stock he holds (or stock he acquires in connection with granting the option), if all of the following are true: (1) the option is traded on a national securities exchange or other market approved by the Secretary of the Treasury, (2) the option is granted more than 30 days before its expiration date, (3) the option is not a *deep-in-the-money option*, (4) the taxpayer is not an options dealer who granted the option in connection with his activity of dealing options, and (5) gain or loss on the option is capital gain or loss.

Qualified principal residence indebtedness: Debt that meets the Section 163(h)(3)(B) definition of acquisition indebtedness for the residential interest expense rules, but only with respect to the taxpayer's principal residence and with a $2 million limit ($1 million for married filing separate taxpayers) on the aggregate amount of debt that can be treated as such.

Recourse debt: Debt that is not backed by collateral from the borrower.

Section 1244 stock: Stock issued to an individual (or a partnership) for money or other property by a domestic small business corporation. It can be either common or preferred stock (unless issued before July 19, 1984, when it must be common stock). Only stock associated with the first $1 million of a corporation's capital will qualify.

Section 1256 contract: Any regulated future contract, foreign currency contract, nonequity option, dealer equity option, or any dealer securities futures contract.

Security: According to the IRS, this includes a bond, debenture, note, certificate, or other evidence of indebtedness issued by a corporation or by a government or political subdivision, with interest coupons or in registered form.

Short sale: When a taxpayer sells borrowed securities. The short seller bets that the price of securities will decline. If so, the taxpayer can buy them at the lower price to replace those borrowed and sold short, profiting from the difference.

Stock holding period: Typically this is the day following the day of acquisition through the day of disposition. If the securities are traded on an established securities market, the holding period begins on the day after the trade date and ends on the date of disposition (the settlement date is ignored). The holding periods for stock that is not purchased (e.g., dividends, splits) are different and addressed separately in IRS guidance.

Straddle: Holding a position that substantially diminishes a taxpayer's risk of loss of holding property. The straddle rules are available in IRC Sec. 1092.

Strike price: The set price for a *call options* and *put options*.

Virtual currency: A digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value (e.g., Bitcoin). It may operate like "real" currency, but it does not have legal tender status in any jurisdiction.

Wash sale: A taxpayer sells or trades a security at a loss and, within 30 days after the sale, buys a substantially identical stock or security (or acquires a contract option to do so).

Wraparound mortgage: A special agreement in connection with an *installment sale*. The seller is left liable on the original mortgage and pays it off over time as though the seller still owns the property. Meanwhile, the buyer gives a new mortgage to the seller in an amount equal to the entire purchase price less any down payment. The buyer's mortgage wraps around the seller's mortgage. The seller uses payments from the buyer to make payments on the seller's own mortgage.

Writer: A taxpayer who grants *put options* and *call options*. They receive a premium or fee for agreeing to take the risk to buy and sell securities under the terms of the option. They are sometimes called *grantors*.

INDEX

A

ABANDONMENTS
- Loss deductions . . . 347

ALTERNATIVE MINIMUM TAX
- Capital gains, effect on AMT . . . 273
- Incentive stock options . . . 292

B

BAD DEBTS
- Business and nonbusiness . . . 361
- Guarantees . . . 361
- Partially worthless . . . 361
- Relatives . . . 361

BANKRUPTCY
- Debt discharge income, bankrupt, or insolvent taxpayer . . . 377

BASIS
- Debt discharge, effect on depreciable assets . . . 371, 377
- Installment obligations . . . 324
- Installment sales
  - •• Purchase price adjustment, effect on buyer's . . . 316
  - •• Repossessed real estate . . . 317
- Involuntary conversion, effect on . . . 337
- Like-kind exchange, property received in . . . 326
- Mutual fund shares . . . 277
- Stock reacquired in wash sale . . . 300
- Stock shares . . . 273

BUSINESS ASSETS
- Abandonment of . . . 347
- Casualty loss or gain . . . 355
  - •• Mixed personal and . . . 355
- Debt discharge, basis reduction . . . 377
- Real property, debt discharge . . . 371
- Sale or purchase of
  - •• Depreciable real property . . . 356
  - •• Depreciation recapture . . . 352
  - •• Involuntary conversions . . . 337
  - •• Like-kind exchanges . . . 326
  - •• Purchase price allocations . . . 350
  - •• Related parties . . . 312, 353
  - •• Reporting . . . 356
  - •• Section 1231 recapture . . . 349

BUY/SELL AGREEMENTS
- Purchase price allocations . . . 350

C

CAPITAL GAINS AND LOSSES
- Anticonversion rules . . . 298
- Capital asset, defined . . . 273
- Capital loss carryovers . . . 273
- Constructive sale rules . . . 290
- Debt discharge, reduction of loss carryover . . . 377
- Holding periods . . . 273
- Mutual funds . . . 277
- Nonbusiness bad debts . . . 361
- Option transactions . . . 286
- Pass-through entities, from . . . 273
- Qualified small business stock (QSBS) . . . 299
- Section 1202 stock . . . 299
- Section 1244 stock . . . 280
- Short sales . . . 290
- Tax rates . . . 273
- Wash sales . . . 300
- Worthless securities . . . 280

CARRYBACK AND CARRYOVER
- Capital losses . . . 273
- Debt discharge, reduction of carryovers . . . 377
- Section 1231 nonrecaptured loss carryover . . . 349
- Section 1256 loss . . . 286

CASUALTY AND THEFT LOSSES
- Business . . . 355
- Mixed personal and . . . 355
- Personal
  - •• Gain from insurance reimbursement . . . 337

CREDITS
- Debt discharge, reduction of carryover . . . 377

D

DEBT DISCHARGE INCOME
- Bankrupt or insolvent taxpayer . . . 377
- Credit cards . . . 385
- Foreclosure
  - •• Nonrecourse debt . . . 383
  - •• Recourse debt . . . 382
- Insolvency, computing . . . 377
- S corporations . . . 377
- Solvent taxpayer
  - •• Acquisition by related party . . . 371
  - •• Discounted payoff . . . 371
  - •• Purchase money debt . . . 384
  - •• Qualified farm debt . . . 371
  - •• Qualified real property business debt . . . 371
  - •• Renegotiated debt . . . 371
  - •• Student loans . . . 371

DECEASED TAXPAYERS
- Installment obligations, transfers at death . . . 324

DEPRECIATION
- Basis reduction, computation after . . . 316
- Capital gain rate, Section 1250 property . . . 273
- Recapture . . . 352, 356
- Tables
  - •• Depreciation recapture . . . 352

DISASTER AREA
- Federally declared disaster area . . . 337

DIVORCE
- Installment obligations, transfers . . . 324

E

ELECTIONS
- Capital asset transactions
  - •• Defer gain from involuntary conversions . . . 337
  - •• Installment reporting for sales of residential lots or timeshares . . . 311
  - •• Out of installment reporting . . . 314
  - •• Rollover Section 1202 gain . . . 299
- Debt discharge, qualified real property business debt . . . 371
- Depreciation and cost recovery
  - •• Reduce basis of depreciable assets by bankrupt or insolvent taxpayer . . . 377
- Installment reporting
  - •• Dealers in residential lots . . . 311
  - •• Electing out . . . 314
- Involuntary conversions, deferring gain . . . 337
- Qualified real property business debt . . . 371, 382
- Restricted property, receipt treated as current compensation . . . 292
- Stock options, Section 83(b) . . . 292

EMPLOYEES
- Bad debts . . . 361
- Stock options . . . 292

EXTENDED RETURNS
- Like-kind exchange replacement period, effect on 326

F

FARMING
- Debt discharge income—farm indebtedness 371

FORECLOSURES
- Tax effect to buyer (debtor)
  - •• Nonrecourse debt 383
  - •• Recourse debt 382
- Tax effect to seller (creditor)
  - •• Real property sold on installment 317

G

GIFTS
- Installment obligations 324

GOODWILL
- Amortization 350
- Purchase price allocations 350

I

INCENTIVE STOCK OPTIONS (ISOs)
- Alternative minimum tax (AMT) versus regular tax 292

INSTALLMENT SALES
- Capital gain tax rates 273
- Dealer sales
  - •• Accounting for 311
  - •• Residential lots and timeshares 311
- Defined 314
- Depreciable property 273, 312
- Depreciation recapture 352, 356
- Disposition of installment obligations 324
- Electing out of installment reporting 314
- Purchase price adjustments 316
- Related parties 312
- Repossession of real estate sold on installment basis 317
- Wraparound mortgages 319

INTANGIBLE ASSETS
- Purchase price allocations 350
- Section 197 intangibles 350, 352

INTANGIBLE DRILLING COSTS (IDC)
- Abandonment of property 347

INTEREST AND DIVIDEND INCOME
- Dividends
  - •• "In lieu of" payments 290
  - •• Reinvested in mutual fund 277
- Mutual funds 277
- Wraparound mortgage 319

INTEREST EXPENSE
- Wraparound mortgage 319

INVOLUNTARY CONVERSIONS
- General rules 337
- Residence, special rules 337

L

LEASEHOLD IMPROVEMENTS
- Abandonment 347

LIKE-KIND EXCHANGES
- •• Generally 326
- •• Income earned on escrow account 326
- Depreciating property received in exchange 326
- General rules 326
- Purchase price allocations, effect on 350
- Related party 326
- Residence, personal 326
- Vacation home 326
- Vacation home limitation 326

LOSSES
- Abandonments 347
- Related parties 353
- Section 1231 loss carryovers 349

M

MUTUAL FUNDS
- Basis of shares in 277
- Reporting income 277

N

NET OPERATING LOSSES
- Debt discharge, reduction of carryover 377

NONRECOURSE DEBT
- Definition 383
- Foreclosure 383

O

OIL AND GAS PROPERTY
- Abandonment loss 347

P

PASSIVE ACTIVITIES
- Debt discharge income 371
- Suspended losses
  - •• Debt discharge, reduction of carryovers 377

PURCHASE PRICE ALLOCATIONS
- Like-kind exchanges, effect on 326, 350
- Trade or business property acquisitions 350

Q

QUALIFIED INTERMEDIARY
- Bankrupt or insolvent 326

R

REAL ESTATE AND OTHER INVESTMENT PROPERTY
- Depreciable real property, sale of 356
- Involuntary conversions of 337
- Like-kind exchanges 326

RECAPTURE
- Depreciation ordinary income 352, 356
- Depreciation, unrecaptured Section 1250 356
- Section 1231 loss carryovers 349

RECOURSE DEBT
- Definition 382
- Foreclosure 382

RELATED PARTIES
- Bad debts 361
- Constructive ownership 353
- Installment sales between 312
- Like-kind exchanges 326
- Loss on sale between 353

REPOSSESSION
- Real estate sold on installment basis 317

RESIDENCE
- Debt discharge income 371, 384
- Foreclosure 382
- Involuntary conversion of 337

RESIDENTIAL LOTS
• Dealers, installment method 311

S

S CORPORATIONS AND SHAREHOLDERS
• Bad debt, loans versus capital 361

SECTION 1231
• Abandonments of Section 1231 property 347
• Depreciation recapture 352
• Gain from sale of depreciable real property 356
• Nonrecaptured Section 1231 loss carryovers 349
• Section 197 intangibles 350

SECTION 1250
• Unrecaptured gain 356

SECTION 179 DEDUCTION
• Recapture 352

SECURITIES TRANSACTIONS
• Anticonversion rules 298
• Capital gain tax rates 273
• Constructive sales 290
• Employee stock options 292
• Gain rollover
  •• Qualified small business stock (QSBS) 299
• Holding periods 273
• Identifying shares sold 273
• Incentive stock options
  •• General treatment 292
• Investors, taxation of 302
• Losses
  •• Section 1244 stock 280
  •• Wash sales 300
  •• Worthless securities 280
• Mutual funds
  •• Basis in shares, determining 277
  •• Reporting shareholder income 277
• Options 286, 292
• Qualified small business stock (QSBS) 299
• Sale or exchange
  •• Identifying shares sold 273, 277
  •• Options 286
  •• Qualified small business stock (QSBS) 299
  •• Section 1244 stock 280
  •• Short sales 290
  •• Wash sale losses 300
• Section 1256 contracts 286
• Short sales 290
• Traders, taxation of 302
• Virtual currency 301

SELLER FINANCING
• Installment sale purchase price adjustments 316
• Reduction of debt, basis adjustment 384

SHAREHOLDER
• Bad debt, loans versus capital 361

STOCK OPTIONS
• Employer stock purchase plans (ESPPs)
  •• Income tax issues 292
  •• Payroll tax issues 292
• Incentive stock options (ISOs)
  •• General treatment 292
• Nonqualified stock options (NQSOs) 292
  •• Cashless exercise 292
• Publicly traded 286

T

TABLES
• Characteristics of traders and investors 302
• Summary of tax attributes—investors and traders 302

TIMESHARES
• Installment reporting for sales of 311

V

VACATION HOME
• Like-kind exchange limitation 326

W

WAGES AND SALARIES
• Stock options 292

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1040 Deskbook—Course 1—Business, Farm, and Rental (TDBTG171)

CTEC Course No. 3039-CE-2161

Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____ Firm Fax No.: _____

Firm Email: _____

CTEC No.: _____ PTIN: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘.

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: November 30, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1040 Deskbook—Course 1—Business, Farm, and Rental

Course Acronym: TDBTG171

Your Name (optional): _____

Date: _____

CTEC Number: 3039-CE-2161

Email: _____

IRS Program Number(s): 0YC0C-T-01092-17-S

CE Provider: Checkpoint Learning

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1040 Deskbook—Course 2—Pension and Retirement Income, Other Items of Income, and Adjustments to Income (TDBTG172)

CTEC Course No. 3039-CE-2150

Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____ Firm Fax No.: _____

Firm Email: _____

CTEC No.: _____ PTIN: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: November 30, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1040 Deskbook—Course 2—Pension and Retirement Income, Other Items of Income, and Adjustments to Income

Course Acronym: TDBTG172

Your Name (optional): _____ Date: _____

CTEC Number: 3039-CE-2150 Email: _____

IRS Program Number(s): 0YC0C-T-00939-17-S CE Provider: Checkpoint Learning

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1040 Deskbook—Course 3—Gains and Losses (TDBTG173)

CTEC Course No. 3039-CE-2152

Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____ Firm Fax No.: _____

Firm Email: _____

CTEC No.: _____ PTIN: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answer for each question by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ✓ .

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: November 30, 2018

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1040 Deskbook—Course 3—Gains and Losses

Course Acronym: TDBTG173

Your Name (optional): _____

Date: _____

CTEC Number: 3039-CE-2152

Email: _____

IRS Program Number(s): 0YC0C-T-01008-17-S

CE Provider: Checkpoint Learning

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. _____

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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