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SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Tax Planning for High Income Individuals

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Interactive Self-study CPE

Companion to PPC's Guide to Tax Planning for High Income Individuals

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS

INTRODUCTION

Tax Planning for High Income Individuals consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Tax Planning for High Income Individuals* 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 **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **April 30, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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COMPANION TO PPC'S GUIDE TO TAX PLANNING FOR HIGH INCOME INDIVIDUALS

COURSE 1

RETIREMENT PLANS AND ROTH IRAS (TINTG101)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course summarizes a number of retirement programs that provide tax advantages to both employers and employees.
PUBLICATION/REVISION DATE:	April 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Tax Planning for High Income Individuals*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of income tax preparation.
CPE CREDIT:	6 QAS Hours, 6 Registry Hours 6 CTEC Federal Hours, 0 CTEC California Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. **Enrolled Agents:** This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by **April 30, 2011**
KNOWLEDGE LEVEL:	Intermediate

Learning Objectives:

Lesson 1—Retirement Plans

Completion of this lesson will enable you to:
- Discuss the various retirement plan options for the self-employed.
- Recognize the optimum benefit distribution option for your client.
- Describe the tax considerations in selecting a retirement plan and IRA beneficiary.

Lesson 2—Roth IRAs

Completion of this lesson will enable you to:
- Describe how to use Roth IRAs to maximize individual retirement benefits.
- Recognize how to convert traditional IRAs to Roth IRAs.
- Identify how to maximize retirement benefits with a Roth 401(k).

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Chicago, IL 60694-6700

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Lesson 1: Retirement Plans

INTRODUCTION

Effective use of tax-deferred retirement plans is often essential for clients to meet their retirement goals. To an individual who depends on the retirement plan funds for living expenses, minimizing tax on current distributions from these tax deferred accounts is of primary concern. In addition, the client may have strong feelings regarding how retirement assets remaining at death will be distributed.

Planning for retirement is a relatively high-risk area of tax practice. Some choices are based on assumptions (e.g., life expectancy) and are irrevocable. In addition, the amounts involved may be significant, if not crucial, to the client's financial situation.

Retirement plan beneficiary designations must be reviewed in conjunction with an individual's overall estate plan. Since certain beneficiary designations can result in adverse estate tax consequences, it is important to quantify the individual's potential estate to determine whether estate tax considerations should be a major factor in planning retirement distributions. Individuals with total assets (including retirement assets) under the applicable estate tax exclusion amount may not be concerned with estate taxes. Nevertheless, the designated beneficiary as of the date of the participant's death can have significant effect on the required disposition of those assets and their ability to continue tax-deferred growth.

The practitioner can assist a client in determining both the timing and amount of retirement plan distributions. The participant may have many distribution options from which to choose, including an annuity, rollover, or lump-sum. The effect of the minimum required distribution rules and the early distribution penalty rules should be carefully considered before selecting a form of retirement distribution.

Generally, the client should maximize participation in all available tax-deferred retirement plans. The tax-deferred benefits of maximizing 401(k) plan contributions, contributing to an IRA, or participating in an employer's deferred compensation plan should not be overlooked. In addition to the tax-deferred nature of such savings, employers matching the participant's contributions to certain plans [such as 401(k) plans] can significantly increase an individual's retirement savings. Retirement plans or accounts that allow the participant and/or his employer to make tax-deductible contributions and/or defer tax on the earnings within the plan or account are effective vehicles for retirement saving.

Planning for retirement requires the consideration of income tax, estate tax, and financial planning issues. While this course focuses primarily on the income tax consequences of a decision, the estate tax and financial planning impact of the decision cannot be ignored.

Learning Objectives:

Completion of this lesson will enable you to:

- Discuss the various retirement plan options for the self-employed.
- Recognize the optimum benefit distribution option for your client.
- Describe the tax considerations in selecting a retirement plan and IRA beneficiary.

CHOOSING A RETIREMENT PLAN FOR THE SELF-EMPLOYED

Self-employed individuals can adopt a qualified retirement plan (often referred to as a Keogh plan), a simplified employee pension (SEP) plan, an individual retirement account (IRA), or a savings incentive match plan for employees (SIMPLE IRA plan). These plans offer self-employed individuals the same opportunity to accumulate retirement savings in tax-deferred accounts as individuals covered by corporate retirement plans.

Keogh Plans for the Self-employed

Qualified retirement plans (e.g., profit sharing, money purchase, and defined benefit plans) established by sole proprietorships (or partnerships) for the benefit of the sole proprietor (or partners) and their employees are often referred to as Keogh plans.

Keogh plans are generally subject to the same rules as those covering corporate qualified retirement plans. Like a corporate plan, a Keogh cannot discriminate among employees in determining participation, benefits, or contributions. The deduction limits for contributions on behalf of both employees and self-employed individuals are the same as those for corporate plans. However, the deduction limit for self-employed individuals is based on net self-employment income earned in the trade or business for which the plan is established.

Advantages of a Keogh include the following:

a. A taxpayer with self-employment income can generally establish a Keogh, even though he is covered, as an employee, by an unrelated employer's retirement plan. Examples of common self-employed/employee situations include doctors, lawyers, accountants, and corporate directors.

b. Fees for administering the plan are tax-deductible or may be eligible for a tax credit.

c. Taxes on earnings in the plan are deferred until withdrawn.

d. The self-employed taxpayer can direct plan investments.

e. The contribution deduction is *above-the-line*; the taxpayer does not need to itemize deductions to obtain a tax benefit from the contribution, and, because the deduction reduces adjusted gross income (AGI), it can increase the allowable amount of AGI-sensitive deductions and credits.

f. Lump-sum distributions may be eligible for favorable tax treatment.

Example 1-1: Directors fees used to establish a Keogh plan.

In January 2010, Tim, age 54, was elected to the Board of Directors of the Acme Corp. He receives $40,000 annually for attending quarterly meetings and consulting with the management committee throughout the year. Tim is also an executive of Henderson Hardware Inc., where he participates in the company's retirement plan but owns none of the company's stock.

Tim's director fees are includable in computing net earnings from self-employment and for purposes of making tax-deductible contributions to a Keogh plan established for Tim's business of being a director. Assuming Tim establishes the Keogh plan by year-end (December 31, 2010), he can defer tax on a portion of his directors fees by making a tax-deductible plan contribution, despite his participation in the Henderson Hardware, Inc. retirement plan. Contributions to such a plan could be maximized if the plan includes a 401(k) feature, but only to the extent Tim has not already made elective deferrals to the Henderson Hardware Retirement Plan. (See the discussion later in this course regarding choosing a type of Keogh plan.)

Variation: Alternatively, Tim could establish a SEP to shelter a portion of his director fees. A SEP plan would be more flexible in that it does not have to be adopted by year-end; Tim can adopt a SEP plan any time before the deadline for filing his 2010 individual income tax return (including extensions). (See the discussion later in this lesson regarding SEPs.) A SIMPLE-IRA plan is also an option if Tim has not already made elective deferrals to the Henderson plan, but it must be established by October 1, 2010.

Deducting Keogh Contributions. Like a corporate plan, a Keogh cannot discriminate among employees in determining participation, benefits, or contributions. The deduction limits for contributions on behalf of both employees and self-employed individuals are the same as those for corporate plans. These rules generally allow the following deductions:

a. *Money Purchase and Profit-sharing Plans.* For 2010, the employer's maximum *deduction* for contributions to profit-sharing and money purchase plans is limited to 25% of the total compensation of all participants eligible to share in the contribution allocation. For this computation, each participant's compensation is limited to $245,000. Elective deferrals to a 401(k) plan are not subject to this limit.

b. *Defined Benefit Plans.* The employer's deduction limit for contributions to a defined benefit plan is in most cases the minimum funding amount. The minimum funding standards generally require the employer's annual contribution to be large enough to cover the annual cost of future benefits and administrative expenses, as well as any past benefits not funded. These deduction limits are actuarially determined.

The deduction limit for self-employed individuals is based on net self-employment (SE) income earned in the trade or business for which the plan is established. Net SE income is calculated after the Keogh contribution deduction and the deduction for half of the self-employment (SE) tax. This first reduction results in a simultaneous equation that effectively reduces the self-employed participant's maximum contribution percentage (based on precontribution earned income).

Example 1-2: Calculating a self-employed individual's profit-sharing plan contribution.

John, a self-employed architect, generated Schedule C income of $110,000 net of his SE tax deduction but before the plan contribution during 2010. He has a profit-sharing plan with a stated contribution rate of 25%. The plan defines compensation for self-employed individuals as earned income within the meaning of IRC Sec. 401(c)(2).

The maximum John can contribute to the plan is 25% of his Schedule C income less his SE tax deduction and the contributions to the plan.

Defined Benefit versus Defined Contribution Plans. A defined benefit plan for a self-employed individual who is over age 45 (and has significant net business income and the cash necessary to fund required, and possibly large, annual contributions) can be an excellent vehicle for making relatively large tax deductible contributions. This is possible because the benefit the plan participant will receive is established, and the contributions necessary to create a fund that will provide the desired benefit are calculated based on actuarial assumptions such as interest rates, years until retirement, and life expectancy. However, defined benefit plans are most useful when the owner-participant is significantly older (and better paid) than other employees. Otherwise contributions required to be made on behalf of other employees may be prohibitive. Additionally, the costs of implementing (e.g., legal fees) and maintaining (e.g., actuarial fees) a defined benefit plan must be considered.

Conversely, self-employed individuals under age 45 may be reluctant to establish a defined benefit Keogh plan because of the costs involved in computing the annual contribution, compared to the amount of contribution required for a defined contribution plan (usually not significantly greater compared to other types of self-employed plans since retirement is many years away). Thus, defined contribution (e.g., profit sharing) plans are typically the most popular choice for younger self-employed taxpayers and those without the cash necessary to fund and maintain a defined benefit plan.

Money purchase plans operate similarly to profit-sharing plans. However, the plan must contain a set formula under which contributions are made instead of allowing discretionary contributions. Once adopted, contributions determined by the formula must be made annually. The contribution deduction limit for money purchase plans is 25% of total compensation for all employees. Since the contribution limit of profit-sharing plan is equal to that of money purchase plans, there is no advantage to establishing a new money purchase plan.

One-person 401(k) Plans. One-person 401(k) plans are becoming increasingly popular for a business that employs only the owner. Given the right circumstances, those plans can allow a large amount to be contributed on behalf of the owner while maintaining flexibility in making contributions in future years. The cost of preparing the annual return (Form 5500 required) is nominal in comparison to the additional funding a one-person 401(k) plan allows. Also, because the plan has no employees other than the owner, it is not subject to the complicated nondiscrimination tests normally applicable to 401(k) plans.

For 2010, a business owner can make an elective deferral contribution of up to $16,500 ($22,000 if he is age 50 or older) plus an employer contribution of up to 20% of SE income or 25% of compensation. In calculating the allowable employer contribution, the owner's SE income or compensation is not reduced by the owner's elective deferral contribution.

However, the total contributions (elective deferral plus the employer contribution) cannot exceed the lesser of 100% of the participant's compensation or $49,000 ($54,500 if age 50 or older) for 2010.

Example 1-3: Maximizing contributions with a one-person 401(k) plan.

Randy, age 50 (by the end of the current year), is the sole owner and employee of Flight-in-Training, a sole proprietorship. Flight-in-Training is also the sole source of Randy's earned income. Randy earns $145,000 (net of the SE tax deduction) in the current year and wishes to maximize contributions to a retirement account. Randy believes that the business will probably continue to be profitable, but he would like the flexibility of determining on a year-to-year basis how much to contribute. Randy does not expect to hire employees and will remain a one-person company.

The following table reflects the maximum amount that can be contributed to a profit sharing plan with a 401(k) feature [a one-person 401(k) plan] by Randy in 2010.

25% (20% for self-employed individuals) profit-sharing contribution ($145,000 × 20%)	$ 29,000
Elective 401(k) deferrals	16,500
Contributions subject to annual addition limit	45,500
Catch-up contributions	5,500
Total contributions	$ 51,000

In contrast, Randy's 2010 contribution to a profit sharing plan without a 401(k) feature or a SEP without a salary reduction feature (a regular SEP) would be limited to $29,000 (20% × $145,000).

One-Person 401(k) Is Less Advantageous at Higher Income Levels. The higher the business owner's SE income or compensation, the more can be contributed to his one-person 401(k) account—up to the applicable dollar cap (i.e., the annual additions limit). For 2010, the cap on combined elective deferral and employer contributions to a 401(k) plan account is $49,000, if the owner is under age 50. The 2010 cap for a profit sharing plan without a 401(k) feature or regular SEP is $49,000, regardless of the owner's age.

Because of the $49,000 cap (for 2010), the advantage of a one-person 401(k) plan over a SEP is maximized when SE income is $162,500 or less (because the full $16,500 elective deferral is available even with an employer contribution at the maximum 20% rate). On the other hand, when SE income is $245,000 or more, there is no longer an advantage because the full $49,000 limit can be contributed using a SEP ($245,000 × 20% = $49,000).

Similarly, the $49,000 cap impacts the advantage of a corporate one-person 401(k) versus of SEP, except the amounts are different because the corporation can contribute 25% of the individual's compensation (without any reductions). Thus, the maximum advantage of the 401(k) is realized on compensation up to $130,000 and the advantage is lost when compensation is $196,000 or more.

However, when the business owner is age 50 or older, a one-person 401(k) plan will *always* permit larger annual deductible contributions. This is because the 401(k) cap is increased by the catch-up elective deferral contribution amount. The 401(k) cap for 2010 for a participant who is age 50 or older is $54,500 (*regular* cap of $49,000 plus $5,500 extra due to the catch-up contribution privilege).

When the business employs someone other than the owner, 401(k) contributions may be required for the other employees, in which case the plan would become a "standard" 401(k) plan with all the resulting complications.

However, the plan can exclude from coverage any employee who is under age 21 and any employee who has not worked for at least 1,000 hours during any 12-month period. Because this exclusion rule allows the business owner to avoid covering young and part-time employees, the plan may still qualify as a simple and easy one-person 401(k) arrangement.

Plan Loans. Keogh plans can make plan loans to owner-employees under the same rules applicable to other participants. However, the plan document must set out specific loan provisions.

How to Set Up a Keogh Plan. A Keogh plan must legally exist by the taxpayer's year-end to claim a deduction for the contribution. Thus, calendar-year taxpayers must adopt the plan by December 31. In addition, the trust agreement (if the plan uses a trust) and the plan itself must be in writing and communicated to any employees by that date. Some states require that the trust be funded with at least a nominal amount of money prior to year-end.

The easiest and quickest way to establish a plan is for the taxpayer to adopt a master or prototype plan (offered by most financial institutions). The sponsoring organization has already applied to the IRS for plan approval of the master or prototype plan document, then provides the taxpayer with a copy of the approved plan and determination letter.

Due Date of Keogh Plan Contributions. Contributions to Keogh plans are generally deductible only in the year paid. However, a special rule permits a deduction for certain contributions made after year-end. Under this rule, a contribution is treated as made on the last day of the tax year if: (a) it is identified as being made for that year, and (b) it is actually made by the due date of the taxpayer's return, including extensions. If the contribution is made by mail, the postmark date is the controlling date (see Ltr. Rul. 8551065, which applies to traditional IRA contributions and which, presumably, also applies to contributions to other retirement plans).

Example 1-4: Establishing tax year in which Keogh contribution is deductible.

Fred Ware, a calendar-year taxpayer, is eligible to contribute $15,000 to his Keogh plan. On February 22, 2011, Fred pays $15,000 to the retirement plan trust and identifies the contribution as being for 2010. Since the contribution was made before the due date of Fred's personal tax return and is identified as a 2010 contribution, it is deemed made on the last day of 2010 and thus deductible on Fred's 2010 return (assuming the plan was established on or before December 31, 2010).

SEPs Offer Simplicity but Less Flexibility

In a SEP plan, the employer makes annual contributions on the employee's behalf to an IRA established for the employee (referred to as SEP IRAs). A SEP is generally easy to adopt, and the rules governing participation are straightforward. An advantage of establishing a SEP (rather than a Keogh plan) is that reporting, recordkeeping, and funding requirements are minimal. Taxpayers also have the ability to adopt a SEP plan after year-end, and to make contributions up to the due date of their personal tax return.

An employer is not required to make SEP contributions every year or to maintain a particular contribution level. However, contributions may not discriminate in favor of highly compensated employees. This means contributions for all eligible employees must generally bear a uniform relationship to includable compensation. A contribution rate that decreases as compensation increases is considered uniform.

Despite a SEP's simplicity and ease of adoption, SEP plans do have disadvantages. For example, all eligible employees must be covered. An eligible employee is one who at a minimum (a) has attained age 21; (b) has performed any services for the employer during at least three of the preceding five years; and (c) has received at least $550 in compensation during 2010. Additionally, employees have a nonforfeitable right to contributions (i.e., are immediately vested). Thus, there is no partial vesting, and no possibility that contributions will be reallocated back to the employer or key employee. Finally, every eligible employee must set up or modify an IRA to accept a SEP contribution. Failure of *even one* eligible employee to do so destroys the ability of the employer to use a SEP. However, employers may overcome this problem by setting up an IRA on the employee's behalf. Finally, if contributions are made to IRAs of some but not all eligible employees, none of the SEP contributions are deductible (*Brown*).

How to Adopt a SEP Plan. For most self-employed taxpayers, 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 should be maintained as part of the employer's permanent records. In addition, a copy of Form 5305-SEP (including the accompanying instructions) must be given to each employee covered by the SEP.

Post Year-end Tax Planning with a SEP. Unlike Keogh plans, a SEP does not have to be adopted by the taxpayer's year-end; it can be adopted any time before the deadline for filing the taxpayer's return, including extensions.

Example 1-5: Post year-end tax planning with a SEP.

Lisa starts a home-based business in 2010. The business does well and Lisa ends the year with Schedule C net income of $75,000. In March 2011, Lisa consults with her newly-hired CPA regarding preparation of her 2010 tax return.

Lisa should consider establishing a SEP, which must be done on or before the due date of her tax return (including extensions). Thus, Lisa has until October 17, 2011 to establish a SEP, make the appropriate contributions, and deduct the amounts on her 2010 tax return if her tax return is extended to that date.

Contribution Limit. For 2010, the contribution limit for a SEP is the lesser of (a) 25% of up to $245,000 of compensation or (b) $49,000. For self-employed individuals, the contribution limit is based on net self-employment (SE) income earned in the business that established the SEP. Net SE income is calculated after the SEP contribution deduction and the SE tax deduction. This first reduction results in a simultaneous equation that effectively reduces the self-employed participant's maximum contribution percentage (based on precontribution earned income).

SELF-STUDY QUIZ

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

1. A Keogh plan is a tax-deferred retirement savings plan for self-employed individuals. A self-employed person would benefit from which of the following advantages of a Keogh plan?

    a. There are no early withdrawal penalties.

    b. Fees for administering a Keogh plan are tax-deductible.

    c. Higher contribution limits for individuals.

    d. Allows for catch-up salary deferral contributions for those 50 years and older.

2. Self-employed individuals have the option of adopting a multitude of qualified retirement plans. However, not all qualified retirement plans are one-size-fits all. Which of the following retirement plans is best suited for the higher-income individual who is over age 45?

    a. Defined contribution.

    b. One-person 401(k).

    c. Defined benefit.

    d. Money purchase.

3. For 2010, the maximum annual tax deductible contribution (elective deferral plus employer contribution) to a defined contribution plan on behalf of a person under age 50 cannot exceed the lesser of _______ or 100% of compensation.

    a. $44,000.

    b. $49,000.

    c. $54,500.

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. A Keogh plan is a tax-deferred retirement savings plan for self-employed individuals. A self-employed person would benefit from which of the following advantages of a Keogh plan? **(Page 4)**

   a. There are no early withdrawal penalties. [This answer is incorrect. A Keogh plan has the same early withdrawal penalties as other qualified plans.]

   b. Fees for administering a Keogh plan are tax-deductible. [This answer is correct. Fees for administering the Keogh plan are tax-deductible and may be eligible for a tax credit as stated in IRS Code.]

   c. Higher contribution limits for individuals. [This answer is incorrect. The Keogh plan does not offer higher contribution limits for individuals so this would not be an advantage of the Keogh plan. This is an advantage of the self-employed 401(k) plan.]

   d. Allows for catch-up salary deferral contributions for those 50 years and older. [This answer is incorrect. Keogh plans do not offer catch-up salary deferral contributions for any individuals.]

2. Self-employed individuals have the option of adopting a multitude of qualified retirement plans. However, not all qualified retirement plans are one-size-fits all. Which of the following retirement plans is best suited for the higher-income individual who is over age 45? **(Page 5)**

   a. Defined contribution. [This answer is incorrect. Defined contribution plans are typically the most popular choice for younger self-employed taxpayers and those without the cash necessary to fund and maintain a defined benefit plan.]

   b. One-person 401(k). [This answer is incorrect. Because of the catch-up contribution provisions, a one-person 401(k) plan always yields the business owner age 50 or older larger annual deductible contributions, however, there is a cap on combined employer contributions to a 401(k) account.]

   c. Defined benefit. [This answer is correct. Defined benefit plans are most useful when the owner is significantly older than other employees. A defined benefit plan for a self-employed individual who is over age 45 (and has significant net business income and the cash necessary to fund required, and possibly large, annual contributions) can be an excellent vehicle for making relatively large tax deductible contributions. This is possible because the benefit the plan participant will receive is established, and the contributions necessary to create a fund that will provide that benefits are calculated based on actuarial assumptions such as interest rates, years until retirement, and life expectancy.]

   d. Money purchase. [This answer is incorrect. The contribution deduction limit for a money purchase plan is 25% of total compensation for all employees. Age and income have no significant effect on this plan.]

3. For 2010, the maximum annual tax deductible contribution (elective deferral plus employer contribution) to a defined contribution plan on behalf of a person under age 50 cannot exceed the lesser of _______ or 100% of compensation. **(Page 6)**

   a. $44,000. [This answer is incorrect. For 2006, the total contributions cannot exceed $44,000.]

   b. $49,000. [This answer is correct. For 2009, the maximum annual tax deductible contribution to a defined contribution plan cannot exceed the lesser of $49,000 or 100% of compensation.]

   c. $54,500. [This answer is incorrect. If a participant is age 50 or older, the contribution cannot exceed $54,500.]

SIMPLE IRA Plans

SIMPLE IRA plans 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. An employer may impose less restrictive eligibility requirements by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both, under its SIMPLE IRA Plan. However, the employer cannot impose any other conditions on participating in a SIMPLE IRA Plan (Notice 98-4, Q&A C-2). The employer may not currently maintain any other qualified retirement plans while making contributions to a SIMPLE IRA plan.

SIMPLE IRA plans replace salary reduction simplified employee pensions (SARSEPs). As of January 1, 1997, employers cannot adopt new SARSEPs. However, SARSEPs established before 1997 can continue to receive contributions under present-law rules, and new employees hired after 1996 may participate in the SARSEP under such rules.

The greatest advantage of SIMPLE IRA plans is that they are easier to operate than Keogh 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. However, if a plan will cover only the owner-employee, the complicated nondiscrimination rules do not apply. This may make a one-person 401(k) plan worth consideration. Although the fees for setting up and maintaining a one-person 401(k) plan may be higher, the additional allowable contributions may be substantial.

Contribution Limits. SIMPLE IRA plans allow employee elective contributions and require employer matching contributions or nonelective contributions. For 2010, employee elective contributions are limited to $11,500.

SIMPLE IRA plans can also allow "catch-up contributions" for taxpayers age 50 or older by the end of the applicable year. The catch-up contribution for 2010 is an additional $2,500.

Employer contributions must be made under one of two formulas:

a. *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.

b. *Nonelective Contribution Formula.* In lieu of making matching contributions, the employer may contribute 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 ($245,000 for 2010), thus limiting the contribution to no more than $4,900 (for 2010) per employee.

There is a limit as to the 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 2010, an employee's aggregate elective deferral limit is $16,500 ($22,000 if age 50 or older).

Example 1-6: 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 $8,000 during 2010. She has no ownership in LMN Corp. During 2010, Jane earned $20,000 in directors fees from Snakes, Inc., which is not related to LMN Corp. This $20,000 will be reported as SE income (sole proprietorship) on Jane's 2010 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 2010?

Jane's aggregate elective deferral limit for 2010 is $16,500. Therefore, her elective deferral limit for the SIMPLE IRA plan is $8,500 [$16,500 aggregate elective deferral limit − $8,000 elective deferral made to the 401(k) plan].

Variation 1: What if Jane had deferred $2,000 (rather than $8,000) to the 401(k) plan? Jane's remaining aggregate elective deferral limit would be $14,500 [$16,500 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 limited to $11,500 for 2010.

Variation 2: What if LMN Corp. sponsored a SIMPLE IRA plan (rather than a 401(k) plan) and Jane elected to defer $5,000 to that plan? Based on her aggregate elective deferral limit, it appears that Jane can contribute $11,500 ($16,500 − $5,000) to the sole proprietorship SIMPLE IRA plan. Even though making such a contribution will result in a total of $16,500 of elective deferrals being made to the two unrelated SIMPLE IRA plans, the deferrals made to each plan do not exceed the $11,500 annual SIMPLE IRA plan limit.

Compensation. Under the rules relating to SIMPLE IRA plans, "compensation" equals taxable wages reported on Form W-2, plus any elective deferrals made by the employee. In the case of a self-employed individual, compensation means net earnings from self-employment, as defined in IRC Sec. 1402(a), without regard to the self-employed person's SIMPLE plan contribution.

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:

a. Special rules apply for determining compensation. (See the definition of compensation earlier in this lesson.)

b. Income is deemed to be earned as of the last day of the year. This means that elective deferrals on behalf of the self-employed person need not be deposited until after the last day of the year. 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).

c. 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 How Contributions Are Deductible. Contributions to a SIMPLE IRA plan are deductible in the employer's tax year with or within which the calendar year for which the contributions were made ends. However, for employer matching (or nonelective) contributions, a deduction is allowed for a year only if the contributions are made by the due date (including extensions) for the employer's tax return.

SIMPLE IRA contributions made on behalf of employees are deducted on Schedule C (or F). Payments made on behalf of the self-employed business owner are deducted on Form 1040 as an adjustment to gross income.

Employee elective deferrals (including those attributable to the owner) 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.

Distributions from a SIMPLE IRA Plan. A SIMPLE IRA plan, like a Keogh plan, is attractive to employees because they are not taxed currently on any contributions made to the plan or on any earnings in their accounts until they receive a distribution from the plan. Distributions from a SIMPLE IRA plan generally are subject to IRA distribution rules, not qualified plan distribution rules. However, special rules apply to SIMPLE IRAs that do not apply to other IRAs.

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.

During this two-year period, distributions from the SIMPLE IRA can be rolled over tax-free to another SIMPLE IRA, but not a traditional IRA.

After the two-year period, a SIMPLE IRA is treated as a traditional IRA for rollover purposes. Based on this classification, a SIMPLE IRA can be rolled over to an *eligible retirement plan*. An eligible retirement plan includes a traditional IRA, an individual retirement annuity, a qualified pension, profit-sharing, or stock bonus plan, a governmental Section 457 plan, or a Section 403(b) annuity. Rollovers to eligible retirement plans will generally be tax-free. Rollovers from a SIMPLE IRA to a Roth IRA are also permitted, but will be treated as taxable conversions.

A rollover must take place within 60 days after the participant receives the distribution.

Early Distribution Penalty Tax. As with any IRA, early withdrawals (i.e., distributions before age 59½) from a SIMPLE IRA generally are subject to the 10% early distributions tax unless a specific exception applies. However, if during the initial two-year period, a participant who is not yet age 59½ receives a distribution (to which an exception does not apply), the early distribution tax is 25% (rather than 10%).

Example 1-7: Tax treatment of SIMPLE IRA plan distributions.

Jane, age 28, enters her employer's SIMPLE IRA plan on January 1, 2010. Her employer makes the first deposit into her SIMPLE IRA on January 15, 2010. Jane quits on March 13, 2011, 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?

Jane must roll it 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 tax-free to a traditional IRA (and cannot roll it into a qualified plan). 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 tax as well as income tax.

When SIMPLE IRA Plans Can Be Established. An 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:

a. An IRS model agreement (i.e., Forms 5304-SIMPLE or 5305-SIMPLE). Such plans are referred to as model plans.

b. A prototype SIMPLE IRA plan sponsored by a qualified financial institution (e.g., a bank or mutual fund company) or an individually designed plan. Such plans are referred to as nonmodel plans.

Choosing between a SIMPLE IRA and a SEP

Deciding whether to recommend a SEP or a SIMPLE IRA plan is often a difficult decision, influenced by subjective assumptions about future profitability, compensation levels, and similar unknowns. However, it is possible to make some generalizations. For example, a SIMPLE IRA plan can be an excellent choice for business owners who have few or no employees and relatively low net income or compensation. But, since employer contributions are required each year under a SIMPLE IRA plan (assuming employees elect to make deferrals), problems can arise if the business has no profits. For employers that are not consistently profitable, this is a major disadvantage over a SEP where employer contributions are discretionary and need not be determined until the extended due date of the employer's return for the year to which the contribution relates.

Example 1-8: Sole proprietorship with no employees and relatively low income.

Sheila, age 40, operates Newsletters Plus, a sole proprietorship that has no employees. For 2010, she expects to net approximately $20,000 (after reduction for half the self-employment tax liability). If, by October 1, she establishes a SIMPLE IRA plan for the business, she can defer up to $11,500 of her net earnings into a SIMPLE IRA. In addition, Newsletters Plus can make a 3% matching contribution to the IRA on her behalf, for a total contribution of $12,100. If Sheila instead sets up a SEP, the most she can contribute (and deduct) for 2010 is $4,000 (20% of $20,000).

Variation: If Sheila's net income (after reduction for half the self-employment tax liability) is $100,000, a SEP provides much better results than a SIMPLE IRA plan. Under a SIMPLE IRA plan, her maximum contribution would be $11,500 plus a 3% match ($3,000) for a total of $14,500. Under a SEP, her maximum contribution would be $20,000 (20% of $100,000).

Example 1-9: Partnership in which only one partner wants a plan.

Assume the same facts as in Example 1-8 except that Newsletters Plus is a partnership with Sharon as Sheila's equal partner. Sheila still wants to save for retirement, but Sharon is only interested in maximizing her cash flow. The partnership could adopt a SIMPLE IRA plan with a 2% nonelective contribution that would allow Sheila to defer up to $11,500 of her net earnings even though Sharon chose to defer nothing. (Sharon's SIMPLE IRA, however, would receive her share of the 2% partnership contribution.)

Example 1-10: Small business owner with employees not interested in saving for retirement.

Lentron, Inc. is 100% owned by Larry, age 40. In addition to Larry, the corporation has three other full-time employees who are in their late 20s and have been with the company for several years, but are more interested in current compensation than in saving for retirement. Larry, however, would like to put away as much as possible for retirement (at the lowest cost possible to the company and preferably on a tax-favored basis). With a traditional retirement plan, Lentron would have to make contributions for all of the employees even though the three nonowners presumably would not appreciate them. The same is true for a SEP, although by integrating the plan with social security, the plan could limit the contributions for the nonowners to 3% of their compensation. However, with a SIMPLE IRA, Larry could defer the lesser of $11,500 or 100% of his salary. In addition, if Lentron selected the 3% matching option, up to another $11,500 annually could go into his account. Assuming none of the nonowners elected to defer any of their compensation, Lentron would not need to make a contribution for them.

Example 1-11: Desire to establish a plan retroactively.

Bob Boomer operates Boom.com, a sole proprietorship. Bob has only short-term employees who work no more than one year for him. He had fully intended to set up a SIMPLE IRA plan at the first of the year so he could defer $11,500 and match his deferrals up to 3% of his self-employment income for the year. However, he failed to make the decision and complete the process on a timely basis. This year his self-employment income net of his SE tax deduction will be at least $70,000, and he wishes he had done something prior to year end. His CPA suggests that he adopt a SEP. He can make the decision, adopt, and fund the plan up to the extended due date of his individual tax return. With self-employment income of $70,000 (net of the SE tax deduction), he can contribute $14,000 (20% × $70,000) to the SEP, which is more than he could have contributed to a SIMPLE IRA.

Tax Credit for Retirement Plan Start-up Costs

A small employer who starts a new retirement plan is eligible for a nonrefundable income tax credit of up to $500 per year for the administrative and retirement-education expenses of adopting a new qualified defined benefit or defined contribution plan, a SIMPLE IRA plan, an annuity plan under 403(a), or a SEP.

The credit applies to 50% of the first $1,000 of qualified expenses for each of the first three years of the plan. While the credit will offset regular tax, it will not offset the AMT.

A small employer is defined as an employer that did not employ, in the preceding year, more than 100 employees with compensation of at least $5,000. Additionally, the plan must cover at least one nonhighly compensated employee.

Qualified expenses are defined as ordinary and necessary expenses of an eligible employer, which are paid or incurred in connection with the establishment or administration of an eligible employer plan, or the retirement-related education of employees with respect to the eligible employer plan. The 50% of qualifying expenses eligible for the credit are not deductible; however, the other 50% of such expenses (along with other expenses above the $1,000 limit) are deductible to the extent permitted under present law.

Reporting and Disclosure Requirements. Keogh plans (other than one-participant plans) are required to meet several reporting and disclosure requirements. Form 5500 must be filed annually (by the last day of the seventh month following the plan year-end, unless it is extended). Also, participants must be furnished (a) a summary plan description (SPD) after the plan is adopted (and at 10-year intervals thereafter, or within five years of an amendment to the plan), (b) a summary of material modifications (SMM) after the adoption of any material modification, and (c) a summary annual report (SAR) annually within nine months after the close of the plan year or within two months after the close of extension period for filing the Form 5500, if applicable.

Simplified reporting and disclosure rules apply to one-participant Keogh plans. These plans cover only the sole owner of a business (whether or not incorporated) and spouse, or partners of a partnership and their spouses. One-participant plans generally must file Form 5500-EZ annually with the IRS. However, Form 5500-EZ need not be filed if the assets of the plan do not exceed $250,000 at the end of the plan year. Also, one-participant plans are not required to furnish participants with SPDs, SMMs, or SARs.

Prototype SEPs and SEPs established by completing Form 5305-SEP follow simplified reporting and disclosure requirements. Under these requirements, employers sponsoring SEPs (unlike Keoghs) are not required to file any Form 5500, nor are they required to file SPDs, SMMs, or SARs. However, certain disclosures must be made to employees.

If the SEP was established by completing Form 5305-SEP, the disclosure requirement upon its adoption is met by furnishing employees a copy of the executed Form 5305-SEP (including the accompanying instructions). A disclosure statement describing certain additional information the employer will provide to the employee and discussing the terms of the SEP-IRA must also be given to eligible employees.

Each calendar year, sponsoring employers of an SEP must give each participating employee a statement showing any contribution made to the employee's IRA. If the contribution is made before year-end, this requirement is satisfied by including the information 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), the notification should be within 30 days of the contribution and should be made on a separate statement given to each participating employee.

Simplified reporting and disclosure requirements also apply to SIMPLE 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 trustee. See IRS Notice 98-4 for guidance on reporting and disclosure requirements for SIMPLE IRA plans.

Fiduciary Requirements. Fiduciaries are subject to stringent standards and duties and may be personally liable for losses to the plan resulting from breaching any of those duties. A taxpayer who sponsors a Keogh plan (other than a one-participant plan) and, in any way manages (or makes decisions as to the management of) the plan or its assets is a fiduciary.

The fiduciary rules applicable to Keogh plans generally do not apply to SEPs. However, if an employer sets up a SEP-IRA for an employee who is unable or unwilling to set up his own SEP-IRA, the fiduciary rules apply.

The employer (and any other plan fiduciary) is not subject to fiduciary liability resulting from the employees exercising control over the assets in their SIMPLE IRAs. Employees are treated as exercising control over the assets in their SIMPLE IRAs one year after the account is established or, if earlier, on the date they make an affirmative election on how to invest the contributions or elect to roll over a contribution (including a trustee-to-trustee transfer) to another SIMPLE IRA or regular IRA.

Using a Charitable Remainder Trust in Lieu of a Qualified Plan

A charitable remainder trust (CRT) can be used to meet a grantor's need for retirement income, and thus can be a useful tax planning tool for a charitable-minded business owner who wants to avoid a qualified retirement plan due to the costs of covering rank-and-file employees. (The coverage and contribution requirements imposed by the Internal Revenue Code and ERISA on qualified retirement plans do not apply to a CRT.) Like a qualified retirement plan, a CRT is a trust that normally is not subject to tax.

SELF-STUDY QUIZ

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

4. Which of the following plans do **not** have to meet the nondiscrimination requirements?

   a. SEP.

   b. SARSEP.

   c. Traditional 401(k).

   d. SIMPLE.

5. Which of the following statements about SIMPLE 401(k) plans is the **least** accurate?

   a. Employers may match employee contributions on a dollar-for-dollar basis, up to 3% of the employee's compensation for the calendar year.

   b. Unlike 401(k) plans, a SIMPLE 401(k) plan does not allow individuals to make catch-up contributions.

   c. Employers may contribute 2% of compensation for each eligible employee during the calendar year.

6. An employer should use which of the following schedules when reporting a SIMPLE IRA contribution on behalf of an employee?

   a. Schedule C.

   b. Schedule D.

   c. Schedule H.

   d. Schedule I.

7. The SIMPLE-IRA plan was designed to make it easier for small businesses to offer a tax-advantaged, company-sponsored retirement plan. However, under which of the following situations would having a SIMPLE-IRA plan be considered a major disadvantage?

   a. Employers who are not consistently profitable.

   b. Employers with 100 or more highly compensated employees.

   c. Employers wanting to deduct every qualified dollar they contribute from their taxable income.

8. Candy Coolidge, a calendar-year taxpayer, started a home-based business in 2008 called Candy's Cards and Effects (CCE). Candy's business was a success and she ended the year with Schedule C net income of $80,000. Candy established her retirement plan on October 15, 2009. Which of the following plans did Candy establish that allowed her to adopt the plan after year-end?

   a. SIMPLE IRA.

   b. SEP.

   c. Keogh.

   d. Profit sharing.

9. Which of the following forms should a one-participant plan annually file with the IRS?

   a. Form 5500-EZ.

   b. Form 5305-SEP.

   c. Form 5500.

   d. Form 5498.

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.)**

4. Which of the following plans do **not** have to meet the nondiscrimination requirements? **(Page 11)**

   a. SEP. [This answer is incorrect. The SEP nondiscrimination requirements dictate that the year's actual deferral percentage (ADP) of each eligible highly-compensated employee not exceed the average deferral percentage of the aggregate of non- highly compensated employees by more than 125%.]

   b. SARSEP. [This answer is incorrect. SARSEPs are required to meet certain participation requirements. For example, at least 50% of the employees must participate.]

   c. Traditional 401(k). [This answer is incorrect. Rules relating to traditional 401(k) plans require that contributions made under the plan meet specific nondiscrimination requirements. In order to ensure that the plan satisfies these requirements, the employer must perform annual tests, known as the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests, to verify that deferred wages and employer matching contributions do not discriminate in favor of highly compensated employees.]

   d. SIMPLE. [This answer is correct. The greatest advantage of SIMPLE IRA plans is that they are easier to operate than Keogh plans. SIMPLE IRA plans do not have to meet the nondiscrimination requirements based on the regulations of a Keogh plan.]

5. Which of the following statements about SIMPLE IRA plans is the **least** accurate? **(Page 11)**

   a. Employers may match employee contributions on a dollar-for-dollar basis, up to 3% of the employee's compensation for the calendar year. [This answer is incorrect. Employer contributions to a SIMPLE IRA must be provided under one of two formulas: the matching or the nonelective contribution, not a dollar-for-dollar basis.]

   b. Unlike 401(k) plans, a SIMPLE IRA plan does not allow individuals to make catch-up contributions. [This answer is correct. A SIMPLE IRA plan may allow individuals who have attained at least age 50 by year-end to make catch-up contributions. The limit is $2,500 for 2009.]

   c. Employers may contribute 2% of compensation for each eligible employee during the calendar year. [This answer is incorrect. Employer contributions to a SIMPLE IRA must be provided under one of two formulas: the matching contribution or nonelective contribution. This represents the noncontribution formula and is accurate for a SIMPLE IRA plan.]

6. An employer should use which of the following schedules when reporting a SIMPLE IRA contribution on behalf of an employee? **(Page 12)**

   a. Schedule C. [This answer is correct. SIMPLE IRA contributions made on behalf of employees are deducted on Schedule C (or) F. Payments made on behalf of the self-employed business owner are deducted on Form 1040 as an adjustment to gross income.]

   b. Schedule D. [This answer is incorrect. Schedule D is used to report the capital gains.]

   c. Schedule H. [This answer is incorrect. According to ERISA Sec. 103(a)(3), large retirement plans generally are required to file Schedule H (Form 5500). SIMPLE IRAs do file Schedule H (Form 5500).]

   d. Schedule I. [This answer is incorrect. If a plan has fewer than 100 participants at the beginning of the plan year or is eligible for and files Schedule I for the year, the plan is usually exempt from attaching an independent qualified public accountant's opinion to Form 5500. SIMPLE IRAs do not need an auditor's opinion.]

7. The SIMPLE-IRA plan was designed to make it easier for small businesses to offer a tax-advantaged, company-sponsored retirement plan. However, under which of the following situations would having a SIMPLE-IRA plan be considered a major disadvantage? **(Page 13)**

   a. **Employers who are not consistently profitable. [This answer is correct. Since employer contributions are required each year under a SIMPLE IRA plan (assuming employees elect to make deferrals), problems can arise if the business has no profits. For employers that are not consistently profitable, a SIMPLE-IRA plan is not recommend.]**

   b. Employers with 100 or more highly compensated employees. [This answer is incorrect. A SIMPLE IRA plan can be an excellent choice for business owners who have few or no employees. However, it is generally not adopted by employers with more than 100 employees.]

   c. Employers wanting to deduct every qualified dollar they contribute from their taxable income. [This answer is incorrect. Contributions to a SIMPLE IRA plan are deductible in the employer's tax year with or within which the calendar year for which the contributions were made ends.]

8. Candy Coolidge, a calendar-year taxpayer, started a home-based business in 2008 called Candy's Cards and Effects (CCE). Candy's business was a success and she ended the year with Schedule C net income of $80,000. Candy established her retirement plan on October 15, 2009. Which of the following plans did Candy establish that allowed her to adopt the plan after year-end? **(Page 14)**

   a. SIMPLE IRA. [This answer is incorrect. Contributions to a SIMPLE IRA plan are deductible in the employer's tax year with or within which the calendar for which the contributions were made ends.]

   b. **SEP. [This answer is correct. Unlike Keogh plans, a SEP does not have to be adopted by the taxpayer's year-end. An employer has until the due date of the tax return, including extensions to adopt a SEP plan.]**

   c. Keogh. [This answer is incorrect. A Keogh plan is a type of defined benefit plan. All Keogh plans have to be adopted by the taxpayer's year-end.]

   d. Profit sharing. [This answer is incorrect. A profit-sharing plan is a defined contribution plan and must be adopted by the taxpayer's year-end.]

9. Which of the following forms should a one-participant plan annually file with the IRS? **(Page 15)**

   a. **Form 5500 EZ. [This answer is correct. One-participant plans generally must file Form 5500-EZ annually with the IRS. However, Form 5500-EZ need not be filed if the assets of the plan have not exceeded $100,000 at the end of every plan year beginning after 1993.]**

   b. Form 5305-SEP. [This answer is incorrect. An employer setting up a SEP plan should complete IRS Form 5305-SEP. This form is intended to help set up the SEP plan and it is not filed with the IRS.]

   c. Form 5500. [This answer is incorrect. The Form 5500 Annual Return/Report is used to report information concerning employee benefit plans and Direct Filing Entities (DFEs). Form 5500 must be filed annually by the last day of the seventh month following the plan year-end. Form 5500 is generally used by large employer plans.]

   d. Form 5498. [This answer is incorrect. The IRS requires trustees or issuers of contracts used for Individual Retirement Accounts (IRAs) to submit Form 5498 by May 31 each year. This form reports the fair market value, any rollovers and contributions made to your traditional IRA, Roth IRA, SEP-IRA, or SIMPLE IRA, and recharacterizations of an IRA contribution.]

CHOOSING AMONG BENEFIT DISTRIBUTION OPTIONS

Choosing a retirement plan distribution option involves a combination of income tax and financial considerations of both the participant and designated beneficiary. Adequate planning includes estimating the participant's cash needs during retirement, as well as the surviving spouses' needs in the event of the participant's death. Planning should also include evaluating the economic impact of the retirement proceeds on succeeding generations.

Two issues the practitioner typically faces in assisting a client with retirement planning are (a) selecting the form and timing of *benefit distribution*, and (b) selecting the *beneficiary* of the plan.

Qualified Plan Options

The employer's retirement plan document generally specifies which forms of benefit distribution are available to a participant upon retirement or termination from employment (other than death). Depending on the plan and participant's election, retirement benefits may be distributed in the form of an annuity (discussed later in this course) or lump sum. (Choosing between a lump sum distribution and an annuity is discussed later in this course.)

Qualified plans are of two types—defined benefit and defined contribution plans. Under a defined benefit plan, a contribution is made for each participant to fund a specific, future retirement benefit. Defined benefit plans must offer a qualified joint and survivor annuity (QJSA) as the normal form of benefit distribution. However, other types of annuities and lump-sum distributions may be offered at the participant's election and (if applicable) spouse's consent.

Under a defined contribution plan, retirement benefits are contingent upon the amount of contributions to the plan on the employee's behalf and the length of time the employee participates in the plan. Most defined contribution plans offer lump sum distribution options to participants, although such distributions may be subject to the spousal consent rules. Annuity options may also be offered. Certain defined contribution plans must offer QJSAs as the normal form of benefit.

Qualified retirement plans must require distributions to begin by April 1 of the year after the participant turns age $70^1/_2$ unless the plan allows participants to elect to defer taking distributions until they retire, if they retire after age $70^1/_2$ (this option is not available to participants owning more than 5% of the employer).

Qualified Joint and Survivor Annuities. A QJSA for a married participant is an annuity for the life of the participant with a survivor annuity for the life of the spouse. The amount of the survivor annuity may not be less than 50% (and not greater than 100%) of the annuity payable to the primary annuitant. The QJSA must be the actuarial equivalent of a single annuity for the life of the participant or, if greater, an optional form of life annuity offered under the plan.

All defined benefit, money purchase pension, and target benefit plans are subject to the survivor annuity rules and, thus, must provide a QJSA as the normal form of retirement benefit. (Defined contribution plans offering life annuities to married participants are also subject to the survivor annuity rules.) Participants in such plans who are married must use a QJSA unless the plan offers an optional form of benefit *and* the spouse consents to another form of distribution.

Plans subject to the survivor annuity rules must also provide QJSAs to unmarried participants, unless the plan provides for, and the participant elects, another form of benefit. A QJSA for an unmarried participant is a single life annuity with payments that stop at the participant's death.

Qualified Preretirement Survivor Annuity (QPSA). If a married participant dies prior to retirement, a qualified plan subject to the survivor annuity rules must provide the surviving spouse a qualified preretirement survivor annuity (QPSA). For a defined benefit plan, the QPSA is equal to 50% of the annuity the decedent would have received had he retired as of the date of death. For a defined contribution plan, the QPSA is equal to the actuarial equivalent of 50% of the decedent's vested account balance.

A participant in a qualified plan subject to the survivor annuity rules may waive the QPSA (if the plan document permits) with spousal consent. A waiver would allow the participant to name a nonspouse beneficiary to receive any vested retirement plan benefits.

Other Types of Annuities. A qualified plan may provide other types of annuity retirement benefits from which a participant can choose. Examples of other types of annuities include life, joint and nonspousal survivor, or fixed (for a certain number of years). A life annuity for a period certain (e.g., life annuity with 10 years certain) may also be an option. The selection of alternate annuities by a married participant will require the consent of the participant's spouse. In addition, the annuity amount must conform to the minimum distribution rules.

Lump-sum Distribution. A lump-sum distribution (LSD) is a distribution (or several distributions) of the participant's entire account in a single tax year. Most defined contribution plans offer an LSD option. However, if the plan is subject to the survivor annuity rules, spousal consent will be required for this form of distribution. Defined benefit plans may (but generally do not) offer an LSD option, also subject to the spousal consent rules.

A participant receiving an LSD from a qualified plan may be eligible for favorable tax treatment on the distribution. An LSD can also be rolled over (in whole or part) to an eligible retirement plan.

Selecting the Form of Annuity. Once it has been determined that a participant will annuitize his retirement plan benefits, the practitioner must be prepared to assist the client in choosing among the annuity options offered by the plan (if more than one). The decision is usually based on the client's financial needs and health. The following general considerations should be kept in mind when evaluating annuity choices:

a. When the participant is married and the participant and/or spouse is financially dependent on the annuity, selecting any annuity other than a QJSA should be done cautiously. A single life annuity will mean larger payments while the participant is alive, but could leave the spouse in a difficult financial situation if the participant dies first.

b. An annuity guaranteeing payments for a fixed period may result in larger payments during the term of the annuity, but could leave the participant and/or spouse financially deficient if one or both of them outlive the guaranteed term.

c. When the participant's or spouse's financial independence is not a factor, a single life annuity should be considered when the participant's health is good and he is expected to outlive his and his spouse's actuarial life expectancy. A guaranteed annuity should be considered when the participant's and spouse's health is such that they are not expected to outlive the term of the annuity. A guaranteed annuity may take the form of a fixed series of payments (either fixed in amount or percentage of the principal balance), or a combination of a life annuity for a period certain (such as a life annuity with 10 years certain, under which payments are assured for no less than 10 years).

d. Selecting any annuity other than a single life annuity should be done cautiously for an unmarried participant who will be financially dependent on the annuity. An annuity guaranteeing payments for a fixed period may result in larger payments during the term of the annuity, but could leave the participant without sufficient income if he outlives the guaranteed term.

e. A guaranteed annuity should be considered when the participant is in poor health and not expected to outlive the term of the annuity.

Example 1-12: Choosing between a single and joint-life annuity.

Jim is about to retire. He is 65, and his wife, Flora, is 55. Jim has never had health problems, but Flora has had one heart attack. She is currently collecting an annual $6,000 pension, which contains a cost-of-living escalation provision.

Jim has two choices for his noncontributory pension plan distributions. He may choose either a single-life annuity, or a joint and 75% survivor annuity. Under the joint and survivor annuity, Jim would receive $24,000 per year (there are no cost-of-living escalators for either option), and should he predecease Flora, she would receive an annual pension of $18,000 for the remainder of her life. Alternatively, if they both consent in writing, Jim may elect a single-life annuity of $30,000 per year. If he dies first, Flora would receive nothing.

Obviously, the single-life annuity will produce a higher annuity as long as Jim is alive. If they elect the single-life annuity and Jim outlives Flora (or lives for such a long time that the extra income from the single-life annuity exceeds the loss of income to Flora if Jim dies first), the annuity option was a good choice. Conversely, if Flora outlives Jim by any substantial length of time, the annuity option was a poor choice.

If they elect the joint-life annuity and Flora dies first, they lose. If Jim dies first, they win to the extent Flora's annuity exceeds the extra income they would have had with the single-life annuity.

The real question is whether Jim and Flora have enough resources now, and in the future, to support Flora in the absence of a survivor annuity from Jim's pension should he predecease her. If the answer is clearly "yes," their risk is minimized if they choose a single-life annuity and Jim dies first. If the answer is clearly "no," they cannot afford to take the single-life annuity.

The decision to select a single or joint life annuity option is basically a gamble. If a single life annuity is selected and the participant dies shortly thereafter, the choice may have been unwise (unless sufficient life insurance was purchased as a supplement). Alternatively, selecting a joint and survivor option may not be wise if the spouse dies shortly thereafter, causing the now single participant to receive a reduced benefit.

To mitigate the uncertainty in selecting a form of annuity, many plans offer modified joint annuity options. Monthly payments under a modified joint life annuity would be less than a regular joint life annuity. The benefit is that if one spouse dies after payments have begun, the remaining spouse can "elect" to receive the higher single rate annuity. In effect, the reduced monthly annuity represents insurance against the spouse's death.

Using Life Insurance to Maximize Annuity Distributions. Rather than selecting a survivor annuity, a participant may consider using life insurance to maximize retirement plan benefits. Using this pension maximization strategy, the participant elects the greater single life annuity (with spousal consent) and purchases a life insurance policy for his spouse's protection. To adequately protect the spouse, the participant purchases sufficient life insurance so that the spouse is able to replace the survivor benefit lost as a result of electing the single life annuity.

Example 1-13: Using life insurance to supplement monthly pension.

Doug is retiring and in the process of choosing between his company's noncontributory pension plan annuity options. (The plan is subject to the survivor annuity rules). If he elects the 50% QJSA option he will receive $3,000 per month as long as he lives. If he dies and is survived by his wife, Clare, she will receive $1,500 (50% of $3,000) for the rest of her life. If Doug elects a single life annuity (with Clare's consent), his monthly benefit would be $3,400; however, the monthly payments cease at his death (Clare would receive nothing).

Doug could use the difference between the joint and single life annuity ($400) to purchase life insurance to replace his monthly pension. For example, he may find a life insurance policy that will enable Clare to purchase a commercial annuity (with the life insurance proceeds) which pays her $1,700 per month for life at a cost of $300 per month. Doug would receive an additional $100 per month ($3,400 single life − $3,000 joint life − $300 life insurance premium) if he elects the single life annuity, and Clare will receive an additional $200 per month at his death ($1,700 life insurance annuity − $1,500 survivor annuity).

Additional tax savings could be realized in that a portion of the $1,700 monthly annuity Clare receives would be tax-free (since she has tax basis in the commercial annuity equal to the purchase price of the annuity contract), compared to the fully taxable $1,500 monthly payment she would receive if the 50% QJSA annuity option was selected.

<u>Facts to Consider.</u> Supplementing a single life employer annuity with an insurance policy may be more cost effective than selecting a percentage joint and survivor option. However, the following issues need to be carefully considered:

a. Taxpayers should be careful in selecting a supplemental policy to ensure they understand the cost of the policy and the contractual guarantees regarding the policy's cash values and rates of return.

b. There are many types of insurance products and carriers from which to choose. Since it is imperative the participant obtain sufficient coverage when using the pension maximization strategy, the taxpayer should be assisted in selecting an insurance product to ensure that the assumptions used in the projections are valid, and the carrier will be solvent at the participant's death.

c. Pension maximization is a risky proposition for spouses as they are giving up their legal rights to the retirement benefits. Therefore, it is imperative that the spouse as well as the participant understand all the ramifications. What the spouse receives in the future is totally dependent on the life insurance proceeds under a policy the retiring spouse has no legal obligation to continue. In times of economic stress, even the best intentions are difficult to honor. Divorce, financial hardship, or failure to make timely policy payments could leave a spouse with no benefits at all. It is essential to determine, relative to the client's overall financial position, the importance of the benefit to the spouse's future financial security.

d. All retirement benefits should be identified before undertaking an analysis for pension maximization. Be aware that some retirement plans such as governmental plans provide for cost of living adjustments (COLAs). These plans are extremely difficult to analyze. A reasonable estimate of the COLAs based on recent history will provide some insight. However, governmental plans as well as some corporate plans provide health care benefits to retirees and surviving spouses entitled to a survivor annuity that can be very valuable, but almost impossible to value. For example, Federal government retirees can participate in the civil service insurance program as long as they receive an annuity payment sufficient to cover the retiree's portion of the premium. This supplemented insurance, which includes guaranteed insurability, is passed on to a surviving spouse only as long as the spouse receives an annuity sufficient to pay his or her portion of the premiums. This means that if surviving spouses receive no annuity, they cannot benefit from the Civil Service insurance program. To protect the insurance benefit for the surviving spouse, some retirees will elect a 5% or 10% spousal annuity. The spouse must still waive the QJSA but can participate in the insurance program as long as the reduced annuity will cover the insurance premiums. This will reduce the benefit of maximization approach and in some cases eliminate the ability to maximize.

e. An insurance illustration provided by the insurance company or its agent should not be overly relied on. The actual contract of insurance will list any guaranteed amounts and rates and should act as the basis for any investment decision. The amounts and rates listed in the actual contract are often materially less than amounts and rates used in the illustration.

Choosing between an Annuity and an LSD. When a qualified plan offers the participant a choice between an annuity and LSD, the practitioner may be asked to help the participant determine which choice best fits his situation. Factors to consider when making a choice include the amount of distribution, marginal tax bracket, pre-tax yield on investments, and age of the participant. In addition, Exhibit 1-1 illustrates the advantages and disadvantages of selecting an LSD versus annuity distribution.

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 which of the following plans is a contribution made for each participant to fund a specific, future retirement benefit?

    a. Defined benefit.

    b. SEP.

    c. SIMPLE IRA.

    d. Defined contribution.

11. Which of the following annuities is paid out at no less than 50% and not greater than 100%?

    a. Qualified joint and survivor annuity (QJSA).

    b. Defined contribution plan qualified preretirement survivor annuity.

    c. Defined benefit plan qualified preretirement survivor annuity.

    d. A life annuity.

12. A survivor annuity must be offered by a defined benefit or money purchase plan if a married participant with a vested benefit dies before he or she begins receiving benefits. If a married participant dies prior to retirement, a qualified plan subject to the survivor annuity rules must provide the surviving spouse a qualified preretirement survivor annuity. Which of the following would be the correct percentage for the QPSA if the surviving spouse does not waive the QPSA?

    a. 0%.

    b. Equal to 50% of the annuity.

    c. Equal to the actuarial equivalent of 50%.

    d. 100%.

13. A practitioner must be prepared to assist a client in choosing among the annuity options offered by a particular plan. Which of the following annuities should be considered when a participant is single, in poor health and not expected to outlive the term of the annuity?

    a. Qualified joint and survivor.

    b. Qualified preretirement survivor.

    c. Guaranteed.

14. When a participant is married and the participant and/or spouse is financially dependent on the annuity, which of the following annuities should the participant select?

    a. Deferred.

    b. Qualified joint and survivor annuity.

    c. Single life.

    d. Flexible.

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 which of the following plans is a contribution made for each participant to fund a specific, future retirement benefit? **(Page 21)**

    a. Defined benefit. [This answer is correct. Under a defined benefit plan, a contribution is made for each participant to fund a specific, future retirement benefit. This is part of the requirements of a defined benefit plan. Defined benefit plans must offer a qualified joint and survivor annuity (QJSA) as the normal form of benefit distribution.]

    b. SEP. [This answer is incorrect. Under a SEP plan, the employer makes annual contributions on the employee's behalf to an IRA established for the employee (referred to as SEP IRAs). A SEP is generally easy to adopt, and the rules governing participation are straightforward. Retirement benefits are contingent on the contribution amount, similar to any defined contribution plans.]

    c. SIMPLE IRA. [This answer is incorrect. SIMPLE IRA plans replace salary reduction simplified employee pensions (SARSEPs). During the first two year period, a SIMPLE IRA can be rolled over to another SIMPLE IRA., after the two year period.]

    d. Defined contribution. [This answer is incorrect. With a defined contribution plan, retirement benefits are contingent on the amount of contributions to the plan on the employee's behalf and the length of time the employee participates in the plan. Defined contribution plans typically provide more flexibility than defined benefit plans for the amount and frequency of employer contributions.]

11. Which of the following annuities is paid out at no less than 50% and not greater than 100%? **(Page 21)**

    a. Qualified joint and survivor annuity. [This answer is correct. A QJSA pays out at one level for the duration of the holder's life and then another level, between 50% and 100% of the original, for the duration of the holder's spouse's life.]

    b. Defined contribution plan qualified preretirement survivor annuity. [This answer is incorrect. For a defined contribution plan, the QPSA is equal to the actuarial equivalent of 50% of the decedent's vested account balance.]

    c. Defined benefit plan qualified preretirement survivor annuity. [This answer is incorrect. For a defined benefit plan, the QPSA is equal to 50% of the annuity the decedent would have received had he retired as of the date of death.]

    d. A life annuity. [This answer is incorrect. A life annuity continues to pay out as long as the annuitant is alive.]

12. A survivor annuity must be offered by a defined benefit or money purchase plan if a married participant with a vested benefit dies before he or she begins receiving benefits. If a married participant dies prior to retirement, a qualified plan subject to the survivor annuity rules must provide the surviving spouse a qualified preretirement survivor annuity (QPSA). Which of the following would be the correct percentage for the QPSA if the surviving spouse does not waive the QPSA? **(Page 21)**

    a. 0%. [This answer is incorrect. With spousal consent, a participant may wave the QPSA rules allowing a nonspouse beneficiary to receive any vested retirement plan benefits. The spouse would receive 0% of the benefits.]

    b. Equal to 50% of the annuity. [This answer is correct. For a defined benefit plan, the QPSA is equal to 50% of the annuity the decedent would have received had he retired as of the date of death.]

    c. Equal to the actuarial equivalent of 50%. [This answer is incorrect. For a defined contribution plan, the QPSA is equal to the actuarial equivalent of 50% of the decedent's vested account balance.]

d. 100%. [This answer is incorrect. For a defined benefit plan, the spouse can never receive 100% of the vested retirement plan benefits. The benefit received would be a reduced amount based on the rules of a QPSA.]

13. A practitioner must be prepared to assist a client in choosing among the annuity options offered by a particular plan. Which of the following annuities should be considered when a participant is single, in poor health and not expected to outlive the term of the annuity? **(Page 22)**

a. Qualified joint and survivor. [This answer is incorrect. The qualified joint and survivor annuity is an immediate annuity for the life of the participant, with a survivor annuity for the life of the participant's spouse.]

b. Qualified preretirement survivor. [This answer is incorrect. The qualified preretirement survivor annuity is an immediate annuity for the life of the surviving spouse of a participant who dies before the annuity starting date.]

c. Guaranteed. [This answer is correct. A guaranteed annuity is an annuity that guarantees to make payments for a minimum period even if the annuitant dies during that period. Payments continue after the period, however, if the annuitant remains alive. A guaranteed annuity should be considered when the participant is in poor health and not expected to outlive the term of the annuity.]

14. When a participant is married and the participant and/or spouse is financially dependent on the annuity, which of the following annuities should the participant select? **(Page 22)**

a. Deferred. [This answer is incorrect. A deferred annuity is a type of long-term personal retirement account designed to help a participant grow their assets, and provide a steady income stream once they are retired. A deferred annuity is not the best choice in the above situation.]

b. Qualified joint and survivor annuity. [This answer is correct. When the participant is married and the participant and/or spouse is financially dependent on the annuity, selecting any annuity other than a QJSA should be done cautiously. The qualified joint and survivor annuity notice distributed by the IRS is meant to protect a beneficiary and his or her spouse by requiring certain retirement contribution plans to pay a survivor annuity to a contributor's spouse of not less than 50 percent of the annuity paid to the contributor.]

c. Single life. [This answer is incorrect. Choosing a single life annuity in the above situation would mean larger payments while the participant is alive, but could leave the spouse in a difficult financial situation if the participant dies first.]

d. Flexible. [This answer is incorrect. The flexible annuity does not provide a guarantee on future interest payments so this would not be a good option for a participant and/or spouse that is financially dependent on the annuity.]

Exhibit 1-1

Comparing LSDs to Annuity Distributions

	Advantages	Disadvantages
Lump-sum Distribution	1. Proceeds can be invested in vehicles that guard against inflation. 2. Participant has full access to funds in case of an emergency. 3. Distribution can be rolled over to an eligible retirement plan (including an IRA), thereby maintaining the tax-deferred status. If rolled over to an IRA, the participant's control over the investments and timing and amount of distributions can be maximized. 4. Distribution may be eligible for favorable tax treatment. 5. It may be possible to use all or part of the proceeds to purchase an annuity with a better return than offered by the plan.	1. Participant is responsible for investments. 2. Funds are easy to access and therefore the participant may be inclined to spend funds in excess of budgeted amounts. 3. Distribution may be prematurely exhausted if participant lives well beyond life expectancy.
Annuity Distribution	1. Provides a steady cash flow that, in the case of a life or joint and survivor annuity, will not be outlived. 2. Avoids the risk of losing lump-sum proceeds through unwise investment choices. 3. Plan may be able to obtain an annuity at a better price, resulting in better returns than the participant can achieve through his own investments. 4. Payments are not taxed until received.	1. Access to account funds are limited to monthly payments. 2. Participant's family can lose unpaid amounts in case of premature death(s). 3. Inflation erodes benefits unless payments are indexed or variable. 4. Participant may be unable/unwilling to live on fixed monthly amount.

* * *

Leaving Funds in the Qualified Plan. Plans must generally allow employees to begin receiving benefits when the participant reaches the earlier of age 65 or the plan's normal retirement age. However, a plan can also allow participants to defer the commencement of benefits at least until the minimum distribution rules kick in.

A plan can also allow participants to receive their account balance when they terminate employment. In fact, most defined contribution plans provide for such distributions. Defined benefit plans can, but many do not, provide for such distributions. However, all plans must give the participant the option of leaving the funds in the plan (unless the account balance is $5,000 or less) generally until the earlier of age 65 or the plan's normal retirement age.

Therefore, employees who retire may need to decide not only what form of benefit they want, but also when to begin receiving them. Also, employees who quit working for the employer often need to decide whether to leave the funds in the plan or take them out. The distribution (if chosen) can generally be rolled over (in whole or in part) to another eligible retirement plan, such as an IRA or another qualified plan.

Later in this course is a discussion about the pros and cons of keeping the distribution versus rolling it over to an IRA. However, the participant also needs to consider whether it may be wiser to leave the funds in the former employer's qualified plans. Factors to consider include the following:

- Rolling funds over to the IRA will offer the taxpayer the most control over the funds and flexibility as to how their invested. IRAs can be set up at just about any financial institution or brokerage house and funds can be invested in a wide assortment of vehicles. On the other hand, the funds in the qualified plan can only be invested as allowed by the plan, which is typically very limited.
- The qualified plan may provide access to better investment opportunities (such as a chance to buy A verses B stock) than would be available to the IRA.
- IRAs may be subject to fees not charged to the qualified plan account.
- Qualified retirement plans have federal creditor protection in the case of malpractice, bankruptcy, divorce, business problems, or creditor problems. IRAs are not protected in all states.
- If the employee is separated from service at age 55 or older, the taxpayer can take distributions from the plan, without the 10% early withdrawal penalty. With an IRA, the taxpayer must wait until age 59$^1/_2$ to take penalty-free distributions, unless an exception to the penalty tax applies.
- Investors cannot buy life insurance with money inside an IRA. However, life insurance investments may be permitted by the qualified plans.
- Taxpayers may be able to borrow from the qualified plan, but cannot borrow from IRAs.

Traditional IRA Options

Distribution options under traditional IRAs are, for the most part, flexible. Generally, subject to any requirements or penalties imposed by the IRA trustee, distributions can be made at any time and in any amount at the demand of the IRA owner. Thus, distributions may be made in installments (equal or unequal) or the entire account may be distributed in a lump sum. However, distributions made before the IRA owner reaches age 59$^1/_2$ may be subject to the early distribution tax. In addition, traditional IRAs are subject to the minimum distribution rules which require that distributions begin no later than April 1 of the calendar year following the year in which the IRA owner reaches age 70$^1/_2$. Roth IRAs are not subject to the minimum distribution rules before the participant's death.

IRAs are not subject to the survivor annuity rules or the spousal consent rules that apply to qualified plans. Thus, distributions can be made solely at the IRA holder's discretion without spousal consent. (The exception to this rule is a divorce decree that may require the sharing of the IRA proceeds with a divorced spouse.) Furthermore, state or local laws may provide certain spousal rights (e.g., community property rights).

Although there are no IRA spousal consent rules, there are numerous tax advantages for designating the spouse as the beneficiary.

Unlike qualified retirement plans, a lump-sum distribution (LSD) from an IRA is not eligible for 10-year averaging or capital gain treatment. Instead, LSDs from IRAs (except qualifying distributions from Roth IRAs) are fully taxable (except for the return of nondeductible contributions).

Spousal Consent Rules

Spousal Consent for Beneficiary Designations. If a participant in any qualified plan is married, his spouse must be named as the beneficiary of his account unless the spouse consents, in writing, to the naming of another beneficiary. The spouse's consent must acknowledge the effect of the designation. It must also be notarized or witnessed by a plan representative. Unlike the other spousal consent requirements discussed later in this section, this spousal consent rule applies to all qualified plans, not just those subject to the survivor annuity rules.

The spouse's consent is binding only upon that spouse. If the spouse dies or the couple divorces and the participant later remarries, the consent is not binding on the new spouse. Also, a prenuptial agreement (i.e., an agreement entered into before marriage) will not satisfy the spousal consent requirements.

Spousal Consent for Distributions. If the qualified plan is subject to the survivor annuity rules, married participants must receive their benefits in the form of a qualified joint and survivor annuity or qualified preretirement survivor annuity unless the spouse consents, in writing, to another form of distribution. Thus, for example, a married participant in a money purchase plan cannot elect to receive a lump-sum distribution unless his spouse consents to the distribution.

The spouse's consent must acknowledge the effect of the benefit election. It must also be notarized or witnessed by a plan representative. The distribution election forms used by the plan will normally satisfy these requirements if properly completed.

Spousal Consent for Plan Loans. If the plan is subject to the survivor annuity rules, married participants cannot use their vested account balance as security for a loan. As most plans require the participant's account be used as security for loans, this means that participants generally cannot take a loan from their accounts without written spousal consent.

The spouse's consent must be in writing, must acknowledge the effect of the loan, and must be witnessed by a plan representative or a notary public. The loan papers used by the plan will normally satisfy these requirements if properly completed.

IRAs Not Subject to Spousal Consent Rules. IRAs are not subject to the spousal consent rules that apply to qualified plans. Thus, spousal consent is not necessary to name a nonspouse beneficiary for an IRA or to take distributions. However, a divorce decree may require the sharing of an IRA with a divorced spouse, and state or local laws may provide certain spousal property rights (e.g., community property).

SELF-STUDY QUIZ

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

15. A participant should carefully consider the pros and cons when deciding whether to leave funds in a former employer's qualified plan or rolling it over to an IRA. Which of the following is an advantage of rolling the funds into an IRA?

    a. An investor can borrow from the IRA.

    b. An investor has more control over the funds in an IRA.

    c. An investor can buy life insurance with the money in an IRA.

    d. An IRA provides greater access to better investment opportunities.

16. Which of the following is an advantage of an annuity distribution?

    a. Funds are easy to access.

    b. Participants can receive a steady cash flow.

    c. Funds are eligible for favorable tax treatment.

    d. Proceeds can be invested in vehicles that protect against inflation.

17. Which of the following statements regarding traditional IRA options is most accurate?

    a. Traditional IRA amounts are not taxed before distribution.

    b. A lump-sum distribution from a traditional IRA is eligible for 10-year averaging.

    c. Traditional IRA distributions must be made in a lump sum.

    d. Traditional IRAs are subject to the survivor annuity rules.

18. Which of the following spousal consent rules apply to all qualified plans?

    a. Spousal consent for beneficiary designations.

    b. Spousal consent for distributions.

    c. Spousal consent for plan loans.

    d. Spousal consent for rolling over an IRA distribution.

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. A participant should carefully consider the pros and cons when deciding whether to leave funds in a former employer's qualified plan or rolling it over to an IRA. Which of the following is an advantage of rolling the funds into an IRA? **(Page 29)**

    a. An investor can borrow from the IRA. [This answer is incorrect. A taxpayer may be able to borrow from a qualified plan, but not from an IRA. A taxpayer can withdraw the money from an IRA account and then have 60 days to redeposit the money in the account or in a new IRA account. If the money does not find its way back into an IRA account within the 60-day period, it will be subject to taxes and penalties.]

    b. An investor has more control over the funds in an IRA. [This answer is correct. Rolling funds over to the IRA will offer the taxpayer the most control over the funds and flexibility as to how they are invested. IRAs can be set up at just about any financial institution or brokerage house and funds can be invested in a wide assortment of vehicles. On the other hand, the funds in the qualified plan can only be invested as allowed by the plan, which is typically very limited.]

    c. An investor can buy life insurance with the money in an IRA. [This answer is incorrect. Unfortunately there is no way to make a tax-free transfer of the balance from an IRA to a life insurance policy. Investors cannot buy life insurance with money inside an IRA. However, life insurance investments may be permitted by the qualified plans.]

    d. An IRA provides a greater access to better investment opportunities. [This answer is incorrect. A qualified plan may provide access to better investment opportunities (such as a chance to buy A verses B stock) than would be available to the IRA.]

16. Which of the following is an advantage of an annuity distribution? **(Page 29)**

    a. Funds are easy to access. [This answer is incorrect. For annuity distributions, access to account funds is limited to monthly payments.]

    b. Participants can receive a steady cash flow. [This answer is correct. One advantage of an annuity distribution is that it provides a steady cash flow that, in the case of a life or joint and survivor annuity will not be outlived.]

    c. Funds are eligible for favorable tax treatment. [This answer is incorrect. This is an advantage of a lump-sum distribution. For annuity distributions, payments are not taxed until received.]

    d. Proceeds can be invested in vehicles that protect against inflation. [This answer is incorrect. This is an advantage of a lump-sum distribution.]

17. Which of the following statements regarding traditional IRA options is most accurate? **(Page 29)**

    a. Traditional IRA amounts are not taxed before distribution. [This answer is correct. Generally, amounts in your traditional IRA (including earnings and gains) are not taxed until distributed. Generally, if you take a distribution from your IRA before you reach age 59$^1/_2$, you must pay a 10% additional tax on the early distribution.]

    b. A lump-sum distribution from a traditional IRA is eligible for 10-year averaging. [This answer is incorrect. Unlike qualified retirement plans, a lump sum distribution (LSD) from an IRA is not eligible for 10-year averaging or capital gain treatment.]

    c. Traditional IRA distributions must be made in a lump sum. [This answer is incorrect. Traditional IRA distributions may be made in installments (equal or unequal) or the entire account may be distributed in a lump sum.]

d. Traditional IRAs are subject to the survivor annuity rules. [This answer is incorrect. Survivor annuity rules do not apply to distributions from IRAs. This distinction from qualified plans can be an important planning factor if the participant is considering receiving a distribution from a qualified plan that is subject to the survivor annuity requirements and rolling it to an IRA.]

18. Which of the following spousal consent rules apply to all qualified plans? **(Page 29)**

a. Spousal consent for beneficiary designations. [This answer is correct. If a participant in any qualified plan is married, his spouse must be named as the beneficiary of his account per IRS regulations unless the spouse consents, in writing, to the naming of another beneficiary. This spousal consent rule applies to all qualified plans, not just those subject to the survivor annuity rules.]

b. Spousal consent for distributions. [This answer is incorrect. If the qualified plan is subject to the survivor annuity rules, married participants must receive their benefits in the form of a qualified joint and survivor annuity or qualified preretirement survivor annuity unless the spouse consents, in writing, to another form of distribution. Thus, for example, a married participant in a money purchase plan cannot elect to receive a lump sum distribution unless his spouse consents to the distribution.]

c. Spousal consent for plan loans. [This answer is incorrect. If the plan is subject to the survivor annuity rules, married participants cannot use their vested account balance as security for a loan. As most plans require the participant's account be used as security for loans, this means that participants generally cannot take a loan from their accounts without written spousal consent.]

d. Spousal consent for rolling over an IRA distribution. [This answer is incorrect. This consent applies only to the IRA distributions.]

TAX CONSIDERATIONS IN SELECTING A RETIREMENT PLAN AND IRA BENEFICIARY

A number of factors should be considered when choosing retirement plan and IRA beneficiaries, including the payment options available under the plan's provisions, the participant's (and spouse or other beneficiary's) health and financial needs, the degree of the spouse's dependence on plan distributions, and the participant's desire to pass assets on to his or her heirs.

The designated beneficiary is also significant because the life expectancy of the beneficiary is generally used after the death of the owner in applying the minimum required distribution (MRD) rules. The interaction between the minimum distribution rules and beneficiary must be considered for a participant to make an informed decision when selecting a beneficiary.

In reviewing a client's beneficiary designations, it is important to keep the following in mind:

a. Beneficiary designations as of the date of the owner's death will control the availability of various postmortem tax deferral opportunities. Therefore, it is important to set up the designations to maximize those opportunities.

b. It is important to review beneficiary designations upon any life event, but particularly when a divorce occurs. The beneficiary form, not the divorce decree, determines who gets the participant's share of the assets at the participant's death. Accordingly, if the owner does not update his beneficiary designation, the ex-spouse may end up with his share of the funds.

c. The owner should keep a copy of his beneficiary designation form to avoid any misunderstanding as to who the beneficiary is. Also, trustees have occasionally lost owner beneficiary forms. Without a backup copy, assets may end up going to the default (rather than the intended) beneficiary.

d. A contingent beneficiary should be named (e.g., in the event of simultaneous death of the owner and primary beneficiary). Contingencies should also be planned for cases of multiple beneficiaries. For example, an owner who names his children as primary beneficiaries must decide whether the share of a child who predeceases him should go to the remaining children or other heirs.

e. The trustee's standard beneficiary form may not be adequate. In this case, a customized form may be used with the trustee's written acceptance.

f. It is critical to read the plan or IRA document, which controls actual available choices. For example, although the MRD rules allow a beneficiary to receive death benefits over his life expectancy, the plan may require death benefits to be paid in a lump sum.

This lesson discusses common choices for beneficiaries and the effects these choices have on the ability of the retirement plan assets to continue to grow in a tax-deferred environment. It is presumed that the ultimate goal of this planning process is to stretch out this period as long as possible (these are often referred to as *stretch IRAs* or *stretch-out IRAs*) with the minimum distribution that can be withdrawn. Larger distributions usually can be made if needed or desired, depending on the terms of the IRA or plan.

Who Is the Designated Beneficiary?

Designated beneficiary is an important term. It controls more than simply who receives the plan or IRA funds or benefits—it directly impacts how long funds can remain in their tax-deferred account at the owner's death. For MRD purposes, a designated beneficiary is generally the person who the owner names as beneficiary, usually on the form provided by the administrator or trustee. If the owner fails to name a beneficiary, the document may provide a default provision designating a certain person, such as the owner's spouse, as the beneficiary.

If no designated beneficiary exists when the owner dies, MRDs cannot be made over the beneficiary's single life expectancy. Instead, if the owner dies before the required beginning date (RBD), the entire account must be distributed by the end of the fifth year following the year of the owner's death. (The RBD is generally April 1 of the year following the year the owner turns 70½. Otherwise postdeath MRDs are calculated over the owner's remaining life expectancy.

For the MRD rules, only individuals and qualified trusts 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 under the MRD rules. Accordingly, if there is such a beneficiary as of September 30 of the year following the owner's death, MRDs must be calculated as if there were no beneficiary. However, any beneficiary eliminated by distribution of the benefit or through disclaimer (or otherwise) by September 30 of the year following the year of the owner's death is disregarded.

If, as of September 30 of the year following the year of the employee's death, the employee has more than one designated beneficiary and the account has not been divided into separate accounts or shares for each beneficiary, the oldest beneficiary is the designated beneficiary. However, if the account is divided by the end of the year following the year of the employee's death, MRDs are calculated using each beneficiary's life expectancy.

Example 1-14: Maximizing tax deferrals when there are multiple beneficiaries.

Joe died in 2010 at age 60. He left his IRA 50% to his wife, Wilma (age 55), 30% to his son, Henry (age 30), and 20% to his church. How are the postdeath MRDs calculated if the IRA is not divided (or segregated) and none of the beneficiaries are paid off before September 30, 2011?

When a charity such as a church is a designated beneficiary, the IRA is treated as though there is no beneficiary for MRD purposes. Therefore, the postdeath MRD rules will require the entire account to be distributed by December 31, 2015, the end of the fifth year after Joe's death.

What if the charity is cashed out by September 30, 2011, but the IRA is not otherwise segregated or divided?

Since there is a nonspouse beneficiary on the account as of September 30, 2011, MRDs must commence by December 31, 2011, and are calculated using Wilma's (the oldest beneficiary's) life expectancy (about 27 years). However, Wilma should be able to roll distributions she receives into her own IRA.

What if the charity and Wilma (she rolls the distribution over to her own IRA) are both cashed out before September 30, 2011?

MRDs must still begin by December 31, 2011, but now they are calculated using Henry's life expectancy (about 51 years).

Naming a Contingent Beneficiary

In addition to naming a primary beneficiary, the owner should name contingent beneficiaries (i.e., who will receive any benefits if the primary beneficiary predeceases or dies simultaneously with the owner). For example, an owner who names his children as primary beneficiaries must decide whether the share of a child who dies before him should go to the remaining children or other heirs.

Beneficiaries contingent strictly on the death of the primary beneficiary are not treated as designated beneficiaries under the MRD rules and thus do not affect the lifetime MRDs, as long as the primary beneficiary is alive. Furthermore, such beneficiaries do not affect postdeath MRDs as long as the primary beneficiary is alive (and has not disclaimed the benefit) as of September 30 of the year following the year of the owner's death.

Using Disclaimers. Contingent beneficiaries can be used to set the stage for disclaimers to provide post-mortem planning flexibility. For example, the owner's spouse may be named as the primary beneficiary, with a child (or children) or a trust (e.g., bypass trust) being named as contingent beneficiaries. That way, the spouse has all the options available to a spousal beneficiary (spousal rollovers, unlimited marital deduction, etc., but if needed, can disclaim enough of the assets to maximize the exclusion amount for estate tax purposes. Furthermore, the MRDs for any assets disclaimed are calculated using the contingent beneficiary's life expectancy (often this is a much longer period as contingent beneficiaries are typically from a younger generation). Disclaimers must satisfy the IRC Sec. 2518 rules to qualify.

Example 1-15: Disclaiming IRA assets.

John dies at age 80. He has a substantial estate, including an IRA valued at $3 million for which his wife, Jane (age 78), is the primary beneficiary and their son, Felix (age 50), is the contingent beneficiary. Jane does not need the IRA assets. Assume the applicable estate tax exclusion in the year of John's death is $3.5 million, which he has not otherwise used.

Jane has the following options:

1. She can leave the IRA in John's name. If she does so, MRDs beginning in the year after John's death must be made over her single life expectancy recalculated annually (around 12 years), while she is living and using term certain after she dies. However, while she is alive, her life expectancy is recalculated each year; thus, the IRA will never be entirely distributed during her lifetime.

2. She can roll the IRA assets into her own IRA (or elect to treat John's IRA as her own). MRDs beginning in the year after John's death are calculated using the Uniform Lifetime Table. Furthermore, Jane can name a new primary and contingent beneficiary. For example, she could name Felix as her primary beneficiary and her granddaughter, Suzanne, as the contingent beneficiary. If she does, any remaining funds upon her death can be distributed over Felix's life expectancy (e.g., approximately 30 years if he is 55 when she dies) Furthermore, any IRA assets Felix disclaims can be distributed using Suzanne's life expectancy (e.g., approximately 58 years if she is 25 when Jane dies).

3. She can disclaim the IRA. In this case, MRDs beginning in the year after John's death must be made over Felix's single life expectancy using term certain (around 34 years).

With all three options, estate taxes on the IRA assets are avoided at John's death, either by use of the marital deduction (options 1 and 2) or through use of the applicable exclusion amount (option 3). However, with options 1 and 2, any remaining funds at Jane's death will be included in her estate and thus could be subject to estate taxes. With option 3, the IRA assets may escape estate taxes altogether.

Selecting a Spouse as the Beneficiary

The owner's spouse is the most common designated beneficiary. This is usually for financial reasons (i.e., the spouse needs the funds for support after the owner's death). Fortunately, there are numerous tax advantages as well.

a. If the spouse is more than 10 years younger than the owner, the owner's lifetime MRDs can be calculated over the joint life expectancy of the owner and spouse (i.e., the Uniform Lifetime Table does not have to be used).

b. If the owner dies before his required beginning date (RBD) or at any age for Roth IRA owners, MRDs to the surviving spouse can be postponed until the *later* of the year (1) following the owner's death, or (2) in which the owner would have attained age $70^1/_2$. At that time, MRDs must be paid over a period not exceeding the surviving spouse's life expectancy. Alternatively, the surviving spouse may elect to receive distributions under a five-year rule if the document so permits. In this case, the entire account must be distributed by the end of the fifth year after the owner's death.

c. If the owner dies after his RBD, MRDs are calculated using the surviving spouse's single life expectancy. (This rule does not apply for Roth IRA owners since they are treated as always dying before their RBD. See item b.)

d. Payment of estate tax on the account may be deferred through the unlimited marital deduction.

e. The surviving spouse can roll over distributions she receives as the beneficiary to her own eligible retirement plan (including an IRA). She can also elect to treat the decedent's IRA as her own (if she is the sole beneficiary). This means the surviving spouse becomes the owner of the IRA for all purposes including application of the MRD rules.

f. Naming the spouse as the primary beneficiary and the owner's children as contingent beneficiaries maximizes postmortem planning opportunities. The surviving spouse has all the options available to a spousal beneficiary (spousal rollovers, unlimited marital deduction, etc.), but if needed, can disclaim enough of the assets to take full advantage of the exclusion amount ($3.5 million for 2009) for estate tax purposes. Furthermore, the MRDs for any assets disclaimed are calculated using the contingent beneficiary's life expectancy. See Example 1-15.

Choosing a Child, Grandchild, or Other Nonspouse Beneficiary

Disadvantages of designating someone other than the surviving spouse as the beneficiary are that (a) the unlimited marital deduction cannot be claimed by the estate, and (b) the selection of a grandchild may result in generation-skipping taxes.

Despite these disadvantages, selecting a child, grandchild, or some other nonspouse beneficiary may be the natural choice, such as when the owner is unmarried, widowed, or divorced. For married clients, a beneficiary other than the spouse is sometimes considered because of the beneficiary's financial needs or interests particularly that of children of a previous spouse. However, married clients should select a nonspouse beneficiary only after carefully considering the financial needs of the nonowner spouse and thoroughly reviewing available assets to meet those needs.

Effect on Minimum Required Distributions. After the owner's death, MRDs will generally be calculated over the beneficiary's life expectancy, which may be a significantly long period for a young beneficiary. If more than one beneficiary is selected, the life of the oldest beneficiary is generally used. Note, however, that many qualified plans do not permit anything other than a lump-sum distribution form of benefit upon the participant's death.

Choosing a Trust as the Beneficiary

In certain situations, it may be beneficial to name a trust as the beneficiary for estate tax and other reasons. For example, naming a trust beneficiary may be appropriate for an owner who wants to protect the children of a prior marriage. A trust may also be an appropriate beneficiary (a) when other assets are not available to fund a credit shelter (bypass) trust and the owner's applicable exclusion amount would be wasted, (b) or where the owner leaves retirement plan assets to a child who is not capable of properly managing investments and/or distributions of plan assets.

Qualified Trusts. A trust is treated as a designated beneficiary for MRD purposes only if *all* of the following requirements are met:

a. The trust is valid under state law, or would be except that there is no corpus.

b. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the individual.

c. The trust beneficiaries are identifiable from the trust document.

d. A copy of the trust instrument is provided to the trustee, administrator, or custodian; or the owner meets certain requirements and agrees to provide a copy of the trust instrument to the plan upon request.

If the trust meets these criteria by September 30 of the year following the owner's death, the trust beneficiaries are considered the designated beneficiaries for computing the postdeath MRDs. Therefore, the oldest trust beneficiary's life expectancy is used to compute the MRD. However, if one of the trust beneficiaries is not an individual (e.g., a charity), the account owner is treated as not having a designated beneficiary for computing the postdeath MRDs.

Selecting the Owner's Estate as the Beneficiary

Sometimes an owner will select his estate as the beneficiary of his IRA assets. While this has the advantage of allowing assets to be directed by the owner's will, it is generally not a good choice—not only will assets have to pass through probate (which will generally increase the costs of administering the estate), but MRDs may be greatly accelerated since they will be computed as if there is no designated beneficiary. If the owner dies before his

RBD, the account will have to be totally distributed by December 31 of the fifth year following the year the owner died. If the owner dies after his RBD, MRDs must be calculated using the owner's single life expectancy.

Example 1-16: Calculating MRDs when the estate is the IRA beneficiary.

Jimmy dies in 2010 at age 55. His estate is the beneficiary of his IRA and his wife, Alma (age 45), is the sole beneficiary of his estate. Because the estate is not treated as a designated beneficiary, MRDs must be calculated as though there were no beneficiary. Therefore, the IRA must be entirely distributed by the end of 2015 (the fifth year after the year Jimmy died).

As Jimmy's surviving spouse and sole beneficiary of his estate, can Alma roll the distributions over to her own IRA?

Although not entirely clear, the answer would appear to be "yes" as long as Alma is the beneficiary of the estate and has the authority to direct distributions to herself. The spousal rollover privilege is apparently available when the surviving spouse is both: (a) the sole beneficiary of the deceased account owner's estate and (b) the executor or executrix of the estate. In this circumstance, therefore, the surviving spouse can apparently treat the rollover IRA as owned by him for MRD calculation purposes. However, it is still unclear if this favorable treatment is allowed when someone other than the surviving spouse is the executor or executrix.

Variation: If Alma (rather than the estate) had been the IRA beneficiary, MRDs could have been calculated over Alma's life expectancy and would not have been required to begin until the end of the year in which Jimmy would have turned $70^1/_2$. Furthermore, a spousal rollover clearly would have been allowed.

SELF-STUDY QUIZ

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

19. Minimum required distributions from an IRA to the surviving spouse can be postponed until the later of the year following the owner's death, or in which the owner would have attained age 70$^1/_2$. Which of the following must occur to take advantage of this tax provision?

    a. The owner dies after his required beginning distribution.

    b. The owner dies on the date of his required beginning distribution.

    c. The owner dies after his required beginning distribution.

20. The purpose of the minimum required distribution (MRD) rules is to prevent the continual postponement of tax due on funds held in a retirement account. According to the MRD rules, which of the following can be treated as a designated beneficiary?

    a. Charity.

    b. Owner's estate.

    c. Qualified trust.

    d. Beneficiaries contingent strictly on the death of the primary beneficiary.

21. Which of the following would be an advantage of choosing a nonspouse beneficiary?

    a. The unlimited marital deduction can be claimed by the estate.

    b. Distributions can be rolled over into a beneficiaries own IRA.

    c. When an owner is divorced.

    d. Shorter distribution period.

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. Minimum required distributions from an IRA to the surviving spouse can be postponed until the later of the year following the owner's death, or in which the owner would have attained age $70^1/_2$. When which of the following must occur to take advantage of this tax provision? **(Page 36)**

    a. **The owner dies before his required beginning distribution. [This answer is correct. If the owner dies before his required beginning date (RBD) or at any age for Roth IRA owners, MRDs to the surviving spouse can be postponed until the later of the year following the owner's death, or in which the owner would have attained age $70^1/_2$. At that time, MRDs must be paid over a period not exceeding the surviving spouse's life expectancy. Alternatively, the surviving spouse may elect to receive distributions under a five-year rule if the document so permits. In this case, the entire account must be distributed by the end of the fifth year after the owner's death.]**

    b. The owner dies on the date of his required beginning distribution. [This answer is incorrect. If the IRA owner happens to die right on his or her required beginning distribution, the owner is considered to have died on or after the RBD, and would follow the rules as though he or she died after the RBD.]

    c. The owner dies after his required beginning distribution. [This answer is incorrect. If the owner dies after his RBD, MRDs are calculated using the surviving spouse's single life expectancy.]

20. The purpose of the minimum required distribution (MRD) rules is to prevent the continual postponement of tax due on funds held in a retirement account. According to the MRD rules, which of the following can be treated as a designated beneficiary? **(Page 37)**

    a. Charity. [This answer is incorrect. Although a charity can be named as a beneficiary, under the MRD rules a charity is not recognized as a designated beneficiary.]

    b. Owner's estate. [This answer is incorrect. Although an owner's estate can be named as a beneficiary, under the MRD rules owner's estate is not recognized as a designated beneficiary.]

    c. **Qualified trust. [This answer is correct. According to the MRD rules, only individual and qualified trusts can be treated a designated beneficiaries.]**

    d. Beneficiaries contingent strictly on the death of the primary beneficiary. [This answer is incorrect. Beneficiaries contingent strictly on the death of the primary beneficiary are not treated as designated beneficiaries under the MRD rules and thus do not affect the lifetime MRDs, as long as the primary beneficiary is alive.]

21. Which of the following would be an advantage of choosing a nonspouse beneficiary? **(Page 37)**

    a. The unlimited marital deduction can be claimed by the estate. [This answer is incorrect. The unlimited marital deduction cannot be claimed by the estate and is considered a disadvantage of choosing a nonspouse beneficiary.]

    b. Distributions can be rolled over into a beneficiaries own IRA. [This answer is incorrect. Distributions cannot be rolled over into a beneficiary's own IRA unless the beneficiary is a spouse.]

    c. **When an owner is divorced. [This answer is correct. Despite the disadvantages, selecting a child, grandchild, or some other nonspouse beneficiary may be the natural choice, such as when the owner is unmarried, widowed, or divorced.]**

    d. Shorter distribution period. [This answer is incorrect. A benefit of choosing your child as a beneficiary is that the distributions are calculated over both of your lifetimes. That means a much longer distribution pattern, not a shorter distribution period.]

Leaving Retirement Plan Assets to Charity

Certain assets may be taxed twice when an individual dies—once as part of the gross estate for estate tax purposes, and again as an item of gross income for income tax purposes when actually received (by the estate, heir, beneficiary, or other recipient). These assets [called income in respect of a decedent (IRD)] are the gross income that a decedent was entitled to receive at the time of death but was not included on his final return. IRD arises when money or property is received after the decedent's death that was attributable to activities and efforts of the decedent while he was alive. Examples of IRD include amounts received after death for personal services, investment income, installment sale income, and retirement plan or IRA distributions.

The income taxability of IRD results because there is no step-up in basis to these items. Since the decedent generally has a zero basis in these items, the zero basis will carry over to the recipient, resulting in taxable income upon receipt. The double taxation is partially offset by an income tax deduction allowable for estate tax paid (if any) on the IRD. The deduction is allowed to the recipient in the year of receipt as a miscellaneous itemized deduction not subject to the 2% of AGI limit.

When a client has significant amounts in a qualified plan or IRA (other than a Roth IRA), one strategy to minimize the harsh combined tax effects of the IRD and estate tax rules is to use the account to fund charitable contributions. Assets transferred to charity are sheltered from estate and gift tax because of the unlimited charitable deduction, and are deductible for income tax purposes as well, although certain limits may apply.

A potential drawback to leaving retirement plan assets to charity is the loss of the spouse's or other heir's use of the asset. One way to overcome this problem is to designate a charitable remainder trust as beneficiary. The trust pays no tax when retirement plan distributions are received, and it can make payments to the current income beneficiary for life or a term of years.

Another potential drawback is if a charitable organization is a beneficiary as of September 30 of the year after the owner's death, MRDs must be calculated as though there is no designated beneficiary. To avoid tainting the entire account, the charity should probably be paid out its entire interest before this date.

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 will occur if a charity is named as a designated beneficiary under the minimum required distribution rules?

    a. The owner's estate could end up as the beneficiary.

    b. The distribution could end up in probate.

    c. The minimum distributions will be calculated as if there were no beneficiary.

23. If a client leaves their retirement plan assets to charity, it may result in the loss of the spouse's or other heir's use of the asset. What could be designated as the beneficiary to overcome this problem?

    a. Charitable lead trust (CLT).

    b. Charitable remainder trust (CRT).

    c. Charitable remainder unitrust (CRUT).

    d. Charitable remainder annuity trust (CRAT).

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 will occur if a charity is named as a designated beneficiary under the minimum required distribution rules? **(Page 41)**

    a. The trust pays tax on the distributions to charity. [This answer is incorrect. The trust pays no tax when retirement plan distributions are received, and it can make payments to the current income beneficiary (or charity) for life or a term of years.]

    b. The distribution could end up in probate. [This answer is incorrect. If no named beneficiary survives the owner, the probate estate may end up as the beneficiary by default. But, in this instance, the charity is named the beneficiary, so this is avoided.]

    c. The minimum distributions will be calculated as if there were no beneficiary. [This answer is correct. For the MRD rules, only individuals and qualified trusts 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 under the MRD rules. Accordingly, if there is such a beneficiary as of September 30 of the year following the owner's death, MRDs must be calculated as if there were no beneficiary.]

23. If a client leaves their retirement plan assets to charity, it may result in the loss of the spouse's or other heir's use of the asset. What could be designated as the beneficiary to overcome this problem? **(Page 41)**

    a. Charitable lead trust (CLT). [This is the incorrect answer. Under a charitable lead trust agreement, a donor establishes and funds a trust naming a nonprofit organization as lead beneficiary. Under the agreement, the nonprofit organization receives distributions from the trust until termination of the agreement, at which time the remaining assets in the trust are paid out to the noncharitable beneficiary named by the donor. The donor may restrict the use of the assets distributed to the organization.]

    b. Charitable remainder trust (CRT). [This answer is correct. One way to prevent the spouse from loosing the use of the heir's asset is to designate a charitable remainder trust as beneficiary. The trust pays no tax when retirement plan distributions are received, and it can make payments to the current income beneficiary for life or a term of years.]

    c. Charitable remainder unitrust (CRUT). [This answer is incorrect. Under this type of charitable remainder trust, the beneficiary receives a stated percentage of the fair market value of the trust, determined annually. In some cases, the donor limits the CRUT distributions to the lesser of the actual income earned or the stated distribution percentage.]

    d. Charitable remainder annuity trust (CRAT). [This answer is incorrect. Under this type of charitable remainder trust, distributions to the beneficiary are for a specified dollar amount.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TINTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. For 2010, an employer's maximum deduction for contributions to profit-sharing plans is limited to what percentage of the total compensation of all participants eligible to share in the contribution allocation?

   a. 10%.

   b. 15%.

   c. 25%.

   d. 30%.

2. Dexter Stray, a calendar-year taxpayer is eligible to contribute $15,000 to his Keogh plan. The plan was established on or before December 31, 2010. Assuming Dexter does not file an extension, payment of his contribution for 2010 on which of the following dates will cause him to lose the $15,000 retirement plan deduction for the contribution?

   a. February 1, 2011.

   b. April 18, 2011.

   c. April 15, 2011.

   d. December 31, 2010.

3. Which of the following retirement plans requires ALL eligible employees to set up an IRA to accept the contribution?

   a. SEP.

   b. Keogh.

   c. Defined contribution.

   d. 401(k).

4. Reuben earned $195,000 in compensation from his employer prior to any contributions made to his SEP in 2010. What is the maximum amount that Reuben's employer may contribute to his SEP in 2010?

   a. $43,000.

   b. $44,000.

   c. $48,000.

   d. $49,000.

5. Which of the following is a disadvantage of a SIMPLE IRA plan?

    a. Employer cannot make contributions to any other qualified retirement plans while maintaining a SIMPLE IRA plan.

    b. SIMPLE IRA plans are difficult to operate and maintain for employers.

    c. SIMPLE IRA plans have minimum participation rules.

    d. Self-employed individuals are not eligible to participate in SIMPLE IRA plans.

6. SIMPLE IRA plans allow employee elective contributions and require employer matching contributions or nonelective contributions. For 2009, employee elective contributions are limited to what amount?

    a. $1,500.

    b. $10,000.

    c. $10,550.

    d. $11,500.

7. The total amount of compensation an individual can elect to defer each year is limited. What are the employee deferral limits for 2009?

    a. $10,500 ($13,000 if age 50 or older).

    b. $11,500 ($14,000 if age 50 or older).

    c. $15,500 ($20,500 if age 50 or older).

    d. $16,500 ($22,000 if age 50 or older).

8. Which of the following is true regarding distributions from SIMPLE IRA plans?

    a. SIMPLE IRA plan distributions are subject to qualified plan distribution rules.

    b. If employment terminates, the participant can roll over distributions to another SIMPLE IRA tax-free for two years.

    c. Contributions are taxed in a SIMPLE IRA each year, not when the participant receives a distribution.

    d. An employee is considered participating in a SIMPLE IRA on the first day of the year that the employer contributes to the plan on behalf of the employee.

9. If during the initial two-year period of a SIMPLE IRA, a participant who is not yet age 59½ receives a distribution to which an exception does not apply, the early distribution penalty tax is which of the following percentages?

    a. 10%.

    b. 20%.

    c. 25%.

    d. 30%.

10. For rollover purposes, a SIMPLE IRA is treated as a traditional IRA after how many years?

    a. 2.

    b. 4.

    c. 6.

    d. 8.

11. A SIMPLE IRA plan may only be maintained on a _______ basis.

    a. Plan-year.

    b. Fiscal-year.

    c. Calendar-year.

    d. Short-year.

12. A small employer who starts a new retirement plan is eligible for a nonrefundable income tax credit of up to what dollar amount per year for the administrative and retirement-education expenses of adopting a new qualified defined benefit or defined contribution plan, a SIMPLE IRA plan, an annuity plan under 403(a), or a simplified employee pension (SEP) plan?

    a. $500.

    b. $1,000.

    c. $1,500.

    d. $2,000.

13. To be considered a small business owner an employer has to meet certain qualifications. Which of the following business owners does **not** meet those qualifications?

    a. Anjie, age 54, is the sole owner of Anjie's Boot's and More, Inc. Anjie employs 125 employees with compensation of $5,500 per individual.

    b. Hunter, age 32, is the sole owner of Hunter's Handymen Janitorial Service, Inc. Hunter employs 75 employees with compensation of $6,000 per individual.

    c. Asia, age 26, is the sole owner of Asia's Imports, Inc. Asia employees 50 employees with compensation of $5,075 per individual.

    d. Aimee, age 44, is the sole owner of Aimee's Custom Tattoos, Inc. Aimee employees 15 employees with compensation of $2,500 per individual.

14. What is the maximum amount of plan assets, at the end of the plan year, that a one-participant plan can have without having to file Form-5500 EZ?

    a. $250,000.

    b. $200,000.

    c. $175,000.

    d. $100,000.

15. Which of the following is a narrative summary of the annual report contained in the financial statements of Form 5500?

    a. SPD.

    b. SMM.

    c. SAR.

    d. SEP.

16. Which of the following plans is **not** required to file any Form 5500?

    a. Prototype SEP.

    b. Defined benefit.

    c. Profit sharing.

    d. Money purchase.

17. If a SEP contribution is made after year-end, how many days after the contribution does the employer have to issue the employee a separate statement of contributions?

    a. 30.

    b. 60.

    c. 90.

    d. 120.

18. Lawrence is about to retire. He is 65, and his wife Lorene, is 55. Lawrence has never had health problems, but Lorene has had one heart attack. Lorene currently is collecting an annual $8,000 pension which contains a cost-of-living escalation provision. Which of the following annuities would best suit Lawrence and Lorene?

    a. Single life.

    b. Guaranteed.

    c. Qualified preretirement survivor.

    d. Variable.

19. If an owner dies prior to his or her required beginning date, the IRA balance must be distributed by which of the following?

    a. The beginning of the third year following the year of the owner's death.

    b. The end of the third year following the year of the owner's death.

    c. The beginning of the fifth year following the year of the owner's death.

    d. The end of the fifth year following the year of the owner's death.

20. Which of the following is the most common designated beneficiary of a retirement account?

    a. Child.

    b. Trust.

    c. Spouse.

    d. Grandchild.

21. An owner's lifetime minimum required distributions (MRDs) can be calculated over the joint life expectancy of the owner and spouse if the spouse is more than how many years younger than the owner?

    a. 2 years.

    b. 5 years.

    c. 7 years.

    d. 10 years.

22. Minimum required distributions are computed as though no beneficiary exists under which of the following situations?

    a. When naming a qualified trust as a beneficiary.

    b. When naming an estate as a beneficiary.

    c. When the designated beneficiary disclaims interest.

    d. When naming a nonqualified trust as a beneficiary.

Lesson 2: Roth IRAs

INTRODUCTION

A Roth IRA is simply an IRA that is designated as a Roth IRA when it is opened. Except as provided by IRC Sec. 408A, all the rules that apply to traditional IRAs apply to Roth IRAs. Thus, for example, the penalty tax for excess contributions, the prohibition against pledging or borrowing from the account, and the rules regarding the types of assets that can be contributed apply to Roth IRAs as they do to any other IRA.

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 eventually withdraw funds, including earnings, tax-free if the requirements of IRC Sec. 408A are met.

Learning Objectives:

Completion of this lesson will enable you to:
- Describe how to use Roth IRAs to maximize individual retirement benefits.
- Recognize how to convert traditional IRAs to Roth IRAs.
- Identify how to maximize retirement benefits with a Roth 401(k).

USING ROTH IRAs TO MAXIMIZE INDIVIDUAL RETIREMENT BENEFITS

General Rules for Roth IRAs

For 2010, each individual can contribute to a Roth IRA up to the lesser of (a) $5,000 ($6,000 for individuals who turn age 50 by the end of the year), or (b) the individual's compensation for the year, reduced by the amount contributed to traditional IRAs for the tax year. 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.

As with a traditional IRA, a contribution of up to $5,000 ($6,000 if age 50 or older by the end of the year) can be made for each spouse if the spouses' combined income is at least equal to the contributed amount and they file a joint return. However, unlike traditional IRAs, distributions from Roth IRAs are nontaxable if certain conditions are satisfied. An individual's total annual contributions to all IRAs (deductible, nondeductible, and Roth) are limited to $5,000 ($6,000 if age 50 by the end of the year).

Contributions to a Roth IRA. Contributions to a Roth IRA are not deductible. In addition, for 2010 the $5,000 (or $6,000) maximum contribution to a Roth IRA is phased out ratably over the following range of modified adjusted gross income (AGI):

Filing Status	Phase-out Range
Joint return	$167,000–177,000
Single or head of household	$105,000–120,000
Married filing separate return	$0–10,000

Modified AGI for purposes of the Roth IRA equals a taxpayer's AGI increased by any exclusions claimed for foreign earned income, foreign housing costs, employer-provided adoption assistance, Series EE and I bond interest income used for higher education expenses, foreign housing deduction, student loan interest deduction, deduction for qualified tuition and related expenses, the domestic production activities deduction and any deduction for a contribution to a traditional IRA. Also, for modified AGI, taxpayers are allowed to reduce AGI by any amount included in gross income because of converting a traditional IRA to a Roth IRA. Modified AGI for this purpose, includes income from minimum required distributions (MRDs) from a taxpayer's traditional IRAs as well as from qualified plans.

As with a traditional IRA, taxpayers have until the tax return due date (*not* including extensions) to make a Roth IRA contribution.

Example 2-1: Contributions to a Roth IRA or a deductible IRA.

Mary, age 45, is single and is not a participant in an employer-sponsored retirement plan. Her compensation is $60,000 and her modified AGI is $75,000 in 2010.

Mary is eligible to make a deductible contribution to a traditional IRA. The modified AGI phase-out for deductible IRA contributions is not applicable since she is not a participant in an employer-sponsored plan. Mary is also eligible to make a nondeductible contribution to a Roth IRA since her modified AGI is below the $105,000 beginning phase-out for Roth IRAs. Mary can contribute in any ratio she chooses to a traditional (deductible or nondeductible) IRA or to a Roth IRA. (For example, she could contribute $5,000 to a traditional IRA or $5,000 to a Roth IRA or, $1,000 to a traditional IRA and $4,000 to a Roth IRA.)

Variation: Assume Mary made a $4,000 contribution to a traditional IRA and a $2,000 contribution to a Roth IRA. She has violated the maximum contribution limit by $1,000. The excess contribution is attributable totally to the Roth IRA because an individual's contributions are applied first to a traditional IRA, then to a Roth IRA.

Minimum Distribution Rule. A taxpayer is not required to take distributions from a Roth IRA at a certain age. That is, the pre-death minimum distribution rule for traditional IRAs whereby a taxpayer must take distributions beginning with the year after the year the taxpayer becomes age 70½ does not apply to Roth IRAs. However, the post-death minimum distribution rules for traditional IRAs also apply to Roth IRAs as though the Roth IRA owner died before the required beginning date.

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-tax-year period beginning with the first day of the first tax year for which a regular contribution or conversion contribution is made to any Roth IRA, and is—

a. made on or after the individual is age 59½;

b. made to the account owner's beneficiary or estate after the owner's death;

c. attributable to the individual's being disabled; or

d. made to pay first-time home purchase expenses, up to a lifetime limit of $10,000.

Example 2-2: Determining five-year period for qualified distributions.

Steve, age 57, makes his first $3,000 contribution to his Roth IRA in March 2010 for the 2009 tax year. In March 2011, he makes another $3,000 contribution to the same IRA. On January 2, 2014 (less than three years after his second contribution), he withdraws the entire $7,400 balance (representing two contributions of $3,000 each plus $1,400 of earnings). Steve's withdrawal is entirely free from federal income tax because it was taken after the five-tax-year period beginning with the first day of the first tax year (2009) for which a contribution was made to a Roth IRA and Steve was at least 59½ at the time of the withdrawal.

Variation: Assume the same facts except that the $3,000 contribution made in 2011 was to a newly established Roth IRA. A withdrawal of the full balance of this second IRA in 2014 would also be tax-free (including the earnings portion) even though it was in existence less than five years because the five-year period begins with the first contribution to any Roth IRA (i.e., the first one established in March 2010 for the 2009 tax year).

Nonqualified Roth IRA Distributions

Withdrawals from a Roth IRA that are not qualified distributions are includable in income to the extent attributable to earnings. However, nonqualified 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 contributions are considered only after regular Roth IRA contributions.

Example 2-3: Tax-free withdrawal of principal from a Roth IRA.

George is age 50 when he sets up two Roth IRAs in 2009. He contributes $1,000 to each account that year and $1,000 to each in 2010 and 2011, so he has made total contributions to each account of $3,000. On July 10, 2012, 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 waiting period has not expired. But even though the distribution is composed of $3,000 principal and $1,500 earnings from Account One, the withdrawal is considered to come first from George's $6,000 of total Roth IRA contributions, so the entire withdrawal is tax-free and penalty-free.

Rollover from One Roth IRA to Another

Distributions from a Roth IRA may be rolled over tax-free (and penalty-free) into another Roth IRA under the same rules that apply to traditional IRAs.

Comparing the Roth IRA to a Traditional Deductible IRA

Many individuals must decide whether it is better to make contributions to a Roth IRA or a traditional deductible IRA. Generally, the taxpayers faced with this decision, those eligible to make contributions to either a deductible IRA or Roth IRA, are the following for 2010:

a. Married taxpayers (or a married spouse) who are either (1) not covered by an employer-sponsored retirement plan and whose modified AGI is less than $177,000 or (2) covered by an employer-sponsored plan and whose modified AGI is less than $109,000 ($177,000 if not covered but spouse is covered).

b. Single or head-of-household taxpayers who are either (1) not covered by an employer-sponsored retirement plan and whose modified AGI is less than $120,000 or (2) covered by an employer-sponsored plan and whose modified AGI is less than $66,000.

The decision depends on the client's unique tax and financial situation, and should be made only after considering such factors as the person's age, current income tax situation, net worth, and expected post-retirement tax situation. As with most tax planning alternatives, the practitioner should calculate the numbers for all alternatives before deciding on a particular planning strategy.

Generally, helping a client make the decision will involve highlighting the key differences between deductible IRAs and Roth IRAs. In this regard, traditional IRAs and Roth IRAs are essentially mirror images. Contributions to a traditional IRA are deductible, but the funds (contributions and earnings) are taxable when withdrawn. Roth IRA contributions are nondeductible, but the funds (contributions and earnings) can be withdrawn tax-free. Thus, the tax benefits of deductible IRAs are *frontloaded* while the tax benefits of Roth IRAs are *backloaded*.

Advantages of a Roth IRA. A Roth IRA's biggest advantages are the ability to make tax-free withdrawals (if the requirements are satisfied), no mandatory distribution rules at age 70½, and the ability to continue contributions past age 70½, assuming the taxpayer (or spouse) has earned income.

Roth IRA distributions are taxable only in limited circumstances. Qualified distributions are completely tax-free. Even if the taxpayer receives a nonqualified distribution from a Roth IRA, only the earnings are taxed. Furthermore, contributions are deemed to be distributed prior to earnings. Therefore, taxpayers can withdraw an amount up to contributions at any time, tax-free and penalty-free. However, earnings in nonqualified distributions are subject to the 10% early withdrawal penalty unless the individual is age 59½ or older or qualifies for an exception to the 10% penalty.

Unlike traditional IRAs, the Roth IRA is not subject to the pre-death minimum distribution rules. Taxpayers are free to time their distributions as they see fit (e.g., to meet unplanned cash flow needs). Thus, taxpayers who do not expect to need IRA funds to pay their living expenses will presumably find a Roth IRA a superior wealth maximization vehicle when compared to a traditional IRA because of continued tax-free growth until the account owner's death. The elimination of the minimum distribution requirement coupled with an ability to spread postdeath distributions over the life expectancy of the designated beneficiary offers flexibility and unique planning opportunities.

Factors Favoring a Roth IRA. The following general principles should be considered when advising a client on when a Roth IRA may be preferable to a traditional deductible IRA.

a. Generally, the longer the period the funds will be invested, the more beneficial the deferral and tax-free distribution advantages of the Roth IRA. In the long term, a taxpayer will accumulate more after-tax income under a Roth IRA than a traditional IRA. The shorter the period the funds will be invested, the more beneficial the immediate tax savings advantage of the deductible IRA.

b. A taxpayer who expects to be in a higher tax bracket at retirement than today would favor a Roth IRA with its tax-free withdrawals at retirement, while an individual who expects to be in a lower tax bracket at retirement would favor a traditional IRA with its current deduction at today's higher tax rate.

c. A Roth IRA generally is preferable for taxpayers currently in a low current tax bracket and who anticipate remaining so in the future. They will realize little or no immediate tax savings from contributing to a deductible IRA.

d. Because Roth IRA withdrawals come first from contributions (which are not taxed and not subject to the 10% early withdrawal penalty when withdrawn), taxpayers can withdraw contributions from a Roth IRA tax-free and penalty-free at any time—regardless of how the funds are used. This is true even if the five-year waiting period has not expired and the taxpayer is not yet age 59½. Thus, Roth IRAs can be a useful vehicle for taxpayers who may need their original contributions (for whatever purpose) prior to retirement.

Participant's Marginal Tax Rate at Retirement May Impact Choice. If the taxpayer's marginal tax rate is higher in retirement than today, the Roth IRA is more likely to be a better choice than a deductible IRA. Even a small increase in the tax rates between the time the money is contributed and when it is withdrawn is enough to tilt the scales in favor of the Roth IRA.

Conversely, if a significant drop in tax rates is expected (either because of the taxpayer's changing circumstances or because of an overall rate decrease), the advantages of a Roth IRA are reduced or eliminated and the deductible IRA may be a better choice.

Example 2-4: Impact of marginal tax rates.

Tom Smith, age 60, has $2,000 of income to invest and is considering whether to invest the funds in a deductible IRA or Roth IRA. Tom is in the combined 28% federal and state tax bracket. If he contributes $2,000 to a Roth IRA, $560 of tax (28% of $2,000) will be due on the income. Tom's tax practitioner put together different scenarios to determine whether a deductible IRA or Roth IRA is more advantageous. The sole difference in the scenarios is Tom's marginal tax rate at the time of the contribution versus when funds are taken out of the IRA. (Because Tom is at least 59½ before taking an IRA distribution, the 10% penalty tax does not apply.)

Scenario 1: *Marginal Rate Stays the Same.* Using a Roth IRA, Tom would only have $1,440 to invest after paying $560 of income tax on the $2,000 of earnings. After five years, this $1,440 grows to $2,319 assuming a 10% annual return. At that point, Tom would be free to withdraw the funds without any additional tax liability.

If a traditional IRA is used, the full $2,000 can be invested because no income tax is due on the $2,000 of earnings. Again assuming a 10% annual return, the $2,000 contribution will grow to $3,221 in five years. However, if Tom withdraws the entire balance at that point, a tax of $902 ($3,221 × 28%) is due, leaving an after-tax balance of $2,319. This is exactly the same amount as what Tom would have with a Roth IRA. Thus, when the tax brackets remain the same and the contribution to the Roth IRA is reduced by the upfront tax costs, it makes no difference which type IRA is chosen.

Scenario 2: *Marginal Rate Increases.* Taxpayers tend to assume automatically that their tax rate will drop when they retire. In fact, it may even increase (because their income does not significantly decrease when they retire, or because Congress or their state of residence raises the tax rates, or some combination of both). This scenario assumes a 31% (instead of 28%) marginal tax rate at the time the funds are withdrawn and no changes for the Roth IRA—it still increases to $2,319 after five years.

If a traditional IRA is used, the full $2,000 contribution will grow to $3,221 in five years, as before, assuming a 10% growth rate. However, if Tom withdraws the entire balance at that point, a tax of $999 ($3,221 × 31%) is due, leaving an after-tax balance of $2,222. Therefore, the Roth IRA results in $97 ($2,319 − $2,222) of additional after-tax income. Under this scenario, the Roth IRA is the better choice. As illustrated, even a small increase in the tax rates between the time the money is invested and when it is withdrawn makes enough difference to tip the scales in favor of the Roth IRA.

Scenario 3: *Marginal Rate Decreases.* Assume the same facts except that Tom's marginal tax rate is expected to drop from 28% (at the time the contribution is made) to 18% (five years later when the accumulated funds are withdrawn).

Using a Roth IRA, the results would be the same as in the previous example and variations. Tom would only have $1,440 to invest after paying $560 of income tax on the $2,000 of earnings. After five years, this $1,440 grows to $2,319 assuming a 10% annual return. At that point, Tom would be free to withdraw the funds without any additional tax liability.

If a traditional IRA is used, the full $2,000 can be invested because no income tax is due on the $2,000 of earnings. Again assuming a 10% annual return, the $2,000 contribution will grow to $3,221 in five years. However, if Tom withdraws the entire balance at that point, a tax of $580 ($3,221 × 18%) is due, leaving an after-tax balance of $2,641. Therefore, the deductible IRA results in $322 ($2,641 − $2,319) of additional after-tax income. This $322 difference represents an almost 14% better return over the five-year period for the deductible IRA.

Side-by-side Comparison. The following table summarizes the results of contributing to a traditional deductible IRA, a traditional nondeductible IRA, and a Roth IRA. For this illustration, combined federal and state tax rates are assumed to remain constant (at 28%) and the tax savings from making deductible (traditional IRA) contributions are invested in a taxable account. The Roth IRA benefit of no minimum required distributions (MRDs) and the effect of estate taxes in all of the situations is ignored.

Net After-tax to Family[a, b]

Year	Roth IRA[c]	Deductible IRA[d]	Nondeductible IRA[e]
1	$ 2,200	$ 2,187	$ 2,144
5	16,974	16,598	15,582
10	40,769	39,172	35,513
15	79,089	74,613	65,904
20	140,805	130,370	113,140
25	240,200	218,264	187,504
30	400,276	357,071	305,558
35	658,079	576,660	493,977
40	1,071,074	922,410	793,573

Notes:

[a] The amount shown assumes that the entire account is withdrawn at the end of each period and ignores the effect of any 10% early distributions penalty that may apply.

[b] The comparison table uses a $2,000 annual IRA contribution to illustrate the after-tax results of each IRA option. Contributions greater than $2,000 are permitted, which if used in the analysis, would make the results more dramatic.

[c] Annual contribution of $2,000 with 10% growth rate and an assumed 28% combined federal and state tax rate.

[d] Annual contribution of $2,560 [$2,000 to IRA plus $560 tax savings ($2,000 $\times$ 28%) invested in taxable fund]. Assume 10% growth on inside and outside assets. Outside assets are subject to an assumed blended income tax rate of 24% (to account for the fact that part of the growth will likely include short-term capital gains taxed at ordinary rates and long-term capital gains and qualified dividends taxed at 15%).

[e] Annual contributions of $2,000 with a 10% growth rate and 28% combined federal and state tax rate.

Using these assumptions, the Roth IRA generates the most wealth even before considering the favorable effects of the MRD and estate tax rules. Although a larger amount can be invested each year using a traditional IRA (since the tax saving is available for investing), paying current tax on the "outside account" reduces the benefit of investing these additional funds.

Making Nondeductible Contributions to a Traditional IRA

An individual who cannot (or chooses not to) make contributions to a deductible IRA or Roth IRA may be able to make contributions to a nondeductible IRA. In no event, however, can contributions to all IRAs be more than $5,000 ($6,000 if age 50 by the end of the year) for 2010.

SELF-STUDY QUIZ

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

24. For contributions to a Roth IRA for 2010, which of the following modified AGI phase-out ranges would apply if your filing situation is single or head of household?

    a. $0–$10,000.

    b. $101,000–$116,000.

    c. $105,000–$120,000.

    d. $167,000–$177,000.

25. Certain IRAs require a five-year waiting period before a qualified distribution can occur. Which of the following begins the five-year waiting period with the first day of the first year in which a contribution is made to any IRA?

    a. Traditional IRA.

    b. Roth IRA.

    c. Designated Roth IRA.

    d. SIMPLE IRA.

26. Which of the following IRAs is considered *front-loaded* when contributions are deducted and withdrawals are taxed?

    a. Deductible IRA.

    b. Roth IRA.

    c. Nondeductible IRA.

    d. IRA.

27. Which of the following is an advantage of a Roth IRA?

    a. No mandatory distribution rules at age 70.

    b. First-time homebuyers can withdraw contributions penalty-free during specified times of a calendar year.

    c. Lump-sum distributions may be eligible for favorable tax treatment.

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.)**

24. For contributions to a Roth IRA for 2010, which of the following modified AGI phase-out ranges would apply if your filing situation is single or head of household? **(Page 51)**

    a. $0–$10,000. [This answer is incorrect. For 2010, if your filing status is married filing separately the modified AGI phase-out range is $0–$10,000 per the IRS Code.]

    b. $101,000–$116,000. [This answer is incorrect. For 2008, if your filing status is single or head of household, your modified AGI phase-out range is $101,000–$116,000 according to the IRS Code.]

    c. $105,000–$120,000. [This answer is correct. For 2010, if your filing situation is single or head of household your modified AGI phase-out range is $105,000–$120,000 as stated in the IRS Code.]

    d. $167,000–$177,000. [This answer is incorrect. For 2010, if your filing status is married filing jointly or qualifying widow(er) your modified AGI phase-out range is $167,000–$177,000 per the IRS Code.]

25. Certain IRAs require a five-year waiting period before a qualified distribution can occur. Which of the following begins the five-year waiting period with the first day of the first year in which a contribution is made to any IRA? **(Page 52)**

    a. Traditional IRA. [This answer is incorrect. Distributions from a traditional IRA are subject to age requirements and not how long the contribution has been in the IRA plan.]

    b. Roth IRA. [This answer is correct. With a Roth IRA, the five-year period begins with the first day of the first year in which a contribution is made to any Roth IRA.]

    c. Designated Roth IRA. [This answer is incorrect. For a DRA, the five-year period is five consecutive years beginning with the first year the employee made a contribution to a DRA in the particular plan (the year the elective deferral was included in the employee's income).]

    d. SIMPLE IRA. [This answer is incorrect. Special distributions apply to SEP IRA distributions made within two years beginning on the day the employee first participates in any SIMPLE IRA plan maintained by the employer.]

26. Which of the following IRAs is considered *front-loaded* when contributions are deducted and withdrawals are taxed? **(Page 53)**

    a. Deductible IRA. [This answer is correct. Deductible IRA contributions that are deducted and withdrawals are taxed are considered *front-loaded* since the tax benefits are at the beginning of the process.]

    b. Roth IRA. [This answer is incorrect. The approach used when contributions are not deductible, and no tax is imposed on withdrawal (similar to the treatment of a tax exempt bond) is called a non-deductible or "back-loaded" plan when referring to Roth IRAs.]

    c. Nondeductible IRA. [This answer is incorrect. The contribution to a nondeductible IRA would not be taxed upon withdrawal but is not considered a front-loaded plan.]

    d. IRA. [This answer is incorrect. The tax laws concerning distributions from nondeductible IRAs should be taxed based on a prorated amount, a portion of which must be the withdrawal of earnings but is not considered a front-loaded plan.]

27. Which of the following is an advantage of a Roth IRA? **(Page 54)**

   a. **No mandatory distribution rules at age 70. [This answer is correct. One of the advantages to a Roth IRA is that there is no mandatory distribution rules at age 70$^1/_2$ as dictated by other plans, and the ability to continue contributions past age 70$^1/_2$, assuming the taxpayer (or spouse) has earned income.]**

   b. First-time homebuyers can withdraw contributions penalty-free during specified times of a calendar year. [This answer is incorrect. Taxpayers can withdraw contributions from a Roth IRA tax-free and penalty-free at any time—regardless of how the funds are used.]

   c. Ability to accrue more before-tax income, on a long-term basis. [This answer is incorrect. Generally, the longer the period the funds will be invested in a Roth IRA, the more beneficial the deferral and tax-free distribution advantages of the Roth IRA. In the long term, a taxpayer will accumulate more after-tax income, not before-tax income.]

ROLLOVERS TO ROTH IRAs (INCLUDING IRA CONVERSIONS)

Funds held in a traditional IRA or certain employer retirement plans can be rolled over to a Roth IRA if certain conditions are met. These rollovers, which are sometimes referred to as conversions, normally trigger taxable income to the account owner or plan participant. Rollovers from one Roth IRA to another Roth IRA are allowed without regard to the rules discussed in this section; instead, the regular IRA rollover rules apply.

General Rules Applicable to Rollovers

IRA Conversion. All or any part of a deductible or nondeductible traditional IRA (including SEP IRAs or SIMPLE IRAs after participating in the SIMPLE for at least two years) may be converted or rolled over into a Roth IRA, by any one of three methods: (a) distributions from a traditional IRA can be contributed (rolled over) to a Roth IRA within the 60-day regular rollover period, (b) funds from a traditional IRA can be transferred in a trustee-to-trustee transfer from the trustee of the traditional IRA to the trustee of the Roth IRA, or (c) the traditional IRA can be redesignated as a Roth IRA.

Rollover from Qualified Plan. Individuals also can arrange for direct rollovers of distributions from qualified retirement plans. Section 403(b) tax-sheltered annuities, and governmental Section 457 plans into Roth IRAs using a trustee-to-trustee transfer. The rules and restrictions that apply to individuals converting traditional IRAs to Roth IRAs also apply when rolling funds from these employer plans to a Roth IRA. Thus, employees who change jobs (and become eligible for a qualified plan distribution) should determine whether rolling their plan distribution into a Roth IRA is more beneficial than (a) rolling it into their new employer's plan (where, for example, they may be able to borrow against plan balances), (b) leaving it with their former employer's plan, or (c) rolling it into a traditional IRA.

An individual who is required to take minimum distributions from a traditional IRA or employer plan (i.e., over age 70½) cannot avoid a current year distribution by converting the funds to a Roth IRA. A required minimum distribution must be taken in the year of conversion and that amount cannot be converted to a Roth IRA.

Modified AGI and MFS Restrictions No Longer Apply. Before 2010, a rollover (or conversion) to a Roth IRA was allowed only if the taxpayer's modified AGI was $100,000 or less for the year of the rollover. This restriction prevented most high-income and wealthy taxpayers from converting their traditional IRAs and employer retirement accounts to Roth IRAs, unless they shifted certain income and deductions between tax years so they could get under the AGI threshold. Beginning in 2010, the AGI limit has been eliminated so now all individuals are eligible for rollovers.

In addition to meeting the AGI limit, married taxpayers were also required to file joint returns; married individuals filing separate returns could not make a rollover to a Roth IRA, regardless of their income. Beginning in 2010, the MFS restriction has also been removed so these taxpayers are now eligible for rollovers.

Income Inclusion on Rollover

An individual who rolls over funds from a traditional IRA or eligible employer retirement plan to a Roth IRA must include in income an amount equal to what would have been taxable had the amount been a taken as a regular distribution. This income is included in income in the year of the rollover (but see special rule for 2010 rollovers below). The 10% early withdrawal penalty that normally applies to distributions before age 59 ½ does not apply to income resulting from a Roth conversion.

Special Rule for 2010 Rollovers. For rollovers occurring in 2010, half of the income is reported in 2011 and the other half in 2012 unless the taxpayer elects to report it all in 2010. Taxpayers who elect to include all of the 2010 rollover income on their 2010 return cannot change the election after the due date of the that return.

Example 2-5: Converting IRAs including only deductible contributions.

In 2010, Alicia, who has made only deductible IRA contributions, elects to convert $50,000 from a traditional IRA into a Roth IRA. The $50,000 is fully subject to income tax with $25,000 included in Alicia's 2011 income and $25,000 included in her 2012 income. However, even if Alicia is under age 59½ at the time of the conversion, the 10% early withdrawal penalty does not apply.

The two-year income inclusion for 2010 rollovers is accelerated if converted amounts are distributed before 2012. In that case, the amount included in income in the year of the distribution is increased by the amount distributed. If the distribution occurs in 2010, the amount included in income in 2011 and 2012 is the lesser of: (1) half of the amount includible in income as a result of the conversion; and (2) the remaining portion of such amount not already included in income.

Example 2-6: Acceleration of income inclusion.

Edward has a traditional IRA with a value of $100,000, consisting of deductible contributions and earnings. He does not have a Roth IRA. He converts the traditional IRA to a Roth IRA in 2010, and, as a result of the conversion, $100,000 is includible in gross income. Unless Edward elects otherwise, $50,000 of the income resulting from the conversion is included in income in 2011 and $50,000 in 2012.

Later in 2010, Edward takes a $20,000 distribution from the Roth IRA, which is not a qualified distribution and all of which, under the ordering rules, is attributable to amounts includible in gross income as a result of the conversion. Under the accelerated inclusion rule, Edward must include the following amounts in income:

Year	Amount Included in Income	Computation
2010	$ 20,000	Amount includable for 2010 ($0) increased by amount of distribution in that year ($20,000).
2011	50,000	The lesser of (1) $50,000 (half of the income resulting from the conversion) or (2) $70,000 (the remaining income from the conversion).
2012	30,000	The lesser of (1) $50,000 (half of the income resulting from the conversion) or (2) $30,000 [the remaining income from the conversion, i.e., $100,000 - $70,000 ($20,000 included in income in 2010 and $50,000 included in income in 2011)].
Total	$100,000	

Converting IRAs with Nondeductible Contributions. All of the balances of the individual's IRAs (and all the basis in those IRAs) are combined to determine the taxable amount of the distribution. Although an individual with both deductible and nondeductible IRAs may only convert the nondeductible IRA to a Roth IRA, all of the IRAs must be combined when computing income from the conversion.

Example 2-7: Converting IRAs including nondeductible contributions.

Tyler has an IRA (IRA 1) that he has funded entirely with nondeductible contributions. The IRA has a value of $50,000 and a basis (due to the nondeductible contributions) of $22,000. He also has IRA 2, which he established with a $35,000 rollover from a former employer's 401(k) plan. The value is also $50,000, so the combined value of his IRA is $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.

<u>Variation:</u> If Tyler chooses to convert only IRA 1 into a Roth IRA, his basis must still be spread among all IRA accounts. Thus, even though IRA 1 contained all of the nondeductible contributions, it is only allocated $11,000 [($22,000 ÷ $100,000) × $50,000] of the IRA basis. Thus, Tyler recognizes $39,000 ($50,000 − $11,000) of income from the conversion even though IRA 1 has only $28,000 of accumulated earnings.

Example 11-53: Contribution to nondeductible IRA followed by Roth conversion.

Victor, who is age 54 and single, cannot contribute to a Roth IRA because his income is too high (for 2010, modified AGI limit for single taxpayer is $120,000). All of his retirement funds are in his employer's retirement plan; he does not own any IRAs.

For 2010, Victor can make a $6,000 contribution to a nondeductible IRA and shortly thereafter convert the IRA to a Roth IRA. Income from the conversion would be limited to the value in excess of $6,000 at the time of the conversion. This strategy effectively enables Victor to get funds into a Roth IRA by circumventing the AGI limit on Roth IRA contributions.

Variation 1. Assume Victor owns a traditional IRA (IRA 1) valued at $100,000 with funds he rolled over from a previous employer's retirement plan. Here, Victor's strategy of contributing to a nondeductible IRA (IRA 2) and converting that IRA to a Roth IRA with little or no tax consequences will not work because he must include all of his IRAs when computing the income from the conversion. Assuming the nondeductible IRA is still worth $6,000 at the time of the conversion, the basis allocable to that IRA would be:

$$\frac{\text{\$6,000 total nondeductible contributions}}{\text{\$106,000 total value of all IRAs}} \times \underset{\text{(rollover)}}{\text{\$6,000 distribution}} = \text{\$340 nontaxable portion}$$

Thus, if Victor converted all $6,000 from IRA 2 to a Roth IRA, he must report income from the conversion of $5,660 ($6,000 - $340 basis).

Variation 2. Assume same facts as Variation 1 and that Victor is a participant in his current employer's qualified retirement plan and that plan allows participants to roll the taxable amounts from their own IRAs to the plan. Thus, Victor could roll his $100,000 IRA (IRA 1) to his employer retirement plan account, which would leave him with only the nondeductible IRA (IRA 2). Now, when he converts IRA 2 to a Roth IRA, **there** is little or no income because assets in an employer retirement plan aren't included when making the pro rate calculation for distributions (conversions) from traditional IRAs.

Rollover from a Qualified Plan. If a rollover to a Roth IRA is from a qualified plan that 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.

Deciding Whether to Roll Over to a Roth IRA

It is impossible to reach a single conclusion that applies to all taxpayers when deciding whether to roll a traditional IRA or qualified plan account to a Roth IRA. Whether it makes sense to trigger the resulting tax liability depends on such factors as how long the taxpayer intends to leave the funds in the Roth IRA, what the taxpayer's tax rate is now and what it will be when withdrawals are taken, and whether the taxpayer will have to use the funds from the IRA or qualified plan account to pay the tax due at conversion. As with most tax planning alternatives, the practitioner should calculate the numbers before deciding on a particular strategy.

Taxpayers will generally benefit from converting funds to a Roth IRA if all of the following are met:

a. The taxpayer (or beneficiary) will not need to take withdrawals from the Roth IRA for at least 15 to 20 years.

b. The taxpayer's (or beneficiary's) tax rates when withdrawals are taken are no less than it is at the time the conversion occurs.

c. The taxpayer can pay the tax due on the rollover with funds outside the IRA or qualified plan.

Other factors and practical considerations that should be addressed or discussed with the client include the following:

- Paying the tax with funds outside the IRA or qualified plan is generally necessary to making the rollover economically beneficial. If a taxpayer does not have available funds, it is unlikely a rollover will make economic sense (because the withdrawn from the IRA or plan and funds used to pay the tax are subject to income tax and, in many instances, the 10% premature distribution penalty). Practically speaking, however, many eligible taxpayers may not have outside funds available to pay the tax on a conversion that results in significant taxable income.

- Income generated from a conversion may create unexpected tax consequences. For example, items that are AGI sensitive (itemized deductions, child credit, education credits, etc.) may be adversely affected because of the increase to AGI caused by the IRA conversion income.

- Conversions may be particularly beneficial for wealthy taxpayers who plan to leave large IRA balances to beneficiaries. Because Roth IRAs are not subject to the pre-death minimum distribution rules, the funds can continue to accumulate without taxes for beneficiaries.

- A significant benefit of making a conversion, particularly for younger taxpayers, is the ability to withdraw the converted amount tax-free and penalty-free after the funds have been in the Roth IRA for at least five years. Because Roth withdrawals come first from contributions (including converted amounts), this effectively allows tax-free and penalty-free access to some IRA funds before age $59^1/_2$. However, exceptions to the early withdrawal penalty when IRA funds are used for first-time home expenses and college costs gives owners of traditional IRAs penalty-free access to funds when used for those purposes.

- Projecting a taxpayer's tax rates in retirement is particularly difficult when that time is 20 or 25 years in the future. Future tax analysis is further complicated by the focus on the current tax system and discussions in Congress on how to simplify and reshape it. If Congress abolishes or dramatically lowers the rates in our current income tax system and replaces it or supplements the current system with a value-added tax or national sales tax, paying tax now on a conversion might be a mistake. Further, there is no guarantee that Congress will not change the tax-free status of Roth IRA withdrawals in the future, either directly or indirectly (e.g., as part of an AMT computation); however, adverse political consequences may prevent such changes.

- Taxpayers with deductions or credits that may otherwise go unused are good candidates for conversions because the conversion income may create little or no additional tax liability. For example, elderly persons with high medical expenses or individuals with expiring tax deductions, such as an NOL carryovers, or expiring tax credits, such as an adoption or foreign tax credit, may benefit from a Roth conversion. The ability to undo or recharacterize all or part of the conversion after year end allows these taxpayers to control exactly how much income they want to generate from the conversion, depending on the actual deductions and credits claimed on their return.

Taxability of Social Security Benefits May Have an Impact. Taxpayers receiving Social Security benefits (or who expect to begin receiving them in the near future) who are considering converting to a Roth IRA should consider the effect of the conversion on the taxability of their Social Security benefits. If their Social Security benefits are already taxable up to the 85% limit because of the level of AGI, rolling retirement funds over to a Roth IRA will have no effect on the amount of taxable Social Security benefits.

Some taxpayers with Social Security benefits may actually be better off with a Roth rollover. The rollover will cause taxable income to increase for one year. However, subsequent taxable income should be less than it would otherwise be without the rollover. Not only will rolled over funds *not* be subject to the age $70^1/_2$ minimum distribution rules, but any Roth withdrawals after the age $59^1/_2$ and five-year requirements have been met are tax-free. Thus, taxpayers who are otherwise close to the Social Security taxability threshold without considering any IRA distributions could see less of their benefits subject to tax by rolling their IRA or employer retirement account funds to a Roth IRA.

Other Income Tax Issues to Consider. In addition to the direct impact a rollover has on the taxpayer's taxable income in the year of the rollover, there may also be an indirect effect. Several AGI-sensitive tax benefits may not be available if income is over a certain level. Thus, in the year(s) in which the taxpayer's income increases because of a rollover to a Roth IRA conversion, benefits such as the child or education credits, the adoption credit, or the deduction for interest expense on a loan for higher education expenses may be limited or even lost.

Other items that could be adversely impacted by a jump in income include the $25,000 rental exception to the passive loss rules, the medical and miscellaneous deductions, and the ability to make certain types of IRA contributions.

Medicare Part B Premiums. Extra income from a Roth conversion may adversely impact the monthly Medicare Part B premiums paid by upper income seniors. These higher earning seniors pay a surcharge above the regular monthly Part B premium based on their AGI. For 2010, the surcharge applies if 2008 modified AGI exceeded $85,000 for single filers and $170,000 for joint filers. The maximum surcharge is 220% for single filers with a 2008 AGI above $214,000 and married filers exceeding $428,000 of AGI. The surcharge can be as much as $258 per month in 2010. So, seniors reporting income from a Roth conversion in 2010 could see their 2012 Medicare Part B premium increase. Likewise, those who spread their Roth conversion income over 2011 and 2012 could see their premiums increase in 2013 and 2014.

Additional Considerations for 2010. 2010 will be the first year many high-income or wealthy individuals will have the opportunity to convert a traditional IRA or qualified plan account to a Roth IRA, now that the $100,000 AGI restriction has been eliminated. In addition, many of these and other taxpayers for whom a Roth conversion makes sense may find that 2010 is the best year to convert, given that the resulting income is deferred and spread over two tax years (2011 and 2012). Thus, the conversion income may have less impact on the taxpayer's AGI-sensitive income, deductions, and credits compared to reporting all the income in a single year. In addition, there is some time-value of money benefit for deferring the tax on the income to later years.

Deciding How Much to Roll Over to a Roth IRA

Considerations regarding the amount to rollover include the following:

a. The taxpayer's current income tax situation and projected taxable income for future years.

b. The taxpayer's net worth, age, and post-retirement need for cash.

c. The rollover's effect on the taxation of current and future Social Security benefits and other AGI-sensitive deductions and credits.

d. The estate planning impact of the rollover.

e. Availability of assets outside the account to pay the tax incurred by the rollover.

If an individual elects to convert only a portion of his traditional IRAs to Roth IRAs, the practitioner can provide guidance regarding which investments should be held in non-IRA investments, in traditional IRAs, and in his Roth IRA.

Example 2-8: Choosing investments for Roth IRAs and Traditional IRAs.

An asset allocation model developed for Jon indicates 65% of his investments should be in large cap stocks and 35% of his investments should be in a bond portfolio. The model also indicates Jon should expect a 10% return from his stock portfolio and a 5% return from his bond portfolio. In this instance, Jon would be better off to have his fastest growing assets inside the Roth IRA while retaining the more conservative investments in his traditional IRA, since the income and appreciation in the Roth IRA is not subject to income tax, while tax on the earnings of the traditional IRA is merely deferred and eventually fully taxable.

Reversing a Conversion Rollover of a Traditional IRA to a Roth IRA

A taxpayer can undo a Roth conversion by using a trustee-to-trustee transfer of the funds from the Roth IRA back to a traditional IRA no later than the due date, including extensions, for the income tax return for the year the conversion originally occurred (the IRS refers to this as a *recharacterization* of the contribution to the Roth IRA). 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 individual 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. Also, a recharacterization under these rules is never treated as a *rollover* for purposes of the regular one-rollover-per-year limitation of IRC Sec. 408(d)(3)(B).

There may be instances when a taxpayer who converts to a Roth IRA finds it advantageous to undo a conversion and, in some cases, reconvert back to a Roth IRA. For example, if the value of the individual's IRA falls dramatically following the conversion (e.g., a significant downturn in the stock market or in the value of particular investments held in the IRA), 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 conversion will be based on the reduced value of the IRA and taxed in the year such conversion occurs.

Example 2-9: Reversing a Roth IRA conversion because of a stock market drop.

In January 2010, 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 2010, he rolls the $50,000 into a Roth IRA. He has until the due date (including extensions) of his 2010 income tax return to decide if he wants to undo the transaction.

James decides to extend his 2010 return in April 2011. In September 2011, the market falls 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 of his 2010 return, the Roth IRA conversion is treated as never occurring.

Recharacterizing a Roth conversion may be particularly beneficial when a taxpayer anticipates having unused deductions because of a year of unusually high deductions or lower income than normal, but cannot accurately project the amount. In these instances, it may be advantageous to convert all or most of the taxpayer's traditional IRAs to a Roth IRA to generate taxable income to absorb the unused deductions. The following year, when the actual amount of deductions is known, the taxpayer can recharacterize any part of the conversion that exceeds the actual deductions. This is a post year-end planning opportunity for taxpayers with the foresight to make the conversion before the end of the tax year.

Example 2-10: Fine tuning a conversion after year-end.

Mildred, age 67, incurs an unusually large amount of medical expenses in 2010, which, combined with her other itemized deductions and personal exemptions, will more than offset her AGI for the year. Mildred has a traditional IRA worth $300,000. She converts $100,000 to a Roth IRA in 2010 to offset her projected unused 2010 deductions, which are estimated to be $60,000. A draft of her 2010 return (without considering the Roth IRA conversion) shows that she can generate up to $69,000 of additional income without creating any tax. Therefore, Mildred recharacterizes $31,000 ($100,000 − $69,000) of her Roth IRA conversion, leaving a $69,000 taxable conversion for 2010. Since the conversion occurred in 2010, she elects to include all the income in 2010, rather than spreading to 2011 and 2012. This strategy converts $69,000 of her traditional IRA to a Roth IRA without creating any current tax liability.

The same process can be used to change the results of annual traditional IRA or Roth contributions. Thus, for example, taxpayers who contributes to a traditional IRA in 2010 can decide by the due date of their 2010 return to change the contribution into a Roth IRA contribution (by moving it in a trustee-to-trustee transfer to a Roth IRA). The same can also be done for contributions first made to Roth IRAs that taxpayers subsequently make recharacterizing transfers to a traditional IRAs.

Example 2-11: Recharacterizing a traditional IRA contribution.

Tara makes a $4,000 contribution to a traditional IRA for 2010. On April 1, 2011, when the value of the IRA has increased to $4,500, Tara elects to recharacterize the contribution by transferring the $5,500 to a Roth IRA. As a result, Tara is deemed to have made a $5,000 regular contribution to a Roth IRA for 2010. The $500 of earnings is not treated as a contribution; it can be distributed tax-free only after Tara meets the five-tax-year and age-59½ requirements for qualified Roth IRA distributions.

Undoing a Pre-2010 Erroneous Conversion. Before 2010, if a traditional IRA was converted to a Roth IRA and the taxpayer's modified AGI exceeded $100,000, the conversion would not be effective. Instead, the amount converted became an excess contribution to the Roth IRA that was subject to a 6% tax on excess contributions. It was also considered a distribution from the traditional IRA, subject to income tax and the 10% early withdrawal penalty, unless one of the exceptions applies. In this situation, a taxpayer could take advantage of the recharacterization rules to undo the conversion and thus, avoid any taxes and penalties resulting from the erroneous conversion.

Example 2-12: Reversing an erroneous IRA conversion.

In March 2009, Amy made a qualified rollover of her traditional IRA to a Roth IRA. When Amy's tax practitioner prepared her 2009 extended return in September 2010, it showed that Amy's 2009 modified AGI exceeded $100,000, due in part to an unexpected bonus she received in December. Thus, she was not eligible to convert her traditional IRA to a Roth IRA in 2009.

Amy can undo the conversion by using a trustee-to-trustee transfer of the funds plus earnings from the Roth IRA to a traditional IRA (a recharacterization) no later than October 15, 2010. The transfer can be made to her original IRA or a new IRA, but it must be done trustee-to-trustee. If Amy does not undo the conversion, she will have a distribution from her traditional IRA and an excess contribution to a Roth IRA for 2009.

Taxpayers who fail to timely undo an erroneous IRA conversion can seek relief from the IRS under the provisions of Reg. 301.9100-3. In several cases, the IRS has granted taxpayers extensions of time to recharacterize an erroneous IRA conversion. For example, a taxpayer who made a Roth IRA conversion but discovered after filing her return for the year of the conversion that she was ineligible because her AGI was too high was granted a six month extension (from the date of the letter ruling) to recharacterize the conversion. Similarly, a taxpayer whose IRA trustee failed to recharacterize the taxpayer's IRA as requested was granted a six-month extension. In granting relief, the IRS found that (a) the taxpayers acted reasonably and in good faith and (b) granting relief would not prejudice the interests of the government, as required by Reg. 301.9100-3.

In Service Center Advice 200148051, the IRS stated that a failed Roth IRA conversion could not be remedied after the due date of the return that reported the rollover (including extensions) by using its Office of Taxpayer Advocate because such a determination is outside the scope of the Taxpayer Advocate's authority. Therefore, taxpayers must use Reg. 301.9100-3 to obtain an additional extension of time to recharacterize the conversion. The regulation requires the taxpayer to obtain a letter ruling regarding the situation.

Recharacterizing Conversion Contribution When Roth IRA Holds Funds from Other Contributions

The process of reversing a Roth IRA conversion is easy when the Roth account in question holds only the Roth conversion contribution amount plus or minus subsequent net earnings or net losses and the entire conversion is recharacterized. In this case, the entire account balance is simply recharacterized back to traditional IRA status.

Accomplishing a reversal is more complicated when the Roth account holds other funds (from earlier annual contributions and/or earlier conversion contributions). In this case, the net earnings or net losses attributable to the conversion contribution that will be reversed must be quantified and removed from the Roth account along with the conversion contribution amount. In other words, only part of the Roth account balance (the part attributable to the conversion contribution that will be reversed and the related net earnings or losses) is removed and recharacterized.

Net income or loss allocable to the conversion contribution 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 to calculate the income or loss amount is as follows:

$$\text{Allocable income or loss} = \text{Contribution} \times \frac{\text{Adjusted closing balance} - \text{Adjusted opening balance}}{\text{Adjusted opening balance}}$$

For this purpose—

- The adjusted opening balance is the fair market value (FMV) of the Roth IRA at the beginning of the computation period plus the amount of any transfers into the account or contributions to the account (including the conversion contribution that is being recharacterized) occurring during the computation period.

- The adjusted closing balance is the Roth IRA's FMV at the end of the computation period plus the amount of any withdrawals or transfers from the account occurring during the computation period.

- The computation period is the period beginning immediately before the conversion contribution that is being recharacterized was made to the Roth IRA and ending immediately before that contribution is withdrawn via the recharacterization transaction.

Example 2-13: Partial recharacterization.

On March 1, 2010, Dante made a $160,000 conversion contribution to his existing Roth IRA. Immediately before the contribution, the Roth IRA was worth $80,000. No other contributions were made to the account and no withdrawals have been taken. By April 1, 2011, the stock and mutual fund investments in Dante's Roth IRA declined in value to $225,000. As a result, Dante now wants to recharacterize his 2010 conversion contribution by pulling the $160,000 out (along with the related net loss amount) and rolling the proper amount over into a traditional IRA.

Dante's related net loss is $10,000 calculated as follows:

$$\$160,000 \times \frac{\begin{array}{c}\$240,000\ (\$80,000\ \text{FMV before the conversion contribution} + \$160,000\\ \text{conversion contribution}) - \$225,000\ (\text{value immediately before withdrawal}\\ \text{of the conversion contribution})\end{array}}{\$240,000}$$

To recharacterize Dante's 2010 conversion contribution, the Roth IRA trustee must be directed to transfer $150,000 ($160,000 original conversion contribution less $10,000 allocable net loss) from Dante's Roth IRA into a traditional IRA set up in his name.

Example 2-14: Selected account assets cannot be recharacterized.

Arlene converted her traditional deductible IRA into a Roth IRA. On that date, the account was worth $100,000. The conversion therefore triggered $100,000 of taxable income. Assume the investments in the converted account consist of 1,000 shares of ABC Corp. and 1,000 shares of XYZ Corp. On the conversion date, the ABC shares were worth $60,000 ($60 per share) and the XYZ shares were worth $40,000 ($40 per share).

Arlene now decides she wants to recharacterize the contributed ABC stock, which has fallen to $35 per share, by rolling those shares (and those shares only) back into a traditional IRA. However, the XYZ stock has appreciated to $85 per share, which means the Roth IRA, is currently worth $120,000 [(1,000 × $35) + (1,000 × $85)].

Unfortunately, Arlene can only choose to recharacterize a specific dollar amount or proportion of her conversion contribution. She cannot choose to recharacterize specific investments held in the Roth IRA. Therefore, if Arlene requests her Roth IRA trustee to make a recharacterization by transferring $60,000 (the value of the ABC shares at the time of the conversion contribution) into a traditional IRA set up in her name, the allocable net income will be $12,000 [$60,000 × ($120,000 – $100,000) ÷ $100,000]. So the Roth IRA trustee must transfer assets worth $72,000 ($60,000 original conversion contribution + $12,000 allocable net income) into the traditional IRA. It does not matter which assets are actually transferred: ABC shares, XYZ shares, cash, or any combination of assets worth $72,000 will suffice.

Reconversions after a Recharacterization Are Restricted

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 the following:

a. the beginning of the tax year following the tax year the amount was converted to a Roth IRA, or

b. the end of the 30-day period beginning on the day the original conversion is recharacterized (i.e., the Roth IRA is converted back to a traditional IRA).

Example 2-15: Applying the Roth IRA reconversion rules.

Diane converts her traditional IRA to a Roth IRA in 2010. After a significant drop in the value of the account, Diane recharacterizes the Roth IRA back to a traditional IRA on January 26, 2011. She cannot then reconvert the traditional IRA back to a Roth IRA until February 25, 2011.

Distributions Following Roth IRA Conversions

Distributions of funds that occur anytime after a taxpayer makes a conversion are subject to ordering rules that consider the taxpayer's regular Roth IRA contributions as well as Roth IRA conversions. These ordering rules can impact the taxability of a distribution.

SELF-STUDY QUIZ

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

28. An individual can convert a traditional IRA to a Roth IRA. Which of the following statements regarding the conversion is most accurate?

    a. The conversion is treated as a rollover, regardless of the conversion method used.

    b. An individual who is age 75 can avoid a current-year distribution by converting a traditional IRA to a Roth IRA.

    c. Married individuals filing separately cannot make a rollover contribution from a traditional IRA to a Roth IRA.

29. If a traditional IRA is converted to a Roth IRA and the taxpayer's modified AGI exceeds the limit in years prior to 2010, the conversion will not be effective. A taxpayer can avoid all taxes and penalties and undo the conversion by doing which of the following?

    a. Redesignating the Roth IRA to a traditional IRA.

    b. Rolling over the distributions from a traditional IRA to a Roth IRA within the 90-day regular rollover period.

    c. Rolling the amount converted including all earnings from the date of conversion into a traditional IRA by the due date.

    d. Rolling the amount into a traditional IRA by the original due date of the tax return prior to extensions.

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.)**

28. An individual can convert a traditional IRA to a Roth IRA. Which of the following statements regarding the conversion is most accurate? **(Page 60)**

    a. The conversion is treated as a rollover, regardless of the conversion method used. [This answer is correct. You can convert amounts from a traditional IRA to a Roth IRA in any of the following three ways:

    Rollover. You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.

    Trustee-to-trustee transfer. You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.

    Same trustee transfer. If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.]

    b. An individual who is age 75 can avoid a current-year distribution by converting a traditional IRA to a Roth IRA. [This answer is incorrect. You cannot use your Roth IRA to satisfy minimum distribution requirements for your traditional IRA. Nor can you use distributions from traditional IRAs for required distributions from Roth IRAs. An individual who is required to take minimum distributions from a Traditional IRA (i.e., over age $70^1/_2$) cannot avoid a current-year distribution by converting a Traditional IR A to a Roth IRA.]

    c. Married individuals filing separately cannot make a rollover contribution from a traditional IRA to a Roth IRA. [This answer is incorrect. Beginning in 2010, the MFS restriction has been removed so these taxpayers are now eligible for rollovers.]

29. If a traditional IRA is converted to a Roth IRA and the taxpayer's modified AGI exceeds the limit in years prior to 2010, the conversion will not be effective. A taxpayer can avoid all taxes and penalties and undo the conversion by doing which of the following? **(Page 64)**

    a. Redesignating the Roth IRA to a traditional IRA. [This answer is incorrect. Redesignating the Roth IRA to a traditional IRA, does not eliminate the taxes and penalties that occur as a result of the conversion.]

    b. Rolling over the distributions from a traditional IRA to a Roth IRA within the 90-day regular rollover period. [This answer is incorrect. Distributions from a traditional IRA to a Roth IRA must be made within a 60-day period.]

    c. Rolling the amount converted including all earnings from the date of conversion into a traditional IRA by the due date. [This answer is correct. A taxpayer can avoid any taxes and penalties and undo the conversion by using a trustee-to-trustee transfer of the funds from the Roth IRA back to a traditional IRA no later than the due date, including extensions, for the income tax return for the year the conversion originally occurred (the IRS refers to this as a recharacterization of the contribution to the Roth IRA).]

    d. Rolling the amount into a traditional IRA by the original due date of the tax return prior to extensions. [This answer is incorrect. Extensions must be included with the trustee-to-trustee transfer of funds.]

MAXIMIZING RETIREMENT BENEFITS WITH A ROTH 401(k)

The Roth 401(k) is essentially a traditional 401(k) plan with a Roth account feature added. It combines the traditional 401(k) with some of the features of a Roth IRA. If an employer's 401(k) plan includes the Roth feature, employees may contribute after-tax dollars (an elective deferral known as a *designated Roth contribution*, or DRC) to a *designated Roth account* (DRA). The DRA must be a separate account under the plan. It will grow tax-free and the employee will eventually be able to withdraw tax-free qualified distributions.

Contributions (DRCs) to Roth 401(k) Plans

A *designated Roth contribution* (DRC) is an elective contribution under a qualified cash or deferred arrangement [i.e., a traditional 401(k) plan] that, to the extent permitted under the plan, is—

a. designated irrevocably by the employee at the time of the cash or deferred election as a DRC that is being made in lieu of all or a portion of the pretax elective contributions the employee is otherwise eligible to make under the plan;

b. treated by the employer as includible in the employee's gross income at the time the employee would have received the amount in cash if the employee had not made the cash or deferred election (i.e., by treating the contribution as wages subject to applicable withholding requirements); and

c. maintained by the plan in a separate account.

Unlike a Roth IRA, there is no income threshold to limit eligibility for making a DRC. Although individuals whose modified AGI is above certain levels are not eligible to contribute to a Roth IRA, individuals with high income can contribute to a Roth 401(k).

The maximum amount that may be contributed to a DRA is the same maximum for elective deferral contributions to the taxpayer's traditional 401(k) plan for the year. For 2010, an employee can make total elective deferral contributions of up to $16,500 ($22,000 if the employee is age 50 or older by the end of the year).

The DRA option does not increase the total amount that the employee may contribute through elective deferrals. The employee can contribute in any ratio he chooses to a traditional 401(k) or to a DRA, as long as the total does not exceed the applicable limit for the year.

Example 2-16: Elective deferral contributions to a Roth 401(k) or a traditional 401(k).

Mary, age 52, is a participant in her employer's 401(k) plan. Her compensation for 2010 will be $85,000. Her employer has amended its 401(k) plan to allow DRCs. Mary can contribute up to $22,000 to her traditional 401(k) account, or $22,000 to a DRA, or allocate part of her elective deferrals to DRA and part to a traditional 401(k) account as long as the combined total does not exceed $22,000.

Distributions from Roth 401(k) Plans

Whereas Roth IRAs are exempt from the lifetime minimum required distribution (MRD) rules, DRAs are subject to the same lifetime and post-death MRD rules as other 401(k) plans.

Qualified Distributions. *Qualified distributions* from a DRA are not taxable, just like qualified distributions from a Roth IRA. The definition of a qualified distribution from a DRA is generally the same as from a Roth IRA, except that it does not include a distribution made to first-time homebuyers. However, there is another slight difference regarding the five-year waiting period requirement.

For both a Roth IRA and a DRA, there is a five-year waiting period before a qualified distribution can occur. With a Roth IRA, the five-year period begins with the first day of the first year in which a contribution is made to any Roth IRA. However, for a DRA, the five-year period is five consecutive years beginning with the first year the employee made a contribution to a DRA in the particular plan (the year the elective deferral was included in the employee's income). Thus, the five-year period is determined separately for each plan in which the employee participates, even for two plans maintained by the same employer. However, an exception to this rule provides that when a distribution from a DRA is transferred to another DRA by a direct rollover, the starting point for the five-year period in the transferee plan is the starting point of the transferee plan or the starting point of the transferor plan, whichever is earlier.

Nonqualified Distributions. The treatment of nonqualified distributions is one of the major differences between Roth IRAs and DRAs.

As is true with Roth IRAs, assuming the DRA has appreciated in value throughout the years, the DRA consists of the employee contributions (the employee's basis in the account, paid with after-tax funds) plus the earnings on the account. Nonqualified distributions from a Roth IRA are treated first as a return of contributions or basis. However, with a DRA, there is no special rule allowing contributions to come out first. Therefore, the regular rule of IRC Sec. 72(e)(8) applies, and a nonqualified distribution is deemed to consist of proportionate amounts of the employee's investment in the contract (basis) and earnings.

Income Tax Treatment of DRA Rollovers

Distributions from a DRA may be rolled over subject to the same rollover rules applicable to other types of plans, except that DRA distributions can be rolled only to another DRA of the individual from whose account the distribution was made or to a Roth IRA of such individual. However, the rules are somewhat more complicated.

Rolling Over a Distribution from a DRA to another DRA. An employee can roll over an eligible rollover distribution from one DRA to another DRA by means of a direct rollover. If a direct rollover is done, the entire balance of the DRA must be rolled over into the new DRA; a partial DRA-to-DRA direct rollover is not permitted. Also, a direct rollover of the entire portion is the only way that the nontaxable portion of a distribution from a DRA may be rolled over into another DRA. By utilizing a direct DRA-to-DRA rollover of the entire account, the employee's holding period from the transferor plan is tacked on to the holding period in the transferee plan when determining whether the five-year requirement is satisfied. Also, if the amount rolled over is a qualified distribution, the entire amount of the rollover contribution is allocated to basis in the transferee DRA. Further, if the entire balance of a DRA is rolled over to another DRA in a direct rollover, and, at the time of the distribution, the investment in the contract exceeds the balance in the DRA, the investment in the contract in the distributing plan is included in the investment in the contract of the recipient plan.

In contrast to a direct rollover, an employee may actually receive an eligible rollover distribution from a DRA and roll part or all of that distribution over to another plan within 60 days. Such a rollover is subject to the same 60-day time limit rules as other types of plans and the same federal withholding rules. However, the following special rules apply to a 60-day rollover from a DRA:

a. If the eligible rollover distribution from the DRA is a nonqualified distribution (i.e., part of it would have been includible in gross income of the recipient employee had it not been rolled over) and the employee only rolls over part of the distribution, the part rolled over is deemed to consist first of the taxable part of the distribution.

b. The employee can roll over just the taxable part of a nonqualified distribution to another DRA. The nontaxable portion of the distribution (which would be the entire distribution in the case of a qualified distribution) cannot be rolled over to another DRA.

c. Unlike a direct rollover, the five-year holding period (for determining a later qualified distribution) does not carry over from the transferor DRA to the transferee DRA. The employee's five-year period for the transferee DRA (the one receiving the rollover) is based on the first year he or she made a contribution to that particular DRA (whether the contribution was the rollover contribution or an earlier contribution).

Rolling Over a Distribution from a DRA to a Roth IRA. An employee can roll over an eligible rollover distribution from a DRA to a Roth IRA by means of a direct rollover if the rollover is actually received within the required 60-day period. A key factor here is that a rollover from a DRA to a Roth IRA is permitted even if the employee participant is ineligible to make contributions to a Roth IRA or to convert his or her traditional IRA to a Roth IRA because of AGI requirements that apply before 2010. Thus, a taxpayer can establish a Roth IRA solely for receiving a rollover distribution from his DRA, even if his AGI is too high to otherwise allow him to make regular contributions to a Roth IRA.

If an eligible rollover distribution from a DRA is a nonqualified distribution (i.e., part of it would have been includible in gross income of the recipient employee had it not been rolled over) and the employee only rolls over part of the distribution to a Roth IRA, the part rolled over is deemed to consist first of the taxable part of the distribution. This is the same treatment as with a DRA-to-DRA partial rollover of a nonqualified distribution.

Example 2-17: Partial rollover of eligible rollover distribution received from DRA.

Nancy receives a $14,000 eligible rollover distribution that is a nonqualified distribution from her DRA, consisting of $11,000 of investment in the contract (basis) and $3,000 of earnings. Within 60 days of receipt, Nancy rolls over $7,000 of the distribution into a Roth IRA. The $7,000 is deemed to consist of $3,000 of income and $4,000 of basis. Because the only portion of the distribution that could be includible in gross income (the earnings) is rolled over, none of the distribution is includible in Nancy's gross income.

A disadvantage of rolling over a distribution from a DRA to a Roth IRA is the holding period for purposes of determining a later qualified distribution from the transferee Roth IRA does not carryover from the transferor DRA into the Roth IRA. The general five-year rule for a Roth IRA still applies and does not change because of receiving a rollover from a DRA. Therefore, if the first year a taxpayer has ever owned a Roth IRA is the year the Roth IRA is created with the rollover from the DRA, then he must wait five years to be able to receive a qualified distribution from that Roth IRA, regardless of how long the transferor DRA was in existence and regardless of whether the rollover was a direct rollover or a regular 60-day rollover.

However, if a qualified distribution from a DRA is rolled over to a Roth IRA, the entire rollover amount is treated as a regular contribution to the Roth IRA, and regular contributions (basis) are withdrawn tax-free at any time from a Roth IRA. Also, if a participant has already fulfilled the five-year holding period requirement in a Roth IRA, a rollover from a DRA into that Roth IRA gets the benefit of that qualification, even if the funds were in the DRA for less than five years.

Example 2-18: DRA-to-Roth IRA rollover: five-year holding period restarts.

Tim, age 67, established a DRA in 2009 in his employer's 401(k) plan and made an initial $22,000 contribution ($16,500 regular contribution + $5,500 catch-up contribution for being over 50). In 2012 he retires at age 70 and decides to roll over the DRA to a newly established Roth IRA (his first Roth IRA) in 2012. The DRA is worth $32,000 at the time of rollover (has earnings of $10,000). At the time of the rollover, Tim has completed three of the five years required for receiving a qualified distribution from his DRA. However, the five-year holding period starts over again with the rollover into the Roth IRA and he therefore cannot receive a qualified distribution from the Roth IRA until 2017. Tim's basis in the DRA ($22,000) continues to be treated as basis in the Roth IRA and can be withdrawn tax-free at any time. However, the earnings cannot be withdrawn tax-free until 2017.

Example 2-19: DRA-to-Roth IRA rollover: five-year holding period already met.

Assume the same facts as in Example 2-18, except that the rollover transferee Roth IRA had been established in 2005. Even though Tim's holding period for the DRA is only three years (and the distribution from the DRA is nonqualified), it immediately becomes qualified since Tim rolled it into a Roth IRA that had already met the five-year requirement. Also, since Tim is over $59^1/_2$, he can withdraw any amount from the Roth IRA tax-free.

Example 2-20: Qualified distribution rollover from DRA to Roth IRA.

Tim receives a $50,000 qualified distribution (consisting of $35,000 in basis and $15,000 in earnings) from his DRA in 2014 and rolls it over into his newly established, first Roth IRA within the 60-day required period. Although he cannot receive a qualified distribution from the Roth IRA until 2019, Tim can withdraw up to the entire $50,000 from the Roth IRA at any time as tax-free recovery of basis. This is because the distribution from the DRA was a qualified distribution and the entire amount (including earnings) is treated as a regular contribution to the Roth IRA.

SELF-STUDY QUIZ

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

30. The definition of a qualified distribution from a designated Roth account (DRA) generally is the same as from a Roth IRA, except that the qualified distribution from a DRA excludes which of the following?

    a. Distributions made on or after the individual is age 59 1/2.

    b. Distributions made to first-time home purchase expenses.

    c. Distributions made to the account owner's beneficiary after the owner's death.

    d. Distributions attributable to the individual being disabled.

31. Beginning in 2007, a tax-qualified 401(k) plan may permit employees who make elective contributions to the plan to designate some or all of those contributions as after-tax Roth contributions, effectively creating a Roth 401(k) plan. Which of the following makes a Roth 401(K) plan different from a Roth IRA?

    a. A Roth 401(k) plan permits an individual to contribute after-tax dollars to an IRA without being subject to tax on the future earnings of those contributions.

    b. There are no income restrictions for participation in Roth 401(k) plans.

    c. A Roth 401(k) has a five-year waiting period before a qualified distribution can occur.

    d. Qualified distributions from a designated Roth contribution (DRC) are not taxable.

32. Which of the following statements regarding designated Roth accounts (DRAs) is a correct statement?

    a. An employee can receive an eligible rollover distribution from a DRA and roll part of the distribution over to another plan within 30 days.

    b. The nontaxable portion of a distribution from a DRA may be rolled over into another DRA through a direct rollover of a partial portion amount.

    c. An eligible rollover distribution from one DRA to another DRA is accomplished by means of a direct rollover.

    d. An employee cannot rollover just the taxable portion of a nonqualified distribution to another DRA.

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.)**

30. The definition of a qualified distribution from a designated Roth account (DRA) generally is the same as from a Roth IRA, except that the qualified distribution from a DRA excludes which of the following? **(Page 71)**

    a. Distributions made on or after the individual is age 59 1/2. [This answer is incorrect. Distributions made on or after the individual is age 59 1/2 is a qualified distribution from a Roth IRA.]

    b. Distributions made for first-time home purchase expenses. [This answer is correct. The definition of a qualified distribution from a DRA does not include a distribution made to first-time homebuyers.]

    c. Distributions made to the account owner's beneficiary after the owner's death. [This answer is incorrect. Distributions made to the account owner's beneficiary after the owner's death is a qualified distribution from a Roth IRA.]

    d. Distributions attributable to the individual being disabled. [This answer is incorrect. Distributions attributable to the individual being disabled are a qualified distribution from a Roth IRA.]

31. Beginning in 2007, a tax-qualified 401(k) plan may permit employees who make elective contributions to the plan to designate some or all of those contributions as after-tax Roth contributions, effectively creating a Roth 401(k) plan. Which of the following makes a Roth 401(K) plan different from a Roth IRA? **(Page 72)**

    a. A Roth 401(k) plan permits an individual to contribute after-tax dollars to an IRA without being subject to tax on the future earnings of those contributions. [This answer is incorrect. Designated Roth contributions are subject to the employee elective contributions limits and Roth IRA contributions are made with after-tax dollars.]

    b. There are no income restrictions for participation in Roth 401(k) plans. [This answer is correct. Unlike a Roth IRA, there is no income threshold to limit eligibility for making a DRC according to IRS regulations.]

    c. A Roth 401(k) has a five-year waiting period before a qualified distribution can occur. [This answer is incorrect. One of the tests for a qualified distribution is the five-year requirement. This rule applies to Roth 401(k) and Roth IRA plans.]

    d. Qualified distributions from a designated Roth contribution (DRC) are not taxable. [This answer is incorrect. Like a Roth IRA, DRCs from Roth 401(k) plans are not taxable.]

32. Which of the following statements regarding designated Roth accounts (DRAs) is a correct statement? **(Page 73)**

    a. An employee can receive an eligible rollover distribution from a DRA and roll part of the distribution over to another plan within 30 days. [This answer is incorrect. An employee can receive an eligible rollover distribution from a DRA and roll part or all of that distribution over to another plan within 60 days? Such a rollover is subject to the same 60-day time limit rules as other types of plans and the same federal withholding rules.]

    b. The nontaxable portion of a distribution from a DRA may be rolled over into another DRA through a direct rollover of a partial portion amount. [This answer is incorrect. A direct rollover of the entire portion is the *only* way that the nontaxable portion of a distribution from a DRA may be rolled over into another DRA. If a direct rollover is done, the entire balance of the DRA must be rolled over into the new DRA; a partial DRA-to-DRA direct rollover is not permitted.]

    c. An eligible rollover distribution from one DRA to another DRA is accomplished by means of a direct rollover. [This answer is correct. A direct rollover is a means by which an employee can roll over an eligible rollover distribution from one DRA to another DRA.]

    d. An employee cannot rollover just the taxable portion of a nonqualified distribution to another DRA. [This answer is incorrect. The employee can roll over just the taxable part of a nonqualified distribution to another DRA. The nontaxable portion of the distribution (which would be the entire distribution in the case of a qualified distribution) cannot be rolled over to another DRA.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TINTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

23. For 2010, what is the maximum amount an individual under age 50 can contribute to a Roth IRA?

    a. $4,000.

    b. $5,000.

    c. $6,000.

    d. $7,000.

24. Which of the following retirement plans is **not** subject to pre-death minimum distribution rules?

    a. Traditional IRA.

    b. SEP.

    c. Roth IRA.

    d. SIMPLE.

25. Which of the following plans allows a taxpayer to make tax-free withdrawals?

    a. Roth IRA.

    b. Defined benefit.

    c. Traditional IRA.

    d. SEP.

26. Which of the following IRA accounts does **not** impose the minimum required distribution (MRD) rule?

    a. Roth.

    b. SEP.

    c. SIMPLE.

    d. Traditional.

27. Steven, a 45 year old man, decides in 2010 to convert $30,000 from a traditional IRA into a Roth IRA. All of the contributions were made previously to a deductible IRA account. Which of the following is correct regarding his conversion?

    a. Steven will incur a 10% early withdrawal penalty since he converted before he was 59 1/2 years old.

    b. $15,000 of the conversion will be included in Steven's 2011 income, with the other half included in 2012.

    c. The entire $30,000 converted should be included in Steven's 2010 return as rollover income.

    d. Do not select this answer choice.

28. Younger taxpayers have a significant benefit of being able to withdraw the converted IRA amount penalty-free after the funds have been in a Roth IRA for at least how many years?

    a. 2.

    b. 5.

    c. 7.

    d. 10.

29. A designated Roth contribution (DRC) is defined as a contribution made to a plan that consists of which of the following qualities?

    a. The plan is commingled with funds in the regular 401k plan.

    b. The Roth plan is tax-free, but the employee will have to pay taxes on withdrawals.

    c. The employer does not include the amount in the employee's wages for withholding requirements.

    d. The contribution is assigned by the employee as a DRC made in the place of other pretax elective contributions.

30. Izzie, age 51, is a participant in her employer's 401(k) plan. Her compensation for 2010 will be $85,000. Izzie's employer has amended its 401(k) plan to allow designated Roth contributions (DRC). Izzie can contribute $22,000 to her traditional 401(k) account or allocate part of her elective deferrals to a designated Roth account (DRA) as long as the combined total does not exceed which of the following?

    a. $10,000.

    b. $15,000.

    c. $22,000.

    d. $30,000.

GLOSSARY

Contingent Beneficiary: Anyone who will receive any benefits if the primary beneficiary predeceases or dies simultaneously with the owner.

Defined benefit plan: A defined benefit (DB) plan is a pension plan that defines the amount of pension benefit to be provided, usually as a function of one or more factors including age, years of service, or compensation.

Defined contribution plan: A defined contribution (DC) plan is a pension plan that specifies the amounts contributed to the plan and does not specify the amount of the benefits to be received by the retired employees (SFAS 87.264). Contributions to the plan are based on specified amounts (e.g., 7% of the employee's salary). The benefits to be received by the retired employee are unspecified and uncertain. The employee bears the investment risk and the pension expense is the amount funded (paid in).

Designated beneficiary: The person who the owner names as beneficiary, usually on the form provided by the administrator or trustee.

Eligible retirement plan: Eligible retirement plans include traditional IRAs, qualified pensions, profit sharing, stock bonus plans, governmental Section 457 plans, and 403(b) plans.

Eligible rollover distribution: Any distribution to an employee of part or all of his account balance in a qualified plan.

Individual retirement account: Qualified taxpayers may annually set aside limited amounts of earned income for a retirement fund. The amount set aside may be deductible, partially deductible, or nondeductible depending on whether the taxpayer is an active participant in an employer-maintained retirement plan, and depending on AGI and the amount of the contribution. Money earned by an IRA is tax-deferred until withdrawn. Specific requirements cover the withdrawal of funds from IRAs, and there are penalties for noncompliance. For all years before 2002, the annual contribution allowed was limited to $2,000 per year. The maximum annual contribution allowed has been increased to $3,000 for 2002.

Keogh plan: A Keogh plan is a retirement plan set up for a self-employed taxpayer that permits the tax payer to deduct a portion of the compensation from total income.

Qualified joint and survivor annuity (QJSA): A QJSA for a married participant is an annuity for the life of the participant with a survivor annuity for the life of the spouse.

Qualified preretirement survivor annuity (QPSA): The Qualified Preretirement Survivor Annuity is a benefit that is paid to an employee's surviving spouse in the event of the employee's death prior to retirement.

Roth IRA: The Roth IRA (individual retirement account) is similar to a traditional IRA with a few exceptions. Contributions to a Roth IRA are always nondeductible, do not depend on whether the taxpayer or spouse is an active participant in a company-sponsored qualified retirement plan, and may be made after the taxpayer attains the age of $70^1/_2$. In addition, qualified distributions are nontaxable. (Funds must be held in the IRA for five years prior to the initial distribution for the funds to be nontaxable.) Accounts may be passed to beneficiaries at death and remain nontaxable for income tax purposes.

Lump-sum distribution: A distribution (or several distributions) of the participant's entire account in a single tax year. Most defined contribution plans offer an LSD option.

Minimum distribution rules: Prevent the continual postponement of tax due on funds held in retirement accounts. The rules force individuals to begin distributions by their required beginning date (RBD).

Minimum required distribution (MRD): The amount that Traditional, SEP and SIMPLE IRA owners and qualified plan participants must begin distributing from their retirement accounts by April 1 following the year they reach age $70^1/_2$. RMD amounts must then be distributed each subsequent year.

Qualified retirement plan: Qualified retirement plans, or qualified plans, are defined in IRC Section 4974(c) to be any of the following:

- A plan described in IRC Section 401(a) that includes a trust exempt from tax under IRC Section 501(a)
- An annuity plan described in IRC Section 403(a)
- An annuity contract described in IRC Section 403(b)
- An IRA (individual retirement account) described in IRC Section 408(a)
- An IRA annuity described in IRC Section 408(b)

Required beginning date (RBD): The absolute deadline for taking your first distribution from your retirement plan.

Simplified employee pension (SEP) plan: In general, simplified employee pension (SEP) plans were established by employers and funded by employer contributions to employee IRAs. SEP plans were created to give small businesses a method of providing retirement benefits to employees without having to meet the complex requirements associated with other qualified plans.

Savings incentive match plan (SIMPLE IRA): A savings incentive match plan for employees (SIMPLE) became available in taxable year 1997. An employer with 100 or fewer employees is able to adopt this new type of retirement savings plan for employees. The new plan is "simple" to maintain, has higher limits, and is available to a larger number of "small employers." In general, a SIMPLE plan can be either an IRA (individual retirement account) or a 401(k). For an IRA SIMPLE plan, individual IRA accounts are set up for employees. For a 401(k) SIMPLE plan, individual 401(k) accounts are set up for the employees.

Traditional IRA: Beginning in 1998, an IRA that permits either a deductible or nondeductible contribution is referred to as a traditional IRA or IRA.

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COMPANION TO PPC'S GUIDE TO TAX PLANNING FOR HIGH INCOME INDIVIDUALS

COURSE 2

TAX PLANNING FOR SOLE PROPRIETORS AND OTHER BUSINESS OWNERS (TINTG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to the ways a self-employed taxpayer can maximize their business deductions for taxes. Lesson one introduces business deductions and explains how to avoid having a business classified as a hobby. Lesson two describes numerous business deductions including how a self-employed taxpayer can organize their business to save on taxes, how to claim a home office and ways to write off bad business debt. Lesson three addresses depreciation and how a sole proprietor can maximize depreciation and other business deductions related to automobiles. Finally, lesson four details business travel deductions and the restrictions and qualifications on travel expenses and meals and entertainment deductions.

PUBLICATION/REVISION DATE: April, 2010

RECOMMENDED FOR: Users of *PPC's Guide to Tax Planning for High Income Individuals*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

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

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

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **April 30, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Business Deductions for the Self-Employed Taxpayer and Hobby Loss Rules

Completion of this lesson will enable you to:
- Identify business deductions for self-employed taxpayers, including start-up costs.
- Recognize how taxpayer activities are classified as a hobby and calculate hobby loss income and deductions.

Lesson 2—Miscellaneous Business Deductions and Options for the Self-Employed Taxpayer

Completion of this lesson will enable you to:
- Identify different options for a taxpayer to save on SE tax, including organization of the business, rental income, and health savings accounts.

- Discuss the rules for claiming a home office deduction and how to calculate basis of depreciation on a home office.
- Define business bad debt, how a debt qualifies and how the taxpayer deducts a worthless debt and determine the Section 179 deduction limitations.

Lesson 3—Maximizing Depreciation and Tax Benefits for Autos

- Recognize ways to maximize depreciation for business deductions including establishing a minimum capitalization floor, bonus depreciation and midquarter convention.
- Identify methods for maximizing business deductions for costs associated with automobile use and determine the requirements for recordkeeping associated with business autos.

Lesson 4—Business Travel Deductions and Meals and Entertainment

- Discuss the restrictions and qualifications for a taxpayer to claim deductions for business travel expenses.
- Recognize the limits on meals and entertainment deductions in different business situations.

TO COMPLETE THIS LEARNING PROCESS:

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

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TINTG102 Self-study CPE
36786 Treasury Center
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ADMINISTRATIVE POLICIES:

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Lesson 1: Business Deductions For The Self-employed Taxpayer And Hobby Loss Rules

INTRODUCTION

Once a client decides to start a business, the practitioner and client must direct their attention to forming the appropriate legal structure and funding the company. This involves choosing the type of legal entity to own and operate the business. It also involves the transfer of property, including money, from the owners in what may be a taxable or tax-free transaction. Other planning considerations may also impact the start-up business. These include—

a. Related party transactions must be structured with an eye toward minimizing FICA and self-employment (SE) taxes.

b. Investigation and start-up expenses must be identified and properly handled.

c. The start-up activity must avoid the IRS's hobby loss trap.

d. The Section 1244 and Section 1202 rules on certain small business stock should be considered.

Businesses operated as sole proprietorships have many opportunities for tax savings. With proper planning, opportunities exist to maximize deductions of expenses combining business and personal elements. Business deductions for self-employed taxpayers are doubly important since they generally reduce both federal income and self-employment (SE) taxes.

Exhibit 1-1 lists some key income tax planning strategies included in this lesson.

Exhibit 1-1

Summary of Sole Proprietor Tax Strategies

Topic	Strategy
Bad debts	In order to justify a deduction for a business bad debt, the taxpayer should keep a detailed record of collection efforts. Proving worthlessness to sustain the deduction is a question of fact, and the best way to substantiate fact is accurate, detailed documentation.
Entertainment expenses—making the business connection	A valid business connection must exist in order for entertainment expenses to be deductible. The easiest way to validate this connection is to have bona fide business discussions at an office or some obvious business setting immediately before or after (associated with) the entertainment activity.
Health Savings Accounts (HSAs)	High income individuals should consider HSAs for a number of tax and financial reasons. They can be used to offset all forms of income; i.e., passive, non-passive, and portfolio. These tax-advantaged accounts can also be used to purchase over-the-counter medicines, even though these are not deductible medical expenses. They can also be used by healthy individuals to build up a tax-deferred fund much like an IRA, without the AGI limitations on deductible IRA contributions for high income individuals.
Hobby losses—combining activities	Combining similar, interrelated undertakings into an activity could prevent the application of the hobby loss restrictions and allow deductions otherwise missed.

Topic	Strategy
Home office principal place of business	Taxpayers should consider moving the administrative and management activities of their business to their personal residence to qualify for the home office deduction.
Meals and entertainment limits on deductibility	Certain meals and entertainment expenses are exempt from the general 50% disallowance rule. Practitioners should become familiar with these exceptions and advise their clients accordingly.
Midquarter convention for depreciation	Taxpayers can use the Section 179 deduction for assets purchased in the last quarter of the tax year to possibly prevent application of the mid-quarter convention.
Per diems for substantiating travel deductions	Self-employed taxpayers should consider using federally approved per diem amounts to substantiate the *amount* of deductible travel expenses to eliminate the need for documentation to support those amounts.
Section 179	Taxpayers should allocate much of the Section 179 deduction to assets with long recovery periods to maximize depreciation.
Self employment (SE) taxes—minimizing the impact	An individual can lease property to their closely held corporation or partnership, allowing a withdrawal of cash from the business that is not subject to FICA or SE taxes. Also, self-insured medical reimbursement plans and deductible educational assistance plans for legitimate family-employees can reduce SE taxes.
Traveling for business—away from home test	Self-employed taxpayers traveling for business should stay overnight to qualify for away from home status to deduct traveling expenses. Driving out of town and coming back later the same evening without staying overnight for adequate rest will not qualify.
Vehicles—depreciation	Certain vehicles are exempt from the depreciation limits that otherwise apply to "luxury" automobiles. Taxpayers should be aware of these exemptions to maximize available depreciation deductions for vehicles.
Vehicles—trading vs. selling	Trading vehicles can result in the basis in the currently owned vehicle to build up to levels substantially higher than the economic loss of the car, due to the Section 280F depreciation limits over time.

*   *   *

Learning Objectives:

Completion of this lesson will enable you to:

- Identify business deductions for self-employed taxpayers, including start-up costs.
- Recognize how taxpayer activities are classified as a hobby and calculate hobby loss income and deductions.

MAXIMIZING DEDUCTIONS FOR START-UP EXPENSES

Start-up costs, as the name implies, are expenses incurred before the business actually begins. They are also often called *preopening expenses*. Taxpayers can generally claim up to $5,000 as a current deduction. Start-up costs in excess of $5,000 are not currently deductible but can be amortized over 180 months starting with the month in which the active trade or business begins or is acquired.

Taxpayers can immediately deduct up to $5,000 of start-up expenses in the year when active conduct of business begins. However, the $5,000 instant deduction allowance is reduced dollar for dollar by cumulative start-up expenses in excess of $50,000 for the business in question. Start-up expenses that cannot be immediately deducted in the year business begins must be capitalized and amortized over 180 months on a straight-line basis (the same as Section 197 intangibles). This is effective for amounts paid or incurred after October 22, 2004. Taxpayers could elect to amortize start-up expenses paid or incurred on or before October 22, 2004 over 60 months. In many cases, start-up expenses for small businesses will be modest enough to qualify for immediate deduction under the $5,000 instant deduction allowance in the year when active conduct of business commences.

Example 1-1: Claiming the deduction for start-up expenses.

Suzie (a calendar-year taxpayer) incurs $52,000 of start-up expenses in 2010 before opening her new car wash that begins business in November of 2010. Suzie's 2010 deduction is $3,544 [$5,000 immediate writeoff − $2,000 (start-up costs over $50,000) plus amortization of $544 (based on capitalized amount of $49,000 ÷ 180 months × 2 months)]. The remaining capitalized cost of $48,456 is amortized on a straight-line basis over the subsequent 178 months ($272 per month).

Start-up Costs Defined

The general rule for start-up expenditures of a new business is that Section 195 treatment applies to expenses that would otherwise be currently deductible as ordinary and necessary business expenses under IRC Sec. 162 if they were incurred by an existing business. (Such expenses are referred to as Section 195 expenses.) Amounts required to be capitalized under the Section 195 rules (i.e., amounts in excess of $5,000 for most taxpayers) must be amortized over 180 months. This relatively favorable treatment is only allowed for start-up expenditures that are "Section 162-type" expenses.

Most start-up expenditures can be segregated into two broad categories: (1) investigatory expenses and (2) business preopening costs.

Investigatory expenses are costs incurred before reaching a decision to acquire or create a specific business. They include, but are not limited to, expenses for the analysis or survey of potential markets, products, labor supply, and transportation facilities [H. Rep. No. 96-1278, 96th Cong., 2nd Sess., reprinted in 1980-2 CB 712]. If incurred in investigating the acquisition of an existing business, investigatory expenses are Section 195 expenses only if the taxpayer actually acquires an equity interest in the business and then actively participates in managing that business.

Business preopening costs are expenses incurred after the taxpayer decides to establish or acquire a specific business, but before the active conduct of that business actually begins. Such costs can 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 similar professional services [H. Rep. No. 96-1278, 96th Cong., 2nd Sess., reprinted in 1980-2 CB 712]. However, if the activity was previously an activity entered into for the production of income and later converted to a trade or business, the expenses that occurred after the taxpayer first engaged in the activity but before the activity was converted to a trade or business do not need to be treated as start-up expenses. Instead, they will qualify as investment expenses deductible on Schedule A and subject to the 2% AGI limitation (*Toth*).

Impact of Section 263 Regulations

The issue of which amounts qualify as Section 195 expenses has been impacted by the Section 263(a) regulations. These regulations changed the rules regarding which amounts qualify as Section 162-type expenses. This fact was briefly mentioned in the preamble to the regulations (T.D. 9107). More specifically, amounts that must be capitalized under the Section 263(a) regulations simply do not qualify as Section 195 expenses. Instead, these capitalized amounts may (or may not) be eligible for amortization or depreciation under other tax rules. [See, for example, the amortization rules found in Reg. 1.167(a)-3.]

In general, Reg. 1.263(a)-4 requires capitalization of amounts paid to:

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

- Create intangible assets described in the regulations [i.e., if the asset in question is not described in the Section 263(a) regulations, costs to create the asset need not be capitalized under those regulations].
- 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.
- Create or enhance future benefits to be identified in yet-to-be published IRS guidance.
- Facilitate the acquisition or creation of intangible assets previously described.

In addition, Reg. 1.263(a)-5 generally requires capitalization of amounts paid to facilitate:

- Acquisition of assets constituting a trade or business or the acquisition of an ownership interest in a business when the taxpayer and the target entity are considered related parties.
- Acquisition of an ownership interest in the taxpayer.
- Certain business entity restructuring, reorganization, capitalization, and recapitalization transactions.
- Formation or organization of a disregarded entity (e.g., a single-member limited liability company or qualified Subchapter S subsidiary).
- Acquisition of capital (including stock issuances and borrowing transactions), and the writing of an option.

Amounts capitalized under the Section 263(a) regulations are generally added to the tax basis of the intangible asset that is acquired or created.

Example 1-2: Different tax treatments for different pre-opening expense items.

In 2010, Barb opens up a new retail store that is completely separate and apart from her existing business activities. In establishing the new retail business, Barb makes various start-up expenditures. Section 162-type expenditures that could be currently deducted by an existing retail business must be handled under the relatively favorable Section 195 rules (i.e., the first $5,000 can generally be deducted in the year when business begins with any excess expenses amortized over 180 months).

In contrast, start-up expenditures that must be capitalized under the Section 263(a) regulations *do not* qualify as Section 195 expenses. These amounts must be amortized or depreciated (if at all) under other tax rules.

For instance, Barb's start-up expenditures to recruit and train employees for the new retail store are Section 195 expenses. So are any start-up expenditures to advertise the new retail business. These types of expenditures are not required to be capitalized under the Section 263(a) regulations. However, Barb must capitalize the following start-up expenditures under the Section 263(a) regulations:

- Amounts paid to acquire a lease agreement for the new retail store and transaction costs to acquire or create the lease, such as attorneys fees to negotiate an agreement. These capitalized amounts can then be amortized over the life of the lease.
- Prepaid expense items—such as prepayments for liability and casualty insurance coverage for the retail store and any prepaid rent for the retail location. These amounts can generally be deducted in the periods to which they relate.
- For liability protection reasons, Barb pays an attorney to establish a new single-member LLC (SMLLC) for the retail operation. The SMLLC is a disregarded entity for federal tax purposes. However, amounts paid to facilitate the formation or organization of a disregarded entity generally must be capitalized under the Section 263(a) regulations. Unfortunately, there is apparently no provision allowing amortization of amounts capitalized under this rule.

- Barb may incur other start-up expenditures that must be capitalized under the Section 263(a) regulations. The only sure way to identify all these items is to carefully review the regulations.

In summary, start-up expenditures that must be capitalized under the Section 263(a) regulations do not qualify for the relatively favorable treatment allowed under the Section 195 rules. However, they may qualify for amortization or depreciation under other tax rules. Also, some amounts may escape the Section 263(a) capitalization requirement under various exceptions, as explained in the following discussion.

Taking Advantage of Favorable Exceptions to Avoid Capitalization. The Section 263(a) regulations include several favorable exceptions that negate the general capitalization requirement. In the context of business start-up expenditures, the most important exceptions are the following:

- The $5,000 *de minimis* rule for created contract right intangibles [see Reg. 1.263(a)-4(d)(6)(v)].

- The 12-month rule for created intangibles with short lives [see Reg. 1.263(a)-4(f)].

- For certain transaction costs: the exceptions for employee compensation, overhead, and *de minimis* costs of $5,000 or less [see Reg. 1.263(a)-4(e)(4)].

- For transaction costs specifically to facilitate the creation of financial interest intangibles and contract right intangibles: the exception for the cost of activities performed before the applicable bright-line date [see Reg. 1.263(a)-4(e)(1)(ii)].

- For costs to facilitate the formation or organization of a disregarded entity (e.g., an SMLLC or QSUB): the exceptions for employee compensation, overhead, and *de minimis* costs of $5,000 or less [see Reg. 1.263(a)-5(d)].

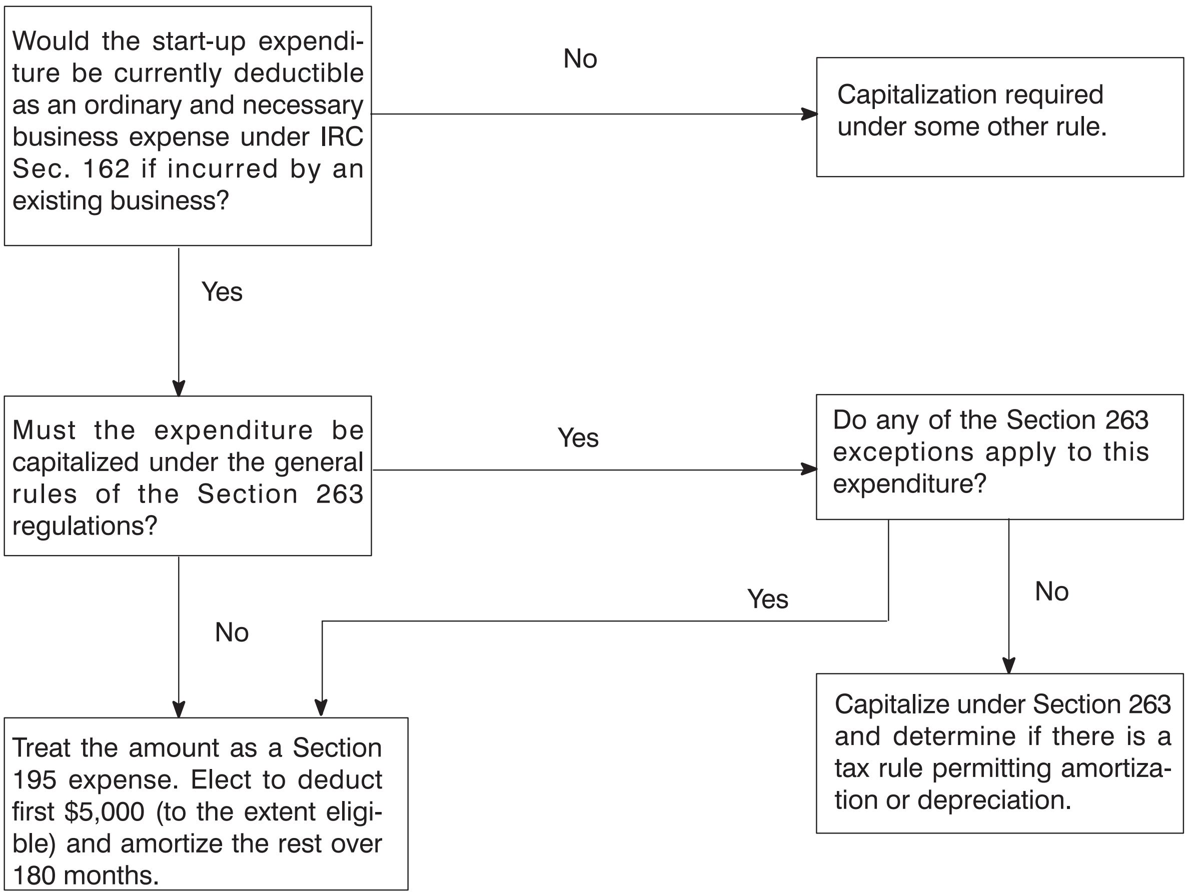
The final Section 263(a) regulations include several other exceptions that are not listed here. Depending on the client's exact circumstances, these other exceptions can be important too.

Steps to Classify Start-up Expenditures

The flowchart in Exhibit 1-2 helps to properly classify preopening expenditures incurred in connection with starting up a new business.

Exhibit 1-2

Determining the Tax Treatment of Start-up Costs



* * *

Business Expansion Costs

Taxpayers can claim current deductions for start-up expenditures to expand an existing business, provided such costs are properly classified as ordinary and necessary business expenses—in other words, Section 162-type expenses. For example, TAM 9645002 allowed current deductions for a retailer's costs to establish additional stores as part of a long-term expansion of an existing line of business. Same-line-of-business expansion costs can qualify as currently deductible Section 162 expenses even when the expansion is accomplished through an acquisition (e.g., when a chain of retail stores expands by acquiring the assets of another retail chain). The costs of employee hiring, relocation, training, and travel costs for visiting employees of the acquiring taxpayer are examples of Section 162-type expenses that can be currently deducted when paid or incurred.

In contrast, current Section 162 deductions are *not* allowed for start-up costs when the business 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 entity, or the target's assets could be purchased by a newly formed entity owned by the acquiring taxpayer. In such cases, Section 195 expense treatment would apply to expansion costs that would otherwise be currently deductible Section 162 expenses. (See *Specialty Restaurants Corp.* and TAM 8423005.)

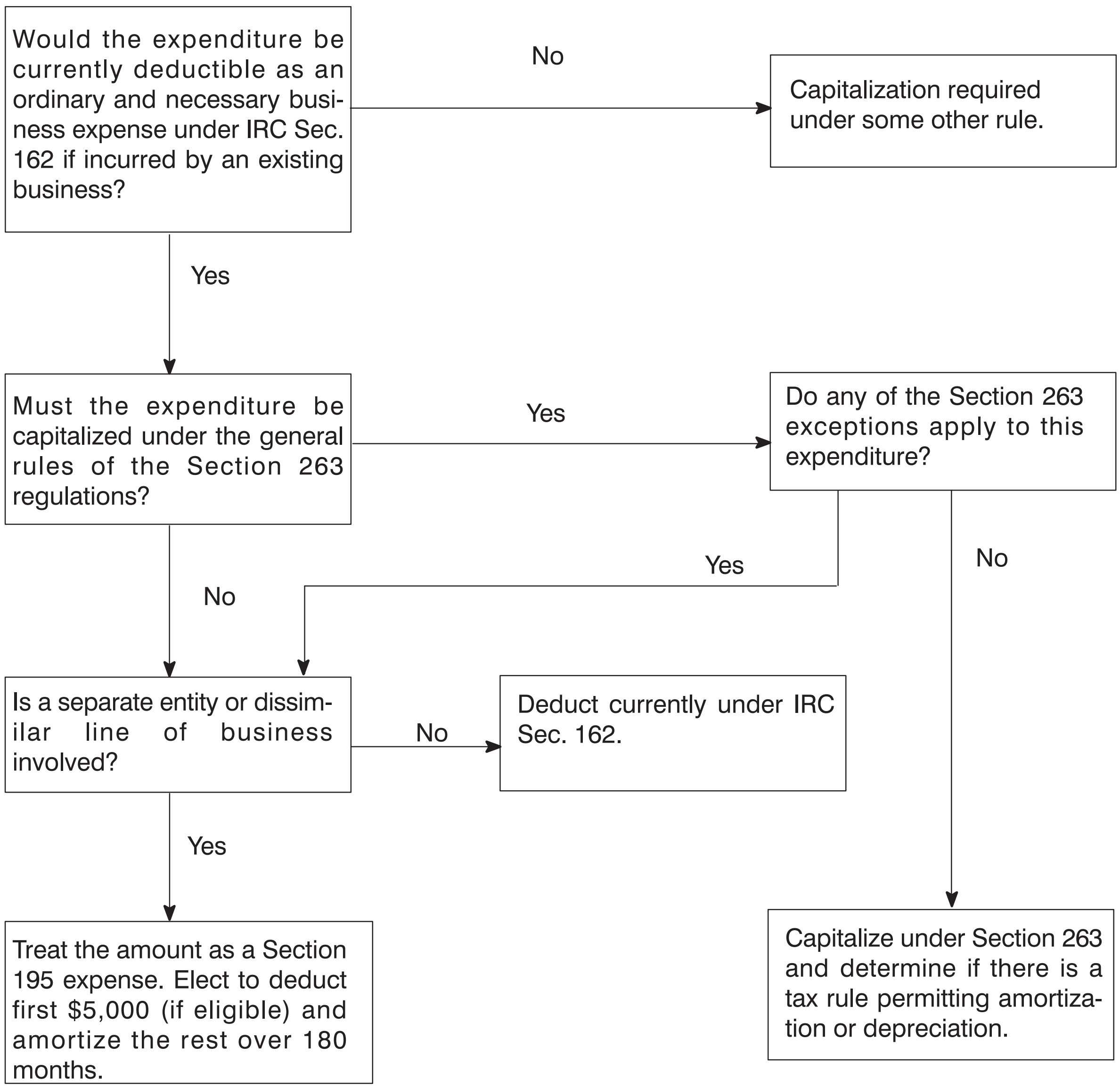
Same-line-of-business expansion/acquisition costs and dissimilar-line-of-business acquisition costs that must be capitalized under the Section 263(a) regulations do not qualify as currently deductible Section 162 expenses, nor do they qualify as Section 195 expenses. Instead, amounts required to be capitalized 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 allow taxpayers to avoid capitalization (e.g., the $5,000 *de minimis* rules previously mentioned).

Steps to Classify Business Expansion Expenditures

Use the flowchart in Exhibit 1-3 to classify pre-opening costs incurred in connection with business expansions and acquisitions.

Exhibit 1-3

Determining the Tax Treatment of Business Expansion Costs



*   *   *

Making the Election to Deduct Start-up Expenses

Before the issuance of final and temporary regulations on July 7, 2008 taxpayers wanting to make this election did so by filing a separate statement with their return. The temporary regulations changed how this works, probably because the vast majority of taxpayers that incur start-up expenses elect to deduct them.

Essentially, for eligible expenses paid or incurred after September 8, 2008, no election statement is needed. Instead, the taxpayer is deemed to have made the election to deduct start-up expenses for the tax year in which the active trade or business begins or the entity begins business. Therefore, under the temporary regulations, a taxpayer is no longer required to attach a statement to the return or specifically identify the deducted amount as start-up expenses for the election to be effective. Additionally, taxpayers may apply this new deemed election rule to expenses paid or incurred after October 22, 2004, provided the period of limitations on assessment of tax has not expired for the year. Presumably, this means that a taxpayer who inadvertently failed to attach an election statement for expenses incurred after this date to a previously filed (but still open) return can still deduct/amortize the expenses under the deemed election rule. In this case, an amended return would presumably be needed if the expenditures were not properly expensed and amortized. However, if all that was missing was the election statement, an amended return would presumably not be needed as nothing would change.

Alternately, the entity may choose to forgo the deemed election by clearly 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.

Treatment of Start-up Expenditures after Disposition or Abandonment of Related Business

If a business is completely disposed of before the related capitalized Section 195 start-up costs have been fully deducted, the unamortized balance can be deducted as an ordinary loss under IRC Sec. 165 and should be claimed as a miscellaneous itemized deduction (subject to the 2% limitation) on Schedule A of Form 1040.

The proper tax treatment of start-up expenditures when the taxpayer never actually enters into a business is not as clear. Individuals cannot deduct losses under IRC Sec. 165 unless they are related to a business or profit-making venture or the result of casualty or theft. Rev. Rul. 57-418 provides that losses incurred in the search for a business or investment are deductible only when the activities are more than investigatory, such as when the taxpayer actually enters into a specific transaction for profit, but the venture is later abandoned.

In Rev. Rul. 77-254, the IRS took the analysis one step further in concluding that a taxpayer will be considered to have entered into a specific transaction for profit if, based on all 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. In this case, the now-worthless expenditure amount can be claimed as a Section 165 abandonment loss and treated as a miscellaneous itemized deduction item (subject to the 2%-of-AGI limitation) on Schedule A of the individual's Form 1040. Rev. Rul. 77-254 also held that expenses related to the general decision on whether to enter into a trade or business (and which trade or business to possibly enter) are personal nondeductible expenses.

SELF-STUDY QUIZ

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

1. In February, 2010, Aaron opens a new printing business, incurring $35,000 of start-up expenses. Aaron has opted to run his business on a calendar year. How much will Aaron be able to deduct for start up expenses in 2010?

   a. $0.

   b. $2,139.

   c. $6,417.

   d. $6,833.

2. In 2010, John decided to open a sandwich shop. This sandwich shop is not part of his line of country-cooking restaurants that he currently owns and carries its own name. John finds the location of the store, stocks it and hires employees to run the shop. In addition, John has hired a lawyer to set up the sandwich shop as a new single-member LLC separate from the other restaurants. Which of the following expenses that John incurred with the start up of the new shop would receive the favorable treatment allowed under Section 195 rules?

   a. Overhead expenses for recruiting and training new employees for the sandwich shop.

   b. The amount John paid for the acquisition of the lease on the building for the new sandwich shop.

   c. Prepayment of liability insurance for the sandwich shop for 2010 and 2011.

   d. The attorney's fees to set up the sandwich shop as a single-member LLC.

3. A start-up expense for a business expansion has the following characteristics:

   - Deductible as an ordinary and necessary expense under IRC Sec. 162, if it had been incurred by an existing business.

   - Capitalized under the Section 263 regulations.

   - No Section 263 exceptions apply to it.

   What accounting treatment should the taxpayer apply to the start-up expense?

   a. The taxpayer should deduct the start-up expense of the business expansion under IRC Sec. 162.

   b. The start-up expense of the business expansion should be capitalized under Section 263 and then a decision should be made about amortization or depreciation.

   c. Handle the start-up expense of the business expansion as a Section 195 expense.

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. In February, 2010, Aaron opens a new printing business, incurring $35,000 of start-up expenses. Aaron has opted to run his business on a calendar year. How much will Aaron be able to deduct for start up expenses in 2010? **(Page 87)**

   a. $0. [This answer is incorrect. The Internal Revenue Code allows for a portion of start-up expenses to be deducted in the year when active conduct of the business begins. Aaron not only started the business, incurring the start-up expenses in 2010, his business opened for business in 2010, thus making him eligible for a start-up expense deduction.]

   b. $2,139. [This answer is incorrect. Start-up expenses must be capitalized and amortized over a 180 month period on a straight-line basis according to the Internal Revenue Code. This calculation is [($35,000/180 months) x 11 months that the business was open]. However, the taxpayer is eligible for an instant deduction allowance in addition to the capitalized expenses for businesses started after October 22, 2004.]

   c. $6,417. [This answer is incorrect. Before October 22, 2004, taxpayers could elect to amortize start-up expenses over a 60 month period according to the Internal Revenue Code. Since Aaron started his printing business after this date, he is not eligible for this amount.]

   d. $6,833. [This answer is correct. Aaron is eligible to deduct up to $5,000 of start-up expenses in the year when active conduct of business begins per the Internal Revenue Code. In addition to the $5,000, the remaining amount can be capitalized and amortized over 180 months on a straight-line basis. This makes Aaron eligible for a $6,833 deduction for start-up expenses in 2010. [($35,000-$5,000)/180] x 11 months that the printing business is in business for 2010.]

2. In 2010, John decided to open a sandwich shop. This sandwich shop is not part of his line of country-cooking restaurants that he currently owns and carries its own name. John finds the location of the store, stocks it and hires employees to run the shop. In addition, John has hired a lawyer to set up the sandwich shop as a new single-member LLC separate from the other restaurants. Which of the following expenses that John incurred with the start up of the new shop would receive the favorable treatment allowed under Section 195 rules? **(Page 88)**

   a. **Overhead expenses for recruiting and training new employees for the sandwich shop. [This answer is correct. Start-up expenditures to recruit and train employees for the new sandwich shop are Section 195 expenses under IRS regulations. These types of expenditures are not required to be capitalized under the Section 263(a) regulations and would be a Section 195 expense.]**

   b. The amount John paid for the acquisition of the lease on the building for the new sandwich shop. [This answer is incorrect. According to IRS regulations, amounts paid to acquire a lease agreement for a new store and the transaction to acquire or create the lease must be capitalized as start-up expenses under Section 263(a) regulations.]

   c. Prepayment of liability insurance for the sandwich shop for 2010 and 2011. [This answer is incorrect. Prepaid expense items, such as prepayment of liability insurance coverage, should be capitalized as start-up expenditures under the Section 263(a) regulations, not a Section 195 expense. Prepaid expenses can generally be deducted in the periods to which they relate.]

   d. The attorney's fees to set up the sandwich shop as a single-member LLC. [This answer is incorrect. The single-member LLC is a disregarded entity for federal tax purposes. Amounts paid to facilitate the formation or organization of a disregarded entity generally must be capitalized under the Section 263(a) regulations.]

3. A start-up expense for a business expansion has the following characteristics:

   - Deductible as an ordinary and necessary expense under IRC Sec. 162, if it had been incurred by an existing business.
   - Capitalized under the Section 263 regulations.
   - No Section 263 exceptions apply to it.

   What accounting treatment should the taxpayer apply to the start-up expense? (Page **91**)

   a. The taxpayer should deduct the start-up expense of the business expansion under IRC Sec. 162. [This answer is incorrect. The taxpayer can only deduct the expense under IRC Sec. 162 if it determines that the expense cannot be capitalized under the Section 263 regulations and the business expansion is not a separate entity or dissimilar line of business, per the Internal Revenue Code.]

   b. The start-up expense of the business expansion should be capitalized under Section 263 and then a decision should be made about amortization or depreciation. [This answer is correct. Based on this information, the correct tax treatment for the start-up expense of a business expansion would be to capitalize the expense under Section 263 of the Internal Revenue Code. Then, a determination should be made by the taxpayer if the expense is eligible for amortization or depreciation under the tax rules of the Internal Revenue Code.]

   c. Handle the start-up expense of the business expansion as a Section 195 expense. [This answer is incorrect. According to the Internal Revenue Code, the start-up expense for the business expansion can only be treated as a Section 195 expense if the expense cannot be capitalize under Section 263 regulations and the expansion is a separate entity or a dissimilar line of business.]

AVOIDING THE HOBBY LOSS TRAP

Activities Vulnerable to the Hobby Loss Trap

The Internal Revenue Code backs into the definition of 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 the management, conservation, or maintenance of property held for the production of income).

The determination of whether an activity is engaged in for profit is based on the facts and circumstances of each case and can be very subjective. See Exhibit 1-4 for a list of factors to consider.

Exhibit 1-4

Factors in Establishing a Profit Motive

- *Manner in Which the Taxpayer Carries on the Activity.* The lack of a businesslike approach (for example, not maintaining complete and accurate books and records) indicates a lack of profit motive.
- *Taxpayer's or Adviser's Expertise.* The taxpayer's lack of expertise and failure to consult experts in the field indicate the lack of profit motive. However, if the taxpayer can establish that he is attempting to develop new or improved techniques, a profit motive may be established.
- *Taxpayer's Time and Effort.* The activity need not be the only occupation of the taxpayer; however, the devotion of a substantial amount of time and effort indicates the existence of a profit motive. If the activity has significant personal or recreational aspects, the fact that the taxpayer devotes substantial time and effort may not be a strong indication of profit motive. Alternately, profit motive is indicated by taxpayer's employment of competent people to carry on the activity even though the taxpayer's time and effort are minimal.
- *Expectation of Appreciation in the Assets of the Business.* A reasonable expectation of asset appreciation indicates a strong profit motive. It is not always necessary that there be an expectation of profit derived from operations if there is a reasonable expectation of profit from appreciated assets.
- *Taxpayer's Previous Success.* The existence of a profit motive may be indicated by the taxpayer's prior experience. For example, if the taxpayer has previously turned an unsuccessful business into a successful one, this indicates that the taxpayer is seeking profit in the activity.
- *Prior Income and Losses of the Activity.* The existence of a profit motive can be indicated by the activity's past performance. Prior substantial net income is a strong indication that the activity is being operated for profit. Losses during the first years do not necessarily indicate the lack of profit motive if such start-up losses are normal.
- *The Amount of Occasional Profits and Their Relation to Losses and the Taxpayer's Investment.* Occasional profits will not by themselves indicate a profit motive if they are small in relation to the taxpayer's investment or if they are offset by large losses in other years.
- *Financial Status of the Taxpayer.* Lack of profit motive is indicated if the taxpayer has substantial income from other sources and the activity generates substantial tax or recreational benefits. Alternatively, the existence of a profit motive may be indicated by the fact that the taxpayer does not have substantial income from other sources.
- *Personal Pleasure or Recreation.* Although the presence of personal pleasure or recreation may indicate the lack of profit motive, the fact that the taxpayer may derive personal pleasure from the activity is not, by itself, sufficient reason to classify the activity as a hobby.

* * *

Many hobby loss issues center on the weekend farmer/rancher. However, the rules are applicable to any type of activity and have frequently been applied to auto racing; horse (or dog) racing, breeding, or showing; cattle breeding; certain "pyramid" marketing schemes; and acting, films, and filmmaking. 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 (*Fairbanks*; *Filios*). While maintaining financial records can be an indication of a taxpayer's profit motive (*Tamms*), the existence of financial records alone may not be enough to demonstrate that an activity is not a hobby (*Stasewich*). 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 (*O'Connor*).

Combining Activities to Avoid Hobby Treatment

Practitioners should be alert for situations where the combination of two similar activities may be beneficial, particularly when one activity without the other could be treated as a hobby rather than a legitimate business activity. The regulations allow multiple undertakings to be treated as a single activity if they are sufficiently interconnected. The most important factors in making this determination are the degree of organizational and economic interrelationship of the undertakings, the business purpose served by carrying on the undertakings separately or together, and the similarity of the undertakings. The Tax Court allowed a tobacco farmer in Kentucky who opened a display garden business to aggregate the farming and garden business activities as one for purposes of testing the hobby loss rules. The court determined that there was a close organizational and economic relationship between the farm and the display garden business, both activities were conducted at the same location, and both were attempts to make the farm profitable (*Tobin*). Conversely, the Tax Court rejected combining an apple farming activity with a dental practice despite the health aspect of each (*Zdun*). In another case, the Tax Court provided factors to consider when determining whether a taxpayer's activities should be separated or combined, including: (a) whether the undertakings are conducted at the same place, (b) whether they were formed as separate activities, (c) whether one activity benefits the other, (d) whether one activity is used to advertise the other, (e) the degree to which the undertakings share management, and (f) whether the same accountant works with the owner on both activities (*Topping*).

Ordering Rules for Claiming Hobby Deductions

If a proprietor activity qualifies as a trade or business carried on for profit, the income and expenses are reported on Schedule C (Form 1040). Losses are fully deductible, subject to the at-risk and passive activity loss limitation rules.

In contrast, an activity operating without a profit motive is subject to the hobby loss rules. The expenses from the activity are deductible only to the extent of income produced by the activity, reduced—

a. first by expenses incurred that are otherwise allowable without regard to profit motive (such as interest or taxes);

b. then by expenses incurred that would be deductible if the activity was engaged in for profit, but which do not result in an adjustment to the basis of the property, such as advertising, insurance, utilities, and wages; and

c. then by expenses meeting the requirements in item b. which result in a decrease in the basis of property, such as depreciation and amortization.

Expenses in item b or c are deductible only to the extent of the excess, if any, of income from the activity over the allowable expenses from item a. However, all the deductions allowable against hobby loss income under items b and c are reported on Schedule A as itemized deductions subject to the 2% limitation. Thus, a taxpayer may end up with net taxable income from a hobby even though the allowable expenses equal the activity's income.

Example 1-3: Hobby loss limitations.

Fred Ware derives $2,200 of income in 2010 from sailboat races. He does not expect to report a profit for three out of five years (2010 is his first year). Fred's expenses from the operation are as follows:

Storage and entry fees	$ 2,000
Maintenance	400
Insurance	800
Depreciation	600
Property tax	200
Total expenses	$ 4,000

Fred's AGI (before the sailboat racing activity) for the year is $95,000. He has no other miscellaneous itemized deductions.

Trade or Business. If Fred has engaged in the sailboat racing as a business for profit, all income and expenses from the activity are deducted on Schedule C of his personal tax return. Thus, he reports an $1,800 loss ($2,200 income − $4,000 expenses) on Schedule C attributable to the sailboat racing activity. This loss can offset other income and reduces self-employment income.

Hobby Loss. If Fred is unable to prove that he has engaged in the sailboat racing for profit, the expenses are deductible only to the extent of the hobby income of $2,200 and only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed 2% of AGI. The following schedule reflects the tax effects of the hobby determination.

Prize money		$ 2,200
Category a—expenses deductible without regard to the nature of the activity:		
Property tax	200	(200)
Subtotal		2,000
Category b—expenses not affecting basis that would be deductible if the activity had a profit motive:		
Storage and entry fees	2,000	
Maintenance	400	
Insurance	800	
Total	3,200	
Amount deductible (limited to income net of property tax)		(2,000)
Category c—expenses affecting basis that would be deductible if the activity had a profit motive:		
Depreciation	600	
Amount deductible (limited to net income of zero)		—
Net income from racing		$ -0-

However, the $2,000 of hobby loss Category b expenses is reported on Schedule A as miscellaneous itemized deductions subject to the 2% limitation. The net amount of miscellaneous itemized deductions is calculated as follows:

Miscellaneous itemized deductions from hobby	$ 2,000
2% of AGI [2% × ($95,000 + $2,200 hobby income)]	(1,944)
Net miscellaneous itemized deductions allowed	$ 56

Thus, Fred must report $2,200 of hobby income as "other income" on page 1 of Form 1040, but is allowed only $256 ($200 property tax + $56 miscellaneous itemized deduction) of offsetting deductions because of the 2% limitation on miscellaneous itemized deductions. The practical effect is to disallow deductions for $3,744 ($4,000 − $256) of expenses incurred in the hobby activity. There is no provision for the carryover of disallowed hobby expenses. The income is not subject to SE tax since it is derived from a hobby rather than from carrying on a trade or business.

Using the Safe Harbor Rule to Eliminate Uncertainty

A statutory safe harbor is provided that, if met, causes a presumption that the activity is a for-profit endeavor. If the safe harbor is not met, the taxpayer must establish a profit motive using the subjective factors discussed in the previous exhibit. To meet the safe harbor, an activity must generate a profit in at least three of five years (two of seven years for activities involving horse racing, breeding, or showing) ending with the tax year in question. If this 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). In most cases, if the safe harbor is met, the IRS will not attempt to rebut the presumption unless there are extenuating circumstances.

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 1-4: Applying the safe harbor rule.

Tim Jones begins a new activity in Year 1 and incurs losses from that activity in Years 1, 3, and 6. The activity is profitable in Years 2, 4, and 5. 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 mentioned in Exhibit 1-4).

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 1-5: Three profit years must precede safe harbor loss year.

At the end of Year 3 in Example 1-4, Tim could not rely on the safe harbor at that time (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 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, or showing) tax year after the tax year in which the taxpayer first engages in the activity. The advantage of this election over the general presumptive rule of IRC Sec. 183(d) is that losses from the activity during the five-year period are tentatively allowed during that period (as opposed to being disallowed until the activity has been profitable for three years) and reported on Schedule C. If the election is made and the activity is profitable for three or more of the five years, the activity is presumed engaged in for profit throughout the entire five-year period. The election shifts the timing of the ability to utilize the safe harbor rule to an earlier period. However, if the election is made and the taxpayer fails the three-out-of-five-year test, the taxpayer may be faced with a substantial tax deficiency for all years involved.

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) and execute a waiver of statute of limitations. The election of Form 5213 is filed, separate from any other form or return, with the IRS Service Center where the taxpayer files his tax return. Filing Form 5213 automatically extends the statute of limitations for any deficiency attributable to the activity. The statute extension runs until two years after the due date (without extensions) of the return for the last tax year in the five-year (or seven-year) presumption period.

Example 1-6: Electing to postpone the safe harbor profit presumption.

Assume the same facts as in Example 1-4. Also assume that, upon processing the return for Year 1, the IRS proposes to disallow deductions related to the loss for that year. Tim timely files the election to postpone the determination of the safe harbor profit presumption upon receiving the notice of deficiency for Year 1 (of course, not knowing yet how subsequent years would turn out). By making this election, then in fact the losses could be taken for Years 1 and 3 and the burden of proof would have been shifted to the IRS to disprove a profit-related activity for Years 1–5. [Determination of safe harbor profit presumption is delayed until the end of the fourth year following the first year of the activity (i.e., Year 5) and three of those five years produced net profit.]

Establishing a Profit Motive Based on Facts and Circumstances

If the taxpayer does not meet the safe harbor presumption discussed previously, the determination of whether an activity is engaged in for profit is based on the facts and circumstances of each case and thus can be very subjective. Exhibit 1-4 lists factors that should be considered in making this determination.

Although the activity must be engaged in for profit, the expectation of profit does not necessarily have to be "reasonable." It may be sufficient that a small chance of making a large profit exists. For example, a taxpayer may very well have a profit motive for investing in a risky venture (for example, wildcat drilling or providing capital to start-up businesses). The circumstances should indicate that the taxpayer entered into, or continued, the activity with the honest *objective* of making a profit.

Practical Steps for Establishing a Profit Motive. The practitioner should recommend that the client adopt some or all of the following actions to establish a profit motive:

- *Conduct the Activity in a Businesslike Manner.* Keep accurate books and records. Open a separate checking account for the activity. File the necessary business forms (for example, assumed name certificates) for all counties and states in which the activity does business. The Tax Court has ruled that books and records must be maintained for a bona fide business purpose (e.g., cutting expenses, increasing profits, or evaluating the overall performance of the business) and not merely a representation of attention to detail (*Stasewich*).

- *Eliminate Personal Pleasure and Recreation as a Major Factor for Conducting the Activity.* The mere fact that some pleasure or recreation is derived does not cause the activity to be classified as not-for-profit if other factors point to profit status. However, the potential for personal pleasure and recreation should be minimal.

- *Devote More Time to the Activity.*

- *Consider Hiring a Competent, Qualified Person to Operate the Activity.* Employing someone else to operate the activity accomplishes several goals: (a) it shows that the taxpayer is relying on others for their expertise; (b) it gives the taxpayer an opportunity to expand the activity and earn more income; and (c) it reduces the amount of personal pleasure and recreation derived from the activity.

Avoiding a Hobby Loss Issue by Setting up a New Entity

An important factor in establishing a profit motive is the manner in which the taxpayer carries on the activity, including such formalities as maintaining books and records. This factor is clearly enhanced when a taxpayer conducts the activity in a businesslike fashion, maintaining a separate checking account, accurate business records, and the other formalities normally associated with a for-profit trade or business.

A planning technique that should be considered is to incorporate the activity or set up a partnership. This can provide several benefits: (a) the company must use its own checking account for the activity and file a separate company income tax return, and (b) the taxpayer may receive a Form W-2 (or guaranteed payments) for labor provided to the company activity.

At a minimum, the existence of a separate company enhances the businesslike appearance. In fact, by using the additional procedures associated with the formation of a corporation or partnership and expanding the record-keeping requirements, the taxpayer would likely improve his or her ability to meet the various subjective factors that go into the determination of a hobby loss issue. (See Exhibit 1-4.)

SELF-STUDY QUIZ

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

4. Which of the following factors would point to an activity being classified as a hobby?

   a. The amount of time the taxpayer commits to the activity.

   b. If the taxpayer is an expert at the activity in which they are engaged.

   c. The taxpayer engages in the activity for personal recreation.

   d. Soliciting professional advice on how to make an activity profitable, but then not following the advice.

5. Mike earns $2,000 of prize money in 2010 from showing his classic '65 Mustang in car shows. Due to his age, Mike does not expect to continue participating in car shows for more than two more years. Mike's expenses for the car shows are as follows:

Property taxes on car	$ 200
Maintenance	2,000
Depreciation	500
Insurance	600
Total expenses	$ 3,300

   Mike's tax preparer establishes that Mike's car showing is deemed a hobby, not a trade or business. Mike's AGI for 2010 is $96,000. What amount must Mike report as other income on page 1 of Form 1040 for his hobby?

   a. $0.

   b. $1,160.

   c. $2,000.

   d. $3,300.

6. Based on the information provided in question 5, what amount of deductions would Mike be able to claim on his Form 1040 for his car showing in 2010?

   a. $0

   b. $840.

   c. $2,560.

   d. $3,300.

7. If a tax preparer is counseling a client on how to keep an activity from being classified as a hobby, which of the following would he or she suggest?

   a. Make sure the activity is one that the taxpayer feels passionate about.

   b. Become more involved in the day-to-day operations of the activity.

   c. Spend less time on the activity.

   d. Managing the activity like a 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.)**

4. Which of the following factors would point to an activity being classified as a hobby? **(Page 97)**

   a. The amount of time the taxpayer commits to the activity. [This answer is incorrect. The activity need not be the only occupation of the taxpayer; however, the devotion of a substantial amount of time and effort indicates the existence of a profit motive and would not be classified as a hobby.]

   b. If the taxpayer is an expert at the activity in which they are engaged. [This answer is incorrect. If a taxpayer is an expert in the field in which they are engaged and does not consult any other experts in the field, it could indicate a profit motive for the taxpayer and keep the activity from being classified as a hobby.]

   c. The taxpayer engages in the activity for personal recreation. [This answer is incorrect. Although the presence of personal pleasure or recreation may indicate a lack of profit motive, the fact that the taxpayer may derive personal pleasure from the activity is not, by itself, a sufficient reason to classify the activity as a hobby.]

   d. Soliciting professional advice on how to make an activity profitable, but then not following the advice. [This answer is correct. Obtaining professional advice about how to make the activity profitable is another indicator of a profit motive and would disqualify an activity from being classified as a hobby, but if the taxpayer does not follow the advice after it is obtained, it could demonstrate the lack of motive to make a profit and the taxpayer may have to claim the activity as a hobby.]

5. Mike earns $2,000 of prize money in 2010 from showing his classic '65 Mustang in car shows. Due to his age, Mike does not expect to continue participating in car shows for more than two more years. Mike's expenses for the car shows are as follows:

Property taxes on car	$ 200
Maintenance	2,000
Depreciation	500
Insurance	600
Total expenses	$ 3,300

   Mike's tax preparer establishes that Mike's car showing is deemed a hobby, not a trade or business. Mike's AGI for 2010 is $96,000. What amount must Mike report as other income on page 1 of Form 1040 for his hobby? **(Page 97)**

   a. $0. [This answer is incorrect. Since it has been determined that Mike's car showing is deemed a hobby and not a trade or business, Mike is not allowed all of the deductions that would be allowed for a trade or business and would offset the income from his prize money. Mike would need to report an amount for other income on his Form 1040 per the IRS regulations.]

   b. $1,160. [This answer is incorrect. In determining the amount that Mike would report as other income on page 1 of Form 1040, the allowable deductions for Mike's car showing are not included. They are reported separately in miscellaneous itemized deductions on Form 1040.]

   c. $2,000. [This answer is correct. Since Mike's car showing is deemed a hobby, all of the prize money that Mike won in 2010 should be reported as other income on page 1 of Form 1040 as indicated by the IRS regulations.]

   d. $3,300. [This answer is incorrect. The $3,300 is the total of the expenses that Mike has incurred for his car showing hobby. It does not affect the amount that Mike has to report on his Form 1040 as other income for his hobby according to IRS regulations.]

6. Based on the information provided in question 5, what amount of deductions would Mike be able to claim on his Form 1040 for his car showing in 2010? **(Page 97)**

   a. $0. [This answer is incorrect. While the deductions are subject to rules due to the hobby status of the activity, Mike is allowed deductions for 2010 per the IRS regulations.]

   b. $840. [This answer is correct. Mike is allowed a deduction of $840 for 2010. This is calculated by adding Mike's AGI for 2010 to his prize money of $2,000 for a total income of $98,000. This $98,000 is multiplied by the 2% of AGI limitation, which yields $1,960. The property taxes are allowed in full ($200), but the maintenance and insurance must be reduced by the AGI limitation ($2,000 + $600 - $1,960 = $640). Depreciation is not allowed as a deduction since it would reduce the basis of the property.]

   c. $2,560. [This answer is incorrect. This is the amount of disallowed deductions of expenses that will not be able to be carried over since there is no provision in the IRS regulations for the carryover of disallowed hobby expenses.]

   d. $3,300. [This answer is incorrect. Since Mike's car showing has been classified as a hobby, the expenses are only deductible to the extent of the hobby income. In addition, the expenses are subject to other limitations due to hobby status of the activity.]

7. If a tax preparer is counseling a client on how to keep an activity from being classified as a hobby, which of the following would he or she suggest? **(Page 100)**

   a. Make sure the activity is one that the taxpayer feels passionate about. [This answer is incorrect. A taxpayer should try to eliminate personal pleasure and recreation as a major factor for conducting the activity. If the activity is something the taxpayer enjoys coupled with the activity not generating a profit, it will lean towards being classified as a hobby.]

   b. Become more involved in the day-to-day operations of the activity. [This answer is incorrect. If the taxpayer employs someone else to operate the activity, it accomplishes several goals: (a) it shows that the taxpayer is relying on others for their expertise; (b) it gives the taxpayer an opportunity to expand the activity and earn more income; and (c) it reduces the amount of personal pleasure and recreation derived from the activity. So, the tax preparer would counsel the taxpayer to consider hiring a competent, qualified person to operate the activity, not encourage the taxpayer to become more involved.]

   c. Spend less time on the activity. [This answer is incorrect. The taxpayer should devote more time to the activity, not less. Devotion of a substantial amount of time and effort indicates that the taxpayer is trying to generate a profit.]

   d. Managing the activity like a business. [This answer is correct. To increase the likelihood of an activity being classified as for-profit instead of a hobby, a taxpayer should run the activity like a business. The Tax Court has ruled that books and records must be maintained for a bona fide business purpose and not merely for the representation of attention to detail.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TINTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following is most important for a self-employed taxpayer to identify, in order to decrease the taxpayer's federal and self-employment taxes?

   a. Start-up expenses.

   b. Business deductions.

   c. Related party transactions.

   d. Personal deductions.

2. Steven started a house-flipping business in 2010. Before he started the business, he made several trips to major markets to decide where he should start his business, based on the high-end realty market. After deciding on Los Angeles and purchasing his first house to flip, Steven hired a general contractor and an administrative assistant, who is interested in going into the flipping business, too. Steven is training the assistant on the ways of the business as they work. Steven continues to travel for the business to check out new products that are coming onto the market and what customers would want installed in their new house. Which of the following expenses could Steven deduct as an investigatory expense as part of his start-up expenditures?

   a. The amount spent to train the administrative assistant.

   b. Steven's travel when he is investigating new products.

   c. Travel expenses when Steven was analyzing potential markets.

   d. The wages paid to the general contractor of the business.

3. Rose is trying to determine the tax treatment for the start-up expenses she had when opening her flower shop in 2010. She has determined that the expenses would be currently deductible as an ordinary and necessary business expenses under IRC Sec. 162 if the expenses were incurred by an existing business. What is the next decision that Rose needs to make?

   a. Decide how many months the expenditures should be capitalized for.

   b. Conclude if the expense qualifies for a Section 263 exception.

   c. Handle the expenditures as a Section 195 expense and deduct the first $5,000 of start-up costs.

   d. Determine if the start-up expense should be capitalized under the Section 263 regulations.

4. If a taxpayer is attempting to combine activities of two businesses to keep one activity from being classified as a hobby, which of the following factors would facilitate the taxpayer in his or her end purpose?

   a. if one activity is used to advertise the other activity.

   b. If the two activities have their own management and are not commingled.

   c. If the two activities are owned by the same taxpayer.

   d. Each activity employs its own accountant to keep financial records.

5. Lee earns $4,000 of prize money in 2010 from racing his Camaro in local car races. He does not expect to continue to win this much in the next five years, since he has decided to stop racing so much, at his wife's request. Lee's expenses for the car races are as follows:

Property taxes on car	$ 200
Maintenance	2,000
Depreciation	500
Insurance	600
Total expenses	$ 3,300

Lee's tax preparer establishes that Lee's car showing is deemed a hobby, not a trade or business. Lee's AGI for 2010 is $90,000. What amount must Lee report as other income on page 1 of Form 1040 for his hobby?

a. $0.

b. $2,000.

c. $4,000.

d. $4,900.

6. Using the information in question 5, and knowing that Lee's AGI for 2010 is $90,000, what amount of deductions would Lee be able to claim on his Form 1040 from racing his car in 2010?

a. $0.

b. $720.

c. $920.

d. $1,880.

7. Thomas started building picnic tables for a profit in 2004. He incurred losses from the activity in 2004, 2006, and 2009. His building business generated a profit in 2005, 2007, and 2008. What year would the safe harbor test apply to Thomas' activity of building picnic tables?

a. 2004.

b. 2007.

c. 2008.

d. 2009.

Lesson 2: Miscellaneous Business Deductions And Options For The Self-employed Taxpayer

INTRODUCTION

Most business clients rightfully complain about the level of payroll (FICA or SE) taxes on their income. In 2010, the first $106,800 of employee wage income is subject to FICA tax at a rate of 15.3% (combined employer and employee shares). Wages above the $106,800 threshold continue to be subject to the Medicare health insurance portion of the FICA tax at a rate of 2.9% (combined employer and employee shares). There is no upper limit on the amount of wage income subject to the 2.9% tax rate. For SE income, the SE tax applies at the same rates on the same amounts of SE income, and like the FICA tax, there is no upper limit on the amount of income subject to the 2.9% tax rate.

This lesson presents planning ideas to help clients save FICA or SE tax dollars. (For simplicity, the text will sometimes refer to both FICA and SE taxes as payroll taxes.)

Learning Objectives:

Completion of this lesson will enable you to:

- Identify different options for a taxpayer to save on SE tax, including organization of the business, rental income, and health savings accounts.
- Discuss the rules for claiming a home office deduction and how to calculate basis of depreciation on a home office.
- Define business bad business, how a debt qualifies and how the taxpayer deducts a worthless debt and determine the Section 179 deduction limitations.

How Choice of Entity Impacts FICA and/or SE Tax

The choice of entity for a client's business hinges on a host of tax and nontax factors. The ability of an entity choice to minimize FICA and SE taxes is an important factor to consider. Practitioners should be prepared to counsel clients on the impact that the choice of entity will have on FICA and/or SE taxes.

Exhibit 2-1 summarizes each entity's FICA and SE tax treatment of pass-through income and other wage-type payments made to the business's owners.

Exhibit 2-1

SE and FICA Tax Treatment of Pass-through Income and Owner Wage Payments

Entity	Explanation
C Corporation	Wages paid to the shareholder-employee are subject to FICA tax.
S Corporation	Wages paid to a shareholder-employee are subject to FICA tax. Pass-through income is excluded from the shareholder's SE income. IRS looks to see that compensation is "reasonable."
General Partnership:	
1. General Partner	Pass-through income is included in the partner's SE income if the partnership engages in a trade or business. Guaranteed payments to a general partner are included in SE income.
2. Retired Partner	Retirement income under a written plan is excluded if the retired partner receives life-long periodic payments, his share of partnership capital has been fully repaid, he performs no services, and the partnership owes the partner only retirement payments.

Entity	Explanation
Limited Partnership:	
1. General Partner	Pass-through income is included in the partner's SE income if the partnership engages in a trade or business. Guaranteed payments to the general partner are included in SE income.
2. Limited Partner	Pass-through income is excluded from the limited partner's SE income. Guaranteed payments for services are included in SE income.
Limited Liability Company (LLC) Treated as a Partnership	Practitioners currently have little guidance in determining whether LLC members are subject to SE tax on pass-through income. Guaranteed payments to managing members for services rendered to the LLC are included in SE income.
Sole Proprietorship	All proprietor earnings are SE income. This is true whether the proprietor works in the business or hires others to do the work.

* * *

Maximizing S Shareholder Distributions to Minimize Payroll Taxes

The taxable income passed through by an S corporation to shareholder-employees is not self-employment income for SE tax purposes. This has lead to the tax planning strategy of minimizing the salary of S corporation shareholder-employees (and thus minimizing the payroll tax liability) and maximizing the amounts treated as S corporation dividend distributions. This still gets the cash in the hands of the shareholder-employee while minimizing the payroll tax burden. However, the taxpayer's age and qualification for maximum social security benefits should be considered before minimizing the current year payroll taxes.

Example 2-1: Minimizing salary income of S corporation shareholder-employees.

Kevin is the sole shareholder of KJ, Inc., an S corporation. He works full-time in the business. During 2010, the corporation passes through ordinary income from operations of $85,000. The corporation pays an annual salary to Kevin of $40,000. In addition, the corporation distributes $85,000 to Kevin during the year as a distribution rather than paying this amount out as additional salary. Thus, wages and distribution payments to Kevin for the year total $125,000.

If the $40,000 is a reasonable salary for the services performed by Kevin, the transaction will probably withstand IRS scrutiny. In that case, the company and its shareholder have collectively saved the following amount of FICA tax by not paying the entire $125,000 as salary income to Kevin:

OASDI Savings—[($106,800 wage base − $40,000 salary) × 12.4%]	$ 8,283
HI Savings—[($125,000 − $40,000) × 2.9%]	2,465
Total FICA tax savings	$ 10,748

Example 2-2: S shareholder distributions recharacterized as salary.

Assume the same facts as in Example 2-1 except the IRS determines the $40,000 salary paid to Kevin is unreasonably low. The IRS could recharacterize some or all of the $85,000 cash distributions as salary income subject to payroll taxes. Payroll tax penalties could also apply. The pass-through income from the S corporation would be amended to reflect the deemed wages and additional payroll taxes.

The court decisions noted previously dealt with situations where the shareholder-employees' wages were clearly understated to an extreme extent. The decisions do not change the fact that S corporations are free to characterize the minimum amount that is *reasonable* under the circumstances as wages paid to shareholder-employees.

Thus, the planning technique works, but it must be used with judgment. In situations where any question exists, it is probably wise to document why amounts characterized as wages were not so low as to be unreasonable in relation to the services performed by the shareholder-employee. In addition, clients should be made aware that unreasonably low compensation of S corporation shareholder/employees is sometimes an audit issue with the IRS. Audit exposure is high especially when the shareholder/employee is a corporate officer (*Spicer Accounting, Inc.*).

Incorporating a Sole Proprietorship Can Save Payroll Taxes

If a self-employed client is willing to live with the advantages and disadvantages of corporate taxation, using a C or S corporation can save payroll taxes. This is because essentially all of a sole proprietor's business income is subject to SE tax, while only the wage or salary income of a shareholder-employee is subject to FICA tax.

Incorporating a sole proprietorship can be especially beneficial when the business needs to retain income for expansion or debt retirement. Corporate income, unlike proprietor income, can be retained in the company free of either FICA or SE tax.

Example 2-3: Incorporating a sole proprietorship.

David Stevens operates a repair business as a sole proprietor. In recent years, David has reported about $85,000 of net income, all of which has been subject to SE tax. On the average, David has been withdrawing about $60,000 from the business for personal use, while the remaining $25,000 of earnings has been used for equipment, tools, and business cash flow needs.

David's tax practitioner suggests that David consider incorporating the business as a C corporation. The corporation would pay a $60,000 salary to David and retain the other $25,000 within the business for equipment and business cash flow. If this is done, it saves approximately $3,500 ($25,000 × .9235 × 15.3%) in SE tax.

Minimizing SE Taxes for an LLC Member

It is no secret that one of the most controversial limited liability company (LLC) tax issues is whether earnings from an LLC are SE income. The focus of the controversy is whether LLC members are treated as limited partners. If they are, IRC Sec. 1402(a)(13) allows them to exclude their share of LLC income from SE tax [except, of course, for any guaranteed payments for services under IRC Sec. 707(c)—such payments *are* subject to SE tax even if made to a limited partner].

In 1997, Prop. Reg. 1.1402(a)-2 was issued. Generally, the regulation provides that an LLC member, except in a service LLC, will be subject to self-employment tax on the member's share of the LLC's income if the member meets one of the following three tests:

a. The member has partial or total personal liability under state law for the LLC's obligations (liability created by guarantees, endorsements, or otherwise is not counted).

b. The member has statutory or contractual authority to make contracts on behalf of the LLC under the law of the state in which the LLC was formed.

c. The member participates in the LLC's business for more than 500 hours per year.

The default rules in most states provide that all LLC members have contract authority, causing the members to be subject to SE tax under item b. If the business operations of the LLC do not require all members to be able to act as an agent and/or have contract authority, the LLC should consider amending its articles of incorporation to limit this authority to the members who participate in day-to-day management of the LLC.

Some LLC members are automatically subject to SE tax on their LLC earnings because they fall under either items a or b. However, those who do not fall into these categories, but who participate in the LLC's operations may be able to control whether or not they are subject to SE tax by tracking and manipulating the number of hours they participate in the LLC's business each year. In some cases, deferring participation from December to the following January may allow the member to fall below the 500 hour threshold.

The proposed regulations do not provide any guidance on how the 500-hour participation test is applied. Possibly, the test will be applied in a manner similar to the passive activity regulations, which excludes participation in an individual's capacity as an investor.

The proposed regulations permit an owner of two different interests in an LLC to be a limited partner in one of them if (a) the member fails to qualify as a limited partner because of one of the three tests above; (b) the limited partner ownership class is owned, at least in part, by other limited partners; (c) the other limited partners own a substantial (generally 20% or more) continuing interest in the second class; and (d) the multiple class owner's rights and obligations with respect to the second class are identical to the rights and obligations of the other limited partners in the class. Individuals meeting these four tests would not be subject to SE tax on earnings related to the second ownership class under the proposed regulations.

Under Prop. Reg. 1.1402(a)-2(h)(5), a service member or partner in a service entity can never be considered a limited partner. A service member is a member who provides other than *de minimis* services to the service LLC. No example of "*de minimis*" services is included in the proposed regulations. A service entity is one in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting. Service members of service LLCs appear to be subject to SE tax regardless of how the membership is structured.

Example 2-4: Member providing *de minimis* services in a service LLC.

Megabyte LLC is a computer consulting firm. Lotta Kash has contributed a substantial amount of money to the LLC in exchange for a membership interest. Lotta Kash provides no services to the LLC, but does attend monthly business meetings. Megabyte LLC is a service LLC, but Lotta Kash is not considered a service member because she provides only *de minimis* services. However, even though she is not subject to SE tax under the specific rules that apply to service LLCs, her distributive share of LLC income is still subject to SE tax unless she is a limited member under the general rules of the proposed regulations.

Leasing Property to a Closely Held Business

A common tax planning strategy is for individuals to lease property to their closely held corporations or partnerships, especially in those states that do not impose sales or use tax on rental transactions. This can be an effective technique for withdrawing cash from a business entity without FICA or SE taxes, as would otherwise occur with salaries or guaranteed payments.

Rentals of Real Property. Rentals of real property (and from personal property leased with the real estate) held for investment do not generate SE income unless services are rendered to the occupants. For example, income earned by leasing investment (nondealer) real estate to a closely held business is not SE income.

In contrast, real property rental income received by a real estate dealer in the ordinary course of business is subject to SE tax. Similarly, rental income from real property activities in which services are rendered to occupants is SE income. Thus, rents earned by leasing living quarters, or for the use or occupancy of space in parking lots, warehouses, or storage facilities are SE income if services are rendered.

Example 2-5: Rental income from real property.

Harry Henderson leases a plant facility and the underlying land to his closely held corporation, Henderson Hardware Inc. (HHI). Harry receives $48,000 of rental payments each year. Harry is president of the company and is employed full-time. Under the terms of the lease, HHI is responsible for all taxes, insurance, maintenance, and upkeep of the property. Harry does not own or lease any other real property or equipment to HHI or to any other business. Nor does HHI engage in any other real estate leasing or development activities. (Assume, based on this, that Harry is not a real estate dealer.) Harry is paid a reasonable salary by the corporation.

The $48,000 of rental payments is not self-employment income to Harry because he is not a real estate dealer and no services were rendered. (However, this amount would be subject to a combined 15.3% FICA tax if it were paid out to Harry in the form of wages.) As an added benefit, the corporation's rental payments are deductible and provide an additional way to get cash out of the corporation free of double taxation.

Rentals of Personal Property. Rentals of tangible personal property (such as business equipment) do not generate SE income unless the rental activity rises to the level of a trade or business. Whether an activity constitutes a trade or business depends on such factors as profit motive, the amount of time devoted by the taxpayer, and whether the activity is done on a regular and continuous basis (*Groetzinger*).

In *Stevenson*, for example, the Tax Court found that a taxpayer who operates a sole proprietorship engaged in the sale and rental of portable signs was engaged in a trade or business. The taxpayer purchased the portable signs, advertised their availability, received calls for their rental, and maintained bank accounts for the rental venture. In contrast, casual rentals of personal property would not constitute a trade or business and, thus, the income would not be subject to SE tax.

Example 2-6: Rental income from personal property.

John Stevens owns a lathe machine that he leases to Popco, a closely held corporation controlled by his father. John receives rental payments of $18,000 per year. John is a machinist employed full-time by Popco. Under the terms of the lease, Popco is responsible for all maintenance and upkeep of the equipment. John does not own or lease any other equipment to Popco or any other business. He does not maintain separate bank accounts or records for this activity.

Whether the rental activity constitutes a trade or business subject to SE tax is determined based on the facts. Since John has a full-time position, is not actively involved in this rental activity, and does not engage in any other leasing transactions, it is the authors' opinion that the activity is not a trade or business and does not produce SE income.

Renting Property to a Proprietor Spouse Reduces SE Income

When a married couple jointly owns property that is used in a spouse's sole proprietorship, the couple can rent the property to the proprietor spouse, who then deducts (on his or her Schedule C) the portion of the rent attributable (paid) to the nonproprietor spouse. An equal amount of rental income is reported on Schedule E. Deducting rent paid to a spouse reduces the couple's overall tax liability since it reduces the proprietor's SE tax without any corresponding tax increase to the other spouse.

In a decision affirmed by the 8th Circuit, the Tax Court allowed a taxpayer to deduct on his Schedule C rent paid to his spouse. In *Cox*, a self-employed attorney used an office in a building jointly owned (as tenants by entireties) by him and his spouse. He paid rent to himself and his spouse, claimed a Schedule C business deduction, and reported the rent income on Schedule E of their joint return. The Tax Court held that since the property was held jointly and each spouse was therefore entitled to half of the rental income, a Schedule C business deduction (and an equal amount of Schedule E rent income) was allowed for half of the rent paid. No deduction was allowed for the half allocable to the attorney since he had an equity interest in the business.

Example 2-7: Business rent paid to spouse.

George Sheppard operates a small retail grocery business out of a building jointly owned by him and his wife, Sheila. Fair rental value for the building space George uses is $1,500 a month. In 2009, George paid a total of $18,000 in rent from his business account to his and Sheila's joint account.

Because the property is jointly held, only half of the rent is allocable to Sheila, who has no ownership in George's grocery business. Thus, George can deduct $9,000 of rent expense on his Schedule C. They also report $9,000 of rent income on Schedule E (along with any other rent from the building). Depreciation and other property expenses related to the office space are reported half on Schedule C (George's ownership) and half on Schedule E (Sheila's ownership).

Based on the *Cox* holding, it appears that if property is owned as the separate property of one spouse and rented to the sole proprietorship of the other spouse, 100% of the rent paid can be deducted on the sole proprietor's Schedule C, with a corresponding amount reported on Schedule E as rent income. Less clear is the proper treatment when property is rented to a single-member limited liability company (LLC), that has elected to be treated as a sole proprietorship. Although the LLC is taxed as a sole proprietorship, it is generally a separate legal entity from the owner under state law. Thus, it appears a case could be made to deduct on Schedule C (for the LLC) 100% of the rent paid to the owners, even if the property is jointly held. Of course, an equal amount must be reported as rent income on Schedule E. This is a gray area, so the practitioner should proceed with extreme caution and weigh the benefits versus the risk involved.

Employing Family Members

Employing family members can be a useful strategy to reduce overall tax liability. If the family member is a bona fide employee, then the taxpayer can deduct the wages and benefits, including medical benefits, paid to the employee on Schedule C or F as a business expense (*Frahm*; *Eyler*).

Employing the spouse can reduce overall tax liability because the spouse can receive tax-free reimbursement of medical expenses from the business, even though the business deducts the reimbursements. The self-insured reimbursement plan can cover the entire family, so the family's out-of-pocket medical expenses (including health insurance premiums) are paid with pre-tax dollars. Properly structured and administered, a self-insured medical reimbursement plan established for the self-employed owner's employee-spouse can save both income and SE taxes. The plan should be in writing, the employee-spouse should observe all the formalities of being a true employee (employment agreement with expected duties and hours to be worked, time sheets to document hours and tasks performed, etc), and the employee-spouse should pay the out-of-pocket expenses to the medical providers and actually be reimbursed by the plan with a check drawn on the company account (*Albers*; *Eyler*; *Francis*). However, the business must provide the medical benefit to all qualifying employees. Thus, the cost may be prohibitive unless there are few other employees that would qualify for coverage. In addition, the spouse would be subject to FICA on the spouse's employee compensation. If the business has more than $106,800 (for 2010) in net income, the decrease in income taxes for the spouse's compensation would be partially offset by the increase in social security taxes.

Employing the taxpayer's children can reduce overall tax liability. Children under age 18 who work for their parents are not subject to FICA or FUTA taxes. In addition, wage income would be taxed at the child's lower tax rate and may be wholly or partially offset by the child's standard deduction of up to $5,700 (for 2010). The wages must be reasonable for the work done. Additionally, a sole proprietor can provide up to $5,250 in annual tax-free educational assistance (for both undergraduate and graduate courses) to each eligible employee and deduct the costs. Properly arranged, this benefit is available to the sole proprietor's child that is: (1) age 21 or older, (2) a legitimate employee of the business, (3) not more than a direct 5% owner of the business, and (4) not a dependent of the parent business owner. See IRC Sec. 127(b) for the qualification rules for these tax-free educational assistance programs.

OBTAINING TAX BENEFITS WITH HEALTH SAVINGS ACCOUNTS (HSAs)

The Medicare Prescription Drug and Modernization Act of 2003 (Medicare Act) established Health Savings Accounts (HSAs), which are targeted mainly at self-employed taxpayers, small business owners, and employees of small-sized to medium-sized firms. While the Medicare Act established HSAs, taxpayers do not have to be senior citizens to benefit.

The tax benefits of HSAs are quite favorable and substantial. Eligible individuals can make tax deductible (as an adjustment to AGI) contributions into HSA accounts. The earnings inside the HSA are free from federal income tax and funds are later withdrawn tax-free to pay eligible health care costs.

Key Definitions for HSAs

An HSA is a tax-exempt trust or custodial account established exclusively for the purpose of paying 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). Consequently, an HSA is not insurance; it is an account, which must be opened with a bank, brokerage firm, or other provider (i.e., insurance company). It is therefore different from a flexible spending account in that it involves an outside provider serving as a custodian or trustee.

An HDHP is generally a health plan that satisfies certain requirements with respect to deductibles and out-or-pocket expenses. Specifically, for self-only coverage for 2010, the qualifying HDHP must have (a) an annual deductible of at least $1,200 and (b) an annual limit on total out-of-pocket costs (including the deductible, co-payments, and other amounts, but not premiums) for covered benefits of no more than $5,950. For family coverage, the qualifying insurance must have (a) an annual deductible of at least $2,400 and (b) an annual cap on total out-of-pocket costs of no more than $11,900. These amounts are adjusted for inflation. For family coverage, a plan is an HDHP only if, under its terms and without regard to which family member or members incur expenses, no amounts are payable from it until the family has incurred annual covered medical expenses in excess of the minimum annual deductible. Higher deductibles for out-of-network services do not count towards the annual deductible limit and out-of-pocket costs for out-of-network services are not counted towards the annual cap for the HDHP. Finally, it is permissible for the plan to not impose any deductible (or a deductible lower than the HDHP minimum) for preventive care (such as annual checkups). However, except for preventive care, a plan may not provide benefits for any year until the deductible for that year is met. Notice 2004-23 (and its appendix) provides a safe-harbor list of services considered to be "preventive care" for purposes of the HDHP rules.

Example 2-8: Qualifying as an HDHP.

Tim has a plan that provides coverage for himself and his family. The plan has a *family* deductible of $2,400 and provides for the payment of covered medical expenses of any member of Tim's family if the member has incurred covered medical expenses during the year in excess of $1,000, even if the family member has not incurred covered medical expenses in excess of $2,400. Therefore, if Tim's son John incurred covered medical expenses of $1,500 in a year, the plan would pay $500. Because benefits are potentially available before the family's (or any one member of the family's) covered medical expenses exceed $2,400, the plan is not an HDHP.

<u>Variation:</u> Assume the same facts, except that the plan has a $5,000 *family* deductible and provides payment for covered medical expenses if any one member of Tim's family has incurred covered medical expenses during the year in excess of $2,400. The plan satisfies the requirements for an HDHP with respect to the deductibles.

Eligibility Guidelines

An HSA must be established by an eligible individual; i.e., an individual who with respect to any month has qualifying high-deductible health coverage as of the first day of that month. Generally, individuals are ineligible for any month they also have any nonhigh-deductible health coverage (whether as an individual, spouse, or dependent) that covers any benefit also covered under the high-deductible insurance plan. However, an otherwise eligible individual who has family HDHP coverage that includes a dependent with disqualifying, non-HDHP coverage, the individual is still an eligible individual. In applying these restrictions, however, the following types of health-related insurance and coverage are ignored:

a. Workers compensation insurance.

b. Tort liabilities.

c. Liabilities relating to ownership or use of property.

d. Insurance for a specific disease or illness (for example, cancer insurance).

e. Insurance that pays a fixed amount per day or other period of hospitalization.

f. Coverage, whether through insurance or otherwise, for accidents, disability, dental care, vision care, or long-term care.

An individual who is covered by an employer-sponsored healthcare flexible spending account plan (FSA), health reimbursement arrangement (HRA), or Section 105 medical reimbursement plan will typically be ineligible to make HSA contributions. The same is true when a person is covered by such an arrangement via his or her spouse's employment. The reason is these arrangements are considered "heath plans" under the HSA rules, and they typically provide benefits on a first-dollar basis. Therefore, they violate the rule that an HSA contributor cannot be covered by a health plan that is not an HDHP.

Two exceptions are when the FSA plan, HRA, or Section 105 plan (a) pays benefits only after the HDHP's deductible has been met or (b) provides coverage only for those limited types of expenses that are allowed to be covered by an HDHP before the deductible is satisfied (e.g., dental and vision care and certain preventive care). In these two circumstances, HSA contributions would be allowed assuming all the other eligibility rules are met. Other exceptions are when the individual is only covered by a suspended HRA (pursuant to an election) or by a retirement HRA that pays or reimburses only for medical expenses incurred after retirement.

Also, in IRS Notice 2005-42, the FSA "use-it-or-lose-it" rule was relaxed and employers are now allowed to extend the year-end deadline for employees to spend down FSA balances by providing a grace period following the FSA's year end for up to 2½ months. An individual participating in a health FSA who is covered by the grace period is generally not eligible to contribute to an HSA until the first day of the first month following the end of the grace period. However, participation in an FSA during the grace period does not disqualify the individual from being an HSA-eligible individual during that grace period if: (a) the balance in the FSA at the end of the prior year is zero, or (b) the individual is making a qualifying rollover distribution of the entire balance in the FSA, later in this lesson.

Example 2-9: Interaction of FSA grace period and HSA eligibility.

Tim is single with no dependents. He participated in his employer's calendar year FSA plan for 2009, which allows a 2½ month grace period (ending March 15, 2010) to spend down his $500 FSA balance remaining at the end of 2009. He does not participate in the FSA for the 2010 calendar plan year. Assuming Tim has no other disqualifying coverage for 2010, he is HSA-eligible on April 1, 2010. While Tim may contribute the full deductible amount of $3,050, he may not use any of these contributions to cover medical expenses incurred in January—March 2010. Alternatively, Tim's employer may roll over the unused balance of the FSA into Tim's HSA. Also, if Tim's FSA balance at the end of 2009 was zero, his participation in the FSA during the January—March 15, 2010 period would not disqualify him as an eligible individual for an HSA during that time.

Further, no HSA contributions are allowed for a person who can be claimed as a dependent on another person's federal income tax return for the year in question. Also, contributions are not allowed for the month an individual becomes eligible for Medicare (age 65 under current law) and for all subsequent months.

Contributions to HSAs

Tax Treatment of Contributions. 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. Also, contributions can be made by or on behalf of an eligible individual even if the individual has no compensation or if the contributions exceed their compensation.

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 2010, the maximum monthly contribution for eligible individuals is 1/12 of $3,050 for single coverage or $6,150 for family coverage. Also, for tax years beginning after 2006, 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 in December), he 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 testing period which 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 the amount contributed for the period he or she was ineligible as income 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 10% penalty tax 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 2-10: Annual contribution to an HSA.

William is a self-employed sole proprietor. He begins self-only coverage under an HDHP on August 1, 2010 and continues to be covered throughout the remainder of the year. He continues this coverage beyond December 31, 2011. The annual deductible is $4,000 under the plan. For 2010, William can contribute (and deduct) a maximum amount of $3,050 to an HSA.

Variation: William accepts a new position with Whizzigig, Inc. in June 2011. Whizzigig provides comprehensive medical coverage as part of its compensation package. Since William ceased being an eligible individual prior to December 31, 2011, he must report $1,779 ($3,050 × 7/12 related to January–July 2010) recapture income on his 2011 return, plus pay $178 ($1,779 × 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 the aggregate contributions to an MSA. Contributions may be made by or on behalf of eligible individuals even if the individuals have no compensation or if the contributions exceed their compensation. For an individual with more than one HSA, the aggregate annual contributions to all HSAs are subject to the limit.

Contribution Limits for Older Individuals. An participant (and his or her spouse covered under an HDHP) who is 55 or older as of the end of the tax year for which an HSA contribution is made is allowed to make a larger deductible contribution. Specifically, the annual contribution limit that would otherwise apply is increased by $1,000. However, the participant loses the right to make HSA contributions after reaching the Medicare eligibility age, which is age 65 under current law.

Example 2-11: Catch-up contributions to HSAs for older individuals.

Amanda has family health insurance coverage with a $3,000 deductible. If she will be 55 or older on December 31, 2010, she can contribute up to $7,150 to her HSA for 2009 (the normal $6,150 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, 2010, Amanda can contribute up to $8,150 to her HSA (the normal $6,150 limitation + $1,000 extra due to her age + another $1,000 extra due to her spouse's age).

Variation: Assume the same facts except that Amanda is not married and attains age 65, becoming eligible for Medicare benefits, in July 2010. She cannot make HSA contributions (including catch-up contributions) after June 2010. Amanda can make total contributions for 2010 (January through June) equal to $3,575 [($6,150 × 6/12) + ($1,000 × 6/12)].

Spouses with Family Coverage. If either an individual or spouse has family coverage, they are both considered to have family 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 and the limit is divided between them by agreement. If the spouses have different family 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 spouse's non-HDHP does not cover the individual. Consequently, that individual may contribute to an HSA. The following two examples illustrate how the HSA contribution limitation rules work in this scenario.

Example 2-12: Spouse not under other spouse's non-HDHP coverage.

Tim and Nancy are married. Both are under age 55. For all of 2010, Tim has self-only coverage under an HDHP with a $2,000 annual deductible. He has no other health coverage. Nancy has non-HDHP family coverage for herself and the couple's two dependent children. Tim is not covered by Nancy's non-HDHP. Because he has no health coverage beyond his own HDHP, Tim is eligible to contribute up to $3,050 to an HSA for the 2010 tax year (the maximum contribution amount for self-only coverage for 2010). Since Nancy is under non-HDHP coverage, she is ineligible to make any HSA contribution for 2010.

Example 2-13: Spouse and child not under other spouse's non-HDHP coverage.

Assume the same facts as in Example 2-12, except that Tim has HDHP family coverage for all of 2010 for himself and one of the dependent children. The HDHP has an annual deductible of $5,000. Nancy has non-HDHP family coverage for herself and the other dependent child. Once again, Tim has no other health coverage and is not covered by Nancy's non-HDHP. Because he has no health coverage beyond his own HDHP, Tim can contribute up to $6,150 to an HSA for the 2010 tax year (the maximum for family coverage for 2010). Nancy has non-HDHP coverage and is therefore ineligible to make any HSA contribution for 2010.

Example 2-14: Calculating contribution and catch-up amounts with two separate family coverage HDHPs.

David, age 58, and Mary, age 53, are married. Both have family coverage under separate HDHPs. David's HDHP has a $3,000 deductible, and Mary's has a $2,500 deductible. David and Mary are treated as covered under the plan with the $2,500 deductible and, therefore, meet the minimum $2,400 requirement for a family coverage HDHP. For 2010, David can contribute $4,075 to his HSA (one-half of the family coverage limit of $6,150 + the entire $1,000 catch-up contribution), and Mary can contribute $3,075 to her HSA (unless they agree on a different division).

Employer-funded Contributions and Comparability Rules. Employers are permitted to (but are not required to) make deductible contributions to HSAs set up for their employees—subject to the same dollar limits and eligibility rules previously discussed. The employee cannot deduct employer contributions on his federal income tax return. Instead, employer-funded HSA contributions are exempt from federal income, social security, Medicare, and FUTA taxes because they are considered to be for an employer-provided accident or health plan. However, the employer may be subject to a 35% excise tax (35% of the employer's total HSA contributions for the year) if comparable contributions are not made for all employees who have comparable coverage during the same period. For this purpose, *comparable contribution* means the same amount or the same percentage of the health insurance deductible for all employees within the same category of HDHP coverage. For this purpose, there are *two* HDHP coverage categories: (a) self-only coverage and (b) family coverage, which means anything other than self-only coverage. In general, HSA contributions can be made for employees in only one coverage category or the other without violating the comparability rules. More generous contributions can be made for employees in one category while less generous or no contributions are made for employees in the other category. However, the employer can also offer the following self-plus family coverage options: (a) self plus one, (b) self plus two, and (c) self plus three or more. In this scenario, special rules apply. Each option can be treated as a separate coverage category. But, contributions for self plus two coverage must at least equal contributions for self plus one, and contributions for self plus three or more coverage must at least equal contributions for self plus two. Also, all family coverage options that cover the same number of people must be treated as being in the same self-plus family coverage category. For example, self plus spouse and self plus one dependent both fall into the self plus one category.

Under the regulations, *three* employee categories also exist: (a) current full-time workers (those who work 30 or more hours per week), (b) current part-time workers (those who work fewer than 30 hours per week), and (c) former employees (this category however does not include former employees with continued HDHP coverage under the COBRA rules). The comparability rules are generally applied separately to each category. Again, more generous contributions can be made for employees in one category while less generous or no contributions are made for employees in the other categories.

Example 2-15: HSA comparability rules for employers.

For 2010, Cold Rush Co. makes equal $1,000 contributions for all employees who are eligible for HSA contributions and who have self-only HDHP coverage. It also makes equal $2,000 contributions for all eligible employees with family HDHP coverage. No contributions are made for part-time or former employees. These contributions pass the comparability test even though a larger dollar amount is contributed for employees with family coverage and no contributions are made for part-time or former employees.

For years beginning in 2007 and beyond, highly compensated employees (HCEs) may be treated as a separate class from non-HCEs as long as larger HSA contributions are made for the non-HCEs. Thus, comparable contributions can be made to all eligible non-HCEs without making any contributions to the HSA of any HCE. An HCE is anyone who (a) was a more than 5% owner at any time during the year or preceding year or (b) for the preceding year received compensation in excess of $110,000 (for plan years beginning in 2009) and, if the company so elected, was in the top 20% of employees when ranked by pay.

Source of HDHP Coverage. In general, employees who have HDHP coverage provided by an employer and those with HDHP coverage from outside sources are not considered to be comparable participating employees. Therefore, the comparability rules allow the employer to limit HSA contributions to only those employees eligible for HSA contributions based on HDHP coverage provided by that employer. No contributions are required for those who do not have HDHP coverage from that employer. However, if the employer chooses to make contributions only for employees with HDHP coverage from that employer, comparable contributions must be made for all comparable participating employees with such coverage. And, if the employer chooses to make contributions for all eligible employees regardless of the source of their HDHP coverage, the employer must make comparable contributions for all comparable participating employees, regardless of whether they have HDHP coverage from that employer or coverage from an outside source.

HSA Contributions Provided under a Cafeteria Plan. The previously mentioned comparability rules do not apply to HSA contributions made through salary reduction contributions under a Section 125 cafeteria plan. The separate Section 125 nondiscrimination rules apply to this situation.

Excess Contributions. Contributions by individuals to an HSA, or if made on behalf of an individual to an HSA, are not deductible to the extent they exceed the previously discussed limits. Contributions by an employer to an HSA for an employee are included in the gross income of the employee to the extent they exceed the limits or if they are made on behalf of an employee who is not an eligible individual. In addition, an excise tax of 6% for each tax year is imposed on the participant (the individual on whose behalf the health savings account was established) for excess individual and employer contributions.

If the excess contribution for a taxable year and the net income attributable to such excess contribution is paid to the participant (withdrawn by the participant) before the due date (including extensions) for filing the participant federal income tax return for the tax year, then the net income attributable to the excess contribution is included in the participant gross income for the tax year in which the distribution is received but the excise tax is not imposed and the distribution of the excess contribution is not taxed.

Example 2-16: Reversing an excess contribution to an HSA.

Jim is 45 and has self-only coverage under an HDHP. He established an HSA on January 1, 2010 and contributed $4,050 to the HSA for 2010. The deductible under the plan is $5,000. His contribution limit for 2010 was $3,050 and he has an excess contribution of $1,000. If Jim withdraws the $1,000 from the HSA and the earnings attributable to that $1,000 before the due date including extensions of his federal income tax return for 2010, only the earnings attributable to the $1,000 will be includible in his gross income for the year in which he receives the withdrawal (taxable in 2010 if he withdraws the proper amount in 2011). The excess contribution is not taxed, nor is there any excise tax imposed for the excess contribution.

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 may be made on the first day of the year.

Rollovers. Rollover contributions from MSAs and other HSAs into an HSA are permitted at any time. A rollover from an HSA to another HSA of the same participant 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.

At any time before January 1, 2012, a taxpayer may make one tax-free rollover from a traditional or Roth IRA (that would be otherwise taxable when distributed) to an HSA and one tax-free rollover from an FSA or HRA to an HSA. The rollover contribution from an IRA may not exceed the taxpayer's maximum HSA contribution for the year and is also not subject to the early distribution penalty tax. The rollover contribution from an FSA or HRA may not exceed the lesser of the balance in such arrangement on September 21, 2006 or on the date of the rollover distribution (i.e., a *qualified HSA distribution*). 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. Rollovers from FSAs or HRAs do not affect the employee's or the employer's ability to make regular deductible contributions to the employee's HSA. However, IRA rollover contributions do reduce an individual's deductible HSA contribution maximum for the year of the rollover.

IRS Notice 2007-22 provides guidance regarding these rules. According to this notice, by plan year-end, the plan must be amended to provide for such rollovers, the employee must elect the rollover, and the year-end balance must be frozen. In addition, the funds must be transferred by the employer within two and a half months after plan year-end and result in a zero balance in the health FSA or HRA. The IRS expects to provide additional guidance at a later date. Practitioners should be alert for such guidance.

Example 2-17: Rollover from an FSA to an HSA.

For 2010, Abernathy, Inc. has a calendar year general purpose health FSA with a grace period ending March 15, 2011. Before January 1, 2011, Abernathy amended the health FSA to allow for qualified HSA distributions, allowing employees with HDHP coverage to elect to have any health FSA balance at year-end, determined on a cash basis, contributed directly to an HSA trustee for the employee. If the employee elects the qualified HSA distribution, he or she cannot submit any additional claims after December 31, 2010, regardless of when the expense was incurred, nor will any pending claims submitted before December 31, 2010, be paid after December 31, 2010. Rather, the entire balance will be distributed to the employe's HSA.

Albert White, an employee of Abernathy, Inc., had a balance of $960 in his health FSA on September 21, 2006, and a balance of $700 on December 31, 2010. He elects HDHP coverage beginning January 1, 2011 and also elects to have a qualified HSA distribution from his 2010 FSA. He submitted a claim for $200 to the FSA on December 19, 2010, but it was not processed and paid by December 31, 2010.

Since Abernathy amended the plan by plan year-end and Albert elected the HSA distribution, the plan was frozen on December 31, 2010. As such, the $200 claim submitted on December 19, 2010, will not be paid. Before March 15, 2011, Abernathy must distribute $700 (the amount frozen in Albert's FSA account at plan year-end) into Albert's HSA. Since Albert elected HDHP coverage beginning January 1, 2011, he is an eligible individual to receive the FSA distribution into his HSA.

IRS Notice 2007-22 also provides guidance and examples on the consequences of failing to meet the conditions to be a qualified rollover. If the entire FSA is not frozen and distributed to the HSA, the employee will not be an eligible individual as of the beginning of the plan year (typically January 1) but will remain an ineligible employee until the two and a half month grace period has expired. Because the employee is ineligible, the HSA distribution will become taxable income to the employee in the year of distribution and be subject to a 10% penalty tax.

Distributions from HSAs

An individual may receive distributions from an HSA at any time.

Tax Treatment of Distributions. Distributions from an HSA used solely to pay "qualified medical expenses" of the participant, his or her spouse, or dependents are excludable from gross income, even after the HSA account holder reaches age 65 and is no longer permitted to contribute to the account. Any amount of a distribution not used for qualified medical expenses of the participant, spouse, or dependents is includable in gross income of the participant and is subject to a 10% penalty tax, unless the distribution is made after the participant reaches age 65, becomes disabled, or dies.

<u>Qualified Medical Expenses.</u> Qualified medical expenses are expenses paid by the participant, his or her spouse or dependents (as defined in IRC Sec. 152) for medical care as defined in IRC Sec. 213(d) (including nonprescription drugs as described in Rev. Rul. 2003-102), but only to the extent such amounts are not compensated for by insurance or otherwise. Notice 2004-50, Q&A-27 states the following about whether prescription drug costs can be

considered preventive care costs and thus escape the general rule that no benefits can be paid under a qualifying high-deductible health plan (HDHP) until after the plan's annual deductible has been met:

> . . . Notice 2004-23 sets out a preventive care deductible safe harbor for HDHPs under IRC Sec. 223(c)(2)(C). Solely for this purpose, drugs or medications are preventive care when taken by a person who has developed risk factors for a disease that has not yet manifested itself or not yet become clinically apparent (i.e., asymptomatic), or to prevent the reoccurrence of a disease from which a person has recovered. For example, the treatment of high cholesterol with cholesterol-lowering medications (e.g., statins) to prevent heart disease or the treatment of recovered heart attack or stroke victims with Angiotensin-converting Enzyme (ACE) inhibitors to prevent a reoccurrence, constitute preventive care. In addition, drugs or medications used as part of procedures providing preventive care services specified in Notice 2004-23, including obesity weight-loss and tobacco cessation programs, are also preventive care. However, the preventive care safe harbor under IRC Sec. 223(c)(2)(C) does not include any service or benefit intended to treat an existing illness, injury, or condition, including drugs or medications used to treat an existing illness, injury or condition.

In summary, except under the limited circumstances explained in Notice 2004-50, prescription drug costs do *not* count as preventive care costs. Therefore, they generally cannot be covered until the HDHP's annual deductible has been satisfied.

Finally, qualified medical expenses must be incurred only after the HSA has been established. For purposes of determining the itemized deduction for medical expenses, medical expenses paid or reimbursed by distributions from an HSA are not treated as expenses paid for medical care under IRC Sec. 213.

Generally, health insurance premiums are not qualified medical expenses, except for the following:

a. COBRA health care continuation coverage,

b. Qualified long-term care insurance,

c. Health care coverage while an individual is receiving unemployment compensation, and

d. For over-65-age individuals, premiums for Medicare Part A, Part B, and Part D (according to IRS Notice 2008-59, Q&A 29), Medicare HMO, and the employee 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 (IRS Notice 2008-59, Q&A 30). Premiums for Medigap policies are not qualified medical expenses.

Transfers upon Death of HSA Participant. If an HSA still has a balance when the participant dies, a surviving spouse can take over the account free of federal income tax and treat it as his or her own HSA (the spouse is taxed only to the extent distributions from the HSA are not used for qualified medical expenses), provided he or she was named as the account beneficiary in the event of the original participant's death. For accounts passing to nonspousal beneficiaries, the HSA's date-of-death FMV generally must be included in taxable income on that date by the person who inherits the account. A reduction is allowed for any of the decedent's medical expenses paid by the inheritor within one year of the date of death.

Transfer of HSA Incident to Divorce. The transfer of an HSA balance pursuant to a divorce or separation agreement is not a taxable transfer and is treated by the transferee spouse or former spouse as his or her own HSA Setting up an HSA.

Setting up an HSA

Any eligible individual can establish an HSA with a qualified HSA trustee or custodian, much in the same way as establishing an IRA. No permission or authorization from the IRS is necessary to establish an HSA. An eligible individual who is an employee may establish an HSA with or without involvement of his or her employer. A qualified trustee or custodian includes a bank [or similar financial institution as defined in the Internal Revenue Code, an insurance company, or any other person already approved by the IRS to be a trustee or custodian of IRAs or MSAs.

Forms 5305-B (Health Savings Trust Account) and 5305-C (Health Savings Custodial Account) are used to establish HSAs. These forms are model trust and model custodian account agreements, respectively. Each takes only a few seconds to fill out. The account owners's Social Security number serves as the HSA's identifying number. The completed Form 5305-B or 5305-C is not filed with the IRS. Instead, it should be kept with the account owner's permanent tax records.

SELF-STUDY QUIZ

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

8. Gavin has set up his sole proprietorship as an S Corporation, in an attempt to save payroll taxes. Why would setting the company up as an S Corporation be beneficial to Gavin?

   a. To pay Gavin a higher salary for his services to his company.

   b. To minimize the likelihood of being audited by the IRS.

   c. Only the wages of a shareholder-employee are subject to FICA tax.

   d. To distribute more income to the shareholders.

9. Henry contributes a substantial amount of money to HighTower Resources, an LLC, in exchange for an interest in the business. Henry participates in the management of the business for approximately 300 hours per year. He does not have authority to execute contracts for the company, but he has signed personal guarantees for two loans that HighTower Resources has taken out at the bank. Henry is subject to SE tax on his LLC earnings. Which of the following is the reason that Henry's earnings are subject to SE tax?

   a. Henry signed personal guarantees for two loans for the LLC.

   b. Henry worked too many hours in the management of the LLC.

   c. Henry is not able to execute contracts for HighTower Resources.

10. In which of the following scenarios would the taxpayer be eligible to establish a health spending account (HSA)?

    a. Tim owns his own business and carries an HDHP for himself and his family. His wife is employed, but does not participate in her employer's health insurance. His wife does contribute to a healthcare flexible spending account with her employer.

    b. Lynn owns a family boutique that she and her daughters run. They have a family benefit plan with a deductible of $4,000, but pays out to any individual with covered medical expenses exceeding $4,000 and annual out-of-pocket expenses no more than $11,500.

    c. Frank runs a family business and provides health coverage for everyone with a family deductible of $2,500. The HDHP provides payment to covered medical expenses of any member of the family in excess of $1,000, even if the expenses do not exceed $2,500.

    d. Karen is self-employed and carries her own HDHP health plan for herself. She is also employed part-time and her employer offers a health reimbursement arrangement for all of their employees, even part-time employees, and Karen participates.

11. Melanie is a self-employed proprietor. She enrolls in a single coverage HDHP on April 1 of the current year and continues coverage for the remaining of the year. The annual deductible for the plan is $3,500. What amount can Melanie contribute to an HSA for the current year?

    a. $0.

    b. $2,288.

    c. $3,050.

12. Which of the following is correct regarding contributions to employee HSAs?

    a. Highly compensated employees (HCEs) are considered their own category, so employers can contribute to their HSAs without contributing to non-HCE accounts.

    b. Employers can make contributions to employees' HSAs based on length of service with the company, regardless of status with the company.

    c. Different contribution amounts can be made to employees of different categories.

    d. Employers are required to provide the same amount of contributions to employee HSAs, whether or not they enroll in the HDHP.

13. Which of the following distributions from an HSA would be included in the taxpayer's gross income for the year?

    a. Larry, a 68 year old self-employed man, used a distribution from his HSA to pay the amount of his prescription drugs that are not covered by his HDHP.

    b. Sean, a 35 year-old self-employed man, uses a distribution from his HSA to pay his health care premium for the year.

    c. Karen uses HSA distributions from her husband's account to pay his medical bills, qualified and nonqualified, after her husband's death.

    d. Ed used distributions from his HSA account to pay for premiums on his COBRA health care continuation coverage.

14. It is easy for a taxpayer to set up an HSA. Which of the following is true about setting up an HSA?

    a. A Form 5305-B and 5305-C are used to set up an HSA and are filed with the IRS.

    b. An employee must have their employer's permission to set up an HSA.

    c. Each HSA is assigned a unique identifying account number by the IRS when it is set up.

    d. The IRS does not have to provide any authorization for a taxpayer to set up an HSA.

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. Gavin has set up his sole proprietorship as an S Corporation, in an attempt to save payroll taxes. Why would setting the company up as an S Corporation be beneficial to Gavin? **(Page 109)**

   a. To pay Gavin a higher salary for his services to his company. [This answer is incorrect. The tax planning strategy is minimizing the salary of S corporation shareholder-employees (and thus minimizing the payroll tax liability) and maximizing the amounts treated as S corporation dividend distributions.]

   b. To minimize the likelihood of being audited by the IRS. [This answer is incorrect. Actually, setting up a sole proprietorship as an S Corporation, can set the company up for an audit issue with the IRS. Audit exposure is high, especially when the shareholder/employee is a corporate officer. The sole proprietor should use this planning technique with judgment.]

   c. Only the wages of a shareholder-employee are subject to FICA tax. [This answer is correct. Normally, all of a sole proprietor's business income is subject to SE tax, but only the wage or salary income of a shareholder-employee is subject to FICA tax.]

   d. To distribute more income to the shareholders. [This answer is incorrect. Incorporating a sole proprietorship can be especially beneficial when the business needs to retain income for expansion or debt retirement. Corporate income, unlike proprietor income, can be retained in the company free of either FICA or SE tax.]

9. Henry contributes a substantial amount of money to HighTower Resources, an LLC, in exchange for an interest in the business. Henry participates in the management of the business for approximately 300 hours per year. He does not have authority to execute contracts for the company, but he has signed personal guarantees for two loans that HighTower Resources has taken out at the bank. Henry is subject to SE tax on his LLC earnings. Which of the following is the reason that Henry's earnings are subject to SE tax? **(Page 109)**

   a. Henry signed personal guarantees for two loans for the LLC. [This answer is correct. According to Prop. Reg. 1.1402(a)-2, a member's share of earnings distributed from an LLC would be subject to SE tax if the member has a partial or total personal liability under state law for the LLC's obligations. This includes liabilities created by guarantees, endorsements, or otherwise not counted.]

   b. Henry worked too many hours in the management of the LLC. [This answer is incorrect. A member would be subject to SE tax on their distributions from an LLC if the member participates in the LLC's business for more than 500 hours per year. Henry currently works approximately 300 hours per year. This would not be enough to subject him to SE tax.]

   c. Henry is not able to execute contracts for HighTower Resources. [This answer is incorrect. A rule that could subject an LLC member to SE tax on their distributions is if the member has statutory or contractual authority to make contracts on behalf of the LLC under the law of the state in which the LLC was formed.]

10. In which of the following scenarios would the taxpayer be eligible to establish a health spending account (HSA)? **(Page 112)**

   a. Tim owns his own business and carries an HDHP for himself and his family. His wife is employed, but does not participate in her employer's health insurance. His wife does contribute to a healthcare flexible spending account with her employer. [This answer is incorrect. Since Tim's wife is covered with a flexible spending account via her employer, Tim is not eligible to contribute to an HSA for being self-employed and having an HDHP.]

   b. Lynn owns a family boutique that she and her daughters run. They have a family benefit plan with a deductible of $4,000, but pays out to any individual with covered medical expenses exceeding

$4,000 and annual out-of-pocket expenses no more than $11,500. [This answer is correct. Since Lynn's family plan qualifies as a HDHP (since it has a more than $2,400 deductible, does not pay out before that amount and it out-of-pocket costs do not exceed $11,500). Since her plan does qualify, Lynn could establish a health spending account.]

c. Frank runs a family business and provides health coverage for everyone with a family deductible of $2,500. The HDHP provides payment to covered medical expenses of any member of the family in excess of $1,000, even if the expenses do not exceed $2,500. [This answer is incorrect. An HSA is only available to health plans that are covered as an HDHP. Since Frank's plan will pay out to an individual with expenses exceeding $1,000, even if the expenses do not exceed the deductible of $2,500, it is not considered an HDHP.]

d. Karen is self-employed and carries her own HDHP health plan for herself. She is also employed part-time and her employer offers a health reimbursement arrangement for all of their employees, even part-time employees, and Karen participates. [This answer is incorrect. If an individual is covered by an employer-sponsored healthcare flexible spending account plan, health reimbursement arrangement, or Section 105 medical reimbursement plan he or she will typically be ineligible to make HSA contributions.]

11. Melanie is a self-employed proprietor. She enrolls in a single coverage HDHP on April 1 of the current year and continues coverage for the remaining of the year. The annual deductible for the plan is $3,500. What amount can Melanie contribute to an HSA for the current year? **(Page 114)**

    a. $0. [This answer is incorrect. Since Melanie is covered by an HDHP that has an annual deductible over $1,200, she is eligible to contribute to an HSA per the Internal Revenue Code.]

    b. $2,288. [This answer is incorrect. Melanie is eligible to contribute to an HSA in the current year, even though she enrolled in a HDHP after the year began. Melanie's contribution amount would not be prorated for the year per the Internal Revenue Code.]

    c. $3,050. [This answer is correct. Since Melanie enrolled in a HDHP with a deductible higher than $1,200, she is eligible to contribute the full amount allowed to her HSA account for the year. Since she established the HSA in the middle of the year, 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 her for an HSA.]

12. Which of the following is correct regarding contributions to employee HSAs? **(Page 116)**

    a. Highly compensated employees (HCEs) are considered their own category, so employers can contribute to their HSAs without contributing to non-HCE accounts. [This answer is incorrect. For years beginning in 2007 and beyond, highly compensated employees (HCEs) may be treated as a separate class from non-HCEs as long as larger HSA contributions are made for the non-HCEs per the Internal Revenue Code.]

    b. Employers can make contributions to employees' HSAs based on length of service with the company, regardless of status with the company. [This answer is incorrect. Under the regulations, contributions have to be made based on the three employee categories: full-time workers, current-part time workers and former employees.]

    c. Different contribution amounts can be made to employees of different categories. [This answer is correct. Comparability rules are generally applied separately for each category of employees and under IRS regulations, more generous contributions can be made for employees in one category while less general or no contributions are made for employees in the other categories.]

    d. Employers are required to provide the same amount of contributions to employee HSAs, whether or not they enroll in the HDHP. [This answer is incorrect. The comparability rules allow the employer to limit HSA contributions to only those employees eligible for HSA contributions based on HDHP coverage provided by that employer per IRS regulations. No contributions are required for those who do not have HDHP coverage from that employer.]

13. Which of the following distributions from an HSA would be included in the taxpayer's gross income for the year? **(Page 118)**

    a. Larry, a 68 year old self-employed man, used a distribution from his HSA to pay the amount of his prescription drugs that are not covered by his HDHP. [This answer is incorrect. According to the Internal Revenue Code, since Larry is over the age of 65, distributions are not includable in gross income.]

    b. Sean, a 35 year-old self-employed man, uses a distribution from his HSA to pay his health care premium for the year. [This answer is correct. Since Sean used his distribution to pay for a nonqualified medical expense, per the Internal Revenue Code, his distribution is includable in his gross income for the year.]

    c. Karen uses HSA distributions from her husband's account to pay his medical bills, qualified and nonqualified, after her husband's death. [This answer is incorrect. Any amount not used for qualified medical expenses of the account beneficiary is not included in gross income if the distribution is made after the account beneficiary dies according the Internal Revenue Code.]

    d. Ed used distributions from his HSA account to pay for premiums on his COBRA health care continuation coverage. [This answer is incorrect. Generally, health insurance premiums are not qualified medical expenses, per the Internal Revenue Code, with some exceptions. One of those exceptions noted in the Internal Revenue Code is paying for COBRA health care continuation coverage.]

14. It is easy for a taxpayer to set up an HSA. Which of the following is true about setting up an HSA? **(Page 119)**

    a. A Form 5305-B and 5305-C are used to set up an HSA and are filed with the IRS. [This answer is incorrect. Forms 5305-B and 5305-C are used to establish HSAs, but the completed forms are not filed with the IRS. Instead, they should be kept with the account owner's permanent records.]

    b. An employee must have their employer's permission to set up an HSA. [This answer is incorrect. Per the IRS Notice, an eligible individual who is an employee may establish an HSA with or without the involvement of his or her employer.]

    c. Each HSA is assigned a unique identifying account number by the IRS when it is set up. [This answer is incorrect. When an HSA is set up with the IRS, the account owner's Social Security number serves as the HSA's identifying number. It is not assigned a unique number.]

    d. The IRS does not have to provide any authorization for a taxpayer to set up an HSA. [This answer is correct. According to the Internal Revenue Code, any eligible individual can establish an HSA with a qualified HSA trustee or custodian, much in the same way as establishing an IRA. No permission or authorization from the IRS is necessary to establish an HSA.]

CLAIMING THE HOME OFFICE DEDUCTION

A sole proprietor may be able to claim deductions for the business use of his home. These deductions include mortgage interest, real estate taxes, maintenance, insurance, utilities, depreciation, etc. However, certain conditions must be met and the IRS closely scrutinizes these home office deductions due to perceived abuses in this area.

General Rules

To deduct home office expenses, a self-employed taxpayer must use the space *exclusively* and *regularly* —

a. as a principal place of business,

b. as a place to meet or deal with clients and customers in the normal course of business, or

c. in connection with the business if the space is a separate structure from the residence (e.g., a barn or detached garage).

Regular and Exclusive Use

Regular Use. Regular use means the taxpayer must use the portion of the home on a continuing basis. Even though the portion of the home is used exclusively 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 he did not meet there with patients in the normal course of his business (*Pearson*).

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 this space. There are two exceptions to the exclusive use rule: (a) storage of inventory (including product samples) if the home is the sole fixed location of the trade or business, and (b) certain daycare facilities. Space used for these two purposes can also be used for personal purposes.

A taxpayer can operate two or more businesses using a single home office and still meet the exclusive and regular use requirements. However, each business must separately meet the requirements to sustain the deduction (*Hamacher*; *Genck*). This could present a problem for an employee who uses the home office for his employment-related duties and for a self-employment (i.e., sideline) business. If at least one of the activities fails the Section 280A requirements, no home office deduction will be allowed for any activity.

Example 2-18: Regular and exclusive use—taxpayer is both an employee and self-employed.

Ben is a CPA and a senior manager of an accounting firm. He 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 generated on Schedule C as a sole proprietor. Ben meets the Section 280A(c) requirements of regular and exclusive use of the office space for his sole proprietorship. However, since the work performed in the same home office as an employee of the accounting firm was for Ben's own convenience and not for the convenience of the employer, no home office deduction is allowed.

Principal Place of Business

Of the three tests listed previously, the principal place of business test is usually the one most taxpayers try to meet. In the landmark 1993 *Soliman* case, the Supreme Court identified two primary factors for determining whether a home office qualifies as the taxpayer's principal place of business: (a) the relative importance of the activities performed at each business location and (b) 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 are given great weight (*Strohmaier*). 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 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 Supreme 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. The definition of *principal place of business* includes a place that:

a. is used exclusively and regularly by the taxpayer to conduct *administrative or management* activities of a trade or business, and

b. is the only fixed location where the taxpayer conducts substantial administrative or management activities of that trade or business.

This effectively allows more taxpayers to meet the *principal place of business* definition. However, this does not change the regular and exclusive use requirements for the taxpayer to deduct home office expenses. Also, the principles set forth in *Soliman* would still apply in situations not covered by these rules for administrative and management activities.

Example 2-19: Home office used for administrative and managerial duties.

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 space is used for no other purpose. She can claim a deduction for having an office in her home 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, even though 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 that work at home.

Example 2-20: Principal place of business when taxpayer has an office outside the home.

Assume the same facts as in Example 2-19 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.

IRS Pub. 587 notes that administrative or managerial activities include (a) billing customers, clients, or patients; (b) keeping books and records; (c) ordering supplies; (d) setting up appointments; and (e) forwarding orders or writing reports. It also gives several examples of activities that will *not* disqualify a taxpayer's home office from being a principal place of business based on the administrative or management activities performed there.

Depreciating a Home Office

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

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

b. the fair market value (FMV) of the portion of the home allocated to the office space.

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 2009 is depreciated over 39 years under MACRS.

Example 2-21: 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 1992 and until recently rented office space for his business in a downtown building. In January 2010, 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 (a) 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 (b) the FMV of the converted office space at the time of conversion. In addition, Buddy must use a 39-year recovery period, beginning January 2010, 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.

Other Considerations of Qualifying for a Home Office Deduction

Altering Business to Qualify for Home Office Deduction. If the home office does not qualify as the principal place of business, it can still qualify for the home office deduction if it is used regularly and exclusively in connection with the business and (a) the taxpayer uses the office regularly and exclusively to meet and deal with clients in the normal course of business or (b) the office is a separate structure not attached to the house and used regularly and exclusively in connection with the business. (See earlier discussion in this section under "General Rules.") Taxpayers who cannot meet the principal place of business test might consider restructuring their businesses to meet one of these two tests if possible. However, taxpayers who do not meet the principal place of business test cannot deduct travel from their homes to another business even if their homes qualify for the home office deduction under one of these other tests—see the next paragraph.

Two auxiliary benefits of qualifying for a home office deduction under the *principal place of business* test are the ability to deduct additional transportation costs and the more favorable rules on depreciating computers used in the home office. Generally, expenses incurred for transportation between a taxpayer's home and regular place of business are personal, nondeductible expenses. However, when a taxpayer's home office qualifies as the principal place of business under IRC Sec. 280A(c)(1)(A), he can deduct all daily transportation costs incurred in going between his residence and other work locations in the same trade or business. This applies regardless of whether the other work location is regular or temporary and regardless of the distance. Computers and peripheral equipment are not considered "listed property" if used exclusively in a business conducted in a qualifying home office. Therefore, a taxpayer is more likely to qualify for claiming a Section 179 deduction or faster depreciation write-offs for business computers.

Disadvantages When Selling the Residence. While qualifying for the home office deduction allows a taxpayer to depreciate part of the residence, this status may be detrimental when the residence is sold. At a minimum, long-term gain to the extent of depreciation attributable to periods after May 6, 1997 is not eligible for gain exclusion, but is taxed at a maximum 25% rate. This includes depreciation that is allowed or allowable; i.e., gain cannot be avoided by foregoing depreciation deductions. Further, if the home office is in a structure separate from the dwelling unit (e.g., a detached garage) and such use causes that portion of the residence to no longer qualify as a residence under the Section 121 rules [e.g., because it was not used as a residence for at least two of the five years preceding the sale—IRC Sec. 121(a)], none of the gain attributable to that portion of the home can be excluded. For sales and exchanges after August 12, 2004, safe harbors allow reduced gain exclusion when a portion of a home was not used as a residence for two of the preceding five years.

SELF-STUDY QUIZ

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

15. When contemplating the principal place of business for a home office deduction, which of the following is correct?

    a. A taxpayer can fulfill the principal place of business test and satisfy the requirements for the deduction.

    b. The point where clients are met or goods and services are delivered is vital to determining the relative importance test.

    c. The time test is first examined in the principal place of business test.

    d. If the taxpayer has an another office away from home, the home office deduction cannot be claimed.

16. Sherry has decided to close her office location and convert her garage into a home office for her architectural business after the birth of her first child. The garage is 1/6 of Sherry's house. She originally bought the house for $150,000 and has spent an additional $36,000 converting the garage. It is estimated that the land is $30,000 of the original price of the home. The current fair market value of her house, after the conversion, is $180,000, with $35,000 being allocated to the home office. What basis should Sherry use when determining the depreciation of her home office for year one?

    a. $31,000.

    b. $35,000.

    c. $36,000.

    d. $56,000.

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.)**

15. When contemplating the principal place of business for a home office deduction, which of the following is correct? **(Page 126)**

    a. A taxpayer can fulfill the principal place of business test and satisfy the requirements for the deduction. [This answer is incorrect. According to the Internal Revenue Code, even if the principal place of business test is met, it does not change the regular and exclusive use requirements for the taxpayer to deduct home office expenses.]

    b. The point where clients are met or goods and services are delivered is vital to determining the relative importance test. [This answer is correct. As demonstrated in the *Strohmaier* case, in analyzing the relative importance of the activities performed at each location, the point where clients are met or goods and services are delivered are given great weight.]

    c. The time test is first examined in the principal place of business test. [This answer is incorrect. The relative importance test is analyzed first and, if no definitive answer is reached, the time test is considered according to IRS publications.]

    d. If the taxpayer has an another office away from home, the home office deduction cannot be claimed. [This answer is incorrect. 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 and management work is actually done – not where it *could* be done.]

16. Sherry has decided to close her office location and convert her garage into a home office for her architectural business after the birth of her first child. The garage is 1/6 of Sherry's house. She originally bought the house for $150,000 and has spent an additional $36,000 converting the garage. It is estimated that the land is $30,000 of the original price of the home. The current fair market value of her house, after the conversion, is $180,000, with $35,000 being allocated to the home office. What basis should Sherry use when determining the depreciation of her home office for year one? **(Page 128)**

    a. $31,000. [This answer is incorrect. The $31,000 figure would be the cost basis of the home allocated to the garage, plus improvements, but it would not take into account deducting the land from the basis, as required by Reg.1.168(1)4(b).]

    b. $35,000. [This answer is correct. The basis of the home office is decided by the lower of (a) 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 (b) the FMV of the converted office space at the time of conversion. Since the FMV, based on the appraisal, is $35,000, and this is less than the cost plus improvements, according to Reg.1.168(i)4(b), this would be the basis.]

    c. $36,000. [This answer is incorrect. The $36,000 would be computed by taking the current FMV of the house of $180,000 and adding the improvements of $36,000 and dividing by the 1/6 of the house that the garage takes up. This would not be an appropriate measurement per the IRS regulations to figure out the basis of the home office.]

    d. $56,000. [This answer is incorrect. The cost of the basis of the home allocated to the garage (net of land) plus improvements made to convert the garage to an office is one measurement that is appropriate to determine the basis for depreciation, but as stated in Reg.1.168(i)4(b), it is only one measurement and the appropriate measurement is the one that is the lowest. This measurement is not the lowest that the IRS allows.]

DEDUCTING BUSINESS BAD DEBTS

It is not uncommon for high income individual taxpayers to hold uncollectible or worthless business debts. Careful tax planning that maximizes the business bad debt deduction can help minimize the taxpayer's overall economic loss.

Establishing a Bona Fide Debt with a Related Business

A bona fide debt is one arising from a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable amount of money . The taxpayer must be able to show that it was the *intent* of the parties at the time of the transfer to create a debtor-creditor relationship. In other words, the taxpayer must be able to show that at the time of the transaction, he had a real expectation of repayment, and there was an intent to enforce the indebtedness. A formal loan agreement is not absolutely necessary to create a bona fide debt. Also, the giving of a note or other evidence of legally enforceable indebtedness is not in itself conclusive evidence of a bona fide debt.

The fact that the debtor is a related business does not preclude a bad debt deduction by the individual taxpayer. If owner or related party loans made for legitimate business purposes become worthless, they are treated no differently than debts to an unrelated party. Of course, this assumes that the loans meet the bona fide standard (that is, a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable amount of money). Debts between related parties are generally subject to closer scrutiny than other debts.

Distinguishing Business from Nonbusiness Bad Debts

Two types of bad debt deductions are allowed under IRC Sec. 166: business bad debts and nonbusiness bad debts. Business bad debts give rise to ordinary losses, while nonbusiness bad debts give rise to short-term capital losses. Because of the limitation on capital losses, distinguishing business and nonbusiness bad debts is critical.

A business bad debt often originates as a result of credit sales to customers for goods sold or services provided. If a sole proprietor sells goods or services on credit and the account receivable subsequently becomes worthless, a business bad debt deduction is permitted, but only if the income arising from the creation of the receivable was previously included in income. Thus, 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.

Business bad debts can also take the form of loans to suppliers, clients, employees, and distributors. Additionally, a guarantor is allowed a business bad debt deduction for any payment made in the capacity as guarantor if the reason for guaranteeing the debt was business. Here, the guarantor's payment results in a loan to the debtor, and the taxpayer is allowed a bad debt deduction once the loan (including any right of subrogation against the debtor) becomes partially or totally worthless.

Loans to businesses owned by the taxpayer can also generate business bad debts if the loans were made to preserve the taxpayer's employment status and income earning potential, or in the course of the taxpayer's business of buying and selling businesses.

Debts that do not qualify as business bad debts are nonbusiness bad debts (or possibly gifts).

Business Reason Must Be Dominant Motivation for the Loan. In distinguishing business and nonbusiness bad debts, the question which must be asked is, Does the loss bear a "proximate" relation to the taxpayer's trade or business? If so, the regulations state that the debt qualifies as a business bad debt. However, the Supreme Court has taken it a step further and held that, in determining whether the relation is proximate, the *dominant motivation* for making the loan must be business oriented (*Generes*). Significant motivation between the debt and the taxpayer's business does not satisfy this requirement.

Example 2-22: Business bad debt for loan to supplier.

Steve Hill, a sole proprietor, operates a retail store. He guaranteed payment of a $10,000 note of his best supplier, who is also a close friend, in an effort to ensure that the supplier continued in business. The supplier later filed for bankruptcy and defaulted on the note. Steve was forced to make full payment under his guarantee. His efforts to recover his guarantee payment proved unsuccessful.

It appears Steve's bad debt loss is considered a business bad debt since his guarantee was spurred by his business motive to retain his best supplier. The close personal friendship between Steve and his supplier does not affect the business nature of the bad debt loss if the facts show the dominant motivation for the loan was business. The guarantee can thus be considered closely related to his business and gives rise to a business bad debt.

Business of Lending Money. A taxpayer who can establish that he is in the trade or business of lending money normally can claim a business bad debt deduction for uncollectible loans. In determining whether the taxpayer is in the trade or business of lending money, the courts generally consider: (a) the total number of loans made; (b) the time period over which the loans were made; (c) the adequacy and nature of the taxpayer's records; (d) whether the loan activities were kept separate and apart from the taxpayer's other activities; (e) whether the taxpayer sought out the lending business; and (f) the amount of time and effort expended in the lending activity and the relationship between the taxpayer and his debtors (*Henderson*, *Serot*).

Proving Worthlessness

The worthlessness of a debt is a question of fact. All pertinent evidence should be considered, including the value of any collateral and the financial condition of the debtor. Proof of worthlessness is best established by an identifiable event demonstrating the loss of value for the debt.

Example 2-23: Proof of worthlessness.

HiFi Security is a sole proprietorship selling sophisticated security systems. It uses the accrual method of accounting. In March 2010, it sold $25,000 of security equipment to a retail store for $5,000 down and the balance due in 90 days. When the balance became due, HiFi found that the customer had closed its doors, and the owner could not be located. Subsequent correspondence was returned by the post office.

The cessation of business by the customer is an identifiable event that established proof of worthlessness of the amount due from the customer. Therefore, HiFi should be entitled to a $20,000 bad debt deduction in 2010. (The income would have been booked at the time of the sale since HiFi is an accrual-method business.)

Worthlessness can be established when the taxpayer sues the debtor, wins a judgment, and then shows the judgment is uncollectible. However, when the surrounding circumstances indicate a debt is worthless and uncollectible, and that legal action to collect the debt would in all probability not result in collection, proof of these facts is sufficient to justify the deduction.

Evidence that a debtor is experiencing financial difficulties will not by itself support an argument for worthlessness. The debtor's bankruptcy, however, generally does indicate that an unsecured business debt is at least partially worthless. Thus, retaining a copy of the bankruptcy notice should support at least a partial reduction in the value of a receivable or other noncollateralized debt due from the bankrupt business.

Beyond cessation of the debtor's business or a bankruptcy notice, the courts have accepted the following as proof that a debt's value has declined or become worthless:

a. The disappearance or death of an individual debtor (documented by a newspaper clipping, return mail marked deceased, etc.).

b. The uncollectibility of a deficiency after the property securing the debt is sold.

c. A writ of execution returned by the sheriff with the notation "no property found" or "not satisfied."

d. The worthlessness of a judgment against the debtor.

When to Claim a Business Bad Debt Deduction

A business bad debt can be either partially or totally worthless. If the taxpayer can collect some, but not all, of the debt, they have a partially worthless debt. If the taxpayer cannot collect any of the remaining amount of a debt, even if they collected some of it in the past, they have a totally worthless bad debt. All taxpayers, except for certain financial institutions, use the specific charge-off method to deduct business bad debts as they become partly or totally worthless.

Deducting a Partially Worthless Debt. Before the taxpayer can deduct a partially worthless business debt, they must be able to show that partial worthlessness has occurred and the amount of partial worthlessness that has been charged off on the books of the business. The taxpayer may choose from among the following options concerning how to handle the debt for tax purposes:

a. The taxpayer may claim a deduction for any portion of the debt, up to the amount actually written off its books during the year. The requirement to record a book charge-off means 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.

b. The business can always forgo a current-year tax deduction in favor of waiting until the balance of the debt is either collected or determined to be worthless. It can claim a bad debt deduction for the entire uncollected amount at that time.

The taxpayer may treat each partially worthless debt differently. However, in no case may the taxpayer claim a tax deduction any later than the year in which a debt becomes completely worthless.

Example 2-24: Deducting a partially worthless debt.

Cindy owns and operates an accrual method sole proprietorship selling computer equipment. The business has a note receivable from a customer with a balance of $30,000. The customer is having financial problems. In 2010, after repeated collection attempts, Cindy determines $20,000 of the receivable is uncollectible and writes this amount off on its books. The remaining $10,000, which Cindy is confident of someday receiving, is left on the books.

For tax purposes, Cindy may take a bad debt deduction in any amount up to $20,000 in 2010. Alternately, she may wait until the balance of the debt is either collected or determined to be worthless and claim a bad debt deduction for the entire uncollected amount at that time.

Deducting a Totally Worthless Debt. A totally worthless debt is deductible only in the tax year it becomes totally worthless. The deduction for the debt does not include any amount deducted in an earlier year when the debt was only partially worthless [Reg. 1.166-3(b)].

MAXIMIZING THE SECTION 179 DEDUCTION

General Rules

For tax years beginning in 2010, taxpayers are allowed to deduct, rather than capitalize and recover through depreciation, up to $250,000 of the cost of eligible property acquired and placed in service in 2010.

The property's basis must be reduced by the amount of the Section 179 deduction before MACRS depreciation is computed for the year.

In addition to the $250,000 limit, the allowable Section 179 deduction is subject to the following limits:

a. *$800,000 Eligible Property Ceiling.* The $250,000 limit is reduced dollar for dollar (but not below zero) by the investment in qualifying property in excess of $800,000 (for tax years beginning in 2010) in a tax year Accordingly, no Section 179 deduction is available for 2010 if the total investment in qualifying property is $1,050,000 or more.

b. *Taxable Income Limitation.* The Section 179 deduction cannot exceed the total amount of taxable income derived from the active conduct of any trade or business during the year.

The Section 179 deduction is allowed for regular tax and AMT. If Section 179 property is placed in service part way through a tax year (or even at the end of the year), no proration of the Section 179 deduction is required. Similarly, if the Section 179 property is placed in service in a short tax year, no proration of the Section 179 deduction is required.

Amending or Revoking the Section 179 Deduction

Taxpayers can amend or revoke the Section 179 expense election or specifications within the election for property acquired after 2002 and before 2011 by filing an amended return within the allowable span of time for the year in question. The amended return must reflect all changes to income as a result of the Section 179 modifications such as changes in depreciation for the current and succeeding years. The amended election must also specify the items of property expensed and the portion of the cost of each item.

A taxpayer can make the following changes regarding the Section 179 election subject to the deduction and income limitations:

a. Additional expense under IRC Sec. 179 can be claimed for assets that had previously been capitalized;

b. One specific asset can be substituted for another asset of the same type;

c. The amount that is being expensed for a specific item can be increased or decreased; or

d. The election to expense an asset can be totally revoked.

Once a deduction is revoked, the Section 179 deduction on that property cannot be reinstated; that is, the revocation itself is irrevocable.

What Is Qualifying Property?

Qualifying property is depreciable tangible property that is Section 1245 property acquired by purchase from an unrelated party and used more than 50% in an active business (i.e., other than investment use). Buildings or real property are not considered eligible property. Special rules apply for noncorporate lessors. Off-the-shelf computer software placed in service in 2003 through 2010 may be Section 179 property if all requirements are met.

Section 179 expensing is *not available* for any tangible property that is the following:

a. Used predominantly to furnish lodging or in connection with the furnishing of lodging (with the exception of hotel/motel operations) as described in IRC Sec. 50(b)(2).

b. Used outside of the United States, as described in IRC Sec. 50(b)(1).

c. Used by tax-exempt organizations, as described in IRC Sec. 50(b)(3).

d. Used by certain government units, or foreign persons or entities, as described in IRC Sec. 50(b)(4).

e. An air conditioning or heating unit.

f. Placed in service by an estate or trust [IRC Sec. 179(d)(4)].

Mixed Use Property. To be qualifying property, the property must be used more than 50% in an active trade or business (i.e., other than investment use). The $250,000 limit, the $800,000 eligible property ceiling, and the taxable income limit are applied only to the business portion of the property's cost.

Property Acquired via Trade-in. In a trade-in, that part of the basis of the old property that is carried over to the new property due to the like-kind nature of the exchange is not eligible for the Section 179 deduction. However, the taxpayer may elect the Section 179 deduction for the part of the cost of the new property that is not determined by reference to property traded in.

Example 2-25: Section 179 deduction on property acquired by trade-in.

Fred Ware, who operates a real estate brokerage, trades two photocopiers (total adjusted basis of $5,000) plus $10,000 cash for a new photocopier worth $20,000. The beginning basis of the new copier is $15,000 ($5,000 substitute basis plus $10,000 cash paid). Of that amount, $10,000 is eligible for the Section 179 deduction.

Planning around the $800,000 (for 2009) Eligible Property Ceiling

The $250,000 (for 2010) limit is reduced, dollar for dollar, to the extent eligible property placed in service during the year exceeds $800,000 (for 2010). Thus, a taxpayer that places $1,050,000 or more of eligible property in service during 2010 is not entitled to a Section 179 deduction for that year. Taxpayers close to exceeding the $800,000 (for 2010) threshold may want to delay the acquisition of additional eligible property until the following year.

Example 2-26: Delaying asset purchases to avoid phase-out of Section 179 deduction.

Bob Richards operates several auto repair shops as a sole proprietorship. He is upgrading his business equipment. During the second and third quarters of 2010, he purchases $798,000 of new equipment. Bob is considering purchasing an additional $12,000 worth of equipment in the last quarter of the year.

If the $12,000 of equipment is purchased and placed in service in 2010, Bob's Section 179 election is limited to $240,000 [$250,000 − ($810,000 − $800,000)]. He should consider delaying the purchase of the $12,000 of equipment (or of at least $10,000 worth) until the following year. This will allow him to claim the $250,000 maximum Section 179 deduction for the property already purchased and placed in service during the year.

Generating Active Business Income to Avoid the Taxable Income Limitation

A Section 179 deduction is limited to the taxpayer's aggregate taxable income derived from the active conduct of *any* trade or business (referred to as *active business income*). The business may carry over indefinitely to future tax years any deduction lost as a result of this limitation. The deduction is claimed as the taxpayer generates sufficient trade or business income. However, the allowable Section 179 deduction may not exceed the annual dollar limitation for any given tax year. Any unused Section 179 deduction that must be carried over as a result of the taxable income limit is allocated to specific properties by the taxpayer in the year the properties are placed in service. If no allocation is made, the carryover deduction is apportioned equally over the expensed properties.

Defining Active Business Income. An important planning task is to ensure taxpayers have sufficient *active business income* to allow them to take the full Section 179 deduction. For purposes of the taxable income limitation, active business income includes (a) the proprietorship net income (or loss) in the return; (b) a partner's or S shareholder's allocable share of the partnership's or S corporation's taxable income (or loss) from the active conduct of any of the entity's trades or businesses, if the partner or S shareholder is engaged in the active conduct of at least one of the entity's trades or businesses (c) any Section 1231 gains (or losses) and Sections 1245 and 1250 recapture income from a trade or business; (d) interest earned from working capital related to a trade or business; and (e) wages, salaries, tips, and other compensation earned as an employee.

Active business income is not reduced by any NOL carryover or carryback to the tax year or by the deduction for half of SE taxes. The amount of active business income is also computed without regard to the expensing deduction for any Section 179 property.

Example 2-27: Aggregating business income to support a Section 179 deduction.

Tim, a single taxpayer, conducts a proprietorship that reports a $45,000 loss for the calendar year 2010, before considering any Section 179 deduction. He is also a 50% partner in a partnership. He is active in the partnership's business and for 2010, his allocable share of the partnership's taxable income from the business is $300,000. There is no Section 179 pass-through allocation from the partnership. Tim's total active business income for the Section 179 taxable income limit is $255,000 ($300,000 from the partnership minus the $45,000 loss from the proprietorship). Tim is eligible to claim up to the full $250,000 Section 179 deduction for any eligible assets purchased in his proprietorship (assuming total qualifying property does not exceed $800,000).

If a joint return is filed, the active business incomes of both spouses are aggregated even though the Section 179 deduction may be related to the activities of only one spouse.

Example 2-28: Using W-2 income to support a Section 179 deduction.

Betty is an executive with 2010 W-2 income of $150,000. Her husband, Steve, owns a proprietorship that reports a $15,000 business loss. Active business income for claiming a Section 179 deduction on equipment added to Steve's proprietorship is $135,000 ($150,000 − $15,000). Steve is entitled to claim up to $135,000 of Section 179 expense on assets added to his proprietorship for 2010 (assuming total qualifying property does not exceed $800,000).

Planning for a Partner's or S Shareholder's Section 179 Deduction

For partnerships and S corporations, the Section 179 deduction passes through to the individual owners. The $250,000 limit, the $800,000 eligible property ceiling, and the taxable income limitation apply to both the business entity and to each owner. The business entity must separately apply these limits at its level (*Hayden*). In addition, each partner or S shareholder must separately apply these limits on their individual tax returns. The sequence for computing the allowable Section 179 deduction is as follows:

a. The pass-through entity determines its Section 179 deduction subject to the $250,000 limit (for 2010), and allocates the deduction among the owners.

b. Each owner adds the Section 179 deduction passed through from the company (as reported on Schedule K-1) to his or her other Section 179 deductions and then applies the $250,000 limit (for 2010) to this total to determine the Section 179 deduction.

Example 2-29: Applying the Section 179 limit (for 2010) to a partner.

During 2010, CD Partnership (a calendar year partnership) purchases and places in service Section 179 property costing $150,000 and elects to expense $18,000 of its cost. CD allocates to Clarence (a calendar year taxpayer and a 50% partner in CD) $9,000 of Section 179 expense on Schedule K-1. When Clarence applies the $250,000 annual limit for 2010, he must include the $9,000 of Section 179 expense passed through from CD Partnership. Clarence is eligible to deduct up to another $241,000 of Section 179 property on his individual return.

Example 2-30: S shareholder's Section 179 deduction is lost unless adjustment is made.

George owns 60% of ABC, Inc., a calendar-year S corporation. In the current year, ABC elects a $180,000 Section 179 deduction. His share is $108,000. George also owns a ranch he operates as a sole proprietorship. He elects a $183,000 Section 179 deduction on assets used in the ranching business.

Neither the S corporation nor the sole proprietorship has expensed more than the $250,000 limit for the year. However, when the limit is applied on George's individual tax return, he can deduct only $250,000 of the total $291,000 of Section 179 expense election. No carryover provision exists for the excess amount so George will lose a $41,000 deduction for the current year and for all subsequent tax years. George should reduce the amount of Section 179 expense related to his sole proprietorship to avoid the permanent loss of a deduction.

Eligible Property Ceiling. When applying the $800,000 (for 2010) property-placed-in-service limit, neither the company nor the owners must aggregate its purchases with those of any other party. Therefore, to determine if a partner or S shareholder has exceeded the $800,000 eligible property ceiling for purposes of their individual tax returns, the cost of Section 179 property placed in service by the partnership or S corporation is not attributed to the partner or S shareholder.

Example 2-31: Eligible property ceiling for a partnership.

Assume the same facts as in Example 2-29. In determining the amount of property Clarence has placed in service for the $800,000 eligible property limit, the cost of Section 179 property placed in service by CD

Partnership is not attributed to him. Thus, Clarence (individually) can place in service up to $800,000 of Section 179 property before the $800,000 eligible property ceiling comes into play. CD reports only the allocable share of Section 179 *deduction* to each partner. No reporting of Section 179 property purchases (subject to the eligible property ceiling) is required.

Taxable Income Limitation. A partnership or S corporation cannot pass through a Section 179 deduction that exceeds its taxable income limitation for the year (*Hayden*). Similarly, partners or S shareholders cannot deduct Section 179 expense (including amounts passed through from the company) in excess of their taxable income from all active trade or business activities.

a. *Company Level.* The partnership or S corporation determines its Section 179 deduction subject to the taxable income limitation. [The partnership or S corporation can elect the full $250,000 (for 2010) and then carryover any excess amount.] It then allocates this deduction among its owners.

b. *Owner Level.* Each owner adds the *deduction* passed through from the company (as shown on Schedule K-1) to his or her other Section 179 deductions and then applies the taxable income limit to this total to determine the Section 179 deduction on his personal return.

Reduced Section 179 Deduction for Heavy SUVs

The American Jobs Creation Act of 2004 (Jobs Act) placed a lower $25,000 limit on Section 179 deductions for heavy SUVs with gross vehicle weight ratings (GVWRs) between 6,001 and 14,000 pounds. This unfavorable change applies to SUVs placed in service after October 22, 2004. Under prior law, SUVs with GVWRs of more than 6,000 pounds were eligible for the full Section 179 allowance. However, the reduced deduction rule does not affect vehicles that are *not* considered to be SUVs under the tax law.

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 is correct regarding business bad debt?

    a. To be classified as a business bad debt, a loan must have dominant motivation.

    b. The result of business bad debt is a short-term capital loss for the taxpayer.

    c. If the taxpayer is a guarantor on a loan, it cannot be classified as business bad debt.

    d. If the business bad debt is a result of a credit sale, a cash basis taxpayer can claim a business bad debt deduction.

18. If a collector is attempting to prove the worthlessness of a debt, which of the following would suffice for the debtor to record a bad debt expense for the entire amount of the uncollectible loan and deduct a bad business debt?

    a. The debtor filing bankruptcy for their business.

    b. The collector deciding to sue the debtor for the outstanding amount.

    c. An obituary of the debtor in the newspaper.

    d. Proof that the debtor is encountering financial difficulty in their business.

19. Libby owns and operates a sole proprietorship food service supply company. One of her customers, China-to-Go, currently owes Libby $25,000 for supplies ordered over the last year. Libby has tried repeatedly to collect some of the open amount and the owner of China-to-Go has expressed that they are having financial troubles. At the end of 2009, Libby decides, after receiving information from the China-to-Go owner, to write off $10,000. In February, 2010, Libby discovers that the China-to-Go owner was in a car accident and passed away in January. Libby decides to write off the remaining $15,000 in March, 2010, but takes a $10,000 deduction on her 2009 return. How much can Libby take as a deduction for bad business debt in 2010?

    a. $0.

    b. $10,000.

    c. $15,000.

    d. $25,000.

20. Which of the following is correct in relation to amending or revoking a Section 179 deduction?

    a. If a deduction is cancelled, then it can be reinstated by filing an amended return.

    b. No substitutions for assets are allowed within the amended return.

    c. If an asset has already been expensed, it cannot be withdrawn.

    d. Previously capitalized assets can have additional Section 179 expenses in an amendment.

21. Which of the following is correct for a Section 179 deduction for a partner or S shareholder?

    a. After receiving the pass through Section 179 deduction from the entity, the individual must separately apply the Section 179 limits.

    b. Each partner in a partnership gets a separate Section 179 deduction limit.

    c. An individual's Section 179 deduction is separate from their partnership or S corporation deduction.

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 is correct regarding business bad debt? **(Page 133)**

    a. To be classified as a business bad debt, a loan must have dominant motivation. [This answer is correct. To be classified as business bad debt, the loss must bear a "proximate" relation to the taxpayer's trade or business and the motivation for making the loan must be business oriented per the Supreme Court (*Generes*.)]

    b. The result of business bad debt is a short-term capital loss for the taxpayer. [This answer is incorrect. According the Internal Revenue Code, business bad debt results in ordinary losses, while nonbusiness bad debt gives rise to short-term capital losses.]

    c. If the taxpayer is a guarantor on a loan, it cannot be classified as business bad debt. [This answer is incorrect. According to IRS regulations, a guarantor is allowed a business bad debt deduction for any payment made in the capacity as guarantor if the reason for guaranteeing the debt was business. The guarantor's payment results in a loan to the debtor, and the taxpayer is allowed a bad debt deduction once the loan become partially or totally worthless.]

    d. If the business bad debt is a result of a credit sale, a cash basis taxpayer can claim a business bad debt deduction. [This answer is incorrect. A credit sale for a cash basis taxpayer that results in a business bad debt will generally not allow for a bed debt deduction since uncollectible accounts receivable are not included in income until received, in cash basis accounting.]

18. If a collector is attempting to prove the worthlessness of a debt, which of the following would suffice for the debtor to record a bad debt expense for the entire amount of the uncollectible loan and deduct a bad business debt? **(Page 134)**

    a. The debtor filing bankruptcy for their business. [This answer is incorrect. A debtor's bankruptcy generally indicates that an unsecured business debt is at least partially worthless according to IRS regulations. Retaining a copy of the bankruptcy notice should support at least a partial reduction in the value of a receivable or other noncollateralized debt due, but will not allow the collector to expense the entire bad debt.]

    b. The collector deciding to sue the debtor for the outstanding amount. [This answer is incorrect. Worthlessness can be established when the taxpayer sues the debtor, wins a judgment and then shows the judgment is uncollectible. Simply deciding to sue the debtor to try and recover the outstanding bad debt is not enough to warrant writing off the uncollectible loan.]

    c. An obituary of the debtor in the newspaper. [This answer is correct. The courts have accepted the disappearance or death of an individual debtor that is documented by a newspaper clipping, as proof that a debt's value has become worthless. Proving the death of the debtor would be one way for a collector to be able to write off the entire amount of the uncollectible loan.]

    d. Proof that the debtor is encountering financial difficulty in their business. [This answer is incorrect. Evidence that a debtor is experiencing financial difficulties will not, by itself, support an argument for worthlessness since this is not an identifiable event demonstrating the loss of value for the debt.]

19. Libby owns and operates a sole proprietorship food service supply company. One of her customers, China-to-Go, currently owes Libby $25,000 for supplies ordered over the last year. Libby has tried repeatedly to collect some of the open amount and the owner of China-to-Go has expressed that they are having financial troubles. At the end of 2009, Libby decides, after receiving information from the China-to-Go owner, to write off $10,000. In February, 2010, Libby discovers that the China-to-Go owner was in a car accident and passed away in January. Libby decides to write off the remaining $15,000 in March, 2010, but takes a $10,000 deduction on her 2009 return. How much can Libby take as a deduction for bad business debt in 2010? **(Page 135)**

    a. $0. [This answer is incorrect. A taxpayer can deduct a partially worthless bad business debt on their tax return according to IRS regulations.]

    b. $10,000. [This answer is incorrect. While a taxpayer may claim a deduction for any portion of the debt as stated in the IRS regulations, it cannot deduct for the debt any amount deducted in an earlier year when the debt was only partially worthless.]

    c. $15,000. [This answer is correct. Per IRS regulations, a taxpayer may claim a deduction for any portion of the debt, up to the amount actually written off its books during the year.]

    d. $25,000. [This answer is incorrect. A totally worthless debt is deductible only in the tax year it becomes totally worthless. The deduction for the debt does not include any amount deducted in an earlier year when the debt was only partially worthless per IRS regulations.]

20. Which of the following is correct in relation to amending or revoking a Section 179 deduction? **(Page 136)**

    a. If a deduction is cancelled, then it can be reinstated by filing an amended return. [This answer is incorrect. Once a deduction is revoked, the Section 179 deduction on that property cannot be reinstated. The revocation itself is irrevocable per Reg.1.179-5(c)(s)(ii).]

    b. No substitutions for assets are allowed within the amended return. [This answer is incorrect. As stated in the Internal Revenue Code, one specific asset can be substituted for another asset of the same type if the taxpayer decides to make an amendment or revocation of its Section 179 election.]

    c. If an asset has already been expensed, it cannot be withdrawn. [This answer is incorrect. A taxpayer that chooses to make a change regarding their Section 179 election through amendment or revocation can elect to expense an asset that was previously totally revoked per the Internal Revenue Code.]

    d. **Previously capitalized assets can have additional Section 179 expenses in an amendment. [This answer is correct. A taxpayer can make a change regarding a Section 179 election, subject to deduction and income limitation, by claiming additional under IRC Sec. 179 for assets that had been previously capitalized.]**

21. Which of the following is correct for a Section 179 deduction for a partner or S shareholder? **(Page 138)**

    a. After receiving the pass through Section 179 deduction from the entity, the individual must separately apply the Section 179 limits. [This answer is correct. Each owner adds the Section 179 deduction pass through from the company (as reported on Schedule K-1) to his or her other Section 179 deductions and then applies the $250,000 limit to this total to determine the Section 179 deduction according to Reg.1.179-2(b)(3)and (4).]

    b. Each partner in a partnership gets a separate Section 179 deduction limit. [This answer is incorrect. The pass-through entity determines its Section 179 deduction subject to the $250,000 limit for the partnership and then allocates the deduction among its owners. The business entity must separately apply these limits at its level (*Hayden*).]

    c. An individual's Section 179 deduction is separate from their partnership or S corporation deduction. [This answer is incorrect. For partnerships and S corporations, the Section 179 deduction passes through to the individual owners.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TINTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

8. If a taxpayer is attempting to have their pass-through income excluded from their self-employment income, how should the taxpayer structure his or her company?

   a. The taxpayer should be a limited partner in a limited partnership.

   b. The taxpayer should set the company up as a sole proprietorship.

   c. The taxpayer should be a general partner in a limited partnership.

   d. The taxpayer should set the company up as an LLC treated as a partnership.

9. Nick owns an office building and warehouse. He leases both to his closely held corporation, Nick Enterprises. He receives $50,000 in rental payments from the corporation each year. Nick does not provide any services to Nick Enterprises and he does not rent any property to anyone else. In addition to the property rental, Nick rents a generator to Nick Enterprises. Nick is paid a reasonable salary by Nick Enterprises for the services he provides to the corporation. Which of the following is correct?

   a. The rental income for the property will be subject to SE tax.

   b. The rental income for the generator will be subject to SE tax.

   c. None of the rental income that Nick receives will be subject to SE tax.

   d. Do not select this answer choice.

10. Which of the following is another name for a health spending account?

    a. Flexible spending account.

    b. Tax-exempt trust.

    c. Insurance.

    d. High deductible health plan.

11. Paul accepts a new job with Blue Pool Tech, starting on July 1. The company provides medical coverage as part of its comprehensive package. Previously, Paul was self-employed and a single contributor to an HSA. How much does Paul have to recapture in income on his return at the end of the year?

    a. $0.

    b. $1,525.

    c. $1,650.

    d. $3,050.

12. Beth has an HDHP with family coverage and a $2,000 deductible. Beth is 56, but Beth's husband is only 52. How much can Beth and her husband contribute to their HSA this year?

    a. $6,150.

    b. $7,150.

    c. $8,150.

d. $9,150.

13. Which of the following is true regarding contributions to an HSA?

    a. The contributions are due before the taxpayer's income tax return is filed for the year.

    b. Contributions can be made in the form of cash, stock or other property.

    c. Contributions must be made in equal, monthly payments to the HSA account.

    d. Do not select this answer choice.

14. HSAs are transferable. Which of the following is a correct statement about HSA transfers?

    a. HSAs that are transferred to another HSA due to divorce between the two taxpayers are taxable.

    b. Nonspousal beneficiaries that inherit HSAs on the HSA's date-of-death, can inherit the account tax free.

    c. If a spouse inherits a HSA because they are named beneficiary, it can be transferred tax-free.

    d. Taxes must be paid on distributions for the medical bills of an HSA, if they were paid after the HSA's death.

15. If a taxpayer is using a section of their house specifically for business purposes only, in hopes of deducting it as a home office, the taxpayer has fulfilled the _________ test, but to attain the deduction, they would still need to fulfill the _______ test.

    a. Principal place of business; exclusive.

    b. Exclusive; regular use.

    c. Regular use; principal place of business.

    d. Regular use; exclusive.

16. If a taxpayer's home office qualifies under the principal place of business, how can the taxpayer deduct traveling expenses incurred for transportation between the taxpayer's home and the regular place of business?

    a. As a Section 179 deduction.

    b. As a personal, nondeductible expense.

    c. As a business expense.

    d. Do not select this answer choice.

17. Which of the following is required for a debt to be a bona fide debt?

    a. A formal loan agreement between the two parties.

    b. If between related parties, a set time period to pay back the loan.

    c. A legitimate business purpose for the loan to be granted.

    d. A valid and enforceable agreement for a set amount of money.

18. Tim, an owner of a pool company, has personally guaranteed a loan of $15,000 for his number one supplier of tile. Tim uses this tile in every pool that he builds. In addition, the tile supplier is Tim's brother-in-law. Unfortunately, the tile supplier was not able to overcome the financial hardships he was facing and goes out

of business and defaults on the loan. Tim is forced to make full payment on the loan himself and is not able to recover the amount from his brother-in-law. Is the debt considered a business bad debt or a nonbusiness bad debt?

a. Business bad debt.

b. Nonbusiness bad debt.

c. Do not select this answer choice.

d. Do not select this answer choice.

19. Drew owns and operates an accrual method sole proprietorship servicing large trucks. One customer, who Drew has done business with for many years, has an open note receivable of $15,000. Drew has been trying to collect the open note for many months and has learned that the customer is having financial difficulties. At the end of 2009, after speaking to the customer about what they are going to be able to pay, Drew decides to write off $10,000 of the debt. The customer assures Drew that the remaining amount will be paid in early 2010, but in March, 2010, Drew finds out that the customer has declared bankruptcy and Drew decides to write off $5,000. How much can Drew claim as a bad debt deduction on his 2010 tax return?

a. $0.

b. $5,000.

c. $10,000.

d. $15,000.

20. Which of the following would qualify as Section 179 property and be able to be expensed using Section 179 rules?

a. An air conditioning unit purchased and placed into service in a warehouse.

b. A building owned by a sole proprietor and used in the ordinary course of business.

c. A truck placed in service by an estate to facilitate the business of the trust.

d. A photocopier traded in for a new copier, in addition to cash.

21. Which of the following is **not** allowed to be included in business income when a taxpayer is trying to take the full Section 179 deduction?

a. The deduction for expensing Section 179 property.

b. An employee's wages, salaries, tips or other compensation.

c. Section 1231 gains (or losses) from a trade or business.

d. A sole proprietor's net income (or loss) stated on their tax return.

Lesson 3: Maximizing Depreciation And Tax Benefits For Autos

INTRODUCTION

The cost of a business asset with a useful life that extends beyond the current year must be capitalized. The capitalized cost is referred to as the asset's tax basis. The business can claim a limited amount of the tax basis as a Section 179 deduction for the year of purchase. The remaining tax basis of the property must be recovered over the asset's recovery period in the form of depreciation deductions.

Planning in this area centers on selecting the best depreciation method for regular and AMT purposes. (Selecting depreciation methods is one of the few post year-end tax planning opportunities a business taxpayer can make.) Strategies also exist to simplify depreciation records, including the use of a capitalization policy. With proper planning, taxpayers can time their equipment purchases to maximize depreciation deductions.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize ways to maximize depreciation for business deductions including establishing a minimum capitalization floor and midquarter convention.
- Identify methods for maximizing business deductions for costs associated with automobile use and determine the requirements for recordkeeping associated with business autos.

Selecting the Best Depreciation Method and Recovery Period

Many different factors impact the election of a depreciation method. Items such as current and future tax rates, current and future income, and possible application of the AMT are some of the relevant factors. Equally important in some cases is the cost of having to maintain more than one set of depreciation records. Using the same depreciation method for regular taxes, AMT, and other tax purposes has several advantages.

a. It avoids multiple depreciation calculations for an asset each year.

b. It also avoids basis adjustments when an asset is sold or disposed. On the sale of an asset placed in service after 1986 for which different depreciation methods are used for regular tax and AMT, the adjusted basis of the asset for determining gain or loss will be different. This results in an AMT adjustment in the AMT calculation.

Exhibit 3-1 identifies some common objectives and then indicates which depreciation method may work best to achieve those objectives.

Exhibit 3-1

Factors to Consider When Selecting a Depreciation Method

Objective	Explanation of Preferred Method
1. Obtain fastest write-off.	Regular MACRS (i.e., 200% declining balance) provides the fastest write-off and the shortest life available (except, perhaps, depreciation computed under a method not expressed in terms of year) for the regular tax system. However, separate depreciation records must be kept for AMT purposes. (If allowable, IRC Sec. 179 enables a taxpayer to expense rather than depreciate property.)
2. Minimize recordkeeping.[a]	Using the straight-line method under the Alternative Depreciation System (ADS) or the AMT (i.e., 150% declining balance over the MACRS recovery periods) depreciation method for the regular tax system results in only one set of depreciation records for all federal tax depreciation provisions (i.e., no adjustments are required for AMT).

Objective	Explanation of Preferred Method
3. Minimize depreciation.[b]	ADS provides the lowest up-front depreciation deductions and extends depreciation over a longer period while minimizing recordkeeping.
4. Minimize AMT.	The AMT or ADS depreciation method should be elected if the goal is to minimize AMT.

Notes:

[a] Minimizing recordkeeping is important for businesses with small amounts of depreciable property whose depreciation deductions under any method are not significant. This may also be true for businesses with numerous depreciable assets (particularly those holding the assets for a short time) that can benefit from the reduced cost of not having to maintain multiple sets of depreciation schedules.

[b] Minimizing depreciation is important if the taxpayer needs to utilize an NOL carryforward that will expire soon. It is also useful for taxpayers with current or carryover NOLs for which regular tax and AMT does not arise, and taxpayers wanting to defer depreciation deductions into future years in anticipation of future tax rate hikes. Taxpayers subject to passive loss limitations may also want to minimize depreciation.

* * *

Minimum Tax Credit (MTC) Considerations. Before making any depreciation elections, the practitioner should consider other AMT adjustments and the MTC. If other preferences and adjustments that cause the taxpayer to be subject to AMT are exclusion preferences (permanent differences such as nondeductible itemized deductions), the MTC will likely not be available, and any AMT paid becomes a permanent tax. In this case, electing slower AMT depreciation methods for the regular tax system can be beneficial by saving future regular depreciation deductions. Conversely, if AMT arises largely from deferral or timing preferences, the AMT will become an MTC carryforward to offset future regular tax to the extent that regular tax exceeds any AMT in future years. Therefore, any AMT paid in the current year may be recovered as a credit against regular tax in future years. If the taxpayer elects slower depreciation for regular tax, the MTC carryover is reduced in exchange for depreciation deductions that extend over a longer period for regular tax purposes. This is probably not a good trade-off when future depreciation deductions pertain to long-lived assets. Here, the taxpayer would be well advised to use MACRS for regular tax and use the resulting MTC to offset regular tax in future years.

Matching of Recovery Periods for Regular Tax and AMT. Effective for property placed in service after 1998, the depreciation recovery period is the same for both regular tax and AMT purposes; i.e., it is the regular MACRS recovery period. However, an AMT adjustment may still be required depending on the depreciation *method* used [regular MACRS uses 200% declining balance (DB) while AMT depreciation uses 150% DB]. (But, see election discussed in the next paragraph.) In addition, property placed in service before 1999 remains under the previous rules, so the depreciation differences on that property must continue to be dealt with until the property is fully depreciated or disposed of.

Effective for personal property placed in service after 1998, a taxpayer can elect, for regular tax purposes, to use the 150% declining balance method (which is the method normally used for AMT purposes) to compute depreciation on property otherwise qualifying for 200% MACRS. Thus, taxpayers are able to elect for both regular tax and AMT purposes to use the same method (150% declining balance) with the same MACRS recovery periods.

Consequently, the following situations apply for property placed in service after 1998:

a. For personal property otherwise eligible for MACRS depreciation under the 200% declining balance method, taxpayers can elect to use 150% MACRS (150% declining balance method over MACRS recovery periods) instead. Making this election eliminates the need to calculate any AMT depreciation adjustment for the affected property.

If this election is not made an AMT adjustment will be necessary because the 150% declining balance method is used for AMT purposes while the 200% declining balance method is used for regular tax (the recovery methods will be the same, but the methods will be different).

b. AMT recovery periods will be the same as MACRS recovery periods for depreciation on residential and nonresidential real property. No AMT adjustments will be necessary for this property because the same method (i.e., straight-line) and recovery periods are used for both regular and AMT purposes.

Establishing a Minimum Capitalization Floor for Lower-priced Assets

For lower-priced assets having a useful life extending beyond the acquisition year, a business could establish a capitalization floor below which the costs of such assets are expensed. Although the floor is intended to avoid the paperwork necessary to track depreciation of immaterial items (such as a $15 wastebasket or a $20 papercutter), obviously, the higher the floor, the greater the current deduction for fixed asset acquisitions. In addition, items deducted under this *de minimis* rule for regular tax purposes are fully deductible for AMT, too.

In a Tax Court decision, *Alacare Home Health Services, Inc.*, capitalization floors have been called into question. Alacare adopted a $500 capitalization threshold, and expensed any purchase under this amount. The taxpayer chose this $500 floor, in part, because it had to comply with Medicare's guidelines that stated that if a depreciable asset cost at least $500 and had a useful life of at least two years, it had to be capitalized. It used this same threshold for income tax purposes from the date of incorporation in 1982 until the years at issue, 1995 and 1996. When the IRS audited Alacare, it determined that the capitalization floor method was not a proper method of accounting. It disallowed about $470,000 in office expense for 1995, and roughly $370,000 for 1996. The assets that were expensed included bookcases, chairs, credenzas, desks, file cabinets, microwaves, tables, telephones, modems, keyboards, software, and terminals. The Tax Court affirmed the disallowance, saying that the costs should have been capitalized and depreciated or amortized.

Prior to the *Alacare* case, two older cases had set the ground rules regarding capitalization floors. In *Cincinnati, New Orleans & Pacific Railway Company* and *Union Pacific Railroad Company*, the taxpayers were required by the Interstate Commerce Commission (ICC) to expense purchases of certain property costing less than $500. (Because the years involved in these cases were in the 1940s, the $500 minimum capitalization floor would be the equivalent to several thousand dollars today.) The IRS challenged the taxpayers' use of the same expensing policy for income tax purposes. However, the Court of Claims sided with the taxpayers in both cases, noting that the amounts involved were *de minimis* and that the ICC had adopted its minimum capitalization rule after concluding that such a rule would not distort income or cause the railroads' financial statements not to clearly reflect income.

In the *Alacare* case, it should be noted that the amounts expensed were substantial amounts, compared to taxable income. The expensed amounts represented 165% of taxable income in 1995, and 84% of taxable income in 1996. The Tax Court distinguished the *Alacare* case from that of the railroads because of the relative importance of the dollars involved. In the railroads' cases, the dollar amount of items expensed under the capitalization policy was less than 1% of the taxpayers' income.

The bottom line is that if a minimum capitalization floor is used, it cannot distort the taxpayer's income. That concept is what caused Alacare to lose its case. Practitioners should monitor this matter and watch for possible appeals activity related to the *Alacare* case.

If a taxpayer decides to implement a capitalization policy (despite the *Alacare* ruling), consider the following factors:

a. *Determine How Frequently the Business Acquires Assets below a Certain Cost.* For example, infrequent purchases of items costing less than $100 tend to indicate that the business should expense purchases below that amount.

b. *Consider the Relative Size of Expenditures.* A business that regularly spends tens of thousands of dollars on fixed asset additions each year can presumably justify a higher capitalization floor than a business with annual fixed asset additions totaling less than $1,000.

c. *Emphasize Consistency.* Although a business may raise, or even lower, the floor from one year to the next because circumstances change (perhaps a major business expansion causes a significant increase in fixed asset acquisitions), the IRS would likely look for consistent application when evaluating whether a business's capitalization policy is reasonable. Thus, a business that consistently maintains a policy of expensing all depreciable assets costing less than $250 may have an easier time justifying this policy than a similar business that arbitrarily changes its policy to anywhere from a $50 to $250 floor, depending on each year's circumstances.

d. *Examine the Total Amount of Expensed Items Relative to Taxable Income.* In light of the *Alacare* case, it appears that the total amount of items expensed compared to taxable income is an important factor. The ratio should be quite small, as was the situation in the railroad cases previously discussed.

e. *Ensure the Capitalization Policy Does Not Distort Income.* In the *Alacare* case, a major stumbling block in the capitalization floor appeared to be that the policy distorted income. Income must be fairly stated in order to pass IRS scrutiny.

No specific tax rules currently exist for determining an acceptable capitalization floor, provided expensing rather than capitalizing low-costs items does not misstate income. Thus, depending on the nature of the company's business, an appropriate floor may be set anywhere from $50 to $1,000 or more until further regulations are finalized.

Planning for Late-year Equipment Purchases

The practitioner should consider several planning alternatives if the client has any flexibility in timing his late-year fixed asset purchases. With careful planning, the taxpayer may be able to avoid the midquarter convention (or adopt the midquarter convention, if that maximizes depreciation) by timing late-year equipment purchases. The Section 179 deduction can be used to trigger or avoid the midquarter convention.

Half-year and Midquarter Conventions. Depreciable assets other than real property generally are subject to a half-year convention when calculating tax depreciation. (Real property is subject to a midmonth convention.) Thus, regardless of the actual acquisition date, property subject to the half-year convention is assumed to have been acquired at the tax year's midpoint. This method provides a taxpayer with half a full year's depreciation deduction in both the year of acquisition and the year of disposition. No depreciation is allowed for property that is acquired and disposed of in the same tax year.

A midquarter convention (with property assumed to be placed in service at the midpoint of the quarter in which it is acquired) applies to *all* property if more than 40% of depreciable property placed in service during the year is done so in the last three months of the tax year. Real property and property for which a Section 179 deduction has been elected are excluded when testing for the midquarter convention.

Applying the Midquarter Convention. To calculate depreciation deductions under the midquarter convention, the taxpayer first determines depreciation for the full year, and then applies a quarterly percentage based on when the asset was placed in service:

Quarter of the Tax Year Placed in Service	Percentage
First	87.5%
Second	62.5%
Third	37.5%
Fourth	12.5%

Depreciation tables are available that automatically factor in the appropriate midquarter convention.

Example 3-1: Testing for the midquarter convention.

Proprietors A and B each acquire $200,000 of depreciable property during the current year (a $90,000 building; $10,000 of office furniture; and two pieces of machinery, costing $55,000 and $45,000, respectively). In each case, the $55,000 piece of machinery is acquired during August. However, for the second piece of machinery, Proprietor A acquires it in September, while Proprietor B waits until October 1. The machinery is seven-year property. Each business elects to claim the Section 179 deduction for the office furniture.

	Proprietor A		Proprietor B	
Total depreciable assets acquired	$ 200,000		$ 200,000	
Less property not subject to the half-year or midquarter convention:				
Real property[a]	(90,000)		(90,000)	
Office furniture (Section 179 expense)[b]	(10,000)		(10,000)	
Property subject to the half-year or midquarter convention	$ 100,000		$ 100,000	
Testing for midquarter convention:				
Property placed in service in 4th quarter / Total property placed in service	$0 / $100,000	= 0%	$45,000 / $100,000	= 45%
Does the midquarter convention apply?	NO		YES	

Notes:

[a] Real property is subject to a midmonth convention. It is not included in the test to determine if the midquarter convention applies.

[b] Property expensed under IRC Sec. 179 is not included in the test to determine if the midquarter convention applies.

Ways to Avoid the Midquarter Convention. Normally, a business wants to avoid the midquarter convention since property acquired after the midpoint of the tax year is entitled to less depreciation in the first year than under the half-year convention. One way the business accomplishes this is by timing asset purchases so that at least 60% of the assets purchased during the year are placed in service during the first three quarters of the year. Indeed, the taxpayer can make fixed asset purchases as late as September and still use the half-year convention if at least 60% of the assets are placed in service on or before September 30 (assuming a calendar tax year is used).

Example 3-2: Accelerating asset purchases to avoid the midquarter convention.

Assume the same facts as in Example 3-1. First year depreciation on the machinery is calculated as follows:

	Proprietor A	Proprietor B
Applicable convention	Half-year	Midquarter
First-year machinery depreciation:		
$55,000 machine	$ 7,860	$ 5,891
$45,000 machine	6,430	1,607
Total first-year machinery depreciation	$ 14,290	$ 7,498

In this situation, the half-year convention is advantageous because the machinery was purchased after the midpoint of the year. Proprietor A maximizes his machinery depreciation deduction by accelerating the $45,000 asset acquisition into September and avoiding the midquarter convention. This allows Proprietor A to deduct an additional $6,792 ($14,290 − $7,498) of first-year machinery depreciation.

The cost of property expensed under the Section 179 deduction is excluded when applying the 40% rule for the midquarter convention test. Because the company can choose which assets it will expense for Section 179 the Section 179 deduction can be used to trigger or avoid the midquarter convention. Therefore, another way to avoid the midquarter convention is to claim a Section 179 deduction on assets purchased in the fourth quarter to the extent necessary to reduce fourth quarter asset purchases to or below the 40% threshold.

Example 3-3: Using the Section 179 election to avoid the midquarter convention.

Assume the same facts as in Example 3-2. Proprietor B could have avoided the midquarter convention by claiming the Section 179 deduction on the $45,000 machine rather than the office furniture (assuming the office furniture was placed in service before October 1). Assuming the machine was expensed under IRC Sec. 179, the midquarter test for Proprietor B would show the following results:

	Proprietor B	
Total depreciable assets acquired	$ 200,000	
Less property not subject to the half-year or midquarter convention:		
Real property	(90,000)	
$45,000 machine (Section 179 expense)	(45,000)	
Property subject to the half-year or midquarter convention	$ 65,000	
Testing for midquarter convention	$\frac{\$0}{\$65,000}$	= 0%
Does the midquarter convention apply?	NO	

When Using the Midquarter Convention Is Advantageous. The midquarter convention is likely to be advantageous when the company places into service a substantial amount of depreciable assets, other than real property, in the first quarter of the tax year. In this instance, taxpayers might benefit by delaying purchasing additional assets until the fourth quarter to trigger the midquarter convention. Alternately, the taxpayer should claim a Section 179 deduction on assets purchased in the first through third quarter to the extent necessary to ensure fourth quarter asset purchases exceed the 40% threshold.

Example 3-4: Delaying asset purchases to trigger the midquarter convention.

Assume the same facts as in Example 3-1 except Proprietor A and Proprietor B purchase the $55,000 machine in March. Proprietor A purchases the $45,000 machine in August while Proprietor B waits until October. The tax results are as follows:

	Proprietor A		Proprietor B	
Testing for midquarter convention	$\frac{\$0}{\$100,000}$	= 0%	$\frac{\$45,000}{\$100,000}$	= 45%
Does the midquarter convention apply?	NO		YES	
First-year machinery depreciation:				
$55,000 machine	$ 7,860		$ 13,750	
$45,000 machine	6,430		1,607	
Total first-year machinery depreciation	$ 14,290		$ 15,357	

In this situation, the midquarter convention is advantageous because most of the machinery cost was incurred early in the year. Proprietor B maximizes his first-year depreciation deduction by delaying the $45,000 asset acquisition until October and triggering the midquarter convention. This allows Proprietor B to write off an additional $1,067 ($15,357 − $14,290) of first-year machinery depreciation.

Maximizing Depreciation for Assets Used in Specific Activities

Rev. Proc. 87-56 (modified by Rev. Proc. 88-22) lists the MACRS recovery periods for various types of property. The first table in Rev Proc. 87-56 covers depreciable assets used for general purposes in "all business activities." This list includes assets such as office furniture, fixtures and equipment, information systems, data handling equipment, cars, trucks, airplanes, and land improvements. For example, office furniture and fixtures used for general business purposes are assigned a seven-year MACRS recovery period.

The second table in Rev. Proc. 87-56 covers depreciable assets used in certain specific industries and activities. One of the broadest categories in this group is property used in distributive trades and services, including property used in wholesale and retail trade and in personal and professional services (such as accounting, law, or medical practices). Assets falling into that category are assigned a five-year recovery period. (For more on assets properly includable in this class, see TAM 9101003.)

Other specific industries for which assets are assigned a class life (i.e., fall outside the "general" recovery periods) include agriculture, petroleum and petroleum product marketing, recreation (bowling alleys, theatres, etc.), radio and television broadcasting, utilities, and manufacturing.

To qualify for the recovery period assigned to assets used in a specific trade or business, the asset must be unique to the taxpayer's business. In other words, a desk is still seven-year property, even if used by a retailer (i.e., a taxpayer engaged in a distributive trade or service). Display racks for clothing, however, would properly be classified as five-year property because that asset is used in the distributive trade. (See *Norwest Corporation*.) Also, if an item of property is used in two separate activities, depreciation for the item is calculated based on the activity in which the item is primarily used (CCA 200137026).

SELF-STUDY QUIZ

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

22. Stephanie just opened her sole proprietorship in 2010. She is trying to determine what depreciation method she wants to use for her business. She has decided she wants to minimize depreciation in these first few years since she anticipates having losses from the business. Also, since she is a sole proprietor, she would like to keep her record keeping to a minimum. What depreciation method should Stephanie employ?

    a. AMT depreciation system

    b. Alternative Depreciation System.

    c. Regular MACRS.

23. When might a small business owner find it important to minimize recordkeeping in relation to their depreciable assets?

    a. When a small business needs to utilize an NOL carryforward that is going to expire soon.

    b. When the business is employing a different depreciation method for tax purposes.

    c. The taxpayer is anticipating a future tax rate hike.

    d. When the business does not have significant amounts of depreciable property.

24. If a taxpayer chooses to institute a minimum capitalization policy for lower-priced assets, which of the following could get the taxpayer in trouble with the IRS?

    a. The frequency that the taxpayer's business obtains an asset below a certain cost.

    b. The taxpayer stresses consistency with the minimum capitalization policy.

    c. Misrepresenting income due to the capitalization policy.

    d. Contemplating the size of the expenditures in relation to the number of assets acquired in the year.

25. Which of the following is true regarding late-year equipment purchases?

    a. A taxpayer can employ a Section 179 deduction to produce or avoid a midquarter convention for late-year equipment purchases.

    b. The midquarter convention only applies to assets purchased in the last quarter of the tax year, regardless of when the other assets are purchased within the tax year.

    c. Half-year depreciation is available to all assets acquired at the tax year's midpoint, even if the asset is disposed of in the same tax year.

26. Larry and Joe each own a manufacturing business. Each company acquires $300,000 of depreciable property during the current year comprised of:

Building	$	150,000
Office Furniture	$	25,000
Machine A	$	50,000
Machine B	$	75,000

    Larry and Joe each claim a Section 179 deduction for the office furniture. All the machinery is seven-year property. Larry and Joe both acquire Machine A in July, but Larry acquires Machine B in August, while Joe acquires it in November. Which taxpayer does the midquarter convention apply to?

    a. Larry.

    b. Joe.

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. Stephanie just opened her sole proprietorship in 2010. She is trying to determine what depreciation method she wants to use for her business. She has decided she wants to minimize depreciation in these first few years since she anticipates having losses from the business. Also, since she is a sole proprietor, she would like to keep her record keeping to a minimum. What depreciation method should Stephanie employ? **(Page 147)**

    a. AMT depreciation system. [This answer is incorrect. The AMT depreciation system is used if the taxpayer is attempting to minimize AMT or minimize recordkeeping since the system results in only one set of depreciation records for all federal tax depreciation provisions.]

    b. Alternative Depreciation System. [This answer is correct. If Stephanie wants to minimize depreciation and minimize recordkeeping, the Alternative Depreciation System (ADS) provides the lowest up-front depreciation deductions and extends depreciation over a longer period while minimizing recordkeeping.]

    c. Regular MACRS. [This answer is incorrect. Regular MACRS provides the fastest write-off and the shortest life available for the regular tax system, which is the opposite of what Stephanie is trying to accomplish. In addition, using MACRS requires separate depreciation records to be kept for AMT purposes.]

23. When might a small business owner find it important to minimize recordkeeping in relation to their depreciable assets? **(Page 147)**

    a. When a small business needs to utilize an NOL carryforward that is going to expire soon. [This answer is incorrect. If it is important for the business to utilize an NOL carryforward that is going to expire soon, the taxpayer needs to minimize depreciation so that they can take advantage of the NOL carryforward, not minimize recordkeeping.]

    b. When the business is employing a different depreciation method for tax purposes. [This answer is incorrect. If the business is using a different depreciation method for regular taxes, AMT and other financial matters, then the taxpayer is maintaining multiple sets of depreciation schedules, which would not reduce recordkeeping for the taxpayer, it would increase the records that the business would be responsible for sustaining.]

    c. The taxpayer is anticipating a future tax rate hike. [This answer is incorrect. If the small business owner is anticipating a future tax rate hike, then they would want to minimize depreciation in the current year so that the depreciation expense could be moved forward to later years when the tax rate is higher. The taxpayer would be wanting to minimize deprecation, not recordkeeping.]

    d. When the business does not have significant amounts of depreciable property. [This answer is correct. Minimizing recordkeeping is important for businesses with small amounts of depreciable property whose depreciation deductions under any depreciation method are not significant to the business and it is not the best use of the small business' resources.]

24. If a taxpayer chooses to institute a minimum capitalization policy for lower-priced assets, which of the following could get the taxpayer in trouble with the IRS? **(Page 149)**

    a. The frequency that the taxpayer's business obtains an asset below a certain cost. [This answer is incorrect. While monitoring the frequency that an asset below a certain cost is acquired is a best practice for a taxpayer, it should not cause problems with the IRS. In fact, infrequent purchases of items costing less than the minimum capitalization policy tend to indicate that the business should expense purchases below that amount.]

    b. The taxpayer stresses consistency with the minimum capitalization policy. [This answer is incorrect. Although a business may raise, or even lower, the floor from one year to the next because circumstances changed, the IRS would likely look for consistent application when evaluating whether a business's capitalization policy is reasonable. If the taxpayer emphasizes consistent application of the policy, the taxpayer would have an easier time justifying the policy to the IRS.]

c. **Misrepresenting income due to the capitalization policy. [This answer is correct. If the capitalization policy distorts the taxpayer's income, it could cause an issue for the taxpayer with the IRS. Income must be fairly stated in order to pass IRS scrutiny.]**

d. Contemplating the size of the expenditures in relation to the number of assets acquired in the year. [This answer is incorrect. A business that regularly spends tens of thousands of dollars on fixed asset additions each year can presumably justify a higher capitalization floor than a business with low annual fixed asset additions. If the taxpayer keeps this in mind, it should not cause alarm with the IRS.]

25. Which of the following is true regarding late-year equipment purchases? **(Page 150)**

a. **A taxpayer can employ a Section 179 deduction to produce or avoid a midquarter convention for late-year equipment purchases. [This answer is correct. With careful planning, the taxpayer may be able to avoid midquarter convention, or adopt midquarter convention, based on the needed results by timing late-year equipment purchases and utilizing a Section 179 deduction to either trigger or avoid the midquarter convention, whichever is most advantageous to the taxpayer.]**

b. The midquarter convention only applies to assets purchased in the last quarter of the tax year, regardless of when the other assets are purchased within the tax year. [This answer is incorrect. A midquarter convention , which assumes that property is placed into service at the midpoint of the quarter in which it is acquired, applies to all property if more than 40% of depreciable property placed in service during the year is done so in the last three months of the tax year per Reg. 1.168(d)(1).]

c. Half-year depreciation is available to all assets acquired at the tax year's midpoint, even if the asset is disposed of in the same tax year. [This answer is incorrect. Mid-year depreciation provides a taxpayer with half a full year's depreciation deduction in both the year of acquisition and year of disposition, but no depreciation is allowed for property that is acquired and disposed of in the same tax year.]

26. Larry and Joe each own a manufacturing business. Each company acquires $300,000 of depreciable property during the current year comprised of:

Building	$	150,000
Office Furniture	$	25,000
Machine A	$	50,000
Machine B	$	75,000

Larry and Joe each claim a Section 179 deduction for the office furniture. All the machinery is seven-year property. Larry and Joe both acquire Machine A in July, but Larry acquires Machine B in August, while Joe acquires it in November. Which taxpayer does the midquarter convention apply to? **(Page 150)**

a. Larry. [This answer is incorrect. Since Larry acquired both of the pieces of machinery before the 4th quarter, he is not eligible for the midquarter convention as stated in the IRS regulations.]

b. **Joe. [This answer is correct. A midquarter convention applies to all property if more than 40% of the depreciable property placed in service during the year is done so in the last three months of the tax year. The building and office furniture are not eligible for midquarter convention, so that only leaves the machinery. Since Joe acquires 60% of the remaining assets in the 4th quarter of the year, he is eligible for the midquarter convention.]**

TAX BENEFITS FOR AUTOS: DEDUCTIONS AND CREDITS

Congress has enacted rules that limit the ability of taxpayers to claim business deductions for costs associated with automobile use and has also tightened the auto recordkeeping requirements. However, with careful planning, taxpayers can maximize their automobile business deductions and avoid many of the potential tax traps that exist when using their personal cars for business. Planning strategies also exist to help ease the taxpayer's auto recordkeeping burden.

Allocating Costs between Business and Personal Use

If a self-employed taxpayer uses a car for both business and personal use, an allocation must be made in proportion to the number of miles driven during the year for each purpose. This allocation applies to each component of a car's operating expenses except those expenses clearly identified with a particular use of the car.

Taxpayers substantiate auto business mileage by maintaining adequate records. Automobile use not substantiated by adequate records or by other sufficient corroborating evidence is considered personal use. Later in the lesson there is more on the recordkeeping requirements for business autos and for planning strategies to ease the client's automobile recordkeeping burden.

Maximizing Business Commuting Expenses

The costs of commuting from a personal residence to places of business or employment generally are nondeductible personal expenditures. The deduction for commuting costs is disallowed regardless of the distance involved (*Knelman*).

Deducting Local Transportation When the Residence Is the Principal Place of Business. Taxpayers whose residences qualify as their principal place of business under IRC Sec. 280A(c)(1)(A) can deduct local daily transportation expenses incurred in going between their residences and other work locations in the same trade or business, including regular or temporary work locations and regardless of the distance (*Curphey*; Rev. Rul. 99-7).

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 (CCA 200027047).

Example 3-5: Management consultant with home office.

Jack is a self-employed management consultant for a variety of small businesses. He maintains a home office used regularly and exclusively to set up appointments, store client files, and develop management reports for his business clients. Jack does most of his consulting work by telephone or mail from his home office. He routinely uses his personal auto traveling from his home to meet with prospective and current business customers or their representatives. His home office qualifies as his principal place of business under IRC Sec. 280A(c)(1)(A).

Because Jack meets the principal place of business home-office criteria, his mileage traveling from his residence to see clients, to work at other regular or temporary work locations, or to perform other business duties is deductible business use.

Temporary Work Locations. Taxpayers who do not have a home office that qualifies as their principal place of business within the meaning of IRC Sec. 280A(c)(1)(A) can still deduct the cost of daily transportation expenses incurred in going from their residences to *temporary* work locations in the following circumstances: (a) when the location is a temporary work site *outside* the metropolitan area where he lives and normally works (because there is no fixed place of business, the entire metropolitan area is deemed the workplace); or (b) a taxpayer who has one or more regular work locations *away from home* can deduct the cost of transportation from the home to a temporary work site in the same trade or business regardless of the distance (Rev. Rul. 99-7) or whether the site is inside or outside the residential metropolitan area (CCA 200025052).

Generally, a metropolitan area includes the area within the city limits and the suburbs that are considered part of that area (IRS Pub. 463).

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 (CCA 200026025). A *regular place of business* is any location where the taxpayer works or performs services on a regular basis.

Example 3-6: Salesperson with no regular work locations.

Joe Trent is a self-employed salesperson. His only office is a room in his house used to set up appointments, store product samples, and write up orders and other reports for the companies whose products he sells. His business activities involve selling products to customers at various locations within the metro area in which he lives. To make these sales, he regularly travels from his residence to customer sites. Joe's home office does not meet the IRC Sec. 280A(c)(1)(A) principal place of business home-office criteria. Nor does he have any other regular work location.

Because Joe's residence does not qualify as a Section 280A principal place of business and he has no other regular work location, only travel from home to outside of the metropolitan area and travel between customer calls in the metropolitan area is deductible. Travel between his residence and the first customer call in the metro area, as well as travel from the last call of the day to his residence, are not business related.

Example 3-7: Sole proprietor with regular work locations but no home office.

Susan Thomas, a sole proprietor, owns and operates a travel agency with three branch locations throughout the city. She spends approximately 10–15 hours a week in a room at her house used for her business. Susan spends 30–35 hours per week at the three branch locations. Susan's office at home does not qualify as a home office under the IRC Sec. 280A(c)(1)(A) criteria.

Susan's travel between her residence and any of the three branch locations where she regularly works represents commuting and is not deductible. However, if Susan's work takes her temporarily to another location to meet with a business associate (whether inside or outside of the metro area), the travel from her residence to that location would be deductible. Also, under Rev. Rul. 55-109, Susan may deduct any transportation between the three branch locations where she regularly works on a given day.

Planning around the Depreciation Limits on Passenger Automobiles

Four-wheeled vehicles having an unloaded gross weight of 6,000 pounds or less that are manufactured primarily for use on public roads are referred to as *passenger automobiles* and are subject to depreciation limitations under IRC Sec. 280F. The 6,000-pound weight limit for trucks or vans is based on "gross weight" (including passengers and cargo) rather than unloaded weight. Thus, many full-sized SUVs, pickups and large vans may not be subject to the Section 280F depreciation limitations because their gross weight exceeds 6,000 pounds. (See the discussion of exempt vehicles later in this lesson.) In addition, vehicles that by reason of their design or nature, and certain light trucks and vans specially modified for business to preclude the likelihood of personal use are not considered passenger automobiles (e.g., ambulances, hearses, taxicabs, and specially modified vans) and are not subject to the depreciation limitations.

General Limitations for Luxury Autos. Passenger automobiles affected by the Section 280F limits are referred to as luxury autos. The Section 280F limits applicable to a particular vehicle are determined based on the year the vehicle is first placed in service. For autos placed in service in 2010, several different first-year Section 280F limits are possible, depending on whether the vehicle is a car or a "truck or van". For purposes of these rules, the term "trucks and vans" refers to passenger automobiles that are built on a truck chassis, including minivans and sport utility vehicles (SUVs) that are built on a truck chassis.

The first-year Section 280F limits for vehicles placed in service in 2010 are $3,060 for cars, and $3,160 for trucks and vans. Thus, the 2010 Section 280F amounts limit depreciation deductions on the cost of these cars exceeding $15,800 ($3,160 divided by the first-year MACRS rate of 20%) and trucks and vans exceeding $16,300 ($3,260 divided by the first-year MACRS rate of 20%).

If business use is less than 100%, the maximum depreciation deduction is reduced by the percentage of personal use. For example, if business use is 80%, depreciation is limited to 80% of each amount listed. (See Example 3-9 for an illustration of this point.) The ceilings are also reduced in a short tax year in proportion to the ratio of the number of months in the year to 12.

Interaction with Section 179 Deduction. The Section 179 deduction is also subject to the depreciation limits for luxury autos using the Section 179 deduction in combination with MACRS depreciation maximizes the deduction when the cost is less than $14,800 for cars or $15,300 for trucks/vans based on these estimated section 280F limits. (for 2010).

Example 3-8: Computing optimal Section 179 amount when regular Section 280F limit applies.

Mark purchased a used car in 2010 for $12,500. He uses the vehicle 100% for business and wants to maximize use of the Section 179 and depreciation deductions. The allowable Section 179 deduction is subject to the provisions of IRC Sec. 280F. The formula for optimizing his deduction is:

$$\text{Section 179 deduction} = \frac{\text{Section 280F} - [.20 \text{ (first-year depreciation rate)} \times \text{Asset cost}]}{.80 \;(- \text{ first-year depreciation rate)}}$$

Mark's optimal Section 179 amount (X) is computed as follows:

$$\times = \frac{\$3{,}060 - (.20 \times \$12{,}500)}{.80} = \$700$$

The optimal Section 179 deduction ($700) is proved as follows:

Section 179 amount	$ 700
Depreciation [($12,500 − $700) × 20%]	$ 2,360
Maximum Section 280F deduction for 2010	$ 3,060

Variation: If the car cost $25,000, the maximum Section 179 (and depreciation) deduction would be $3,060 (lesser of $3,060 Section 280F limitation or $25,000 cost × 20% five-year DDB percentage under MACRS). In addition, no additional depreciation is allowed on the car for 2010. Thus, there is no benefit from using the Section 179 expense when allowable depreciation exceeds the maximum limitation.

A car is for the example. The higher Section 280F limit for a truck or van would yield different results.

Depreciation Limit Prorated for Personal Use. If business use of a luxury auto is less than 100%, the depreciation limits are reduced by the percentage of personal use.

Example 3-9: Depreciation limits when a luxury car is used for business and personal use.

Tim purchases a new car in 2010 costing $25,000 for use in his sole proprietorship. The car is used 90% for business in 2010, but only 80% for business in 2011 and 2012. Thereafter, it is used 90% for business. Tim uses a half-year convention and the MACRS depreciation method. Because of the vehicle's cost, the Section 280F limits apply each year.

Depreciation is calculated as follows: 2010—$2,754 ($3,060 × 90%); 2011—$3,920 ($4,900 × 80%); 2012—$2,360 ($2,950 × 80%); 2013 through 2019—$1,598 each ($1,775 × 90%); and 2020—$1,499 ($1,665 remaining deductible basis × 90%). Total depreciation deductions equal $21,719.

The difference between the deductible depreciation of $21,719 and the original $25,000 cost is $3,281. This amount represents the personal use portion of the car's tax basis for 2010–2020. This amount can never be deducted (100% of the Section 280F limits are used to determine deductible basis).

Vehicles Exempt from Auto Depreciation Limits. Depreciation limits (i.e., the Section 280F limits) apply only to vehicles that fall under the definition of a *passenger automobile*. A passenger automobile is a four-wheeled vehicle designed for street use with an *unloaded* gross vehicle weight rating of 6,000 pounds or less. Few, if any, cars fall outside this definition of a passenger automobile.

A truck or van falls under the definition of *passenger automobile* only if the gross vehicle weight is 6,000 pounds or less. However, gross vehicle weight for a truck or van means the maximum weight rating for a *loaded* vehicle, as specified by the manufacturer. Included in the definition of trucks and vans are sport utility vehicles (SUVs) and minivans, if they are built on a truck chassis and have an enclosed body.

Several of the popular sport utility vehicles (e.g., Chevrolet Suburbans, Toyota Land Cruisers, etc.) are heavy enough to be rated for gross vehicle weight in excess of 6,000 pounds (Ltr. Rul. 9520034). Some common websites, such as **www.intellichoice.com** and **www.carsdirect.com/research/new_cars**, can be used to look up a vehicle's weight.

When a vehicle is *not* classified as a passenger automobile and is used over 50% for business, it is treated as five-year MACRS property and depreciated under the regular rules for such property. Assuming the half-year convention applies, the annual depreciation will equal the following percentages of the business-use portion of the vehicle's basis.

Year 1:	20.00%
Year 2:	32.00%
Year 3:	19.20%
Year 4:	11.52%
Year 5:	11.52%
Year 6:	5.76%

Example 3-10: Sport utility vehicle avoids luxury auto depreciation limits.

In 2010, John spent $50,000 for a new Chevrolet Suburban. The Suburban is used 100% in John's sole proprietorship. The Suburban is not a passenger automobile since its maximum loaded weight, based on information from the manufacturer, is over 6,000 pounds. Therefore, it is not subject to the Section 280F limits. The 2010 depreciation deduction is calculated as follows: $50,000 cost × 20% = $ 10,000.

Section 179 Deduction. Vehicles that are *not* classified as passenger autos also qualify for the Section 179 deduction (generally up to $134,000 for qualifying assets placed in service in tax years beginning in 2009) when used over 50% for business.

However, heavy SUVs (those with gross vehicle weight ratings between 6,001 and 14,000 pounds) are now subject to a reduced Section 179 allowance of only $25,000. This unfavorable change was included in the American Jobs Creation Act of 2004 (the Jobs Act). However, it is important to understand that the reduced Section 179 deduction rule only applies to vehicles that are (a) classified as *SUVs* for tax purposes and (b) placed in service *after* October 22, 2004.

Example 3-11: SUV eligible for reduced Section 179 deduction.

During August of 2010, Tom, a calendar year sole proprietor, acquires and places in service three new SUVs. Each of the first two SUVs has a gross vehicle weight rating over 6,000 and less than 14,000 pounds. The third SUV has a gross vehicle weight rating over 14,000 pounds. The first SUV costs $70,000 and is used 90% for business. The second SUV costs $55,000 and is used 100% for business. The third SUV costs $59,000 and is used 100% for business. Tom is allowed the following deductions in 2010:

	IRC Sec. 179	Depreciation [a]
SUV 1	$ 25,000	$ 9,000
SUV 2	25,000 [b]	5,400
SUV 3	59,000 [c]	0 [d]
Total	$ 109,000	$ 14,000

Notes:

[a] Since the SUVs have a gross vehicle weight rating over 6,000 pounds, they are not subject to Section 280F limitations. This example assumes that the mid-quarter convention does not apply.

[b] The $25,000 limit is per vehicle, not per taxpayer.

[c] Since the SUV has a gross vehicle weight rating over 14,000 pounds, it is not subject to the $25,000 per vehicle limit. Instead, it is subject to the normal $250,000 (for 2010) limit.

[d] The basis was fully offset by the Section 179 deduction, so depreciation is not available.

Vehicles Unaffected by Reduced Section 179 Deduction. The reduced $25,000 Section 179 deduction rule does not affect vehicles that are *not* considered to be SUVs under the tax law. For this purpose, *non-SUVs* are defined to include the following:

a. Vehicles designed to seat more than nine passengers behind the driver's seat. For example, many hotel shuttle vans will qualify for this exception.

b. Vehicles equipped with a cargo area that is not readily accessible directly from the passenger compartment and that is at least six feet in interior length. The cargo area can be open or designed to be open but enclosed by a cap. For example, many pickups with full-size cargo beds will qualify for this exception. Some "quad cabs" and "extended cabs" with shorter cargo beds may not.

c. Vehicles with (a) an integral enclosure that fully encloses the driver's compartment and load carrying device, (b) no seating behind the driver's seat, and (c) no body section protruding more than 30 inches ahead of the leading edge of the windshield. For example, many delivery vans will qualify for this exception.

Vehicles that fall under the preceding exceptions with gross vehicle weight ratings above 6,000 pounds remain eligible for the full Section 179 deduction ($250,000 for tax years beginning in 2010). In many cases, this means the entire business portion of the cost of a qualifying vehicle can be deducted in Year One under Section 179. Remember, the reduced $25,000 Section 179 limit applies to vehicles that are classified as SUVs.

Example 3-12: Section 179 deduction for non-SUV not limited to $25,000.

Fritz buys a $40,000 long-bed pickup in 2010 that he uses 100% percent in his sole proprietorship contracting business. The pickup has a gross vehicle weight rating above 6,000 pounds and is not considered to be an SUV under the federal tax rules (because the bed is six feet long). Assuming Fritz is not adversely impacted by any of the other Section 179 deduction limitation rules, he can write off the pickup's entire $40,000 cost in 2010. (The reduced $25,000 Section 179 deduction rule only applies to vehicles that are classified for tax purposes as SUVs, so Fritz is unaffected.)

Exceptions for Certain Special-use Vehicles. There are certain vehicles excluded from the definition of "passenger automobiles" regardless of their weight rating. Therefore, these vehicles are also excluded from the Section 280F depreciation limits. These vehicles include ambulances, hearses, taxicabs, and trucks or vans that are qualified nonpersonal use vehicles as defined in Prop. Reg. 1.274-5T(k)(7) (i.e., a truck or van that has been specially modified so that it is not likely to be used more than a *de minimis* amount for personal purposes).

Example 3-13: Specially modified vehicle exempt from depreciation limits.

Tom is a self-employed plumber in 2010. He purchases a cargo van in February 2009 for $35,000. The only seat is the driver seat. He spends an additional $5,000 putting in permanent shelving in the cargo area to carry his tools and various plumbing supplies, and for a special paint job advertising the name and state license number of his master plumbing business on the outside. Tom's van is not considered to be a passenger automobile and is not subject to the Section 280F depreciation limits.

Depreciating a Vehicle Acquired via a Trade-in. Trading in a business vehicle for another business vehicle qualifies as a like-kind exchange. When such an exchange occurs, special rules must be used to determine basis and depreciation deductions on the acquired property (*replacement property*). The basis of a vehicle received in a trade-in is composed of two parts: (a) the adjusted basis (i.e., cost less accumulated depreciation) of the old vehicle (*relinquished property*) traded in (referred to as *exchanged basis*) and (b) the amount of any boot (cash or other property) given (*excess basis*) in the exchange. Depreciation is computed on each separate component with depreciation continuing on the exchanged basis of the *relinquished property* while the *excess basis* is treated as a newly acquired asset. The regulations provide that both the exchanged basis and the excess basis are eligible for the bonus depreciation deduction.

When the Section 280F limits apply (as in the case of automobiles), even though depreciation is calculated on both basis components of the two vehicles involved in a trade-in, an overall depreciation limit applies, based upon the Section 280F limit for the replacement property vehicle (i.e., the acquired vehicle).

The following multi-step process can be used to calculate depreciation in the following order and subject to the following limits:

Step 1 The depreciation on the relinquished property vehicle for the year of disposition (half-year convention computation) is calculated, limited to the smaller of the relinquished property vehicle Section 280F limit or the replacement property vehicle Section 280F limit.

Step 2 The remaining half-year convention computation on the relinquished property vehicle's basis is computed, limited to the smaller of the relinquished property vehicle Section 280F limit or the replacement property vehicle Section 280F limit.

Step 3 Any Section 179 deduction on the excess basis is claimed, limited to the Section 280F limit for the replacement property vehicle.

Step 4 The regular depreciation computation for the remaining excess basis in the replacement property vehicle is computed, limited to the replacement property vehicle Section 280F limit.

As the computation occurs in each step and the comparison is made to the applicable Section 280F limit, all of the prior depreciation deductions must be considered to determine if the Section 280F limit has been reached.

<u>Election Not to Apply Like-kind Exchange Depreciation Regulations.</u> Taxpayers may elect not to apply the depreciation rules referred to in Reg. 1.168(i)-6. Making such an election will effectively allow taxpayers to combine the adjusted tax basis of the relinquished asset with the boot on the new asset, treating it as a single item for depreciation purposes.

With regard to its effect on autos, the advantage of electing not to apply the new rules is for simplicity. However, the regulations state that some rules continue to apply, and one of those is that the taxpayer must make a depreciation computation for the relinquished asset in the year of disposition. Thus, two components of a depreciation calculation are still required in the year of disposition. But in the year following the trade and going forward, the taxpayer would have a single line depreciation calculation for the newly acquired asset.

The election out of the like-kind exchange regulations is made on Form 4562 (Depreciation and Amortization) by figuring depreciation for the new property in Part III (or Part V for listed property). Also, a statement indicating "Election made under Section 1.168(i)-6(i)" for each property involved in the exchange should be attached to the return. The election must be made by the due date (including extensions) of the taxpayer's federal return for the year of the trade. The election is required on an asset-by-asset basis.

Example 3-14: Depreciation of auto acquired in like-kind exchange.

Tom placed a new $30,000 Audi in service in January 2009, used it 100% in his sole proprietorship business. In 2010 Tom exchanges, in a like—kind exchange, his Audi plus $15,000 cash for a new BMW that will also be used 100% in his business. The relinquished property vehicle Section 280F limit for the Audi for 2010 is $4,800. The replacement property vehicle Section 280F limit for the BMW for 2010 is $3,060. The depreciation and basis calculations for 2010 is as follows:

	Audi		BMW	
	Depr.	Basis	Depr.	Basis
Purchase Audi in 2009 for $30,000		$ 30,000		
Depr. for 2009	$ (10,960)	$ 19,040		
2010 — Trade Audi for BMW + $15,000 cash				
Audi depr.: Lesser of —				$ 15,000
1) 1/2 yr. depr. of $3,808 ($19,040 × 40% × 1/2),				
2) 2nd yr. limit of $4,800 on Audi, or				
3) 1st yr. limit on BMW of $3,060	$ (3,060)	15,980	→	15,980
Basis of BMW at end of 2010				$ 30,980

For 2010 no depreciation is allowable for the excess basis and the exchanged basis in the BMW, because the applicable Section 280F limit of $3,060 has been reached with the depreciation deduction for the relinquished Audi.

Leasing Business Autos

Automobile leases have certain advantages. They require a minimal investment and are convenient if the customer replaces the car every two or three years. With a lease, there is no hassle with selling or trading in the car. Instead, the lease customer simply drops it off at the end of the lease and arranges another lease for a new one.

Leases are normally worth considering if the lease customer does *not* intend to drive the car beyond the end of the lease term and wants to minimize his cash outlay. However, the lease customer also must be prepared to maintain the car and stay within the mileage allowance; otherwise, he will be charged for excess wear and tear and mileage when the car is turned in.

The Lease Income Inclusion Rule for Luxury Autos. When a taxpayer leases an auto and uses it in a trade or business, the business use percentage of the lease expense can be deducted if the actual cost method for claiming auto expenses is used. However, to achieve approximate parity with the depreciation limitations that apply to *owned* luxury cars, the IRS releases an annual table of leased "income inclusion" amounts that apply to luxury cars leased for 30 days or more. The annual income inclusion amount is subtracted from the lessee's lease expense for the year to determine the net deduction for the year. The deductions of the car's owner (the lessor) are not affected by this adjustment.

The amount to be included in income depends on the auto's FMV on the first day of the lease term. There are two parts to the income inclusion table; the first part is for autos other than trucks and vans/SUVs and the second part is for trucks and vans/SUVs. This is due to the higher depreciation limits provided for trucks and vans/SUVs (see earlier discussion).

Tax Aspects of Leasing versus Buying

Auto leasing firms constantly advertise the tax advantages of car leasing in comparison to a purchase. That may be true in some cases, but buying can still be the best alternative in others. Practitioners should consider the following key tax aspects of leasing versus buying.

Depreciation versus Lease Deductions. A rough parity exists between the rules for depreciation on purchased automobiles and deductions for leased autos.

For owned autos used more than 50% for business, taxpayers can use regular MACRS depreciation, which is the 200% declining balance method applied to a five-year recovery period. However, for luxury autos depreciation is limited to the maximums listed in IRC Sec. 280F(a) (as adjusted periodically for inflation). Thus, few cars have the advantage of the accelerated depreciation deductions.

The general rule for leased autos used for business is to deduct the business percentage of the lease expense each year. However, to achieve approximate parity with the depreciation limitations that apply to owned luxury autos, the taxpayer's lease deduction is reduced by the business percentage of the income inclusion amount for the year.

Leasing Avoids Tax Basis Complexities. Taxpayers owning a business auto must contend with the following tax basis complexities:

a. *Basis Buildup.* When a taxpayer trades in an owned business auto rather than selling it, the basis of the new auto is the adjusted basis of the old auto plus any additional amount paid. After a few trade-ins, the luxury auto depreciation limitations cause the taxpayer's basis in the currently owned vehicle to build up to inflated levels.

b. *Two Basis Numbers.* If an owned auto is used less than 100% for business and is then traded in, one basis number is used for depreciation purposes and another for gain/loss purposes. The unrecovered basis for depreciation reflects a reduction for the full amount of depreciation that would have been allowed for 100% business use. However, for gain/loss purposes, the unrecovered basis in the trade-ins reflects only the actual depreciation deductions allowed.

c. *Split Sales Transaction.* When an owned auto used only partly for business is sold, the transaction is treated as separate sales of a business asset and a personal asset (*Sharp, Jr.*). The original purchase price and sales proceeds are allocated between the business and personal assets based on cumulative mileage. The allowable depreciation reduces the basis of the business portion.

All of these complexities can be avoided by leasing business autos. The basis buildup rule, the two basis numbers issue, and the complexities in calculating gain/loss on a disposition of an owned auto do not apply if the taxpayer leases the business auto and simply returns it at the end of the lease term. Thus, leasing can be much less burdensome from an accounting and administration standpoint.

Tax Benefit of Selling Rather Than Trading in an Auto

If a taxpayer trades in a business auto rather than selling it, the transaction is treated as a like-kind exchange. The basis of the new auto is the adjusted basis of the old auto plus any additional amounts paid. The result is that after a few trade-ins, the luxury auto depreciation limits can cause the taxpayer's basis in the currently owned vehicle to build up to levels substantially in excess of the economic loss for the car.

Example 3-15: Basis buildup on trade-in of auto.

In 2003, Henry spent $30,000 for a new car used 100% for business. In July 2006, he traded in that car and paid an additional $20,000 for a new vehicle that will also be used 100% for business. Assume the trade-in was valued at $15,000, so the purchase price of the new vehicle was $35,000.

On the old car, Henry claimed 2003, 2004, and 2005 depreciation deductions of $3,060, $4,900, and $2,950 respectively. Henry's basis in the new car is thus $39,090 [$20,000 cash paid + adjusted basis of $19,090 in the old car ($30,000 purchase price − depreciation of $10,910)].

Henry uses this second car for four years and trades it in 2010 for yet another new car. The trade-in is valued at $17,500 and he pays an additional $22,500 of cash for the newest car, which has a $40,000 purchase price.

On the second car, Henry has deducted depreciation of $2,960, $4,800, $2,850, and $1,775 for 2006, 2007, 2008, and 2009 respectively. Accordingly, his adjusted basis in the second car when traded in is $26,705 ($39,090 original basis − depreciation of $12,385).

Henry's beginning depreciable basis in the third car is $49,205 (the $22,500 cash paid + the adjusted basis in the second car of $26,705). If this amount is compared to the actual purchase price of $40,000, it becomes apparent how the basis buildup (the difference between depreciable basis and the actual purchase price) becomes larger over the years. This is caused by the fact that the economic depreciation exceeds the allowable tax depreciation for the cars that were traded in along the way. If the taxpayer continues to trade in cars, the difference is reflected in "excess" tax basis in the current vehicle.

By selling the vehicle outright, the taxpayer recognizes an immediate loss on the sale. This avoids the basis buildup problem. If another vehicle is then purchased, its purchased cost becomes the tax basis for depreciation purposes. Here, the tax results can be much better from an outright sale (thereby recognizing a loss much earlier) than from a trade-in.

Example 3-16: Outright sale of auto avoids tax basis buildup.

Assume the same facts as in Example 3-15 except Henry sells the second car outright in 2010 rather than trading it in. Henry receives $17,500 cash in the sale and recognizes a Section 1231 business loss of $7,430 [$17,500 sale proceeds − $24,930 adjusted basis ($26,705 − $1,775 depreciation for 2010)]. Henry then purchases the third car from the dealership for $40,000. The economic effect of this scenario equals that of the previous example. However, an outright sale avoids the basis buildup problem and allows Henry to recognize a tax loss on the transaction.

Standard Mileage Rate Simplifies Auto Records and Deductions

There are two IRS-authorized methods for computing car expenses for local transportation or travel away from home: the standard mileage rate method (for 2010, 50¢ per mile for business use) and the actual cost method. Generally, a taxpayer can use the method that generates the largest deduction. The IRS annually updates the standard mileage rate to account for changes in automobile costs.

Restrictions on Use of Standard Mileage Rate. The actual cost method is available for use by any taxpayer. The standard mileage rate can be elected only by self-employed individuals or employees. The standard mileage rate can be used for passenger automobiles, including vans, pickups, or panel trucks and can be used for leased as well as purchased autos.

The standard mileage rate is subject to the following limitations:

a. The standard mileage rate cannot be used if the car has been previously depreciated using a method other than straight-line.

b. The taxpayer may change from the standard rate method to the actual cost method, but must then use straight-line depreciation for the automobile's remaining estimated useful life (subject to the luxury car limits of IRC Sec. 280F). When the standard rate method is used for leased vehicles, it must be used for the entire term of the lease (or for the period after 1997 if the lease commenced before 1998).

c. The standard mileage rate cannot be used if the taxpayer uses five or more cars simultaneously in his trade or business. However, if a taxpayer alternates using different cars for different periods during the year, the standard mileage rate can be applied to the total business miles of five or more cars.

d. The standard mileage rate may not be used to compute deductible expenses of vehicles used for hire, such as taxicabs.

What Does the Standard Mileage Rate Cover? The standard mileage rate is in lieu of operating and fixed costs of the automobile. This includes items such as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and registration fees.

Parking fees and tolls attributable to business use of the automobile may be deducted as separate items. Likewise, business interest attributable to the purchase of the automobile as well as state and local personal property taxes may be deducted separately, but only to the extent otherwise allowed under IRC Secs. 163 (interest) and 164 (taxes), respectively. State and local taxes paid in connection with the acquisition of the automobile (e.g., sales tax) are not deductible but instead are treated as part of the cost of the property.

When Does Using the Standard Mileage Rate Method Make Sense? Many self-employed taxpayers will find that the actual cost method results in the largest auto tax deductions. This is particularly true for more expensive automobiles, or for vehicles requiring a high degree of maintenance.

However, use of the actual cost method entails a considerable recordkeeping burden. It is necessary to substantiate and keep detailed records of each cost expenditure for the automobile. In contrast, self-employed taxpayers who want to minimize their automobile recordkeeping chores may decide that smaller auto deductions are a small price to pay for simplified recordkeeping. If the standard mileage rate method is used, the taxpayer need only keep records substantiating the time, place, and business purpose of the business mileage for which the standard mileage rate is being claimed. (The taxpayer must also record total mileage for the year.)

Easing the Auto Recordkeeping Burden. Self-employed taxpayers using the actual cost method to compute auto expenses must substantiate each cost or expenditure incurred to operate and maintain the automobile (plus a calculation of depreciation).

Taxpayers substantiate automobile business use by maintaining adequate records, or by other sufficient corroborating evidence. Failure to comply with this requirement can result in loss of the deduction. See, for example *Marquardt*, in which the Tax Court disallowed a deduction because of the taxpayer's failure to maintain a mileage record. In maintaining records, taxpayers must substantiate the following *elements* of each business use:

a. The amount of each business use (i.e., number of miles).

b. The time and place.

c. The business purpose.

d. The business relationship.

These elements must be substantiated by maintaining *both*: (a) mileage logs, account books, diaries, trip sheets, expense reports, or similar records and (b) the documentary evidence including receipts or invoices and cancelled checks documenting the car's purchase price, fuel costs, repairs, taxes, insurance, and other out-of-pocket costs. While a contemporaneous mileage log or record (i.e., a log entry made "at" the time the use occurs) is not required, a record made at or near the time of the use is considered more credible than a statement made at a later date. A mileage log maintained on a weekly basis, which accounts for use during the week, generally is sufficient.

Keeping automobile records that will withstand IRS scrutiny can be a time-consuming process. Listed in the following paragraphs are some planning tips that may help ease the taxpayer's auto recordkeeping burden.

Sampling Method. A taxpayer who maintains business-usage records for only a portion of the tax year can apply those to the entire tax year, provided he can show that they are representative of the use for the tax year. Here, the taxpayer is deemed to have provided sufficient corroborative evidence to establish that he has substantially complied with the adequate records requirement.

Example 3-17: Using a sampling method to substantiate business use.

Linda, a sole proprietor, operates an interior decorating business out of her home, which qualifies as a home office under the IRC Sec. 280A(c)(1)(A) principal place of business criteria. Linda uses an automobile for local business travel to visit the homes or offices of clients, to meet with suppliers and other subcontractors, and to pick up and deliver certain items to clients. Linda and her family also use the automobile for personal purposes.

Linda maintains adequate records for the first three months of 2010 indicating that 75% of the use of the automobile was in her business. Invoices from subcontractors and paid bills indicate that Linda's business continued at approximately the same rate for the remainder of 2009. If other circumstances do not change (e.g., Linda does not obtain a second car for use in her business), the sample showing that business use for the year is 75% should be accepted as sufficient corroborative evidence by the IRS.

Variation: Assume the facts are the same except Linda maintains adequate records during the first week of every month, which indicate the 75% of her use of the auto is for business purposes. The invoices from Linda's business indicate that her business continued at the same rate during the subsequent weeks of each month. Thus, her weekly records are representative of each month's business use of the automobile. The IRS should accept this sample as sufficient corroborative evidence showing that Linda's car is used 75% for business during the year.

Circumstances Beyond Control of Taxpayer. If adequate records or sufficient evidence are unavailable due to circumstances beyond the taxpayer's control, the substantiation requirements will be deemed satisfied if the taxpayer presents credible evidence supporting the deduction. A taxpayer was allowed 15,000 business miles as a basis for a deduction, even though he had no records to support any of his mileage. Although his records had been lost when his home was foreclosed, the taxpayer convinced the court that he had driven at least 15,000 miles for business (*Power*).

Established Route Drivers. A self-employed individual who regularly drives an established route to make deliveries can satisfy the adequate record requirement by simply recording the total miles driven during the year, the length of the delivery trip (once), and notation of the date of each trip made at or near the date of the trip.

Example 3-18: Established route driver uses sample to document auto use.

Barry owns and operates a uniform cleaning service as a sole proprietorship. He uses his own automobile to travel within the metropolitan area on pickups and deliveries. Barry also uses the automobile for personal purposes.

During the first week of each month, Barry substantiates that his automobile is used 80% for business that week by substantiating the length of each delivery trip (once), and notation of the date of each trip made at or near the date of the trip. Throughout the remainder of the month, he simply notes the date he completes each pickup or delivery route. A review of his customer records for the remaining weeks in each month indicates that his customer base remains constant throughout the remainder of the month.

Barry's weekly records are representative of each month's business use of the automobile. The IRS should accept this sample as sufficient corroborative evidence showing that his car is used 80% for business during the year.

Qualified Nonpersonal Use Vehicle. All usage of a qualified nonpersonal use vehicle is considered business use. Thus, these vehicles are exempt from the substantiation requirements. A qualified nonpersonal use vehicle is any vehicle which, by reason of its design or nature is not likely to be used more than a *de minimis* amount for personal purposes. This includes (a) any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds; (b) any vehicle specifically listed as such by regulation; and (c) a pickup or van with a loaded gross vehicle weight not exceeding 14,000 pounds if it meets certain requirements.

Common examples of a qualified nonpersonal use vehicle include clearly marked police and fire vehicles, flatbed trucks, unmarked law enforcement vehicles, delivery trucks with seating only for the driver or only for the driver plus a folding jumpseat, and specialized utility repair trucks. See that regulation for a complete list.

Substantiation Safe Harbor Methods. To relieve employers from the detailed recordkeeping that would otherwise be required to substantiate business use of company vehicles, substantiation safe harbors are provided in the temporary regulations. Sole proprietors may find the following safe harbor methods helpful when a business auto is used by employees of the business:

a. *Solely for Business—Vehicles Kept on Employer's Premises.* No personal use is allowed except for *de minimis* personal use (requires written company policy statement).

b. *Personal Use Permitted for Commuting Use Only.* No personal use is allowed except for commuting or *de minimis* personal use (requires written company policy statement).

c. *Vehicles Used in Farming.* Business use is deemed to be 75% (plus that percentage, if any, attributable to an amount included in an employee's gross income). This exception applies to owned or leased vehicles where used in connection with the business of farming during most of a normal business day.

d. *Vehicles Treated as Used by Employees Entirely for Personal Purposes.* No employer substantiation is required when 100% of the annual lease value of the vehicle is reported to the employee as income, since the entire documentation burden is shifted to the employee. However, if the vehicle is used by a 5% owner or related party, the employer must have the employee provide documentation regarding the actual use of the vehicle in the employer's business. Unless the 5% owner or related party uses the vehicle more than 50% in the employer's business, the employer must use five-year, straight-line (SL) depreciation. Qualified business use does not include the compensation element of a vehicle provided to a 5% owner or related person. Also, the employer may incur larger FICA costs if 100% of the value is included in the employee's income.

Under these safe harbors, the employer generally is not required to maintain detailed usage records. Two of these, the "Solely for Business," and "Personal Use Permitted for Commuting Use Only" safe harbors, require written policy statements.

Claiming the Alternative Motor Vehicle Credit

The alternative motor vehicle credit is available for new (not used) vehicles that are either purchased or leased by the taxpayer and for both business and personal vehicles.

Components of the Credit. The alternative motor vehicle credit consists of the sum of the following five component credits.

<u>Qualified Hybrid Motor Vehicle Credit.</u> Qualified hybrid motor vehicles combine an internal combustion engine with another propulsion system that uses an onboard rechargeable energy source such as electric batteries. These vehicles must also meet certain federal emission standards. The hybrid motor vehicle credit applies in differing amounts to passenger automobiles and light trucks [gross vehicle weight rating (GVWR) of 8,500 pounds or less]. The credit consists of two components within this category. Fuel economy credits between $400 and $2,400 are allowed, calculated on a sliding scale based on fuel efficiency improvements compared to 2002 models. *Conservation credits* of $250 to $1,000 are allowed based on anticipated lifetime fuel savings, expressed in gallons of gasoline. Consequently, the minimum combined credit amount for a hybrid passenger automobile or light truck that qualified for both the fuel economy and conservation credits is $650 ($400 + $250), and the maximum combined credit is $3,400 ($2,400 + $1,000). This credit applies to qualified vehicles purchased before 2011.

The hybrid motor vehicle credit available for vehicles from a specific manufacturer will begin phasing out over a period of four calendar quarters once the manufacturer sells a cumulative total of 60,000 qualifying vehicles for use in the United States. The phaseout period begins with the second calendar quarter following the quarter in which the 60,000 milestone is reached. During the first two quarters of the four-quarter phaseout period, the credit is reduced to 50% of the otherwise allowable amount. During the last two quarters of the phaseout period, the credit is reduced to only 25% of the otherwise allowable amount. Consequently, starting with the sixth quarter after the 60,000 milestone is reached, phaseout is complete and no further credits will be allowed for vehicles from that manufacturer.

The IRS has issued Notice 2006-9 giving auto manufacturers guidance on the process they can use to certify a vehicle and the amount of the credit for the purchaser of a hybrid motor vehicle or advanced lean burn technology motor vehicle. The notice provides that taxpayers can rely on the manufacturer's certification to claim the credit on their tax return.

<u>Advanced Lean Burn Technology Motor Vehicle Credit.</u> Qualified advanced lean burn motor vehicles are passenger automobiles and light trucks (GVWR of 8,500 pounds or less) with an internal combustion engine that uses lean burn technology, which involves direct injection of a fuel mix using more air than is necessary for complete combustion of the fuel, such as certain diesel engines. The credit amounts are the same as for qualified hybrid motor vehicles with a GVWR of 8,500 pounds or less. These vehicles must also meet certain federal emission standards. This credit applies to qualified vehicles purchased before 2011 and is also subject to the same phaseout rule as for qualified hybrid motor vehicles.

<u>Qualified Fuel Cell Motor Vehicle Credit.</u> A qualified fuel cell motor vehicle is propelled by power derived from one or more cells that convert chemical energy directly into electricity by combining oxygen with hydrogen fuel that is stored on board the vehicle and may or may not require reformation prior to use. These vehicles must also meet certain federal emission standards. The fuel cell motor vehicle credit consists of two parts: (1) a base credit amount

depending upon the GVWR of the qualifying vehicle and (2) an additional credit amount based on fuel efficiency improvements compared to 2002 models. The credit applies to qualified vehicles purchased before 2015. As of the time this lesson was published, the 2005, 2006 and 2009 (according to the IRS website) models of the Honda FCX had been certified for a $12,000 credit (IR 2007-133).

Taxpayers may rely on the certification by a domestic manufacturer (or, in the case of a foreign manufacturer, its domestic distributor) that a make, model, and model year of a vehicle qualifies as a fuel cell motor vehicle, and the amount of the credit allowable for that vehicle.

Qualified Alternative Fuel Motor Vehicle Credit . Qualified alternative fuel motor vehicles are those vehicles that are only capable of running and operating on compressed or liquefied natural gas, liquefied petroleum gas, hydrogen, or any liquid that is at least 85% methanol. The amount of the credit is calculated as a percentage (of up to 80%) of the *incremental cost* of the vehicle. The incremental cost of the vehicle is the excess of the manufacturer's suggested retail price (MSRP) for the vehicle over the MSRP for a gasoline or diesel fuel motor vehicle of the same model. However, the incremental cost cannot exceed certain maximums, based upon the GVWR of the vehicle. For example, the incremental cost of a qualified vehicle with a GVWR of 8,500 pounds or less is limited to $5,000, translating into a maximum credit of $4,000. IRS Notice 2006-54 provides guidance on the credit and the conditions for which the taxpayer may rely on the manufacturer's certification. At the time this lesson was published, the 2005, 2006, 2007, and 2008, and 2009 (according to the IRS website) models of the Honda Civic GX, and a model of the 2010 Ford Focus had been certified for a $4,000 credit (IR 2006-109, IR 2006-182, and IR 2007-181).

Reduced credits are allowed for mixed-fuel vehicles that run on a mixture consisting of at least 75% of an alternative fuel and not more than 25% of a petroleum-based fuel. To qualify for the credit on mixed-fuel vehicles, the vehicle must also meet certain federal emission standards.

The credit applies to qualified vehicles purchased before 2011.

Plug-in Conversion Credit. A plug-in conversion credit is allowed for any motor vehicle (personal-use, business-use, or investment-use) that is converted to a qualified plug-in electric drive motor (QPEDM) vehicle. The credit is 10% of the cost of conversion, up to a maximum conversion cost of $40,000 (i.e., a maximum $4,000 credit). A *QPEDM vehicle* is defined as any new qualified plug-in electric drive motor vehicle determined without regard to whether the vehicle is made by a manufacturer or whether the original use of the vehicle begins with the taxpayer. Consequently, a used car that is converted into a QPEDM vehicle can qualify for the plug-in conversion credit. Also, a plug-in conversion credit can be allowed for a vehicle that previously qualified for one of the other four components of the alternative motor vehicle credit in an earlier tax year.

The credit is allowed for property placed in service after February 17, 2009 (the date of enactment of the 2009 Recovery Act) and conversions made prior to January 1, 2012.

Limitations and Special Rules. The tax liability limitation of the alternative motor vehicle credit is limited based on whether it is claimed on personal vehicles or depreciable vehicles used in a trade or business. The credit claimed on personal vehicles is treated as part of the taxpayer's nonrefundable personal credits and for 2010 can reduce the taxpayer's regular tax liability, plus AMT less the sum of the dependent care credit, credit for the elderly and disabled, child tax credit, mortgage interest credit, education credits, retirement saver's credit, the nonbusiness energy property credit, and the foreign tax credit. The credit claimed on depreciable business vehicles becomes part of the taxpayer's general business credits and, therefore, if unused in the current year is available for carryback (but not for years prior to 2006) and carryover under the rules for general business credits. Also, any vehicle that is eligible for the new qualified plug-in electric drive motor vehicle credit is not eligible for the alternative motor vehicle credit.

The basis (depreciable basis or personal basis) of property for which a credit is claimed must be reduced by the amount of the credit allowed, computed without regard to the tax limitation mentioned in the previous paragraph.

The Treasury Department will be issuing regulations providing for the recapture of the credit for vehicles that cease to be eligible for the credit (except by reason of conversion to a qualified plug-in electric drive motor vehicle), including recapture in the case of a lease period that is less than the economic life of the vehicle.

Claiming the New Qualified Plug-in Electric Drive Motor Vehicle Credit (NQPEDMV)

The 2008 Energy Act provided for a tax credit for certain plug-in electric vehicles . Qualifying vehicles must draw propulsion using a battery with at least 4 kilowatt hours of capacity; use an external source of energy to recharge the battery (hence the name *plug-in*); be used primarily on public streets, roads, and highways; have four wheels; meet certain federal emission and clean air standards based upon the gross vehicle weight rating (GVWR) of the vehicle; and the use must originate with the taxpayer. The credit is subject to various limitations discussed later in this lesson and is available for tax years beginning after December 31, 2008.

The IRS has provided interim guidance on the certification procedures for manufacturers (and domestic distributors of foreign vehicles) of qualifying vehicles and has stated that purchasers may rely on the manufacturer's (or in the case of a foreign vehicle, its domestic distributor's) certification of a vehicle and the amount of the credit allowable with respect to that vehicle.

Amount of the Credit. The credit is $2,500 for vehicles powered by a 4-kilowatt hour battery, with an additional $417 for each kilowatt hour of battery power beyond that. The credit cannot exceed $7,500.

<u>Phase-out Rules.</u> The NQPEDMV will begin phasing out over a period of four calendar quarters once the total number of qualifying vehicles sold for use in the United States is at least 200,000. The phase-out period begins with the second calendar quarter following the quarter in which the 200,000 milestone is reached. During the first two quarters of the four-quarter phase-out period, the credit is reduced to 50% of the otherwise allowable amount. During the last two quarters of the phase-out period, the credit is reduced to 25% of the otherwise allowable amount. Consequently, starting with the sixth quarter after the 200,000 milestone is reached, phase-out of the credit is complete and no further credit is allowed.

Limitations and Special Rules. The tax liability limit for the NQPEDMV depends on whether it is claimed on personal vehicles or depreciable vehicles used in a trade or business. The credit claimed on personal vehicles is treated as part of the taxpayer's nonrefundable personal credits and for 2010 is allowed to offset the taxpayer's regular tax, plus AMT less the sum of the dependent care credit, credit for the elderly and disabled, child tax credit, mortgage interest credit, education credits, retirement saver's credit, nonbusiness energy property credit, and the foreign tax credit., as amended by the 2009 Recovery Act]. The credit claimed on depreciable business vehicles becomes part of the taxpayer's general business credit and is applied under those rules.

The basis (depreciable or personal) of property for which the credit is allowed is reduced by the amount of the credit allowed.

The Treasury Department is authorized to issue regulations that provide for the recapture of the credit for vehicles that cease to be eligible for the credit.

Election Not to Claim the Credit. Taxpayers may elect not to claim the NQPEDMV.

Claiming the Credit for Certain Other Qualified Electric Plug-in Vehicles

The 2009 Recovery Act provided for a tax credit for certain other plug-in electric vehicles. This credit is different from the NQPEDMV previously discussed, although some of its limitations and special rules are the same as the NQPEDMV. Qualifying vehicles must be either a low speed vehicle (four-wheeled vehicle with a GVWR of no more than 3,000 pounds, capable of attaining speeds of no less than 20 mph and no more than 25 mph) or have 2 or 3 wheels, draw propulsion using a battery with at least 4 kilowatt hours (2.5 kilowatt hours for a 2 or 3-wheeled vehicle) of capacity, use an external source of energy to recharge the battery (hence the name *plug-in*), made by a manufacturer primarily for use on public streets, roads, and highways, have a GVWR of less than 14,000 pounds, and the use must originate with the taxpayer. The credit is available for vehicles acquired after February 17, 2009 and before January 1, 2012.

The IRS has provided interim guidance on the certification procedures for manufacturers (and domestic distributors of foreign vehicles) of qualifying vehicles and has stated that purchasers may rely on the manufacturer's (or in the case of a foreign vehicle, its domestic distributor's) certification of a vehicle and the amount of the credit allowable with respect to that vehicle.

Amount of the Credit. The amount of the qualified plug-in electric vehicle (QPEV) credit equals 10% of the cost of qualifying vehicles placed in service by the taxpayer during the year, with a maximum credit of $2,500 per vehicle.

Limitations and Special Rules. The tax liability limit for the QPEV credit depends on whether it is claimed on personal vehicles or depreciable vehicles used in a trade or business. The credit claimed on personal vehicles is treated as part of the taxpayer's nonrefundable personal credits and, therefore, for 2009 is allowed to offset the taxpayer's regular tax, plus AMT less the sum of the dependent care credit, credit for the elderly and disabled, child tax credit, mortgage interest credit, education credits, retirement saver's credit, nonbusiness energy property credit, and the foreign tax credit. The credit claimed on depreciable business vehicles becomes part of the taxpayer's general business credit and is applied under those rules.

The basis (depreciable or personal) of property for which the credit is allowed is reduced by the amount of the credit allowed.

The Treasury Department is authorized to issue regulations that provide for the recapture of the credit for vehicles that cease to be eligible for the credit.

Election Not to Claim the Credit. Taxpayers may elect not to claim the QPEV credit.

SELF-STUDY QUIZ

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

27. Taxpayers are allowed to claim business deductions for the costs associated with automobile use. Which of the following is correct regarding this deduction?

    a. A taxpayer's commute from home to work is generally a deductible expense associated with the business.

    b. If a self-employed taxpayer uses a car for both business and personal use, all of the car's operating expenses can be deducted by the taxpayer.

    c. A taxpayer can take a deduction for automobile use, even with adequate records, if they are self-employed.

    d. If a taxpayer works solely from their residence, they can deduct local daily transportation between their home and other work locations in the same line of business.

28. Scott purchases a Toyota Land Cruiser for $52,000 in 2010 to be used 100% in his sole proprietorship. The Toyota Land Cruiser cannot be classified as a passenger automobile since its maximum loaded weight, based on information from the manufacturer, is over 6,000 pounds. What would the depreciation be for Scott's Toyota Land Cruiser in 2011?

    a. $5,990.

    b. $9,984.

    c. $10,400.

    d. $16,640.

29. Which of the following would be an advantage of owning a vehicle for a taxpayer's business instead of leasing the vehicle?

    a. The taxpayer can utilize accelerated depreciation methods when they own the vehicle.

    b. !f the vehicle is used personally and for business, the basis number of the vehicle remains intact when traded in.

    c. The accounting treatment for an owned vehicle is much simpler than a leased vehicle.

    d. The owned vehicle will usually have a lower adjusted basis than a leased vehicle.

30. Self-employed taxpayers may use the standard mileage rate for computing car expenses for local transportation or travel away from home. Which of the following is a limitation of using the standard mileage rate?

    a. If the taxpayer begins using the standard mileage rate, they are locked into that method and cannot change to the actual cost method.

    b. If a taxpayer used multiple vehicles simultaneously in his or her trade or business, the standard mileage rate can only be applied to one vehicle per year.

    c. If a vehicle is used for hire in the taxpayer's trade or business, then it may not employ the standard mileage rate.

    d. The taxpayer must use the accelerated depreciation method of MACRS when depreciating the vehicle.

31. Which of the following situations would qualify for safe harbor, so that the employer would not have to maintain records of use for the auto deduction?

    a. Richard owns a small farm and works running it on the weekends. He bought a truck to drive when he is working on the farm, but he also drives it when he is commuting and working at his full-time job of appliance repair.

    b. Bob is given a company truck to drive to his electrical repair jobs. Although his employer provides the truck, he is only allowed to drive it for company purposes and leaves the truck each night at his employer's location. When hired, Bob signed a company policy saying he would not use the truck for personal use.

    c. Denise was provided with a leased company car when she accepted her job as CEO of Bright Light Industries. A driver picks Denise up each morning and takes her to all job related appointments. Her leased vehicle is a perk and is added to her compensation for the year.

    d. Jose is given a company car to use in his salesperson position with Twilight Sales. He drives the car 100% of the time, both for sales calls and for personal use. The company requires Jose to turn in documentation at the end of the year detailing his personal use of the car.

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.)**

27. Taxpayers are allowed to claim business deductions for the costs associated with automobile use. Which of the following is correct regarding this deduction? **(Page 158)**

    a. A taxpayer's commute from home to work is generally a deductible expense associated with the business. [This answer is incorrect. The costs of commuting from a personal residence to places of business or employment are generally nondeductible personal expenditures under Regs.1.162-2(c) and 1.262-1(b)(5).]

    b. If a self-employed taxpayer uses a car for both business and personal use, all of the car's operating expenses can be deducted by the taxpayer. [This answer is incorrect. If a self-employed taxpayer uses a care for both business and personal use, an allocation must be made in proportion to the number of miles driven during the year for each purpose as stated in the IRS temporary regulations. This allocation applies to each component of a car's operating expenses except those expenses clearly identified with a particular use of the car.]

    c. A taxpayer can take a deduction for automobile use, even with adequate records, if they are self-employed. [This answer is incorrect. Taxpayers substantiate auto business mileage by maintaining adequate records. Per IRS temporary regulations, if the automobile use is not substantiated by adequate records or other sufficient corroborating evidence, then it is considered personal use and cannot be deducted.]

    d. If a taxpayer works solely from their residence, they can deduct local daily transportation between their home and other work locations in the same line of business. [This answer is correct. Taxpayers whose residences qualify as their principal place of business under IRC Sec. 280A(c)(1)(A) can deduct local daily transportation expenses incurred commuting between their residences and other work locations in the same trade or business. But the taxpayer's home office must be for the convenience of his employer (if not self-employed) in addition to being used exclusively and regularly as his principal place of business.]

28. Scott purchases a Toyota Land Cruiser for $52,000 in 2010 to be used 100% in his sole proprietorship. The Toyota Land Cruiser cannot be classified as a passenger automobile since its maximum loaded weight, based on information from the manufacturer, is over 6,000 pounds. What would the depreciation be for Scott's Toyota Land Cruiser in 2011? **(Page 160)**

    a. $5,990. [This answer is incorrect. Based on the table applicable to vehicles not classified as passenger automobiles based on loaded weight of the vehicle, this would be the Year 4 or 5 depreciation for the Toyota Land Cruiser. $52,000 x 11.52% = $5,990.]

    b. $9,984. [This answer is incorrect. Based on the table applicable to vehicles not classified as passenger automobiles based on loaded weight of the vehicle, this would be the Year 3 depreciation for the Toyota Land Cruiser. $52,000 x 19.2% = $10,400.]

    c. $10,400. [This answer is incorrect. Based on the table applicable to vehicles not classified as passenger automobiles based on loaded weight of the vehicle, this would be the Year 1 depreciation for the Toyota Land Cruiser. $52,000 x 20% = $10,400.]

    d. $16,640. [This answer is correct. When a vehicle is not classified as a passenger automobile and is used over 50% for business, it is treated as five-year MACRS property and depreciated under the regular rules for such property. A table indicates the depreciation percentage in these instances, with the second year of ownership eligible for 32% depreciation. $52,000 x 32% = $16,640.]

29. Which of the following would be an advantage of owning a vehicle for a taxpayer's business instead of leasing the vehicle? **(Page 164)**

   a. The taxpayer can utilize accelerated depreciation methods when they own the vehicle. [This answer is correct. For owned autos used more than 50% for business, taxpayers can use regular MACRS depreciation, which is the 200% declining balance method applied to a five-year recovery period. For leased autos, only the business percentage of the lease expense can be deducted each year.]

   b. If the vehicle is used personally and for business, the basis number of the vehicle remains intact when traded in. [This answer is incorrect. If an owned auto is used less than 100% for business and is then traded in, one basis number is used for depreciation purposes and another for gain/loss purposes. The unrecovered basis for depreciation reflects a reduction for the full amount of depreciation that would have been allowed for 100% business use.]

   c. The accounting treatment for an owned vehicle is much simpler than a leased vehicle. [This answer is incorrect. There are many complexities related to owning a vehicle: basis issues, depreciation records, gain/loss on disposition of the vehicle. If the taxpayer leases the business auto, he simply returns it at the end of the lease term. Thus, leasing can be much less burdensome from an accounting and administrative standpoint.]

   d. The owned vehicle will usually have a lower adjusted basis than a leased vehicle. [This answer is incorrect. An owned vehicle will usually have a higher adjusted basis than a leased vehicle. When a taxpayer trades in an owned business auto rather than selling it, the basis of the new auto is the adjusted basis of the old auto plus any additional amount paid. After a few trade-ins, the luxury auto depreciation limitations cause the taxpayer's basis in the currently owned vehicle to build up to inflated levels.]

30. Self-employed taxpayers may use the standard mileage rate for computing car expenses for local transportation or travel away from home. Which of the following is a limitation of using the standard mileage rate? **(Page 166)**

   a. If the taxpayer begins using the standard mileage rate, they are locked into that method and cannot change to the actual cost method. [This answer is incorrect. The taxpayer may change from the standard rate method to the actual cost method, but must then use straight-line depreciation for the automobile's remaining estimated useful life.]

   b. if a taxpayer used multiple vehicles simultaneously in his or her trade or business, the standard mileage rate can only be applied to one vehicle per year. [This answer is incorrect. The standard mileage rate cannot be used if the taxpayer used five or more cars simultaneously in his trade or business. However, if a taxpayer alternates using different cars for different periods during the year, the standard mileage rate can be applied to the total business miles of five or more cars.]

   c. If a vehicle is used for hire in the taxpayer's trade or business, then it may not employ the standard mileage rate. [This answer is correct. According to Rev. Proc. 2008-72, the standard mileage rate may not be used to compute deductible expenses of vehicles used for hire, such as taxicabs.]

   d. The taxpayer must use the accelerated depreciation method of MACRS when depreciating the vehicle. [This answer is incorrect. The standard mileage rate cannot be used if the car has been previously depreciated using a method other than straight-line depreciation.]

31. Which of the following situations would qualify for safe harbor, so that the employer would not have to maintain records of use for the auto deduction? **(Page 168)**

    a. Richard owns a small farm and works running it on the weekends. He bought a truck to drive when he is working on the farm, but he also drives it when he is commuting and working at his full-time job of appliance repair. [This answer is incorrect. Richard's purchase of the truck would not qualify for safe harbor treatment according to the IRS temporary regulations. The safe harbor rules state that business use is deemed to be 75% used in farming. Since Richard does not use the vehicle at least 75% of the time for farm use, it does not qualify under this safe harbor rule.]

    b. Bob is given a company truck to drive to his electrical repair jobs. Although his employer provides the truck, he is only allowed to drive it for company purposes and leaves the truck each night at his employer's location. When hired, Bob signed a company policy saying he would not use the truck for personal use. [This answer is incorrect. One way to substantiate auto use under the safe harbor method per IRS temporary regulations and relieve the employer from having to keep detailed records, is for the automobile to be used solely for business and for the employee to keep the vehicle on the employer's premise each day after work. No personal use is allowed except for *de minimis* personal use and it requires a written company policy statement.]

    c. Denise was provided with a leased company car when she accepted her job as CEO of Bright Light Industries. A driver picks Denise up each morning and takes her to all job related appointments. Her leased vehicle is a perk and is added to her compensation for the year. [This answer is correct. No employer substantiation is required when 100% of the annual lease value of the vehicle is reported to the employee as income, since the entire documentation burden is shifted to the employee. This qualifies under the safe harbor rules as a vehicle treated as used by an employee entirely for personal use.]

    d. Jose is given a company car to use in his salesperson position with Twilight Sales. He drives the car 100% of the time, both for sales calls and for personal use. The company requires Jose to turn in documentation at the end of the year detailing his personal use of the car. [This answer is incorrect. Jose's company will not qualify for a safe harbor method. To qualify for that, and allow Jose to use the company for some personal use, the company would have to limit Jose's personal use to commuting use only and require Jose to sign a company policy stating that it is all the car would be used for. Since Jose's personal use of the vehicle is not limited, it would not qualify for a safe harbor method of substantiation under the IRS temporary regulations.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (TINTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

22. Which depreciation method would provide the taxpayer with the shortest life available for an asset?

    a. Straight-line depreciation.

    b. Alternative depreciation system.

    c. AMT depreciation method.

    d. Regular MACRS.

23. Which depreciation method should a taxpayer use if they are attempting to minimize AMT?

    a. Straight line depreciation.

    b. Alternative Depreciation System.

    c. Regular MACRS.

    d. Do not select this answer choice.

24. The IRS has established specific rules for a company to decide on an acceptable capitalization floor.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

25. Braden purchases an asset in November, 2009 and decides that it qualifies for the midquarter convention. After calculating the depreciation for the asset for the full year, what percentage does he apply to the deprecation to determine the midquarter convention depreciation?

    a. 12.5%.

    b. 37.5%.

    c. 62.5%

    d. 87.5%.

26. When classifying assets into recovery periods based on the MACRS chart, how can an asset qualify for the recovery period assigned to assets used in a specific trade or business?

    a. Basing the classification on the activity that the asset is primarily used for.

    b. The asset must be unique to the taxpayer's business.

    c. Classifying the asset as "general use".

    d. Do not select this answer choice.

27. Todd is a self-employed salesperson, selling workout equipment to gyms in and around the Dallas/Ft. Worth metroplex. The only office that Todd has is one in his home where he places orders for his customers, keeps sales literature and maintains his financial records. Six days a week, Todd travels to gyms around North Texas, making sales calls to customers. Which of the following travel could Todd deduct?

    a. Only travel that takes place outside the metroplex.

    b. Travel from his home to his first customer of the day.

    c. Travel between customer sales calls within the metroplex.

    d. Travel from his last customer of the day to his residence.

28. Ed purchases a used car in 2010 for $10,000 for one of his salespeople to drive and to be used 100% for work. Ed would like to maximize his use of the Section 179 and depreciation deductions. What is the maximum Section 280F deduction for 2010 for Ed?

    a. $0.

    b. $1,200.

    c. $1,760.

    d. $3,060.

29. Which of the following does **not** have a special exception making it eligible for a Section 179 deduction or excluded from the Section 280F depreciation limits, even though it exceeds the standards in weight?

    a. A heavy SUV weighing more than 6,000 lbs.

    b. A hotel passenger van.

    c. An ambulance.

    d. A delivery van with no seating behind the driver.

30. For a taxpayer to use the cost method to compute auto expenses, each expenditure incurred to operate and maintain the vehicle must be substantiated. Which of the following is the taxpayer **not** required to keep?

    a. Receipts detailing the fuel costs for the automobile.

    b. A mileage log with each trip documented in it at the time it happens.

    c. A cancelled check showing the purchase price of the vehicle.

    d. Invoices and cancelled checks for repairs done on the vehicle.

31. Kim purchases a qualified plug-in electric drive motor vehicle to use in her newly acquired business. The vehicle weighs approximately 18,000 lbs and has a 30-kilowatt hour battery. How much credit can Kim qualify for under the 2008 Energy Act?

    a. $2,500.

    b. $7,500.

    c. $10,000.

    d. $12,500.

Lesson 4: Business Travel Deductions and Meals and Entertainment

INTRODUCTION

Travel expenses include transportation, lodging, meals, and related incidentals. Business travel expenses incurred by a self-employed individual are fully deductible (subject, however, to the 50% disallowance for meals and entertainment), but must be properly substantiated. In contrast, payments of personal living expenses or of personal travel (vacation) costs are not deductible.

Learning Objectives:

Completion of this lesson will enable you to:

- Discuss the restrictions and qualifications for a taxpayer to claim deductions for business travel expenses.
- Recognize the limits on meals and entertainment deductions in different business situations.

Ensuring Business Travel Qualifies as "Away from Home"

Attaining Travel Status for Overnight Business. A self-employed taxpayer is considered to be in travel status on a business trip only if his duties require him to be away from his tax home substantially longer than an ordinary day's work, and sleep or rest is required to meet the demands of the work. (This is known as the *overnight rule* or the *sleep or rest rule*.) Thus, determining the location of an individual's tax home is critical to the deductibility of travel expenses.

This is not a literal test in the sense that the taxpayer must be away from his tax home for the whole day or from dusk to dawn. However, the trip must be of such a length as to require adequate sleep or rest to allow the taxpayer to continue working (Rev. Rul. 75-170). If the taxpayer fails to achieve business travel status for the day's work, any travel costs (including meal costs) are personal expenses.

> **Example 4-1: Attaining business travel status requires sleep or rest.**
>
> Joe Harder, a self-employed computer programmer, works out of an office in his home. On Monday morning, he is called to a client's business location 250 miles away to solve a computer systems problem. Joe leaves home at 7 a.m. and arrives at the client's location by 11 a.m. Other than stopping briefly for lunch and dinner, he works straight through until 9 p.m. to resolve the problems. At this point, Joe has two choices: (a) return home the same night, or (b) stay overnight in a local hotel and return home on Tuesday morning. He decides to take a one-hour nap and return home the same night, arriving home at 2 a.m. on Tuesday morning.
>
> Joe's trip is not likely to be considered overnight travel away from his tax home because his one-hour nap is not considered an adequate rest period. Since Joe has not attained travel status, his expenses for meals and incidentals are personal in nature, and do not satisfy the deductibility rules under IRC Sec. 162. However, the transportation expenses of going between his personal residence and the client's business location are deductible.

Lack of a Tax Home Can Prevent Travel Deductions. A self-employed taxpayer's tax home is normally his regular or principal (if more than one regular) place of business. 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 (*Bjornstad*).

It is important to note that a taxpayer's home is not limited to a particular building or property, but includes the entire city or general locality in which he customarily carries on his trade or business (Rev. Rul. 56-49). In this case, when a taxpayer is working in different locations or areas around the city, in the suburbs, or within the metropolitan area, the taxpayer is not away from home and cannot claim travel deductions. The taxpayer, however, can claim deductions for local transportation costs (see Key Issue 12G of *PPC's 1040 Deskbook*).

When a taxpayer does not have a regular or principal place of business, the deductibility of travel expenses hinges on whether he has a regular place of abode in the real and substantial sense or is an itinerant (i.e., a person who travels from place to place).The IRS has provided three factors to help determine whether the taxpayer's regular place of abode is his tax home:

a. The taxpayer conducts business in the vicinity of the claimed tax home and uses the home for lodging while doing so.

b. Living expenses at the claimed tax home are duplicated when business requires the taxpayer to be elsewhere.

c. The taxpayer has not abandoned his historical vicinity of lodging and abode, has family members residing at the claimed tax home, or uses the claimed tax home frequently for lodging.

If all three factors are satisfied, the taxpayer's claimed tax home can be used to determine travel expenses. (The taxpayer achieves business travel status for any travel away from this tax home.) 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 (*Henderson*).

Example 4-2: Itinerant outside salesperson with no tax home.

Bill Stevens, an outside salesman, has a sales territory covering several states. Bill's employer has its main office in St. Louis, but Bill does not go there. His work assignments are temporary, and he has no way of knowing where his future assignments will be located. He has a room in his married 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 performs no work in the vicinity of Chicago. Bill has abandoned his historical and other contacts, which are near Milwaukee. Bill pays his own travel expenses.

Bill, not having satisfied any of the objective factors discussed previously, is an itinerant having his "home" wherever he happens to work. Thus, since he is not away from home, the costs of his lodging and meals are not deductible as traveling expenses under IRC Sec. 162(a)(2).

Two or More Geographically Separate Businesses. Generally, a taxpayer engaged in two or more businesses that are 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 business location are deductible. To determine which is the principal and which is the secondary business location, the courts have considered (a) the amount time spent at each place, (b) the proportion of the taxpayer's income earned in each location, (c) the degree of activity engaged in by the taxpayer at each location, (d) where the taxpayer maintains his permanent residence, and (e) whether employment at one location is temporary (*Ziporyn*; *Bjornstad*).

Example 4-3: Taxpayer has two geographically separate businesses.

Terry owns a ski shop in Colorado that he personally operates November–March. The remainder of the year he runs a contracting business firm that builds retirement homes in Arizona. He maintains a permanent residence in each location.

Both residences are necessary for business. Based strictly on time spent (i.e., without considering the business activity and income earned at each location), it appears the Arizona residence will be considered Terry's tax home, and all expenses of travel (for business purposes) between the residences and for living in Colorado will be deductible under IRC Sec. 162. Only 50% of Terry's meals in Colorado may be deducted and, furthermore, an allocation will be required if his family lives with him in Colorado (since only his expenses will be deductible).

Temporary versus Indefinite Work Assignments. Travel expenses paid or incurred in connection with temporary work assignments away from home are deductible business expenses since the taxpayer is in business travel status away from his current tax home. However, travel expenses paid or incurred in connection with work assignments of an indefinite duration are not deductible business expenses since the taxpayer is considered to have relocated his tax home to the location of the extended work assignment and is no longer in business travel status. Such payments are for personal living expenses.

A taxpayer's work assignment away from home in a single location is deemed indefinite if it lasts more than one year. However, the one-year rule does not apply to federal employees whose employment away from home (a) is certified by the Attorney General (or designee), and (b) 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 assignment away from home in a single location is realistically expected to last (and in fact does last) one year or less, the employment will be treated as temporary in the absence of facts and circumstances indicating otherwise. If assignment away from home in a single location is realistically expected to last more than one year, or there is no realistic expectation that the assignment will last one year or less, the assignment will be treated as indefinite (*Saric*), regardless of whether it actually exceeds one year. If assignment away from home in a single location initially is realistically expected to last one year or less, but at some later date the assignment is realistically expected to exceed one year, at that point the assignment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) and travel expenses are no longer deductible until the date that the taxpayer's realistic expectation changes. 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 duration (*Sanderson*). 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 (*Mitchell*). 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 (*Daiz*). 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 (*Wasik*; *Stockwell*).

Example 4-4: Indefinite work assignment converts business travel to personal travel.

Jill Brady is a self-employed architect headquartered in Phoenix. On May 1, 2009, Jill contracted with a company out of Boston to design and oversee a building renovation project. The project was realistically expected to last 10 months. Jill rented a suite in Boston. On February 1, 2010 (after nine months on the assignment), Jill was asked to perform additional procedures that would require an additional six months to finish up. Jill stayed on location until August 1, 2010. She paid all travel-related expenses incurred while on the job (including rent and related living expenses).

The assignment was initially deemed temporary since the original length was expected to be one year or less. However, the change in status on February 1, 2010 converted it to an indefinite assignment of more than one year. Thus, the expenses incurred from May 1, 2009–January 31, 2010 are for temporary employment and are deductible business expenses. The expenses incurred beginning February 1, 2010, are related to indefinite employment and are not deductible.

When a Saturday Night Stay Becomes Deductible. If the taxpayer wraps up a business trip on a Friday and decides to remain at the travel location until the weekend to avail himself of lower return airfare rates, the additional lodging and meal costs incurred during the extra days will be deductible travel expenses if, using a common sense test, a hardheaded business person would have incurred the additional expenses under like circumstances.

Example 4-5: 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 "hard-headed" 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.

Preserving Deductions for Combined Business/Pleasure Travel

If a taxpayer's trip is undertaken solely for business reasons, all reasonable and necessary travel expenses, including travel fares, lodging, meals, and incidental expenses in getting to and from the destination are deductible (subject to the 50% disallowance for meals and entertainment). So are transportation, lodging, meals and incidentals incurred while at the destination. This rule applies for both domestic and foreign travel.

However, if the taxpayer's trip involves both business and personal activities, a portion of the travel expenses may be nondeductible personal expenses rather than deductible business expenses. One set of rules applies for domestic travel (i.e., travel within the United States) and a separate set of rules applies to foreign travel (i.e., travel outside the United States). For this purpose, the term *United States* means only the 50 states and the District of Columbia.

Domestic Travel. If the taxpayer travels on business in the United States and while at the business destination extends his stay for a vacation, makes a nonbusiness side trip, or has other nonbusiness activities, the proper treatment of the taxpayer's travel expenses depends on how much of the trip was business related. The following guidelines apply:

a. *Primarily Business.* If the trip was primarily for business, the deductible travel expenses include the costs of getting to and from the business destination and any business-related expenses while at the business destination. Personal (vacation) costs incurred while at the destination are not deductible.

b. *Primarily Personal.* If the trip was primarily for personal reasons, such as a vacation, the costs of getting to and from the destination are personal (nondeductible) travel costs. Personal costs incurred while at the destination are also nondeductible. However, any business costs incurred while at the destination are deductible expenses.

Whether a trip is primarily business or primarily personal depends on the facts and circumstances in each case. The amount of time spent on business activities compared to the amount spent on personal activities is an important factor. While this is often regarded as a more-than-50% test, no direct IRS authority supports this approach. For example, the IRS states that a trip involving one week of business activities and five weeks of personal activities are considered primarily personal in the absence of a clear showing to the contrary.

Example 4-6: Taxpayer mixes domestic business travel and vacation.

Fred Ware's real estate brokerage business is located in Atlanta. He travels to San Diego on business. On the way, he stops in Santa Fe for four days of rest and relaxation where he spends $950 for personal activities. He spends $830 for roundtrip air travel tickets from Atlanta to San Diego—with a stopover in Santa Fe. The cost of a direct roundtrip flight from Atlanta to San Diego is $720. He wraps up his San Diego business after 10 days of meetings and returns home after incurring $920 of lodging, meal and incidental costs while in San Diego.

It is necessary to determine whether the trip was primarily business or primarily personal. Based strictly on the ratio of time spent on business activities (10 days) to time spent on personal activities (four days), it is assumed Fred's trip is primarily business. The deductible travel expenses include the $720 airfare cost for a direct roundtrip between Atlanta and San Diego and the $920 of lodging, meals, and related costs incurred while in San Diego (limited to 50% for meals and entertainment). The $110 ($830 − $720) of additional airfare costs of getting to Santa Fe, and the $950 of personal costs incurred while at Santa Fe are not deductible travel expenses.

Had the trip been primarily personal, the entire $830 of airfare costs and the $950 of personal costs would not be deductible. However, the $920 of business expenses while in San Diego would be deductible as business expenses.

Foreign Travel Deemed Entirely for Business. Generally, a self-employed taxpayer can deduct 100% of foreign travel expenses 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 are deductible. Out-of-pocket costs incurred on personal days are never deductible.

Although the foreign travel rules require an allocation of expenses if business travel is combined with personal travel, a safe harbor is provided by IRC Sec. 274(c)(2). If *either* of the following exceptions is met, allocation of the transportation expenses (getting to and from the destination) on a day-to-day basis is not required. Instead, the taxpayer may deduct those expenses as though the trip was 100% business.

a. *No More Than Seven Consecutive Days Are Spent Outside the United States*. Accordingly, by keeping a foreign business trip to a week 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) are deductible. Out-of-pocket costs incurred on personal days are not deductible. For meeting the seven-day test, the day of departure is ignored, but the day of return is included.

b. *Less Than 25% of the Total Time on the Trip Is Devoted to Nonbusiness Activities.* For meeting the 25% test, both the day of departure and the day of return are considered. The same rules for out-of-pocket costs apply as in exception a.

c. *The Taxpayer Has No Substantial Control over Arranging the Trip*. A taxpayer who travels for an employer 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.)

d. T*he Taxpayer Establishes That 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.

Example 4-7: Combining minimal personal travel with a business trip.

Fred Ware flew to Paris on Sunday to attend several business meetings. He spent Monday through Thursday meeting with various business clients. Instead or returning home immediately after the meetings, he stayed in Paris to do some sightseeing and returned home Sunday.

Fred's trip meets the seven-day safe harbor exception (Monday–Sunday). The purpose of the trip was primarily business related because four out of seven days were business days. Thus, 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 Primary for Business. If the travel is primarily for business and the taxpayer cannot meet one of the safe harbor exceptions, the travel expenses should be allocated to deductible and nondeductible categories using a day-to-day allocation method (or other method that the taxpayer establishes clearly reflects the allocation). The following equation is used to calculate deductible travel expenses using the day-by-day method:

$$\text{Total travel expenses} \times \frac{\text{Number of business days}}{\text{Total days outside U.S.}}$$

Both departure and return days are included in the denominator. Transportation days are considered business days 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.

If the taxpayer's presence is required at a particular place for a specific and bona fide business purpose, it 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 4-8: Wrapping business around a weekend.

Assume the same facts as in Example 4-7 except Fred flew to Paris on Tuesday, spent Wednesday through Friday in business meetings, did his sightseeing on Saturday and Sunday, and had a five-hour business meeting on Monday. He meets the seven-day safe harbor exception (Wednesday through Monday). Thus, all of his travel expenses [including food (50%) and lodging on the weekend] would be considered business expenses.

Example 4-9: Allocating travel expenses of a combined business and pleasure trip.

Fred Ware flew from his hometown of Atlanta to Munich on a buying trip involving distressed real estate property. He spent two days meeting with realtors and sellers. He then drove to Austria for a five-day vacation before returning home. Fred would not have made the trip except for the business he conducted in Munich.

Fred's travel outside the U.S., including two days of travel, totaled nine days. He does not meet either the one-week or less-than-25% nonbusiness test. Further assume Fred cannot establish that he had no substantial control over arranging the trip, or that a personal vacation was not a major consideration in making the trip. Thus, he does not qualify for any of the safe harbor tests. Fred's 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 from Atlanta to Munich that were attributable to transportation and food (subject to the 50% disallowance) and that would have been incurred had he returned from Munich to Atlanta 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.

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 (a) the purpose and activities of the meeting, (b) the sponsoring organization, (c) the residences of the organization's active members, and (d) 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:

a. 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.

b. 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.

Planning around the Restrictions on Accompanied Travel

IRC Sec. 274(m)(3) disallows a deduction for amounts paid or incurred with respect to a spouse, dependent, or other individual accompanying a taxpayer on business travel, unless—

a. the accompanying individual is an employee of the taxpayer,

b. the travel of the accompanying individual is for a bona fide business purpose, and

c. the travel expenses would otherwise be deductible by the accompanying individual.

It may be difficult to convince the IRS that a bona fide business purpose exists when a spouse accompanies a taxpayer on a business trip. Based on a long line of court cases, the presence of the spouse (or other traveling companion) on a trip must be necessary, not merely helpful, to establish the requisite business purpose (*Moorman*; *Johnson*). Thus staffing a convention hospitality (*Johnson*), hosting a reception (*Sheldon*), socializing with business associates (*Fenstermaker*), or performing light clerical duties (Rev. Rul. 56-168) while on a business trip have all been found insufficient, by themselves, for establishing a bona fide business reason for the spouse's presence.

Example 4-10: Spouse as social hostess is not a business purpose.

Jerry King, a sole proprietor, and his spouse, Maria, travel to Miami for a two-day business meeting. Maria works as an employee in Jerry's business. In Miami, Maria serves as a social hostess for the spouses of the business associates and also attends dinner functions during the two-day period.

The IRS may contend that Maria is performing only incidental services which do not establish a bona fide reason for her presence. Jerry will likely be unable to deduct Maria's share of the travel costs.

Example 4-11: Deducting the appropriate portion of travel costs.

Fred Ware and his wife, Cathy, travel by car from Dallas to Denver on business. They leave on Monday and return on Friday of the same week. Assume that Cathy performs only incidental services and thus cannot establish a bona fide business reason for her presence. Lodging is $150 per night for a double room (assume the single-rate cost is $100 per night). Transportation expense for the 2,000 mile roundtrip at 55 cents per mile (for 2009) is $1,100 (2,000 miles × 55 cents per mile). Meal costs total $800; if Fred had traveled alone, his meals costs would have been $600.

Fred is entitled to deduct those costs he would have otherwise incurred to travel alone. Here, he is entitled to deduct $100 per night lodging expense, plus all of the transportation costs, and $300 of the meal costs ($600 × 50%). The deductible amount is more than simply "half" the total costs.

In a few cases, the courts have found a legitimate business reason for the spouse's presence. Thus, a spouse's travel expenses were deductible where her presence was required by the business, and it helped promote the company's public image, enhance the morale of company representatives, and improved business relationships (*Disney*; see also *Bank of Stockton*).

Example 4-12: Spouse has a bona fide business purpose.

Assume the same facts as in Example 4-10 except the meetings are with Spanish-speaking participants. Jerry does not speak Spanish, but Maria does fluently. Maria acts as Jerry's translator during the two-day period.

There appears to be a bona fide purpose for Maria's presence on the trip. Thus, Jerry arguably may also deduct Maria's share of the business travel expenses.

Using Per Diems to Simplify Travel Records

In lieu of deducting actual travel expenses for meals and incidentals, self-employed taxpayers may opt to deduct a per diem allowance regardless of how much they actually spend. Per diems eliminate the need for self-employed taxpayers to gather documentation and receipts supporting the *amount* of meal and incidental travel expenses.

The IRS allows self-employed taxpayers to use the federal employee travel allowances (per diem rates that apply for federal government employees) to substantiate meal and incidental expenses (M&IE) without substantiating the actual amount of their expenses. Self-employed individuals who do not pay or incur meal expenses while traveling (e.g., meals are furnished) can deduct $5 per day for unreimbursed incidental expenses. That amount will be deemed substantiated if the taxpayer establishes the time, place and business purpose of the travel. However, no deemed substantiation rules exist for a self-employed taxpayer's lodging expenses. Thus, self-employed taxpayers must substantiate the actual amount of lodging expenses to claim a deduction.

The term *incidental expenses* means fees and tips for porters, baggage carriers, etc., but not expenses for laundry, lodging taxes, or telephone calls.

The current Domestic M&IE rates can be accessed on the Internet at **www.gsa.gov/perdiem**. Self-employed taxpayers need not limit their deductions to these "deemed substantiated" amounts if they can document actual expenses that are greater.

Example 4-13: Using per diem rates for a self-employed individual.

Jack, a sole proprietor, owns and operates two sporting goods stores, one in Denver and one in Salt Lake City. During 2010, Jack, who lives in Denver, spends 36 full days (and nights) in Salt Lake City. Assuming the M&IE rate for Salt Lake City for 2010 is $54, Jack may deduct $972 (36 × $54 × 50%) on his Schedule C for meals and incidentals while traveling away from home. In addition, he may deduct his actual lodging expenses.

This example assumes Jack can otherwise substantiate the time, place, and business purpose of his trips (e.g., via hotel receipts and/or an appointment book). It also assumes that he was away from home for a full 24-hour period for his overnight trips to Salt Lake City. (The M&IE rate for the day of departure and the day of return must be prorated—see paragraph below.)

Prorating the M&IE Per Diem Rate for Partial Day Travel. 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. Alternately, the taxpayer may prorate the daily M&IE component of the federal rate using "any method that is consistently applied and in accordance with reasonable business practice".

PROVING A BUSINESS CONNECTION FOR MEALS AND ENTERTAINMENT

General Rules for Deductible Meals and Entertainment Expenses

Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Meal and entertainment expenses incurred by a taxpayer to entertain a client, customer, employee, or other business associate are deductible only if the expenses satisfy the following strict requirements imposed by the Code:

a. *Ordinary and Necessary.* Meal or entertainment expenses must be ordinary and necessary to be deductible. An ordinary expense is one that is common and accepted in the taxpayer's business, trade, or profession. A necessary expense is one that is helpful and appropriate, although not necessarily indispensable, for the employer's business, trade, or profession.

b. *Business Connection.* There must be a clear connection between the meal or entertainment and a business event (such as a discussion, meeting, transaction, or negotiation). That is, the taxpayer must prove a valid business purpose for the business event that occurs before, during, or after the meal or entertainment activity.

c. *Lavish or Extravagant.* The meal or entertainment cost is deductible only to the extent it is not lavish or extravagant under the circumstances. Any portion deemed to be lavish or extravagant is not deductible. The remaining portion is deductible.

d. *Substantiation.* A deduction is allowed only for meal or entertainment expenses that are properly substantiated. No substantiation means no deduction.

e. *Taxpayer's Presence.* The taxpayer or a representative must be present when the activity involves business meals. Otherwise, the cost of the meal is nondeductible.

Of these requirements, the business connection requirement imposed under IRC Sec. 274(a) is perhaps the most difficult to meet. This requirement focuses on the reason for which the taxpayer's expense is paid or incurred and requires a business connection between the expense and the taxpayer's trade or business. Meals or entertainment that fail to show a clear business connection are deemed personal (nondeductible) expenses.

Distinguishing *Directly Related* and *Associated-with* Entertainment

Business meals or entertainment activities can occur before, during, or after the related business event (i.e., business meeting, discussion, negotiation, etc.). Thus, these business expenses are deductible if they qualify under either of the following tests:

a. *"Directly Related" Entertainment.* The business event and the entertainment activity occur simultaneously.

b. *"Associated-with" Entertainment.* The entertainment activity precedes or follows the business discussion.

Under the business connection requirement, meal or entertainment expenses are not deductible unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's business, or in the case of an item directly preceding or following a substantial and bona fide business discussion, that the item was associated with the active conduct of the taxpayer's business. It is often more difficult to prove a business connection for directly related entertainment than for associated-with entertainment.

Directly Related Entertainment. A meal or entertainment activity that occurs while business is being conducted (i.e., a combined entertainment-business event) must meet the following requirements to be deductible as directly related entertainment:

a. *Main Purpose.* The primary purpose of the combined entertainment-business event is the active conduct of the taxpayer's trade or business. It is not necessary that more time be devoted to business than to entertainment to meet this requirement. However, business discussion that is only incidental to the entertainment does not satisfy this requirement.

b. *Active Business.* The taxpayer actively engages in a business meeting, discussion, negotiation, or other bona fide business transactions during the entertainment period.

c. *Profit Expectation.* The taxpayer had more than a general expectation of getting income or some other specific business benefit from conducting the business discussion (other than the goodwill of the person or persons with whom the discussion occurred).

Proving a business connection for directly related entertainment is difficult because the meal or entertainment is commingled with the business. The taxpayer must show that a valid business event took place in an entertainment setting. It becomes necessary to maximize the importance of the business event and minimize the enjoyment from the entertainment.

Example 4-14: Directly related entertainment.

A business customer flies in from out of town to talk business with Fred Ware. The two discuss business over a meal. To show a business connection, Fred must prove that (1) the primary purpose of the combined business-entertainment event was the active conduct of business, (2) he actively engaged in business meeting or discussion, and (3) he had a profit expectation—more than simply business goodwill.

Example 4-15: Proving a business purpose for directly related entertainment.

Fred Ware meets with three business associates at a country club for a round of golf to discuss a business deal on a significant real estate property. After 20 minutes of intense business discussions while completing the first two holes, a deal is struck. The golf game wraps up three hours later.

The amount of time spent on business is clearly much less than that on entertainment. However, the critical nature of the business discussion can go a long way toward proving a business purpose. To support a business purpose for the golfing event, Fred's written record should highlight the importance of the business discussion and its possible impact on his business.

The taxpayer also must have more than a general expectation of getting income or some other specific business benefit—other than the goodwill of the person or persons entertained. However, it is not necessary that the taxpayer actually close on a deal.

Example 4-16: Taxpayer must expect a specific business benefit.

Fred Ware takes a business client to lunch. The two talk about business in general, but fail to discuss the specifics of any possible business arrangement. The IRS may assert this is simply a goodwill meal for which Fred did not expect a specific business benefit. If so, Fred will fail to show a business connection under the directly related test.

The setting or location of the combined entertainment-business event is of critical importance for deductibility. See below for how setting or location impacts the deductibility of directly related entertainment. See below also for how to keep goodwill meals or entertainment deductible by meeting the associated-with requirement.

Associated-with Entertainment. A meal or entertainment activity that directly precedes or follows a business discussion, meeting, negotiation, etc., must meet the following requirements to be deductible as associated-with entertainment:

a. *Associated with Taxpayer's Business.* The meal or entertainment is associated with the active conduct of the taxpayer's business. Generally, any ordinary and necessary expense is associated with the active conduct of the taxpayer's business if the taxpayer can prove a clear business purpose for incurring the entertainment expense. Generating business goodwill (i.e., to get new business or to encourage the continuation of an existing business relationship) is considered a clear business purpose.

b. *Substantial Business Discussion.* The entertainment must "directly" precede or follow a substantial business discussion. A business discussion is considered to be substantial only if the following apply:

   (1) The primary purpose of the combined entertainment and business activity was the active conduct of the taxpayer's trade or business. It is not necessary that more time be devoted to business than to entertainment to meet this requirement. However, business discussion that is only incidental to the entertainment does not satisfy this requirement.

   (2) The taxpayer actively engaged in a business meeting, discussion, negotiation, or other bona fide business transaction.

   (3) The taxpayer had more than a general expectation of getting income or some other specific business benefit from conducting the business discussion (other than the goodwill of the person or persons with whom the discussion occurred).

Note: These three requirements are applicable only to the business discussion. The entertainment that precedes or follows the business discussion is subject only to the much less rigorous "clear business purpose" requirement.

Entertainment that occurs on the same day as the substantial business discussion is considered to directly precede or follow the discussion. If the entertainment and business discussion do not occur on the same day, the taxpayer must consider the facts and circumstances to see if the entertainment precedes or follows the business discussion. Among the factors to consider are the date, place, and duration of the business discussion. If either party is from out of town, consideration should also be given to dates of arrival and departure, and the reasons the entertainment and discussion did not take place on the same day. The entertainment of out-of-town business associates on the evening before, or on the evening of the day following, the business discussion will generally be regarded as directly preceding or following the discussion.

Example 4-17: Associated-with entertainment.

A business customer flies in the night before a business meeting. Fred Ware entertains the business customer the evening before the business meeting and on the day after the business meeting. This is associated-with entertainment. To be deductible, Fred must establish a clear business purpose (such as goodwill) for the entertainment and prove that it directly preceded or followed a substantial business discussion.

Location or Setting Is Key for Directly Related Entertainment

When the meal or entertainment activity occurs simultaneously with the business event (i.e., directly related entertainment), the setting or location becomes critical. Meals or entertainment occurring in a clear business setting or a setting conducive to business (such as a luncheon or dinner club) will meet the directly related requirement if a valid business discussion, meeting, etc. occurs. Meals or entertainment occurring in "suspect" settings will likely not.

Clear Business Setting. If the entertainment occurs in a clear business setting, it meets the directly related test. For this purpose, a clear business setting includes a hospitality room or convention where business goodwill is created through the display or discussion of business products. It also includes entertainment that is mainly a price rebate on the sale of the taxpayer's products (e.g., a restaurant owner providing an occasional free meal to a loyal customer), or entertainment of a clear business nature occurring under circumstances where no meaningful personal or social relationship exists between the taxpayer and the persons entertained (e.g., entertainment of civic or business leaders at an open house).

Example 4-18: Clear business setting.

A retail merchant opens a new branch retail store. The merchant invites local city officials to the grand opening and serves refreshments to the public. The entertainment activities occur in a clear business setting and meet the directly related requirement.

Luncheon or Dinner Clubs. Luncheon or dinner clubs provide an atmosphere that is conducive to business meetings, discussions, negotiations, etc. Thus, it is relatively easy to satisfy the directly related requirement for meals taken at a luncheon or dinner club—provided the taxpayer proves the meal occurred during an active business discussion.

Example 4-19: Business meeting at dinner club.

Fred Ware regularly takes business associates to dinner at a local dinner club. If Fred properly documents that (1) the primary purpose of the meal was business, (2) a valid business discussion or negotiation took place during the meal, and (3) he had a specific profit expectation, the cost of the meal will meet the directly related requirement.

"Suspect" Locations or Settings. Meal or entertainment expenses may not be deductible under the directly-related criteria if they occur in settings or locations where, because of substantial distractions, there is little or no possibility of engaging in the active conduct of business, or the primary purpose is not considered to be business. This includes:

a. Meetings or discussions held at night clubs, theaters, and sporting events, or during essentially social gatherings such as cocktail parties.

b. Meetings or discussions held at places such as cocktail lounges, country clubs, golf and athletic clubs, or at vacation resorts, *if* the taxpayer meets with a group of persons that includes nonbusiness associates.

c. Meetings or discussions held on hunting or fishing trips, or on yachts and other pleasure boats.

In the preceding three instances, the presumption is that the entertainment is not directly related to the active conduct of the employer's business (the first and second items), or the primary purpose of the entertainment is personal, not business (the third item). While the employee can refute this presumption and prove the entertainment is directly related or has a primary business purpose by showing a substantial business meeting or discussion was held during the entertainment activity, the burden of proof is on the taxpayer.

Example 4-20: "Tainted" setting spoils deduction for directly related entertainment.

Fred Ware routinely takes many of his clients and customers to local professional sporting events. Some business discussion occurs during the sporting events, but no business discussion precedes or follows the sporting event (thus, the *associated-with* criteria is not met).

The directly related test is generally not met when the location of the combined business discussion-entertainment is a sporting event. Here, it is presumed there is little or no possibility of engaging in the active conduct of the taxpayer's business. While Fred may overcome this presumption, it is difficult to do so. Thus, it is likely the expenses incurred for the entertainment at the local sporting events are nondeductible.

Example 4-21: Presence of nonbusiness associates taints business connection.

Fred Ware maintains a membership at the local country club. He often invites business associates and prospective clients to the club for lunch and an afternoon round of golf, during which business is often discussed. Sometimes personal friends or other nonbusiness associates may join in during lunch and for the afternoon golf game. No business discussion occurs before or after these country club outings.

The directly related test will likely be met in those instances where the golf outings involve only business associates. For these outings, the setting will not, in-and-of itself, cause the entertainment activity to fail the directly related test. If Fred can prove a valid business discussion occurred and otherwise satisfy the directly related requirements, the golf outing expenses will be deductible business expenses.

The directly related test will likely *not* be met in those instances where the country club outings also involve nonbusiness associates. For these outings, the setting, combined with the presence of nonbusiness associates, likely causes the entertainment activity to fail the directly related test. The presumption is there was little or no possibility of engaging in the active conduct of the taxpayer's business during the entertainment event. While Fred may be able to overcome this presumption, it may be difficult to do so.

Keeping Business "Goodwill" Meals and Entertainment Deductible

Entertainment that directly precedes or follows a substantial business discussion may occur in any setting or location without hindering the "business" aspect of the business discussion. Thus, if the business discussion is held in a setting which is conducive to business, the entertainment meal or activity may occur anywhere (even at those suspect settings) and still satisfy the clear business purpose requirement associated with the test. Here, the cost of the goodwill entertainment is a deductible business expense.

Example 4-22: How to keep "goodwill" entertainment deductible.

Fred Ware frequently incurs meal expenses by entertaining lunch and dinner guests. Some of the entertaining involves bona fide business discussions with existing and potential clients and with professional advisors such as bankers, accountants, and attorneys. Some of the entertaining is done on a friendship or goodwill basis with longtime clients and business associates and does not involve business discussions.

Meal expenses incurred by Fred in the first situation are deductible as business expenses because they meet the directly related requirement for deductibility (assuming he properly substantiates the expenses). The business goodwill meal expenses in the second situation do not meet the "directly related" test because no business is discussed or conducted during the meals. Fred is not entitled to a business deduction for these amounts.

SELF-STUDY QUIZ

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

32. Amy left her home in Dallas at 8am and drove to a client site in Austin. She arrived there at noon. She met with the client and had lunch and then went back and worked at the client site until 6pm that evening. After work, Amy chose to check into a hotel and spend the night before returning home the next day. Has Amy achieved business travel status for the day, so that she can deduct her travel expenses?

    a. Yes.

    b. No.

33. If a taxpayer is working at a temporary location, which of these would be considered an indefinite work assignment and therefore not qualify for business travel deductions?

    a. A taxpayer is assigned to work away from home in a single location and the realistic expectation is that the assignment will last more than one year, but it wraps up after nine months.

    b. An assignment away from home in a single location is expected to less than one year, but at some later date the assignment's expectations change to more than one year.

    c. A taxpayer was assigned to a temporary location out of town, and the taxpayer was assured that she was eventually going to be assigned a permanent location within her home area by her supervisor, even if the assignment lasts more than a year.

    d. An assignment away from home in a single location that is realistically expected to last one year or less.

34. Leslie travels to San Francisco on a 6 day business trip, with a layover the preceding weekend in Las Vegas to vacation with some friends. The cost to fly directly to San Francisco was $1,000 for a roundtrip ticket. Because she stopped in Las Vegas on the way, Leslie pays $1,200 for the flight. She spends $300 on food and lodging while in Vegas and then spends another $2,100 for food and lodging while she is in San Francisco. How much should Leslie be able to deduct for the business trip, without taking into account limitations?

    a. $3,100.

    b. $3,300.

    c. $3,400.

    d. $3,600.

35. Rob has been invited to attend a sales conference in Germany for the home health equipment that he sells. He has decided to take his wife with him and sightsee while he is there. All representatives that sell for the company are located in the United States. The sales conference is 4 days long and Rob and his wife are going to stay for a total of 10 days. Which of the following expenses will Rob be able to deduct?

    a. Rob's airline ticket to fly to and from Germany.

    b. Rob's wife's airline ticket to fly to and from Germany.

    c. The meeting registration fees for Rob.

    d. All of the meals and lodging for the time spent in Germany.

36. A self-employed taxpayer can choose to deduct a per diem allocation for travel expenses instead of actual expenses. Which of the following is correct regarding a per diem allowance?

    a. The per diem amount includes lodging expenses for the taxpayer.

    b. A taxpayer using a per diem allowance can simplify tax reporting.

    c. Laundry and telephone expenses are included in incidental expenses for a per diem.

    d. If the taxpayer only travels a partial day, he or she only gets a ½ per diem allocated.

37. Which of the following is a characteristic of an associated-with entertainment, as opposed to directly-related entertainment?

    a. The main purpose is the active conduct of the taxpayer's business.

    b. The entertainment directly precedes or follows a business meeting.

    c. The taxpayer has an expectation of securing income by attending the entertainment.

    d. The taxpayer actively engages in a business meeting at the entertainment.

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.)**

32. Amy left her home in Dallas at 8am and drove to a client site in Austin. She arrived there at noon. She met with the client and had lunch and then went back and worked at the client site until 6pm that evening. After work, Amy chose to check into a hotel and spend the night before returning home the next day. Has Amy achieved business travel status for the day, so that she can deduct her travel expenses? **(Page 181)**

    a. Yes. [This answer is correct. Amy does qualify for business travel status for the day and she can deduct her travel expenses. To achieve business travel status for the day is not dependent on the amount of work time to require sleep or rest, but rather whether Amy actually stopped for adequate sleep or rest. Since Amy chose to stop and lodge overnight and return home the next day, all of her costs associated with the trip would have been deductible travel expenses. Staying overnight would have provided the necessary level of adequate sleep or rest to allow Amy to achieve travel status.]

    b. No. [This answer is incorrect. Although Amy did not work a full day, that is not the test that she must satisfy. The taxpayer is not required to be away from their tax home for the whole day or from dusk to dawn to qualify for business travel status. The trip must be of such a length as to require adequate sleep or rest to allow the taxpayer to continue working.]

33. If a taxpayer is working at a temporary location, which of these would be considered an indefinite work assignment and therefore not qualify for business travel deductions? **(Page 183)**

    a. A taxpayer is assigned to work away from home in a single location and the realistic expectation is that the assignment will last more than one year, but it wraps up after nine months. [This answer is correct. If the assignment away from home in a single location is realistically expected to last more than one year, or there is not a realistic expectation that the assignment will last one year or less, the assignment will be treated as indefinite per Rev. Rul. 93-86, regardless of whether it actually exceeds one year. The assignment would not qualify for business travel deductions.]

    b. An assignment away from home in a single location is expected to less than one year, but at some later date the assignment's expectations change to more than one year. [This answer is incorrect. If an assignment away from home in a single location initially is realistically expected to last one year or less, but at some later date the assignment is realistically expected to exceed one year, at that point the assignment will be treated as temporary, but the travel expenses are no longer deductible until the date that the taxpayer's realistic expectations change. Any previous expenses that were deemed temporary are deductible business expenses.]

    c. A taxpayer was assigned to a temporary location out of town, and the taxpayer was assured that she was eventually going to be assigned a permanent location within her home area by her supervisor, even if the assignment lasts more than a year. [This answer is incorrect. Employment was considered temporary, even though it lasted for more than a year, when the employee's supervisor assured the employee that the assignments were temporary and that the employee would eventually be assigned to a permanent location within the employee's home area as stated in *Diaz*.]

    d. An assignment away from home in a single location that is realistically expected to last one year or less. [This answer is incorrect. Travel expenses can be deducted if the assignment away from home in a single location is realistically expected to last one year or less. The employment is treated as temporary in the absence of facts and circumstances indicating otherwise.]

34. Leslie travels to San Francisco on a 6 day business trip, with a layover the preceding weekend in Las Vegas to vacation with some friends. The cost to fly directly to San Francisco was $1,000 for a roundtrip ticket. Because she stopped in Las Vegas on the way, Leslie pays $1,200 for the flight. She spends $300 on food and lodging while in Vegas and then spends another $2,100 for food and lodging while she is in San Francisco. How much should Leslie be able to deduct for the business trip, without taking into account limitations? **(Page 184)**

    a. $3,100. [This answer is correct. Leslie can only deduct the amount of the portion of the flight that was attributable to her business trip. Since it would have only cost $1,000 for Leslie to fly to San Francisco if she had not stopped in Las Vegas, that is the only portion of her flight expense she can deduct. In addition, Leslie can only deduct expenses attributable to her stay in San Francisco, where her business meeting was conducted.]

    b. $3,300. [This answer is incorrect. Although Leslie can deduct the expenses related to her food and lodging for the period of time she was in San Francisco, she cannot deduct the entire cost of the flight, since part of the expense was for a stop in Las Vegas, which was a personal trip.]

    c. $3,400. [This answer is incorrect. Leslie cannot deduct any amount that is related to her layover in Las Vegas. Therefore, she cannot include the $300 paid for the weekend's food and lodging while in Las Vegas on her way to San Francisco.]

    d. $3,600. [This answer is incorrect. Since Leslie mixed pleasure into her business trip, she can no longer deduct the entire amount spent on meals, lodging and air travel as stated in the IRS regulations.]

35. Rob has been invited to attend a sales conference in Germany for the home health equipment that he sells. He has decided to take his wife with him and sightsee while he is there. All representatives that sell for the company are located in the United States. The sales conference is 4 days long and Rob and his wife are going to stay for a total of 10 days. Which of the following expenses will Rob be able to deduct? **(Page 186)**

    a. Rob's airline ticket to fly to and from Germany. [This answer is incorrect. Since the trip lasts longer than seven consecutive days, the trip cannot be considered a foreign business trip per the IRS regulations. In addition, more than 25% of the total time on the trip is devoted to nonbusiness activities.]

    b. Rob's wife's airline ticket to fly to and from Germany. [This answer is incorrect. Since Rob's wife is not attending the conference and is not affiliated with Rob's sales business, according to IRS Sec 274 (m) (3), a deduction for amounts paid or incurred with respect to a spouse is not allowed.]

    c. The meeting registration fees for Rob. [This answer is correct. 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. Since this cannot be established for Rob's sales conference because all sales associates live in the United States and since a major portion of the trip is deemed to be a personal vacation, the only deductions that Rob can take are the meeting registration fees and other direct business costs.]

    d. All of the meals and lodging for the time spent in Germany. [This answer is incorrect. Since a large portion of the time is devoted to nonbusiness activities, all of the meals and lodging would not be deductible. Any direct business costs (i.e. for the time period that Rob is attending the sales conference) that Rob incurs would be deductible, subject to limitations.]

36. A self-employed taxpayer can choose to deduct a per diem allocation for travel expenses instead of actual expenses. Which of the following is correct regarding a per diem allowance? **(Page 188)**

    a. The per diem amount includes lodging expenses for the taxpayer. [This answer is incorrect. According to Rev. Proc. 2009-47, no deemed substantiation rules exist for a self-employed taxpayer's lodging expenses. The self-employed taxpayer must substantiate the actual amount of lodging expenses to claim a deduction.]

    b. A taxpayer using a per diem allowance can simplify tax reporting. [This answer is correct. In lieu of deducting actual travel expenses for meals and incidentals, self-employed taxpayers may opt to deduct a per diem allowance regardless of how much they actually spend. Per diems eliminate the need for self-employed taxpayers to gather documentation and receipts supporting the amount of meal and incidental travel expenses.]

    c. Laundry and telephone expenses are included in incidental expenses for a per diem. [This answer is incorrect. As stated in Rev. Proc. 2008-59, the term incidental expenses means fees and tips for porters, baggage carriers, etc., but not expenses for laundry, lodging taxes or telephone calls.]

    d. If the taxpayer only travels a partial day, he or she only gets a ½ per diem allocated. [This answer is incorrect. 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.]

37. Which of the following is a characteristic of an associated-with entertainment, as opposed to directly-related entertainment? **(Page 189)**

    a. The main purpose is the active conduct of the taxpayer's business. [This answer is incorrect. The primary purpose of the combined entertainment-business event should be the active conduct of the taxpayer's trade or business for both associated-with and directly-related entertainment. For both types, it is not necessary that more time be devoted to business than to entertainment to meet this requirement, but the business discussion that is only incidental to the entertainment does not satisfy this requirement for either type.]

    b. The entertainment directly precedes or follows a business meeting. [This answer is correct. For associated-with entertainment, the entertainment activity precedes or follows the business discussion. For directly-related entertainment, the business event and the entertainment activity occur simultaneously.]

    c. The taxpayer has an expectation of securing income by attending the entertainment. [This answer is incorrect. A common characteristic of associated-with entertainment and directly-related entertainment is that the taxpayer has more than a general expectation of getting income or some other specific business benefit from conducting the business discussion (other than the goodwill of the person or persons with whom the discussion occurred.)]

    d. The taxpayer actively engages in a business meeting at the entertainment. [This answer is incorrect. An ordinary expectation of both associated-with and directly-related entertainment is that the taxpayer actively engage in a business meeting, discussion, negotiation, or other bona fide business transaction in connection with the entertainment.]

NAVIGATING AROUND LIMITS ON ENTERTAINMENT DEDUCTIONS

Entertainment items are generally deductible business expenses if the taxpayer proves a business connection. However, some entertainment expenses are fully or partly nondeductible even if there is a business connection for the expense. For example, deductions for the cost of tickets, skyboxes, business gifts, club dues, or operating an entertainment facility are often limited or are disallowed entirely. Similarly, the 50% disallowance rule limits the business deduction for otherwise deductible meals and entertainment.

This section presents planning strategies that help maximize the taxpayer's deductions for entertainment expenses. The focus is on navigating around the deductible limits that might otherwise apply.

Keeping Entertainment Tickets Business Related

Business deductions for tickets to entertainment events generally are limited to the face value of the tickets. However, tickets to certain certain fund-raising sporting events are exempt from this rule. When the taxpayer provides a business customer with tickets to an athletic or other entertainment event and a business connection exists for the expenditure, proper tax treatment depends on whether an employee or representative of the taxpayer accompanies the customer to the event.

a. *Taxpayer or Employee Attends.* If the taxpayer or an employee of the taxpayer attends the entertainment event with a customer, the cost of the tickets is considered an entertainment expense.

b. *Taxpayer or Employee Does Not Attend.* If the customer is not accompanied by the taxpayer or an employee of the taxpayer, the cost of the tickets may be treated as either a business gift or entertainment (deductible business expense), at the election of the taxpayer.

Example 4-23: Tickets treated as business gifts.

Fred Ware regularly purchases two tickets to professional football games. The face value of each ticket is $75 per game. He then provides the tickets to his clients and advisors. Neither Fred nor an employee attends the games.

Fred 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 $150, treatment of the tickets as business gifts to one individual would result in a nondeductible expense of $125 per game (unless, of course, each ticket was used by a separate customer, in which case the nondeductible expense would be $100 per game).

Example 4-24: Tickets treated as entertainment.

Assume the same facts as the previous example except Fred elects to treat the cost of the tickets as an entertainment expense. According to IRC Sec. 274(a), to be deductible, 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 entertainment activity directly precedes or follows a substantial and bona fide business discussion).

The deductible cost for the tickets as entertainment expenses is limited to the face value of the tickets, subject to the 50% disallowance for meals and entertainment expenses. No deduction is allowed for any cost above the ticket's face value. Although there is no dollar limit on entertainment expenses, as compared to business gifts, it may be difficult to meet the *directly related* or *associated-with* test necessary to achieve deductibility under IRC Sec. 274(a). Thus, treatment of the tickets as business gifts may be a better alternative for Fred, even though a portion of the expense may be disallowed.

If Fred or an employee can attend the event and engage in a substantial business discussion before of after the game, the cost of the tickets (up to the face value) would be deductible as associated-with entertainment expense, subject to the 50% disallowance for meals and entertainment expenses.

Tickets to Certain Charitable Events. Deductions for entertainment tickets are normally limited to face value. However, expenses for tickets to fund-raising charitable sporting events are not limited to face value (and not subject to the 50% limit for meals and entertainment)—

a. the event is organized for the primary purpose of benefiting a Section 501(c)(3) organization,

b. all the net proceeds are donated to the charitable organization, and

c. volunteers are used for substantially all of the work performed in carrying out the event, if necessary.

Example 4-25: Tickets to charitable sporting events.

Fred Ware buys tickets to a golf tournament organized by the local Big Brothers/Big Sisters organization. He pays $200 for tickets with a face value of $50. All of the net proceeds from the tourney 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 rules do not apply.

Preserving Deductions for Skybox Rentals

Presuming that 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.

Example 4-26: Cost of skybox rentals.

Fred Ware paid $4,000 to rent a 10-seat skybox at the local sports stadium for three baseball games. The cost of a regular nonluxury box seat is $20 per game. The allowable deduction, before application of the 50% limit, is $600 (3 games × 10 seats × $20/seat).

Maximizing Deductions for Business Gifts

Generally, all gifts presented to an employee are compensation (a taxable noncash fringe benefit) to the employee. Deductions for business gifts made (directly or indirectly) during the tax year to any one nonemployee individual is limited to $25—anything above this amount is nondeductible.

Business Gifts to Employees. Generally, the FMV of all gifts presented to an employee is a taxable fringe benefit to the employee. The employer deducts the full cost of providing the gift as business expenses. This is true even though the employer is not required to make the payment, and might otherwise be able to prove *detached and disinterested generosity* in making the gift. However, there are deductible limits (generally $400 per employee) for certain employee achievement awards—see IRC Sec. 274(j)(2).

Business Gifts to Nonemployees or Other Companies. The deduction for business gifts made (directly or indirectly) during the tax year to any one individual is limited to $25—anything above this amount is nondeductible. The deductible portion is reported on the income tax return in the same manner as other travel and entertainment expenses. The recipient excludes the gift from gross income.

A gift to a corporation or other business entity that is intended for the eventual personal use or benefit of an employee or owner of the entity is considered a gift to an individual (and thus nondeductible to the extent it exceeds $25). A gift to a corporation or other business entity for use in its business (for example, a technical manual) is not considered a gift to an individual and thus is not subject to the $25 limitation.

The following items are not considered gifts subject to the $25 limit:

a. An item costing the company $4 or less on which the company name is clearly imprinted, and that is one of a number of identical such items given away.

b. A sign, display rack, or other promotional item to be used on the recipient's business premises.

When Are Club Dues Deductible?

No deduction is allowed for club dues paid or incurred for membership in any club organized for business, pleasure, recreation, social, athletic, luncheon, airline frequent flyer, etc., purposes.

The dues disallowance provisions of IRC Sec. 274(a)(3) apply to business luncheon clubs and airline and hotel clubs, but generally not to professional organizations (such as bar associations and medical associations) or civic or public service organizations (such as Kiwanis, Lions, Rotary, Civitan, and similar organizations) as long as their principal purpose is not entertainment. Certain organizations similar to professional organizations are also generally excepted from dues disallowance. Specific examples include business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards.

Example 4-27: Payment of country club dues.

Fred Ware belongs to a country club that he uses partly for business reasons. No deduction is allowed for any portion of the country club dues. However, Fred can deduct 50% of meal or entertainment costs incurred while using the club if he shows a business connection for the cost.

Coping with the Disallowance Rules for Costs Related to Entertainment Facilities

Generally, a self-employed taxpayer cannot deduct any expenditures for an entertainment facility even if there is a business connection. An entertainment facility is any property owned or rented and used for entertainment, amusement, or recreation. Examples of entertainment facilities include yachts, hunting lodges, hotel suites, fishing camps, and swimming pools.

However, out-of-pocket expenses incurred while using an entertainment facility are treated like other entertainment expenses. These expenses may be deducted (subject to the 50% disallowance rule) if the taxpayer proves a business connection.

Example 4-28: Operation of and costs related to an entertainment facility.

Fred Ware paid $5,000 to lease hunting rights to entertain current and prospective business clients. He kept logs establishing 100% business use of the lease. He also incurred $1,000 for food, drink, equipment, and supplies used during hunting expeditions.

The $5,000 lease fee is a nondeductible entertainment facility cost. However, the $1,000 of other expenses are not affected by the entertainment facility rules; rather, their treatment would be determined by the general rules of IRC Sec. 274 governing meals and entertainment expenses (i.e., directly related or associated with the business and properly substantiated).

Planning around the 50% Disallowance Rule for Meals and Entertainment

Only 50% of otherwise allowable meal and entertainment expenses are deductible as business expenses. This includes 50% of all business meal and entertainment expenses, including those incurred while attending professional seminars and while traveling away from home. If a hotel or other lodging establishment includes meals in its room charge, a reasonable allocation must be made to determine the portion of the expenditure subject to the 50% disallowance.

Taxes and tips related to meals or entertainment are included in the amount that is subject to the 50% limit. Also subject are expenses for cover charges to clubs, room rental for a dinner or cocktail party, and amounts paid for parking at an entertainment location. However, transportation costs incurred in getting to and from the entertainment activity are not subject to the 50% disallowance. When a self-employed taxpayer uses a per diem method for travel expenses, the federal M&IE rate is treated as an expense for food and beverages, and thus is subject to the 50% disallowance.

Example 4-29: Costs subject to 50% disallowance.

Fred Ware meets with a business associate at a local restaurant for dinner. The dinner meets the directly related requirement for a business entertainment activity. The cab fare to the restaurant and back is $25. The meal costs $100, including $18 for tips and tax. The cab fare is fully deductible. Only 50% of the $100 meal cost can be deducted.

Example 4-30: Disallowance of meal expenses incurred while traveling.

Fred Ware travels extensively. During the year, Fred incurred $3,000 in meal expenses while traveling on business. He can deduct $1,500 (50% of $3,000) for meals on his Schedule C.

However, certain meal and entertainment expenses are exempt from the 50% disallowance rules. Taxpayers are allowed a 100% deduction for these costs. The following discussion presents planning strategies for maximizing the use of the exceptions to the 50% disallowance rules.

Amounts Included in Employee's Income. The employer gets a 100% deduction if meal expense reimbursements or allowances paid for or to an employee under a nonaccountable plan are treated as compensation to the employee. Of course, the employer must then pay FICA taxes and the income is subject to normal withholding, but this rule basically allows employers to shift the 50% disallowance to employees.

Conversely, if the employee adequately accounts for the expenses and the employer properly reimburses the expenses under an accountable plan arrangement, the employer is subject to the 50% limitation on its reimbursement. The employee has nothing to report since the reimbursement offsets the expenses incurred.

Nonemployee Prizes and Awards. The taxpayer gets a 100% deduction if expenses for meals and entertainment are includable in gross income of a nonemployee recipient when a Form 1099 is issued to the recipient. No 50% disallowance applies at any level. For example, as a sales promotion a sole proprietor holds a drawing and awards to a customer a $750 dinner cruise for 10. If a Form 1099 is properly issued, the proprietor gets a 100% deduction.

Amounts Billed to Clients. When services are provided as an independent contractor, the service provider can deduct 100% of job-related meal expenses by billing the client separately for these costs. The client is then subject to the 50% disallowance rule for payments to the service provider representing reimbursements for such expenses.

If separate billing does not occur, the meal reimbursements and allowances are included in the income of the service provider and are 100% deductible by the client. Here, the 50% disallowance rule applies to the service provider.

Example 4-31: 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 ad agency is not subject to the 50% limitation; rather, the clients to whom the expenses are billed must apply the limitation.

<u>Variation:</u> Assume instead that the ad agency incurs expenses for meals and entertainment in the course of providing services to its clients, but does not separately account for the expenses and seek reimbursement from its clients. (Rather, these costs are combined with service fees on billing statements presented to clients.) The ad agency itself is subject to the 50% limitation.

For the Benefit of Employees. If a sole proprietor sponsors recreational, social, or entertainment gatherings primarily for the benefit of rank and file (rather than highly compensated) employees, the 50% disallowance rule does not apply to related meal expenses. Examples include company outings (such as a summer picnic) and banquets or other gatherings (such as the annual Christmas party) for employees and their guests.

Advertising or Goodwill. Expenses incurred for meals made available to the general public are 100% deductible. Examples include food and beverages at free concerts put on by a shopping mall, free dinners for potential restaurant customers, free hot dogs at a car dealership promotion, a free wine and food tasting exhibition sponsored by a liquor dealer, and free hors d'oeuvres furnished by a realtor for a client's open house. This exception also applies to meals provided to potential customers as part of a sales presentation (Ltr. Rul. 9414040). The exception does not apply when the meals and entertainment are provided on an invitation-only basis and not otherwise available to the general public (*Churchill Downs, Inc.*).

***De Minimis* Fringe Benefits.** When meal or beverage items provided to employees qualify as tax-free *de minimis* fringe benefits under IRC Sec. 132(e), the employer can deduct 100% of the costs, even though the benefits are excluded from the employees' taxable income. 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* (TAM 200030001). The most common applications of this rule are when employers provide their employees with (a) free coffee and soft drinks or (b) subsidized meals (on a nondiscriminatory basis) in a cafeteria on or near the employer's business premises.

Included in Price of Package for Charity Sporting Event. The amount of the allowable charitable deduction is not reduced by the 50% meal disallowance rule when meals are included in a package with tickets to a charity sporting event. The classic example is a charity golf tournament with a meal included in the deal. The package must include admission to the event, but it can also include meals and refreshments. To qualify for this exception, the charitable event must give 100% of its net proceeds to a Section 501(c)(3) charity and use volunteers to do almost all the work behind the event itself (paid concessionaires are okay).

Moving Expense Reimbursements. 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.

SELF-STUDY QUIZ

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

38. If a taxpayer provides a customer with tickets to a sporting event and attends the event with the customer, how does the taxpayer treat the expense for deduction purposes?

    a. As a business gift or entertainment expense, at the discretion of the taxpayer.

    b. Deductible as an entertainment expense on the taxpayer's tax return.

39. When are tickets to an entertainment event completely deductible by a taxpayer, regardless if the face value of the ticket is less than what the taxpayer paid for the ticket?

    a. When the ticket is to a fund-raising charitable sporting event.

    b. When the taxpayer provides the tickets to a customer as a gift.

    c. For the rental of a skybox at a sports stadium for a customer event.

    d. If the taxpayer gives the tickets to a corporation, but they are intended for the owner's use.

40. Brown and Biddle, an architectural firm, is currently working on a big project. Mr. Brown, the owner of the firm, is taking the staff out to lunch. He has rented a room at a local restaurant to accommodate the entire staff. The cab ride to the restaurant is $100, including the tip. The lunch is $500, before a $75 tip added on by Mr. Brown. Which of the following is true concerning Mr. Brown's deductions for this lunch with his staff members?

    a. The taxi ride to the restaurant is subject to the 50% disallowance for meals and entertainment.

    b. The tip is not included in the deductions that Mr. Brown will be allowed to take.

    c. Mr. Brown can deduct the entire cost of renting the room at the restaurant.

    d. Mr. Brown will be allowed to deduct $250 of the cost of lunch as a business deduction.

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.)**

38. If a taxpayer provides a customer with tickets to a sporting event and attends the event with the customer, how does the taxpayer treat the expense for deduction purposes? **(Page 200)**

    a. As a business gift or entertainment expense, at the discretion of the taxpayer. [This answer is incorrect. As stated in the IRS regulations, if the customer is not accompanied by the taxpayer or an employee of the taxpayer, the cost of the tickets may be treated as either a business gift or entertainment, at the election of the taxpayer.]

    b. Deductible as an entertainment expense on the taxpayer's tax return. [This answer is correct. According to IRS regulations, if the taxpayer or an employee of the taxpayer attends the entertainment even with the customer, the cost of the tickets is considered an entertainment expense.]

39. When are tickets to an entertainment event completely deductible by a taxpayer, regardless if the face value of the ticket is less than what the taxpayer paid for the ticket? **(Page 201)**

    a. When the ticket is to a fund-raising charitable sporting event. [This answer is correct. According to the Internal Revenue Code, when the expenses are for tickets to fund-raising charitable sporting events, they are not limited to the face value of the ticket and are not subject to the 50% limit for meals and entertainment. The event must be organized for the primary purpose of benefitting a Section 501(c)(3) organization, all the net proceeds must be donated to the charitable organization, and the volunteers that are used must do substantially all of the work to be performed to carry out the event.]

    b. When the taxpayer provides the tickets to a customer as a gift. [This answer is incorrect. When the taxpayer provides entertainment tickets to a customer as a gift, the taxpayer is limited to a $25 per year individual deduction per donee, regardless of the face value of the tickets. Anything above this amount is nondeductible.]

    c. For the rental of a skybox at a sports stadium for a customer event. [This answer is incorrect. Presuming that a business connection exists, the deduction for rental of a skybox at a sports stadium is limited to the number of seats in the skybox times the price of a nonluxury box-seat ticket, as stated in the Internal Revenue Code.]

    d. If the taxpayer gives the tickets to a corporation, but they are intended for the owner's use. [This answer is incorrect. A gift to a corporation or other business entity that is intended for the eventual use or benefit of an employee or owner of the entity is considered a gift to the individual and is subject to the $25 limitation of business gifts to an individual.]

40. Brown and Biddle, an architectural firm, is currently working on a big project. Mr. Brown, the owner of the firm, is taking the staff out to lunch. He has rented a room at a local restaurant to accommodate the entire staff. The cab ride to the restaurant is $100, including the tip. The lunch is $500, before a $75 tip added on by Mr. Brown. Which of the following is true concerning Mr. Brown's deductions for this lunch with his staff members? **(Page 202)**

    a. The taxi ride to the restaurant is subject to the 50% disallowance for meals and entertainment. [This answer is incorrect. Transportation costs incurred getting to and from the entertainment activity are not subject to the 50% disallowance per the Internal Revenue Code.]

    b. The tip is not included in the deductions that Mr. Brown will be allowed to take. [This answer is incorrect. Tips and tax related to meals and entertainment are included in the amount that is subject to the 50% limit according to the Internal Revenue Code.]

c. Mr. Brown can deduct the entire cost of renting the room at the restaurant. [This answer is incorrect. Cover charges to clubs, room rentals for dinner or cocktail parties and amounts paid for parking at an entertainment local are all subject to a 50% limit, but are all allowed to be deducted as part of meals and entertainment as stated in the Internal Revenue Code.]

d. Mr. Brown will be allowed to deduct $250 of the cost of lunch as a business deduction. [This answer is correct. Mr. Brown is allowed 50% of allowable meals and entertainment expenses as deductible business expenses. Mr. Brown will also be allowed to also deduct the cab ride to the restaurant and 50% of the room rental and tip as business deductions.]

EXAMINATION FOR CPE CREDIT

Lesson 4 (TINTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

32. If a taxpayer has two or more businesses that are in in separate geographic locations, the travel expenses incurred while away from the principal place of business can be deducted. Which of the following is **not** a consideration that the taxpayer has to take into account when determining which location is the principal place of business?

    a. How much income is earned at each location.

    b. The amount of time spent at each location.

    c. At which location the taxpayer's family resides.

    d. Whether the employment at one location is temporary.

33. Which of the following are deductible, whether a trip is deemed to be primarily business or primarily personal?

    a. Business costs incurred while at the destination.

    b. Costs incurred to travel to the destination.

    c. Personal costs incurred while at the destination.

    d. Costs incurred to travel home from the destination.

34. Lynn travels to London on Sunday for business meetings that lasted from Monday to Thursday afternoon. On Thursday, Lynn grabs the train to Paris to sightsee for the rest of Thursday and Friday. She flies back home on Saturday. Which portion of Lynn's expenses would be deemed personal expenses?

    a. The flight to London.

    b. Meals and lodging while Lynn was in Paris

    c. Meals and lodging while Lynn was in London.

    d. The flight home from Paris.

35. If a business convention is held on a cruise ship, which of the following is correct regarding the deduction limitations?

    a. There are no restrictions on the ports of call that the ship can visit, as long as the convention is held on the ship.

    b. The taxpayer only has to provide the itinerary of the cruise for documentation with his tax return.

    c. The taxpayer can deduct up to $5,000 per individual, per year for conventions held on cruise ships.

    d. The cruise ship must be a U.S. registered vessel that the convention is held on to qualify.

36. Andrew and his wife, Dana, travel to Puerto Rico for Andrew to bid on a job for his sole proprietorship. Dana is accompanying him to be his translator because Andrew speaks no Spanish and Dana is fluent in Spanish. Their round-trip flights were each $300, lodging was $600 for double occupancy ($400 for single occupancy) and their meals were $400 for the two of them. Meals would have been $250 if Andrew had traveled alone. If all limitations are ignored, how much should Andrew be able to deduct for this business trip?

    a. $950.

    b. $1,150.

    c. $1,300.

    d. $1,600.

37. Which one of the following would qualify as a clear business setting for a taxpayer that owns a shop that designs dresses?

    a. Meeting the buyer for a baseball game to discuss a contract over the game.

    b. Asking a buyer to come to a retail shop that carries the designer's merchandise and have a catered lunch.

    c. Inviting the buyer to the designer's yacht for a sail around the harbor and lunch.

    d. Playing tennis at the designer's country club and then having lunch and talking business.

38. Jay has two tickets to the Stanley Cup playoffs that he purchased for $200 per ticket. The face value of each ticket is $100. Jay decides to take his biggest customer to the playoff game, so that he can talk to the customer about a new product Jay's company is producing and sell the product to the customer at the game. How much can Jay deduct for the tickets as an entertainment expense?

    a. $0.

    b. $100.

    c. $200.

    d. $400.

39. For which of the following would a taxpayer be allowed to deduct expenses associated with dues?

    a. Payments on a hunting lodge used to entertain clients.

    b. Upgrading an airline frequent flyer club membership.

    c. Dues for joining the city's chamber of commerce.

    d. Cost of a country club membership to take clients golfing.

40. Which of the following would be subject to the 50% disallowance rule for meals and entertainment?

    a. Hot dogs provided at a car dealership for customers.

    b. Lunch with a client at a country club to discuss business after golfing.

    c. Cost of annual company Christmas party with all employees.

    d. Feeding all employees when the office is moving to a new location.

GLOSSARY

ADS: The alternative depreciation system (ADS) applies to nonlisted property and uses the applicable recovery period, depreciation method, and convention.

AMT: The AMT is a special tax computation that is compared to the regular tax (before credits) computation with the excess amount (alternative computation over regular) being an additional tax payable. It is computed on the alternative minimum taxable income (AMTI) (see special rules) at a rate of 26% (up to $175,000 of AMTI) and 28% (over $175,000 of AMTI) for individuals in excess of the 2007 AMT exemption amount of $44,300 (single), $66,250 (married filing jointly), or $33,125 (married filing separately), and 20% for corporations in excess of $40,000.

Associated-with expense: Entertainment activity precedes or follows the business discussion.

Bad debt: A receivable that is considered to be uncollectible is a bad debt.

Business preopening costs: Expenses incurred after the taxpayer decides to establish or acquire a specific business, but before the active conduct of that business actually begins.

Capitalization: To capitalize a cost is to record it as an asset and defer its recognition as an expense to future periods. The asset can be tangible (e.g., inventory or fixed assets) or intangible (e.g., securities, organization, or rearrangement costs) or can represent the right to receive services in the future (e.g., a prepaid expense, such as prepaid rent, insurance, subscriptions, or any service paid for in advance of receipt of the service). Assets are subject to an assessment of recoverability by the enterprise, such as the benefits to be derived and the periods benefited.

Contribution: Voluntary donations of cash or other assets usually received from private sources, such as individuals, commercial enterprises, or foundations.

Credits: Amounts deducted from tentative tax to compute income tax payable, such as the credit for the elderly or the disabled, the credit for child and dependent care, the foreign tax credit, the general business credit, the earned income credit, the adoption credit, the Hope credit for higher education, and the Lifetime Learning credit.

De minimis fringe: A benefit that has a value which is (after taking into account the frequency with which similar fringes are provided by the employer to the employees) so small as to make accounting for it unreasonable or administratively impractical.

Deduction: An amount that may be subtracted to arrive at taxable income.

Depreciation: A process of systematic, rational allocation of the cost of capital assets used in operations to the accounting periods benefited. It is not a process of valuation (ARB 43, chap. 9C.5). It does not represent a reserve to replace the asset—it does not mean that cash will be available to replace the asset.

Directly related expense: Business event and the entertainment activity occur simultaneously.

Exclusive use: The taxpayer must use a specific portion of the home only for business use; there is not other use of this space.

Investigatory expenses: Costs incurred before reaching a decision to acquire or create a specific business.

Goodwill: The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed (SFAS 141, glossary). Goodwill may not be amortized; however, it must be tested at least annually for possible impairment.

HAS (Health Savings Account): A tax-exempt trust or custodial account established exclusively for the purpose of paying qualified medical expenses of the account beneficiary who, for the months which contributions are made to an HAS, is covered under a high-deductible health plan (HDHP).

HDHP (High-deductible Health Plan): A health plan that satisfies certain requirements with respect to deductibles and out-of-pocket expenses.

Hobby loss: A nondeductible loss arising from a personal hobby, as contrasted with a loss arising from an activity engaged in for profit.

Lease: An agreement conveying the right to use property, plant, or equipment (i.e., land and/or depreciable property), usually for a stated period of time. A lease does not include agreements that are contracts for services or that concern the rights to explore for or to exploit natural resources or licensing agreements for items such as motion picture films, plays, manuscripts, patents, and copyrights.

Leasehold improvement: Costs incurred to increase the benefit derived from property that is under an operating lease (additions, finish-out, parking areas, upgrades to facilities, etc.); are intangible, identifiable, inseparable assets (because the property to which the improvements are attached does not belong to the entity); and are amortized, usually straight-line, over the shorter of the useful life of the improvement or the remaining lease term.

Like-kind exchange: Sometimes referred to as "Section 1031 exchanges," like-kind exchanges involve a trade of one piece of property for another of similar or "like" kind. Under IRC §1031, trade or business gains and losses from like-kind exchanges must be deferred. No gain or loss will be recognized on the exchange of property held in a trade or business or for investment if the property is exchanged solely for property of like kind, which is to be held in a trade or business or for investment. If there is no gain or loss recognized and no boot given or received in the transaction, then the adjusted basis of the new property will be equal to the adjusted basis of the old property given up in the exchange, thus deferring any gain to be recognized at a future time when the new property is sold.

Modified accelerated cost recovery system (MACRS): A depreciation method specified in the tax law applied to assets acquired after 1986. MACRS replaced the accelerated cost recovery system (ACRS) and prescribes asset lives and rates of depreciation for classes of assets.

Original use: Generally means the first use to which an asset is put – whether or not the nature of that use corresponds to the nature of the use by the taxpayer.

Regular use: The taxpayer must use the portion of the home on a continuing basis.

Restriction: Limits on assets of not-for-profit entities imposed by donors' explicit, or clearly evident implicit, stipulations. Decisions, resolutions, appropriations, and so forth by directors, trustees, or managers do not result in restrictions on assets.

Safe harbor rules: Rules or regulations that outline conditions under which the Internal Revenue Service (IRS) will not challenge the position taken by the taxpayer in reporting certain types of transactions.

Sole proprietor: A business form of one person conducting business as an individual. It is not a legal, taxable entity separate from the owner. The owner is personally liable for the debts of the proprietorship. It is governed by the laws of contracts and agency. The owner may hire employees or agents (or independent contractors). (Contrast to partnership and corporation.)

INDEX

COMPANION TO PPC'S GUIDE TO TAX PLANNING FOR HIGH INCOME INDIVIDUALS

COURSE 3

STOCKS, BONDS, AND OTHER FINANCIAL INVESTMENTS (TINTG103)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses the advantages of the capital gain rules and lower dividend tax rates, tax strategies for cash and cash equivalents, as well as tax planning for stock and bond transactions, and other financial instruments.
PUBLICATION/REVISION DATE:	April 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Tax Planning for High Income Individuals*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of tax preparation.
CPE CREDIT:	6 QAS Hours, 6 Registry Hours 6 CTEC Federal Hours, 0 CTEC California Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. **Enrolled Agents:** This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by **April 30, 2011**
KNOWLEDGE LEVEL:	Intermediate

Learning Objectives:

Lesson 1—Taking Advantage of the Capital Gains Rules and Lower Dividend Tax Rates

Completion of this lesson will enable you to:
- Identify general planning strategies involving the capital gain rules, and define qualified dividend, and identify qualified dividend pitfalls.
- Recognize when a stock redemption occurs, and the associated tax consequences.

Lesson 2—Tax Strategies for Cash and Cash Equivalents

Completion of this lesson will enable you to:
- Identify the various tax strategies for cash and cash equivalents.

Lesson 3—Tax Planning for Bond Transactions

Completion of this lesson will enable you to:
- Differentiate between selling or redeeming bonds purchased at a discount, and bonds purchased at a premium.
- Summarize the tax-wise strategies for U.S. Savings Bonds, municipal bond swaps, and Treasury Inflation Protection Securities.

Lesson 4—Tax Planning for Stock Transactions

Completion of this lesson will enable you to:
- Apply the specific identification method and holding period rules to reduce tax.
- Recognize ordinary losses for Section 1244 Stock, and apply the rules for gains from small business stock.
- Identify tax losses by avoiding wash sales.
- Obtain a deduction for worthless securities, determine when stock dividends and splits are taxable, and structure securities transactions so as not to trigger a constructive sale.

Lesson 5—Tax Planning for Other Financial Investments

Completion of this lesson will enable you to:
- Identify tax planning strategies for mutual fund investments.
- Describe the tax benefits of investing in exchange-traded funds.
- Recognize the tax planning tactics for publicly traded stock options.
- Identify stock right, stock warrant, and explain the tax planning strategies for stock rights and warrants.

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Lesson 1: Taking Advantage of the Capital Gain Rules and Lower Dividend Tax Rates

INTRODUCTION

Tax considerations are normally an important factor but not the driving force behind investors' financial planning strategies. Instead, factors such as age, financial situation, and risk tolerance are likely to be more significant in selecting an appropriate allocation of assets. For example, older taxpayers are generally less likely to make high risk investments; capital preservation is a concern. Conversely, younger taxpayers are more likely to take risks, given the investment returns that can be realized over long periods. In addition, an overriding investment strategy for a taxpayer in need of funds is structuring a portfolio that generates a steady cash flow.

The capital gain rules are fundamental to tax planning for financial investments, so practitioners advising clients in these matters must be well versed in them. This lesson summarizes the rules and provides general planning strategies. These rules are also considered in the other sections of this lesson dealing with tax planning for specific types of financial investments.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify general planning strategies involving the capital gain rules, and define qualified dividend, and identify qualified dividend pitfalls.
- Recognize when a stock redemption occurs, and the associated tax consequences.

Capital Gains and Losses

Capital Gains. Capital gains (and losses) are either short-term or long-term depending on how long the capital asset was held before being sold or exchanged. Long-term treatment applies whenever the holding period is more than one year. For long-term capital gains, the maximum tax rate is 15% (in 2010). For taxpayers taxed at a maximum ordinary rate of 15% or less, long-term capital gains are taxed at 0% (in 2010) to the extent they would otherwise be taxed at an ordinary rate of 15% or less. Long-term capital gains from certain types of assets (e.g., collectibles, Section 1250 unrecaptured gain) are subject to rates higher than the normal capital gains rate. See Exhibit 1-1 for a summary of the capital gain rates, categories, and holding periods.

Exhibit 1-1

Summary of Capital Gains Rates for 2010

Type of Property	Period Held	Maximum Rate
Capital assets, other than those listed below	12 months or less	35%
	More than 12 months	15%[a]
Gain attributable to depreciation on Section 1250 real property, other than that subject to ordinary income recapture	12 months or less	35%
	More than 12 months	25%
Collectibles (i.e., art, rugs, antiques, metal, gems, stamps, coins, alcoholic beverages, etc., that are capital assets)	12 months or less	35%
	More than 12 months	28%
Qualified small business stock issued after August 10, 1993	12 months or less	35%
	More than 12 months, but not more than 5 years	15%[a]
	More than 5 years	14%[b]

Notes:

[a] 0% for taxpayers with a marginal tax rate on ordinary income below 25%.

[b] If qualified small business stock is held more than five years, the taxpayer can exclude 50% (75% for stock acquired after February 17, 2009 and before January 1, 2011) of the gain when sold. The 28% maximum capital gains rate applies to this stock, so the effective maximum capital gains rate is 14% (7% for stock acquired after February 17, 2009 and before January 1, 2011).

*   *   *

Qualified Five-year Gains. Prior to the 2003 Tax Act, gain from the sale or exchange of property held more than five years that would otherwise be subject to the 10% capital gain rate was taxed at a reduced rate of 8%. Also gains eligible for the 20% long-term capital gain rate were to be taxed at a reduced rate of 18% when the property was held more than five years. However, the 18% rate only applied to property acquired after 2000, which included property for which a deemed sale election was made in 2001. With a deemed sale election, a taxpayer reported unrealized gain (but not loss) based on the capital asset's fair market value at January 1 (or January 2 in the case of marketable securities). Because of the five-year holding period, the 18% rate was not available until 2006.

The 2003 Tax Act repealed the special rules for qualified five-year gains, effective for sales or exchanges after May 5, 2003. However, the 2003 Tax Act provisions are now scheduled to sunset in 2010 (as amended by TIPRA), so at this time, the qualified five-year gain rules are currently scheduled to return beginning in 2011.

Installment Sales. Installment sale gains are taxed based on the capital gain rates in effect in the year collections are received, not the year the installment sale occurs. Thus, capital gains recognized during the course of the installment sale period might be taxed differently from one year to the next if the capital gain rules or rates change during the period. For securities, the installment method for reporting gain cannot be used if the security is traded on an established securities market.

Capital Losses. Capital losses offset capital gains and, to the extent there is an excess loss, up to $3,000 ($1,500 for married filing separate) can be deducted for the tax year with the remainder carrying forward to future tax years. There is no limit as to how long a capital loss can carry forward except that carryover losses not used in a decedent's final return expire unused. However, spouses of taxpayers with short life expectancies living in community property states may be able to extend the expiration date for their half of the decedent's capital loss.

When a taxpayer has both capital gains and losses that are subject to different capital gains rates, the capital gains and losses are first grouped into long-term (property held more than one year) and short-term (property held one year or less) groups, with the long-term group divided into the capital gains rate groups (i.e., 28%, 25%, and 15%). A net loss in a long-term group first offsets gains in the highest long-term tax rate group (e.g., a net long-term capital loss in the 15% group offsets a net gain in the 28% group before a net gain in the 25% group). A net short-term capital loss first offsets net gain from the highest long-term rate group before being applied to the other long-term rate groups (i.e., a net short-term capital loss offsets 28% long-term capital gains before being applied to the 25% and 15% long-term capital gains).

Similarly, a long-term capital loss carryover offsets long-term capital gains first, beginning with the highest long-term capital gain rate group. A short-term capital loss carryover offsets net short-term capital gain first; any remaining carryover offsets long-term gains, beginning with the highest long-term capital gains rate group.

Double Benefit from Deductions Reducing the Capital Gain Rate

A two-tiered capital gain rate applies under IRC Sec. 1(h). To the extent a capital gain would be taxed at an ordinary rate under 25%, a long-term capital gain may be reported at 0% (effectively, not taxed) in 2010. For capital gains that would otherwise be taxable at an ordinary rate of 25% or greater, a 15% (in 2010) long-term capital gain rate applies. The structure of IRC Sec. 1(h) is to treat the capital gain as the last tier of income and the taxpayer's ordinary income as the first tier.

If a taxpayer has a long-term capital gain (after considering other ordinary income) that is partially taxed at the 0% (in 2010) rate, any deduction that decreases ordinary income will also simultaneously decrease the tax rate on a comparable amount of long-term capital gain from 15% to 0% (in 2010). This has the effect of producing a double benefit for that deduction.

Example 1-1: Double deduction benefit.

Jeff and Jani, filing jointly for 2010, have net ordinary income of $60,000 and a long-term capital gain from the sale of stock of $40,000, for total income of $100,000. For 2010, the joint rates applicable to ordinary income change from 15% to 25% at $68,000. Accordingly, $8,000 ($68,000 – $60,000) of their long-term capital gain will be taxed at 0% and the balance of $32,000 ($40,000 – $8,000) is taxable at 15%. All income, both capital and ordinary, is taxed at a rate of 15% or less.

If Jeff and Jani contribute $10,000 to their deductible IRAs ($5,000 each for 2010, assuming they are both under age 50), they receive a 30% tax rate savings, even though their highest tax bracket is 15%. The $10,000 IRA deduction reduces ordinary income at the 15% rate, but also shifts $10,000 of capital gain taxation from the 15% to the 0% bracket, for another 15% savings. This produces a total tax benefit of 30% on the $10,000 reduction.

A similar impact would occur for any expenditure or deduction that reduced ordinary income (i.e., Section 179 bonus depreciation, additional interest expense, etc.). Conversely, adding ordinary income at the 15% bracket would cause a 30% impact, as additional ordinary income would push a portion of the capital gains formerly at 0% upward into the 15% bracket.

Timing Security Sales to Minimize Taxes

Carefully timing when securities (e.g., stocks and bonds) are sold can produce significant tax savings for clients subject to the 15% (in 2010) long-term capital gains rate. Taxpayers in the top ordinary tax bracket may reduce their tax rate on a gain from 35% to 15% (for 2010) by recognizing a long-term rather than a short-term capital gain.

The tax treatment of capital losses also provides tax planning opportunities. Short-term capital losses produce the most tax savings when they offset short-term gains. Likewise, taxpayers may benefit more by recognizing long-term losses when they can offset capital gains taxed at rates higher than 15% (i.e., short-term gains, 25% unrecaptured Section 1250 gain, or 28% capital gains).

Example 1-2: Timing capital losses to maximize tax benefit.

Fred invested $10,000 in Pepco stock on November 3, 2009. In September 2010, the value of the stock has dropped $8,000 to $2,000. He thinks the chances of the stock increasing in value are slim so he plans to sell it. Fred is in the 35% tax bracket and has recognized other 2010 short-term and long-term (15%) capital gains of $15,000 and $20,000, respectively. He does not anticipate any other trades for the year.

If Fred sells the stock before November 4, 2010, he will recognize a short-term capital loss of $8,000 (assuming no change in value). This loss will offset $8,000 of his short-term capital gains for the year, thus producing a $2,800 ($8,000 × 35%) tax savings.

If, on the other hand, Fred waits and sells the stock after November 3 but before January 1, 2011, he will recognize an $8,000 long-term loss (assuming no change in value occurs). This loss will offset $8,000 of his long-term capital gains in the year of the sale, thus producing a $1,200 ($8,000 × 15%) tax savings.

By selling the stock before November 4, 2010 and generating a short-term capital loss, Fred saves an additional $1,600 ($2,800 – $1,200) in taxes because of the difference in the tax rates applied to his short-term (35%) and long-term (15%) capital gains.

Variation: If Fred had no short-term capital gains, it would make no difference whether the $8,000 Pepco stock loss was short-term or long-term. Either way, it would offset his long-term capital gains.

Sometimes, taxpayers are better off recognizing a larger gain if that gain is taxed at the long-term, rather than short-term, capital gain rate. When the taxpayer sells less than his entire holdings of a security (purchased at different times and prices) at a gain, he should consider selling the shares that meet the long-term holding period requirement. The taxpayer may need to provide adequate share identification. While greater gain may be recognized (depending on the basis in the stock), it may be more than offset by the taxes saved by triggering a long-term gain.

Another strategy for maximizing tax benefits is to recognize losses in a portfolio even when the investor wants to continue to hold the stock (usually because he or she expects it to appreciate). The taxpayer sells the stock at a loss and reinvests the proceeds in the same stock. Provided the wash sale rules are avoided by making sure there are no purchases of identical stock within the period beginning 30 days before and ending 30 days after the sale, the taxpayer obtains the current benefit of a tax loss without changing his or her economic position, if the price does not rise significantly during the 30 day period following the sale. Even if the loss cannot be deducted fully in the current year (due to the $3,000 limit on offsetting ordinary income) it can be carried forward indefinitely to offset future gains.

Taxpayers who are unwilling to wait 30 days to reacquire the stock that was sold can immediately invest the proceeds in a similar stock (e.g., sell Dell and acquire Apple). As an alternative to investing in a similar stock, the taxpayer can invest the sale proceeds in an industry sector exchange-traded fund. Or, the taxpayer can purchase an identical position at least 31 days before the stock is sold at a loss. This avoids the wash sale problem (since identical shares are acquired more than 30 days before the sale at a loss), ensures that the taxpayer benefits from any appreciation (since he or she is always invested in the stock), and generates a current tax loss. The only cost is the expense of holding the duplicate position for at least 31 days before the sale.

To summarize, the following strategies for timing the sale of securities will generally help taxpayers reduce their tax on capital gains:

- If necessary to meet the 12-month long-term holding period requirement, delay the date of a planned sale, including an installment sale.

- Because of the substantial difference between the tax rate of short-term (12 months or less) and long-term (over 12 months) capital gains, taxpayers should consider timing the recognition of capital losses for years when they can offset short-term gains rather than long-term gains.

This lesson discusses other tax planning strategies that involve the timing of a security sale or disposition. These include the following—

- Using the holding period rules to minimize tax on stock sales.

- Recognizing losses from worthless securities.

- Timing the sale of publicly traded options to minimize taxes.

Computing the Stock Price/Capital Gain Rate Breakeven Point

It is not unusual for investors to hold stocks that appreciate significantly in a relatively short time. This often results in the taxpayer owning a highly appreciated stock with a holding period of less than one year. An immediate sale of the stock would result in a short-term capital gain, normally taxed at the individual's ordinary tax rate and not the more favorable long-term capital gain rate.

A difficult dilemma many investors in these situations face is that of weighing the benefits of deferring the sale of an appreciated stock so the gain is taxed at favorable long-term capital gain rates against the risk of the stock price falling during that period. Given the differences in the short-term and long-term capital gain tax rates, investors will often maximize their after-tax sales proceeds by waiting to sell the stock so tax is paid at the lower 15% (in 2010) long-term capital gain rate. This is true even if the price of the stock falls modestly during the period between when the decision is made to sell the stock and when the one-year holding period is surpassed.

If investors fear a decline in stock value, the question becomes how much can the stock value decline before waiting for long-term treatment is no longer advantageous. Computing the breakeven point helps investors decide whether they should continue holding the stock to meet the one-year holding period or go ahead and sell, recognizing a short-term capital gain. The breakeven point can be computed mathematically based on the current price of the stock, the taxpayer's basis, and the taxpayer's ordinary income (short-term capital gain) tax rate.

For taxpayers eligible for the 15% (in 2010) long-term capital gains rate, the formula for determining the breakeven price is as follows:

$$\begin{matrix}\text{Stock price} \\ \text{breakeven point}\end{matrix} = \frac{\text{Current price} - [(\text{Current price} - \text{basis}) \times \text{ordinary tax rate}] - .15\ (\text{basis})}{.85}$$

The formula computes the price to which the stock can fall and it is still advantageous to hold it for long-term capital gain treatment. At a price lower than the breakeven amount, the investor is better off selling the stock at the current price and recognizing a short-term capital gain.

Example 1-3: Computing the stock price breakeven point for potential sale.

Amy purchased 1,000 shares of Zoom Corp. on November 19, 2009 for $5 a share. The stock price soared and on October 6, 2010 it is trading at $28 a share. Amy is anxious to sell the stock and realize her profit because she believes it may decline in value. However, she is concerned about the taxes she will owe because a sale would result in a short-term capital gain. Amy is in the 35% tax bracket.

She is trying to decide whether she should sell the stock now or after November 19, 2010, when the sale would be eligible for long-term capital gain treatment. Based on the current value, how much can the stock price fall and long-term capital gain treatment still be advantageous? Using the formula previously discussed, the stock price breakeven point is computed as follows:

$$\text{Breakeven point} = \frac{\$28 - [(\$28 - \$5) \times .35] - .15\ (\$5)}{.85}$$

$$\text{Breakeven point} = \$22.59$$

If Amy were to sell the stock at its current price, her after-tax proceeds would be $19,950 ($28,000 sales proceeds less tax of $8,050). If the price were to fall to $22.59 a share but she did not sell it until the long-term capital gain rates apply, her after-tax proceeds would be $19,951 ($22,590 sales proceeds less tax of $2,639). Thus, if Amy believes the stock price will not fall below $22.59 per share between October 6, 2010 and November 20, 2010 she would net more after-tax by holding the stock until at least November 20, 2010 when a sale would be treated as a long-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.

1. What is the maximum capital gains rate for gain attributable to depreciation on Section 1250 real property that is held for more than 12 months?

   a. 14%.

   b. 15%.

   c. 25%.

   d. 35%.

2. Which of the following statements regarding strategies taxpayers can use to maximize their tax benefits is most accurate?

   a. A taxpayer can benefit from recognizing a larger gain if that gain is taxed at the long-term rather than a short-term, capital gain rate.

   b. Taxpayers who have a short life expectancy and hold increased capital assets are encouraged to recognize the gain.

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. What is the maximum capital gains rate for gain attributable to depreciation on Section 1250 real property that is held for more than 12 months? **(Page 217)**

   a. 14%. [This answer is incorrect. For qualified business stock that was issued after August 10, 1993, the effective maximum rate for property held for more than five years is 14%, as stated in the IRS code.]

   b. 15%. [This answer is incorrect. According to the IRS code, the 15% maximum tax rate for qualified business stock issued after August 10, 1993, is for property held for more than 12 months, and five years or less.]

   c. 25%. [This answer is correct. Gain attributable to depreciation on Section 1250 real property that is not subject to ordinary income recapture is 25% if held for more than 12 months according to IRS code.]

   d. 35%. [This answer is incorrect. The 35% maximum tax applies to gain attributable to depreciation on Section 1250 real property that is held 12 months or less per the IRS code.]

2. Which of the following statements regarding strategies taxpayers can use to maximize their tax benefits is most accurate? **(Page 219)**

   a. A taxpayer can benefit from recognizing a larger gain if that gain is taxed at the long-term rather than a short-term, capital gain rate. [This answer is correct. A taxpayer should consider selling the shares that meet the long-term period condition if that taxpayer sells less than his or her total security holdings at a gain. The greater gain recognized may be more than offset by the tax savings.]

   b. A taxpayer can sell stock at a loss and reinvest in the same stock within 30 days of selling the stock. [This answer is incorrect. Because of the wash sale rules, a taxpayer cannot reinvest in the same stock within 30 days of selling the stock.]

CAPITALIZING ON THE LOWER DIVIDEND TAX RATE

The maximum tax rate on qualified dividends received by an individual, trust, or estate is 15% (in 2010). Dividends that would otherwise be taxed at the 10% or 15% ordinary income rate are taxed at 0% (essentially, not taxed) 2010. Thus, qualified dividends are taxed at the long-term capital gain rates in 2010. Identifying qualified dividends and helping taxpayers meet the requirements for qualified dividend status are valuable client services.

What Is a Qualified Dividend?

Qualified dividends are distributions of cash or property made by a domestic or qualified foreign corporation out of its earnings and profits (E&P) to a shareholder with respect to its stock. Therefore, distributions from domestic C corporations (to the extent of E&P) are generally qualified dividends. An S corporation, on the other hand, can only have accumulated E&P if it was formerly a C corporation or merged with a C corporation. Therefore, distributions from S corporations are often not qualified dividends because they are not made from E&P but instead represent a distribution of S corporation earnings. (However, qualified dividends that an S corporation receives are passed through to the shareholders and potentially taxed at the lower rates, regardless of whether the S corporation makes any shareholder distributions.)

Qualified Foreign Corporations. Qualified dividends include otherwise qualified dividends received from qualified foreign corporations. A corporation is a qualified foreign corporation if it is (a) incorporated in the U.S. or a U.S. possession, (b) readily tradable on an established U.S. securities market, or (c) eligible for benefits of a comprehensive income tax treaty with the U.S. that the Treasury Secretary determines is satisfactory for purposes of the reduced tax rate on dividends and includes an exchange of information program.

IRS Notice 2003-71 defines *readily tradable on an established U.S. securities market* to include common or ordinary stock, or an American depository receipt in respect of such stock, if it is listed on the following securities exchanges: American Stock Exchange, the Boston Stock Exchange, the Cincinnati Stock Exchange, the Chicago Stock Exchange, the NYSE, the Philadelphia Stock Exchange, the Pacific Exchange, Inc., or the Nasdaq Stock Market. (Several of these exchanges have merged or changed their names since the issuance of Notice 2003-71.)

IRS Notice 2006-101 provides that the U.S. treaties with the following countries satisfy the requirements of IRC Sec. 1(h)(11)(C) requirements: Australia, Austria, Bangladesh, Barbados, Belgium, Canada, China, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kazakhstan, Korea, Latvia, Lithuania, Luxembourg, Mexico, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Portugal, Romania, Russian Federation, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Thailand, Trinidad and Tobago, Tunisia, Turkey, Ukraine, United Kingdom, and Venezuela. This list will be updated as appropriate. Note that a payor corporation must be eligible for the treaty benefits to be a qualified foreign corporation.

Dividends from a foreign corporation will not qualify for the reduced tax rate if they were paid by a foreign corporation that for the current or immediately prior tax year was a Section 552 foreign personal holding company, a Section 1246(b) foreign investment company, or a Section 1297 passive foreign investment company.

Any foreign tax credit allowed with respect to dividends eligible for the reduced tax rates will be scaled back under rules similar to those imposed by IRC Sec. 904(b)(2)(B) relating to certain capital gains. This prevents the taxpayer from claiming a foreign tax credit greater than the U.S. tax paid on that income.

Pass-through Entities. Partnerships (including LLCs taxed as partnerships) pass qualified dividend income through to noncorporate partners, where the dividends are taxed at the favorable rates. S corporations (including LLCs taxed as such) also pass through qualified dividends (received from corporations in which the S corporation holds stock) to their noncorporate shareholders because the character of a pass-through item from an S corporation is determined as if the pass-through item were realized directly from the source. Also, qualified dividends received by a single-member LLC that is treated as a disregarded entity should be treated as if the LLC member received them.

Mutual Fund Dividends. Although most distributions from mutual funds (i.e., regulated investment companies) are referred to as dividends, mutual fund distributions will qualify for the reduced tax rate on dividends only to the extent the amount is attributable to qualified dividends received by the fund. To the extent mutual fund distributions are attributable to items such as interest and short-term capital gains, they will not qualify (although distributions attributable to long-term capital gains continue to qualify for the preferential long-term capital gain rate).

Qualified Dividend Pitfalls

Investors cannot assume that all dividends, even those that appear to be qualified dividends, are eligible for the reduced tax rate. Instead, certain transactions may render a dividend ineligible. This is especially true for investors who frequently trade securities or enter into more sophisticated financial transactions.

Nonqualified Payers. Dividends received from a tax-exempt corporation (e.g., farmers cooperative) (including a corporation with that status for the year before the distribution) and dividends allowed as a deduction under IRC Sec. 591 (relating to mutual savings banks and certain other savings institutions) do not qualify for the reduced tax rate.

Short Sales and Derivatives. Any dividend to the extent the taxpayer is obligated (because of a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property is not a qualified dividend. This includes certain derivatives [i.e., financial contracts in which value or income is determined (or derived) at least in part on that of an underlying security or variable] such as a swap transaction, where the owner of the stock pays the dividends to a counterparty in return for a payment based on a different investment or index. This rule would also apply to investors who hold a long and short position in the same stock.

Disguised Interest. Taxpayers should pay particular attention to investments labeled as preferred stock. Many investments (e.g., trust preferred securities) have been marketed as such, even though the issuer treats them as debt and deducts the interest expense. Because the issuer's classification controls the investment's tax classification, if the issuer deducts interest paid to investors, the owner cannot treat the investment as stock for purposes of the reduced tax rate. Taxpayers might find the prospectus or even certain websites (e.g., **www.quantumonline.com**) helpful in determining whether an investment is a true dividend-paying preferred stock, but in some cases it may be necessary to contact the broker or issuing company to be sure.

REIT Distributions. Because real estate investment trusts (REITs) normally invest in real estate and pay no entity-level tax, they will rarely pay dividends eligible for the reduced rates. However, to the extent they are attributable to (a) dividends the REIT received from taxable non-REIT corporations or (b) income on which the REIT paid tax (e.g., undistributed income) less the amount of tax the REIT paid on that income, REIT distributions should qualify for the lower rate.

Holding Period Requirement. Dividends are not eligible for the reduced tax rates unless the shareholder holds the underlying shares for a certain period of time revolving around the stock's ex-dividend date. A stock's ex-dividend date is the day it begins trading without rights to an announced, but as yet unpaid, dividend. To qualify for the reduced rate on dividends, a shareholder must hold the stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date. For preferred stock dividends attributable to a period or periods aggregating more than 366 days (e.g., cumulative preferred stock with dividends in arrears), the holding period is more than 90 days during the 181-day period beginning 90 days before the stock's ex-dividend date. Preferred stock not subject to this special rule is subject to the regular 61-day holding period rule. The holding period includes the date of disposition, but not the acquisition date.

To receive the dividend, the taxpayer must own the stock at least one day before the ex-dividend date. Because the required holding period is more than 60 days during a period beginning 60 days before the ex-dividend date, this necessarily means that the holding period must include the ex-dividend date. However, the 61-day (or 91-day) holding period does not have to be consecutive. Also, certain transactions that limit the taxpayer's risk of loss with respect to the stock (e.g., the taxpayer has made and not disclosed on a short sale) toll the taxpayer's holding period until those transactions are closed.

Example 1-4: Required holding period for the reduced rate on dividends.

Courtney purchased 100 shares of Winston Corp. common stock on October 15, 2010. Winston declared and paid one dividend in 2010. The stock's ex-dividend date was November 1, 2010 and the dividend was paid on

November 19, 2010. Therefore, the required 61-day holding period for the November 19 dividend would have to be satisfied between September 2, 2010 (60 days before the ex-dividend date) and December 31, 2010 (end of the 121-day period).

If Courtney sold her stock on December 2, 2010 and did not repurchase any Winston shares, the dividend would not qualify for the reduced rate because she held her stock for less than 61 days. However, if she repurchases 100 shares of Winston stock after December 2, 2010 and holds it for at least 15 days before January 1, 2011, she will hold the stock for the required 61 days, qualifying the dividend for the reduced tax rate.

Payments in Lieu of Dividends. When the owner of stock lends that stock to a short seller (who uses it to cover a short sale), any dividends paid while the loan is outstanding are paid to the short seller's buyer. To compensate the lender of the stock for the missed dividend, the short seller pays him a payment in lieu of dividends. This payment is not a dividend and does not qualify for the reduced tax rate. Most standard brokerage agreements allow the broker to lend out stock held in a margin account. In the past, investors were generally indifferent (and often unaware) that their stock was lent out, since it did not affect the amount they received and dividends and payments-in-lieu were taxed at the same rate. Clearly, the rate reduction on qualified dividends in 2010 creates a tax cost to lending securities.

Example 1-5: Payments in lieu of dividends.

Cheryl's margin account with Surviving Brokers holds 500 shares of Sound Bank, Inc., her only investment. Harvey, also a customer of Surviving Brokers owns no Sound Bank stock, but wants to sell 500 shares short. He believes Sound Bank's stock price will fall and he will be able to cover his short position profitably. To facilitate the short sale on January 4, 2010, Surviving Brokers borrows 500 shares of Sound Bank stock from Cheryl's account and sells it in Harvey's account. On October 1, 2010, Harvey covers his short position and the Sound Bank stock is restored to Cheryl's account. Cheryl was unaware of these transactions.

During 2010, Sound Banks declared and paid quarterly dividends of $1 per share on Cheryl's stock totaling $2,000 (500 shares × $1 × 4 quarters) for the year. While the short sale was open, Harvey was required to pay Cheryl substitute dividends totaling $1,500 (500 shares × $1 × 3 quarters). In January 2011, Cheryl receives a composite substitute statement Form 1099-DIV from Sound Brokers indicating that in 2010 she received $500 in qualified dividends and $1,500 in substitute payments in lieu of dividends which are not eligible for qualified dividend treatment.

Investment Income Election. Investment interest expense is deductible as an itemized deduction, but only to the extent of net investment income. Qualified dividend income is not treated as investment income for purposes of IRC Sec. 163. However, taxpayers can elect to treat qualified dividend income as investment income. If the election is made, the dividends treated as investment income will not qualify for taxation at the reduced rates. (A similar rule applies to long-term capital gains.) This gives taxpayers the choice of applying the favorable tax rates to dividend income or using qualified dividend income to offset investment interest expense.

SELF-STUDY QUIZ

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

3. Qualified dividends generally consist of which of the following?

   a. Distributions from S corporations.

   b. Distributions from mutual funds.

   c. Distributions from domestic C corporations.

4. Not all dividends are eligible for the reduced tax rate. Which of the following is considered a qualified dividend that is eligible for the reduced tax rate?

   a. Dividends received from a tax-exempt corporation.

   b. Dividends passed through from partnerships to noncorporate partners.

5. Unless a shareholder holds the underlying shares for a specific time period revolving around the stock's ex-dividend date, the dividends are not eligible for the reduced tax rates. When is the stock's ex-dividend date?

   a. The stock trading date of an announced dividend.

   b. The day following its acquisition.

   c. The day of disposition.

   d. The dividend payment date.

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. Qualified dividends generally consist of which of the following? **(Page 225)**

   a. Distributions from S corporations. [This answer is incorrect. Because these dividends do not come from earnings and profits (E&P), they generally are not qualified dividends. Distributions from S corporations represent S corporation earnings distributions.]

   b. Distributions from mutual funds. [This answer is incorrect. Even though most mutual fund distributions are referred to as dividends, mutual fund distributions qualify for the reduced tax rate on dividends, only to the degree the amount is attributable to qualified dividends the fund receives.]

   c. Distributions from domestic C corporations. [This answer is correct. Qualified dividend distributions of cash or property can only be made by a qualified domestic corporation to a shareholder with respect to its stock and can only come from its earnings and profits.]

4. Not all dividends are eligible for the reduced tax rate. Which of the following is considered a qualified dividend that is eligible for the reduced tax rate? **(Page 225)**

   a. Dividends received from a tax-exempt corporation. [This answer is incorrect. Any dividends received from a tax-exempt organization such as a farmer's cooperative are not considered qualified dividends as stated in IRC Sec. 501 and 502.]

   b. Dividends passed through from partnerships to noncorporate partners. [This answer is correct. Partnerships pass qualified dividend income through to noncorporate partners, where the dividends are taxed at the favorable rates according to IRC Sec. 702(a)(5).]

5. Unless a shareholder holds the underlying shares for a specific time period revolving around the stock's ex-dividend date, the dividends are not eligible for the reduced tax rates. When is the stock's ex-dividend date? **(Page 226)**

   a. The stock trading date of an announced dividend. [This answer is correct. The day stock begins trading without rights to an announced, but as yet unpaid dividend is a stock's ex-dividend date. For a dividend to qualify for the decreased dividend rate, a shareholder must hold the stock for a specific amount of days during the 121-day period starting 60 days before the ex-dividend date.]

   b. The day following its acquisition. [This answer is incorrect. The day following the day of acquisition and ending on the day of disposition is a stock's holding period.]

   c. The day of disposition. [This answer is incorrect. The day of disposition is the day a stock's holding period generally ends.]

   d. The date the dividend is paid. [This answer is incorrect. The date the dividend is paid is the dividend payment date and is different from the ex-dividend date.]

Stock Redemptions

A stock redemption occurs when a corporation acquires its stock from a shareholder in exchange for property (including cash), whether the stock acquired by the corporation is canceled, retired, or held as treasury stock. A redemption may be treated as a dividend distribution to the shareholder or as a sale or exchange transaction. If it is a dividend, the distribution is taxed to the shareholder as ordinary income to the extent of the corporation's earnings and profits (E&P). Amounts distributed in excess of E&P are treated first as a return of capital to the extent of shareholder basis, then as capital gain.

If the redemption qualifies as a sale or exchange, the shareholder is taxed on a capital gain equal to the excess of the distribution over the shareholder's basis in the stock surrendered. A redemption qualifies as a sale or exchange (i.e., a capital gain transaction) if it meets one of the following five criteria:

a. It is made in complete termination of the shareholder's interest.

b. It is a substantially disproportionate redemption.

c. It is not essentially equivalent to a dividend.

d. It represents a partial liquidation of the corporation.

e. It represents stock acquired from an estate or beneficiary, to the extent of estate taxes and administration expenses.

Before the 2003 Tax Act, determining whether a redemption qualified as a sale or exchange or a dividend was critical because the spread between the applicable capital gain rate and ordinary income rates was significant. And because the constructive ownership rules apply in determining stock ownership under IRC Sec. 302(b), sale or exchange treatment is sometimes difficult to achieve, especially for closely-held family owned corporations. However, with qualified dividends being taxed at the preferential capital gain rates in 2010, redeemed shareholders will often be less concerned whether the redemption is treated as a sale or exchange or as a dividend. However, there are situations (such as when the taxpayer has significant basis in the redeemed stock, or capital loss carryovers) where sale or exchange treatment is still preferable to a dividend.

Example 1-6: Basis of redeemed shareholder shifted to a related party.

Joni and her husband Keith each own 50% of VMI, Inc.'s (VMI's) outstanding stock. Both have $50,000 basis in their stock. VMI has $10 million of earnings and profits. All of Joni's stock is redeemed for $4 million. Assume she does not elect to waive family attribution. Keith's ownership is attributed to her, so she cannot meet any of the IRC Sec. 302(b) tests for sale or exchange treatment. The redemption proceeds are treated as a nonliquidating distribution. Joni recognizes $4 million of dividend income. Her $50,000 basis in her stock is added to Keith's basis in VMI.

Short-term Stock Holding Period. A redeemed shareholder who has held his stock for one year or less would normally prefer dividend rather than sale or exchange treatment. Here, sale or exchange treatment would result in a short-term capital gain taxed at higher ordinary rates than the preferential capital gain rate that applies to qualified dividends (assuming the 61-day or 91-day holding period for a qualified dividend is met).

SELF-STUDY QUIZ

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

6. Which of the following statements best describes a stock redemption?

   a. When a corporation repurchases all stock owned by a shareholder.

   b. When a corporation acquires its stock from a shareholder in exchange for property.

   c. When a corporation repurchased enough stock so that immediately afterward, the shareholder owns less than 50% of the total combined voting power.

   d. When a corporation obtains similar stock within a period beginning 30 days before and ending 30 days after the sale date.

7. Which of the following would a redeemed shareholder prefer if he or she holds stock for one year or less?

   a. Sale treatment.

   b. Exchange treatment.

   c. Dividend treatment.

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. Which of the following statements best describes a stock redemption? **(Page 231)**

   a. When a corporation repurchases all stock owned by a shareholder. [This answer is incorrect. A complete termination occurs when a corporation repurchases all stock actually or constructively owned by the shareholder.]

   b. When a corporation acquires its stock from a shareholder in exchange for property. [This answer is correct. Whether the corporation acquires stock that is held as treasury stock, retired, or canceled; the stock redemption will occur when the corporation acquires its stock from a shareholder in exchange for property or cash as stated in IRC Sec. 317(b).]

   c. When a corporation repurchased enough stock so that immediately afterward, the shareholder owns less than 50% of the total combined voting power. [This answer is incorrect. A substantially disproportionate redemption occurs when a corporation repurchases enough stock so that immediately afterward the shareholder owns less than 50% of the total combined voting power and the shareholder's percentage of both voting stock and common stock is reduced to less than 80% of the shareholder's percentage of voting stock and common stock immediately before the redemption.]

   d. When a corporation obtains similar stock within a period beginning 30 days before and ending 30 days after the sale date. [This answer is incorrect. According to the Section 1091 wash sale rules, recognition of stock loss can be deferred when taxpayers acquire the same stock within a period beginning 30 days before and ending 30 days after the sale date. This does not describe a stock redemption.]

7. Which of the following would a redeemed shareholder prefer if he or she holds stock for one year or less? **(Page 231)**

   a. Sale treatment. [This answer is incorrect. Sale treatment results in a short-term capital gain taxed at higher ordinary rates This is not what a taxpayer would prefer.]

   b. Exchange treatment. [This answer is incorrect. Exchange treatment results in a short-term capital gain taxed at higher ordinary rates so this would not be the preference of the taxpayer.]

   c. Dividend treatment. [This answer is correct. Assuming the 61-day or 91-day holding period for the qualified dividend is met, qualified dividends are taxed at lower ordinary rates and; therefore, are preferred by the redeemed shareholder.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TINTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following has the highest maximum tax rate for a holding period of more than 12 months?

   a. Collectibles such as alcoholic beverages and stamps.

   b. Qualified small business stock issued after August 10, 1993.

   c. Gain attributable to depreciation on Section 1250 real property that is not subject to ordinary income recapture.

   d. Capital assets other than those listed above.

2. Jenny's marginal tax rate on her ordinary income is 12%. For 2010, what is her maximum long-term capital gain tax rate?

   a. 0%.

   b. 5%.

   c. 15%.

   d. 35%.

3. Forrest has stock from a qualified small business that he acquired in 2008. What is the most Forrest can be taxed on his long-term capital gain?

   a. 0%.

   b. 10%.

   c. 15%.

   d. 25%.

4. In 2010, the 2003 Tax Act provisions are scheduled to expire. When will the qualified five-year gain rules return, once this occurs?

   a. 2010.

   b. 2011.

   c. 2012.

   d. 2013.

5. If Sarah sells her Dell stock at a loss on May 12, 2010, when can she reinvest the proceeds in the same stock without triggering the wash sale rules?

   a. May 13, 2010.

   b. May 21, 2010.

c. June 1, 2010.

d. June 20, 2010.

6. How long must a shareholder hold common stock for it to qualify for the reduced rate on dividends?

   a. Less than 30 days.

   b. More than 30 days.

   c. Less than 60 days.

   d. More than 60 days.

7. A stock redemption must meet certain standards to qualify as an exchange or sale. Which of the following is **not** one of those standards?

   a. It must be equal to a dividend.

   b. It represents partial corporation liquidation.

   c. It occurs only in a complete termination of the shareholder's interest.

   d. It is largely an unequal redemption.

8. Sarah and her husband James each own 50% of Triple A, Inc.'s (AAA) outstanding stock. Both have $50,000 basis in their stock. AAA has $10 million of earnings and profits. All of Sarah's stock is redeemed for $4 million. Assume Sarah does not elect to waive family attribution. James' ownership is attributed to her, so she cannot meet any of the IRC Sec. 302(b) tests for sale or exchange treatment. The redemption proceeds are treated as a nonliquidating distribution. How much dividend income does Sarah recognize and how much of her basis in stock is added to James' basis in AAA?

   a. $2 million; $25,000.

   b. $3 million; $50,000.

   c. $4 million; $25,000.

   d. $4 million; $50,000.

Lesson 2: Tax Strategies for Cash and Cash Equivalents

INTRODUCTION

An investor's cash reserves are typically invested in short-term, highly liquid investments. These investments are often referred to as cash and cash equivalents, and may take the form of money market accounts, certificates of deposit (CDs), or Treasury bills. Money market accounts may be either taxable or tax-exempt, so taxpayers must compare after-tax yields when analyzing these investments. Note that some federally tax-exempt money market mutual funds avoid the alternative minimum tax in addition to regular taxation.

With short-term cash investments, taxpayers typically report interest income currently (i.e., as earned). However, interest income from CDs maturing in one year or less and Treasury bills is recognized when these investments mature, which enables taxpayers to defer income recognition from one year to another. For some investors, this may be a factor when making investment decisions.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify various tax strategies for cash and cash equivalents.

Choosing between Taxable and Tax-exempt Investments

Comparing Taxable and Tax-exempt Returns. An investor often evaluates investment alternatives in terms of after-tax return. The practitioner may be asked to assist the taxpayer in deciding between a taxable investment (such as U.S. Treasury Bill or Certificates of Deposit) and a tax-exempt instrument. Depending on the investor's tax bracket and state tax consequences, the difference on the return between taxable and tax-exempt investments can be significant. For tax-exempt investing, a taxpayer can purchase municipal bonds, tax-free money market accounts, or invest in mutual funds investing only in municipal bonds. Some funds invest only in tax-exempt bonds of a specific state so residents of that state who invest in that fund avoid state income tax on the earnings as well (i.e., states generally do not tax residents on interest earned on bonds issued by that state).

Municipal bonds usually carry a lower stated interest rate than taxable bonds of similar quality and safety. However, much of the appeal of investing in municipal bonds is that, depending on the investor's tax rate, the after-tax yield from these bonds can exceed the after-tax yield from a bond that pays a higher rate of taxable interest.

Example 2-1: Comparing yields on taxable and tax-exempt investments.

Cathy Ware is considering investing in either a AAA-rated insured tax-exempt bond paying interest of 4% or a GNMA security producing taxable interest of 6%. She wants to know which bond produces the larger after-tax yield. She is in the 35% marginal federal tax bracket and her state tax rate is 4%. However, Cathy's state does not tax the tax-exempt bond interest. Cathy does not itemize deductions on her federal return. (The interest rates and investment yields used in this example may not reflect those currently available.)

The interest on the tax-exempt bond has already been stated in terms of an after-tax yield of 4%. However, the after-tax yield of the GNMA bonds can be determined using the following formula.

$$\begin{array}{c}\text{Pretax yield}\\ \text{of taxable bond}\end{array} \times (1 - \text{Combined State and Federal tax rate}) = \text{After-tax yield}$$

$$6\% \times [1 - (.35 + .04)] = 3.66\%$$

Because the after-tax yield of the AAA-rated insured tax-exempt bond (4%) is greater than the after-tax yield of the GNMA bond (3.66%), the tax-exempt bond appears to be the better investment.

Variation 1: If (1) the taxable interest is subject to state income tax; *and* (2) state taxes are deductible on Cathy's federal tax return (as an itemized deduction), the formula would be—

$$\text{Pretax yield} \times \left[1 - \frac{\text{Combined State and}}{\text{Federal tax rate}} + (\text{Federal rate} \times \text{State rate})\right] = \text{After-tax yield}$$

$$6\% \times (1 - .39 + .014) = 3.774\%$$

Here, the tax-exempt bond yields the greater after-tax return, even though Cathy is allowed to deduct the state income taxes paid on the taxable interest on her federal return.

Variation 2: If several taxable bonds are being considered, it may be easier to calculate an equivalent taxable yield on the tax-exempt bond, and use it as the benchmark in evaluating taxable bonds (i.e., a taxable bond is a better investment from a yield standpoint if its pretax yield exceeds the calculated equivalent taxable yield of the tax-exempt bond). The equivalent taxable yield rate of the AAA-rated insured tax-exempt bond could be calculated as—

$$\frac{\text{Tax-exempt yield (i.e., after-tax yield)}}{(1 - \text{Combined state and Federal tax rate})} = \text{Equivalent taxable yield}$$

$$\frac{4\%}{[1 - (.35 + .04)]} = 6.56\%$$

Therefore, if Cathy finds a taxable bond that has a taxable (pretax) yield in excess of 6.56%, it would have a better after-tax yield than the equivalent after-tax yield of the 4% tax-exempt bond.

If state income taxes paid on taxable interest are deductible on Cathy's federal return, the equivalent taxable yield would be:

$$\frac{\text{Tax-exempt yield (i.e., after-tax yield)}}{[1 - \text{Combined state and Federal tax rate} + (\text{Federal rate} \times \text{State rate})]} = \text{Equivalent taxable yield}$$

$$\frac{4\%}{1 - (.35 + .04) + .014} = 6.41\%$$

Other Factors to Consider. Other factors in addition to state and federal marginal tax rates can affect the analysis of taxable versus tax-exempt investments. These include the following:

a. Taxable or tax-exempt income can indirectly affect a taxpayer's tax liability because of the effect the income has on other tax items. For example, taxable interest income increases adjusted gross income (AGI), which can reduce certain credits subject to AGI-based phase-out.

b. For taxpayers receiving Social Security benefits, tax-exempt interest is included in their provisional income, which is used to determine the taxable amount of such benefits. Thus, tax-exempt interest can impact the tax liability of Social Security recipients, particularly for those whose provisional income is at or near the base amounts used for computing taxable Social Security benefits (e.g., $34,000 for single taxpayers and $44,000 for taxpayers filing jointly). However, the impact may be less than if the taxpayer invested in taxable accounts since the amount of tax-exempt income would generally be smaller.

c. Taxpayers who do not generate sufficient taxable income may lose the benefit of their itemized or standard deductions and personal exemptions. Thus, taxpayers will generally want to generate enough taxable income to benefit from these deductions, assuming the rate they earn on taxable investments exceeds that on tax-free investments.

Tax Advantages of Treasury Bills

Treasury bills (sometimes referred to as T-bills) are money market securities that represent short-term government financing with maturities of one, three, six, and 12 months. Periodic interest is not paid on Treasury bills; instead, they are sold at a discount and mature at face value. Treasury bills are ideal for investors who want safety and liquidity. Treasury bills can be purchased through banks and brokerage firms or directly from the Treasury at **http://www.treasurydirect.gov**. Alternatively, investments in Treasury bills can be made through mutual funds that specifically invest in short-term debt instruments.

The original issue discount (OID) rules of IRC Sec. 1272 generally control the timing of income recognition for certain instruments issued at a discount. IRC Sec. 1272 requires that OID be treated as interest income over the life of the obligation, rather than when the instrument matures. However, these rules do not apply to short-term obligations (i.e., those with fixed maturity dates not more than one year from the date of issue, such as short-term CDs and Treasury bills); instead, their income is taxable at maturity (or sale date, if earlier). Thus, the obvious planning technique is to acquire a short-term debt instrument that matures in the following (as opposed to the current) tax year, to defer income recognition for a year. However, this planning technique may not be appropriate if the taxpayer expects to be in a higher tax bracket in the following year.

- *Treasury Bills.* These instruments are issued at a discount and mature in 12 months or less. Their taxation is discussed in this lesson.

- *Treasury Notes.* These are medium-term instruments (terms ranging from two to 10 years) that pay interest semi-annually. Interest is taxable when received (or constructively received) and these notes may be purchased at a discount or premium, depending on market conditions when acquired.

- *Treasury Bonds.* These bonds are like treasury notes except they have longer maturities. These are taxed to holders in the same manner as treasury notes.

- *Treasury STRIPs.* These are treasury notes and bonds that have been stripped of their interest coupons. (STRIPS is an acronym for Separate Trading of Registered Interest and Principal of Securities.) Thus, they are sold at a discount and the holder receives the principal when the debt matures. Treasury STRIPs are zero coupon instruments because holders do not receive periodic interest payments. Investors recognize income on these bonds under the OID rules.

- *Treasury Inflation-protection Securities, or TIPS.* These are bonds that both pay interest semiannually and pay investors for inflation adjustments to the bond's principal.

- *U.S. Savings Bonds.* Series E savings bonds were issued at a discount until they were discontinued and replaced by Series EE savings bonds on July 1, 1980. Paper form Series EE savings bonds are issued at a discount (1/2 of face value) and electronic form Series EE savings bonds are issued at face value. Series I bonds are inflation-indexed bonds issued at face value. The interest, which is added to the bond monthly, is paid when the bond is redeemed. Series HH bonds were issued at full face value. (The Treasury discontinued issuing HH bonds in 2004.) Unlike Series I and EE bonds, Series HH bonds do not increase in value; instead, they pay interest every six months. They were acquired only in exchange for eligible Series E and EE bonds or upon reinvestment of the proceeds of matured Series H bonds.

A taxpayer who holds a Treasury bill to maturity recognizes no capital gain or loss. Instead, proceeds in excess of basis (i.e., the acquisition discount amount) are taxed as ordinary income because it is considered a recovery of discount or interest income.

An election is available under IRC Sec. 1282(b)(2) to recognize the acquisition discount over the bond's life rather than at maturity or sale. The acquisition discount is measured by the difference between the stated redemption price at maturity and the cost of the Treasury bill. The election is made by attaching an election statement to the taxpayer's return and, once made, applies to all short-term obligations acquired by the taxpayer on or after the first day of the first tax year to which the election applies. It then applies to the tax year for which the election was made and all subsequent tax years, unless the IRS agrees to revoke the election at the request of the taxpayer.

State and local governments cannot tax interest income from Treasury bills. This can be beneficial for taxpayers who are subject to state and local income taxes.

If a Treasury bill is sold before maturity, any amount received in excess of tax basis is taxed as ordinary income to the extent it represents a recovery of the acquisition discount. Proceeds in excess of the recovered discount are taxed as short-term capital gain because Treasury bills are capital assets.

Example 2-2: Computing gain on Treasury bill sold prior to maturity.

Glenda purchased a six-month, $10,000 Treasury bill for $9,400 on September 1, 2010. She sold the bill (before maturity) on January 22, 2011 for $9,900. Glenda did not elect to accrue the $600 acquisition discount prior to maturity. (The interest rates and investment yields used in this example may not reflect those currently available.)

Glenda realized $500 gain on the sale ($9,900 proceeds less $9,400 cost) in 2011. Of that amount, Glenda reports $477 as interest income ($600 discount ÷ 181 days to maturity × 144 days held), and the remaining $23 ($500 − $477) 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.

8. State and federal marginal tax rates can significantly affect the analysis of taxable versus tax-exempt investments. What additional factors should be considered?

   a. Social Security benefits.

   b. Securities.

9. Taxpayers who purchase this medium-term debt instrument receive semi-annual interest payments.

   a. Treasury STRIPs.

   b. Treasury Bonds.

   c. Treasury Notes.

   d. Treasury Bills.

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. State and federal marginal tax rates can significantly affect the analysis of taxable versus tax-exempt investments. What additional factors should be considered? **(Page 238)**

   a. Social Security benefits. [This answer is correct. Because tax-exempt interest is included in a taxpayer's provisional income, it can affect the tax liability of Social Security recipients; especially for taxpayers who have provisional income that is near or at the base amounts used for computing taxable Social Security benefits.]

   b. Securities. [This answer is incorrect. Securities do not affect the analysis of taxable versus tax-exempt investments. However, one factor that can affect this analysis is when a taxpayer cannot produce enough taxable income. These taxpayers may lose the benefit of their itemized or standard deduction and/or personal exemptions.]

9. Taxpayers who purchase this medium-term debt instrument receive semi-annual interest payments. **(Page 239)**

   a. Treasury STRIPs. [This answer is incorrect. Treasury STRIPs are bonds and notes that have had their interest coupons stripped. Holders do not receive periodic interest payments.]

   b. Treasury Bonds. [This answer is incorrect. A Treasury Bond is a long-term debt-instrument issued by the U.S. government, not a medium-term debt instrument.]

   c. Treasury Notes. [This answer is correct. A Treasury Note is an intermediate-term (two to 10 years) debt instrument of the U.S. government that pays interest semi-annually.]

   d. Treasury Bills. [This answer is incorrect. Treasury Bills are U.S. government promissory notes issued by the U.S. Treasury that have a maturity period of six months or less.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TINTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

9. Jimmy Johnson is considering investing in either a AAA-rated insured tax-exempt bond paying interest of 5% or a GNMA security producing taxable interest of 6%. He wants to know which bond produces the larger after-tax yield. He is in the 20% marginal federal tax bracket and his state tax rate is 3%. However, Jimmy's state does not tax the tax-exempt bond interest. Jimmy does not itemize deductions on his federal return.

   What is the after-tax yield on the GNMA bonds if the taxable interest is subject to state income tax, and state taxes are deductible on Jimmy's federal tax return?

   a. 4.37%.

   b. 4.58%.

   c. 4.62%.

   d. 4.78%.

10. Now, use the same example as above, but Jimmy lives in Texas where there is no state income tax. What is the after-tax yield on the GNMA bonds?

    a. 4.368%.

    b. 4.8%.

    c. 5.140%.

    d. 6%.

11. Sarah Taxpayer is interested in a bond that will pay interest semiannually and pay investors for inflation adjustments to the bond's principal. Which of the following should she consider?

    a. Treasury Bond.

    b. Treasury Inflation-protection Security.

    c. U.S. Savings Bond.

    d. Treasury STRIP.

Lesson 3: Tax Planning for Bond Transactions

INTRODUCTION

Bond interest is taxable when paid by a corporation, the U.S. Treasury, or certain federal government agencies, or nontaxable when paid by states, cities, or political subdivisions. Investors who purchase newly issued bonds either pay face value (i.e., purchase at par) or acquire the bond at a discount or premium, depending on market conditions. When bonds subsequently change hands, their price fluctuates based on current interest rates, quality of the bond, maturity, and demand. In times of rising interest rates, a bond with a stated rate of interest less than the current rate will sell for a lower price so that it can compete with new bonds issued paying a higher interest rate. When current interest rates are falling, a bond with a stated rate higher than the current rate will sell for a higher price. Regardless of the purchase price, the bond holder will be paid the face amount of the bond if held to maturity.

Learning Objectives:

Completion of this lesson will enable you to:

- Differentiate between selling or redeeming bonds purchased at a discount, and bonds purchased at a premium.
- Summarize the tax-wise strategies for U.S. Savings Bonds, municipal bond swaps, and Treasury Inflation Protection Securities.

Bonds Issued or Purchased at a Discount

When a bond is acquired at a price less than the stated redemption amount (i.e., at a discount), the difference can be the result of either original issue discount (OID), market discount, or both. OID arises with the original purchase (issue) of a bond, while market discount can occur anytime subsequent to the bond's issuance.

Original Issue Discount Bonds. When a debt security such as a bond is *issued* at a price less than the stated redemption price (i.e., at a discount), the difference is referred to as OID. Under IRC Sec. 1272(a), OID is included in the holder's income over the security's term.

Holders of taxable corporate bonds issued after May 27, 1969, and before July 2, 1982, must include equal monthly portions of the discount in interest income over the term of the bond. For taxable bonds issued after July 1, 1982, the discount is included in income as it accrues economically; that is, in smaller amounts in early years and greater amounts in later years. The taxpayer's basis in the bond is increased by the discount included in income.

Tax-exempt bonds, treasury bills and other short-term obligations, and Series E, EE, and I U.S. Savings bonds issued at a discount are exempt from the OID rules.

A simplified rule applies if OID is less than a *de minimis* amount. The *de minimis* amount is defined as .25% of the stated redemption price at maturity multiplied by the number of complete years from the date of original issuance to maturity.

The general OID rules do not apply to *de minimis* OID. Instead, *de minimis* OID is included in the bondholder's income as principal payments are received. The amount of *de minimis* OID to be included in income is equal to the *de minimis* OID multiplied by a fraction. The numerator of the fraction is the amount of the principal payment received, and the denominator is the bond's stated principal amount.

> **Example 3-1: *De minimis* amount of OID.**
>
> A bond issued on January 4, 2010, is redeemable on September 15, 2014, for $100,000. The *de minimis* amount of OID is .25% × $100,000 × 4 years, or $1,000. Accordingly, if the issue price exceeds $99,000, but is less than $100,000, the OID is considered *de minimis* and is included in income as principal payments are received. Here, all the *de minimis* OID is included in the bondholder's income at maturity because the bond calls for only one payment of principal at maturity.

A taxpayer who purchases a bond that was originally issued at a discount must continue to include OID in income based on the discount remaining when the bond is purchased (although he or she was not the original purchaser), less any amount paid for the bond over the seller's basis in the bond (the original issue price of the bond plus OID included in income up to the bond's sale date).

Market Discount Bonds. Market discount is generally defined as the excess of the bond's stated redemption price at maturity over the taxpayer's basis in such bond immediately after acquisition in the secondary market (i.e., not at original issue). Changes in interest rates or other factors affecting the quality of the debt (e.g., creditworthiness of issuer) generally give rise to market discount, and such discount can occur with the purchase of a bond that includes OID.

The market discount rules do not apply to the following bonds: (a) short-term obligations having a fixed maturity date one year or less from the date of issue (e.g., T-bills), (b) tax-exempt obligations acquired before May 1, 1993, and (c) U.S. savings bonds. In addition, a *de minimis* rule excepts bonds with a market discount of less than .25% of the stated redemption price multiplied by the number of complete years to maturity (after the taxpayer acquired the bond).

Generally, market discount is not taxed until the bond matures or is sold or redeemed. However, taxpayers can elect to recognize market discount as it accrues. Then, the market discount is taken into income either (a) ratably or (b) as it economically accrues, applying the OID (constant interest) rate rules. Both elections (i.e., to recognize discount as it accrues and the method of computing the annual accrual) are made by attaching an election statement to the taxpayer's return for the year the election is effective. Any market discount recognized under the election increases the taxpayer's basis in the bond.

SELF-STUDY QUIZ

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

10. What is an original issue discount bond (OID)?

    a. A bond that sells below face value at a time after its issuance.

    b. A bond that is obtained and issued at a price less than the stated amount.

    c. A bond that defers taxes on the interest until maturity.

    d. A bond that is purchased for an amount greater than face value.

11. The market discount rule does not apply to all types of bonds. To which of the following does the market discount rule apply?

    a. U.S. savings bonds.

    b. T-bills.

    c. Tax-exempt bonds.

    d. Short-term obligations.

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. What is an original issue discount bond (OID)? **(Page 245)**

    a. A bond that sells below face value at a time after its issuance. [This answer is incorrect. A market discount bond is a bond that sells below face value at a time after its issuance.]

    b. A bond that is obtained and issued at a price less than the stated amount. [This answer is correct. An OID bond is a bond discount from par value at the time the bond is issued.]

    c. A bond that defers taxes on the interest until maturity. [This answer is incorrect. Series I U.S. Savings bonds defer taxes on the interest until maturity and provide inflation protected growth.]

    d. A bond that is purchased for an amount greater than face value. [This answer is incorrect. A bond is purchased at a premium, not a discount, if the price paid is greater than face value. This does not qualify as a discount bond.]

11. The market discount rule does not apply to all types of bonds. To which of the following does the market discount rule apply? **(Page 246)**

    a. U.S. Savings bonds. [This answer is incorrect. Generally, U.S. Savings bonds are not subject to market discount rules. U.S. savings bonds issued at a discount are exempt from the OID rules.]

    b. T-bills. [This answer is incorrect. Generally T-bills, sometimes referred to as treasury bills, are not subject to market discount rules. Periodic interest is not paid on Treasury bills; instead, they are sold at a discount and mature at face value.]

    c. Tax-exempt bonds. [This answer is correct. The market discount rules apply to all tax-exempt bonds. If a tax-exempt bond was purchased before May 1, 1993 at a market discount, the early redemption or sale of the bond produces capital gain equal to the redemption or sale price less the original cost.]

    d. Short-term obligations. [This answer is incorrect. Generally, any short-term obligation having a fixed maturity date of one year or less from the issue date is not subject to market discount rules.]

Selling or Redeeming Bonds Purchased at a Discount

Taxable Bonds. If a taxpayer sells or redeems a bond with OID prior to maturity, capital gain or loss on the sale or early redemption is determined by the difference between the sales price and the original cost plus the OID included in income to date. An OID bond held to maturity will have a basis equal to the bond's face value and no gain or loss will be recognized on the redemption. However, the maturity must still be reported on Form 1040, Schedule D.

For market discount bonds, any gain recognized at disposition is recharacterized as ordinary income to the extent of the accrued, but unrecognized market discount at the disposition date. Any gain in excess of that amount is a capital gain. The accrued market discount is calculated (at the taxpayer's election) either ratably or using the constant interest method. If no election is made, the ratable inclusion method applies. Of course, if the bond is held to maturity, the total accrued discount is the same under either method.

Using the constant rate method will generally result in less accrued market discount than the ratable accrual method (assuming the bond is disposed of before maturity). Therefore, a sale of a bond before maturity will trigger less ordinary gain when the constant interest method is elected. However, the calculation is more complex than the ratable accrual method; thus, the time and cost of using the constant rate method may exceed the tax benefit derived. The constant interest method must be elected during the first tax year for which a determination of the accrued market discount must be made. Unless the taxpayer has elected to recognize market discount as it accrues, this is generally the year that the bond (or a bond in the class of bonds for which the election is made) is sold or redeemed. The election is made for either a specific bond or for a class or group of bonds. Once made, it is irrevocable.

Example 3-2: Disposing of market discount bonds.

In 1992, Sally acquired a $10,000 Treasury bond that was issued after July 18, 1984 for $9,500. The bond did not include any OID, and Sally did not elect to accrue the market discount. In 2010, the Treasury bond matured, and Sally received the $10,000 principal amount.

Because Sally's bond was issued after July 18, 1984, she must report the $500 ($10,000 redemption amount less $9,500 cost) of market discount on Schedule B as interest income. On Schedule D, Sally reports the maturity proceeds of $10,000 less her basis of $10,000 ($9,500 plus $500 of market discount included on Schedule B), so that no gain or loss is recognized.

<u>Variation:</u> Had the bond been issued on or before July 18, 1984, the $500 of gain would be a capital gain (long-term) rather than ordinary income since she purchased it before May 1, 1993.

A bond originally issued at a discount may be purchased in the secondary market at a discount exceeding its OID amount. Here, the bond's market discount is the excess of its revised issue price (original issue price plus OID accrued and included in the income of all previous bondholders) over its basis immediately after its purchase in the secondary market.

Tax-exempt Bonds. For tax-exempt bonds purchased before May 1, 1993 at a market discount, the sale or early redemption of the bonds generates capital gain equal to the sale or redemption price less the original cost. (If the bond has OID, basis is increased by the amount of OID the taxpayer would have included in income if the bond was taxable). Tax-exempt bonds purchased after April 30, 1993, are subject to the market discount rule discussed previously. Thus, the gain on disposition of such tax-exempt bonds is ordinary income to the extent of any accrued market discount. This rule also affects taxpayers who own shares in tax-exempt bond mutual funds. Recognized gain in excess of the accrued market discount is capital gain.

Purchasing Bonds at a Premium

Taxable Bonds. Bonds purchased at a price above face value are purchased at a premium. A taxpayer can elect to deduct the premium paid on a taxable bond over the life of the bond. The election, once made, is irrevocable and will apply to all subsequent purchases of similar debt instruments. The bond's original cost basis is reduced by the premium deducted each year. If the taxpayer does not elect to amortize the premium, the bond's basis will always be its original cost.

For bonds issued after September 27, 1985, premium amortization is computed using the yield to maturity method. For bonds issued prior to September 28, 1985, any reasonable method for computing amortization is allowed (e.g., straight-line or constant-yield methods). If the bond has an earlier call date, the amortization is computed with reference to the call date if this results in a smaller amortization amount.

Once elected, the amortization of bond premium is treated as a miscellaneous itemized deduction not subject to the 2% AGI limitation for bonds acquired before October 23, 1986. For bonds acquired after October 22, 1986, and before 1988, the amortization is treated as interest expense subject to investment interest limitations unless the taxpayer elects to treat it as an offset to interest income on the bond. Amortization of premium on bonds acquired after 1987 is an offset to interest income on the bond.

Amortization of bond premium is generally advantageous because the taxpayer can offset a portion of ordinary income from the bond. Also, an unamortized premium becomes part of the bond's basis so its recovery reduces capital gains (or increases capital losses), which is usually less beneficial than an ordinary deduction. Factors to consider before making the election include the following: (a) the election is irrevocable and (b) it applies to purchases of all bonds of such class (or classes) bought in the future (i.e., bonds, notes, debentures, certificates, or other evidence of indebtedness). In addition, the administrative burden of computing and tracking the amortization must be considered. The election is made by claiming an offset to interest income for bond premium and attaching a statement that the election is being made to the return.

Tax-exempt Bonds. A taxpayer is *required* to amortize the premium of a nontaxable bond, which will reduce the original cost basis of the bond. However, the amortization is not deductible. Thus, there is no loss when tax-exempt bonds are purchased at a premium and held until maturity.

Selling or Redeeming Bonds Purchased at a Premium

Sale or Early Redemption. If the taxpayer elects to amortize the premium, the sale or early redemption of a taxable bond purchased at a premium will result in capital gain or loss equal to the difference between the sales or redemption price and the original cost less the premium amortization to date. The same holds true when a nontaxable bond is sold or called, although the amortization of a nontaxable bond premium is required but is not deductible. If the taxpayer did not elect to amortize the premium on a taxable bond, the sale or early redemption of the bond will generate capital gain or loss equal to the difference between the sales or redemption price and the original cost of the bond (including the bond premium).

Sale and Repurchase Creates Tax Benefit. A beneficial tax situation is for a taxpayer to receive capital gain treatment on the sale of a bond and obtain an offsetting ordinary deduction. This is possible when a bond has a corresponding premium deduction.

Example 3-3: Bond repurchase offsets capital gain with ordinary deduction.

Sally is in the 35% marginal tax bracket. She owns a $20,000, 9% noncallable, 10-year corporate bond she acquired for par when it was issued in January 2003. In January 2010, she sells the bond when it is trading at $23,000. Sally recognizes long-term capital gain of $3,000 on the transaction, which is taxed at a maximum capital gains rate of 15%. She repurchases the same bond several weeks later for $23,000.

While Sally recognized $3,000 of *long-term capital* gain on the transaction, she will receive approximately a $1,000 per year *ordinary* deduction for amortization of the bond premium until maturity if she elects to amortize the premium. This creates an overall tax benefit to her since she pays tax on the capital gain at 15% (in 2010) and will receive a 35% tax benefit for the amortization deductions. Of course, the time value of money must be considered since tax is due on the capital gain in 2010 while the tax benefit from the deduction is spread over several years.

Bonds Held to Maturity. If a taxpayer holds a bond until maturity, a taxable bond that was amortized, as well as a nontaxable bond, will have a basis equal to its face value and no gain or loss will be recognized on the redemption. A taxable bond held to maturity that did not have the premium amortized will have a cost basis equal to the original cost of the bond including the bond premium, and, accordingly, the taxpayer will recognize capital loss on redemption at maturity.

Example 3-4: Maturity of bond acquired at a premium.

In 2002, Harry acquired a $10,000 Treasury note for $10,500. In 2010, the note matured, and Harry received $10,000. He did not elect to amortize the premium on the Treasury note.

Harry reports a long-term capital loss of $500, the difference between the $10,000 maturity proceeds and his basis of $10,500.

Variation: Had Harry elected to amortize the bond premium, he would have recognized no gain or loss on the maturity of the bond. Instead, an election would have converted the capital loss into an ordinary deduction; the $500 premium would have offset interest income from the bond (deducted on an annual basis using the yield to maturity method). In addition, the deduction for the premium would have been accelerated, thus accelerating the timing of the tax benefit.

SELF-STUDY QUIZ

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

12. Which of the following statements regarding selling or redeeming taxable bonds at a discount is most accurate?

    a. If a taxpayer sells a bond with an original issue date (OID) prior to maturity, any capital gain or loss on the sale is determined by the difference between the stated redemption price at maturity and the cost of the bond.

    b. If a taxpayer sells a bond before it matures, it will trigger less ordinary gain if the taxpayer uses the ratable accrual method.

    c. The time and cost savings of the ratable accrual method, generally is more advantageous to the taxpayer than the constant rate method.

13. The method used to calculate the amortization of bond premium for bonds issued after September 27, 1985, is which of the following?

    a. Constant interest method.

    b. Constant yield method.

    c. Yield-to-maturity method.

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.)**

12. Which of the following statements regarding selling or redeeming taxable bonds at a discount is most accurate? **(Page 249)**

    a. If a taxpayer sells a bond with an original issue date (OID) prior to maturity, any capital gain or loss on the sale is determined by the difference between the stated redemption price at maturity and the cost of the bond. [This answer is incorrect. When a taxpayer sells or redeems a taxable bond, the capital gain or loss on the sale is determined by the difference between the sales price and the original cost plus the OID included in income to date. Also, the sale must occur prior to maturity instead of at maturity.]

    b. If a taxpayer sells a bond before it matures, it will trigger less ordinary gain if the taxpayer uses the ratable accrual method. [This answer is incorrect. The taxpayer must use the constant rate method for the sale to trigger less ordinary gain. By using the constant rate method, the sale generally will result in less accrued market discount than the ratable accrual method.]

    c. The time and cost savings of the ratable accrual method, generally is more advantageous to the taxpayer than the constant rate method. [This answer is correct. The cost and time of using the constant rate method may exceed the tax benefit derived due to the complexity of the calculation.]

13. The method used to calculate the amortization of bond premium for bonds issued after September 27, 1985, is which of the following? **(Page 250)**

    a. Constant interest method. [This answer is incorrect. The constant interest method is used to compute the accrued market discount for a bond, not the amortization of bond premium.]

    b. Constant yield method. [This answer is incorrect. Although this method is used to calculate the amortization of premium bonds, it applies only to premium bonds issued prior to September 27, 1985 as stated in IRC Sec. code.]

    c. Yield-to-maturity method. [This answer is correct. The yield-to-maturity method is used to compute premium amortization for bonds issued after September 27, 1985 according to IRC Sec. 171(b)(3).]

Tax-wise Strategies for U.S. Savings Bonds

Series E savings bonds were issued at a discount until they were discontinued and replaced by Series EE savings bonds on July 1, 1980. Paper form Series EE savings bonds are issued at a discount ($^1/_2$ of face value) and electronic form Series EE savings bonds are issued at face value. Interest on Series E and EE bonds accrues and is paid at the earlier of their redemption or maturity. For each year prior to maturity, the bond's redemption value increases. This annual increase in value represents the "interest accrual" for each year. Cash basis taxpayers generally report the interest earned on Series E and EE bonds in the year the bonds are redeemed or mature—whichever comes first.

Series I U.S. Savings bonds combine the features of deferring taxes on the interest until maturity with inflation protected growth. Series I bonds are issued at face value and pay a fixed interest rate plus a semi-annual inflation adjusted rate. Interest is added to the bond monthly and paid when the bond is redeemed. Like Series E and EE bonds, cash-basis individuals report interest on Series I bonds in the year of maturity (or in the year redeemed, if earlier). Beginning in 2010, taxpayers can use their tax refund to purchase Series I bonds.

Election to Accrue Interest Income. Taxpayers can elect to report interest on the accrual method (i.e., as earned) for Series E, Series EE, and Series I bonds. If made, the election applies to all such bonds owned in the year of election and to any subsequently acquired. Furthermore, in the year of election, the taxpayer must report all income accrued on the bonds from date of acquisition. If the taxpayer holds Series H (or HH) bonds received in exchange for Series E (or EE) bonds, the election also applies to the accrued Series E (or EE) interest at the time of the exchange (if such interest was not reported at the time of the exchange).

The election to convert to the accrual method for U.S. savings bond interest should be considered for a taxpayer when—

a. Additional current income may go untaxed (e.g., the taxpayer's income is below the filing limit). This includes bonds owned by children who are not subject to the kiddie tax.

b. Additional current income would be taxed at a lower rate than income in the year of the bond's maturity (after considering the time value of money).

c. The tax rate is relatively low for the final return of a deceased taxpayer in relation to the tax rate of the estate or beneficiaries.

d. A net operating loss or other carryforward item is expiring or otherwise could be used to offset the additional income.

e. Itemized deductions are of little or no benefit because of a low level of taxable income.

f. The accelerated income may be offset by a deduction for investment interest that would otherwise be deferred under IRC Sec. 163(d).

g. Excess investment interest expense materially exceeds investment income.

The election to accrue interest on U.S. savings bonds is made by attaching an election statement to the taxpayer's return for the year it is effective. It can be revoked only with IRS consent, but the IRS provides taxpayers with an expeditious method of revoking the election, thereby allowing taxpayers to return to the cash basis method for reporting the interest income. Revoking the election may be appropriate when income recognized under the accrual method is subject to tax or taxed at an increased rate.

If a U.S. savings bond is transferred during the owner's lifetime, the transferor generally must recognize any income that has been accrued, but not yet reported. Nevertheless, gifting a bond may be beneficial if substantial income is yet to be earned on the bond and the donee is in a lower tax bracket than the donor.

Example 3-5: Transfer of U.S. savings bond to donee in lower tax bracket.

Tom purchased Series EE bonds in 2009. In 2010, he decided to start a savings plan for his son, Tim. He does not elect to recognize the accrued income each year. Tom transfers the bonds to Tim, who will redeem them when he needs the proceeds for college. Tim's tax rate when he redeems the bonds will be lower than Tom's rate.

Tom could structure the transfers to Tim as annual gifts qualifying for the annual $13,000 gift tax exclusion under IRC Sec. 2503(b). The value of the gift would be the sum of the bonds' redemption values (according to government tables) which include accrued interest. Tom must include in his income the increment in value (accrued interest) as of the date of the transfers. Any subsequent earnings on the bonds are taxed to Tim.

A Series E or EE (and presumably, a Series I) bond can be transferred to a revocable (living) trust without triggering the deferred income. A Series H or HH bond can also be transferred to a revocable trust without triggering the deferred Series E and EE interest income.

Series H, HH, I, E, and EE U.S. savings bonds are subject to state inheritance, gift, and excise taxes. They are not, however, subject to the income taxes of states, U.S. possessions, or local taxing authorities. Taxpayers living in high tax states may achieve tax savings by investing in U.S. bonds, since the interest is not taxable by states. However, such taxpayers must own the bonds directly, not through a qualified plan or IRA, to achieve state income tax savings. Most states tax IRA and qualified plan distributions (to some extent) regardless of the nature of the assets held in the plan or IRA.

Tax savings can also be realized by using Series EE U.S. savings bonds to pay for a child's education expenses. All or a portion of interest on Series EE U.S. savings bonds issued after December 31, 1989, may be excluded from income if bond proceeds are used to pay qualified higher education expenses at eligible educational institutions. However, from an investment strategy standpoint, the returns from other investments may exceed the relatively low yields on savings bonds, making other investments preferable despite the exclusion of savings bond interest.

Swapping Municipal Bonds to Claim Losses

Taxpayers holding municipal bonds that have decreased in value may benefit from a technique known as a bond swap. A bond swap enables a taxpayer to currently benefit from the decline in a bond's value and either increase or keep the same cash flow generated by the bond. This technique is beneficial if the taxpayer has current capital gains, particularly short-term, that can be offset by the bond's capital loss, or the taxpayer's overall net capital loss following the bond disposition is $3,000 or less (which the taxpayer can offset with other ordinary income).

Example 3-6: Municipal bond swap produces current tax savings.

Harry owns a $50,000 Silver City municipal bond that he bought at face value. The bond has a 3% coupon rate. Because of rising interest rates, the bond is currently selling at 90, or $45,000. If Harry sells the bond in 2010, he will recognize a $5,000 capital loss. He can then invest the $45,000 of proceeds in a new municipal bond paying interest at 4%. Harry's effective state and federal tax rate is 40%. His combined rate on long-term capital gains is 20%.

This series of transactions enables Harry to currently benefit from the $5,000 decline in the bond's value. His tax savings could range anywhere from $2,000 ($5,000 × 40%) if the loss offsets short-term capital gains or ordinary income to $1,000 ($5,000 × 20%) if the loss offsets long-term capital gains. Although Harry now has bonds that will pay $5,000 less at maturity, he may more than offset this with the increase in current municipal bond income ($1,800 per year with the new bond versus $1,500 per year with the old bond) and the current tax savings from the capital loss.

Variation: Harry may benefit from this transaction even if the new bond he purchases pays the same interest rate and has the same redemption value as the old bond. Assuming he reinvests in another $50,000 municipal bond paying 3% and currently selling for $45,000, his annual municipal bond income does not change, but he has recognized a current $5,000 tax loss. Here, he will recoup the $5,000 loss when the new bond matures and the $5,000 gain at that time will be treated as ordinary income rather than capital gain. However, this technique can prove beneficial, especially if the current loss offsets short-term capital gains and, thus, results in a current 40% tax benefit.

Alternative Minimum Tax (AMT) Considerations for Bonds

The income from private activity bonds, which are bonds issued by state and local governments and used for nongovernmental purposes, is generally taxable. The tests to determine if a bond is a *private activity bond* are found in IRC Sec. 141(a).

However, the income from private activity bonds that are considered *qualified bonds*, as defined in IRC Sec. 141(e)(1), is not taxable for regular tax purposes. Qualified bonds are private activity bonds whose proceeds are used for purposes specified in IRC Sec. 141(e)(1), including exempt facilities (e.g., qualified residential rental projects), qualified veterans' mortgages, qualified small issues, and qualified student loans.

The interest on private activity bonds not taxable for regular income tax is included as a tax preference item in the calculation of AMT if the bonds generating the interest were issued after August 7, 1986. Bonds fitting into this category are referred to as *specified private activity bonds*. Investments in these types of municipal bonds can diminish the tax savings of owning tax-exempt bonds if the taxpayer is subject to AMT. However, tax-exempt interest on private activity bonds issued in 2009 and 2010 is not an item of tax preference for AMT purposes. This includes the interest on private activity bonds issued in 2009 and 2010 to currently refund a private activity bond issued after 2003 and before 2009.

Premium amortization on specified private activity bonds is deductible for AMT. The year's amortization should be treated as a reduction of the private activity bond tax preference, with the net tax preference included on Form 6251. Similarly, interest from specified private activity bonds included in income for AMT purposes also increases the amount of investment interest income when computing the amount of investment interest expense allowed for AMT.

Assessing the Tax Aspects of Inflation-indexed Bonds

Treasury Inflation-Protection Securities (or TIPS) are 5-year, 10-year, and 30-year marketable Treasury securities; issued in electronic form; and indexed for inflation. They are sold in multiples of $100 and provide investors with a guaranteed hedge against inflation.

Interest on TIPS is paid semiannually at a fixed interest rate. Also, the bond's principal for computing interest is adjusted semiannually for economic inflation or deflation (based on a government consumer price index). If the bond's principal increases during its term because of inflation adjustments, the increase is paid at maturity. If deflation causes the bond's adjusted principal at maturity to be less than its face amount, Treasury will pay the face amount.

How Bondholders Are Taxed. Each year, holders of TIPS are taxed on the interest they receive plus any increase in the principal resulting from the inflation adjustment. If the bond's principal decreases because of deflation, the holder can offset the interest income received during the year by the decrease. If the decrease exceeds current year income from the bond, a loss can be claimed to the extent the holder has previously recognized income from the bond; any excess is carried over to offset future income.

Taxing the inflation adjustment as it occurs rather than when paid (at maturity) causes the holder to prepay the tax on funds that will be received at a later date. This acceleration of the tax liability on the inflation adjustment to the bond's principal is perhaps the most significant drawback to holding these bonds.

Holders of TIPS will use one of two methods to account for the bond's stated interest and original issue discount: (a) the coupon bond method, or (b) the discount bond method.

The *coupon bond method* applies when (a) a *de minimis* difference exists between the debt instrument's issue price and its principal amount at issuance, and (b) all stated interest is payable in cash at least annually. This method will apply to TIPS that are not stripped into principal and interest components.

The *discount bond method* is used if the bond does not qualify for the coupon bond method (e.g., the bond is issued at a discount). The discount method essentially requires the taxpayer to accrue original issue discount (OID) using the constant yield method under Reg. 1.1272-1(b)(1).

Tax Effects of Increases to the Bond's Principal. As previously stated, inflationary increases to the bond's principal are taxed each year even though the bondholder does not receive payment for such increases until the bond matures. This creates phantom income to the holder because tax is being paid on income that is not currently received. This greatly decreases the cash flow a holder realizes during the term of the note.

If a TIPS is analyzed on a cash flow basis, the tax on the inflationary increases to principal results in an exorbitant effective tax rate until the year of maturity. This is apparent from Exhibit 3-1, which is based on a taxpayer in a 28% combined federal and state marginal tax bracket. For taxpayers in higher marginal tax brackets, the results would be even more dramatic.

Exhibit 3-1

Effective Tax Rate on Inflation-indexed Bond[a]

Year	Principal[b]	Inflation Adjustment	Interest (Cash) Received	Taxable Income	Tax at 28%[c]	Effective Tax Rate on Cash Received[d]
Issue	$ 1,000.00	$ —	$ —	$ —	$ —	N/A
1	1,030.00	30.00	30.90	60.90	17.05	55.19%
2	1,060.90	30.90	31.83	62.73	17.56	55.19%
3	1,092.73	31.83	32.78	64.61	18.09	55.19%
4	1,125.51	32.78	33.77	66.55	18.63	55.19%
5	1,159.27	33.77	34.78	68.55	19.19	55.19%
6	1,194.05	34.78	35.82	70.60	19.77	55.19%
7	1,229.87	35.82	36.90	72.72	20.36	55.19%
8	1,266.77	36.90	38.00	74.90	20.97	55.19%
9	1,304.77	38.00	39.14	77.15	21.60	55.19%
10	1,343.92	39.14	384.24 [e]	79.46	22.25	5.79%

Notes:

[a] This table assumes a TIPS that pays a stated interest rate of 3% and inflation is 3% throughout its 10-year term. (The interest and inflation rates used in this exhibit may not reflect current market rates.)

[b] For simplicity, principal adjustments are computed annually rather than semiannually.

[c] Assumes taxpayer is in a 28% combined federal and state marginal tax bracket.

[d] Tax divided by interest (cash) received.

[e] In the year of maturity, current year income plus all prior year income inflation adjustments are received.

* * *

As inflation increases, the significance of reporting phantom income from the increases in the bond's principal becomes more pronounced. As Exhibit 3-2 illustrates, periods of high inflation can actually result in current tax liabilities that exceed the cash income the bondholder receives during the year. Like Exhibit 3-1, Exhibit 3-2 uses a 28% combined federal and state marginal tax bracket, but the results are more dramatic for taxpayers in higher marginal tax brackets.

Exhibit 3-2

Effective Tax Rate on Cash Received at Various Inflation Rates

Inflation Rate	Inflation Adjustment	Interest Paid (3%)[a]	Total Income	Tax at 28%[b]	Net Cash	Effective Tax Rate on Cash Received
0%	$ —	$ 30.00	$ 30.00	$ 8.40	$ 21.60	28.00%
1%	10.00	30.30	40.30	11.28	19.02	37.23%
2%	20.00	30.60	50.60	14.17	16.43	46.31%
3%	30.00	30.90	60.90	17.05	13.85	55.18%
4%	40.00	31.20	71.20	19.94	11.26	63.91%
5%	50.00	31.50	81.50	22.82	8.68	72.44%
6%	60.00	31.80	91.80	25.70	6.10	80.82%
7%	70.00	32.10	102.10	28.59	3.51	89.07%
8%	80.00	32.40	112.40	31.47	.93	97.13%
9%	90.00	32.70	122.70	34.36	(1.66)	105.08%
10%	100.00	33.00	133.00	37.24	(4.24)	112.84%

Notes:

[a] This table assumes a TIPS that pays a stated interest rate of 3%. (The interest rate used in this exhibit may not reflect the current interest rate environment.)

[b] Assumes taxpayer is in a 28% combined federal and state marginal tax bracket.

* * *

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 should a taxpayer consider the election to convert to the accrual method for U.S. savings bond interest?

    a. Additional current income may go untaxed.

    b. Itemized deductions are of substantial benefit.

    c. Additional current income is taxed at a higher rate than income in the year the bond matures.

    d. The tax rate is substantially higher for the final return of a deceased taxpayer in relation to the estate tax rate.

15. How is a bond swap advantageous to a taxpayer?

    a. It allows taxpayers to delay income from one year to another.

    b. It allows a taxpayer to currently benefit from the decline in a bond's value and either increase or keep the same cash flow generated by the bond.

    c. It requires the owner of the stock to pay the dividends to a counterparty in return for a payment based on a different investment or index.

16. How are bondholders taxed on inflation-indexed bonds?

    a. They are taxed on the interest they receive plus any increase in the principal resulting from the inflation adjustment.

    b. They are taxed at a maximum ordinary rate of 15% or less.

    c. They are taxed at a rate based on the capital gains rates.

17. How does *phantom income* affect a bondholder?

    a. It increases the adjusted gross income (AGI).

    b. It decreases the bond's principal.

    c. It decreases ordinary income.

    d. It decreases the cash flow realized by the holder during the note term.

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 should a taxpayer consider the election to convert to the accrual method for U.S. savings bond interest? **(Page 256)**

    a. **Additional current income may go untaxed. [This answer is correct. A taxpayer should consider the election to convert to the accrual method for U.S. Savings bond interest when additional current income may go untaxed. One example is children who own bonds and are not subject to the kiddie tax.]**

    b. Itemized deductions are of substantial benefit. [This answer is incorrect. Any itemized deductions with little or no benefit because of a low-level taxable income should be considered.]

    c. Additional current income is taxed at a higher rate than income in the year the bond matures. [This answer is incorrect. A taxpayer should consider the election to convert to the accrual method for U.S. savings bond interest when additional current income is taxed at a lower rate, not a higher rate, than income in the year of the bond's maturity.]

    d. The tax rate is substantially higher for the final return of a deceased taxpayer in relation to the estate tax rate. [This answer is incorrect. A taxpayer should consider the election to convert to the accrual method for U.S. savings bond interest when the tax rate is comparatively low for the final return of a deceased taxpayer in relation to the tax rate of the additional income.]

15. How is a bond swap advantageous to a taxpayer? **(Page 256)**

    a. It allows taxpayers to delay income from one year to another. [This answer is incorrect. When investments such as short-term cash investments mature, interest income from CDs maturing in one year or less allows taxpayers to delay income from one year to another.]

    b. **It allows a taxpayer to currently benefit from the decline in a bond's value and either increase or keep the same cash flow generated by the bond. [This answer is correct. The bond swap method is advantageous if the taxpayer currently has capital gains that can be offset by the bond's capital loss, or the taxpayer's overall net capital loss following the bond disposition is $3,000 or less.]**

    c. It requires the owner of the stock to pay the dividends to a counterparty in return for a payment based on a different investment or index. [This answer is incorrect. This rule applies to investors who hold a long and short position in the same stock. This technique is known as a swap transaction, not a bond swap.]

16. How are bondholders taxed on inflation-indexed bonds? **(Page 257)**

    a. **They are taxed on the interest they receive plus any increase in the principal resulting from the inflation adjustment. [This answer is correct. Although bondholders are taxed on the interest they receive plus any increase in the principal resulting from the inflation adjustment, the holder can counterbalance the interest income received during the year of the decrease if the bond's principal decreases as a result of inflation.]**

b. They are taxed at a maximum ordinary rate of 15% or less. [This answer is incorrect. Taxpayers who are taxed at a maximum ordinary rate of 15% or less are taxed at 5% to the extent they would otherwise be taxed at an ordinary rate of 15% or less. This is how capital gains are taxed, not how bondholders are taxed on inflation-indexed bonds.]

c. They are taxed at a rate based on the capital gains rates. [This answer is incorrect. Installment sales gains are an example of gains which are taxed based on capital gains rates. However, bondholders are not taxed on inflation-indexed bonds using the capital gains rates.]

17. How does *phantom income* affect a bondholder? **(Page 258)**

a. It increases the adjusted gross income (AGI). [This answer is incorrect. This is an example of how taxable income indirectly affects a taxpayer's tax liability because of the effect the income has on other tax items.]

b. It decreases the bond's principal. [This answer is incorrect. A bond's principal can decrease because of inflation, not because of *phantom income*.]

c. It decreases ordinary income. [This answer is incorrect. When a taxpayer has a long-term capital gain that is partly taxed at the 5% rate, any deduction that decreases ordinary income will also simultaneously decrease the tax rate on a comparable amount of long-term capital gain from 15% to 5%. This has no effect on how the *phantom income* affects a bondholder.]

d. It decreases the cash flow realized by the holder during the note term. [This answer is correct. Even though a bondholder does not receive payment for inflationary increases until a bond matures, the inflationary increases to the bond's principal are taxed. This produces a phantom income to the holder because tax is being paid on income that is currently not being received.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (TINTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

12. For bond interest to be taxable, it must be paid by which of the following?

    i. States.

    ii. Political Subdivisions.

    iii. Corporations.

    iv. U.S. Treasury.

    v. Cities.

    vi. Certain federal government agencies.

    a. i, ii, v.

    b. iii, iv, vi.

    c. i, iii, iv.

    d. iii, iv, v.

13. What is the advantage of amortizing a bond premium?

    a. The taxpayer can reverse the election to deduct the premium paid on a taxable bond over the life of the bond.

    b. For premium bonds issued after September 27, 1985, any reasonable method of accounting is allowed.

    c. The net earnings are not subject to SE tax.

    d. A portion of ordinary income from the bond can be offset by the taxpayer.

14. What happens to the early redemption of a taxable bond purchased at a premium if a taxpayer chooses to amortize the premium?

    a. The capital gain or loss will equal the difference between the redemption price and the original cost less the premium amortization to date.

    b. The capital gain or loss will equal the difference between the sales price and the original cost.

    c. The capital gain or loss will equal the difference between the sales or redemption price and the original cost less the premium amortization to date.

    d. The capital gain or loss will equal the difference between the debt instrument's issue price and its principal amount.

15. What happens to a taxable bond that is held to maturity and did not have the premium amortized?

    a. The bond will have a tax basis equal to its face value.

b. The tax basis will be equal to the initial cost of the bond, including the bond premium.

c. The tax basis is taxed as ordinary income.

d. The tax basis is equal to the sales difference of the original cost and redemption price.

16. The phrase "defers taxes on interest until maturity with inflation protected growth" best describes which of the following?

    a. Series E savings bonds.

    b. Series EE savings bonds.

    c. Series H savings bonds.

    d. Series I savings bonds.

17. Gifting a savings bond is most profitable for which of the following?

    a. A donor with little income yet to be earned on the bond and the donee is in a lower tax bracket.

    b. A donor in a lower tax bracket than the donee and the savings bond has ample income yet to be earned.

    c. A donor in a higher tax bracket than a donee with substantial income yet to be earned on the savings bond.

    d. Do not select this answer choice.

18. Which of the following is correctly matched?

1. Qualified bonds	a. Ideal for investors who want safety and liquidity
2. Municipal bonds	b. Proceeds are used for qualified residential rental projects
3. Treasury bonds	c. Carry a lower stated interest rate than taxable bonds
4. Series E bonds	d. Can be transferred to a revocable living trust without triggering income

    a. 1; b.

    b. 2; a.

    c. 3; b.

    d. 4; c.

19. The coupon bond method and the discount bond method generally used to account for the bond's stated interest and original interest is discounted by holder of which of the following?

    a. Holders of Treasury Notes.

    b. Holders of Treasury Inflation-protection Securities (TIPS).

    c. Holders of Treasury STRIPs.

    d. Holders U.S. Savings Bonds.

Lesson 4: Tax Planning for Stock Transactions

INTRODUCTION

The tax basis of each share of stock is generally equal to its original cost. However, basis may be impacted by stock dividends, stock splits, or exercise of stock warrants.

Two methods exist for identifying shares of stock sold when taxpayers sell less than their entire holdings in a particular stock: (a) the first-in, first-out (FIFO) method and (b) the specific identification method.

Under the FIFO method, if the stock or securities have been acquired on different dates or at different prices and the taxpayer does not or cannot identify the specific shares sold, they are considered to be sold in the order they were purchased.

Alternatively, if the taxpayer chooses to use the specific identification method and specifically identifies the shares sold, the basis and holding period of those shares is used in computing the character (short-term or long-term) and amount of the 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, (a) the taxpayer must, at the time of sale, specify to the broker which shares are to be sold, and (b) 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.

Taxpayers can use the specific identification method to sell shares with the highest basis, thereby reducing the recognized gain or increasing the recognized loss. Additionally, taxpayers may be able to select shares with specific holding periods. This can be of benefit since long-term capital gains are taxed at a maximum rate of 15% in 2010 if the capital asset is held more than 12 months, while short-term capital gains (gains from capital assets held one year or less) are taxed at ordinary income rates that can be as high as 35% in 2010.

Learning Objectives:

Completion of this lesson will enable you to:

- Apply the specific identification method and holding period rules to reduce tax.
- Recognize ordinary losses for Section 1244 Stock, and apply the rules for gains from small business stock.
- Identify tax losses by avoiding wash sales.
- Obtain a deduction for worthless securities and determine when stock dividends and splits are taxable, and structure securities transactions so as not to trigger a constructive sale.

Using the Holding Period Rules to Reduce Tax. A nondealer's sale of securities results in long-term or short-term capital gain or loss depending on the securities' holding period. Holding periods for determining capital gains rates on securities sales are as follows: (a) 12 months or less is short-term, and (b) more than 12 months is long-term.

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 taxpayer's overall method of accounting does not affect the year in which the transaction is reported, and gain or loss must be reported in the tax year in which the disposition (i.e., trade date) falls.

> **Example 4-1: Using the trade date to identify year-end sales.**
>
> Jeff sold publicly traded stock he had held for several years at a gain on December 29, 2010. The stock was delivered to the broker and Jeff received the sale proceeds on January 3, 2011.
>
> For tax purposes, the sale occurred on the trade date, December 29, 2010. The gain must be reported on Jeff's 2010 tax return, even though he did not receive the sale proceeds until 2011.

Example 4-2: Determining if the one-year holding period is met.

Jane purchased publicly-traded stock on April 16, 2008 (so her holding period began on the following day, April 17, 2008). If she sells the stock on or before April 16, 2009, her holding period is not more than one year so her gain or loss is short-term. On the other hand, if she sells the stock after April 16, 2009 her gain or loss is long-term since her holding period exceeds one year.

Stock can be acquired other than by direct purchase, which may impact how the holding period is determined. These include the following:

a. *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.

b. *Dividend Reinvestment Plans.* When a shareholder buys company stock under a dividend reinvestment plan, either from 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.

c. *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.

d. *Stock Received as a Gift.* When a taxpayer receives a gift of stock and his basis in the stock is the same as the donor's basis, the donor's holding period tacks on to the donee's. However, if the donee's basis in the gifted stock is 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.

e. *Inherited Stock.* Property inherited from a decedent is automatically deemed to be held more than one year. Therefore, the sale or exchange of inherited stock results in long-term treatment regardless of how long the heir actually held it. It is unclear whether a long-term holding period will apply after 2009, when estate tax repeal and modified carryover basis rules are in effect. Practitioners should monitor this area for legislation.

f. *Stock Acquired under an Employee Stock Option Plan.* The holding period of stock acquired by the exercise of a stock option begins on the date after the option is exercised.

g. *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.

h. *Employer Stock Received from an Employer's Retirement Plan.* If a taxpayer receives employer stock in a distribution from the employer's retirement plan, his holding period in the stock begins on the day after the plan trustee delivers the stock to the transfer agent with instructions to reissue the stock in the taxpayer's name. However, to the extent the distributed stock includes net unrealized appreciation excluded from the recipient's income at the time of distribution under IRC Sec. 402(e)(4) (because it is either a lump-sum distribution or attributable to nondeductible employee contributions), gain from the subsequent sale automatically receives long-term treatment to the extent of such net unrealized appreciation. The long-term or short-term nature of any gain in excess of that amount depends on the taxpayer's actual holding period.

i. *Insurance Company Demutualization.* In recent years, a number of mutual insurance companies (i.e., companies owned by the policyholders and annuitants) have converted to stock companies (i.e., companies owned by the stockholders). This process, called *demutualization*, normally results in the company's policyholders and annuitants receiving stock or cash in exchange for their equity interest. Typically, demutualizations are structured as Section 368 tax-free reorganizations. The IRS has ruled that the policyholder's basis in the equity interest given up is zero, so that the stock received in the exchange will have a zero basis, and any cash received will result in capital gain. This conclusion is based on the IRS' position that none of the policyholder's basis in the insurance contract is assigned to the ownership interest.

(This position is also reflected in the Schedule D instructions, and has been followed by many insurance companies in the advice they have given owners regarding the tax consequences of demutualization.) However, some commentators have suggested that the mutual company insurance contract represents a right to both insurance protection and equity ownership and that these rights are inseparable. Thus, the policyholders' basis in the contract should be attributed to the equity interest that is exchanged for stock in the demutualization. This basis would carry over to the stock received, and could limit the amount of gain recognized with respect to any cash received. Treasury appealed the *Fisher* case to the Federal Circuit Court of Appeals where the lower court's decision was affirmed. The IRS can appeal this latest decision to the Supreme Court or ask for a rehearing. Practitioners should monitor this issue for developments.

Coordinating the Share Identification and Holding Period Rules. The specific identification method for identifying shares sold must be used in view of the various capital gains rates. Identifying shares so a sale results in the smallest gain possible does not necessarily equate to the smallest tax liability for the sale. Thus, an analysis requires considering both basis and holding period when specifically identifying the shares sold. In addition, the investor's other capital gains and losses may also impact the decision of selecting which shares to sell.

Example 4-3: Coordinating the share identification and holding period rules.

Thomas Henderson owns 10,000 shares in the Acme Company. The basis in the shares are different because he purchased the stock over a period of time. He is in the 35% marginal tax bracket.

On June 16, 2010, the stock is trading at $35 per share. Thomas wants to sell 5,000 shares. Sales proceeds will be $175,000. The following schedule illustrates the purchase dates and prices of Thomas' shares as well as the capital gains tax rate that would apply to him for each of the lots:

Transaction Number	Number of Shares	Acquisition Date	Purchase Price per Share	Capital Gain (Applicable Tax Rate)
1006	2,200	6/15/99	$ 11	Long-term (15%)
1138	1,500	3/23/04	22	Long-term (15%)
1624	1,500	10/21/05	24	Long-term (15%)
2001	2,000	12/18/07	29	Long-term (15%)
2050	1,300	8/14/08	15	Short-term (35%)
3775	1,500	3/12/09	25	Short-term (35%)

Thomas' capital gain and tax from the sale varies depending on the method used to identify shares sold. The following summarize three different results:

FIFO Method for Identifying Shares Sold

Transaction Number	Number of Shares	Sales Price per Share	Purchase Price per Share	Capital Gain	Capital Gains Tax Rate	Tax
1006	2,200	$ 35	$ 11	$ 52,800	15%	$ 7,920
1138	1,500	35	22	19,500	15%	2,925
1624	1,300	35	24	14,300	15%	2,145
Totals	5,000			$ 86,600		$ 12,990

Specific Identification to Minimize Gain

Transaction Number	Number of Shares	Sales Price per Share	Purchase Price per Share	Capital Gain	Capital Gains Tax Rate	Tax
1624	1,500	$ 35	$ 24	$ 16,500	15%	$ 2,475
2001	2,000	35	29	12,000	15%	1,800
3775	1,500	35	25	15,000	35%	5,250
Totals	5,000			$ 43,500		$ 9,525

Specific Identification to Minimize the Tax Liability

Transaction Number	Number of Shares	Sales Price per Share	Purchase Price per Share	Capital Gain	Capital Gains Tax Rate	Tax
1138	1,500	$ 35	$ 22	$ 19,500	15%	$ 2,925
1624	1,500	35	24	16,500	15%	2,475
2001	2,000	35	29	12,000	15%	1,800
Totals	5,000			$ 48,000		$ 7,200

New Basis and Character Reporting Rules for Stock Sales

Under a tax law change enacted as part of the Energy Improvement and Extension Act of 2008 (2008 Energy Act), generally effective on January 1, 2011, every broker that is required to file an information return reporting the gross proceeds of a stock sale must include in the return the customer's adjusted basis in the stock and whether any gain or loss with respect to the stock's sale is short term or long term.

The stock's adjusted basis is determined on an account-by-account basis using the first-in first-out (FIFO) method unless the customer notifies the broker to use an alternative means of making an adequate identification of the stock sold or transferred. Except as otherwise provided, the customer's adjusted basis is determined without regard to Section 1091 (relating to disallowed loss from wash sales of stock or securities) unless the transactions occur in the same account with respect to identical securities.

This new reporting requirement pertains to stock acquired after January 1, 2011 through a transaction in the account in which the stock is held or stock that was transferred to that account from an account in which the stock was subject to the reporting requirement, but only if the broker received a statement under Section 6045A regarding the transfer. Reporting for a short sale under Section 6045 will be made for the year in which the sale is closed, rather than, as under currently applicable rules for gross proceeds reporting, the year in which the short sale is entered into.

SELF-STUDY QUIZ

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

18. Which of the following methods is used to sell shares of stock with the highest basis, thus reducing the recognized gain or increasing the recognized loss?

    a. Specific identification.

    b. First-in, first-out (FIFO).

    c. Average basis method.

19. What type of stock is involved when the donor's holding period tacks on to the donee's holding period?

    a. Stock dividends.

    b. Stock received as a gift.

    c. Stock acquired under an employee stock option plan.

    d. Dividend reinvestment plans.

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.)**

18. Which of the following methods is used to sell shares of stock with the highest basis, thus reducing the recognized gain or increasing the recognized loss? **(Page 267)**

    a. Specific identification. [This answer is correct. The specific identification method is generally used by taxpayers to sell shares with the highest basis which reduces the recognized gain or increases the recognized loss. This method also allows taxpayers to choose shares with specific holding periods.]

    b. First-in, first-out (FIFO). [This answer is incorrect. Securities are considered sold in the order purchased under this method if the securities or stock was acquired on different dates or prices and the taxpayer cannot or does not identify the specific shares sold.]

    c. Average basis method. [This answer is incorrect. Under this method, the average basis is calculated using either the single or double category methods.]

19. What type of stock is involved when the donor's holding period tacks on to the donee's holding period? **(Page 268)**

    a. Stock dividends. [This answer is incorrect. The holding period for new stock is the same as the old shares on which the dividend was based if the stock dividend is nontaxable.]

    b. Stock received as a gift. [This answer is correct. A donor's holding period tacks on to the donee's holding period when the taxpayer receives a gift of stock and the stock's basis is the same as the donor's basis.]

    c. Stock acquired under an employee stock option plan. [This answer is incorrect. For any stock acquired under an employee stock option plan, the holding period begins on the day after the option is exercised.]

    d. Dividend reinvestment plans. [This answer is incorrect. When stock is purchased under the dividend investment plan, the participating shareholder's holding period begins on the day following the day on which the shares are credited to the participant's account.]

Claiming Ordinary Losses for Section 1244 Stock

IRC Sec. 1244 encourages new investment in small business by permitting investors to claim an ordinary (rather than a capital) loss on disposition (including worthlessness) of qualifying small business stock. As an added benefit, any loss that qualifies as an ordinary loss under IRC Sec. 1244 is also treated as a trade or business loss in computing an individual's net operating loss (NOL). Thus, Section 1244 losses are allowed for NOL purposes without being limited by nonbusiness income.

Example 4-4: Utilizing Section 1244 stock losses.

In 2000, Steve contributed $150,000 cash to his corporation, Steveco, in exchange for stock. The business never attained the success Steve had originally envisioned. In 2010, Steve sold his stock in Steveco to an unrelated party for $40,000. Steve's tax loss on his sale of stock is $110,000 ($40,000 proceeds − $150,000 stock basis). The stock qualified as Section 1244 stock. Steve files a joint return with his wife, Sally.

In the year of sale, Steve can claim a $100,000 ordinary loss deduction (Section 1244) and a $10,000 capital loss. If Steve has no 2010 capital gains, his capital loss is limited to $3,000 (with the balance carried forward), but his ordinary deduction is allowed in full in 2010 (assuming he has adequate taxable income).

Variation: Assume instead that Steve sells 90% of his Steveco stock in 2010 for $36,000 and the remaining 10% in early 2011 for $4,000. Steve's tax loss on his 2010 stock sale is $99,000 [$36,000 proceeds − ($150,000 stock basis × 90%)]. Steve's tax loss on his 2011 stock sale is $11,000 [$4,000 proceeds − ($150,000 − $135,000)]. By structuring the sale of stock over two years, Steve is able to avoid the $100,000 annual limitation on Section 1244 losses. Therefore, Steve can claim a $110,000 ($99,000 in 2010 + $11,000 in 2011) ordinary loss deduction (Section 1244) and avoid a capital loss on the stock sale.

Practitioners should always attempt to structure a corporation so that the stock qualifies for Section 1244 treatment. There is no election necessary. No penalty exists for attempting to qualify stock for Section 1244 treatment. The only result of failure is that the stock is treated the same as it would if no attempt had been made. In many cases, no special planning is needed. Many small corporations will qualify for Section 1244 treatment because of the nature and size of their business. Practitioners should also be alert for sales of stock that may qualify for Section 1244 loss treatment. This is particularly true for sales of closely held or other nonpublicly traded stock.

Meeting the Section 1244 Requirements. To qualify as small business stock under IRC Sec. 1244, certain requirements must be met when the stock is issued and in the year of loss.

For stock to be considered Section 1244 stock, the following requirements must be met as of the date of issuance:

a. *Small Business Corporation.* The corporation issuing the Section 1244 stock must be a small business corporation. A domestic corporation (including an S corporation) is a small business corporation if, when the stock is issued, the total amount of money and property received by the corporation for stock (or as a contribution to capital or as paid-in-surplus) does not exceed $1 million. This determination is made each time stock is issued and includes the amount received by the corporation when issuing that specific stock. In the year the $1 million threshold is exceeded, the corporation may designate the shares to be treated as Section 1244 stock. If no designation is made, the remaining Section 1244 benefit is allocated among all shares issued that year.

b. *Solely Cash or Property.* The stock must be issued in exchange for cash or other property (other than stock and securities). Thus, stock issued in exchange for services does not qualify. (If possible, the corporation should pay shareholders in cash for the services rendered and then permit them to buy the stock, if desired.) Stock issued in exchange for stock or securities, including stock of the issuing corporation, normally does not qualify for Section 1244 treatment. However, stock received in (1) certain stock dividend transactions, (2) a Type E reorganization (a recapitalization) under IRC Sec. 368(a)(1)(E), or (3) a Type F reorganization (a change in identity, form, or place of organization) under IRC Sec. 368(a)(1)(F) can qualify.

c. *Original Owner.* The stock must be issued directly to the original owner—who is the only one entitled to claim a Section 1244 loss. In addition, such owner must be an individual or a partnership. In the case of a Section 1244 loss passed through a partnership, the loss is deductible only by individuals who were partners both when the stock was issued to the partnership and when the loss is sustained (and then only to the extent that their partnership interest has not decreased since the stock was purchased by the partnership). Any Section 1244 stock held by a partnership and subsequently distributed to partners is not Section 1244 stock in the partners' hands.

d. *Common or Preferred Stock.* Section 1244 stock can be either common or preferred stock, provided the preferred stock was issued after July 18, 1984. Common stock does not include securities convertible into common stock, nor common stock convertible into other securities. For common stock issued before November 7, 1978, other requirements must be met.

For stock to be considered Section 1244 stock in the year the shareholder realizes the loss, the corporation must meet a gross receipts test. Under this test, during the five most recent tax years ending before the date the loss was sustained by the shareholder (or the life of the corporation, if less than five years), the corporation must have derived more than 50% of its aggregate gross receipts from sources *other than* royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities.

The gross receipts requirement does not apply if the corporation's cumulative deductions (excluding the NOL carryover and carryback deduction and the special dividend received deductions) exceed its cumulative gross income during the five-year testing period.

However, even if the gross receipts test is passed, the stock will qualify as Section 1244 stock only if the corporation is an operating company for the five-year testing period. It must not be a mere holding or investment company (e.g., a corporation that acquires and holds nonincome-producing real estate).

Subsequent Capital Contributions. To qualify for Section 1244 treatment, stock must be issued. Any additional stockholder contributions treated as paid in capital will not qualify for Section 1244 treatment even though such contributions increase the shareholder's basis in the stock. Such basis increases are considered non-Section 1244 stock.

Example 4-5: Stock must be issued for capital contributions to be eligible for Section 1244 treatment.

Jay contributes $10,000 to a new corporation in exchange for stock. One year later, he contributes another $5,000 as additional paid in capital but receives no stock. Two years later the stock is worthless. Only the original $10,000 contribution (in exchange for stock) qualifies as Section 1244 stock. Since no stock was issued for the $5,000 additional paid in capital, Section 1244 does not apply to that capital contribution. In the year of worthlessness, Jay can claim a $10,000 ordinary loss deduction (Section 1244) and a $5,000 capital loss.

Variation: Assume Jay's stock is not worthless and he sells it for $12,000, resulting in a $3,000 loss. The amount of Section 1244 loss is calculated as follows:

$$\frac{\$10,000 \text{ Section 1244 stock}}{\$15,000 \text{ total basis}} \times \$3,000 \text{ loss recognized} = \$2,000 \text{ Section 1244 loss}$$

S Corporation Stock Basis Adjustments. Under IRC Sec. 1367(a)(1), the basis of an S corporation shareholder's stock is increased for various items of pass-through income. An increase in basis caused by the pass-through of income does not qualify for Section 1244 treatment. A loss on stock with a disqualifying basis increase must be allocated based on the ratio of the stock's qualifying Section 1244 basis to its total basis.

However, the regulations do not define an increase in basis for this purpose. It is unclear whether this refers to any specific increase due to pass-through items in any given year or cumulative net increases in basis from the date the stock is acquired up through its disposition date. It is the authors' opinion that Section 1244 treatment is allowed to the extent of the shareholder's original investment in the stock; that is, increases in basis due to pass-through items are allowed, but only to the extent these increases have restored basis reductions from the pass-through of previous losses.

Shareholder Recordkeeping. Shareholders who own both Section 1244 stock and non-Section 1244 stock in a corporation must maintain sufficient records to enable the IRS to distinguish between the two types of stock.

In addition, if the stock becomes completely worthless and cannot be sold, the shareholder must maintain adequate records to prove the stock's worthlessness (i.e., that the stock has no realizable value). Examples of evidence supporting worthlessness include the following:

a. Financial statements of the corporation showing financial condition.

b. Corporate income tax returns.

c. Letters from creditors of the corporation.

d. Copies of corporate minutes describing the company's financial condition.

e. Bankruptcy documents of the corporation.

f. Corporate dissolution documents.

g. Going-out-of-business notices to the public.

As a practical matter, the shareholder should assemble as much evidence as possible rather than rely on one item to establish worthlessness. For example, corporate dissolution documents in and of themselves probably would not be sufficient to establish worthlessness. Each case depends on the amount and character of the evidence presented by the shareholder.

Corporate Recordkeeping. The corporation should keep the following records *at the time the stock is issued*:

a. The names of the person to whom the stock was issued.

b. Date of issuance of Section 1244 stock to the persons in the first item.

c. Description of the amount and type of consideration received by the corporation from each shareholder, including (if the consideration received in property) the property's adjusted basis in the hands of the shareholder and its FMV when received by the corporation.

d. A breakdown of money and basis in the hands of the corporation of property received in exchange for stock, as a contribution to capital, or as paid-in surplus.

e. Information regarding any tax-free stock dividends or Type E or F tax-free reorganizations.

The corporation should also retain tax returns for the five most recent years preceding the year in which a shareholder claims a Section 1244 loss (or the years of the corporation's existence, if less). This will prove compliance with the gross receipts test.

Special Rules for Gains from Small Business Stock

Owners of qualified small business stock can take advantage of two special rules that apply if the stock is sold at a gain. Under IRC Sec. 1202, 50% (75% for stock acquired after February 17, 2009 and before January 1, 2011, as amended by the American Recovery and Reinvestment Act of 2009) of the capital gain on the sale of qualified small business stock can be excluded from income if certain conditions are met. Alternately, IRC Sec. 1045 allows taxpayers to rollover gain from the sale of qualified small business stock.

Excluding 50% of Gain from Sale of Qualified Small Business Stock. IRC Sec. 1202 allows noncorporate taxpayers to exclude from gross income 50% of any gain from the sale or exchange of *qualified small business stock* acquired before February 18, 2009 or after December 31, 2010 and held for more than five years. The term qualified small business stock does not include options to acquire stock (*Natkunanathan*). This provision applies to stock issued after August 10, 1993. The 50% capital gain exclusion removes some of the double taxation tax cost that applies to ownership of stock in C corporations. If the corporation needs to retain income, the lower corporate tax rates on the first $75,000 of taxable income, combined with the 50% capital gain exclusion, may make the use of a qualified small business quite attractive.

Status as a qualified small business corporation (QSBC) is not a matter of choice (i.e., no election is required) but an opportunity to save taxes if the fairly restrictive qualification requirements can be met. The major problems with qualification are the limits on the size of the business, types of eligible businesses, and types of assets a corporation can have and still meet the definition of a qualified small business. In addition, S corporation shareholders do not qualify for the gain exclusion tax break.

Gains from the sale of QSBS held more than one year but not more than five years are taxed at the regular long-term capital gain rate of 15% (in 2010). Thus, there is only a 1% rate advantage to meeting the five-year holding requirement and obtaining the 50% exclusion under IRC Sec. 1202 (so the effective tax rate is 14%). This diminishes the benefit of IRC Sec. 1202, at least through 2010. Beginning in 2011, the regular long-term capital gain rate is currently scheduled to return to 20% so the difference between the two rates will be 6% (20% regular long-term capital gain rate versus 14% effective rate under IRC Sec. 1202). Thus, it still makes sense to meet the QSBS requirements when possible, since the stock may be sold when the capital gains are taxed a higher rate than 15%. Also, the ability to roll over gains on QSBS remains an advantage.

Example 4-6: Combined effective tax rate on qualified small business stock income.

Tipton, Inc. issues QSBS to its shareholders. The corporation has a marginal corporate tax rate of 34%. Assume Tipton's taxable income minus the corporate income tax it pays increases the value of its stock dollar for dollar. When shareholders sell the stock, after meeting the five-year holding period, corporate income is effectively taxed again at a 9.24% rate {shareholder's gain includes 66% of corporate income, the amount remaining after corporate level tax; gain is 50% excludable and then taxed at a 28% capital gains rate [(100% − 34%) × 50% × 28%]}. Thus, the combined corporate and shareholder effective tax rate for Tipton and its shareholders is 43.24% (34% + 9.24%). This is fairly close to the maximum 2010 rate of 35% for income from pass-through entities and therefore relieves a large portion of the double-taxation tax cost that applies to shareholders in a C corporation.

If the corporate-level rate is less than 34%, so much the better. A corporate-level rate of 15% results in a combined effective tax rate of only 26.9% {[(100% − 15%) × 50% × 28% = 11.9%] at the shareholder level when the stock is sold + 15% at the corporate level}.

Excluding 75% of Gain from Sale of Qualified Small Business Stock. The 2009 Recovery Act increased the 50% capital gain exclusion from the sale or exchange of QSBS held more than five years to 75% for qualified stock acquired after February 17, 2009 and before January 1, 2011 (as amended by the 2009 Recovery Act). Therefore, the effective regular tax rate applicable to such sale is 7% (28% × 75%). However, the excluded gain is an AMT preference item. Thus, if the entire preference is subject to the 28% AMT rate, the effective rate on the gain for taxpayers subject to AMT is 12.88% {[25% + (75% × 28%)] × 28%}.

Example 4-7: 75% Gain Exclusion on QSBS Stock.

Harley Oaks, an unmarried individual, acquired 100 shares of QSBS in March, 2010 at a total cost of $100,000. He subsequently sells the stock in April, 2018 for $1.1 million. This is the only QSBS stock Harley has ever owned. He can exclude $750,000 [(75% × ($1,100,000 − $100,000)] of the gain on his 2018 individual federal tax return.

Calculating the Gain Exclusion Limits. IRC Sec. 1202(b)(1) limits the amount of gain eligible for the 50% (75% for stock acquired after February 17, 2009 and before January 1, 2011) exclusion in a tax year with respect to a particular QSBS to the greater of—

a. 10 times the taxpayer's aggregate adjusted basis in the qualified small business stock that is sold, or

b. $10 million ($5 million for married filing separate status) reduced by the amount of eligible gain taken into account in prior tax years for dispositions of stock issued by the same corporation. This limitation is a lifetime per corporation limitation—it applies to the cumulative gains from dispositions of qualified small business stock.

There is no carryover of eligible gain when a limitation applies. If a married taxpayer filing a joint return is limited by the $10 million eligible gain limitation for a particular QSBS, the maximum gain that can be excluded is limited to $5 million (50% of the $10 million eligible gain limitation). However, if the 10 times the basis limitation applies, there is no fixed dollar cap on the amount of gain eligible for the 50% (75% for stock acquired after February 17, 2009 and before January 1, 2011) (75% for stock acquired after February 17, 2009 and before January 1, 2011, as amended by the American Recovery and Reinvestment Act of 2009) exclusion—the eligible gain limitation depends on the basis of the stock.

Example 4-8: $10 million eligible gain limitation.

Tom and Glenda Henderson, who file a joint return, sold qualified small business stock with a basis of $600,000 for a gain of $30 million in 2010. This was the first time they sold stock in that corporation. The maximum gain eligible for the 50% exclusion is the greater of $6 million (10 times the basis of the stock sold) or $10 million reduced by eligible gain taken into account in prior tax years (i.e., $10 million minus zero). Thus, the Hendersons can exclude $5 million of gain from gross income (50% of $10 million).

Example 4-9: 10 times the basis limitation.

Steve and Nancy Larsen, who file a joint return, sold qualified small business stock with a basis of $3 million for a gain of $8 million in 2010. They had taken eligible gains of $7 million into account in earlier tax years related to this same corporation. The maximum gain eligible for exclusion is the greater of $30 million (10 times the basis) or $3 million ($10 million less the $7 million "used up"). Thus, the Larsens' entire $8 million gain is eligible for the 50% exclusion (under the 10 times the basis limitation), and they can exclude $4 million of gain.

If a taxpayer contributes appreciated property in return for stock, the property's basis is its FMV on the contribution date for purposes of computing the gain potentially eligible for exclusion and for applying the 10 times the stock basis limitation rule.

Rollover of Gain Election. IRC Sec. 1045 allows taxpayers to elect to roll over gain from the sale of qualified small business stock if stock in another qualified small business is acquired within 60 days beginning on the date of the sale. For this purpose, qualified small business stock has the same meaning as for IRC Sec. 1202.

For purposes of the Section 1045 gain rollover rule, the replacement stock must meet the active trade or business requirement described in IRC Sec. 1202(c)(2) for the six-month period following its purchase. The holding period of the stock purchased will generally include that of the stock sold.

Meeting the Requirements for Qualified Small Business Stock. Qualified small business stock is stock originally issued after August 10, 1993 by a C corporation with aggregate gross assets of $50 million or less for all times from August 10, 1993 to immediately after the stock is issued. 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, banking and other financial services, farming, mineral extraction businesses, and hotels and restaurants. Businesses such as manufacturing, wholesale or retail trade, and transportation activities generally qualify. QSBS stock can be acquired either in exchange for money or other property (but not stock) or as compensation for services.

SELF-STUDY QUIZ

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

20. Which of the following statements regarding qualifying for Section 1244 treatment is most accurate?

    a. The corporation's size often determines eligibility for Section 1244 treatment.

    b. Corporations must make a special election to qualify for Section 1244 treatment.

    c. A corporation can be fined for not attempting to qualify for Section 1244 treatment.

21. How are losses treated with respect to calculating an individual's net operating loss (NOL) when qualifying as ordinary losses under IRC Sec. 1244?

    a. Capital loss.

    b. Business loss.

    c. Passive loss.

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.)**

20. Which of the following statements regarding qualifying for Section 1244 treatment is most accurate? **(Page 273)**

    a. The corporation's size often determines eligibility for Section 1244 treatment. [This answer is correct. The size and nature of a corporation determines the corporation's Section 1244 treatment. Often, small corporations qualify for Section 1244 treatment because of the size and nature of their business.]

    b. Corporations must make a special election to qualify for Section 1244 treatment. [This answer is incorrect. No election is necessary per the Section 1244 requirements.]

    c. A corporation can be fined for not attempting to qualify for Section 1244 treatment. [This answer is incorrect. Corporations are not subject to any penalties for failure to qualify for Section 1244 treatment.]

21. How are losses treated with respect to calculating an individual's net operating loss (NOL) when qualifying as ordinary losses under IRC Sec. 1244? **(Page 273)**

    a. Capital loss. [This answer is incorrect. Capital losses offset capital gains and, to the extent there is an excess loss, up to $3,000 can be deducted for the tax year with the remainder carrying forward to future tax years.]

    b. Business loss. [This answer is correct. The losses that qualify as ordinary losses under IRC Sec. 1244 are treated as trade or business losses when calculating an individual's NOL. Therefore, Section 1244 losses are allowed for NOL purposes without being limited by nonbusiness income.]

    c. Passive loss. [This answer is incorrect. Passive losses are only used to offset passive income.]

Preserving Tax Losses by Avoiding the Wash Sale Rules

A taxpayer cannot deduct the loss realized on the sale of stock or securities (including shares in a mutual fund) if the taxpayer purchases substantially identical stock or securities within the period beginning 30 days before and ending 30 days after the sale.

The wash sale rules apply to stock, securities, options, and short sales; they do not apply to transactions involving foreign currency and commodities. These rules apply whether the taxpayer voluntarily or involuntarily disposes of the stock or securities. Thus, the taxpayer must be careful when replacing stock that was sold at a loss. Dealers in stocks or securities are not subject to these rules if the sale is made in the ordinary course of business.

For the wash sale rules to apply, the stocks or securities must be substantially identical. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation.

Some taxpayers have tried to circumvent the wash sale rules by having a related party purchase the replacement stock or securities. Although IRC Sec. 1092 and the regulations do not apply the wash sale rules to related parties, the courts generally have not allowed the loss in these situations. The courts have ruled that the replacement was part of the original plan or, in some cases, have ruled 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. Taxpayers and their IRAs are related parties. Thus, the sale of an asset at a loss would be disallowed if, as part of a plan, the taxpayer's IRA purchased an identical asset. However, if the acquisition of an identical asset by a related party is a purely coincidental, rather than prearranged, the transaction is not subject to the related party loss disallowance rules.

A loss that is not recognized under the wash sale rules is generally deferred; that is, the basis in the substantially identical stock or securities is increased by the amount of the disallowed loss and may be recognized on a subsequent sale. In addition, the holding period of the acquired securities includes that of the original stock sold.

Example 4-10: Loss deferred under the wash sale rules.

Harry acquired 100 shares of Sterling Corp. on October 12, 2008, for $30 per share. On November 16, 2010 Harry buys another 100 shares for $15 per share. On December 11, 2010, he sells his original 100 shares for $12 per share for a long-term capital loss of $1,800 ($1,200 sales proceeds less $3,000 basis). On January 4, 2011, he sells his remaining 100 shares for $16 per share.

Under the wash sale rules, Harry cannot recognize the $1,800 loss from the December 11, 2010, sale because he acquired 100 shares of the same stock within 30 days of the sale. Instead, the $1,800 loss is added to the basis of the shares he purchased on November 16, 2010. The holding period of those shares is also added on. When he sells his remaining shares on January 4, 2011, he recognizes a long-term capital loss of $1,700 ($1,600 sales proceeds less $3,300 basis).

A wash sale can be used to generate long-term capital gain treatment should the stock subsequently increase in value. Conversely, it can also turn a short-term loss into a less desirable long-term loss.

Example 4-11: Using the wash sale rules to generate long-term capital gain treatment.

In March 2010, John recognized a short-term loss of $2,000 on the sale of 100 shares of Yarco, Inc. that he had purchased in April 2009 (i.e., held for 11 months). Two weeks after the sale, the stock price decreased further to the point John felt he could make money on the stock in the short term. He repurchased 100 shares of Yarco stock within 30 days of the sale; therefore, the first sale is a wash sale, and the loss is not recognized. The basis in the new stock is adjusted for the disallowed loss and the 11 month holding period from the first sale tacks on to the new stock.

John sold the Yarco stock in November 2010 at a $4,000 gain. John is taxed on the gain at the long-term capital gain rate since he is deemed to have held the stock more than 12 months (April 2009–November 2010).

A call option causing a wash sale might also be used to convert a long-term capital loss into a short-term loss. Although there is no direct authority addressing this strategy, it appears the following sequence of events allow this: (a) sell long-term stock at a loss; (b) purchase a call option within 30 days of the stock sale so the loss is disallowed under the wash sale rules; (c) exercise the call option and sell the newly acquired stock at a loss (due partly to the increased basis resulting from the wash sale). Under IRC Sec. 1223(4), the holding period of the stock or security causing the wash sale includes the holding period of the stock or security sold at a loss. Thus, the call option has a holding period that includes the stock originally sold at a loss (and disallowed under the wash sale rules). When the call option is exercised, the newly acquired shares have a holding period beginning on the following day. Exercising the call option effectively resets the holding period for the stock.

Example 4-12: Using a call option and a wash sale to convert loss from long-term to short-term.

Jack sells 100 shares of Acme stock, realizing a $3,000 long-term capital loss. Immediately thereafter, he pays $500 for a call option to purchase 100 shares of Acme stock. Purchasing the option causes the stock loss to be disallowed under the wash sale rules. The $3,000 loss is added to the basis in the call option he purchased.

Soon thereafter, he exercises the call option and acquires 100 shares of Acme stock for $5,000. The cost of the option plus the disallowed wash sale loss are added to the basis of the newly acquired Acme shares, resulting in a total basis of $8,500 ($5,000 + $500 + $3,000). The holding period of the newly acquired Acme shares begins on the day following the day the option is exercised. Several months later, Jack sells the 100 shares of Acme stock for $5,200, resulting in a short-term loss of $3,300. Through this series of transactions, Jack has essentially converted what originally was a $3,000 long-term capital loss into a short-term capital loss.

Obtaining a Deduction for Worthless or Abandoned Securities

A taxpayer is allowed a capital loss for securities held as capital assets if the investment becomes worthless. However, the loss is allowed only in the year the stock or security becomes completely worthless; partial losses are not allowed. Such losses are generally long-term or short-term capital losses, depending on holding period; however, losses from Section 1244 small business stock generally qualify for ordinary loss treatment.

Recognizing that the taxpayer may have difficulty determining in which year the security becomes worthless, a special statute of limitations exists for worthless security losses. Instead of the normal three-year statute, the statute of limitations for worthless securities is extended to seven years. Generally, the security is considered worthless at the time it first has no liquidation value and no reasonable hope or expectation exists that it will become valuable at some future date. 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.

The question of when, under all facts and circumstances, a security becomes worthless has been the subject of many court cases and IRS rulings. Merely declaring bankruptcy is not sufficient to claim a loss when the shareholders may obtain stock in a reorganization. In *Thun*, the court ruled that a loss claimed three years prior to the corporation ceasing business was not allowed. Conversely, in *Steadman*, the taxpayer's loss was allowed two years prior to the corporation filing bankruptcy. One court suggested that a loss be claimed in the earliest year possible. The judicial guidance on this issue cannot be easily summarized as each case depends on the particular facts and circumstances.

The taxpayer often determines when a particular security becomes worthless; thus, the loss should be taken as soon as the determination is made, whether or not the security issuer is in bankruptcy or liquidation. If there is a subsequent recovery of the investment, the loss will be recovered in income in a later year.

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.

The issue of establishing worthlessness can be avoided by selling the security to an unrelated third party. A bona fide transaction in which the taxpayer transfers ownership of the security at a loss should secure a loss deduction. However, the possibility of a subsequent recovery in value should be considered before disposing of 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.

22. Which of the following statements best describes a condition of the wash sale rules?

    a. A stock or security must be identical for the wash sale rules to apply.

    b. Generally, a taxpayer cannot defer a loss that is not recognized under the wash sale rules.

    c. Per IRC Sec. 1092, wash sale rules apply to related party transactions.

    d. A taxpayer cannot avoid the wash sale rules by allowing a related party to purchase the replacement stock.

23. What happens when a taxpayer causes a wash sale by using the call option?

    a. Ordinary income is converted from a distribution to capital gain from the sale.

    b. Ordinary income is converted to long-term gain.

    c. Long-term capital loss is converted to a short-term loss.

    d. Gains are converted to ordinary income.

24. Generally, which of the following is **not** an adequate reason to declare a security completely worthless?

    a. A taxpayer files bankruptcy.

    b. The security has no liquidation value.

    c. If a corporation's liabilities exceed its assets.

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 statements best describes a condition of the wash sale rules? **(Page 281)**

    a. A stock or security must be identical for the wash sale rules to apply. [This answer is incorrect. A stock or security must be substantially identical for the wash sale rules to apply. Generally, a stock of one corporation is not considered substantially identical to the stock of another corporation.]

    b. Generally, a taxpayer cannot defer a loss that is not recognized under the wash sale rules. [This answer is incorrect. Per IRC Sec. 1092, regulations do not apply to wash sales rules and related parties.]

    c. Per IRC Sec. 1092, wash sale rules apply to related party transactions. [This answer is incorrect. Per IRC Sec. 1092, regulations do not apply to wash sales rules and related parties.]

    d. A taxpayer cannot avoid the wash sale rules by allowing a related party to purchase the replacement stock. [This answer is correct. The courts have not allowed taxpayers to obtain a loss in these situations. Accordingly, taxpayers and their IRAs are considered related parties. Therefore, the sale of an asset at a loss would be prohibited if, as part of the plan, the taxpayer's IRA purchased an identical asset.]

23. What happens when a taxpayer causes a wash sale by using the call option? **(Page 282)**

    a. Ordinary income is converted from a distribution to capital gain from the sale. [This answer is incorrect. If a taxpayer sells a share in a mutual fund prior to an income distribution, the sell converts what would be ordinary income from the distribution to capital gain from the sale.]

    b. Ordinary income is converted to long-term gain. [This answer is incorrect. Ordinary income can be converted to long-term capital gains when taxpayers sell shares in mutual funds.]

    c. Long-term capital loss is converted to a short-term loss. [This answer is correct. Though there is no direct authority addressing this tactic, a taxpayer can use the call option to cause a wash sale so that long-term capital loss is converted to a short-term loss.]

    d. Gains are converted to ordinary income. [This answer is incorrect. Section 475 mark-to-market election converts gains and losses to ordinary income, not a wash sale using a call option.]

24. Generally, which of the following is **not** an adequate reason to declare a security completely worthless? **(Page 282)**

    a. A taxpayer files bankruptcy. [This answer is correct. Filing bankruptcy is not enough to declare a security completely worthless. The question of when a security becomes worthless has been the subject of several court cases, and the judicial guidance on this matter cannot easily be analyzed since each case depends on specific facts and circumstances.]

    b. The security has no liquidation value. [This answer is incorrect. Once a security has no liquidation value, and no reasonable chance to become valuable in the future, the security can be deemed completely worthless.]

    c. If a corporation's liabilities exceed its assets. [This answer is incorrect. The date a corporation is deemed as disregarded because its liabilities exceed its assets; any securities owned by that corporation are declared completely worthless.]

Deferring Gain from Sale of Publicly Traded Securities

Individuals can elect to roll over capital gains on the sale of publicly traded securities by purchasing within 60 days common stock or a partnership interest in a specialized small business investment company (SSBIC). SSBICs are entities (partnerships and corporations) licensed by the Small Business Administration under Section 301(d) of the Small Business Investment Act of 1958 as in effect on May 13, 1993. SSBICs are privately owned and managed investment firms that use their own capital, plus funds borrowed at favorable rates with an SBA guarantee, to make venture capital investments in small businesses. SSBICs invest in small businesses owned by entrepreneurs who are socially or economically disadvantaged, mainly members of minority groups.

The election to defer gain is made by attaching an election statement containing the details of rollover transactions to the taxpayer's return for the year in which the publicly traded securities are sold. A rollover results in tax deferral, not permanent tax exclusion. The basis of the investor's SSBIC common stock or partnership interest is reduced by the gain not recognized. There is a $50,000 ($25,000 for married filing separately) per year gain rollover limitation and a $500,000 ($250,000 for married filing separately) lifetime cap.

Taxation of Stock Dividends and Splits

Stock dividends are dividend distributions made to shareholders using the distributing corporation's own stock. Stock dividends are generally tax free; however, they can be taxable in certain circumstances. For example, stock dividends are taxable if the shareholder has the option of receiving dividends in cash or stock. Stock splits, on the other hand, are not taxable and represent a division (or combination) of outstanding shares into a greater (or smaller) number of shares that reduces (or increases) the per share value of the outstanding stock.

Nontaxable Stock Dividends and Stock Splits. Nontaxable stock dividends and splits result in a deferral rather than a permanent exclusion of income. Rather than taxing stock dividends currently, the per share basis in the taxpayer's stock is reduced. This increases gain or decreases loss on a subsequent sale of the stock if the taxpayer sells less than his entire holding of the stock.

If a shareholder receives a nontaxable stock dividend, and the new stock is identical to the old stock on which the dividend is declared, the basis of both the old and new stock is determined by dividing the old stock's adjusted basis by the total number of shares of the old and new stock. If the old stock was bought at different times and at different prices, the basis of both the old and new stock is determined by allocating to each lot of stock the share of stock dividends attributable to it and allocating basis accordingly.

When selling stock, a taxpayer should adjust the basis for any stock dividends or splits. In addition, a taxpayer should consider selling specific shares when multiple stock dividends/splits have occurred (and the underlying stock was purchased at different prices) to minimize or maximize gains and losses, depending on the selling strategy.

Example 4-13: Adjusting stock basis for identical stock received in a nontaxable stock dividend.

Sally owns 200 shares of common stock of Chemcorp, Inc. She purchased the stock in two lots of 100 shares each for $27 and $30 per share, respectively. Chemcorp declared a nontaxable dividend of two shares for each share held. Sally now owns 600 shares with the following basis:

300 shares @ $9 per share [$2,700 purchase price ÷ (100 shares + 200 shares)]
300 shares @ $10 per share [$3,000 purchase price ÷ (100 shares + 200 shares)]

If Sally subsequently sells the stock, she can use the specific identification method to minimize any gain (or maximize any loss) recognized on the sale.

If the new stock received as a tax-free stock dividend is not identical to the old stock, the adjusted basis of the old stock is allocated to both the old and new stock based on each stock's FMV on the distribution date.

Example 4-14: Adjusting stock basis for nonidentical stock received in a nontaxable stock dividend.

Assume the same facts in the previous example except Sally receives one share of Chemcorp preferred stock for each common share held. On the date of distribution, the FMV of a common share is $30 and the FMV of a preferred share is $20. Sally now owns 200 shares of common and 200 shares of preferred stock. Her basis is as follows:

Common Stock:	100 shares × $27 × ($30/$50) = $1,620
	100 shares × $30 × ($30/$50) = $1,800
Preferred Stock:	100 shares × $27 × ($20/$50) = $1,080
	100 shares × $30 × ($20/$50) = $1,200

The holding period for the new stock is the same as for the old stock. The adjusted basis and holding period of stock received in a stock split is computed in the same manner as a stock dividend, as previously set out.

Taxable Stock Dividends. If the stock dividend is taxable to the taxpayer, the basis of the new stock is the FMV on the date of distribution. The holding period begins on the date of distribution. The basis of the old stock does not change.

A stock dividend is taxable when shareholders are given the choice between cash or stock. Other taxable stock dividend distributions include disproportionate dividends and most stock payouts on preferred stock.

SELF-STUDY QUIZ

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

25. When a shareholder receives a nontaxable stock dividend, and the old stock on which the dividend is declared is identical to the new stock, how is the basis of both the old and new stock determined?

    a. The share of stock dividends is allocated to each lot of stock attributable to it and the basis is allocated accordingly.

    b. The old stock's adjusted basis is allocated to both the old and new stock based on each stock's FMV on the distribution date.

    c. The old stock's adjusted basis is divided by the total number of shares of the new and old stock.

26. When is a stock dividend taxable?

    a. When shareholders have a choice between receiving their dividend in cash or stock.

    b. When paid by certain federal government agencies.

    c. When the shareholder buys stock under a dividend reinvestment plan.

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.)**

25. When a shareholder receives a nontaxable stock dividend, and the old stock on which the dividend is declared is identical to the new stock, how is the basis of both the old and new stock determined? **(Page 285)**

    a. The share of stock dividends is allocated to each lot of stock attributable to it and the basis is allocated accordingly. [This answer is incorrect. If old stock is bought at a different time and at a different price, the basis of both the old and new stock is determined by allocating to each lot of stock the share of stock dividends attributable to it and allocating accordingly.]

    b. The old stock's adjusted basis is allocated to both the old and new stock based on each stock's FMV on the distribution date. [This answer is incorrect. If the new stock received as a tax-free stock dividend is not identical to the old stock, the adjusted basis of the old stock is allocated to both the old and new stock based on each stock's FMV on the distribution date.]

    c. The old stock's adjusted basis is divided by the total number of shares of the new and old stock. [This answer is correct. If a shareholder receives a nontaxable stock dividend, and the new stock is identical to the old stock on which the dividend is declared, the basis of both the old and new stock is determined by dividing the old stock's adjusted basis by the total number of shares of the old and new stock according to IRC Sec. 307(a).]

26. When is a stock dividend taxable? **(Page 286)**

    a. When shareholders have a choice between receiving their dividend in cash or stock. [This answer is correct. When taxpayers are given a choice between cash or stock, the stock dividend is taxable. Other examples include disproportionate dividends and most stock payouts on preferred stock.]

    b. When paid by certain federal government agencies. [This answer is incorrect. Federal government agencies do not pay stock dividends. Bond interest is taxable when paid by certain government federal agencies, or corporations.]

    c. When the shareholder buys stock under a dividend reinvestment plan. [This answer is incorrect. The participating shareholder's holding period begins on the date following the day on which the shares are credited to the participant's account when the shareholder buys stock under a dividend reinvestment plan. This has nothing to do with whether this stock dividend is taxable.]

Watch Out for the Constructive Sale Rules

Taxpayers holding appreciated financial positions and who enter into certain transactions are deemed to have a constructive sale of the security and thus, must recognize the gain (but not loss) at that time. The rule applies to any appreciated financial position in stock, a partnership interest, or debt (other than certain straight debt). When planning for securities transactions, practitioners need to ensure clients do not run afoul of these rules and trigger unexpected tax results.

A constructive sale occurs when the taxpayer (or a related person) holding an appreciated financial position enters into one of the following transactions for the same or substantially identical property:

- A short sale.
- An offsetting notional principal contract.
- A futures or forward contract.
- An acquisition of the actual property (i.e., a long position) that is the subject of a transaction listed in the first and third items.
- Under forthcoming regulations, a transaction that has substantially the same effect as the first item through the fourth.

The gain is calculated as if the property were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. The property's basis then is increased by gain recognized on the constructive sale.

Definitions. The following definitions apply for purposes of the Section 1259 rules:

a. *Appreciated Financial Position.* An appreciated financial position is any position relating to a stock, a debt instrument, or a partnership interest where there would be gain if the position were sold, assigned, or otherwise terminated at its fair market value. The term *position* means an interest, including a futures or forward contract, short sale, or option. Specifically excluded from the definition of appreciated financial position are positions with respect to straight debt and any related hedges and any position that is marked to market under any Code section or regulation.

b. *Straight Debt.* A straight debt is an obligation that unconditionally entitles the holder to receive a specified principal amount, has interest payments that are payable based on a fixed or variable rate, and cannot be converted (directly or indirectly) into stock of the issuer or any related person.

c. *Offsetting Notional Principal Contract.* An offsetting notional principal contract is an agreement that includes the following:

   (1) A requirement to pay all or substantially all of the investment yield (including appreciation) related to the property for a specified period.

   (2) A right to be reimbursed for all or substantially all of any decline in the value of the property.

d. *Forward Contract.* A forward contract is a contract to deliver a substantially fixed amount of property for a substantially fixed price.

Exceptions to the Section 1259 Rules. Certain transactions are excepted from the Section 1259 gain recognition rules for constructive sales. These include the following:

a. *Nonmarketable Securities If Sale Is Closed within One Year.* A contract for sale of any stock, debt instrument, or partnership interest is not a constructive sale if the contract is settled within one year after the date the contract is entered into. This exception does not apply if the property is a marketable security (i.e., a security for which there is a market on an established securities market or otherwise).

b. *Certain Sales Closed within 30 Days after the Close of the Tax Year.* A contract for sale of any stock, debt instrument, or partnership interest is not a constructive sale if—

(1) the transaction is closed before the end of the 30th day after the close of the tax year,

(2) the taxpayer holds the appreciated financial position throughout the 60-day period beginning on the date the transaction is closed, and

(3) at no time during the 60-day period in item b is the taxpayer's risk of loss relating to the appreciated financial position reduced by reason of positions held for substantially similar or related property.

Planning Collar Transactions to Avoid a Constructive Sale. Congress gave the IRS authority to issue regulations to identify more transactions that will fall within the scope of the constructive sale rules. The TRA '97 Committee Report states that the regulations should establish safe harbor rules for avoiding these rules. Transactions Congress suggests IRS address are collars and in-the-money options. As yet, no regulations have been issued.

In a collar transaction, an investor holding an appreciated stock acquires a put with a strike price less than the stock's current trading price and sells a call with a strike price above the current price. Thus, he has both upside and downside protection to movements in the stock's price because of the options collaring the stock. It is expected that the regulations will provide guidelines as to when the spread between the put and call prices causes the transaction to be a constructive sale. Regulations on collars are expected to be applied prospectively except in cases to prevent abuse.

Example 4-15: Collar transaction may result in constructive sale of stock.

Amy owns 100 shares of Allied Corp. stock with a basis of $65 a share and currently trading at $100 a share. She enters into a collar transaction whereby she buys a put option on Allied stock with a strike price of $95 and sells a call option on Allied stock with a strike price of $110. Thus, Amy has retained the risk of loss and opportunity for gain as long as the stock trades between $95 and $110 a share. Outside of that range, she is protected from further loss or opportunity for gain because the option transactions she entered into collar her stock.

Without indicating whether this is a constructive sale, Congress used this fact pattern as an example of a collar transaction in the TRA '97 Committee Reports. Preliminary indications from the IRS are that they may adopt a safe harbor test that uses a 20% spread between the put price and the call price as the basis for determining whether a collar is treated as a constructive sale. However, practitioners should monitor IRS activity until official guidance is released.

Certain collar transactions may result in constructive sales because they provide the investor both upside and downside protection to movements in the stock's price. Conversely, an investor who enters only into a put option, even one with an exercise price equal to the current market price (an "at the money" option), does not trigger a constructive sale because the option reduces only the taxpayer's risk of loss and not the opportunity for gain.

Short Sales and the Constructive Sale Rules

Investors who expect an asset's value to fall can profit by selling that asset short. A short sale occurs when the seller borrows the asset that is sold, collects the sales proceeds, and later closes the sale by purchasing an identical asset and repaying the lender. Thus, a short position merely means that an investor owes an asset to someone. When the price of an asset sold short declines, the seller profits because he or she received proceeds equal to the asset's value on the date of the short sale, but closes the sale with an asset purchased at a lower price.

Usually, the asset is borrowed from the investor's brokerage firm, and the taxpayer instructs the broker when to purchase the asset used for repayment. The lender may be the brokerage firm itself, or a client of the firm who holds the borrowed security in his or her portfolio.

Short sale gains offer a tax benefit since no tax is due when the short sales proceeds are received. Instead, any gain is deferred until the sale is closed, which may occur in a later tax year. Many practitioners normally relied on Reg.

1.1233-1(a)(1) as authority for reporting gains on short sales (the difference between the short sales proceeds and the amount spent to repay the lender) in the year the property to close the short sale was delivered to the lender. However, the IRS issued Rev. Rul. 2002-44 clarifying that the constructive sales rules trump the general rule of Reg. 1.1233-1(a)(1) when stock is purchased to close a short sale at a gain. Thus, for gains, but not losses, the sale is considered closed (i.e., gain is recognized) on the date the asset to close the sale is purchased rather than the date it is delivered to the lender.

According to Rev. Rul. 2002-44, when stock to close an appreciated short position is acquired, a constructive sale takes place and gain is recognized. Therefore, 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 sales rules), regardless of Reg. 1.1223-1(a)(1), which says gain is deferred until the date the property is delivered to close the sale.

Example 4-16: Recognizing loss on a short sale.

Courtney sells 100 shares of Acme Inc. (a publicly traded stock) short on October 30, 2010 when Acme is trading at $40 per share. Courtney does not own any Acme, Inc. stock. On December 29, 2010, 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 29, but the shares are not delivered to the lender to close the short sale until January 3, 2010. Courtney does not realize her loss on the short sale until January 4, 2011.

Example 4-17: Recognizing gain on a short sale.

Assume the same facts as Example 4-16, except that on December 29, 2010, 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 29, 2010, the constructive sale rule applies. Courtney recognizes her gain on the short sale on December 29, 2010 (the trade date), even though the shares are not delivered to the lender to close the sale until January 3, 2011.

SELF-STUDY QUIZ

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

27. When does a constructive sale occur?

    a. When a seller borrows an asset that is sold, collects the sales proceeds, and later closes the sale by purchasing an identical asset and repaying the lender.

    b. When a taxpayer holding an appreciated financial position enters into a transaction such as a forward contract for identical property.

    c. When a corporation acquires its stock from a shareholder in exchange for property.

28. How does an investor trigger a constructive sale?

    a. By entering only into a put option.

    b. By entering into an *at the money* option.

    c. By entering into certain collar transactions.

    d. By entering into a closing transaction.

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.)**

27. When does a constructive sale occur? **(Page 289)**

    a. When a seller borrows an asset that is sold, collects the sales proceeds, and later closes the sale by purchasing an identical asset and repaying the lender. [This answer is incorrect. This transaction is considered a short sale, not a constructive sale.]

    b. When a taxpayer holding an appreciated financial position enters into a transaction such as a forward contract for identical property. [This answer is correct. The constructive sale rules apply to any appreciated financial position in a partnership interest, stock, or debt. Any taxpayers who hold a financial position and enter into a transaction such as a forward contract for substantially identical property are subject to the constructive sale rules. Other transactions include the acquisition of actual property that is the subject of a transaction of a short sale or a futures contract, and any offsetting notional contract.]

    c. When a corporation acquires its stock from a shareholder in exchange for property. [This answer is incorrect. When a corporation attains its stock from a shareholder in exchange for property or cash, a stock redemption occurs.]

28. How does an investor trigger a constructive sale? **(Page 290)**

    a. By entering only into a put option. [This answer is incorrect. By entering only into a put option, a constructive sale is not triggered because the option reduces only the taxpayer's risk of loss not an opportunity for gain.]

    b. By entering into an *at the money* option. [This answer is incorrect. By entering only into an *at the money* option, a constructive sale is not triggered because the option reduces only the taxpayer's risk of loss not an opportunity for gain.]

    c. By entering into certain collar transactions. [This answer is correct. Certain collar transactions allow investors protection from both upside and downside protection in the stock's price. This can result in a constructive sale.]

    d. By entering into a closing transaction. [This answer is incorrect. Entering into a closing transaction is generally used when an option writer is trying to avoid the consequences of having an option exercised. This transaction does not trigger a constructive sale.]

EXAMINATION FOR CPE CREDIT

Lesson 4 (TINTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

20. Generally, what is the tax basis of individual shares of stock equal to?

    a. The excess of the distribution over the shareholder's basis in the stock surrendered.

    b. The de minimis OID multiplied by a fraction.

    c. The original cost.

    d. The redemption price less the original cost.

21. Which of the following stock options automatically is deemed to be held more than one year and results in long-term treatment?

    a. Inherited stock.

    b. Employer stock received from an employer's retirement plan.

    c. Stock splits.

    d. Stock dividends.

22. In 2000, Stan contributed $170,000 cash to his corporation, Stanco, in exchange for stock. The business never attained the success Stan had originally envisioned. In 2010, Stan sold his stock in Stanco to an unrelated party for $60,000. Stan's tax loss on his sale of stock is $110,000 ($60,000 proceeds – $170,000 stock basis). The stock qualified as Section 1244 stock. Stan files a joint return with his wife, Stacy.

    How much can Stan claim as an ordinary loss deduction in the year of sale?

    a. $50,000.

    b. $75,000.

    c. $100,000.

    d. $150,000.

23. If Stan, in the example above, has no 2010 capital gains, what is his capital loss limited to?

    a. $2,000.

    b. $3,000.

    c. $4,000.

    d. $5,000.

24. How much of a corporation's aggregate gross receipts must come from sources other than investment income if the corporation would like their stock to be considered Section 1244 stock?

    a. Less than 25%.

    b. More than 25%.

    c. Less than 50%.

    d. More than 50%.

25. The wash sale rules apply to all of the following **except**:

    a. Commodities.

    b. Short sales.

    c. Options.

    d. Securities.

26. Halle acquired 100 shares of Sterling Corp. on September 10, 2009, for $60 per share. Halle sells the shares at $50 per share on October 1, 2010 for a long term loss of $1,000. If Halle is planning to deduct the realized loss on the sale of the stock, what is the earliest date she can purchase another stock that is substantially similar to the stock she sold?

    a. August 1, 2010.

    b. October 1, 2010.

    c. October 31, 2010.

    d. November 1, 2010.

27. How can a taxpayer avoid the issue of establishing the worthlessness of a security?

    a. Maintaining a low portfolio turnover rate and considering taxes when buying and selling securities.

    b. Reinvesting in the stock of a different company in the same industry sector.

    c. Entering into a closing transaction.

    d. Selling the security to an unrelated third party.

28. How do specialized small business investment companies (SSBIC) help individuals defer gain from the sale of publicly traded securities?

    a. By purchasing common stock in a SSBIC within 60 days of the gain.

    b. By purchasing assets in the SSBIC and transferring them to a new corporation.

    c. By purchasing an identical asset and repaying the SSBIC.

    d. By purchasing an option from the SSBIC.

29. The term *position* as is related to appreciated financial position, for purposes of the Section 1259 rules, means an interest including all of the following **except**:

    a. Futures contract.

    b. Straight debt.

    c. Short sale.

    d. Option.

30. According to Rev. Rul. 2002-44, what type of sale occurs when stock to close an appreciated short position is acquired?

    a. Constructive.

    b. Short.

    c. Wash.

    d. Installment.

Lesson 5: Tax Planning for Other Financial Investments

INTRODUCTION

Determining Basis for Mutual Fund Share Sales

Calculating basis for a sale of mutual fund shares is usually more complicated than for a regular stock sale because of the nature of the investment. The total basis of the shares are constantly adjusted when there are reinvested dividends and capital gains (resulting in additional fund shares). When there is a partial sale of fund shares purchased over a period of several years, the time involved in tracking the basis of each share sold is often time consuming and costly.

Learning Objectives

Completion of this lesson will enable you to:

- Identify tax planning strategies for mutual fund investments.
- Describe the tax benefits of investing in exchange-traded funds.
- Recognize the tax planning tactics for publicly traded stock options.
- Identify stock right, stock warrant, and explain the tax planning strategies for stock rights and warrants.

Three methods exist for determining the basis of mutual fund shares when taxpayers sell less than their entire holdings in a particular fund: (a) the first-in, first-out (FIFO) method, (b) the specific identification method, and (c) 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-term 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.

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. The average basis is figured using either the single or double category methods.

A taxpayer elects to use an average basis method by attaching an election statement [indicating which method (single or double category) is being used] to the return for the first year the election is effective. Once the election is made, the average basis method must be used for all accounts in the same fund. A different method can be used for shares in other funds, even those within the same family of funds. The election is revocable only with permission from the IRS.

Single Category Method. The single category method applies to all shares of a particular mutual fund in a single account. Each share's basis is the total cost or basis of all shares in the account at the time of the sale, divided by the number of shares. The FIFO method is used to determine the holding period of the shares sold.

Example 5-1: Calculating mutual fund share basis using the single category method.

Fred enters into an agreement with his broker to purchase $3,000 in shares of the Blue Chip Mutual Fund on a monthly basis. A summary of his holdings is as follows:

Acquisition Date	Number of Shares	Total Cost
3/6/10	250	$ 3,000
4/3/10	180	3,000
5/4/10	190	3,000
6/5/10	200	3,000
Totals	820	$ 12,000

Fred sells 300 shares on November 12, 2010, for $5,400 ($18 per share), and elects to use the single category method for determining basis of shares sold. The average basis of the shares sold is calculated by dividing the total cost of the shares ($12,000) by the number of shares in the account on the date of sale (820), which is $14.63 per share. Thus, Fred will recognize a $1,011 short-term gain on the sale [($18 selling price less $14.63 basis) × 300 shares sold].

Double Category Method. When the double category method is used, all shares of a particular fund are first divided (based on holding period) into two categories at the time of each sale: short-term (i.e., shares held one year or less) and long-term (i.e., shares held more than one year). After the taxpayer has held a share of the mutual fund for the long-term holding period, the share and its related tax basis is transferred from the short-term category to the long-term category. Next, the average basis of each share is calculated for each category at the time of sale. The taxpayer can then specify from which category (i.e., short-term or long-term) shares are deemed to be sold.

When transferring shares from the short-term to the long-term category, a share's original cost basis transfers with it unless shares in the short-term category have previously been disposed of. In this case, a share's basis becomes that computed under the average basis method at the time of the most recent disposition from the short-term category.

Example 5-2: Calculating mutual fund share basis using the double category method.

Assume the same facts as in Example 5-1 except that the first 250 shares were purchased in March 2009, and Fred elects the double category method for computing basis. The first step is to put the shares into long-term and short-term categories at the time of sale. The long-term category consists of the 250 shares purchased in March 2009 at an average cost of $12 per share. The short-term category consists of the remaining 570 shares with an average basis per share of $15.79 ($9,000 cost ÷ 570 shares).

If Fred decides to sell his long-term shares first, he will recognize a total gain of $1,611. Of this gain, $1,500 will be long-term [($18 − $12/share) × 250 shares] and $111 will be short-term [($18 − $15.79/share) × 50 shares]. Conversely, a sale of the short-term shares would result in a $663 short-term gain [($18 − $15.79/share) × 300 shares]. Fred should sell the shares which best fit his tax strategy given his overall net capital gain or loss position and considering his maximum capital gain and ordinary income tax rates.

Elimination of the Double Category Method. Proposed regulations would eliminate the double category method and provide that the taxpayer may use the average basis method (i.e., the single category method) to determine the basis of mutual fund shares. Basis is computed by averaging the basis of all identical shares in an account regardless of holding period. However, a taxpayer may not average together the basis of identical shares held in separate accounts that the taxpayer sells, exchanges, or otherwise disposes of on or after January 1, 2012. A transition rule would require taxpayers using the double category method to average the basis of all identical stock in an account on the date of publication of final regulations. The regulations regarding the determination of basis under Section 1012 are proposed to apply for tax years beginning after the date the regulations are published as final regulations in the Federal Register.

New Basis and Character Reporting Rules for Mutual Fund Sales

Under a tax law change enacted as part of the 2008 Energy Act, generally effective on January 1, 2012, 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 mutual fund share's adjusted basis is determined on an account-by-account basis using the first-in first-out (FIFO) method unless the customer notifies the broker to use an alternative means of making an adequate identification of the fund shares sold or transferred. Except as otherwise provided, the customer's adjusted basis is determined without regard to Section 1091 (relating to disallowed loss from wash sales of stock or securities) unless the transactions occur in the same account with respect to identical securities.

This new reporting requirement pertains to mutual fund shares acquired after January 1, 2012, through a transaction in the account in which the fund shares are held or mutual fund shares that were transferred to that account from an account in which the mutual fund shares were subject to the reporting requirement, but only if the broker received a statement under IRC Sec. 6045A regarding the transfer.

Determining the Holding Period for Mutual Fund Shares

It is often difficult to track the holding period for mutual fund shares. Because dividends are often reinvested in additional fund shares, the holding period of additional fund purchases may be determined on a monthly basis.

Example 5-3: Tracking the holding period of mutual fund shares.

Cathy purchased 500 shares of the Green Mutual Fund on February 9, 2009, and sold the shares at a gain on August 1, 2010. However, Cathy held 528 shares on the date of sale due to the reinvestment of monthly dividends (approximately 2 shares were purchased each month).

Shares purchased through reinvested dividends from August 2009 through July 2010 are treated as short-term sales since they have been held one year or less. The sale of shares acquired through reinvested income from February 2009 through July 2009 results in long-term treatment since these were held more than one year. The basis assigned to each share sold depends on whether the FIFO, single-category, or double-category method is used.

Avoiding Income by Deferring Year-end Purchases

Mutual funds must pay out their gains and income to shareholders at least annually to avoid tax at the fund level. Income and balanced funds typically make taxable distributions to shareholders either monthly or quarterly while equity funds normally make one annual distribution at or near the fund's year-end. These taxable distributions to shareholders reflect the income and net gains realized by the fund. In addition to this income, shareholders may benefit from unrealized gains on securities held by the fund and will recognize this income either when the fund disposes of the securities or the shareholder redeems his mutual fund shares. Sometimes, a fund that appears to have a minimal or negative overall return for the year may actually make taxable distributions to shareholders because of gains the fund recognized on appreciation that occurred in prior years. From an investor's standpoint, distributions do not result in additional return on their investment; instead, distributions are already reflected in the fund's per share value so after a distribution is made, the per share value is reduced accordingly.

Because of the income distributions mutual funds must make, the timing of when an investor purchases shares in a particular fund can affect his tax liability. Purchasing shares just before the record date (i.e., the date that determines which shareholders will receive the distribution) of a fund's distribution is essentially purchasing a tax liability. This is because the price of the shares just before the distribution includes the income that is about to be paid out. When the distribution is made, the price per share falls although the value of the shareholder's total investment remains the same (i.e., if income is reinvested, the shareholder now owns more shares with a lower value per share, or if income is distributed, the cash received plus the value of his shares equals his investment before the distribution). Thus, investors in mutual funds should pay particular attention to when they invest in a fund. This is especially true for equity funds that make only one distribution each year.

Example 5-4: Untimely purchase of mutual fund shares results in "purchasing" a tax liability.

Harry invested $15,000 in the ABC Equity fund on December 24, 2010, when the price per share was $10. On December 29, 2010 the fund declared an income distribution of $1 per share to shareholders of record on December 29, 2010. On December 31, 2010, the fund distributed $1 per share, which reduced the price per share to $9. Harry's $1,500 ($1 per share × 1,500 shares) distribution was automatically reinvested, resulting in an additional 166.67 shares ($1,500/$9 per share). Harry's holding in the fund before and after the distribution were as follows:

	Value	Tax Basis
Before the distribution:		
1,500 shares	$ 15,000	$ 15,000
After the distribution:		
1,500 shares	13,500	15,000
166.67 shares	1,500	1,500
Total	$ 15,000	$ 16,500

By purchasing the shares just prior to the record date of the distribution, Harry essentially purchased a tax liability on $1,500 of income. As shown above, although he owns more shares after the distribution, the total value of his investment is unchanged because of the lower price per share. The $1,500 distribution is taxable to Harry in 2010, and is added to the basis in the shares he owns.

Variation: Had Harry purchased his shares after the December 31st distribution, he would not have recognized any income from the fund in 2010.

Tax-efficient Funds Can Minimize Current Taxes

A mutual fund's tax efficiency refers to how the fund's operations affect when income will be distributed and taxable to its shareholders. Tax efficiency can affect the overall net return a shareholder realizes from a fund and is often one of the factors shareholders consider when selecting mutual fund investments. Tax efficiency is more likely to be a factor in funds holding stocks and other equity instruments. It is not a concern when selecting mutual fund investments in retirement accounts like 401(k) plans and IRAs (and other tax-deferred accounts such as variable annuities).

Tax efficiency is essentially a function of a fund's portfolio turnover rate. Turnover rate refers to how often a fund sells, or turns over, its portfolio of securities. Generally, funds with high turnover rates are less efficient than those with low turnover rates because it is the disposal of securities that causes the fund to recognize gain on an appreciated security. And because mutual funds must distribute virtually all of their income to shareholders each year, the more income a fund recognizes in a year, the more income shareholders must report for that year.

Generally, the more tax efficient a fund is, the less current income a shareholder recognizes. In addition, many of the gains recognized by funds with high turnover rates are likely to be short-term rather than long-term and thus, not eligible for the preferential capital gains rate.

Index funds tend to be more tax efficient than other mutual funds. Stocks held by an index fund normally replicate a particular securities market benchmark (e.g., S&P 500 stock portfolio). Thus, the fund is not actively managed like other funds with specific fund objectives. Index funds generally use a buy and hold approach to investing, selling securities only when cash is needed to redeem shareholders. They hold rather than sell appreciated securities so gains are unrealized rather than realized and recognized for tax purposes. Thus, index funds generally have a low turnover rate which minimizes the current taxable income distributed to shareholders.

As previously mentioned, a fund's tax efficiency is not an issue when selecting mutual funds for retirement account assets such as IRAs and 401(k) accounts (and other tax-deferred accounts such as variable annuities). This is an important consideration when choosing investments for taxable versus retirement accounts. An individual wanting to invest in both actively managed and index funds will generally benefit by using the index funds for taxable investment assets and reserving the actively managed funds for retirement plan assets.

Some equity mutual funds are tax-managed funds. For these funds, minimizing taxes to shareholders by maintaining a low portfolio turnover rate and considering taxes when buying and selling securities is one of the fund's objectives. These funds often charge a redemption fee to investors who withdraw funds before a specified length of time (e.g., one year). Practitioners with clients who want to minimize taxes through mutual fund investments might recommend that they consider tax-managed funds.

When choosing mutual fund investments, investors must consider the fund's tax efficiency in view of their particular tax situation. Many investors will want to minimize their current taxes and defer gain recognition to future year. This makes the more tax efficient funds the most appealing. However, investors with capital loss carryovers, excess investment interest, or other unused deductions may benefit from a fund with a high turnover rate that is more likely to generate more current taxable income. Of course, tax efficiency is only one factor in selecting a fund. The fund's overall expected performance and whether it meets the investor's personal financial planning needs are likely to be more critical criteria.

Example 5-5: Tax-efficient fund minimizes current taxes.

John Henderson has $40,000 he plans to invest in a stock mutual fund. After analyzing the various funds that meet his objectives, he has narrowed the choice down to either the ABC Growth Fund or the ABC Index Fund. The Growth Fund is an actively managed fund with an annual portfolio turnover rate of 150%. The Index Fund is a passive fund that replicates the performance of the S&P 500 stocks. It has a very low portfolio turnover rate. John is in the highest ordinary income tax bracket and plans to invest in the fund for the long term.

If John would be satisfied with either fund, he should choose the Index Fund. Because it has a low portfolio turnover rate, much of the income he hopes to realize from his investment will be deferred until future years when he redeems his shares. The fund's annual shareholder distributions should be less than those of the Growth Fund, which actually enhances the return of the Index Fund over the entire time he plans to hold it.

Selling Shares before Income Distribution

Investors in mutual funds generally recognize income from funds in two ways: (a) ordinary income and capital gains resulting from fund distributions and (b) capital gain or loss from the sale or redemption of shares in the fund. Investors normally have no control over income distributed by the fund but can control when they recognize gain or loss from disposing of shares in the fund.

Mutual funds distribute both ordinary income and capital gains realized by the fund to shareholders. Short-term capital gains lose their capital gain character when distributed and are treated as ordinary income to the shareholders.

Carefully timing when taxpayers sell shares in a mutual fund may enable them to convert ordinary income to long-term capital gain. Selling just prior to an income distribution (generally based on the record date of the distribution) converts what would be ordinary income from the distribution to capital gain from the sale.

Example 5-6: Selling shares before income distribution.

Karen owns 500 shares of Sky Income Fund which she plans to sell before year-end. The shares currently have a net asset value (NAV) of $25 per share. Her basis is $15 per share, all of which have been held more than 12 months. The fund plans to make a $3 per share distribution to shareholders of record on December 22 [which will reduce the NAV to $22 per share ($25 − $3)]. Of this amount, $2 will be ordinary income and $1 will be long-term capital gain.

If Karen waits until after December 22 to sell her shares, she will recognize $1,000 of ordinary income and $500 of capital gain from the distribution plus $3,500 long-term capital gain from the sale ($22 NAV per share after the distribution − $15 basis per share × 500 shares sold).

If Karen sells the 500 shares on December 21, she avoids the income distribution which includes the $1,000 of ordinary income. Instead, she recognizes a long-term capital gain of $5,000 ($25 NAV per share − $15 basis per share × 500 shares). Her total income is the same whether she sells before or after December 22, but by selling before the income distribution she converts $1,000 of ordinary income into long-term capital gain.

Other Mutual Fund Tax Planning Considerations

Wash Sales. The wash sale rules prevent taxpayers from recognizing a loss from the sale of a stock or security if a substantially identical stock or security is purchased within the period beginning 30 days before and ending 30 days after the sale. Although these rules are typically thought of in connection with individual stocks, they also apply to mutual fund investments.

When compared to stocks, determining when shares in one mutual fund are substantially identical to shares in another is less clear. In IRS Pub. 564, Mutual Fund Distributions, the IRS states that when determining whether the shares are substantially identical, taxpayers should consider all the facts and circumstances but ordinarily shares issued by one mutual fund are not considered to be substantially identical to shares issued by another mutual fund. Presumably, one would consider each fund's securities portfolio as well as other factors such as each fund's expense ratios and transaction charges.

It would appear that few, if any, mutual funds would be substantially identical for purposes of the wash sale rules. Actively managed funds with the same investment criteria will normally have different stock portfolios. While certain index funds may each invest in stock forming a specific fund index (e.g., S&P 500 index), it appears they would not be substantially identical if managed by different mutual fund companies because of other differences that may exist (expense ratios, etc.).

Investing in comparable, but not substantially identical, mutual funds should enable taxpayers to avoid the wash sale rules and claim losses without changing their investment strategy.

Example 5-7: Planning around wash sale rules with mutual funds.

Jerry owns 500 shares of ABC International Growth Fund. He paid $10,000 for his shares and they are currently worth $7,500. He would like to sell the shares to claim the tax loss, but immediately reinvest the proceeds in the XYZ International Fund, a mutual fund with a similar investment objective but with a different family of mutual funds. Although XYZ fund has a similar investment objective, its stock holdings will differ from ABC and thus, is not substantially identical to ABC under IRC Sec. 1091. Therefore, Jerry can sell his shares and claim the $2,500 capital loss.

Special Treatment for Certain Losses. A loss on the sale of mutual fund shares equal to the load charge on the original shares is not allowed in certain situations where the sale occurs within 90 days of purchasing the original shares and the taxpayer reinvests the proceeds in another mutual fund in the same family of funds. Also, IRC Sec. 852(b)(4) provides that when a taxpayer sells shares held six months or less at a loss and receives a capital gain distribution with respect to those shares (prior to the sale), the loss up to the amount of the capital gain distribution is recharacterized as a long-term loss. This provision prevents taxpayers from obtaining a tax benefit by generating short-term capital losses that are due, at least in part, to a capital gain (i.e., long-term capital gain) distribution received from the fund.

Capital Loss Carryover. Mutual funds that incur capital losses cannot distribute them to shareholders. If capital gains are not sufficient to absorb the capital losses, the fund will have a capital loss carryover that will apply to future fund gains. The fund can carry the loss forward for eight years. If a fund has a capital loss carryover, it will be disclosed in the financial information included in the fund prospectus.

Unrealized Portfolio Appreciation/Depreciation. A mutual fund's prospectus includes information regarding the fund's unrealized appreciation or depreciation in its securities portfolio. This information may give investors some insight into the future tax consequences of investing in the fund. Significant unrealized appreciation often generates recognized capital gains to the fund that, in turn, are distributed to the shareholders. Conversely, funds with little unrealized appreciation or unrealized depreciation in securities may generate less severe tax consequences to shareholders than those with significant unrealized appreciation, at least in the short term.

SELF-STUDY QUIZ

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

29. Using selected methods for calculating the basis of mutual fund shares can allow taxpayers to save taxes. Which of the following methods divide all shares of a particular fund into two categories at the time of each sale?

    a. Double category.

    b. Specific identification.

    c. Single category.

    d. FIFO method.

30. What is affected when a mutual fund's income will be distributed and taxable to its shareholders?

    a. The fund's tax efficiency.

    b. The fund's average basis.

    c. The fund's turnover rate.

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.)**

29. Using selected methods for calculating the basis of mutual fund shares can allow taxpayers to save taxes. Which of the following methods divide all shares of a particular fund into two categories at the time of each sale? **(Page 300)**

    a. Double category. [This answer is correct. All shares of a particular fund are split into short-term and long-term shares when the double category method is used. The shares and their related tax bases are transferred from the short-term category to the long-term category once the taxpayer has held the shares of the mutual fund for the long-term holding period.]

    b. Specific identification. [This answer is incorrect. The specific identification method is one method used to determine the basis of mutual fund shares when a taxpayer sells less than their entire holdings in a particular fund. However, this method does not divide all shares of a particular fund into two categories at the time of each sale.]

    c. Single category. [This answer is incorrect. Under the single category method, each share's basis is the total basis or cost of all shares in the account at the time of sale, divided by the number of shares, not divided into two categories.]

    d. FIFO method. [This answer is incorrect. The FIFO method calculates sales based on the first shares purchased are the first shared sold and costing is based on those shares.]

30. What is affected when a mutual fund's income will be distributed and taxable to its shareholders? **(Page 302)**

    a. The fund's tax efficiency. [This answer is correct. Tax efficiency can affect the complete net return a shareholder realizes from a fund and usually is one of the factors shareholders consider when selecting mutual fund investments. The tax efficiency refers to how a fund's operations affect when income will be distributed and taxable to its shareholders.]

    b. The fund's average basis. [This answer is incorrect. The average basis method is one of three methods used to determine the basis of mutual fund shares when taxpayers sell less than their entire holdings in a particular fund.]

    c. The fund's turnover rate. [This answer is incorrect. Turnover rate refers to how often a fund sells, or turns over, its portfolio of securities.]

TAX PLANNING FOR EXCHANGE-TRADED FUNDS

Like mutual funds, exchange-traded funds (ETFs) offer investors a simple method of investing in portfolios of stocks that closely track the performance and dividend yield of specific indexes. ETFs give investors the opportunity to buy or sell an entire portfolio of stocks in a single security, as easily as buying or selling a share of stock.

ETFs are similar to traditional mutual funds in that they are an investment structure that pools the assets of its investors and uses professional managers to invest the money to meet clearly identified objectives, such as current income or capital appreciation. Unlike a mutual fund, ETFs are traded like other listed stocks. An ETF is created when an institutional investor deposits securities into the fund in exchange for creation units. In return for the deposit, the institutional investor receives a fixed amount of shares, some or all of which may be traded and priced throughout the day on a stock exchange. Non-institutional investors (e.g., individual investors) do not purchase or redeem ETF shares directly from the fund. They buy or sell ETF shares on the stock exchange in the same manner they would purchase or sell any other listed stock.

All the buying and selling methods and strategies associated with stocks (e.g., market orders, limit orders, stop orders, and buying on margin) can be used when buying or selling ETFs.

The price of an ETF usually approximates, but is not directly linked to, the underlying net asset value of the fund. When demand for fund shares exceeds supply, the market price at which an ETF trades may be higher than its underlying net-asset-value, and vice-versa.

Some of the benefits of investing in ETFs include the following:

- *No Sales Loads.* Brokerage commissions still apply to the same extent they would to the purchase or sale of any other stock.

- *Ability to Buy and Sell at Any Time during the Trading Day.* Unlike open-end mutual funds that can only be redeemed at the end of the day, ETFs are priced throughout the day and can be bought or sold just like a stock.

- *Ability to Buy on Margin.* This cannot be done with mutual funds.

- *Ability to Sell Short.* This cannot be done with mutual funds.

- *Instant Exposure to a Diversified Portfolio of Stocks.* There are ETFs representing broad-based market indexes and specific industry sectors or specific geographical sectors.

- *Relatively Low Management Fees.* Expense ratios are very similar between ETFs and open-end mutual funds. Usually, they range from .15% of the value of the fund to 1.0%.

- *Tax Efficiency.* ETFs provide a tax advantage not available with mutual funds. Mutual funds sell securities to cover redemptions. These sales create capital gains, which are distributed to owners of the fund. ETFs transfer securities out to redeeming shareholders instead of selling the securities thus minimizing taxable capital gains. Investors who want to liquidate shares in an ETF simply sell them to other investors through exchange trading. Because of this unique structure, ETFs are not required to sell stocks to meet investor cash redemptions, potentially generating capital gains tax liability for remaining investors.

- *Diversification*. By owning an ETF containing the stocks in an entire market index or industry sector, an investor owns a large, diversified number of companies, which gives a degree of protection in case the price of one company in the index goes lower.

Harvest Tax Losses Using Exchange-traded Funds

Where a taxpayer sells stock at a loss and repurchases the same company's stock within 30 days, the capital loss on the sale of the original stock must be deferred. In this scenario, the new stock is substantially identical to the original stock (the same company) and, thus, triggers the wash sale rules requiring the deferral of any capital loss on the original sale.

Example 5-8: Triggering the wash sale rules.

Ernie sells 500 shares of Innovative Computer Corporation (INCC), a manufacturer of computers and peripheral equipment, at a loss of $5,000. Three weeks later (less than 30 days), he reads a large brokerage firm's report indicating that computer sales are expected to increase substantially during the next year. That same day, Ernie purchases 500 shares of INCC to take advantage of any potential price appreciation. Because Ernie subsequently purchased stock substantially identical to the stock he originally sold less than 30 days before, the $5,000 capital loss from the original stock sale must be deferred because of the wash sale rules.

The wash sale rules and required capital loss deferral can be avoided when the new investment (made within 30 days) is not substantially identical to that original investment. If a taxpayer believes that a company's stock that was originally sold at a capital loss less than 30 days ago once again represents a good investment opportunity, he or she can purchase stock of another company in the same industry as an alternative to repurchasing stock in the same company. In this case, the new stock is not substantially identical to the original stock; therefore, the purchase does not trigger the wash sale rules or restrict capital loss recognition on the original stock and theoretically preserves the opportunity for appreciation if the new stock does well.

Example 5-9: Avoid the wash sale rules and maintain the capital loss.

Using the fact situation in Example 5-8, if Ernie purchased stock in Peach Computer Corporation (PECC), another company in the same industry sector as INCC, to replace his original INCC stock, the $5,000 capital loss from his original INCC stock sale would be maintained. In this scenario, the wash sale rules do not apply because the replacement shares in PECC are not substantially identical to the original shares in INCC.

As shown in Example 5-9, the taxpayer can avoid the wash sale rules, maintain a capital loss from an original stock sale, and have an opportunity for price appreciation by reinvesting (within 30 days) in the stock of a different company in the same industry sector. However, quite often companies within the same industry sector are similar in some aspects, but significantly different in others. Where no acceptable alternative individual company in the same industry sector represents a viable investment option, investing in a related industry ETF may be advantageous.

Where a taxpayer sells stock in an individual company at a loss and within 30 days purchases the stock of an ETF in the same industry sector as the original company, the wash sale rules are avoided and the capital loss from the original sale is preserved since an industry ETF is not substantially identical to any individual company. In addition, by investing in the industry ETF, the potential for appreciation is preserved if the industry performs well.

Example 5-10: Use exchange-traded funds to harvest tax losses.

Maureen sells 900 shares of Logistic Computer Corporation (LOCC), a manufacturer of laptop computers, with a current market value of $27,000 at a loss of $9,000. One week later, she reads a story in *The Tech Stock Reporter* indicating laptop sales are about to boom because of a new remote access technology that business travelers will require. Maureen does not want to miss the opportunity for investment gains resulting from the new technology and related laptop sales, but wants to avoid the wash sale rules and use her $9,000 loss on LOCC to offset gains she has made on other investments this year.

As an alternative to reinvesting in LOCC, Maureen considers investing in Primary Computer Corporation (PRCC) because PRCC manufactures laptops. However, PRCC also manufactures and sells desktop computers, portable music players and sells music online. After completing her research on PRCC, Maureen is concerned that one or more of Primary's other business lines will falter and offset any profit from their laptop business.

Because Maureen cannot find a viable individual company replacement within the same industry as LOCC, she decides to reinvest her $27,000 in the Current Technology Fund (CTF). CTF is a listed and actively traded ETF with investments in fifteen technology-related companies, including five that manufacture laptops. By investing in CTF, Maureen preserves her $9,000 capital loss on LOCC since CTF is not substantially identical to LOCC and, thus, avoids the wash sale rules. She will also have the opportunity to participate in any price appreciation of CTF.

Commodities Exchange-traded Funds

Commodities listed on U.S. futures and securities exchanges are now being traded in various forms as ETFs. These new ETFs are designed to track the investment performance of commodities such as silver, gold, platinum, palladium, crude oil, and Euros. Commodities based ETFs have been organized and operated as grantor trusts and limited partnerships. As a grantor trust, the ETF will generally be treated as a disregarded entity for federal income tax purposes. Practitioners should note that the tax treatment for the commodity-based ETFs can be quite different from that of the more traditional ETFs.

Special Tax Considerations for Precious Metals ETFs Organized as Grantor Trusts. An investment in a precious metal bullion-based ETF may be considered a direct investment in a collectible. If considered to be a collectible, long-term gains on a precious metal ETF held more than one year would be taxed at a maximum rate of 28%, rather than 15% in 2010.

In addition, collectibles are generally not permitted investments for IRAs and participant-directed Section 401(a) qualified plan accounts. Therefore, any direct investment in a precious metals ETF could be considered a taxable distribution equal to the cost of the collectible. However, exceptions apply for certain coins and gold and silver bullion.

Finally, favorable Section 1256 treatment is generally not available for precious metals ETFs.

Special Tax Considerations for Euro Currency ETFs Organized as Grantor Trusts. In general, foreign currency gain or loss is computed separately and treated as ordinary income or loss. Therefore, any gain or loss on the sale of a foreign currency based ETF or currency contracts within the ETF will be considered ordinary income or loss for federal income tax purposes.

Ordinary treatment of losses can be favorable since the annual capital loss limitation will be avoided. However, any ordinary gains are subject to a marginal rate as high as 35% (in 2010). Similar to the precious metals ETFs, favorable Section 1256 treatment is generally not available for currency-related ETFs.

Special Tax Considerations for Crude Oil ETFs Organized as Limited Partnerships. Favorable Section 1256 (60/40) treatment should apply for domestic oil futures contracts traded by a crude oil ETF organized as a limited partnership. This treatment will be reported on the investor's Form K-1 for the tax year. Gain or loss on the actual ETF shares will be treated as short-term or long-term capital gain, depending on the length of time the investment was held.

Fixed Income ETFs

Fixed income or bond ETFs operate very much like stock ETFs. They are actively traded, offer diversification, can be shorted, and offer low internal expense ratios. However, unlike stock ETFs, bond ETFs are generally not tax efficient due to the regular income distribution schedule.

The movement of interest rates impacts the value of bond ETFs similar to the way an individual bond is influenced. That is, there is an inverse relationship where rising interest rates cause a bond to decrease in value, and vice versa. Bond ETFs generally distribute income monthly to investors. The monthly distribution changes regularly and in some cases may be reinvested depending on the investor's brokerage arrangement.

SELF-STUDY QUIZ

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

31. How are exchange-traded funds (ETF) similar to mutual funds?

    a. Investors have the ability to buy on margin.

    b. Investors can trade mutual funds and ETFs just like other listed stocks.

    c. Investors can sell mutual funds and ETFs short.

    d. Investors benefit from a simple method of investing in portfolios of stocks that track the performance of specific indexes.

32. If a precious metal ETF considered to be a collectible is held more than one year, at what percentage would the long-term capital gain be taxed?

    a. 14%.

    b. 15%.

    c. 28%.

    d. 35%.

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.)**

31. How are exchange-traded funds (ETF) similar to mutual funds? **(Page 307)**

    a. Investors have the ability to buy on margin. [This answer is incorrect. The ability to buy on margin is one benefit of investing in an ETF. This cannot be done with mutual funds.]

    b. Investors can trade mutual funds and ETFs just like other listed stocks. [This answer is incorrect. ETFs are traded like other listed stocks. Mutual funds cannot be traded like other listed stocks.]

    c. Investors can sell mutual funds and ETFs short. [This answer is incorrect. The ability to sell an ETF short is one benefit that mutual funds do not have.]

    d. Investors benefit from a simple method of investing in portfolios of stocks that track the performance of specific indexes. [This answer is correct. Not only do ETFs give investors the chance to buy or sell an entire portfolio, but like mutual funds, ETFs offer investors an easy method of investing in stock portfolios that closely track the performance and specific indexes dividend yield.]

32. If a precious metal ETF considered to be a collectible is held more than one year, at what percentage would the long-term capital gain be taxed? **(Page 309)**

    a. 14%. [This answer is incorrect. Any qualified small business stock that was issued after August 10, 1993, and held for more than five years is taxed at a maximum rate of 14%, not long-term gains on precious metal ETFS.]

    b. 15%. [This answer is incorrect. For capital assets such as IBM stock, the maximum tax rate would be 15% if the stock is held for more than 12 months. This is not applicable to long-term gains on ETFS.]

    c. 28%. [This answer is correct. Gains for precious metal ETFs held for more than 12 months are taxed at a maximum rate of 28% if considered a collectible per IRC Secs. 1(h)(4) and (5).]

    d. 35%. [This answer is incorrect. The maximum tax rate for short-term capital gains for collectibles such as antiques, metal, and stamps is 35% according to IRS code.]

TAX PLANNING FOR PUBLICLY-TRADED STOCK OPTIONS

A person purchasing an option (the option holder) acquires a right (but not an obligation) to either buy or sell property. The person selling the option, who is called the writer, receives a premium from the holder for writing the option.

A put option gives the holder the right to sell (and requires the writer to buy) the underlying shares for a certain price (the strike or exercise price). Thus, if the holder exercises his option, the writer will end up holding the stock unless he has acquired an offsetting option.

A call option gives the holder the right to purchase the shares at the strike price. Thus, if the price of the stock rises above the strike price, the holder will normally exercise the option, forcing the writer to sell his stock.

Because the option transaction is not considered a closed transaction, the writing of an option generally does not trigger any tax consequences for either the writer or holder until the option expires, is exercised, or is offset by a closing transaction. A closing transaction is any transaction (other than the exercise or expiration of the option) that terminates the writer's obligation.

Buying and Selling Call Options

Call Fundamentals and Taxation. A call is an option to buy a specified number of shares of stock at a specific price within a specified period. Call options are written by security dealers or individual investors. Writers of call options receive a premium or fee for agreeing to risk having to sell to the call holder the underlying security according to the terms of the option. The receipt of the premium has no tax consequences to the writer until the option either lapses (expires), is exercised, or is offset in a closing transaction.

The writer or seller's objective of a call is to generate additional income from the security or realize a gain when (if) the option expires. Call writers can assume the call will be exercised and that they will have to deliver the stock if the exercise price is below the market price as the expiration date approaches.

The reason investors purchase call options is the anticipation of a price increase in the underlying stock. If the stock price increases, the call option's value will also increase and it can either be sold at a profit, or the holder can exercise the call. If the call is exercised (assuming the call price is less than the current stock price), the taxpayer can either sell the underlying stock at a profit, or hold the stock in anticipation of further appreciation. The option approach provides substantial leverage and various degrees of risk to the investor.

The price at which the option holder may elect to exercise the option is called the "strike price." The expiration date is the last day the holder can exercise the option to purchase or sell the stock. The terms of a call are normally expressed by showing company name, expiration month, expiration year, expiration price, and whether it is a call or put. (e.g., MSFT Feb. 2011 25,000 call).

If a call is exercised, the writer sells the stock to the holder at the strike price. The writer recognizes capital gain or loss from the sale of the stock. The gain or loss is short-term or long-term, depending on the holding period of the stock. In computing gain or loss, the amount realized is increased by the amount of premium received for the call option.

If the call option expires, the premium payment the writer received for the option is treated as short-term capital gain at the time the option lapses.

Example 5-11: Consequences of call options to writer.

Tom owns 100 shares of Abco (symbol ABK) common stock for which he paid $50 a share. An ABK Jul. 2010 50,000 call can be written against the stock at a price of $500. In February, Tom deposits the stock with his broker and instructs the broker to write an ABK Jul. 2010 50,000 call on his behalf.

Tom's account will be credited with the $500 premium proceeds. This premium belongs to Tom whether or not the option is ultimately exercised by a buyer. The premium is *not* a down payment toward the purchase of the stock. If the price of the stock does not rise above the option price, the option will not be exercised and Tom will recognize a $500 short-term capital gain. If the stock does rise above the option price and the option is exercised, Tom will receive $50 per share in addition to the option premium previously received.

When the holder of a call exercises the option, he buys the underlying stock. Here, the basis in the stock acquired through the option exercise is increased by the premium paid for the call. The holding period of the acquired stock begins when the call is exercised.

If the holder of the call option allows it to expire, the premium paid for the call is a short-term or long-term capital loss, depending on how long the call was held. Thus, if the option is for more than one year and it appears that it will not be exercised, the holder should consider selling the option before the long-term holding period requirement is met to obtain short-term capital loss treatment.

If the option writer does not own the underlying stock when he writes or sells a call option, the transaction is known as an uncovered or naked option. Substantial risk can exists in writing uncovered options. For example, assume a sharp increase in the market price of the stock leads to the exercise of the call. To satisfy delivery obligations, the writer must acquire the stock in the market at a price substantially above the exercise price. This could result in a large net loss.

The option writer can avoid the consequences of having the option exercised by entering into a closing transaction. In a closing transaction, the writer acquires offsetting positions on the stock. Any gain or loss is treated as 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 5-12: Effect of closing transaction on writer.

Assume the same facts as in Example 5-11, except that Tom does not own any Abco stock. A subsequent change in Abco's management causes Tom to believe that the stock's price will increase. Therefore, he wants to avoid having the option he wrote exercised. He acquires an offsetting position on July 1st by purchasing an ABK Jul. 2010 50,000 call for $800.

Tom recognizes a $300 short-term capital loss from his Abco option writing ($500 premium received less $800 paid in closing transaction). Had Tom not entered into the closing transaction and the stock price subsequently increased to $65 per share, Tom would have lost $1,000 on the transaction ($5,000 received for option exercise plus $500 premium less $6,500 cost of stock purchased to cover the call).

Tax Planning Strategies Using Calls. A call option can either be used with stock held by the investor or traded as a investment in and of itself. Numerous scenarios and situations exist in which calls are used. Strategies that consider the tax ramifications of the call options can either enhance returns or minimize losses.

Tax savings may result from the disposition of a call held for more than one year by creating long-term rather than short-term capital gain.

Example 5-13: Selling rather than exercising a call to generate long-term capital gain.

Karen purchased an 18-month call on 100 shares of Quara, Inc. (QUA Aug 2011 60,000 call) for $600 in February 2009. In May 2010, Karen exercises the call and immediately sells the stock when the stock is selling for $75 per share. She recognizes a $900 [($75 selling price − $60 exercise price) × 100 shares less $600 cost of call] short-term gain on the sale since the stock holding period begins on the day following the date of exercise.

Instead of exercising the call and immediately selling the acquired stock, Karen should have considered selling the call. If she sold the call in May 2010, her gain would still have been approximately $900; however, the gain would be long-term and taxed at more favorable rates since the call was held for more than one year.

Buying and Selling Put Options

Put Fundamentals and Taxation. The buyer of a put option acquires the right to *sell* stock at a fixed price. Both speculation and protection are valid put-buying motives.

An investor may wish to purchase puts as protection against a possible decline in the price of the stock he or she owns. The investor may, for example, have acquired the stock at a price considerably below its current market value and does not want to currently recognize the large taxable gain selling the stock would produce; or the investor may want to continue to own the stock because he believes it has long-term potential. The purchase of a put gives the investor insurance against a drop in the stock's price.

If a put is exercised, the writer acquires the stock for the strike price. His basis in the stock is reduced by the premium received.

When a put is exercised, the holder recognizes gain or loss from the sale of the underlying stock. The amount realized on the stock sale is reduced by the premium paid for the option. The holding period of the stock determines whether the gain or loss is short-term or long-term.

Example 5-14: Effect of put option on holder.

Harry owns 100 shares of Depco common stock with a current market value of $52 a share. Concerned that the price of the stock might decline, Harry buys a put with an exercise price of $50 for $300. The price of the stock falls to $35 a share and the put increases in price to $1,500. Sale of the put results in a short-term gain of $1,200. Alternatively, Harry can exercise the put, selling his 100 shares of Depco for $50 a share. The $1,200 ($5,000 proceeds − $3,500 cost − $300 cost of put) gain will be taxed as either short-term or long-term, depending on how long he held the stock.

On November 1, 2009, the common stock of Funco is selling for $50 a share. Anticipating a decline in the price of the stock, Harry decides to purchase a FUN Jul 2010 50,000 put option at a price of $500 (he currently owns no shares of Funco). Assume that by May 1, 2010, the price of the stock declines to $42 a share. The right to sell the stock at $50 has become more valuable and the put is bid to $900. The put bought at $500 can be sold for $900, resulting in a $400 gain. The $400 gain on a $500 investment illustrates the possible leverage achieved through the purchase of puts.

Tax Planning Strategies Using Puts. Put options enable investors to lock in gains on securities, but maintain a position to benefit from any further increase in the price of the stock. In addition, puts can be acquired in one year with an exercise date in the following year, thereby allowing an investor to defer the gain. The downside, however, is that a put will normally have a strike price that is less than what the stock is trading for at the time it is acquired and the investor incurs the cost of purchasing the put.

Example 5-15: Acquiring a put defers gain and provides upside potential.

Cathy purchased 300 shares of Icon Corp. in 2005 for $20 per share. She considered selling the stock in November 2009 when the stock price was $35 per share. However, her broker recommended she purchase three puts (ICO May 2010 35,000 put) for $600.

In March 2010, the stock is trading at $28 per stock. Cathy exercises her puts to sell the stock at $35 per share. Thus, she recognizes a $3,900 gain ($35 selling price less $20 basis × 300 shares less $600 for the puts) in 2010. Had the stock price risen above $35, Cathy would not have exercised the put options, but instead, sold the shares at the higher price.

For the cost of the put options ($600), Cathy locked in a sales price of at least $35 per share and deferred the recognition of gain until 2010.

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 personal property is a straddle. Actively traded stock is generally included in the definition of personal property when applying the straddle rules if at least one of the offsetting positions is a position with respect to substantially similar or related property. 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 Section 1256 mark to market rules apply.

If the straddle rules apply, losses on positions making up the straddle may be deferred. The loss deferral applies to the extent of unrecognized gain on the offsetting position, determined as of the close of the tax year. For a protective put, 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 a loss is deferred under these rules, the taxpayer must determine the amount of the unrealized gain in the remaining offsetting position as of the end of each subsequent year. (This amount will be zero at the end of the year the stock is sold). Loss can be recognized in any subsequent year to the extent the unrealized gain is less than the deferred loss.

If the straddle rules apply, the offsetting positions' 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 or disposition is long-term. Entering into the straddle does not affect the stock's holding period. However, 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. In addition, the holding period for the stock itself restarts on the day the option expires. Thus, if the option expires before the stock is sold, the loss is short-term. Finally, any interest and carrying charges associated with the straddle must be capitalized.

Example 5-16: Applying the straddle rules to expired put options.

Sarah owns 100 shares of Fort, Inc., that she purchased three years ago for $10 per share and is currently worth $50 per share. Concerned about a possible decline in the stock price, on June 2, 2010 she acquires a FOR Nov 2010 45,000 put option for $500. With the option, she has the ability to sell her shares for $45 per share on November 12, 2010.

The stock does not fall in price but instead rises to $60 per share. Therefore, on November 12, 2010, Sarah lets the put option expire unused and continues to hold the stock. On December 31, 2010, the stock is trading at $65 per share. Since she did not sell the stock and the unrecognized gain at December 31, 2010 exceeds $500, the $500 loss Sarah realized on November 12, 2010 when the put option expired must be deferred. Assume that Sarah sells her Fort, Inc. stock on July 1, 2010. Her unrealized gain with respect to that stock on December 31, 2011 is zero. Thus, she can recognize the $500 deferred loss on the option in 2011.

<u>Variation:</u> Assume instead that Sarah's basis in the 100 shares of Fort is $71 per share. Thus, at December 31, 2010, she has an unrecognized loss of $600 [($65 FMV − $71 basis) × 100 shares]. Here, Sarah would recognize the $500 long-term loss on the expired put option in 2010 (i.e., the loss is not deferred). This is because the stock she owns would not generate a gain (if sold on December 31, 2009) 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 does 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: (a) the option is traded on a national securities exchange or other market approved by the Secretary of the Treasury, (b) the option is granted more than 30 days before its expiration date, (c) 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], (d) the taxpayer is not an options dealer who granted the option in connection with his activity of dealing in options, and (e) gain or loss on the option is capital gain or loss.

In Rev. Rul. 2002-66, the IRS ruled that if a taxpayer owning a stock on which he has written a qualified covered call option also acquires a put option on the same stock, the presence of the put option causes the stock and qualified covered call option to be part of a larger straddle and thus, no longer qualify 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 5-17: Acquiring a put option disqualifies covered call option from straddle exception.

On October 1, 2010, Tom purchases 100 shares of ABC Corp. for $102 per share. On October 2, 2010, when the fair market value 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 1, 2010, 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 $100.

Prior to December 1, 2010, 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 1, 2010, all of the Tom's positions in ABC stock are part of a larger straddle and therefore, the exception for covered call options no longer applies to any of them beginning on that date.

Tax Consequences of Unexercised Options

When an option expires, the writer recognizes short-term capital gain equal to the premium received for writing the option.

Holders who allow the option to expire sustain a capital loss equal to the premium paid. The loss will be long-term if they held the option for more than one year. If the holders held the option for one year or less, the loss will be short-term. (However, in certain situations a put option is treated as part of a straddle so the loss on expiration is deferred.)

A closing transaction is any transaction that ends the writer's obligation. The holder of an option is not affected by a closing transaction entered into by the writer. However, the writer recognizes short-term capital gain or loss from the closing transaction. The amount of gain or loss equals the difference between the amount of premium received from writing the original option and the amount of premium paid for the offsetting option.

Because the writing of an option is not a closed transaction, no gain or loss is recognized until the option expires, is exercised, or is offset by a closing transaction. Thus, if an option is open at year-end, there are no tax consequences for either the writer or the holder.

Managing Risk and Taxes with Cash-settled Collars

Entering into a Zero-cost Collar. A zero-cost collar is the simultaneous purchase of a put and the sale of a call option on the same stock. The price of the call option sold and the put option purchased offset each other, so no cash is used when the collar is put into place. However, the true cost of the collar is the appreciation potential that is given up when the call option is sold.

Collars are often settled in cash. Thus, if the stock price rises above the strike price of the call, the investor does not have to actually deliver stock to the counterparty. Instead, the counterparty is paid cash equal to the excess of the stock's value over the strike price on the day the option is exercised. Likewise, if the stock's value declines below the put option's strike price, the counterparty pays the investor the difference between the stock's value and the strike price.

A cash-settled option benefits the investor because if the call is exercised (i.e., the price goes up), the investor does not have to give up his or her shares. If instead of settling in cash, the investor actually sold the shares when a call option was exercised, the investor would trigger any capital gain in the stock. Of course, the downside is that the investor must have sufficient cash to make the settlement payment.

Example 5-18: Zero-cost collar with cash-settled option.

Susan worked for 10 years for a start-up company that included stock in its compensation plan. In 2009, the company went public in a very successful offering. By the end of 2009, Susan had 80,000 shares of stock worth $32 a share. Her financial advisers urged her to diversify her portfolio, but she was unwilling to pay the capital gains tax that would be triggered if she sold significant amounts of the stock. Susan considered purchasing a put option on her shares, but did not have sufficient cash. Instead, on January 5, 2010, Susan sold a call at $36 a share. She used the proceeds of the call to purchase a put option with a strike price of $29 a share. Both options had an 18-month term. This is a zero-cost collar because the premium received for the call option exactly equaled the amount Susan had to pay for the put option.

The broker who sold the put option also bought the call option (this is the typical arrangement). The collar was settled in cash. The results of this transaction (per share) is as follows depending on the price of the stock when the options are exercised:

If the stock price when the option is exercised is	Susan pays this amount to the broker (per share)	Susan receives this amount from the broker (per share)	Value of Susan's position (per share)	Explanation of cash settlement payments
$25	$0	$4	$25 stock value + $4 = $29	Susan exercises her put option. $29 strike price − $25 stock value = $4.
$30	$0	$0	$30 stock value + $0 = $30	Neither the call nor the put are exercised—price is within the collar.
$34	$0	$0	$34 stock value + $0 = $34	Neither the call nor the put are exercised—price is within the collar.
$38	$2	$0	$38 stock value − $2 = $36	Broker exercises the call option. $38 stock value − $36 strike price = $2.

As this table illustrates, when the stock is worth $29 or more, the broker does not owe Susan anything because of the put option she acquired. At $36 or below, she does not owe the broker anything. Thus, if the stock stays within this range, Susan is unlikely to exercise her put option (because she can sell her stock for more on the open market) and the holder of the call option she sold is unlikely to exercise it (since the stock could be acquired for a cheaper price on the open market).

The receipt of the premium when a call is sold has no tax consequences to the writer until the option lapses (expires), is exercised, or is offset in a closing transaction. Likewise, there are no tax consequences when a put option is acquired. Thus, there is no taxable gain or loss when the collar is established.

If the collar expires unexercised (i.e., the stock price remained between the strike price for the call and the put), the premium received for the call option is treated as short-term capital gain when the option lapses. The premium paid for the put option is treated as a capital loss; however, the loss might be deferred under the straddle rules. Generally, an option's holding period is based on the amount of time it was held. However, if the option is part of a straddle, special holding period rules apply. Thus, for a zero-cost collar, the amount of gain and loss on the expiration of the put and call is the same. However, the expiration of the call will always result in short-term gain, while the expiration of the put can result in either short-term or long-term loss, and might be deferred until the time the underlying stock is sold.

A cash-settled option is treated as any other option to buy or sell property. Thus, the rules for determining gain or loss are the same as if the option had been exercised. Amounts paid or received at settlement represent additional capital gain or loss.

SELF-STUDY QUIZ

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

33. Why do investors purchase call options?

    a. The expectation of price increases in the underlying stock.

    b. To maximize after-tax sales proceeds.

    c. Because they fear a decline in stock value.

    d. For protection against inflation.

34. What can an option writer do to avoid the consequences of having the option exercised?

    a. Obtain a call option.

    b. Enter into a closing transaction.

    c. Purchase a put.

35. Which of the following statements regarding put options is most accurate?

    a. The purchase of put options protects the investor from an increase in the price of the stock.

    b. Investors can buy a put in one year with an exercise date in the following year.

    c. Once a put option is purchased, the holder cannot sell the shares.

    d. A writer can sell stock to the holder at the strike price if a put is exercised.

36. What happens when the straddle rules under IRC Sec. 1092 are applied to put options?

    a. Losses on positions may be deferred.

    b. The writer recognizes short-term capital gain equal to the premium received for writing the option.

    c. The investor does not have to give up his or her shares.

    d. No gain or loss is recognized.

37. What is a zero-cost collar?

    a. When a holder purchases stock at a strike price.

    b. When stock is purchased to close a short sale at a gain.

    c. When substantially identical stock is purchased within the period beginning 30 days before and ending 30 days after the sale.

    d. When a put is purchased and the sale of a call option on the same stock takes place at the same time.

38. What happens if a collar expires unexercised?

    a. The holder sustains a capital loss equal to the premium paid.

    b. The counterparty pays the investor the difference between the stock's value and the strike price.

    c. The premium received for the call option is treated as short-term capital gain when the option lapses.

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.)**

33. Why do investors purchase call options? **(Page 313)**

    a. The expectation of price increases in the underlying stock. [This answer is correct. When stock prices increase, a call option's value also increases and can be either sold at a profit or the holder can exercise the call.]

    b. To maximize after-tax sales proceeds. [This answer is incorrect. Investors often have difficulty weighing the benefits of deferring the appreciated stock sale so the gain is taxed as favorable long-term capital gain rates against the risk of the stock price falling during that period. Investors will often maximize their after-tax sales proceeds by waiting to sell the stock so tax is paid at the lower 15% long-term capital gain rate.]

    c. Because they fear a decline in stock value. [This answer is incorrect. If an investor fears a decline in stock value, computing the breakeven point helps the investor decide if they should continue holding the stock or sell.]

    d. For protection against inflation. [This answer is incorrect. Treasury inflation-protection securities (or TIPS), are 5-year, 10-year, and 20-year marketable treasury securities indexed to inflation. They are sold in $1,000 denominations and provide investors with a guaranteed hedge against inflation.]

34. What can an option writer do to avoid the consequences of having the option exercised? **(Page 314)**

    a. Obtain a call option. [This answer is incorrect. Purchasing a call option is not a tax planning strategy that options writers use to avoid the consequences of having the option exercised since a call is an option to buy a specified number of shares of stock at a specific price within a specified period. Obtaining a call would not keep an option from being exercised.]

    b. Enter into a closing transaction. [This answer is correct. By entering into a closing transaction, an option writer can acquire offsetting positions on the stock as well as avoid the consequences of having the option exercised.]

    c. Purchase a put. [This answer is incorrect. An investor can purchase a put as protection against a possible decline in the price of stock owned but it would not keep an option from being exercised.]

35. Which of the following statements regarding put options is most accurate? **(Page 315)**

    a. The purchase of put options protects the investor from an increase in the price of the stock. [This answer is incorrect. Puts serve as protection against any possible decline in the price of stock, but not an increase.]

    b. Investors can buy a put in one year with an exercise date in the following year. [This answer is correct. This allows an investor to defer the gain. However, a put normally will have a strike price that is less than what the stock is trading for at the time it is acquired and the investor incurs the cost of purchasing the put.]

    c. Once a put option is purchased, the holder cannot sell the shares. [This answer is incorrect. This choice gives the holder the option to sell the underlying shares for a specific price, but does not keep the holder from selling the shares.]

    d. A writer can sell stock to the holder at the strike price if a put is exercised. [This answer is incorrect. This happens only if a call is exercised.]

36. What happens when the straddle rules under IRC Sec. 1092 are applied to put options? **(Page 316)**

  a. Losses on positions may be deferred. [This answer is correct. The losses on positions making up the straddle may be deferred if the straddle rules apply according to IRS code. This loss deferral applies to the extent of unrecognized gain on the offsetting position determined as of the close of the tax year.]

  b. The writer recognizes short-term capital gain equal to the premium received for writing the option. [This answer is incorrect. This occurs when an option expires, not under the straddle rules.]

  c. The investor does not have to give up his or her shares. [This answer is incorrect. Investors benefit from cash-settled options because if a call is exercised, the investor does not have to give up their shares. This does not pertain to the straddle rules.]

  d. No gain or loss is recognized. [This answer is incorrect. When the writing of an option is not a closed transaction, no gain or loss is recognized until the option expires, is exercised, or is offset by a closing transaction.]

37. What is a zero-cost collar? **(Page 317)**

  a. When a holder purchases stock at a strike price. [This answer is incorrect. This is referred to as a call option, not a zero-cost collar.]

  b. When stock is purchased to close a short sale at a gain. [This answer is incorrect. Rev. Rul. 2002-44 clarifying that the constructive sales rules "trump" the general rule of Reg. 1.1233-1(a)(1) when stock is purchased to close a short sale at a gain. Thus, for gains, but not losses, the sale is considered closed (i.e., gain is recognized) on the date the asset to close the sale is purchased rather than the date it is delivered to the lender.]

  c. When substantially identical stock is purchased within the period beginning 30 days before and ending 30 days after the sale. [This answer is incorrect. This is considered a wash sale.]

  d. When a put is purchased and the sale of a call option on the same stock takes place at the same time. [This answer is correct. A zero-cost collar occurs when the sale of a call option and the purchase of a put on the same stock occur at the same time. The price of the call option sold and the put option purchased offset each other, so not cash is used when the collar is put into place.]

38. What happens if a collar expires unexercised? **(Page 318)**

  a. The holder sustains a capital loss equal to the premium paid. [This answer is incorrect. Holders who allow an option to expire sustain a capital loss equal to the premium paid.]

  b. The counterparty pays the investor the difference between the stock's value and the strike price. [This answer is incorrect. This occurs when the stock's value declines below the put option's strike price.]

  c. The premium received for the call option is treated as short-term capital gain when the option lapses. [This answer is correct. If the collar expires unexercised (i.e., the stock price remained between the strike price for the call and the put), the premium received for the call option is treated as short-term capital gain when the option lapses according to IRC Sec. 1234(b)(1). The premium paid for the put option is treated as a capital loss; however, the loss might be deferred under the straddle rules.]

TAX PLANNING FOR STOCK RIGHTS AND WARRANTS

A stock right or warrant is a right to acquire a corporation's stock at a set price within a specified period of time. Stock rights normally have short exercise periods while stock warrants may have periods that extend several years. A stock right is generally issued to existing shareholders and can be either exercised or traded on the open market. The exercise price of stock rights is typically set at an amount less than the stock's current trading value as an inducement for shareholders to exercise the rights and acquire more shares. A stock warrant is generally available to the public on the open market, where it can be exercised or traded. These rights or warrants can be exercised by purchasing the stock, or the rights or warrants can be sold or allowed to expire. The sale of stock rights or warrants will generate a capital gain or loss.

When stock rights or warrants are included as part of an investor's portfolio, the practitioner should help the taxpayer determine whether a return will be maximized by selling the rights or warrants or by exercising them and subsequently selling the stock.

Planning for Nontaxable Stock Rights

A taxpayer is generally not taxed on the receipt of stock rights. This rule has certain exceptions, including situations where the taxpayer is given the option to receive cash or other property in lieu of the stock rights. If, on the date the stock rights are distributed, their FMV is 15% or more of the stock's FMV on the distribution date, the adjusted basis of the taxpayer's old stock must be allocated to the stock and the stock rights. The allocation is made using a ratio of the FMV of each to their total FMV on the date of distribution.

If the FMV of the stock rights is less than 15% of the FMV of the stock, the basis of the rights is zero. However, a taxpayer can elect to allocate the basis of the stock between the stock and the rights relative to their FMV on the date the rights were distributed. The election is made by attaching statement to the taxpayer's return for the tax year the rights are received.

Nontaxable stock rights take on the same holding period as the underlying stock. That is, the holding period of the related stock tacks on to the stock right. However, if the rights are exercised and additional stock is acquired, the holding period of such shares begins on the date the rights are exercised and the new shares are acquired.

The election to allocate stock basis to the rights should be considered when the taxpayer plans to (a) sell only the rights, (b) exercise the rights and sell the acquired stock within one year, or (c) exercise the rights and sell both the old and new shares within one year if the old shares will generate long-term capital gain because this would maximize the long-term gain and reduce the short-term gain.

Example 5-19: Electing to allocate basis to stock rights reduces taxes.

Thomas Henderson purchased 200 shares of ABC Energy Corp. in 2010 for $50 a share. Later in 2010, he received 200 stock rights in a nontaxable transaction, enabling him to purchase an additional 200 shares. At the time he received the stock rights, the stock was trading for $75 a share and the rights were valued at $10 each (less than 15% of $75). Thomas plans to sell the stock rights in 2010, but hold the stock for the long-term.

Thomas can elect to allocate stock basis to the stock rights. Making the election would benefit Thomas because it reduces the short-term gain he will realize on the rights when they are sold in 2010, and assuming the stock is sold in the future at a gain, increase the future long-term gain. (The sale of the stock rights in 2010 would be a short-term transaction since they have the same holding period as the stock, which was acquired in 2010.)

Under the election, Thomas allocates $1,176 of his stock basis to the stock rights based on the following computation:

Basis in ABC Energy Corp. stock (200 shares × $50/share)	$ 10,000
At the date of the stock rights distribution:	
FMV of stock (200 shares × $75/share)	$ 15,000
FMV of stock rights (200 rights × $10/right)	2,000
Total	$ 17,000

Allocation of basis to stock rights: $10,000 × ($2,000 ÷ $17,000) = $1,176

Thus, by making the election, Thomas reduces his current year short-term gain from the sale of the stock rights by $1,176.

Planning for Taxable Stock Rights

The basis of taxable stock rights received by a taxpayer is their FMV at the time of distribution. The basis of the old stock does not change. The holding period begins on the date of distribution.

If the taxpayer exercises the stock rights, the basis of the new stock is its cost plus the basis of the stock rights exercised. The holding period for the new stock begins on the date the rights are exercised.

Planning for Stock Warrants

Taxpayers may purchase stock warrants outright on the market. On the purchase date, the price of the warrant should be low in relation to the price of the common stock. Also, the common stock should have growth potential and be paying small dividends, if any, since dividends generally limit significant price appreciation.

The basis of a stock warrant is its original cost. Upon exercise, the basis of the new stock is its cost plus the basis of the warrant. The holding period for the new stock begins on the date the warrants are exercised.

TAX STRATEGIES FOR INVESTMENT EXPENSES

Maximizing the Investment Interest Deduction

Investment interest is interest paid or accrued on indebtedness incurred to purchase or carry property held for investment. Investment interest does not include qualified residence interest or interest incurred in a passive activity. However, if a passive activity generates portfolio income (interest, dividends, etc.), the portion of the passive activity interest expense allocable to the portfolio income is investment interest rather than passive activity interest.

Property held for investment includes any property producing interest, dividends, annuities, royalties, and gain-generating property other than that used in a trade or business activity or passive activity. Investment property also includes an interest involving the conduct of a trade or business that is not considered a passive activity but in which the taxpayer does not materially participate (generally, oil and gas working interests in which the taxpayer does not materially participate) [IRC Sec. 163(d)(5)]. Income from these properties increase investment income while deductions (including net losses from oil and gas working interests treated as investment property) related to these reduce investment income.

Investment interest expense does not include interest expense that is capitalized (e.g., under IRC Sec. 263A) or interest expense related to tax-exempt income that is not deductible under IRC Sec. 265(a)(2). This rule also applies to mutual funds so that if a fund invests in both taxable and tax-exempt securities, the interest expense must be allocated proportionately based on the income from the fund. Prepaying interest on a margin account is generally not deductible in the year paid (unlike other itemized deductions, such as state income or real estate taxes); instead, it is carried forward and deducted in the year when it properly accrues.

Interest expense incurred by a trader who materially participates in the trading activity is not subject to the investment interest expense limitations. Whether a taxpayer is a trader or investor generally depends on the amount of trading activity and other factors.

Investment interest is deductible as an itemized deduction but limited to net investment income. Net investment income is defined as the excess of investment income over investment expenses. Investment income includes (a) gross income from property held for investment (e.g., interest), (b) the excess of any net gain over any net capital gain resulting from the disposition of investment property, and (c) as much of the taxpayer's qualified dividend income and net capital gain from the disposition of investment property as he or she elects to include (see the following discussion of the election). Investment expenses are the deductions allowed (other than interest) that are directly related to the production of investment income. An expense subject to the 2% AGI limitation on miscellaneous itemized deductions is considered only to the extent a deduction is allowed.

For item (b) in the above paragraph, only dispositions of property held for investment are considered (i.e., Section 1231 gains treated as long-term capital gains are not considered), and net gain refers to the net gain from all investment assets whether short-term or long-term. Capital loss carryovers must be considered when computing net gain. Net capital gain refers to the excess of net long-term capital gain over net short-term capital loss. The intent is to exclude net capital gains (i.e., gains taxed at favorable capital gains rates of 15% or 28%) from investment income unless the taxpayer elects to include all or part of these.

Electing to Include Qualified Dividend Income and Net Capital Gains in Investment Income. The definition of net investment income excludes qualified dividend income and net capital gains (i.e., the excess of net long-term capital gains over net short-term capital losses) unless the taxpayer elects to include all or part of these in investment income. The election for gains is available only for net capital gains resulting from the disposition of property held for investment (Section 1231 gains treated as long-term capital gains are not available for the election). If the election is made, the amount of qualified dividend income and net capital gain included in net investment income is no longer eligible for the 15% maximum rate. In effect, this causes the elected amount to be treated as ordinary income and potentially taxed at rates as high as 35% for 2010. The election is made on the return for the tax year the election is effective.

The election to include net capital gain is limited to the lesser of (a) net capital gains from property held for investment or (b) net gains from property held for investment. For example, an investor with a net capital gain of $5,000 and a Section 1244 ordinary loss of $3,000 has a net gain of $2,000. Thus, the amount eligible for the election is limited to $2,000.

Obviously, an election should not be made if a taxpayer has sufficient other current year net investment income to allow a deduction of all investment interest expense. Because disallowed investment interest expense carries over indefinitely, deciding whether to make the election may require an analysis that includes a number of future tax years. Key factors in making the decision are (a) current and future (anticipated) marginal tax rates, (b) expected net investment income (excluding net capital gains and qualified dividends) and investment interest expense for future tax years, and (c) the taxpayer's discount rate or factor for computing his time value of money. With this information, a reasonable present value analysis can be done to determine whether the election is beneficial. Of course, the amount of disallowed investment interest expense would determine whether an extensive analysis is necessary and cost-effective.

Example 5-20: Electing to include net capital gains in investment income.

Jeff is in the 33% tax bracket for 2010. His income includes $2,000 of interest income and $6,500 of net long-term capital gain from sale of stock. He also has $5,000 of investment interest expense from broker margin accounts. He expects his 2011 income and deductions to be similar to 2010. Without an election, Jeff can deduct $2,000 of his 2010 investment interest expense and carry forward the remaining $3,000 indefinitely.

The decision on whether to make the election may depend on the applicable capital gain rate. If the election causes gain subject to the 28% rate (e.g., collectibles gain) to be treated as ordinary income, no significant tax benefit is received by carrying the deduction over to 2011. (The best he could do is receive a 33% tax benefit, assuming the interest was deductible, rather than the 28% tax benefit he could receive by electing to include a portion of the long-term gain in investment income in 2010.) Thus, it is probably better for Jeff to make the election in 2010 and treat $3,000 of the net capital gain as investment income. The $150 [$3,000 × (33% − 28%)] of additional tax paid on the net capital gain is offset by a $990 ($3,000 × 33%) tax savings from the additional interest expense deduction. Thus, the actual 2010 tax benefit realized from the additional deduction is 28%, or $840.

However, if the election affects a $3,000 gain subject to the 15% capital gain rate, the cost of making the election increases. If the election is made, Jeff must pay additional tax of $540 [$3,000 × (33% − 15%)] on the capital gain. Thus, making the election to claim the deduction in 2010 results in net tax savings of only $450, a 15% tax benefit [($3,000 × 33%) − $540]. By not making the election and carrying the deduction forward, Jeff may be able to increase his tax savings from the deduction to $990, a 33% tax benefit. Thus, forgoing the election may be the preferred strategy in this case.

Similarly, if Jeff expected his 2011 investment income to increase so that the investment interest carryover would be deductible in 2011, and he expected his 2011 taxable income to increase significantly so that he would be in a higher tax bracket, a decision to forgo the election and defer the deduction to 2011 is probably the better choice.

Example 5-21: Present value analysis aids in election decision.

In 2010, Lee paid $30,000 in investment interest expense, has interest income totaling $10,000, and net capital gains of $20,000, all subject to a 15% capital gains rate. He is in a 40% combined federal and state marginal tax bracket. In 2011, he will pay off his investment debt so he will have little or no investment interest expense in 2011 and he expects his interest income that year to total $20,000. He expects to be in a 35% combined tax bracket in 2011. He uses an 6% discount rate in analyzing his investments.

Here, a present value analysis makes sense because of the amount of investment interest involved and the taxpayer's changing tax rates for the years involved. The analysis helps quantify the effects of making the election to include net capital gains in net investment income in 2010. The following summarizes Lee's tax situation for the investment income and investment interest expense based on his projections for 2011.

	No Election		Election Made	
	2010	2011	2010	2011
Marginal tax rate	40.0 %	35 %	40.0 %	35 %
Tax on $20,000 net capital gain[a]	$ 3,000	$ —	$ 8,000	$ —
Tax on investment income	4,000	7,000	4,000	7,000
Tax savings from investment interest expense[b]	(4,000)	(7,000)	(12,000)	—
Net tax	$ 3,000	$ -0-	$ -0-	$ 7,000

If no election is made, Lee will pay $3,000 tax on his interest and capital gain in 2010. If the election is made, the tax is shifted to 2011, but amounts to $7,000. If the $7,000 tax for 2010 is discounted back to 2010 using an 6% discount factor, the result is $6,604.[c] Thus, Lee saves $3,604 ($6,604 − $3,000) by *not* making the election. The result might be somewhat different if Lee were not able to realize a tax benefit from the disallowed interest expense until tax years after 2011 or his 2011 tax rate bracket was less than 35%.

Notes:

[a] If the election is not made, the net capital gain is taxed at 15%; with the election, the applicable rate is 40.0%.

[b] If no election is made, $10,000 of investment interest is deducted in 2010 and $20,000 is carried over and deducted in 2011.

[c] Present value computed using the formula:

$$PV = \frac{FV}{(1 + I)^{n}}$$

where FV = future value; i = discount rate: and n = number of full periods (years);

$$\frac{\$\,7{,}000}{(1+.08)} = \frac{\$\,7{,}000}{1.08} = \$6,481$$

Minimizing the Allocation of Expense to Tax-exempt Income

Investors receiving tax-exempt interest income cannot deduct interest expense and other Section 212 expenses (i.e., investment expenses) directly related to such income. In addition to directly related expenses, investors often incur expenses that relate to both taxable and tax-exempt income. For example, investors may incur general office expenses or custodial account expenses (e.g., bank custodial fees for accounts that include both taxable and tax-exempt securities) that cannot be traced to either the taxable or tax-exempt securities. For these indirect expenses, investors must make a reasonable allocation in light of all the facts and circumstances to divide them between the taxable and tax-exempt income. One acceptable method for making this allocation is to divide the expenses in the same proportion as exempt (or taxable) income is to total income.

Example 5-22: Allocation of expenses based on ratio of tax-exempt to total income.

During the year, Albert received $6,000 in interest, of which $4,800 was tax-exempt and $1,200 was taxable. He paid $500 to an investment adviser in connection with the interest, but he cannot specifically identify the amount of the investment adviser's time attributable to each category. An acceptable allocation of the expense is 80% to tax-exempt income ($4,800 ÷ $6,000) and 20% to taxable income ($1,200 ÷ $6,000). Albert can deduct $100 (20% of $500) of the expense under IRC Sec. 212. The remaining $400 is allocated to tax-exempt income and cannot be deducted.

Because expenses allocable to tax-exempt income are not deductible, the allocation of indirect expenses to such income should be minimized to the extent possible. Therefore, practitioners should consider other reasonable methods than the income ratio method for allocating expenses to provide a greater allocation to taxable income. For example, in the author's opinion, allocations based on the number of transactions occurring during the tax year or the amount of time spent on each class of income may be reasonable in some situations. These methods may provide larger allocations to taxable income, particularly when the tax-exempt income is generated from municipal bonds that the taxpayer buys and holds and the only maintenance involved is depositing periodic interest checks.

Example 5-23: Alternative method of allocating expenses minimizes amount to tax-exempt income.

For her investment activities, Marge has hired a secretary and a part-time bookkeeper. Her investment portfolio includes rental real estate, oil and gas working and royalty interests, stocks, and tax-exempt municipal bonds. Her stocks and tax-exempt municipal bonds are held in a brokerage account and require little time to manage. About 50% of her investment income is generated from the tax-exempt bonds. However, Marge estimates that only 10% of her staff's time is spent on the tax-exempt bonds while 90% is spent dealing with tenants and negotiating oil and gas leases. Because only 10% of the staff costs are connected with the tax-exempt income, it may be reasonable to allocate 10% of these costs to the tax-exempt income and 90% to the taxable income. This yields Marge a greater tax deduction than if the allocation was made based on income.

Taxpayers who receive tax-exempt income must submit with their returns an itemized statement showing the amount of each class of exempt income and the expenses allocated to each class. If an item is allocated between tax-exempt and taxable income, the statement must show the basis of the allocation. This report must clearly state that none of the deductions claimed in the return is in any way attributable to tax-exempt income. The records used to create the allocation must also be retained by the taxpayer.

SELF-STUDY QUIZ

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

39. What is a stock right?

    a. An obligation that unconditionally entitles the holder to receive a specified principal amount.

    b. An agreement that gives the taxpayer the right to be reimbursed for all or substantially all of any decline in the value of the property.

    c. The power to acquire a corporation's stock at a set price within a specified period of time.

40. Which of the following statements regarding stock rights and warrants is most accurate?

    a. Taxpayers usually are taxed on the receipt of stock rights.

    b. Stock rights that are nontaxable have the same holding period as the underlying stock.

    c. The basis of a right is zero if the FMV of the stock rights is less than 20% of the stock's FMV.

    d. The basis of a stock warrant is the market price of the underlying 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.)**

39. What is a stock right? **(Page 323)**

    a. An obligation that unconditionally entitles the holder to receive a specified principal amount. [This answer is incorrect. A straight debt is an obligation that unconditionally allows the holder to receive a specific principal amount, has interest payments that are payable based on a fixed or variable rate, and cannot be converted into stock of the issuer or any related person.]

    b. An agreement that gives the taxpayer the right to be reimbursed for all or substantially all of any decline in the value of the property. [This answer is incorrect. An agreement that requires a taxpayer to pay all or substantially all of the investment yield (including appreciation) related to the property for a specified period, as well as the right to be reimbursed for all or substantially all of any decline in the value of the property is called an offsetting notional principal contract.]

    c. The power to acquire a corporation's stock at a set price within a specified period of time. [This answer is correct. Stock rights generally are issued to existing shareholders and can be exercised on the open market or traded. Stock rights allow shareholder to acquire a corporation's stock at a set price within a specified time period.]

40. Which of the following statements regarding stock rights and warrants is most accurate? **(Page 323)**

    a. Taxpayers usually are taxed on the receipt of stock rights. [This answer is incorrect. Although there are exceptions to this rule, taxpayers generally are not taxed on the receipt of stock rights according to IRS code.]

    b. Stock rights that are nontaxable have the same holding period as the underlying stock. [This answer is correct. The related stock's holding period tacks on to the stock, therefore, nontaxable stock rights take on the same holding period as the underlying stock.]

    c. The basis of a right is zero if the FMV of the stock rights is less than 20% of the stock's FMV. [This answer is incorrect. The stock rights must be less than 15% of the stock's FMV for the basis of the right to be zero as stated in IRS regulations.]

    d. The basis of a stock warrant is the market price of the underlying stock. [This answer is incorrect. The basis of a stock warrant is its original cost.]

EXAMINATION FOR CPE CREDIT

Lesson 5 (TINTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

31. Which of the following is **not** one of three methods used for determining the basis of mutual fund shares when a taxpayer sells less than their entire holdings in a particular fund?

    a. Ratable accrual.

    b. Average basis.

    c. First-in, first-out (FIFO).

    d. Specific identification.

32. Which of the following types of funds generally tends to be more tax efficient?

    a. Index.

    b. Equity.

    c. Exchange-traded.

    d. Money-market.

33. Opie sells 500 shares of Mayberry Computer Corporation (MCC), a manufacturer of computers and peripheral equipment, at a loss of $5,000. Three weeks later (less than 30 days), he reads a large brokerage firm's report indicating that computer sales are expected to increase substantially during the next year. That same day, Opie purchases 500 shares of MCC to take advantage of any potential price appreciation. Because Opie subsequently purchased stock substantially identical to the stock he originally sold less than 30 days before, the $5,000 capital loss from the original stock sale must be deferred because of which of the following rules?

    a. Original discount rules.

    b. Wash sale rules.

    c. Market discount rules.

    d. Constant interest rate rules.

34. Which of the following generally qualifies for favorable Section 1256 treatment?

    a. Currency-related ETFs.

    b. Treasury notes.

    c. Domestic oil futures contracts.

    d. Precious metals ETFs.

35. The tax treatment of commodity-based ETFs is the same as that of traditional ETFs.

    a. True.

b. False.

c. Do not select this answer choice.

d. Do not select this answer choice.

36. What is the seller's objective of a call?

a. To minimize taxable distributions to shareholders.

b. To provide financial assistance to their children.

c. To reduce the tax liability of either party to the loan.

d. To realize a gain if the option expires.

37. When a put is exercised, what determines whether gain or loss is short-term or long-term?

a. The stock's holding period.

b. The distribution date.

c. The disposition date.

d. The IRS.

38. The receipt of a premium when a call is sold has no tax consequences to the writer until all of the following occurs **except**:

a. The option lapses.

b. The option is exercised.

c. The option is offset in a closing transaction.

d. The option causes the stock loss to be disallowed under the wash sale rules.

39. Which of the following is the basis of the new stock when a taxpayer exercises a stock warrant?

a. Cost plus any increase in the principal resulting from the inflation adjustment.

b. Cost plus the basis of the stock rights exercised.

c. Cost plus the basis of the warrant.

d. Cost plus the OID included in income to date.

40. When stock rights are exercised, when does the holding period for new stock begin?

a. The date the warrants are exercised.

b. The date the stock rights are distributed.

c. The date the rights are exercised and the new shares are acquired.

d. The date of disposition.

GLOSSARY

Appreciated Financial Position: An appreciated financial position is any "position" relating to a stock, a debt instrument, or a partnership interest where there would be gain if the position were sold, assigned, or otherwise terminated at its fair market value. The term "position" means an interest, including a futures or forward contract, short sale, or option. Specifically excluded from the definition of appreciated financial position are positions with respect to straight debt and any related hedges and any position that is marked to market under any Code section or regulation.

Bond Swap: A bond swap enables a taxpayer to currently benefit from the decline in a bond's value and either increase or keep the same cash flow generated by the bond.

Call Option: A call gives its holder the right to buy stock under the same conditions.

Closing Transaction: Any transaction that ends the writer's obligation.

Collar Transaction: In a collar transaction, an investor holding an appreciated stock acquires a put with a strike price less than the stock's current trading price and sells a call with a strike price above the current price. Thus, he has both upside and downside protection to movements in the stock's price because of the options collaring the stock.

Coupon Bond Method: The coupon bond method applies when (a) a de minimis difference exists between the debt instrument's issue price and its principal amount at issuance, and (b) all stated interest is payable in cash at least annually. This method will apply to TIPS that are not stripped into principal and interest components.

Discount Bond Method: The discount bond method is used if the bond does not qualify for the coupon bond method (e.g., the bond is issued at a discount). The discount method essentially requires the taxpayer to accrue original issue discount (OID) using the constant yield method under Reg. 1.1272-1(b)(1).

Double Category Method: When the double category method is used, all shares of a particular fund are first divided (based on holding period) into two categories at the time of each sale: short-term (i.e., shares held one year or less) and long-term (i.e., shares held more than one year).

Exchange-traded Funds (ETFs): Exchange-traded funds (ETFs) offer investors a simple method of investing in portfolios of stocks that closely track the performance and dividend yield of specific indexes. ETFs give investors the opportunity to buy or sell an entire portfolio of stocks in a single security, as easily as buying or selling a share of stock.

Forward Contract: A forward contract is a contract to deliver a substantially fixed amount of property for a substantially fixed price.

Market Discount: The excess of the bond's stated redemption price at maturity over the taxpayer's basis in such bond immediately after acquisition in the secondary market (i.e., not at original issue).

Original Issue Discount Bonds (OID): When a debt security such as a bond is *issued* at a price less than the stated redemption price (i.e., at a discount), the difference is referred to as OID.

Offsetting Notional Principal Contract: An offsetting notional principal contract is an agreement that includes the following:

A requirement to pay all or substantially the entire investment yield (including appreciation) related to the property for a specified period.

A right to be reimbursed for all or substantially all of any decline in the value of the property.

Put Option: A transferable option to offer or deliver a given number of shares of stock at a stated price below current market within a stated time period not usually exceeding more than three months.

Qualified Dividends: Qualified dividends are distributions of cash or property made by a domestic or qualified foreign corporation out of its earnings and profits (E&P) to a shareholder with respect to its stock.

Stock Redemption: A stock redemption occurs when a corporation acquires its stock from a shareholder in exchange for property (including cash), whether the stock acquired by the corporation is canceled, retired, or held as treasury stock.

Straight Debt: A straight debt is an obligation that unconditionally entitles the holder to receive a specified principal amount, has interest payments that are payable based on a fixed or variable rate, and cannot be converted (directly or indirectly) into stock of the issuer or any related person.

Taxable Bonds: Bonds purchased at a price above face value are purchased at a premium.

Treasury Bills (T-bills): Money market securities that represent short-term government financing with maturities of one, three, and six months.

Treasury Bonds: Like treasury notes except they have longer maturities. These are taxed to holders in the same manner as treasury notes.

Treasury Inflation—protection Securities (TIPS): These are bonds that both pay interest semiannually and pay investors for inflation adjustments to the bond's principal.

Treasury Notes: Medium-term instruments (terms ranging from two to 10 years) that pay interest semi-annually. Interest is taxable when received (or constructively received) and these notes may be purchased at a discount or premium, depending on market conditions when acquired.

Treasury STRIPs: These are treasury notes and bonds that have been stripped of their interest coupons. (STRIPS is an acronym for Separate Trading of Registered Interest and Principal of Securities.) Thus, they are sold at a discount and the holder receives the principal when the debt matures. Treasury STRIPs are zero coupon instruments because holders do not receive periodic interest payments. Investors recognize income on these bonds under the OID rules.

U.S. Savings Bonds: Series E savings bonds were issued at a discount until they were discontinued and replaced by Series EE savings bonds on July 1, 1980. Paper form Series EE savings bonds are issued at a discount ($^1/_2$ of face value) and electronic form Series EE savings bonds are issued at face value.

Stock right or Warrant: A stock right or warrant is a right to acquire a corporation's stock at a set price within a specified period of time.

Wash Sale Rule: A taxpayer cannot deduct the loss realized on the sale of stock or securities (including shares in a mutual fund) if the taxpayer purchases substantially identical stock or securities within the period beginning 30 days before and ending 30 days after the sale.

Zero-cost Collar: The simultaneous purchase of a put and the sale of a call option on the same stock.

INDEX

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Tax Planning for High Income Individuals—Course 1—Retirement Plans and Roth IRAs (TINTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Tax Planning for High Income Individuals—Course 1—Retirement Plans and Roth IRAs (TINTG101)

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Companion to Tax Planning for High Income Individuals—Course 2—Tax Planning for Sole Proprietors and Other Business Owners (TINTG102)

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

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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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Your Name (optional): ______________________ Date: ______________

Email: ______________________

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?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to Tax Planning for High Income Individuals—Course 3—Stocks, Bonds, and Other Financial Investments (TINTG103)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** 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 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 mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. 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.

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

   Thomson Reuters
   Tax & Accounting—R&G
   TINTG103 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are 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. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 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 $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **April 30, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **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

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The 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 each lesson, 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.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Tax Planning for High Income Individuals—Course 3—Stocks, Bonds, and Other Financial Investments (TINTG103)

CTEC Course No. 3039-CE-0247
Price $79

First Name: ______________________________

Last Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________ State /ZIP: ______________

Firm Phone: ______________________________

Firm Fax No.: ______________________________

Firm Email: ______________________________

Express Grading Requested: ☐ Add $24.95

CTEC No.: ______________________________

Signature: ______________________________

Credit Card Number: ______________________ Expiration Date: ______________

Birth Month: ______________________ Licensing State: ______________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ○ ○ .

	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.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: April 30, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Tax Planning for High Income Individuals—Course 3—Stocks, Bonds, and Other Financial Investments

Course Acronym: TINTG103

Your Name (optional): ____________________ Date: ____________

Email: ____________________

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:	○	○	○	○	○	○	○	○	○	○
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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?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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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** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________